

27 March 2015

Alena Fielding
Gas Transmission
Ofgem
9 Millbank
London SW1P 3GE

Dear Alena

Consultation on the Gas Transmission Charging Review

South Hook Gas (SHG) is grateful for the opportunity to respond to the consultation in respect of the gas transmission charging review published on 30 January 2015 (Consultation), which is of critical importance to SHG's LNG importation activities.

SHG manages and owns the primary capacity at one of Europe's largest LNG terminals, the South Hook LNG terminal located at Milford Haven in South Wales (Terminal). Our principal role is to handle LNG cargo deliveries from the Qatargas 2 project in Qatar but we also seek to maximise the use of the Terminal capacity. Commercial operations commenced in April 2010 and since then SHG has supplied natural gas into the NTS every day. SHG has regularly acquired long-term capacity in allocation auctions since 2004, with this considerable investment demonstrating its long-term partnership with the UK.

Answers to specific questions:

Chapter 2

Question 1: What are your views on our proposed changes?

While SHG notes Ofgem's concerns relating to a reliance on commodity charges to recover NGGT revenue, SHG does not believe that the proposed changes represent an equitable means of achieving Ofgem's aims for the reasons set out in this response.

As a general point, SHG is concerned that the proposals set out in the Consultation are shaped, to a material degree, by the outcomes generated by Ofgem's model, a model which Ofgem acknowledges should only be relied upon to provide directional indicators. Like Ofgem, we do not believe that the model is sufficiently robust to generate accurate outputs (please see our responses to Questions 1 and 2 of Chapter 3 below). In summary, we do not consider it appropriate that the model should form the basis for such significant changes to the existing capacity charging methodology.

Additionally, SHG recognises that, as indicated in paragraph 1.9 of the Consultation, this review is to a large extent driven by the development of the TAR NC. SHG does not see the rationale for considering the proposed radical changes to capacity charges when discussions at the EU level have not concluded. If changes of this magnitude were to be necessary, SHG would expect clear and final direction to have first been given at the EU level and would expect that these changes would apply at Interconnecting Points only.

SHG has identified the following specific issues with the proposal:

- 1. Disproportionate detrimental effect on flexible sources holding long-term capacity**
- 1.1 SHG believes that there are three 'classes' of capacity holders:
 - 1.1.1 Users who have flat delivery profiles or who can profile their bookings on a daily basis;
 - 1.1.2 Users who historically booked incremental or long-term maximum capacity and cannot mitigate against the imposition of a floating charge; and
 - 1.1.3 Users who will have to book long-term incremental capacity in the future.
- 1.2 The distributional effects of the proposed changes may be beneficial to those Users in paragraph 1.1.1 above but will be acutely detrimental to that class of Users who are required to buy long-term capacity due to the mechanics of the incremental capacity process. Such disadvantaged Users have to buy their peak supply level for an eight year period, and cannot profile their holdings. Users who have booked historical incremental or long-term maximum capacity will not have the means to mitigate the impact of the imposition of a floating charge.
- 1.3 The level of LNG imports into the SHLNG terminal is variable, being largely a function of the wider LNG market and its interaction with the local GB gas market. SHG does, however, seek to ensure that it holds adequate entry capacity in the

event that the full regasification capacity of the terminal is required. Therefore since 2004 SHG has regularly participated in the QSEC auctions to provide a signal to NGGT of its requirement for capacity. As a result, SHG currently holds long-term capacity out to 2030.

- 1.4 Having a flexible source of supply and holding long-term capacity, SHG falls into the class of capacity holders in paragraph 1.1.2 above. SHG feels that the introduction of fully-floating charges will result in these flexible, long-term capacity holders, such as SHG, paying significantly higher charges than were previously anticipated. It is indisputable that this class of users is particularly affected by the proposed changes. SHG's own analysis of publicly available data on booked capacity suggests that LNG importers hold the largest volume of booked capacity on an ASEP basis (once exempted medium range storage is discounted).
- 1.5 SHG has participated in long-term auctions in order to mitigate the risk of downwards rebasing at its proximate ASEP. This position originates from NGGT's previous downwards rebasing of ASEPs based on booked capacity, either through a periodical review of baselines or substitution between ASEPs. The booking of long-term capacity has also been encouraged by NGGT. As a result, SHG has made considerable investments in long-term capacity and would therefore be concerned if there were an indication that SHG would be commercially prejudiced by virtue of having taken this approach.
- 1.6 For the reasons outlined above, SHG believes that the implementation of fully-floating charges will result in a charging regime that is discriminatory against long-term capacity holders with flexible assets.

