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27 March 2015

Dear Sir/Madam

Re: Gas Transmission Charging Review – Ofgem's policy position on future entry capacity charging arrangements

PETRONAS Energy Trading Limited ("PETL") welcomes the opportunity to comment on the policy position and associated impact assessment.

PETL feels that the suite of proposed changes set out in the policy position have not been fully justified by Ofgem. In particular, we are concerned that the proposal to introduce floating capacity charges will impose unwarranted costs and create User inequality. We will explore these effects later in this response.

PETL appreciates that Ofgem has provided a number of justifications for the changes but at the same time we feel that other policy objectives which are as equally valid have not been fully considered. For example; regulatory stability, contractual certainty, User equitability, gas security and a low cost of implementation are all important objectives which we feel are yet to be considered by Ofgem.

To assist Ofgem in assessing the full impact of the proposed changes, we have looked at the relevant justifications and/or objectives and provided our observations regarding the suitability of the policy position in furthering their achievement. The list contains justifications and/or objectives presented by Ofgem in its consultation documents, as well as those PETL has identified as being of relevance to the GTCR.

1. Inefficient allocation of historical costs

The combined change of increasing short term reserve prices and applying a floating capacity charge will, to some degree, result in Users making a greater contribution to historical costs. This would also be the case if short term reserve prices were increased in isolation. PETL suspects, however, that the focus given to the historical costs argument by Ofgem is not proportionate.

PETL believes that it is not correct to say that allocation of allowed revenue to a specific capacity period (which can be as short as a day) is an accurate allocation of previously incurred historical costs. Allowed revenue is, as the term indicates, a level of earnings granted to National Grid NTS to maintain the network and earn a

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permitted rate of return. It reflects an array of costs, some of which are historical and others which are current, as well as numerous incentives designed to secure efficiency in the delivery of service.

Furthermore, as the aggregate allowed revenue is required to be distilled down into daily increments, to ensure that the daily capacity product is consistent with the "route to revenue recovery," the link between historical costs and User contribution is further weakened. On this basis, it is quite a leap to claim that the policy position will result in a more efficient allocation of historical costs.

2. Low cost, or free capacity has led to overbooking.

In an unconstrained network, PETL does not understand why this causes any problems for the market or National Grid. In terms of the market, the ability to procure additional, low-cost capacity should be viewed as securing an option to flow, potentially at short notice and in response to a market price signal. Such strategies produce favourable outcomes for the market and customers and should not be discouraged by "fixes" to the charging regime.

For National Grid, we cannot see any strategic or operational advantages which it would obtain from reduced capacity bookings. In terms of network planning, short term bookings can only be relied upon to provide short term signals. The recently introduced PARCA arrangements provide a robust basis for informing network investment. The day to day operation of the network will continue to be managed on a dynamic basis, ensuring that ever-changing demands are supplied in the most effective manner.

Short-term capacity bookings will not, in our opinion provide National Grid with any additional, useful information as: a) the products represent only a potential end of day volume; and b) they do not vary to reflect dynamic, within-day flows.

3. Lack of price signals with a zero-priced product

This point is correct, but only in relation to the reduction in the discount associated with the short-term capacity product. As with the commodity charge, a floating capacity will dilute the locational price differences. That being said, similar to the points raised above, the reinforcement of locational price signals is of little significance in an unconstrained network.

4*.* Detrimental to trade, or at least undermines price arbitrage between GB and Belgium

The "premium" which is applied to the basic capacity product to ensure revenue recovery is understood to be the main impediment to imports. Any reduction in the short term capacity discount will remedy this problem, to some degree, but will not entirely remove it. There is little difference between a capacity based revenue recovery mechanism with one based on commodity, and for this reason we see little advantage in introducing such a significant change to this element of the charging mechanism. Furthermore, if the scope of the analysis is broadened to include other import entry points, such as LNG terminals, it could be argued that the overall increase in costs for such capacity holders would be detrimental to trade in global LNG markets and, by extension, detrimental to LNG imports. Based on recent experience, entry capacity utilisation at LNG facilities has been low and, if this trend continues, a floating capacity charge would inflate the unit cost of capacity at these points.

