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Friday, 19 October 2007

Dear Joanna

Gas Distribution Price Control Review (GDPCR) – Updated Proposals Document

Thank you for the opportunity to comment on the above consultation. Statoil (UK) Ltd (STUK) is responsible for the marketing supplies of its parent company's Norwegian equity gas and the Norwegian State's equity gas in the UK market. As we import gas into the UK and maintain a supply portfolio we are directly affected by changes to the Gas Distribution Price Control Review. Please find below our comments to Ofgem's Gas Distribution Price Control Review (GDPCR) – Updated Proposals Document.

Cost of Capital

The 2007 – 2012 GDPCR Updated Proposals Document has proposed the removal of the volume driver from GDNs price control. Combined with the proposal to implement a change to the GDN charge structure to change the split between capacity and commodity to a ratio of 95 pct capacity and only 5 pct commodity, this raises questions over the future cost of capital available to the GDNs.

The effect of these changes would be to guarantee virtually all of the GDNs revenue every year and spread the revenue more equally through the year. Spreading of the revenue has the benefit to the industry that it will make transportation charges more predictable it also puts the GDNs in the fairly unusual position to have a guaranteed stable cash flow. Logically this will increase the attractiveness of the GDNs as customers to the capital markets. These changes will substantially lower the short-term risk GDNs currently have to their cash flow which in turn should have the affect of lowering the cost of borrowing for the GDNs.

It is important that any such changes to GDNs charging methodologies are examined to consider the affect on GDNs cash flow and thereby on cost of capital. Where changes will result in a lower cost of capital this should be recognised within the GDPCR.



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Funding of xoserve

Principle of User Pays

We are unconvinced that the user pays principle will benefit the industry and consumers. We believe the question of accepting user pays as a principle is still to be proven before the discussion of implementation. To inform discussion however we offer the following comments:

In the Updated Proposals Document Ofgem states that it considered that a “core plus user pays” approach to the funding of xoserve would be in the benefit of consumers in the medium term. Ofgem recognise that a number of responses raised concerns over the detail of the governance and indicate that they believe the industry group established to look at how the user pays principle could be implemented in practice will address these concerns.

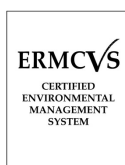
What remains unclear is what analysis has been undertaken to ensure that the benefit that Ofgem believe may be realised in the medium term of a user pays approach is not destroyed or exceeded by costs of implementation.

Statoil has considered the outstanding issues and risks relating to the required change to the governance regime and the implementation of the service lines and have serious concerns that the introduction of a user pays principle could seriously impact on the efficiency of xoserve services and the effectiveness of the industry change processes.

While initial discussions centred around the possibility of a user pays principle and discovery of the barriers to such a process*, recent discussions have jumped to discussion of implementation. While Ofgem have recognised that users will be the key stakeholders for any service lines, it is unclear where in this process the users of these services have thoroughly discussed and evaluated the costs, benefits and risks of such a regime in the short, medium and long term. While Ofgem assess the user pays model in their GDPCR – Third Consultation Document- Appendices further analysis is required to understand the potential risks associated with this model and to quantify the costs and benefits.

It has been suggested in meetings that the service lines identified by Ofgem as moving to a ‘user pays’ basis could be viewed as a trial to demonstrate the effectiveness of this principle. Yet it has also been recognised that there is very little benefit that can be identified in support of these services moving to a user pays basis. Xoserve themselves recognise that their costs are likely to increase slightly as they would have to track, invoice, manage queries, manage credit and collect cash for these services. This is without considering the costs to the industry of users having to validate charges, manage queries, provide credit and pay these charges.

* Industry Dialogue on xoserve Service – Terms of Engagement states under xoserve funding arrangements that, ‘While Ofgem has not yet made a decision on the funding of xoserve, it is appropriate to develop a more detailed understanding of how a user pays option could look.’



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Governance for new changes/modifications

For the industry to work effectively and efficiently it is important that users can understand the regulatory regime in which they operate. The Governance regime therefore needs to be well developed and considered prior to any implementation.

While the GDPCR Price Control Document recognises that an industry group has been established to develop the required governance arrangements little progress has been made to address some fairly key issues which could if not addressed prior to implementation cause significant problems and issues. If these issues are not addressed then there remain significant risks that disagreements over costs, benefits, data ownership, Intellectual Property Rights (IPR) and restrictive practice will halt system changes.

