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Office of Gas and Electricity Markets
9 Millbank
London
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For the attention of Philip Davies – GB Markets

Dear Philip

Re: Consultation on Statoil UK Ltd's application for an exemption from Section 19B of the Gas Act 1986

Thank you for the opportunity to comment on the application by Statoil UK Ltd (STUK) for third party exemption for its share of the Aldbrough gas storage facility.

British Gas Trading Limited (BGT) supports any increase in the availability of gas storage in the GB market. With domestic gas production falling and an increasing reliance on imported gas, we believe new sources of flexibility, including new storage facilities, will play a key role in the UK gas market. It is not clear whether the construction of new storage facilities will match the demand for their services going forward and decisions to exempt from third party access (TPA) should not be taken without a thorough examination of all the issues at hand.

DO YOU CONSIDER OUR MARKET DEFINITION IS APPROPRIATE?

We agree with Ofgem that market definition is the first step of any competition analysis. We are also pleased that Ofgem agree with the Competition Commission's 2003 Rough inquiry (the CC Report) conclusion that flexibility is the relevant market in which gas storage competes. The CC Report further concludes that all sources of flexibility are linked through their interaction with forward prices and that, while admitting that sources of flexibility differ in terms of quantities, lead times and value, "we have not been able to identify a robust basis for excluding any sources of flexibility from the market definition" (CC report paragraph 5.43).

However, Ofgem then appear to have eliminated sources of flexibility as substitutes for Medium Range Storage (MRS), reportedly based on analysis of UK gas flows over a very short time frame (November 2006 to March 2007) during an unusually mild winter. We believe that this analysis is incomplete, for a number of reasons (also discussed in more detail in the attached note by CRA International).

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First, Ofgem appear only to have carried out an analysis and calculation of market shares based on historic gas flows. This approach not only excludes sources that are not yet in operation (even though Aldborough itself is not due 100% on stream for several years), but more generally will not capture the future capacity of existing sources to contribute flexibility. In practice, this could well be very different in the next decade from the situation last winter.

Second, looking specifically at the details of that historic analysis, while we understand Ofgem's desire to update a relevant market definition to include recent infrastructure developments like Langedale and BBL, the use of historic data over such a short sample time frame is insufficient to support a robust market definition. Furthermore, according to MET Office figures, the sample period was the second warmest winter since records began. We feel this further supports the view that such a narrow sample is seriously misleading.

- For instance, flows from the Isle of Grain have been excluded as a source of flexibility because it has, "been running base load this winter, demonstrating no flexible response to price so far". Our analysis of metered flows suggests otherwise. Applying Ofgem's "flexible range" formula to a flow sample covering the whole winter 2006 period (October 2006 to March 2007) we observe that Grain exported nothing on 12% of days and had a "flexible range" of 98% (defined as the percentage by which the average flows on the highest 10 days exceed the lowest 10 flow days). Even if we widen the sample to include the lowest 20 days to make the averages more meaningful, this still only reduces the "flexible range" to 80%. On the basis of Ofgem's market substitutes chart, this would make Grain a close substitute to Rough. Therefore, we suggest that the Isle of Grain should be included in the market definition. By the same token, other LNG supplies should be included prospectively, since the market definition should be appropriate to the period in which Aldborough becomes operational. We note that Ofgem has in the past accepted the prospect of LNG import facilities providing additional flexibility to the UK market.¹
- The definition of flexible beach gas in the consultation paper only comprises Sean and Barrow flows. We consider this definition too narrow. For instance, applying Ofgem's "flexible range" formula to a sample period of winter 2006, we can see that the Teesside Amoco and Bacton Shell sub-terminals have ranges of 58% and 65% respectively. This means they would appear as more flexible than the "beach flex" data point on Ofgem's substitutes chart. We also observed that the "flexible range" for the St Fergus Shell Sub-terminal is 36%. However, the "beach" data point on Ofgem's substitutes chart is between 15% and 20%. This would suggest that all non Sean and Barrow beach flows are less flexible than a sub-terminal predominantly flowing flatter profiled associated gas. This seems counterintuitive to us. We believe that the true ability of the UK Continental Shelf to vary its flows has been missed due to the short sample time frame. We would suggest that widening the sample period to include both summer and winter flows would better capture the true flexibility of UK gas production.
- The consultation paper also omits demand-side response (self-interruption of gas fired power stations and commercially interruptible supply contracts) from its market definition but does not explain why. Admittedly, the paper points out that this sector is extremely responsive to high prices and that their exclusion probably means that the number of substitutes is under-estimated. We would argue that demand-side response is a close substitute for MRS and that it should be included in the market definition. We would note that the Competition Commission accepted the role of demand interruption as a source of flexibility in its inquiry into Centrica's acquisition of Dynegy Storage, and that more recently Ofgem has itself estimated that self-interruption by power generators can be a significant source of flexibility. For example, Ofgem has recently referred to demand interruption contributing around 40 mcm/day of flexibility in the 2005/6 winter.²

¹ See for example "Our Energy Challenge: Ofgem's response", April 2006, paragraph 3.17 (available at <http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/13924-8206.pdf>).

