49 York Place

Edinburgh EH1 3JD

Tel: 0131 550 3380

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Ofgem
GB Markets
9 Millbank,
London SW1P 3GE

gb.markets@ofgem.gov.uk

Andrew.Wright@ofgem.gov.uk;	Senior Partner GB Markets
Ian.Marlee@ofgem.gov.uk;	Partner GB Markets
Giles.Stevens@ofgem.gov.uk;	Head of Competition Economics
Peter.Sherry @ofgem.gov.uk ;	Senior Economist

Dear Members of the GB markets team,

Stag Energy response to the Gas Security of Supply Significant Code Review (SCR) Initial Consultation

Background to Stag Energy

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

Gateway 1 has received all necessary planning and consents and has completed the Front End Engineering and Design ("FEED").

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 December 2010 ten year statement (Appendix A), and 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.

Gateway 1 is the largest storage facility being developed by an “independent” – i.e. a company with no other related gas market interests.

Stag Energy is a member of the Gas Storage Operator’s Group (“GSOG”). GSOG is a trade association which was formed in May 2006 within the Society of British Gas Industries (SBGI). The group has seventeen members comprising almost all the active participants in the GB Gas Storage Market, and as such represents a wide range of interests. The group includes both established operators and developers of new storage projects, large multinational companies and smaller private ventures.

GSOG aims to speak with one voice in areas of common interest, ranging from taxation issues to regulations affecting data disclosure and access. However it should be understood by OFGEM that there are clear differences in view between GSOG members when it comes to major policy questions depending on whether the relevant storage company is;

1. An existing storage incumbent, or a new entrant which may potentially challenge an incumbent

2. Part of a wider integrated gas group with other interests in the gas chain, or a stand alone storage company.

Stag Energy approaches this consultation from the viewpoint of a new entrant stand alone storage company. We welcome the opportunity to contribute to the SCR on this individual company basis.

Criteria for assessing direction of high level policy

We agree with two key points made by Ian Marlee in his Launch Statement letter dated 11th January 2011 that this SCR is now urgently necessary because:

- Project Discovery has concluded that current GB gas market arrangements do not provide adequate protection against low frequency but potentially catastrophic gas supply events.

- The EU Gas Security of Supply Regulation entered into force in December 2010. (Appendix B). DECC, will need to be able to clearly demonstrate compliance with this Regulation, having notified the EU Commission that it is the competent authority.

We think it therefore directly follows that the criteria for design of potential new measures should focus on how quickly and cost effectively they deliver the level of assured security deemed necessary by DECC.

In this context, considerations as to whether measures “work with the grain of the market” or whether customers receive appropriate compensation are surely of secondary importance and more subjective in character.

The EU Regulation prefers "market based solutions" but we understand this to mean measures involving monopolist state or system operator roles are to be avoided. Public Service Obligations (PSO or so-called "supplier stocking arrangements") based on supplier shares obtained in competitive markets are the storage regulatory norm in mainland Europe and are interpreted as a market based solution.

Customer representatives (EIUG and MEUC) stressed in both the SCR workshops and at the SCR closing seminar on February 9th that a secure gas supply was a question of business survival for some of their members. Consequently they were not interested in compensation schemes as part of a less reliable gas supply.

We also understood from OFGEM statements made both at the closing seminar and to a GSOG meeting on February 17th that additional storage could be incentivized by movements in the gas curve resulting from possible balancing market changes, but this traded market process was necessarily unpredictable regarding both timing and degree of effect.

We therefore think that the degree of uncertainty around the final effect of balancing changes may not make this route fully compatible with the EU security directive. We understood from comments at the GSOG meeting that DECC has already taken legal advice on this point, so we believe it would be helpful if this advice is made generally available.

Pros and cons of balancing market changes versus a PSO

The SCR consultation broadly considers two paths for change. It has a "primary focus" on changes to the balancing mechanisms in Chapter 3, but also examines possible PSO models in Chapter 4.

It is not clear to Stag Energy whether OFGEM considers these paths to be mutually exclusive, or indeed why OFGEM has already concluded that changes to the balancing mechanism should receive a "primary focus."

GSOG does not consider these two paths to be mutually exclusive. In fact there is a limited PSO already in place which was transferred from supplier to transporter licenses in 2007 following a DECC consultation. Clearly there is a case for revisiting this transfer and reassessing the scope of the existing PSO as complementary to anything that may be changed with respect to balancing rules.

We therefore think it helpful to step back from the detailed implementation aspects of the questions raised in Chapters 3 and 4 and first consider the strategic issues which lie behind the consultation.

