

Gas Quality Consultation
Office of Gas and Electricity Markets
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22 August 2007

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Dear Sir,

National Grid Gas plc (“NGG”) in its capacity as the holder of a gas transporter licence in respect of the National Transmission System (“NTS”) welcomes the opportunity to respond to the consultation on “The Economic Regulation of Gas Processing Services - Key Issues and Initial Thoughts” published by Ofgem on 11 July 2007.

In this covering letter we set out what NGG believes to be the main issues associated with the provision of gas processing services and, as an annex to this letter, we set out our more detailed responses to the specific questions contained within the consultation document.

Historically, the UK has been supplied by natural gas principally sourced from the UK Continental Shelf. Gas processing services have been a necessary component of bringing gas to market and there is ample evidence to demonstrate that normal commercial incentives delivered efficient investment in the appropriate gas processing services associated with these sources of supply.

However, it is clear that the UK is becoming increasingly dependant on imported gas supplies. These new supplies are being delivered principally through a combination of new pipeline supplies from Norway, new LNG imports, and the capability for increased levels of interconnection with continental Europe.

The principle examples of new sources of imported gas include Milford Haven LNG terminal, Isle of Grain LNG terminal, the Langeled pipeline and the BBL pipeline. In each case, the provision of gas processing services (either upstream or at the UK terminal) has been a necessary component of the supply chain involved in delivering this gas to the UK market and normal commercial incentives have delivered the necessary investment in such gas processing services.

The other major increase in new sources has been through increased levels of European imports through Interconnector UK from Zeebrugge in Belgium to Bacton in the UK. Evidence indicates that this relies on differentials in price between Europe and the UK and, as such, deliveries to the UK are 'opportunistic' in the sense that Shippers take the opportunity to flow gas from Zeebrugge to Bacton only when the UK gas price is higher than the European gas price.

It is feasible that flows to the UK from Zeebrugge to Bacton may be restricted even when the UK gas price is higher than the continental Europe gas price. Such a situation may arise where the UK may not be able to access continental gas where such gas is outside the Gas Safety (Management) Regulations ("GS(M)R") but within a specification more broadly applied across, and hence available to, continental countries. Because flows are currently 'opportunistic', the market is unlikely to provide sufficiently robust investment signals to support normal commercial investment in gas processing services at Bacton to enable access to such gas outwith the GS(M)R specification.

Should the situation change regarding flows through Interconnector UK and flows become 'planned' (i.e. a firm requirement for gas to flow consistently into the UK) rather than 'opportunistic', then the current uncertainty surrounding the requirement for any gas processing services at Bacton are likely to be removed and the normal commercial drivers for investment in gas processing services will trigger. However, NGG believes that, should such investment be triggered, the market may not deliver sufficient processing capability in time (because of the lengthy lead times associated with building gas processing facilities) to prevent a potential shortfall in UK gas availability. However, it should be emphasised that NGG does not have sufficient information to quantify the likelihood of such a scenario arising.

The current legislative and licensing framework does not oblige NGG to engage in any active gas treatment/processing activities. NGG is however obliged by the GS(M)R to only convey gas which is compliant with such regulations. This is underpinned by the obligation on upstream operators to only deliver gas to the transportation system that meets the gas specification as set out in the relevant Network Entry Agreement, consistent with the GS(M)R specification.

In general, NGG believes that the current framework has delivered, and will continue to facilitate, efficient investment in gas processing services and normal commercial incentives are the appropriate mechanism for the delivery of such investment.

However, in specific circumstances (such as those described above relating to the Bacton terminal), NGG recognises that the market may not deliver sufficient processing capability in a timely manner. In such circumstances, it may be appropriate, in order to maintain the overriding considerations associated with security and diversity of supply, for new gas processing

services to be developed in advance of normal commercial incentives providing the appropriate investment signals.

Under such a scenario, the decision to proceed with investment in gas processing services would need to be taken by the appropriate regulatory body and the risk associated with such investment would require some form of underwriting by consumers. In such a case, it may be appropriate that NGG has a part to play in the provision of gas processing services.

This would be a fundamental change compared to the current arrangements.