One of the principles defined by the Industry Dialogue on xoserve Services was that users should have discretion on whether or how to use a user pays service. It is now clear that some of these services could still be monopolistic in nature. As well as having a monopoly on the provision of services xoserve may also have a monopoly on the setting of prices. The governance regime currently proposed by xoserve suggests that the prices for the services and the pricing methodology should be contained in a charging statement which would be presented to Ofgem for approval or rejection. This proposal does not allow the users of the service to suggest alternative, superior pricing structures. Rather it gives xoserve, who could be the monopoly service provider, the unique position of being the only party that can set prices and pricing methodologies.

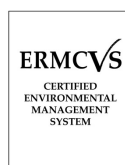
STUK questions why prices and charging arrangements cannot be contained in the UNC or an ancillary document to the UNC where they could be challenged through the UNC governance process by Shippers and Transporters. This would still provide Ofgem with the opportunity to reject these if they felt they were not economic and efficient.

Currently the industry uses the UNC process to govern prices and charging arrangements for areas such as User Suppressed Reconciliation Values (USRV) charges and to define how much xoserve should be allowed to charge for the provision of the service. This allows users the opportunity to openly discuss methodologies and make proposals on how these could be improved. The use of the UNC would also help to ensure no undue discrimination occurs and that services are transparent to all users.

Investment Costs and Burden of Risk

One fairly significant issue yet to be considered is how investment costs will be recovered and over what period. Logically the two most likely investment options would be either for costs to be recovered up front or over a period of time. A third option could be a composite option with part of the costs recovered up front and part recovered over a period of time.

It is likely however that one arbitrary period would be inappropriate and inefficient as individual proposals raised at different places in the price control periods or system lifecycle are likely to have different logical investment timescales. Certainly for a user to analyse



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whether it would wish to use a service it would need to understand the timescale over which investment could be recovered fairly early on in the governance process. In any regime stability and certainty of charges will be key for users.

The investment timescale will also to a large extent drive the balance of risk between xoserve and customers. The longer the investment period the greater the risk xoserve will bear that users do not use the service and it is unable to regain its costs. The shorter the investment period the more likely it is that early users of a service will pay a greater proportion of the investment costs. This also increases the risk that other shippers will not fund investment and will wait to use a service once the investment costs are paid.

This then raises questions regarding the appropriateness of either restricting access to those who paid the investment costs or how much an additional user should pay if they choose to take the service either during the investment payback period or after. Either of these options would raise questions regarding what the true costs were of providing a service at that point and what benefits the initial users had gained through early adoption. Any form of restriction of a service would also raise questions regarding restrictive practices.

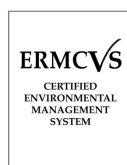
What is the definition of core and user pays?

During the Industry Dialogue on xoserve Services Workgroup meetings it was recognised that not all service lines would be appropriate for a user pays funding mechanism. These service lines would be considered 'core' services which should continue to be funded using ordinary price controlled allowed revenues. The group initially developed a minimum set of criteria which would identify candidates for a user pays structure. The group then considered all 242 xoserve service lines against this criteria and discovered that only 12 service lines fulfilled this minimum criteria. Eventually six service lines have been identified as being worth further consideration. These are:

- Provision of Information
- Reporting
- User Admission
- Must Reads
- AQ Amendments & Appeals
- Shipper Agreed Reads

The total value of these service lines has been identified as £2.83m which will be funded outside the price controlled allowed revenues. The other 236 xoserve service lines will continue to be provided through the ordinary price controlled allowed revenues as core services.

While this process has been used to define which of the current services can be user pays it is unclear is how and when the definition of core or user pays will be applied to future changes suggested through the UNC process.



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Impact of changes

Any changed governance regime will need to consider the impact when user pays and core services effect each other. This is particularly true when one or both of the services are monopolistic in nature. It is easy to envisage a scenario where two users propose competing changes and are willing to pay for their own model to be implemented. Each model may use common infrastructure will mean both models cannot be built. How the competing solutions are judged in such a case is not clear.

Many user pays services will involve making some changes to systems or file formats that could affect the core service. While the user may offer to pay all of xoserve's cost this would impose costs on the other users of the system. In this scenario xoserve may well be happy to implement the change as they will receive funding for more efficient servers and software but other users could consider the change unnecessary and unfair. Alternatively this could work the other way where a user has invested in changes which are made ineffectual by a change to the core service.

