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**The economic regulation of gas processing services – key issues and initial thoughts
July 2007**

Dear Bruce

We welcome the opportunity to comment on the issues raised in this consultation. This response reflects the views of RWE npower and the UK based business of RWE Trading GmbH.

General Comments

We recognise that as its indigenous gas supplies decline, GB will become increasingly dependent on supplies from a more diverse range of sources. These will include both pipeline gas, delivered at the beach and through interconnectors and LNG delivered directly into GB or indirectly via mainland Europe. There is a significant level of uncertainty associated not only with the specification of gas imports but also with the gas quality specification that will apply in GB and elsewhere in the EU.

Potential investors in gas processing facilities need to consider the costs arising from gas being prevented from flowing into GB due to gas quality issues, as well as the frequency and duration of such events. Costs will be imposed on individual shippers via cash-out arrangements and GB customers in general as prices would be expected to increase in the short-term due to a reduction in supply. We would also expect an appropriate response with the demand-side turning down and potentially increased LNG in response to the price signals, which would serve to dampen the effect.

Although much of the discussion has focused on providing a solution at Bacton, gas quality is a generic issue. There appear to be number of possible technical solutions available and whether services could be standardised or whether there would need to be different products depending on the divergence of the gas from GS(M)R is uncertain. At this stage it is not clear to us that shippers individually or collectively have sufficient information to judge the case for investment.

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Specific Consultation Questions

- 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?*

To date, commercial incentives alone have delivered and continue to deliver significant levels of investment in the energy sector. These investments have been undertaken based on economic principles and stable and transparent investment conditions. The current uncertainty attached to investing in gas processing facilities is likely to dampen investment at this time. We believe that the market will continue to deliver gas processing facilities where they are dedicated to a particular piece of infrastructure, but may not be willing to invest to insure against the risk of supply side disruption caused by non-compliant gas more generally. However, we would argue that well-functioning markets are the best mechanism to achieve new infrastructure and can see no strong arguments at this stage to develop gas processing facilities based on central-planning assumptions with the costs recovered through general transmission charges and therefore from all network users.

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

We are not convinced that this is the case. National Grid Gas should not have any information that would allow it determine future gas processing requirements any better than other market participants, although it could take an overview and possibly consolidate any individual shipper requirements into a viable project. The greatest potential benefit of NGG providing gas processing services would be as “insurance” for the market as a whole such that the costs could be included in the RAV and recovered from all users. We do not support this approach as it may crowd out investment, although an initial step might be to socialise the costs of any feasibility study if the costs of this are deemed to be a barrier. NGG may offer technical expertise and be able to realise scale economies.

- 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 set out in 3.2 above, we do not believe that NGG involvement is essential. Ofgem believe that for consistency with other initiatives (e.g. entry and exit capacity) the regulatory framework should include some form of user commitment. Existing arrangements for the provision of monopoly assets are based around risk sharing between users, NGG and customers. For instance, for incremental entry capacity, there is an economic test based upon auction bids meeting 50% of the asset costs. It is our understanding that provision of gas processing services is not explicitly within the current licence and other regulatory arrangements. Appropriate drafting to include a model based on 100% user commitment, together with the proposed higher returns for discretionary NGG build, and any explicit NGG obligations would be needed.

- 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 is a key issue in the debate. Although, in principle, arrangements should be consistent, there may be some situations where different treatment is warranted. For instance, at an LNG import terminal, the facilities are designed at the outset to include processing of gas from clearly identified sources that are known to be outside GS(M)R. At co-mingled pipelines that take gas from a

variety of sources, the requirement for processing non-compliant gas will be uncertain and it is more difficult to identify which particular stream is off-spec and therefore to target the costs. In these circumstances there may need to be an element of socialisation, albeit on users of a specific piece of infrastructure rather than all users of the wider network. This approach is consistent with preserving incentives for private investment in gas import and treatment facilities.

3.5 How much of the overall uncertainty attached to investment in offshore 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 do not believe that the upstream physical and commercial arrangements should be characterised as barriers, as they provide the required framework to allow GB shippers to procure GS(M)R compliant gas from mainland Europe.

In our view, it is the lack of clarity about the future GB and European gas specifications and the frequency that off-spec gas will be prevented from reaching the GB market that creates the greatest uncertainty and therefore indicates no clear case for change. We do not see a strong case for implementing a processing solution upstream of the NTS as this is likely to be within a different jurisdiction and the issue of who pays for the investment and targeting the costs that arise will still need to be resolved.

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

Once it becomes difficult to obtain compliant gas, we would expect commercial parties to renegotiate relevant contracts. The only limits will be the time associated with completing the complex and extensive contract renegotiations that would be required. We would expect Ofgem to be involved with other regulators in establishing a stable regulatory framework within which investment could take place. We do not think that Ofgem has a role in any commercial negotiations.

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 obligated to respond to market interest in gas processing services, as under the economic regulation workstream approach?

In terms of the costs to the “investor(s)”, there is no difference between the hybrid regulatory approach and the purely commercial approach, as the investor would fund 100% of the costs. However, a key difference is that there would be different risk-rewards profile faced by the different parties under each approach. NGG would, through user commitment, have all of its costs underwritten and would also receive a regulated rate of return on the assets. Under a purely commercial approach the risk that the facility was not used and therefore stranded would sit entirely with the developer of the facility. In return for the certainty over its revenues, NGG would need to have an obligation to respond and this could be structured along the same lines as existing licence obligations regarding network access. Should the hybrid approach be implemented, it is important that it does not introduce distortions that adversely affect commercial investment.

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 regulatory regime required to remunerate and monitor two different revenue streams from the same asset would appear to be very complex. Without the opportunity to earn significant returns, there are no clear incentives nor is it economically rational for NGG to design for excess supply given the risk of stranded costs. In our view, it is likely that these costs will outweigh any benefits.

We hope these views are helpful and would be happy to discuss matters further.

Yours sincerely

By Email So Unsigned

Charles Ruffell
Economic Regulation