As explained above, the current legislative and licensing framework does not oblige NGG to engage in any active gas treatment/processing activities, merely requiring that we comply with the GS(M)R specification in respect of the gas we convey. As a result, should such obligations be imposed on NGG, we would require appropriate funding, with a risk/ reward profile consistent with our existing pipeline assets, for the development and operation of any future new gas processing services that we may be required to undertake as a regulated activity.

Up until this point, we have focussed on NGG's views regarding wider gas processing services (either upstream or at onshore terminals). However, the consultation document specifically refers to gas blending.

Notwithstanding any implications that gas blending within the NTS would have on the NGG Safety Case, NGG would like to make it clear that opportunities to blend gas within the NTS are not considered to be feasible due to the prevalence of system offtakes (to distribution networks and direct connect customers) being located immediately downstream of beach terminals. The location of such offtakes would result in off-specification gas being delivered to customers before there was opportunity to blend it to make a compliant gas stream resulting in a material, and unacceptable, safety hazard to consumers.

Blending at the beach terminal may have some potential where there are relatively large flows of different quality gases in close proximity. However, in order to provide any new gas blending service, significant capital investment in new infrastructure and metering would be required. Such investment is likely to include new pipelines, metering and gas quality instrumentation and the modification of terminals to include new hardware such as blending loops. Detailed engineering studies of each terminal would be required to assess the extent of any required system modifications.

However, even where gas blending is proven to be feasible, we believe that any such arrangements should be complementary to gas processing and not considered a direct alternative. Whilst gas blending has the potential to reduce the overall cost of transforming off-specification gas to gas that meets the GS(M)R limits, a total reliance on such arrangements would have serious risks for security of supply given that the loss of the blending stream would result in the additional loss of the off-specification gas stream at the times when it is most needed.

From a commercial perspective, to the extent that NGG was able to facilitate the blending of non-compliant gas at its NTS entry terminals, such an arrangement would be dependant on the cooperation of a third party (i.e. the party providing the compliant gas stream against which to blend the non-compliant stream). It is not clear that such cooperation would be in the interests of the third party and whether such cooperation could be achieved.

In conclusion, NGG believes that, with the possible exception of the Interconnector UK onshore terminal at Bacton, the current framework has delivered, and will continue to facilitate, efficient investment in gas processing services and normal commercial incentives are the appropriate mechanism for the delivery of such investment. At the Bacton terminal, there may be merit in the provision of a regulated gas processing service which may require to be underpinned by some form of underwriting by consumers. Finally, NGG does not believe that gas blending on the NTS is feasible and, furthermore, that gas blending at the onshore terminal is only appropriate in addition to, and not as a substitute for, gas processing services.

I trust that the information we have provided is of use to you during the consultation process and please do not hesitate to contact me if you wish to discuss these issues in further detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Graeme Steele', written in a cursive style.

Graeme Steele
For, and on behalf, of Simon Cocks
Commercial Director - Transmission

Annex

Consultation Questions

Allocation of Risk

Question 3.1: To what degree can commercial arrangements 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 the wider historical context of the development of GB gas markets, NGG believes that normal commercial arrangements have delivered efficient investment in gas processing services. In this context, NGG has no foundation for believing that normal commercial incentives will not deliver the necessary investment in appropriate gas processing services.

However NGG recognises the existence of slightly different circumstances at the Bacton/ Zeebrugge interconnection point in that flows are driven by price differentials between continental Europe and the UK. In this case specific arrangements may be required to ensure that access to the IUK system for non GSMR compliant supplies is facilitated thus ensuring that the GB markets have access to these gas supplies.

Under the scenario where Ofgem considered that a gas processing facility was required at the Bacton entry point NGG would envisage that the commercial risks entailed in the construction and operation of such a facility, by whichever party, would need to be underwritten, either in full or in part, by GB gas consumers. At this point in time NGG does not have sufficient information to form a view on the proportion of the commercial risks that would need to be borne by consumers.

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

In the wider context of the GB gas markets, normal commercial incentives have delivered efficient investment in gas processing services. NGG does not consider that the provision by NGG of gas processing services in general would prove to be a more cost effective approach.

