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Dear Bruce,

Reference: The economic regulation of gas processing services – key issues and initial thoughts

Thank you for the opportunity to respond to the above consultation, this response is on behalf of the Centrica group of companies, excluding Centrica Storage Ltd.

This letter response takes the form of some general observations, followed by our views on the specific questions raised in the document.

Overall, Centrica continues to be extremely concerned that the proposed approach to the resolution of gas quality import issues is not going to deliver a robust solution in a timely way. This in turn risks a significant cost burden being placed on GB consumers in the future, as a result of potentially very high gas prices occurring due to an inability to accept sufficient gas for import.

We are also concerned that the consultation document itself portrays a limited view of the concerns expressed by Users in the workstreams referenced. In particular, we believe that the view expressed of the economic workstream is a reflection of the strong guidance issued to the group by Ofgem on the appropriate outcomes at the outset of the discussion.

The consultation document also highlights a critical misunderstanding in 1.5l. The two pipelines linking mainland GB to continental Europe – I-UK and BBL - currently operate to, and transport only, UK specification gas. The upstream transporters for UK-bound gas flows will normally ensure that gas not acceptable in the UK is not tendered for transportation in Zeebrugge and Balgzand respectively. However, if it were, the operators of I-UK and the BBL pipeline would be obliged to reject it, thereby preventing any flows to the UK. The risk, therefore, is not that the UK will receive out of specification gas, but that the market will be left

short as a result of significant quantities of gas being prevented from entering the NTS. This situation would clearly place significant upward pressure on wholesale prices to the detriment of UK consumers.

Instead, the question to be addressed is how much gas would be turned away, and what effect this will have on UK consumers. An important consideration here is the likely development of new high Wobbe gas imports into North West continental Europe, e.g. additional LNG regasification capacity in the Benelux area and possibly a new Troll area pipeline from circa 2012.

Questions raised by the document:

Allocation of risk

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

In trying better to understand the economics of this situation, and in particular Ofgem's perspective about protecting consumers from unnecessary transportation related costs, we have assumed some crude figures in order to facilitate a calculation. For a single, large-scale nitrogen ballasting plant at Bacton, we have assumed a capital cost of £200m, plus a £20m per year operating cost. We have also assumed a GB market size of 35bn therms p/a. If the annualised cost were (say) £40m, then this would be just over 0.1p/therm if spread across the whole UK market.

If a gas quality related constraint pushed up wholesale prices in the UK by just 5p/therm – a conservative estimate – we estimate that a nitrogen ballasting plant in the Bacton area would only have to operate for just 3 months (in 20 plus years) to more than repay the cost of the whole facility. Of course, this applies whether the facility is funded directly or indirectly by consumers, or as a commercial plant. However, whilst in our view commercial incentives alone might deliver a solution eventually, we consider that the risks of the solution not being delivered in a timely manner, or of the solution being sub optimal or more costly, are high.

Our reasons for holding this view are twofold. First, potential investors face significant risk from uncertainty around the regulatory and contractual regime. We also believe that investors will be reluctant to commit up front until the scale of the consequences of not investing becomes clearer. Clarity around such consequences might only be achieved, for example, following a GB gas deficit caused by an inability to import non-UK specification gas for subsequent treatment. More fundamentally still, it is likely that a number of the interested parties (in BBL and/or I-UK) would not be averse to an increase in wholesale gas prices – or at least would not sanction a material investment commitment to prevent it.

In seeking to address the issues raised by the document, there is a need to identify clearly, up front, where the legislative/regulatory boundary lies in the provision of essential services to support security of supply for GB consumers.

As noted in 3.6, if commercial incentives alone will not lead to efficient investment, it may be appropriate for consumers to share some service risks. Whether the market (eventually) provides a solution or whether a regulatory solution is used, the GB customer will eventually bear the cost. Hence we support the most efficient and economic solution, which in our view may well be, at least partially, a regulated solution. GB customers will bear the cost of either the solution or failure, and hence it is appropriate that they share (indirectly) the risk and costs

associated with providing a solution. However, the cots of gas quality adjustment could fall on the relevant shippers in the first instance (see 3.2 below).

In addition to the above points, a major inhibitor for large investment projects is the uncertainty over the rules to be applied to GB Gas Quality (GS(M)R) from 2020. DBERR (formerly DTI) has asserted that the gas quality specifications will not change before 2020. However, given lead times for this type of plant would reasonably be expected to be between 3-5 years depending on planning issues etc, this would mean even plants commissioned now would be unlikely to be functioning before 2010-2012. Hence, for a major investment, there is only a predictable time horizon for payback of between 8 and 10 years. The uncertainty created by the combination of this factor and the potential CEN mandate (with its range of possibilities) further reduces the likelihood of commercial parties being willing to invest in treatment facilities in this way.