We would like to understand whether OFGEM considers the object of the SCR is to promote more storage, or whether it has no specific view on the need for more storage per se. We note that the Minister, as competent authority, stated on December 10th 2010 [(1)];

> The Government believes that, by increasing shippers' exposure to the cost of gas supply interruption, such changes will help underpin commercial demand from shippers for gas supply infrastructure, including gas storage facilities. In addition, of course, individual gas storage projects are keen to gain "first mover advantage". Together, these two drivers are helping to push a number of projects towards Final Investment Decisions.

No measure can be guaranteed to deliver 100 per cent supply security. However, by its very nature, a PSO is ***guaranteed*** to produce a level of storage depending on how it is set.

It is also clearly the case that multiple storage projects within local GB jurisdiction deliver a better quality of security than, for example, flexible supply contracts subject to force majeure or commercial non performance, or the vagaries of international spot LNG markets.

To be meaningful, we also think the value of security needs to capture the whole supply chain – i.e. society as a whole, rather than immediate gas customers. A "low margin" gas consuming activity may well be performing a vital public service.

Multiple and geographically distributed storage enhances the gas distribution systems (NTS and LAN) resilience. Most major historic supply interruptions in GB have arisen from domestic infrastructure failure rather than physical availability of gas.(2) It is difficult to see how balancing changes address this point, or how the consequent penalties can be fairly allocated to those ultimately responsible.

We conclude that if the SCR is to place a sole emphasis on balancing reform rather than a PSO it follows that balancing reform should be safely judged to deliver both the same level of security as a PSO, and at a lower cost. Balancing changes should not be prioritized as a sole measure if the level of security they deliver is uncertain and/or their associated costs are unclear.

DECC, and its predecessor department DBERR, have already considered the respective merits of balancing changes and enhanced PSOs in papers they published in 2007 and 2010.

DECC/DBERR also commissioned OXERA and Poyry to perform financial evaluations. Both consultants concluded a PSO to be more cost effective than balancing changes and these reports remain available on the DECC website. We are therefore surprised that the industry is invited to revisit this topic seemingly afresh and that this extensive body of work, directly commissioned by DECC is not included in the consultation.(3)

Stag Energy considers itself to have expert knowledge as to why new storage investment is not taking place in the GB market. This is because we have recently been in detailed dialogue with a wide number of potential investors in new storage.

Balancing market changes and a PSO are both measures designed to address a perceived market failure; despite known future rapid import growth and more volatile gas consumption patterns resulting from the growth of renewables, there is no storage investment signal in the current GB gas market forward price curve. We believe a summer/Q1 price differential above approximately 27.5 pence/Therm is needed to provide such an incentive, based on the latest public domain information on the costs of new storage construction.

There are two main non market barriers to storage; planning and regulatory;

Stag Energy believes central and local government planning regulations are currently blocking approximately at most 8% of the 18.5 bcm of potential projects, mainly onshore.

Regulatory uncertainty could be blocking up to a further 25% of the potential projects. Where price uncertainty and regulatory uncertainty begins and ends is less obvious than the clear cut planning issue, but they have a negatively reinforcing effect on decision makers.

This major regulatory uncertainty now arises around OFGEM's implementation of the EU third package with regard to "unbundling", requiring free third party access to storage (or "TPA") and potentially associated pricing limits. According to recent press statements this implementation appears to be inhibiting investment by large vertically integrated companies such as Centrica [(4)] which view storage as an integrated part of their whole gas chain activity.

Stag Energy considers unbundling is more logical in most European markets where the PSO norm enforces a guaranteed throughput, but without this guaranteed throughput it is a significant disincentive to many investors. We made this point in our previous letter on the subject of TPA to Ian Marlee of OFGEM on 12th December 2010.

We therefore take the view that there needs to be close linkage in timing, and a coherent approach, between the SCR and OFGEM's current work on unbundling and TPA. We reiterated this point at the GSOG meeting with OFGEM and DECC on February 17th.

In this regard we were encouraged by what we thought Andrew Wright of OFGEM said at the SCR closing seminar; we understood he remarked that care should be taken that our gas market rules do not get too out of line with Europe.

In our view the paramount problem remains the absence of a price signal for the bulk of the potential new projects. This is demonstrably the case in that most of the projects were initiated during the period 2005 to 2008 when the forward price signal was present, and all appear to have stalled now that this signal has disappeared.

There are a number of opinions as to why the GB market forward price curve differential has weakened, albeit the absolute annual average gas price has remained unchanged and comparatively high. Some consider it to be a fundamental structural change signaling a lower need for storage, others that it is a temporary feature driven by the marketing practices of a limited number of large importers. We would urge OFGEM to develop an informed independent view on this market behavior question to assist its considerations.

Storage projects are high risk (technically and commercially) and entail major expenditure and commitment of resources on the part of developers over a number of years. Financing is exclusively from the private sector and the projects must compete for funds with other potential investments (often in other jurisdictions) where risks and rewards may be more attractive.

