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FAO Mr Peter Sherry  
Senior Economist GB Markets  
Office of Gas and Electricity Markets  
9 Milbank  
London SW1P 3GE

22 February 2011

Dear Mr Sherry

**Re: Initial Consultation on Gas Security of Supply Significant Code Review**

IUK welcomes the opportunity to participate in Ofgem's Initial Consultation on Gas Security of Supply Significant Code Review.

A key element set out in Consultation document is consideration of the incentives to import gas in the event of an emergency and to identify the likely barriers to attracting imports during a Gas Deficit Emergency (GDE). In our view, gas quality is likely to be a significant uncertainty to imports from Continental Europe during any GDE due to the lack of regulatory certainty to allow investment in the gas processing facilities necessary to bring European supplies within the UK gas quality standards.

This letter briefly summarises the position and highlights the need for regulatory framework to provide the stability essential to attract investment. The continued absence of investment will result in a technical barrier to gas flowing through the UK-Continent gas interconnector pipelines during times of emergency.

**Background**

The UK gas specification is narrower for one of its key components, the Wobbe Index, than that which is acceptable in Continental European countries. The result is that contractual and regulatory arrangements may constrain quantities of non-UK compliant gas currently flowing in Continental European gas pipeline systems from entering the UK.

New sources of supply to north-west Europe that are outside the UK specification are coming on stream, causing changes in flow patterns and significantly diminishing the flexibility to blend gas in Continental Europe in order to meet the UK specification. The new sources of supply do not require treatment facilities to enter the Continental European gas grid because they meet the specification for delivery to markets in Continental Europe. The situation is expected to deteriorate as the existing sources of supply from the UK continental shelf continue to deplete and possible replacement supplies fall outside the UK specifications. With alternative markets readily available within Europe, there is no incentive to treat gas from new sources before it enters the European grid, for example, at point of production.

The current market structure is likely to continue to result in there being insufficient treatment or blending capacity to meet UK pipeline gas import requirements through grid to grid connections. This contrasts with recently developed LNG import terminals where there is clear ownership of the gas quality issue and the costs of nitrogen ballasting is charged for within the access arrangements.

### **Consequences**

In our view, there is a real risk that, in an emergency, gas available in Continental Europe will not flow to the UK market through UK-Continent gas interconnector capacity because the available gas is outside the UK gas specifications.

The best means to ameliorate this risk has been under review for some time. Currently, the preferred UK regulatory solution continues to be that the market should be left to resolve this issue by, for example, investing in gas quality treatment capacity. To date, the market has failed to deliver a solution.

### **Fostering a Market Solution**

The reason for the absence of a solution provided by the market can be attributed to the current market arrangements. Participants for whom investment in gas treatment facilities is feasible lack incentives to do so because customers are not prepared to pay for the service or the potential investor otherwise cannot identify how an acceptable return on investment can be derived from such a facility. Some of the factors leading to the current impasse are summarised below.

- Shippers will not be incentivized to invest without (a) clear signals that identify the risk and consequences of interruption; and (b) the market arrangements containing measures to avoid any cost advantage accruing to non-investing shippers.
- Commingled streams make it impossible to attribute off-specification gas in the pipeline system to an individual shipper.
- A shipper of gas will not bear the cost of price spikes so sees the risk as easier for it to manage than the risk of investment in under-utilised treatment capacity; conversely, the buyer of gas has no direct liability for off-specification gas but price increases will be imposed indirectly on it by the market.
- The current regulatory framework does not deal with the economic regulation of gas quality treatment plant. Clarity is needed in the regulatory framework to enable investors and their financiers to understand any constraints on the terms which will be applied to use by shipper/investors of the capacity.

Continuing to await a solution from the current market arrangements does not appear to provide any assurance that the issue will be resolved in a timely manner or, indeed, at all.

IUK believes that the reasons for the absence of investment are structural and that regulatory action is essential to incentivize investment. Changes to the regulatory framework must address:

- who will pay for the costs of treatment;

- how to ensure a revenue stream to underwrite the investment;
- how costs will be targeted to avoid the potential unintended consequence of treatment plant *attracting* off-specification gas;
- how to ensure Continental European consumers do not incur costs for the benefit of UK consumers; and
- how to ensure that the necessary changes are enforced in any codes and contracts impacted by the change.

A solution to the UK gas quality issue will require multiple jurisdictions and interests to be taken into account. Implementing a technical solution will take several years to complete.

IUK recommends that the UK regulatory authorities, in conjunction with their European counterparts, engage with industry to develop a regulatory framework that addresses the key commercial uncertainties standing in the way of investment in gas quality treatment facilities for UK gas supplies. Otherwise, the continued absence of investment will result in a technical barrier to gas flowing through the UK-continent interconnector pipelines during times of emergency.

IUK does not consider this response to be confidential.

Yours sincerely,

**DARREN REEVE**  
Commercial Manager