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

Provision of services by NGG will almost certainly be the most cost effective approach. Only NGG has the ability to take a view on the required sizing of such a facility, having already assessed other, complementary resources open to them in their role as SO, for example, blending of flows at entry. Hence, Centrica believes the obligation to provide the facilities should be placed on NG. Given that other parties have taken steps to provide their own ballasting facilities (e.g. new LNG import terminals), we believe it is appropriate for NGG to recover its costs through a separate, non-discretionary charge levied on those who bring in non-UK specification gas through I-UK and/or BBL.

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 so demanded? What other arrangements, if any, would be more appropriate?

In our view, whilst the current regulatory regime could support the provision of a merchant plant, it would not support a hybrid or regulated solution. In addition, in our opinion without changes occurring first to the contractual regime (for example, on import pipelines to permit the transportation of non-UK specification gas), we believe that it is inconceivable that any potential investor would commit to the development of a merchant plant.

Following on from this point, without the assurance of some degree of cost recovery, for example, on the costs of the feasibility study, it is unlikely that either NGG or an individual party will agree to fund, especially given the apparently high levels of cost quoted (£6m). This point is all the more apparent given the limited benefits that will accrue to any payee of this fee, unless their intention is to develop a plant solely for their own use, or to charge other users on a commercial basis.

Competition Issues

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?

Providing that appropriate contractual arrangements and sampling/testing are in place, together with proper cost targeting measures, we can see no reason why the two approaches should not comfortably co-exist.

For example, if NGG assesses and builds a facility, it will target the costs of using that facility on the users who need its services to ensure within specification gas enters the NTS. It may be appropriate to consider this approach in the context of a separate NGG subsidiary being responsible for this operation.

Where private investors have invested in similar facilities, to the extent that they do not require such blending or ballasting services, then they will avoid these additional costs. Equally, this should not deter private investors in other new facilities, the key is in the appropriate targeting of costs wherever feasible. Another option would be for NGG (or an NGG subsidiary as suggested above) to acquire these "similar" facilities, and then to charge the relevant users for the services.

Upstream Issues

3.5 How much of the overall uncertainty attached to investment in onshore gas processing facilities is attributable to gas processing 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?

This issue relates back to the point previously made, with GS(M)R, the boundary has to be upstream of the NTS (even if immediately before the entry point) as off spec gas may not enter the NTS. Thus, the uncertainty is whether or not gas will be offered, rather than whether or not it will be delivered. Nitrogen ballasting in Bacton (upstream of the NTS) will clearly be a much lower cost solution than the adjustment of final customers' appliances.

3.6 Can commercial parties be expected to resolve the upstream barriers to the provision of onshore processing services, to exploit commercial opportunities? If not, what limits might there be to the barriers commercial negotiations might resolve and what is an appropriate role for Ofgem?

The main barrier is that for an individual commercial party simply flowing gas as opposed to developing a major new terminal, the scale of the requirement is prohibitive and pushes the solution towards the continent, which brings its own set of problems and uncertainties.

In respect of developing a solution in continental Europe as opposed to within GB, which we believe to be the only real alternative available, significant new challenges must be overcome. We consider that the scope of this alternative solution is for Fluxys (or I-UK) and GTS (or BBL) to separately invest in Nitrogen ballasting at Zeebrugge and Balgzand respectively. In these circumstances, however, we would realistically expect the total cost of two separate, smaller facilities to be much more than the cost of a single, GB located solution. This would not suggest an efficient or economic outcome, yet it seems certain that GB consumers would be expected to foot the bill through cost pass through by shippers.

More fundamentally, the whole rationale for investing in a Nitrogen ballasting solution would be in order to reduce the risk that flow into GB will be restricted by a future quality constraint, with corresponding wholesale price increases. Given that this is a risk to GB consumers, it would seem likely that GB market players, consumers and regulators would be more focused upon delivering a workable solution than continental European counterparts.

In respect of a GB solution, as stated above, if this is wholly left to commercial parties to resolve, a likely outcome is that such parties will assess and size a solution to meet only their own needs. This will be an inefficient solution, as for one commercial party to develop a facility on this basis, they would have to size it to meet perhaps 105-110% of their need to allow for a

bit of flexing in flows. If this solution is adopted by 4-5 parties, then in total, capacity is oversized and inefficient investment results. Given that none of the parties will invest unless they perceive that they can pass these costs on, GB consumers are likely to foot the bill.