Therefore there needs to be consistent and strong price signals over a number of years to incentivize a significant number of new storage projects.

We find it difficult to understand how balancing market changes on their own will produce such a prolonged and significant signal because, until there is an actual supply failure, gas traders will find it impossible to price in such risk – a good parallel is perhaps the banking crisis of 2008. Nor do the forward gas markets have the degree of time granularity necessary to capture such short term volatility.

Stag Energy's views on some of the more detailed specific questions posed at the end of Chapters 3

Most of the balancing market issues appear from the Minutes to have been well reviewed in the workshops.

We understood NGG to clearly state at the closing workshop that they were neither equipped for, nor wished to conduct, the role assigned to them under Options 2 and 3 of the Emergency Arrangements. Option1 simply appears the most practical for this reason alone.

We agree with the Major Energy User's Council ("MEUC") that a single Value of Lost (gas) Load ("VOLL") cannot be fair to the wide range of customers who may be affected by an interruption. The MEUC presentation to the SCR closing seminar revealed that a range of VOLL between £2.00 and £52.00/Therm had been discussed without a clear conclusion.

The paradox is that levels of VOLL which fairly reflect customer costs and may have an impact on security will probably raise credit costs and potentially bankrupt small shippers. We would suggest OFGEM approaching the insurance industry before making any decisions such as capping VOLL. We were disappointed to see the possibility of capping VOLL already being contemplated in the OFGEM closing seminar slide pack which we feel is somewhat counter intuitive to the whole exercise.

Stag Energy's views on some of the more detailed specific questions posed at the end of Chapters 4.

Stag Energy understands that PSOs are already in place in the majority of European countries so it would be useful for OFGEM to exchange views with their other regulatory colleagues regarding some of these implementation points. We think the countries most relevant to GB are the Irish Republic, France and Spain.

It would also be helpful to study how these countries are approaching the Security Directive, as well as the Third Package before coming to final GB conclusions, to help consistency across the EU.

Stag Energy advocates that, as a minimum, decisions should be made about a GB PSO design framework (or rather modifications to our current existing PSO) now as part of this SCR exercise. Agreeing the framework gives OFGEM the ability to put an enhanced PSO in place more rapidly in the future if it is believed that security has not been achieved through balancing changes. This has the advantage of;

- saving time in the event it is decided an enhanced PSO is needed. Storage projects have lead times typically >3 years
- contributing to a coherent balancing design
- informing market participants of the potential direction of regulatory travel, so reducing regulatory uncertainty regarding storage commercial decisions.

A PSO does not preclude the implementation of other security measures such as balancing changes and need not be increased from current levels if these other security measures prove effective. In this regard we are pleased to note OFGEM state; “Enhanced obligations remain on the table” (January 18th SCR opening seminar slide 8) and “various combinations are possible” (slide 13).

Stag Energy considers that the PSO should be;

- based on previous years (ex post) sales, so it is not unduly market distortive
- applied to all gas shipped from the notional NBP to NTS exit points, i.e. all gas which has an exit nomination. This approach would apply to all suppliers and some shipper sales.
- removed from the transporter license where the existing PSO currently resides and set at the current level through individual shipper and supplier licenses and only progressively increased if OFGEM considers security targets are not being met.

OFGEM should also consider whether a transparent target is set for a minimum increase in the level of gas storage capacity within UK jurisdiction, akin to the December 2010 DECC electricity capacity margin proposals.

We hope that you have found these comments useful and please do not hesitate in contacting us if you wish to discuss the response further.

Yours faithfully,

Mark Rigby

Commercial Director

Appendix A - List of Projects NGG TYS - Dec 2010

NGG TYS - Dec 2010

Facility	Investor	Type	Space (bcm)	Onshore/Offshore
Operational			4.55	
Rough	Centrica Storage	Reservoir	3.50	Offshore
Hornsea	Scottish & Southern	Salt	0.30	Onshore
Humbly Grove	Star Energy	Reservoir	0.30	Onshore
LNG	NGG	Tankage	0.20	Onshore
Hatfield Moor	Scottish Power	Reservoir	0.10	Onshore
Holehouse	EdF	Salt	0.05	Onshore
Aldbrough	SSE Statoil	Salt	0.10	Onshore
Under Development			0.95	
Aldbrough	SSE Statoil	Salt	0.25	Onshore
Holford	EOn	Salt	0.20	Onshore
Hill Top Farm	EdF	Salt	0.10	Onshore
Stublach	GdF	Salt	0.40	Onshore
Consented			10.08	
Gateway	Stag Energy	Salt	1.52	Offshore
Bains	Centrica	Reservoir	0.60	Offshore
Hewett (Deborah)	ENI	Reservoir	4.60	Offshore
Stublach 2	GdF	Salt	0.25	Onshore
British Salt	British Salt	Salt	0.20	Onshore
King Street	NPL	Salt	0.20	Onshore
Aldbrough 2	SSE Statoil	Salt	0.35	Onshore
Whitehill	EOn	Salt	0.42	Onshore
Portland	Infrastrata	Salt	1.00	Onshore
Hatfield West	Scottish Power	Reservoir	0.04	Onshore
Caythorpe	Centrica	Reservoir	0.20	Onshore
Saltfleetby	Wingas	Reservoir	0.70	Onshore
Application			2.40	
Baird	Centrica Storage	Reservoir	2.20	Offshore
Albury 1	Star Energy	Reservoir	0.20	Onshore
Yet to Submit			6.10	
Gateway 2	Stag Energy	Salt	1.50	Offshore
Esmond Gordon	Encore	Reservoir	3.40	Offshore
Fleetwood	Halite Energy	Salt	0.50	Onshore
Albury 2	Star Energy	Reservoir	0.70	Onshore
Total			24.08	