2. Security of supply

- 2.1 As with other LNG receiving terminals in GB, the volume and rate of LNG imports via the Terminal will largely depend on the prevailing price in GB.
- 2.2 Where significant investments have been made in the GB market, those investors require assurance that there is sufficient capacity available to realise value from that investment. Investors who have sought assurance of capacity availability, including SHG, may not be able to "amend...behaviour and mitigate adverse effects" (as suggested in paragraph 4.26 of the Consultation) upon such a material change to the capacity pricing methodology.
- 2.3 LNG is vital for GB security of supply, but increasing costs in the GB market make future supplies uncertain. The suggested fully-floating capacity charges will

effectively increase the cost of delivering LNG into GB at a time when global regasification capacity is increasing. The result could be that GB becomes a less attractive market for LNG, and that in turn will impact cross-border trade in LNG and thereby security of supply.

- 2.4 In paragraph 4.6 of the consultation document, it is stated that “fully-floating capacity charges may result in lower transaction costs for cross-border trade in gas. This can help to better facilitate the security of gas supply”. SHG disagrees with this assertion as it appears to neglect trade beyond the GB/Continent interconnectors. This proposal appears to directly and disproportionately impact LNG suppliers, being the class of capacity users that most typically require long-term capacity on a flexible basis and that are a key driver of cross-border gas trade.
- 2.5 In summary, SHG believes that the imposition of fully-floating charges will result in flexible long-term capacity holders scaling back their acquisition of long-term capacity, which in turn will reduce the flexibility of their facilities and may result in a reduction in LNG imports into GB, adversely affecting both security of supply and GB consumers. The impact of the proposed introduction of fully-floating charges and the willingness of the regulator to impose significant and unforeseen incremental charges unilaterally on existing market participants will also need to be factored into any investment decision by project sponsors of new or expanded infrastructure, thereby potentially discouraging future investment and undermining security of supply.

3. Transparency of policy

- 3.1 A stable regulatory environment is a critical component of any major gas supply project. SHG feels that any change to the charging methodology which has such significant effects on certain classes of users as the current proposal will undermine regulatory stability and thereby adversely affect investor confidence.
- 3.2 SHG has regularly participated in long-term capacity auctions to provide the correct signals to NGGT. SHG are concerned that a purchaser of long-term capacity could be financially penalised as a result of actions it undertook to give the correct signals to NGGT.
- 3.3 SHG also believes that this unilateral change to the charging methodology undermines the transparency of the capacity allocation auction process and this risk of re-pricing will need to be factored into any decision to participate in a future auction. SHG believes that the imposition of such significant and unforeseen incremental charges may deter future investors in GB gas infrastructure.

3.4 At paragraph 2.4 of the Consultation, Ofgem has provided two reasons why fully-floating capacity charges would not reduce auction price transparency, namely:

3.4.1 *"Currently, the price a user ultimately pays is not fixed, but is increased significantly by the addition of the variable commodity charge. This trend is likely to continue [...]".*

SHG feels that the imposition of these additional charges on capacity, rather than flows, adds a secondary layer of pricing uncertainty. SHG believes that this would make the auction pricing equally or potentially more opaque.

3.4.2 *"[The] effectiveness of price discovery (ie ensuring that, where existing entry capacity is scarce, those users who value the capacity most get it) in the existing auctions is questionable, given the presence of significant surplus capacity."*

If effective price discovery is only possible "where entry capacity is scarce", SHG believes that the imposition of fully-floating charges will not resolve this situation as SHG expects that this would only result in there being greater surplus long-term capacity in future auctions.

3.5 This proposed unilateral change in charging methodology was one of the principal reasons why SHG did not participate in the 2015 long-term capacity allocation auction.

4. Conclusion

4.1 On the basis of the above concerns, SHG strongly recommends that Ofgem does not adopt the proposals for fully-floating charges.

4.2 Without prejudice to the above, SHG does support the proposed reduction in the discount to short term capacity bookings, which SHG believes will ensure a fairer allocation of costs and improved recovery of historic costs, without impacting security of supply in GB.

Question 2: Do you agree with our rationale for rejecting the alternatives? If not, please explain why.

No comment.

Chapter 3

Question 1: Do you think we have identified the relevant quantitative impacts?