Conversely, if NGG were to undertake this work, their first step is likely to be an assessment of blending possibilities and other options for addressing the quality issues at that location. They would then design and build to address the remaining quality issue, which is almost certain to be less than 100% requirement. Overall this would lead to a far more efficient outcome and lower longer term costs for consumers, assuming NGG is properly incentivised in terms of the economy and efficiency of the investment made. We believe that Ofgem could have a role in overseeing, to ensure NG efficient investment.

Investment by NGG not backed by user commitment

4.1 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?

As previously noted, in our view, the approach being referred to as the "Economic Workstream approach" does not fully reflect the preferred direction of the workstream, given the strong, up front guidance provided by Ofgem. Instead, it reflects a sub optimal solution which does not capture fully the benefits available under either a fully regulated or a true "hybrid" approach, neither does it capture the normal commercial benefits available to a private investor. Clearly, as stated in the question it is not a pure commercial approach, but in the degree of commitment up front sought from potential users of the facility, it has many of the characteristics of one. In only triggering investment if full user commitment is secured by NGG, the approach leads to NGG being fully protected and receiving generous regulated returns on the asset. On the other hand, those "investing" and taking the risk, namely the users, receive no return at all in a normal commercial sense.

We are not opposed to NGG responding to market interest in gas processing services, indeed we wish to see a clear obligation placed on them to do so. However, in requiring 100% user commitment in this way, we believe Ofgem is inefficiently constraining the development of a potentially much needed asset. This also conflicts with other areas of NGG investment, where lower thresholds are applied.

In addition to these points, the representation of the Economic Workstream Approach fails to properly address the issue raised frequently and forcefully during the discussions, namely the issues around the contractual environment in the Interconnectors. It is unreasonable to expect the achievement of such a high hurdle as 100% commitment without certainty on whether the facility will be used. Equally, it is unreasonable to expect the 100% agreement needed to change the contractual environment in these pipes in the absence of certainty that a facility will be available to treat the resulting gas flows.

The only way to address this circular issue is via a regulatory device i.e. to create the obligation on NGG to address the problem, allowing for a combination of cost targeting and socialisation of limited aspects of costs, to address the regulated element of investment which will need to be added to the RAB. In addition, NGG should then be allowed to make additional returns for an agreed period on the provision of incremental treatment capacity when it is sold (we suggest allowing a reduced, i.e. below regulated, return on unsold capacity for this period), after which period, the facility will revert to the "normal" regulated return and the asset be allowed into the RAB and depreciated in the usual way. It will be necessary to ensure

consistency of the regulatory regime across price control periods to support such an approach.

Noting the comments in chapter 4 in respect of protecting customers from the cost of inefficient investment, we believe that this fails to recognise a greater exposure to GB consumers. This exposure results from either the failure to invest at all or, more likely under a user commitment model, the failure to invest adequately to address the risk of import shortages and consequent high prices.

In addition, we strongly disagree with the contention in 4.5, that the absence of discussion by the economic workstream on whether user commitment was required to cover ex ante or ex post assessments of cost, should lead to an assumption that an ex post interpretation was implied. In our view, user commitment on this basis equates to the relevant users effectively taking on unlimited risk and writing a blank cheque.

Way Forward:

5.1 Do you have any comments on the proposed way forward?

In our view the key issue on these proposals is timing, which is further complicated by the European dimension.

If the EASEE Gas specification is implemented, then GB would face problems as early as 2010 as pipeline operators struggled to meet their obligations. As highlighted above, with a lead time of 3-5 years to build plant, even an immediate commissioning would leave a gap of 1-2 years. However, if the CEN mandate were to move towards a GB view of the problem, then clearly such investment would be wasted. As present, it is difficult to assess the likelihood of such an outcome for the CEN mandate.

In addition, the further uncertainty of the GB situation post 2020, depending on DBERR's later decision on whether GS(M)R might move to either EASEE Gas or CEN, means that post 2020 such investment may or may not become stranded.

All of this means that irrespective of any other influences, it is likely that commercial investment might not occur due to the perceived risks. This means that in the case of reduced import offerings, consumers would bear inflated gas costs until clarity is achieved and any required facility built. Such increased gas costs would be in addition to the actual costs of building the facility which would be passed via one or another route.

We trust these comments have been helpful, and we would be happy to discuss any points in more detail with you.

Yours sincerely,

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