5. Potentially inconsistent with the EU Tariff Code

As the EU Tariff Code is yet to be finalised, PETL is not sure this is a valid justification as there may be further changes to the Code. We would like to see DECC continue to press for tariff arrangements which permitted the continuation of the GB approach to transmission charges beyond the date of Code implementation to ensure the stability and certainty we have set out in paragraphs 6 and 7 below.

6. Regulatory stability

Having a consistent regulatory regime is an essential foundation of an effective market. Regulatory intervention should only occur when there is a clear market failing which results in undesirable outcomes. In particular, the regulator should be mainly concerned where a market failing has a detrimental impact on consumers. In this case, there is no evidence of a market failing, nor any detriment to consumers and it is difficult to justify an overhaul of the charging arrangements purely on the basis, of what it seems to boil down to, an alleged misallocation of historical network costs.

7. Contractual certainty

As with our points raised in point 6 above, markets can be undermined if market participants cannot rely on contractual certainty particularly with regard to charging mechanisms. In the case of entry capacity, Users like PETL have purchased long term products on the basis of a regime which was in operation at the time the contract was struck. In the case of PETRONAS' involvement in the Dragon terminal, the investment, including a commitment to long term capacity, was made on the basis of the existing regime. Similarly for some Users, there would have been no option but to purchase long term capacity in order to pass the NPV tests necessary to trigger the release of incremental capacity. A decision to radically change a charging mechanism, which will have varying impacts on Users, should not be taken lightly and certainly there must be an overwhelming justification to support such a change. There should be a concern that the application of a floating capacity charge will not only undermine the basis upon which the contract to purchase capacity was struck, but also provide a deterrent for any future long term purchases.

While PETL believes the floating capacity charge would not benefit Users or customers, it feels that if the charge was introduced, Users who have committed to long term capacity should have the option to surrender existing capacity commitments.

8. User equitability

The proposed change will create different classes of Users, with those most impacted being long term holders of capacity, with low levels of utilisation. The absolute impact is unknown, as Ofgem correctly states that the model cannot be relied upon to produce precise outputs, but it is clear that, relative to the current arrangements, the relative costs will increase. Again, the unintended consequences of the proposed changes must be properly understood and assessed against the benefits which the proposed changes are intended to provide.

9. Gas Security

Although there cannot be any realistic expectation that the policy position will have any material impact on gas security, it should be understood that the addition of costs on certain Users, such as those holding capacity at

LNG entry points, may reduce the arbitrage value for marginal volumes of gas. In light of the views expressed under point 4 above, there is no evidence to suggest that the changes will enhance GB gas security of supply.

10. Low cost of implementation

We are not sure that Ofgem has addressed the issue of cost of implementation in the publications. There will be a cost of implementation and we suspect that the systems changes necessary to support the change will not be insignificant. Notwithstanding these costs, it would appear that the non-application of the floating charge to storage related entry capacity will provide a number of challenges.

The main areas of complexity, in this regard, relate to those facilities which are in operation, or under development and share an entry point with another non-storage source of supply. Based on the industry experience of attempting to split the Bacton ASEP to accommodate the EU CAM Code, there should be an expectation that any future ASEP splits will be complicated and not without cost. Ofgem must assess the overall benefits of making the change, which we believe to be minimal, if at all, as well as the costs which the industry and, ultimately customers, will incur.

In conclusion, PETL does not believe that the implementation of the policy position would produce any net benefits to the GB gas market and feel the proposals do not generate any benefits for GB customers.

In our response, we have attempted to identify the issues and policy objectives which we believe Ofgem should consider before making a change to the current charging mechanism. We hope that it provides Ofgem with some useful points of reference and will help inform its final decision. If you have any questions regarding our response, then please feel free to get in touch.

Kind regards,

Joe Burfitt

Head of Legal and Compliance

PETRONAS Energy Trading Limited