How a governance regime recognises these costs and mitigates the risks for other users will be vital for the governance regime to work without challenge in a fair and economic manner. As well as considering the impact of changes on users a governance regime will also need to consider the economic costs of applying a user pays model. This will include the costs of invoicing, billing, cash collection etc on both parties.

In the past when such issues have arrived before (such as the BP change proposal to implement an extra API on the Gemini system) the industry has found it difficult to arrive at an answer and the discussions have been lengthy. With the implementation of a user pays principle such debates are likely to occur more often. As well as increasing the costs to users to support such a regime it also increases the risk that the change process could become mired in lengthy discussion of costs and benefits.

To ensure only appropriate charges are levied on users it has been suggested there should be a materiality test of some sorts. There is a compelling argument that with a monopoly service provider there is a risk for users that inefficient charges may be levied if there is no materiality test. STUK believes it is important that this issue is carefully considered. Should a materiality test be introduced it is also important that the test works effectively and in itself does not become a barrier or the subject of perverse behaviour.

Non Price Controlled Revenues

If a user pays principle is introduced then xoserve will be receiving revenues which are not subject to the regulated price control process. This raises a number of issues which could in themselves cause significant problems for any governance regime. It is imperative that these are addressed prior to the implementation of a new regime.

Data ownership – Questions have already been raised about who owns the data which may be provided in services/reports by xoserve. If this data has been collected or calculated either



using regulated assets or under the UNC for the benefit of the industry as a whole then industry participants may question whether xoserve have the right to use this data to provide a service/report on a commercial basis.

Intellectual Property Rights (IPR) – In the current regulated environment the issues of IPR are more or less mute. If unregulated revenues are being generated through the use of processes and systems designed using users resources it is likely issues will be raised over the ownership of the IPR of these jointly developed solutions. It is currently unclear who would own the IPR if xoserve and a user develop systems and processes outside of the UNC.

Clearly if this is a monopoly service xoserve could use its monopoly position to force the other party to give up its IPR rights. This would also allow xoserve to offer the service to all other users. While this would solve the problem of IPR ownership it would raise questions over abuse of its monopoly position and potentially compensation to those users who lose these rights. The loss of such rights without compensation would make it less likely that a user would want to provide the resources necessary to develop a solution with xoserve without the participation of other market participants.

Restrictive/unfair practice – If xoserve offer different service levels to individual shippers then it will be important to ensure that this does not constitute a restrictive or unfair practice. It is important to recognise the commercial pressure the user has to differentiate its service from its competitors. A user may have the legal right through either data ownership or IPR (providing it holds the IPR) to force xoserve to offer a lesser service to competitors and thus gain a service advantage. It will be important to ensure that any differences are appropriate.

Inefficient investment – One of the advantages of the existing processes is that the industry works on solutions together and where more than one model is proposed a decision is made over which model is the most appropriate. That model is then implemented for the entire industry. One major advantage of the existing process is that the investment is only made once. There is a significant risk under this new model that rather than in some instances multiple solutions will be implemented. This clearly adds additional costs to the industry.

Costs – Possibly the hardest issue to address is what costs are fair to pass on to users through the user pays model and what costs should remain as ‘core’. As xoserve and the GTs receive regulated revenue to offer the ‘core services’, there is a direct financial benefit if they can limit costs. As the user pays services are unregulated income and in many cases are monopolistic, it is hard to see what the commercial driver will be for xoserve to drive down costs in this area. This would logically give xoserve an incentive to give greater focus on driving down costs on regulated costs.

Clearly the division of costs will also be an important issue which will need to be addressed, should the user pays principle be implemented. Where resources are shared this becomes much more difficult to quantify. The nature of xoserve’s business may well make this far more subjective than other such unbundling exercises have been in the past. For example the previous unbundling of BG Transco’s meter reading activities was made much easier because the activity was already run as a separate department.



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Payment and Credit – It has been suggested that some or all of these services could be provided under separate bilateral contracts with users. As well as raising questions regarding transparency and fragmentation this also raises questions regarding payment and credit processes. If users are required to contract directly with xoserve then it will be necessary for each user to duplicate the existing credit and payment processes. While the overall credit burden may not increase each time a letter of credit is provided the issuing bank will make a charge. This along with the cost of tracking usage of services, validating and paying separate invoices will increase the overall cost to users.

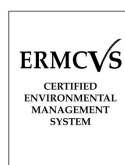
Power to the largest users – Under existing processes any user can propose changes to the monopoly services provided by xoserve without any form of investment through the UNC. These changes will be judged on the merit of the proposals and providing they meet the relevant objectives the proposal will be implemented. This ensures that small users can still engage in the change process. In the future however there is a risk that as smaller market participants will have little or no influence and the largest users will have significantly increased influence.

Encouraging appropriate behaviour – It is important to the industry to ensure that the user pays regime does not introduce perverse incentives on Shippers. For example if the AQ Amendment and Appeals process were too costly then a Shipper may be encouraged not to correct inaccurate AQs. As well as the effect on the RbD regime this could also affect any Shippers who then gained such a site. If the incoming Shipper were acting appropriately by correcting the AQ then they would be subjected to user pays costs that should have been paid by the previous Shipper.

The Six Service Lines Suggested for the User Pays Approach

On 14 September 2007 during the Industry Dialogue on xoserve Services meeting xoserve identified the six service lines that had been identified as possible to consider for adaption to a user pays regime. Since then the industry has met once to consider timescales for a possible implementation plan. This includes plans for meetings to draft the business rules to define how these services will be charged and operated.

While Ofgem has currently valued these service lines as reflecting £2.83m of revenue the actual value is not yet known. This value will only be clear once the business rules for the service lines are set and analysis of current usage is completed. For example one service line is AQ Amendments and Appeals. Clearly there will need to be a rule that states if an AQ calculation is appealed and it is subsequently found that the original xoserve calculation was incorrect then the user should not pay any fee. To do otherwise would leave a perverse incentive where if xoserve incorrectly calculated an AQ it would collect more revenue through the AQ Amendments and Appeals process when the Shipper challenged this. This is just one example that highlights that the business rules are likely to show that the full cost of the service line should not in many cases be collected through a user pays regime. This calls into question the validity of the £2.83m figure.



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STUK is concerned that while £2.83m in comparison to the size of the GDNs overall budgets is not a large value in terms of the overall xoserves budget it relates to around 10 pct of all allowed revenue. To xoserve therefore the £2.83m is a material value. If this figure is incorrect or if the user pays principle is not introduced at the point that the £2.83m is removed from xoserves buget then this could cause xoserve significant issues. In turn this could create inappropriate tensions between users and xoserve. On the one hand xoserve are incentivised to recover the full £2.83m of revenue by April 2008 and users on the other hand need appropriate business rules and governance.

STUK believes that it is unlikely that any benefits from moving these services to a user pays regime will outweigh the costs of administration. In response to this suggestion Ofgem has suggested that this limited introduction of the user pays regime could be seen as a test of the approach on which to build in future. STUK recognises there is often value in conducting a pilot programme with which to discover the costs and benefits of a proposal. In this case however Ofgem is suggesting the decision to go ahead with the full proposal is made prior to the discovery phase of the pilot programme. It should also be noted that many of the difficulties that will be envisaged with the user pays principle are experienced during the investment phase of a proposal. As each of these service lines has already been implemented using regulated resources, thus avoiding these issues, it is unclear what discovery can be made about these issues.

Conclusion – User Pays

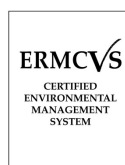
STUK believes the principle of user pays services has yet to be proven and that it would be far more prudent to conduct a greater degree of analysis into a more detailed user pays proposal to consider the long term affects of these changes.

Proposals for a new governance regime are not yet formed and some significant issues regarding data ownership, IPR, restrictive and unfair practice, inefficient investment, costs, payment and credit and market influence have yet to be addressed. If these issues are not addressed then these would represent a considerable risk to all users of the user-pays services who in many cases will have no choice of alternate service provider.

In short STUK has serious concerns that the introduction of a user pays principle could seriously damage the effectiveness of the industry change processes and impact on the efficiency of xoserve services. By removing £2.83m from the xoserve budget, Ofgem have provided an incentive for xoserve to implement a solution by 01 April 2008 without the industry being in a position to recognise, let alone implement, a workable solution.

STUK trust that our comments will be given due consideration and should you wish to discuss any aspect of this response further please contact me on the above number.

Yours faithfully



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Richard Street*
Statoil (UK) Ltd

**Please note as this letter has been delivered electronically this letter is unsigned*



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