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2 May 2018

Oil & Gas UK response to the Ofgem RIIO2 Consultation

About Oil and Gas UK

Oil & Gas UK is the leading representative body for the UK offshore oil and gas industry with over 350 members. Our aim is to strengthen the long-term health of the offshore oil and gas industry in the United Kingdom by working closely with companies across the sector, governments and all other stakeholders. We, on behalf of our members, appreciate the opportunity to feed into Ofgem's approach to the RIIO-2 price controls.

The oil and gas sector is a UK industrial success story, supporting some 330,000 jobs (direct, indirect and induced) across the UK. The industry is a centre of excellence and expertise for offshore technologies and subsea engineering and has supply chain exports worth £12billion per annum to the UK economy. The oil and gas industry not only makes a vital contribution to the economy and the UK's security of energy supply, but it also possesses significant opportunity to help achieve the UK's climate change targets.

This response largely concentrates on issues relating to the gas transmission network which has the most direct impact on Oil and Gas UK members. Where appropriate, comments are also provided on some overall regulatory principles and market design issues. The responses are grouped by each Chapter of the consultation

General Issues

Implications of the Infrastructure Act 2015

This legislation created a new framework for the offshore oil and gas sector by creating an independent regulator, the Oil and Gas Authority, and confirming the overarching primary objective on operators to act in a way consistent with maximising economic recovery of the resources of the UK Continental Shelf ("the MERUK Objective"). These obligations are codified in the MERUK Strategy which imposes detailed obligations on operators.

Although Ofgem has its own statutory duties, consideration needs to be given to the alignment of the regulatory framework between the upstream and downstream elements of the UK gas market. These are not inconsistent, since it is in the interests of consumers to have available a wide range of sources of gas, including indigenous production. The RIIO-2 framework should therefore seek to facilitate sufficient ongoing investment in the maintenance and secure operation of the transmission network in order to continue to support UKCS production.

Maintaining a liquid and competitive gas market

The maintenance of an open and liquid wholesale market for gas, with clear price signals is a key feature of the UK market and one which the regime for gas transmission must continue to facilitate. To some extent this is more important, from a consumer perspective, than the achievement of relatively marginal gains in terms of the approach to efficiency targets or revisions to the approach for outperformance incentives.

Recent developments in the gas market, in particular the substantial reduction in UK gas demand, has meant that the issues facing the transmission system have changed compared to expectations at previous reviews. There is generally sufficient transmission capacity to meet the needs of network users and consumers for the foreseeable future. Therefore, the focus of the regulatory regime needs to evolve to reflect this new position and also consider how the network should meet the changing nature of gas supply.

The current gas charging review is already considering some of these issues by potentially revising the nature and extent of the locational signals given to network users. For a network where capacity constraints have less impact, the case for the targeting of costs to particular classes of users is not as strong. The RIIO-2 regime and the associated charging structure should therefore more clearly recognise the integrity of the network as a whole and adopt a more system wide view of the cost and benefits to users and consumers.

Energy transition and the future of gas

The RIIO-2 period will also encompass the ongoing transition of UK energy provision of which gas will continue to form an important part. There is considerable scope for increased use of gas in the UK for electricity generation and transport as well as its continued primary role in the provision of heating to households and industry. Recent research has demonstrated that continued use of gas for these purposes is likely to be lower cost to consumers than alternative technologies given the cost of some of the required upgrades to electricity networks.

The RIIO-2 review also needs to reflect the prospect of future technologies relating to Carbon Capture Usage and Storage (CCUS) and the use of hydrogen in the gas network. This may require NGC to accept a wider gas specification or to provide a blending service. Indigenous gas is already being lost to UK consumers due to the absence of such requirements. The regulatory regime for these services needs greater scrutiny and clarification as part of the forthcoming review process, including consideration of revisions to the gas transmission licence.

Summary

Overall, the Ofgem consultation is a good basis for the main issues to examine the relevant issues for the RII0-2 price controls. As discussed above we consider that additional emphasis could be given to the ongoing need to ensure the attractiveness of the UK market as a destination for investment and gas supply. Although it is important for network business to be managed efficiently and for potentially excessive returns to be controlled, the role of NGC in providing service to an efficiently functioning gas market are also of high importance to consumers and the need for investment to maintain this is an important part of the regulatory framework.

We trust you will find our response helpful. Should you require any further information or have any queries on the above points, please don't hesitate to contact me at wwebster@oilandgasuk.co.uk.

Yours faithfully,



William Webster
Energy Policy Manager

ANNEX: RESPONSE TO QUESTIONS ON SPECIFIC ISSUES

Chapter 3 Reflecting the views of network users and consumers (Q1)

We support the proposals set out in the Consultation to have greater stakeholder involvement. For transmission, there is a strong value in dialogue between NGC and network users via a User Group. Regulatory approaches such as the CAA's constructive engagement process have been relatively successful in formulating the approach to capital expenditure and could potentially deal with issues around perceived excessive returns and uncertainty about the scope of the investment programme. Likewise, engagement with network users can also help deal with the boundaries between, for example, activities which are regulated versus non-regulated activities. Open Hearings could also be useful in dealing with areas of contention but would require a clear Terms of Reference and governance process.

Chapter 4 Responding to how networks are used (Q2- Q10)

We support the potential shift to a shorter price control period. Experience with RIIO-1 suggests that there are too many uncertainties associated with longer price control periods and this makes it difficult to develop a stable package of outputs and costs as part of the regulatory contract.

