2 March 2007

Gas Quality Consultation
GB Markets,
Office of Gas and Electricity Markets
9 Millbank
London
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Dear Sir

BG Gas Services Response to "The economic regulation of gas processing services – key issues and initial thoughts".

Thank you for the opportunity to comment on the above report. BG Gas Services Limited ("BG") holds a shipper licence under the Gas Act. BG Gas Services is part of BG Group and sells gas on behalf of affiliate companies in the UK wholesale market. BG Group also has capacity rights in the Bacton – Zeebrugge Interconnector, and equity and capacity rights in the Dragon LNG terminal currently under construction.

As we have stated before, BG appreciates the efforts that Ofgem has made in leading the debate on what is a difficult issue. In essence we believe that, at its heart, this is a policy issue for Ofgem to decide. The choice is between relying on the market to provide sufficient gas processing facilities, with the attendant risk of price spikes if such investment is not forthcoming, and a regulated approach with the risk of any stranded costs charged to end consumers. The former approach provides the certainty that there will not be stranded regulated assets; the latter provides a higher level of assurance that consumers will not face potentially high price spikes. Only by weighing up these costs and benefits, and taking a view as to their respective probabilities, will Ofgem be able to decide which approach is better. BG recognises that this is not an easy choice to make, requiring as it does making trade-offs between Ofgem's duties to protect consumers and the need to have regard to security of supply. BG does not believe that either approach is more "correct" than the other, simply that they have different implications.

It is important to recognise that in the past UK upstream companies needed to invest in gas processing facilities where they had no alternative market to the UK. However, as import dependence rises and sources of gas proliferate, gas that might come to the UK, via pipeline or LNG, could also flow to alternative markets, both within and outside Europe.

Question 3.1: *To what degree can commercial incentives alone be relied upon to deliver efficient investment in gas processing services? If not, what is a reasonable balance of risk between customers and users?*

It is clear that companies will invest in gas processing facilities where they have no alternative market for their gas than the UK. For example an LNG terminal in the UK which was not able to send gas into the NTS because of lack of processing capability would not be much use.

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Similarly, North sea producers have invested in gas processing facilities both on platforms and on the beach to enable UKCS gas to enter the NTS. In both cases the decision on how much to invest in processing facilities will be driven by the minimum throughput required to make the project economic.

However the issue becomes less clear cut when the gas which requires treatment has alternative destinations. Because the UK GS(M)R specification is much "tighter" than continental European specifications, companies will take a view as to how much gas they wish to be able to deliver to the UK, the price they are likely to receive after allowing for the cost of gas processing and the cost of delivering to the alternative market. Different companies will have different trade-offs on this curve. Where the UK price is high enough to more than compensate for the cost of processing companies will invest, ceteris paribus. However this may only occur after there have been price spikes in the wholesale market when there have been occurrences of either perceived or actual scarcity of gas entering the UK because of quality issues. The question of the balance of risk between customers and users therefore depends on the cost to consumers of such price spikes. If consumers are happy to bear such price spikes they should be content on relying solely on companies to invest in gas processing. If they are not, and the expected costs of potential stranded assets are less than that of the expected costs of potential stranded assets, consumers should favour a regulated type approach.

Question 3.2: *Would provision of gas processing services by NGG be the most cost effective approach? If so, please explain why?*

Such an approach would allow scrutiny by Ofgem to minimise costs whilst providing a greater degree of certainty about investment in gas processing facilities. If NGG had certainty that it would recover costs, it would benefit from a lower cost of capital than if private companies made the investment. In addition NGG may be in a better position to blend gas from various sources, thus minimising the need for gas processing. Such an approach would also enable charges to be levied on those who benefited from the greater certainty of a regulated approach, namely consumers.

Question 3.3: *If NGG involvement is essential to the efficient provision of gas processing services, to what degree do existing arrangements ensure that NGG develops such services, if they are demanded? What other arrangements, if any, would be more appropriate?*

The current arrangements are only effective if companies perceive a need to invest in gas processing facilities. They do not provide certainty to end users that, on a peak day, there will not be quality constraints preventing gas from entering the UK.

Question 3.4: *Given that existing market participants have already invested in gas import facilities including treatment of gas, how is the approach you favour consistent with preserving incentives for private investment in gas import and treatment facilities.*

This will depend on how users of gas processing facilities are charged. An approach which allows users to book capacity in regulated NGG facilities at below the average cost would impact incentives for private investment.

Question 3.5: *How much of the overall uncertainty attached to investment in onshore gas processing facilities is attributable to upstream issues, rather than future supply sources and demand? To what extent do potential difficulties in resolving such issues favour a processing solution (if required) upstream of the NTS?*

The uncertainty is attributable to several issues:

- The likelihood of gas quality constraints preventing gas entering the UK.
- The costs of gas processing facilities
- The attractiveness of alternative markets
- Various contractual arrangements and development of European transportation rules[1].

Question 4.1: *How different do you consider the regulatory approach developed in the Economic Regulation workstream to be from a purely commercial approach? How important is it that NGG should be obliged to respond to market interest in gas processing services, as under the Economic Regulation workstream approach?*

As we stated in our response to the previous consultation ("Gas Quality Scenario Development and Economic Regulation Workstreams – Conclusions" 2nd March 2007) BG does not believe that the Hybrid approach differs materially from a commercial approach because of its reliance on user commitment.

Question 4.2: *Under a model based on user commitment, to what extent would enabling NGG to make additional investment in the service (subject to a different regulatory regime) introduce costs? What are these costs and would they outweigh the benefits?*

The costs would be the risk of stranded assets and how NGG would be compensated for these (either by a higher allowed cost of capital or by charging these to consumers), or the risk that NGG would not feel able to make the investment at all if the risk of un-recovered costs were too high.

Should you have any queries please do not hesitate to contact me on 0118 929 3442 or at alex.barnes@bg-group.com.

Yours sincerely,

Alex Barnes
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- [1] For example recent developments at the Zeebrugge Platform may enable gas from more sources to enter IUK at Zeebrugge.