Consented plus Applied plus Yet to Submit	18.58
Having Planning Issues	1.40
Percent affected by Planning	7.5%

Appendix B - Security of gas supply in the EU

The new legal framework

On 12 November 2010 the new Regulation (EU) No 994/2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC is published in the Official Journal of the EU and enters into force on 2 December 2010. Based on the lessons drawn from the Russian-Ukrainian gas crisis of January 2009 the new legislation will strengthen the prevention and crisis response mechanisms.

In the framework of the internal energy market, the Regulation will ensure that Member States and gas market participants take well in advance effective action to prevent and mitigate the potential disruptions to gas supplies through new rules to:

Identify risks to security of gas supply through the establishment of a risk assessment;

Establish preventive action plans and emergency plans to address the risks identified;

Ensure gas supplies to households and a range of protected customers for at least 30 days under severe conditions;

Ensure a European approach with a well defined role of the Commission and of the Gas Coordination Group including mechanisms for Member States' cooperation, in a spirit of solidarity under EU law, to deal effectively with any major gas disruption;

Put in evidence a regional approach on security of gas supply measures;

Create transparency of all emergency measures and public service obligations relating to security of gas supply and enhance exchange of information on gas contracts;

Allow the market players, i.e. gas suppliers and transmission system operators, to secure supplies for as long as possible and ensure that the right measures are taken by the competent authorities of the Member States, in a coordinated way at regional and EU levels, in case market measures alone are no longer sufficient.

Enhance flexibility of the gas infrastructure to cope with the disruption of the single largest gas infrastructure (N-1), including enabling bi-directional physical capacity on cross-border interconnections where this enhances security of gas supply;

The realization of projects which can substantially enhance the flexibility and security of gas supply and better interconnect all EU Member States, in particular the isolated systems, has already started. In 2010/11 the European Energy Programme for Recovery (EEPR) supports the construction of 31 gas infrastructure projects with 1.39 billion. Learning from the lessons of the January 2009 gas crisis, the EEPR importantly supports projects for reverse flow in 9 Member States with around 80 million Euros and gas interconnectors with around 1.3 billion Euros, including new import pipelines.

References

1) Letter from Charles Hendry MP to John Pearson, MD AMEC Group, Europe and North Africa December 10th 2010.

2) Professor Jonathan Stern , Director of Gas Research, Oxford Institute for Energy Studies, SGBI, GAS 2009 Conference, Loughborough, November 5th, 2009.

3) DECC conducted a consultation in from October 2006 to May 2007 on gas security of supply where they indentified a number of measures which could enhance security, including changes to the balancing mechanism and a PSO. Most major supplies and shippers made written public contributions to this consultation. DECC also commissioned OXERA to evaluate the impacts of each of these same measures and the OXERA report dated May 2007 is available on the DECC website www.berr.gov.uk/files/file38980.pdf. DECC then published a policy statement in April 2010 revisiting the very same measures again which had been considered in the OXERA report.www.decc.gov.uk/.../decc/.../uk%20energy%20supply/.../gas.../1_20100512151109_e_@@_gassecuritysupply.pdf DECC did not put their April 2010 policy statement out to consultation because of the imminent election. However the industry used the subsequent July 2010 DECC consultation on the Implementation of the EU Third Internal Energy package to comment extensively on the DECC April 2010 gas security policy statement. As part of this same exercise DECC also commissioned Poyry to evaluate the impacts of each of these same measures, (i.e. repeating the study already performed by OXERA in 2007) and this was published by DECC in July 2010. www.decc.gov.uk/assets/.../uk%20energy%20supply/.../gas.../114-poyry-gb.pdf]

4) Centrica results statement, 28th July 2010. *www.upstreamonline.com/live/article223854.ece*