

26th February 2007

Wholesale Markets Team
Office of Gas and Electricity Markets
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Dear Clare, Vanja and Hannah

**Gas Quality – Conclusions of Scenario Development and
Economic Regulation Workstreams: ref 17/07, 30th January 2007**

UKOOA welcomes Ofgem's report of the work about gas quality, conducted under its supervision and examining different supply scenarios and possible means of economic regulation. UKOOA was pleased to have been able to contribute to all of this and would like to thank Ofgem for its considerable efforts in taking a lead in this important subject.

We fully realise the difficulty of encapsulating within a written report all aspects of a complex subject such as this and the debates which took place. However, the abiding impression which was left in the minds of UKOOA's participants was the inherent uncertainties in trying to establish what might happen with the quality of supplies of gas in the future.

We highlight below some particular points in the report on which we have comments and then we offer a suggestion for a way forward.

1. The lack of information from buyers and sellers of gas is very likely to reflect both the uncertainties about the exact source and quality of future gas supplies and an understandable hesitation about revealing potentially sensitive information in front of a range of other market participants. Many will remember the debates about the provision annually of TBE data to National Grid and guarding these from release into the public domain.
2. Ofgem's desire to protect customers from bearing the cost of stranded assets is understandable, but this should be balanced more clearly against the costs which customers will face in the event of high and volatile prices owing to any difficulties with gas supplies (events during the winter of 2005-6 were an illustration of this).
3. Markets tend to respond to quite short term price signals. It is totally different investing in the long term to cover a major change in overall supply (e.g. the Ormen Lange field and pipeline bringing new gas to Great Britain) and investing to cater for an intermittent eventuality of uncertain scale.

4. LNG terminals face few such uncertainties. Almost every source of LNG has a Wobbe index above the specification allowed under GS(M)R. A terminal's capacity is fixed, so the investment decision is straight forward and, in an overall LNG scheme, a nitrogen ballasting plant at a reception terminal is a modest part of the total investment.
5. From both our clear recollection and the notes which several of us made at the time, it was Ofgem who insisted on cost targeting and, therefore, the setting aside of the regulated approach. However, the inherent uncertainties in trying to predict the nature of future gas supplies caused the regulated approach to keep coming back into the debate as this progressed.
6. The hybrid approach was indeed the one taken forward, if only because that was the only option remaining. However, it was far from clear that participants thought that it would work in practice, especially given Ofgem's stipulation that National Grid would need 100% user commitments or take the risk itself. It could be argued that, in many respects, this is little different from today's circumstances.
7. Disappointingly, no mention is made about the availability of about 50 bcm of low calorific UKCS reserves in the southern North Sea and the opportunity which they provide to help ballast higher calorific imports.

UKOOA does agree that this matter merits further work and this should be considered in the light of moves regarding inter-operability within the EU. It should be noted, though, in paragraph 1.12 that the proposal by EASEE-gas is a recommendation to facilitate cross border trading of gas, not to have a common EU gas specification. Having stated that, at the most recent meeting of the Madrid Forum, the Commission confirmed that CEN should review gas quality specifications with an intention of reaching a pan-European standard not only for cross-border trading, but in networks and for appliances.

Suggested Way Forward

To build upon the work done to date, UKOOA would like to suggest the following as a way forward:

- a) Investment by National Grid in a blending/ballasting facility should be approved for inclusion in its RAB and should proceed on the back of a minimum of [50%] user commitment for an agreed minimum number of quarters booked (as in the LTSEC auctions).
- b) The balance of the capacity would be sold by regular, pay-as-bid auctions, right up to the day, enabling shippers to pay as they flow while accepting the risks which this might entail.
- c) There would have to be a minimum auction price, such as $1/365^{\text{th}}$ of the annual fixed cost plus a variable cost, to ensure that there is no disincentive to booking long term where shippers are able to do this. The reserve price would also ensure that those who book capacity in the short term make an appropriate contribution which would at least be a fair share of the costs of the plant, both fixed and variable. However, while those who booked long term would have certainty of

price, those who bought shorter term could face a higher price depending on the demand for gas treatment at the time of the auction.


- d) In this way, the risks and benefits would be shared among market participants - in under-recovery years, uncovered costs would be borne by end users who gain from the security of supply insurance provided, while over-recovery years would compensate for under-recovered years. The under- or over-recovery of costs could be recovered / reimbursed by a specific transport charge.
- e) If, as time passes, more and more years led to over-recovery, the cycle could start again for new capacity, whether at the same or a different terminal.

Such a system should minimise both the creation of stranded assets and costs to consumers, while affording protection from price spikes arising from a lack of access to GB for off-specification gas. It is a hybrid approach which allows the market to value gas treatment capacity, while making it more likely that some capacity will be built within a reasonable timeframe.

Furthermore, it could help provide a clearer framework within which it would become possible to develop those UKCS gas reserves which are currently stranded because of their low calorific value.

Our thinking is very much at an early stage and we have not had time to debate these issues fully among ourselves; for example, the minimum auction price referred to in (c) above would need careful consideration in order to provide an appropriate incentive. Nonetheless, we would like to table them for consideration and discussion within a follow-on work group.

Yours sincerely



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