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Wednesday, 22nd August 2007

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

Dear Bruce,

Thank you for the opportunity to respond to the initial thoughts consultation on the economic regulation of gas processing services. To aid security of gas supply to the GB market in the future, E.ON UK welcomes Ofgem's investigation into the regulation of onshore gas processing services. We offer the following comments in relation to the questions posed in this consultation.

Question 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?

As can be seen with investments such as LNG terminals (Isle of Grain, Teesside, and Milford Haven), Easington for Ormen Lange and Burton Point, commercial incentives are, under certain circumstances, sufficient to deliver efficient investment in gas processing services. However the complexities associated with developing new gas processing facilities at e.g. Bacton suggest that such incentives alone may not deliver the required level of investment. We highlight a number of concerns including;

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- Uncertainty surrounding the requirement of the service and regulatory environment.
- Difficulties associated with developing such facilities at existing locations.
- Contractual complexities and expenses associated with rewriting contracts.

Uncertainty surrounding the need for onshore processing services continues to be a barrier to commercial investment. Without evidence that facilities are required in the UK to guarantee future supplies, we would agree with comments made in this consultation, that commitment to invest may not occur to the required degree or timeframe. The potential change in GB gas quality specifications after 2020 and the CEN mandate add further regulatory uncertainty that limits the commercial incentive to invest.

Difficulties with developing processing facilities at exciting locations may also limit a purely commercial investment. An initial feasibility study conducted by ABB into a Blending facility at Bacton concluded that although possible, the nature of the facility provided a "non-ideal" arrangement. This suggests that the costs associated with developing sites not originally intended for ballasting / blending facilities may be higher than the potential investment rewards.

Currently all parties using e.g. Interconnector UK (IUK) are required by contract to transport only UK specification gas. Reaching a unilateral agreement between IUK users to change contractual terms and conditions may be difficult and costly.

Overall, in light of the above challenges, the benefits of developing a processing facility at an existing location are likely to be insufficient relative to the costs. It is for this reason that purely commercial incentives are unlikely to be effective in delivering the required level of investment.

When considering what a reasonable balance of risk should be between customers and users, it could be argued that by delaying the decision to change the UK gas specification (and not paying the costs associated with this), we have accepted new costs associated with constructing gas treatment facilities. Irrespective of how facilities are paid for initially, it is likely that customers will pay the extra costs – although it is our belief that these are likely to be relatively small when aggregated across the whole GB market.

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

We agree with comments in this consultation that, owing to NGG's ownership and operation of certain sites, NGG are likely to be best placed to enjoy cost advantages over other parties. Market information available to NGG may also suggest that they are best placed to provide optimal gas processing services. Given the challenges associated with purely commercial investments, facilitating NGG to provide gas processing services and recover costs accordingly seems a sensible way forward.

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 arrangement, if any, would be more appropriate?

As raised at the Gas Quality Workshop (18th June, 2007), the current arrangements surrounding processing services are not clear. Future arrangements require development e.g. how the service is to be funded and how any NGG investment is to be recovered.

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?

Ensuring that any approach adopted does not unduly restrict, distort or prevent competition in the gas supply market requires careful consideration. As already mentioned, a number of private gas treatment investments have already been undertaken. However such investment decisions have been made under different circumstances i.e. they have been built with greater foresight of market requirements. LNG terminals for example, are required to accommodate diverse supply sources and thus it is sensible that processing facilities are incorporated into initial building plans. If a retrofit investment at e.g. Bacton is believed to be appropriate to secure future GB gas supplies, and a purely commercial approach will not suffice, it may be argued that such a facility warrants special arrangements.

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?

We agree that upstream issues are a concern and problems associated with unilateral agreements have already been highlighted. Additionally, it may not possible for Fluxys to determine which shipper delivers out of spec gas at Zeebrugge, making it difficult to target costs.

However, future supply sources and demand for processing facilities remain unknown and will continue to restrict commercial investment. It is difficult to envisage how upstream issues can be overcome without greater certainty surrounding the feasibility of onshore processing facilities.

Question 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?

We agree with Ofgem's view in this consultation that if the commercial opportunities available to industry are significant enough to justify investment in a new processing facility, commercial parties are likely to be able to resolve the upstream barriers. The extent to which the commercial opportunities are significant and the length of time that such negotiations may take remain something of a concern.

We further agree with the consultation that Ofgem would be best placed to assist in resolving barriers encountered with other regulators.

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 would be obliged to respond to market interest in gas processing services, as under the Economic Regulation workstream approach?

Consistent with the answer to question 3.2, we believe that NGG may be best placed to provide gas processing services – a feature that distinguishes the regulatory approach from a purely commercial approach. We agree that it would be important for NGG to respond to market interest.

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?

Enabling NGG to make additional investment seems sensible given the unique access NGG have to market information. The financial costs associated with additional investment are likely to be small relative to the level of user-committed investment. We agree with the consultation that such an approach is likely to increase complexity in designing the regulatory regime and may reduce user incentives. We would hope however that the benefits associated with allowing NGG to utilise all information available would outweigh the related costs.

If you have any questions or queries regarding this response, please do not hesitate to contact me.

Yours sincerely

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