² See for example "Our Energy Challenge: Ofgem's response", April 2006, paragraph 3.18, which states: "Unlike in many other European countries, gas-fired power stations account for a significant proportion (approximately 30%) of annual UK gas demand. As has been seen this winter, many of these stations are able to switch to distillate fuels and to reduce their gas demand. These distillate stocks are another source of storage for the UK gas market. Our coal-fired generation fleet also provides a further source of gas storage

- Finally, there is a presumption that gas imports (specifically Langeled and BBL) will flow base load and are therefore excluded from the analysis. However, our examination of Langeled flows (and to a lesser extent BBL) demonstrates a high degree of flexibility and we believe this further demonstrates that drawing conclusions from such a small sample size can be seriously misleading. IUK flows demonstrate how unreliable historic flows can be in forecasting future behaviour. After an initial ramp up phase, flows through the interconnector have evolved year on year in terms of the frequency and timing of flow transitions and physical capabilities. In the longer term we would expect that these import flows could be a very significant source of flexibility: creating an effective link to European gas storage as supplies are switched between UK and continental European supply in response to price signals.

By way of final comment on the Ofgem market share analysis, we note that the Statoil/Hydro merger will have been completed well before Aldbrough becomes operational. It would therefore be appropriate to combine the two company's access to flexibility for the purposes of assessing the STUK application.

IN PARTICULAR DO YOU CONSIDER THE FLEXIBLE GAS MARKET REMAINS THE APPROPRIATE MARKET DEFINITION FOR CONSIDERING THE EFFECT ON COMPETITION OF THE DEVELOPMENT OF A NEW MEDIUM RANGE STORAGE FACILITY?

BGT agrees that the flexible gas market is the appropriate market definition for considering the effect on competition of the development of new storage facilities. Shippers have varying needs for flexible gas and these needs will change at different times of the year. As such, they need a range of flexible sources of gas to cover the differing risks in their portfolio. Gas storage is just one potential source of flexibility that is likely to sit beside beach swing, demand side response and long-term supply contracts, all of which can in principle be accessed through direct contracts or indirectly through the traded market for physical gas.

We believe that all sources of flexibility are linked through the traded forward curve and that the perceived or actual availability of one source of flexibility will affect the value and demand for the others. This adds further support for a wider definition of the market for flexibility as argued above.

WHAT IS YOUR EXPERIENCE OF THE FUNCTIONING OF THIRD PARTY ACCESS (TPA) REGULATION IN THE GB MARKET?

In terms of TPA in the storage market, only Rough and Hornsea are subject to TPA legislation. Therefore, we compare our experiences of access to the two facilities. As Ofgem will be aware, the commercial activities associated with the Rough field are governed by undertakings given by Centrica to the Secretary of State for Trade and Industry in 2003. In accordance with these undertakings, Centrica Storage Limited (CSL) must make all capacity available to the market on a non-discriminatory basis, publish up-to-date prices for their services on both a fixed and index price basis and offer any unsold capacity before the storage year in a zero reserve priced auction. Finally, the proportion of Rough (both Standard Bundled Units and Additional Space) that Centrica can reserve for its own companies is set out in detail and transparent to all.

As Ofgem will also be aware, Scottish and Southern Energy Ltd (SSE) do not find themselves under similar obligations. Our experience of TPA in relation to the Hornsea facility echoes the conclusions of ERGEG's December 2006 report on the implementation of the Guidelines for Good Practice for Storage Operators (GGPSSO)³. ERGEG's results suggest that SSE have designed their own primary sales process (ostensibly without any input from the regulator) and have changed it without consulting the market. Furthermore, the report noted that capacity availability at Hornsea is not released to the market as it is deemed confidential.

as they can be run instead of gas-fired power stations. This winter gas-fired power stations have provided over 40mcm/day of additional gas supplies by switching to coal or distillate. This provides storage deliverability equivalent to the Rough storage facility."