However, NGG recognises the different commercial incentives regarding gas imports through Interconnector UK and considers that the operation, by NGG, of a gas processing facility at the Bacton NTS entry point has the potential to provide some wider economic benefits through the access to IUK of non-GSMR compliant gas.

However, in such a scenario, significant capital investment would be required and it is likely that the commercial risks would need to be, to a greater or lesser extent, underwritten by 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?

As noted in our response to the earlier questions, normal commercial incentives have delivered efficient investment in gas processing services. In this context, NGG's involvement is generally not required for the efficient provision of gas processing services.

In the event that Ofgem should determine that it is necessary for a gas quality service to be provided by NGG, we would seek to mitigate the risk of providing such a service, which is currently outside of our Licence obligations, by ensuring that any amendment to our GT Licence is appropriate and is accompanied with an appropriate level of funding.

NGG would anticipate that it would earn a rate of return on its investment to ensure that the balance between risk and reward for this particular investment was consistent with that for its existing pipeline assets.

Competition Issues

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?

As noted in our responses above, NGG is of the view that, in the wider context of gas processing, the existing commercial arrangements have served, and will continue to serve, the interests of the GB market and gas consumers. NGG considers that these arrangements will continue to provide the necessary incentives for private investment in gas import and treatment facilities as is evidenced by the ongoing commissioning of such facilities at this time, e.g. the nitrogen ballasting facilities currently being installed at Easington to treat Norwegian gas.

As noted above however, NGG considers that some special considerations may exist at the Bacton/Zeebrugge interconnection point. These issues relate to the incentives on European suppliers to treat non GSMR compliant gas supplies such that they can be landed in Bacton. However the uncertainty between future prices on the European and GB markets suggests that European suppliers are unlikely to invest in upstream treatment facilities and thus there may be a case for a regulated gas quality service at Bacton.

It should be recognised, however, that providing a regulated gas processing service, and hence providing access to the UK market for Shippers of non-GSMR compliant gas, may adversely impact existing and future private investment. NGG does not have sufficient information to quantify this risk.

Upstream Issues

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?

NGG considers that the uncertainty attached to investment in onshore processing facilities is primarily observed at the Bacton/ Zeebrugge interface and that this uncertainty is attributable to the difficulty in forecasting future price differentials between European and GB markets rather than to supply source or demand issues. Without the ability to forecast future differentials, it is difficult to assess the economic case for investment in gas processing facilities. NGG believes that if there was a clear cut case for investment, then the normal commercial incentives would ensure the upstream barriers are overcome.

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

NGG is aware of a number of upstream barriers to onshore processing services but considers that due to the complexity of these upstream issues NGG is unable to provide an objective view of whether commercial parties (gas shippers, suppliers and national TSOs) alone would be able to resolve them.

The Level of User Commitment

Question 4.1: How different do you consider the regulatory approach developed in the Economic Regulation workstream to be from a purely commercial framework? 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?

NGG agrees with the view stated by Ofgem in the consultation document that an approach financially underpinned by 100% user commitment is very similar to a pure commercial allocation of service risks.

As stated earlier, NGG believes that, with the exception of the Bacton/ Zeebrugge interface, normal commercial incentives will deliver efficient investment in gas processing facilities.

When considering Bacton, based on discussions held between NGG and other industry parties following the Economic Regulation Workstream, NGG is of the view that the probability of obtaining 100% user commitment for investment in gas processing facilities at Bacton is very low given the scale of the potential costs for the feasibility studies and processing plant construction.

NGG therefore considers it unnecessary for it to be obliged to respond to market interest in gas processing services other than at Bacton. However, NGG believes there is limited scope for it to provide gas quality services to the GB market at the Bacton NTS entry point under the Economic Regulation workstream approach.

Nevertheless, should Ofgem determine that it is necessary for a gas processing service to be provided by NGG, NGG believes it is appropriate that the risk/ reward profile of providing such a service is consistent with that of our existing pipeline assets.

Investment by NGG Not Backed by User Commitment

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

NGG cannot currently envisage a scenario where NGG would make additional investments in a gas processing service over and above those levels backed by user commitments. NGG does not believe it has additional or more accurate information about gas quality and supply issues than Users.

General Comments

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

No further comments.