1. As a general note, due to the number of assumptions and variables which could influence the final result, it is difficult to fully quantify the exact outcome of the proposals. SHG feels that, while the model that informs the proposed changes to the charging methodology may be “relevant” (per paragraph 3.1(3) of the Consultation), it is not to be relied upon as a basis for making these proposals.
2. SHG also believes that certain key inputs into the Ofgem model are incorrect, materially impacting the results obtained and the proposed changes based on this model. Specifically, SHG notes that the bookings attributed to SHG are incorrect. Additionally, the model forecasts no revenue from Milford Haven, despite SHG having already booked long-term capacity to 2030. We would be pleased to discuss this in greater detail with Ofgem.
3. In terms of the identification of the relevant quantitative impacts, SHG does not believe that the potential impact of the proposed changes on either the increased cost of flexibility or price volatility has been assessed.

Question 2: Do you think we have modelled the impacts appropriately?

4. As stated above, the model provided and used by Ofgem in the impact assessment is based on a large number of assumptions and variables. As such, it should not be relied upon to inform decisions.
5. Moreover, as noted above, SHG believes that certain key inputs into the Ofgem model are incorrect, materially impacting the results obtained and thereby the proposed changes based on this model.
6. We would note that the outputs of the Ofgem model do conform with our expectations in some respects, particularly that the introduction of fully-floating charges will be detrimental to flexible users who have committed to long-term capacity.

Question 3: Do you think we have identified the relevant qualitative impacts?

7. **Improved efficiency of network use**
 - 7.1 We see little evidence that the introduction of fully-floating charges would improve the efficiency of network use.
 - 7.2 Regardless of the charging regime, capacity bookings will never provide a completely accurate forecast of flows. Flows are dynamic and will vary in

response to a number of variables, be they market related or due to physical events.

- 7.3 It seems likely that the proposed regime will encourage users to reduce the amount of long-term capacity they book and instead rely on short-term capacity to reduce the risk of paying high charges for capacity booked but not used. SHG believes that such a general reduction in the acquisition of long-term capacity will prevent the efficient recovery of historical costs by NGGT.

8. Promotion of security of supply

- 8.1 SHG considers that the proposed charging arrangements will adversely affect security of supply as it will effectively increase the costs of entering the GB market. We do not believe that Ofgem has fully considered the impact of these proposed charging changes on future investment, LNG deliveries and sources of flexibility and the knock-on effect on security of supply.
- 8.2 Investors put a great deal of stock by regulatory stability. SHG believes that any move by the regulator to unilaterally change the price of an already contracted product, which is a key component to an investment, will not be welcomed by investors. This uncertainty risks making GB a less attractive place to invest, further impacting security of supply.

Chapter 4

Question 1: Do you agree with our assessment of how our changes would align with our principal objective and statutory duties?

1. As stated above, we believe that the fully-floating charging proposal will prejudice LNG importers above all other capacity users and will have a material adverse impact on GB security of supply. In turn, this may result in reduced liquidity and greater volatility in the GB gas market. It is not clear to SHG how these aspects of the proposals can be argued to be consistent with Ofgem's obligation under s.4AA(5)(c) of the Gas Act 1986 to secure a diverse and viable long-term energy supply.
2. Contrary to the assertions in paragraph 4.10 of the Consultation, we believe that competition will be impaired by the proposed changes for the reasons summarised in paragraph 1.2 to the response to Question 1 of Chapter 2:

- 2.1 The distributional effects of the proposed changes may be beneficial to some users (users who have flat deliveries or can profile their bookings on a daily basis) but will be acutely detrimental to that class of users who are required to buy long-term capacity due to the mechanics of the incremental capacity process.
- 2.2 Such disadvantaged users have to buy their peak supply level for an eight year period, and cannot profile their holdings. Users who have historically booked incremental or long-term maximum capacity will not have the means to mitigate the impact of the imposition of a floating charge.

Question 2: Can you provide any evidence that supports or would contradict our assessment against one of more of them?

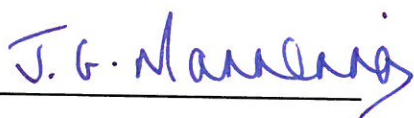
We believe that there is little value in providing any response to this query before a more robust impact assessment on all capacity holders has been developed and agreed which enables the actual outcomes of the proposed changes to be reliably determined. SHG therefore reserves its rights to respond on this query at such later date.

Question 3: Do you think there are other duties or aims that we should assess these changes against? If so, what are your views on how our changes might affect them?

No comment.

We hope that these responses are of assistance.

Yours sincerely



Jeffrey Mannering

Acting General Manager

South Hook Gas Company Ltd.