

'Gas quality consultation'
GB Markets
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Your Ref: Ofgem doc 176/07

Dear Sir/Madam

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

energywatch welcomes the opportunity to respond to the issues raised by this consultation. This response is non-confidential and we are happy for it to be published on the Ofgem website.

Consumers expect the delivery of safe, secure and reliable supplies of gas in an efficient and economic manner. It is the responsibility of market participants, through their licence obligations, and Ofgem, as the industry regulator, to meet consumers' expectations.

We note that it is extremely unlikely, and very costly, to change the current GB gas quality specification until 2020. To do so would require a wholesale replacement of current domestic gas appliances which it would be uneconomic to undertake and those substantial costs will also be passed through to consumers. We also note that a common European gas specification (the 'EASEE gas' proposal) which may cover a wider range of quality of gas from different imported sources has been proposed but is some way from implementation. Until it is appropriate to implement a common specification, a more economic solution to the problem of importing gas which is non-compliant with the GB specification has to be found. Otherwise there is a real risk that gas may not flow and prices for GB consumers will rise as a result.

We note that a more economic solution is for the development of some type of gas processing facilities at the point that gas enters the GB transmission system which will allow blending to ensure compliance. This solution has been the basis of discussions between Ofgem and the industry in recent times. However, we also note and are concerned by a wide disparity of views amongst industry participants about the need for, and who should pay for, these processing services. There appears to be some consensus that there is a problem but the failure to obtain more cooperation from those who could provide useful information – buyers and sellers of gas – on commercial grounds is extremely disappointing.

It also appears that some participants who are already investing in gas infrastructure, which includes processing facilities, believe that they will be able to deliver gas through this infrastructure which will be compliant, and therefore feel no need to participate in a common blending facility. Those participants who are not investing separately may feel that they will end up paying a larger share of costs for any common blending facilities and are unwilling to commit on that basis.

In our view, consumers should bear an appropriate level of the risk, and cost, associated with building and operating any blending facilities and others, through their responsibility to deliver compliant gas to consumers, must pay their share. Risk should be allocated according to who can best manage it. This must mean those who are licensed to provide delivery of gas in an efficient and economic manner, namely the system operator and shippers/producers. The vast majority of consumers are not in a position, individually or collectively, to manage the risks of non-compliant gas entering the transmission system. It is not logical to believe that all imported gas will always meet the GB quality specification before it enters the transmission system. The problem must be tackled, at least from the point of view of delivering safe supplies, by those most able to do so as long as uncertainty around gas quality remains.

Having established the need for blending facilities, it would appear sensible for a feasibility study to be undertaken to develop a proposal which outlines the scope of the facilities required. In our view, National Grid, as the GB system operator, is in the best position to make this assessment. National Grid is incentivised to manage an efficient and economic system on behalf of all gas consumers and will also be aware of its requirements for residual balancing. This does not imply that National Grid is the automatic best choice for building and operating the blending facilities, although it would probably be the most appropriate choice.

The Economic Regulation workstream highlighted a number of different options for the costs of building and operation of the blending facilities. We believe that National Grid must have involvement in the project given its pivotal position in terms of system operation. A fully regulated ('socialisation' of costs) approach has a superficial attraction as the likely costs will become well established and National Grid can earn a regulated rate of return. However, it may not be the least cost option for consumers and could lead to stranded asset risk without sufficient take up from users. We believe that some competitive element to tendering can reduce costs to consumers but must be backed up by appropriate levels of user commitment that ensures that the facilities will not become stranded assets, unused but still paid for by consumers. A hybrid solution is therefore preferable.

Of the two hybrid models already discussed, we believe that hybrid 2 may be more preferable, subject to detailed examination. All potential users of the blending facilities ought to provide a level of commitment to use capacity, backed by effective 'use it or lose it' arrangements to ensure that third parties can access unused capacity. This ought to form the baseline capacity built into the facilities. Additional capacity can be built if there is sufficient demand. The benefits are that only capacity which is actually needed is built, limiting stranding risk. Costs ought to be lower than a fully regulated solution. Those wishing to pursue separate commercial blending

facilities are also able to do so knowing that they have the option of either seeking capacity in the common blending facilities or pursuing their own projects. In all, the solution provides flexibility and potentially lower costs for all consumers.

We recognise that the eventual solution must be consistent with the development of gas specification in continental Europe, particularly at the interfaces between the GB transmission system and the continental interconnectors. We believe that part of the eventual solution also requires engagement with manufacturers of gas appliances to develop products which are compatible with a wider range of gas quality specification. Early action in this respect may allow the natural 'churn' in appliances to reduce the size of the problem over time so that the costs of residual replacement of appliances become more manageable.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers.

We would appreciate being kept informed of the progress of the consultation and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs