



**49 York Place
Edinburgh EH1 3JD
Tel: 0131 550 3380**

6th April, 2010

Ian Marlee
Partner, Trading Arrangements
Ofgem
9 Millbank
London
SW1P 3GE

project.discovery@ofgem.gov.uk

Dear Mr. Marlee,

**Stag Energy Response to Ofgem's consultation on
Project Discovery: Phase II Policy Options**

Stag Energy is a private company based in Edinburgh, which is developing the Gateway 1 Gas Storage project, 1.5BCM salt cavern facility located offshore in the East Irish Sea.

Gateway 1 has received all necessary planning and consents and is currently at the Front End Engineering and Design ("FEED") phase. A second storage project, Gateway 2 has yet to apply for any consents but would add a further 1.5 BCM of storage. Both of these projects are listed in National Grid Gas' latest ten year statement, so comprise a significant part of the Government's recent public statements that up to 18 BCM of gas storage projects are under development in the UK.

Stag Energy is a member of the Gas Storage Operator's Group ("GSOG") who has made a response to this consultation. However Stag Energy considers that active consideration should be given to Level B Policy Options "Enhanced Obligations" and therefore does not support the thrust of the GSOG response.

We wrote to the Authority on the 17th March 2009 following your announcement of the Project Discovery process. We enclosed a copy of a paper with that letter setting out our views on the factors that we considered inhibited the development of new gas storage in the UK.

We also wrote to the Authority on the 24th November 2009 with further comments on the Project Discovery Energy Market Scenarios that the Authority had published for consultation. With respect to gas storage in particular we were concerned that insufficient account had been taken of the reliability and timing of future gas imports into the UK. Nor in our view was the issue of possible internal bottlenecks and breakdowns fully addressed.

We are now pleased to give our views on the applicability to gas storage in particular of the generic policy options set out in your Project Discovery Phase II draft, issued on February 3rd 2010.

General Comments

GSOG has made comments on the Policy Options in their letter to you also dated April 6th. We think the GSOG letter places most emphasis on reducing barriers to storage in regulatory and taxation areas.

We do agree with GSOG that strategic stocks owned by government or similar models with the role of a single storage system operator are likely to prove counter productive. So we are not supportive of Policy Options level D “Capacity Tenders” and level E “Central Energy Buyer”.

However we do not agree with GSOG that no forms of direct market intervention should be considered.

Currently the GB system has form of Public Service Obligation (“PSO”) placed on suppliers.

We consider that the GB PSO is extremely weak and limited compared with the European norm. It is surely worth noting that DECC published their latest Energy Outlook paper in December 2009. This suggests the absence of a GB PSO would place the UK at a disadvantage in the current EU negotiations on security of gas supply. In order to bring the UK in line with the European norm, and to support the Security of Supply objectives outlined by the Secretary of State for Energy and Climate Change in the recent Energy Markets Outlook (December 2009, Para 3.3.2) we think it is imperative that the GB PSO should be strengthened. This would be consistent with Governing Policy Option level B “Enhanced Obligations (EO)” in the Discovery framework, and would provide balance between the three stated Security of Supply objectives, namely:

- Physical Security
- Price Security
- Geopolitical Security

These comments are in line with the arguments already set out in the paper we sent you in March 2009. In summary we highlighted the following limiting factors on new storage in order of importance based on our market experience;

1. Imperfect forward traded markets – the forward markets do not give an incentive to build storage, the signal will only be there when it is too late
2. Multi-national company storage investment strategies – companies have competing pressures for investment. Storage regulation in mainland Europe possibly has the effect of prioritizing storage expenditure outside the UK with the result of seasonal “round tripping” of gas to Europe and back without an absolute security of supply guarantee
3. Individual project technical constraints (mainly geological) become apparent at the development phase
4. There is little incentive for retail gas suppliers to manage price volatility as underlying costs can be passed through to the consumer.

We consider the above four factors play a much greater role in preventing growth in significant scale new entrant storage in the UK than the other factors commonly cited, namely;

5. Regulatory uncertainty
6. Planning regulations and license restrictions
7. Taxation policy

Hence we conclude that an enhanced PSO should be considered.

We favour a PSO over more complex market pricing rule changes designed to partially address factors 1 and 4 above.

This is because a PSO is much easier to implement, is less prone to unforeseen outcomes and is consistent with the European practise so removing distortions to storage investment across the NW Europe marketplace.

As we note below in our comments to your specific questions, we agree with the Authority that there is a not a major issue over the development of new small scale peaking storage (Page 22, Paras 3.41, 3.43, 3.44)

. In this context we think the GSOG response pertains mainly to this small on shore scale peaking development area, as do the possible changes to the pricing area. However we believe an enhanced PSO matching the European standard framework will probably be necessary to ensure significant new large scale seasonal storage development.

Some form of regulatory intervention to promote increased seasonal gas storage via a PSO has now been a subject of debate for nearly a decade.

The adequacy of the existing GB PSO, in providing sufficient gas security within GB in the EU gas trade context, was first considered by a House of Lords Select Committee in 2002, when the level of the GB PSO was queried.

*House of Lords – 12th February 2002.
European Union – Fourteenth Report
<http://www.parliament.the-stationery-office.co.uk/pa/ld200102/ldselect/lducom/82/8202.htm>.*

This committee recommended an enhanced and mandatory PSO for the GB gas market.

DBERR further consulted on the GB PSO level in 2006, and commissioned a report from Oxera in 2007.

Oxera recommended against all forms of direct intervention in the market that had been consulted upon as part of this DTI exercise.

www.berr.gov.uk/files/file38980.pdf

However Oxera concluded the economic benefits of an enhanced GB PSO were only marginally negative, but arguable – i.e. the “least worst”. However the Government then chose to rule out changes to the GB PSO in its subsequent White Paper “Meeting the Energy Challenge”.

We also note that DECC has just issued a Gas Security of Supply “Policy Statement” on April 2nd 2010. This statement revisits the options consulted upon by DBERR in 2006.

DECC explicitly rules out measures consistent with Discovery Governing Policy Options D and E. It does however wish to revisit more complex pricing rules to give greater market price incentives to storage (paras 5.46 to 5.57) and enhanced PSOs (paras 5.57 to 5.82).

Responses to Questions

We now turn to some of the specific questions raised in the consultation.

Question 1: Do you agree with our assessment of the current arrangements?

With respect to gas storage, we agree with the points made in;

Page 16, Para 3.13

Page 17, Para 3.17

We strongly agree with the points made in;

Page 22 Paras 3.41, 3.43, 3.44

(This is the section of the document which makes the point that there is more of problem in the development of large scale storage than small peakers)

Page 26, Paras 3.56, 3.57 & 3.58

Page 25 – Point 4

Question 2: Are there other aspects of the current arrangements which could have a negative impact on secure and sustainable energy supplies, or costs to customers?

And

Question 11: Do you have a view on which package is preferable, or alternative policy measures or packages that you would advocate? We are particularly interested any analysis you may have to support your views.

PSO obligations and/or strategic storage regulations on the continent has the effect of oversized continental investments storing GB gas which is exported in the summer over the IC and re-imported in the winter. This is an extra transport cost to the consumer, but security of supply is not guaranteed.

The EU commission (DG Tren C1) role in seeking to co-ordinate these different approaches is set out in their October 2008 Report (Ramboll Consultants, page 158).

Existing EU regulation on gas storage related to security of supply

In April 2004 the Commission passed the Directive 2004/67/EC concerning measures to safeguard security of natural gas supply. The Directive provides a frame within which EU Member States establish their national provisions concerning measures to ensure security of natural gas supply.

The Directive defines a set of criteria, referred to as 'security of supply standards', which are related to security of supply for specific customers. The Member States who have transposed these into national regulation, have done so through national provisions on Public Service Obligation (PSO) imposed on one or more gas market players (in accordance with Article 3 of the Gas Directive).

Article 4, paragraph 4

There are different tools for achieving the security of supply standards, and according to the Directive (and relevant to this discussion): 'Member States, having

due regard to the geological conditions of their territory and the economic and technical feasibility, *may also take the necessary measures to ensure that gas storage facilities located within their territory contribute to an appropriate degree to achieving the security of supply standards'* (Article 4, paragraph 4).

It is important to note that this paragraph is provisional and imposes as such no obligation on stockpiling or other obligation on use of storage for security of supply.

In addition the article refers to the use of storage facilities located within the territory of the respective EU Member State as mentioned, to be further defined with national provisions.⁶¹ Some EU Member States with national provisions on obligatory stockpiling have further specific requirements that gas is kept in storage within their territory such as Poland.⁶²

The consequences of the different country approaches with regard to storage cover are set out in the table below, which draws on textual descriptions in the Ramboll report, except where noted;

Country	Strategic Stocks	Supplier Stock Obligation	PSO Obligation	Enforced Stock Days
Denmark	Held by SO			60 days storage explicit
Germany			All firm customers	70 days storage effect. Provision is “economically reasonable”. No explicit storage requirement
Holland	Held by SO			Storage exceeds domestic consumption
Belgium	Held by SO			90 days storage effect? Provision is “continuous”
France		Stocks to be held by suppliers to cover domestic only plus key users such as hospitals		80 days effect? Provision is explicit 6 months storage for designated customers
Italy	Held by SO			75 days effect. Provision is explicit 60 days storage applied on basis of assumption of 50% import capability
Spain		Stocks to be held by suppliers for their whole market		Explicit 28 days storage.
Poland		Stocks to be held by suppliers for their whole market		Explicit 30 days storage. Applies notionally to imported gas only.
Hungary	1.2 BCM held by SO		Domestic only	100 days total storage effect. Unique in following two routes. PSO provision is guarantee of entire winter volume set out in specific mcm/day
Czech Rep	Held by SO			? No further information in Ramboll report.
Irish Rep		Planned		No storage at present. Stag Energy understanding is that intention is to impose compulsory supplier storage for importers

				within Irish Republic jurisdiction.
GB			Domestic only	5 days storage effect? In theory whole winter guarantee. Monitored by NGG and OFGEM

Question 3: Do you agree that the five issues we have highlighted are the most important?

With respect to gas storage in particular;

1. Unprecedented investment demand - Agree
2. Carbon price - Disagree
3. Market pricing mechanisms - Agree
4. International interfaces - Agree
5. Consumer prices – Disagree

Question 12: Do you agree with our assessment of the timing for important investment decisions?

We agree with the GSOG assessment. GSOG believes that the three year lead time for storage projects is unrealistic, misleading and based on best case. We submit that decisions on storage investment need to be concluded imminently to guarantee 2015 delivery.

Question 13: Do you believe that early actions should be considered?

We think an early move to a PSO is essential if significant new gas storage projects are to proceed.

Please do not hesitate to contact me should you require any clarification.

Yours faithfully,

Mark Rigby
Commercial Director Stag Energy