³ ERGEG Final 2006 Report on Monitoring the Implementation of the Guidelines for Good TPA Practice for Storage Operators (GGPSSO). Ref: E06-GFG-20-03, 6th December 2006.

Finally, the amount of Hornsea capacity reserved for SSE Trading and Supply is not known and they are not required to release that information to the market.

In summary, our experience of the two sites is very different. CSL operate the Rough facility under a regulatory regime that ensures all capacity is available to the market on non-discriminatory and transparent terms and they are also the only European storage operator deemed to be fully compliant with the GGPSSO.

⁴ On the other hand, SSE have yet to fully comply with the GGPSSO in key areas such as capacity availability and information transparency.

SHOULD OWNERSHIP OF TPA FACILITIES BE INCLUDED IN THE MARKET SHARE USED IN THIS ASSESSMENT?

We note that Ofgem prefers not to include existing facilities subject to TPA in market share analyses for the purposes of exemption applications. We consider that this approach depends on ensuring the effective functioning of the TPA regime in practice which, as outlined below, is only likely to be the case under certain specific conditions.

We believe that the decision to exclude facilities subject to TPA from market share figures depends on whether the operation of that facility meets industry benchmarks for non-discriminatory access, information transparency and competition.

If the operation of the facility in question were open to TPA but not run in such a way that offered access to capacity and operational information to all market participants on equal terms, then the owner of that facility might be in a position to distort or constrain the effective functioning of the flexibility market. In the storage market, full compliance with the industry agreed GGPSSO would address these concerns. At present these guidelines are only voluntary and BGT supports moves to make them binding.

If it could be demonstrated that the storage facility in question was fully compliant with the GGPSSO, we would agree to ownership of that facility being excluded from market share calculations. However, if the site was not compliant, for example failing to provide operational or meaningful stock level information, we would be less comfortable in excluding ownership of that facility from any market share analyses.

DO YOU AGREE WITH OUR OVERALL ASSESSMENT THAT THE PROPOSED EXEMPTION SHOULD BE GRANTED?

We note that Ofgem is minded to grant an exemption on the basis described in the paper, but, we do have some concerns and suggestions for consideration before the exemption is granted. We welcome the recognition that an effective Use-It-Or-Lose-It (UIOLI) regime is required, as highlighted in SSE's Aldbrough exemption application.⁵ However, as details of the scheme are not supplied we cannot comment on its specifics or how it will relate to the operation of the Aldbrough facility.

We believe that a robust UIOLI regime should be made a condition of the exemption, as is the case for exempted LNG regasification terminals such as the Isle of Grain. This UIOLI regime should provide non-discriminatory access to interruptible withdrawal and injection capacity for all market participants and not just the shareholders in the facility. We believe that some third party access to storage space is necessary to underpin a successful storage UIOLI regime, because (a) interruptible injection and withdrawal capacity is worthless unless the market can obtain space into which it can inject and withdraw and (b) interruptible space in itself of little value, in view of the "enforced evacuation" risk.

Also, a UIOLI regime can only function effectively if market participants are able to identify opportunities to use that capacity. We believe the best way to facilitate this is the release of capacity utilisation information

⁴ ERGEG Final 2006 Report on Monitoring the Implementation of the Guidelines for Good TPA Practice for Storage Operators (GGPSSO). Ref: E06-ST)-06-03, 9th July 2006.

⁵ SSE Hornsea Exemption Application, 27th October 2006. (available at http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/TPAccess/Documents1/Aldbrough_TPA_Exemption_Application_27_Oct_2006.pdf).

such as daily aggregate site nominations and weekly stock levels. This is the level of information transparency already required by the GGPSSO. The logical conclusion is that for an Aldbrough UIOLI regime to operate effectively, the operators should be subject to GGPSSO transparency requirements.

There is also a more general argument for adherence to the GGPSSO, above and beyond the need for effective UIOLI. In our view, its provisions should therefore be incorporated into the conditions of any exemption order.

BGT has long been in favour of revisiting exemptions periodically or in light of changing market conditions, in so far as this is compatible with maintaining incentives to invest. Markets evolve over time and the case for an exemption can change in the intervening years. Given the raft of potential storage projects in the pipeline over the next 5-10 years, the competitive environment for storage services is likely to change.

Should you wish to discuss any of our comments please do not hesitate to contact me.

Yours sincerely,

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Commercial Manager

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