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Dear Bruce,

**Re: The Economic Regulation of Gas Processing Services
– Key Issues and Initial Thoughts**

Scottish and Southern Energy plc (SSE) welcomes the opportunity to respond and input into Ofgem's initial thoughts document on the economic regulation of gas processing.

With the UK's growing dependence on gas imports, it makes sense that the UK should explore all possible options to increase the import market that it has available to it. We agree that continuing to limit the UK to the delivery of UK Continental Shelf specification gas could have an impact on gas security of supply in the future.

The UK has one of the narrowest gas specification tolerances in Europe. However, the gas arriving at the UK is controlled in part by the Belgian border and in part through well-defined contractual terms and conditions. As a result, any decision to widen the specification of gas that can be delivered to the UK without involving Europe (and certainly Belgium), and without widespread commitment to amending contract conditions is unlikely to have the desired impact on the UK's potential market for gas imports. It therefore follows that the need for gas processing services is not imminent. However that should not prevent the appropriate regulatory framework being put in place now. In our view the development of the 'hybrid 2' model could be taken forward from this consultation.

We have provided our answers to the consultation questions below. I hope you find our comments helpful, please do not hesitate to contact me should you wish to discuss this further.

Yours sincerely

Rob McDonald
Direct of Regulation

Response to 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?

The decision to invest in gas processing services cannot be taken in the UK without serious consideration of the upstream issues and regulatory risk due to the influence other EU Member States have on the specification of gas that is delivered to the UK. For example, as we understand it, all imported gas currently delivered to the UK market is within UK specification. This is controlled either through contract terms and conditions (T&Cs) or, in the case of IUK, tight restrictions on gas entering the Belgian network. Therefore, unless Belgium is already capable of taking wider specification gas through e.g. a complete overhaul of its gas appliances, any unilateral UK decision would make no difference to the gas being delivered to the UK through the UK-Belgium interconnector. Without resolution or clarity on these external matters, or at least a timescale for their resolution, investing in gas processing facilities in the UK could have little impact on the actual specification of gas capable of being brought to the UK market. Such external regulatory risks should only be borne by the whole market and without resolution of the external issues, it is not clear that solely commercial incentives can be relied on to deliver efficient investment.

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

As noted above, we believe that there are external issues that need to be resolved before the UK market can be expected to provide an investment signal. It is also unlikely that NGG would be prepared to underwrite investment in processing facilities without resolution of these external regulatory issues or a guarantee that they would be able to recover their costs. However, given resolution of these external issues, in our view, the hybrid 2 approach, rather than a purely NGG or purely market approach would be the most cost effective.

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?

We are not aware of any existing arrangements to ensure that NGG develops such services nor are we clear that this issue can, at this stage, be resolved solely in the UK. However we believe that NGG are essential to the provision of processing services, but through a hybrid 2 approach.

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?

The only investments so far in gas processing facilities have been at LNG terminals. These investments have been made on a purely commercial basis. In line with this, by our preferred hybrid 2 approach, we believe that the market risk of the investment in gas processing at an Entry point should be borne by only the participants that signalled that investment at that Entry point. Any external regulatory risks would need to be borne by NGG to be allowed for by Ofgem and funded by the whole market. Any additional investment by NGG should be at NGG's risk and/or provided for under a suitable incentive regime. We believe that the hybrid 2

approach provides a cost-effective solution without disadvantaging private investment in other import and treatment facilities.

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?

Uncertainty upstream is a significant consideration. For example, taking the Belgian situation again, without knowing whether Belgium is able or prepared to accept wider specification gas, it is impossible to know whether gas processing services would be necessary in the UK. Until these external issues are resolved or there is a timescale for their resolution, it is not clear that there will be a commercial investment signal for processing facilities. However this should not prevent the development of a suitable regulatory framework for UK processing facilities.

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?

Whilst commercial parties may be able to resolve some of the upstream barriers preventing lower specification gas from being delivered to the UK, we believe issues that stem from other European countries' gas specifications are unlikely to be resolved commercially.

In terms of Ofgem's role, we believe that there is a role in initiating discussions with other European regulators in an effort to determine what steps, if any, other Member States would be prepared or able to take to increase the gas supply available to the UK.

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?

The main difference is that the regulatory risk and some of the investment cost is underpinned by NGG as a regulated entity in the hybrid approach whereas individual market participants are exposed to the full risk in the purely commercial approach. We believe it is extremely important that NGG are obliged to respond to market interest and that the hybrid 2 model would allow them to do so.

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?

We do not believe that NGG making additional investments should raise costs for market participants if they are suitably incentivised. A parallel can be drawn with the incentives on NGG for making incremental Entry capacity available.

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

No.