Ofgem should deal with questions relating to "whole system outcomes" on a case by case basis rather than trying to build these into the overall regulatory regime. There is also currently considerable uncertainty about the extent of such issues and they may not affect the overall scope of the price control. Furthermore, the current legislative and regulatory regime is predicated on a disaggregated commercial framework and unless this changes fundamentally the regulatory regime should concentrate on the basics of the price control process. With this in mind, we do not support separate remuneration models for the gas TO and SO and agree with the proposed approach.

In relation to "stranded costs" we would disagree with the premise that consumers require additional protection. This will increase uncertainty and potentially distort investment decision making. The network needs to be maintained to meet consumers' needs in a wide variety of different circumstances and retrospective judgements about whether investments have been efficiently incurred should not be used as part of the basic regulatory framework. Many of these issues could be dealt with through a more comprehensive stakeholder process as set out in Chapter 3.

With respect to energy efficiency and decarbonisation of heat, the focus of the network businesses and their regulatory framework should be to support investment in the network. This may, for example, include the scope to deal with a wider range of gas quality parameters. As Ofgem notes, future uncertain and challenges may come from scenarios where use of natural gas will be higher rather than lower. Network companies are not primarily responsible for encouraging reduction in energy use which will result from individual consumers' own choices and their relationship with suppliers. It is not appropriate for the network regulation regime should not second guess particular outcomes.

Chapter 5 Driving innovation and efficiency (Q11-18)

In general, we would agree with Ofgem's premise that innovation should increasingly part of the BaU activities of network operators, particularly in support of the energy transition and future use of gas networks including issues relating to gas specification. Greater stakeholder involvement in the development of innovation support using the structures discussed in Chapter 3 would be helpful to ensure research is in the interests of consumers.

We would agree that competition has provided benefits in specific cases where new, separable and high value investment has been delivered at lower cost than would otherwise be the case. To some extent this is a tried and tested model since the offshore gas network regime has been developed through a competitive framework. We would support the extension to gas transmission; e.g. for connections to new LNG terminals, but it is not clear at this stage whether there are currently projects that would meet the criteria.

Chapter 6 Simplifying price controls (Q19-32)

The proposals relating to “price control deliverables” are not particularly well explained. More detail is needed of the mechanism for recognising “delivery” of particular outputs. In order to be an automatic process, the definition of the output required would need to be unambiguous and objective. However, this could imply a relatively narrow definition which may not be consistent with a wider benefit in terms of consumer outcomes. The stakeholder engagement process may be a way of dealing with this issue. Recognition of specific high value deliverables could be dealt with, for example, through a modified framework for capital expenditure. But this would require a case by case assessment of the outcomes and efficiency of expenditure on an ex-post basis rather than taking the capital programme as a whole.

Cost indexing may be possible but, as with service performance, it may also be problematic to define indices that are relevant in all circumstances. Introducing too many avenues to reopen or index prices controls may make the regime more complicated and uncertain rather than being a simplification.

With respect to information revealing devices and the business plan process. We would generally agree with the direction of travel away from mechanistic devices such as IQI and in favour of stronger engagement and a greater degree of commitment by Boards of Directors to the quality of the Business Plan. Reputational incentives may be stronger than crude financial rewards. We would agree with the removal of “fast tracking” for transmission although we would still expect there to be both a Draft and Final Business Plan to be produced. This is not clear from the consultation document.

Chapter 7 Fair returns and finance-ability (Q33-46)

We would expect Ofgem to take account of recent developments in financial markets, best practice from other regulators and the decisions of the CMA in regulatory determinations and appeals. The estimation of betas for network businesses would appear to be a key determinant of estimated equity costs and have the most impact on charges. With respect to corporation tax, it would appear to be difficult for Ofgem to deal with this issue easily since the tax regime may change during the price control period.

On the subject of ensuring fair returns, we would urge some caution in using the experience in RIIO-1 to guide policy in RIIO-2 since the challenges will inevitably be different. Some of the issues during RIIO-1 may be addressed by moving to a shorter regulatory period and the realisation on efficiency gains in the RIIO-1 period in the starting position for RIIO-2. Increasing complication of the incentive regime will make it less clear to the regulated business what it is expected to achieve and dampen the search for efficiency improvements and cost savings.

There is however some merit in dealing with issues where there is a significant level of uncertainty relating to cost and/or scope at the time of the review. As discussed above, this may require modification of the capital expenditure regime towards a case-by-case assessment of efficiency and delivery as used by other regulators.

Chapter 8 Next steps (Q47-50)

With respect to the gas transmission, the key issues relate to the need to maintain a liquid and attractive market and to encourage a wide range of sources of supply, including from indigenous production. In this regard, the licence requirements with respect to Obligated Capacity should be retained and maintained at the same level.

Looking forward, the potentially increased role for gas in the low carbon economy should be recognised and the regulatory regime must ensure that the full range of technology options for lower emission technology are maintained.

Finally, the regime should also seek to better facilitate a wider range of gas quality specifications and provide a clearer framework that gives National Grid incentives to provide suitable service for blending. This is already a matter of some urgency for investors in some UKCS fields. The attached briefing provided by one of our members sets out the current issues in more detail.

CASE STUDY ON CURRENT GAS QUALITY ISSUES



Cygnus Gas Field – Gas Blending

Neptune Energy's Cygnus gas field which started production in December 2016, exporting to the Perenco Terminal at Bacton, is delivering 8.5 million cubic meters of gas per day to the UK – 8% of indigenous gas production. Bacton is a critical component of the gas transmission network, bridging the UK with mainland Europe and controlling flows into the South East, ensuring security of supply for London.

The Wobbe Index of Cygnus gas lies between the Gas Safety (Management) Regulations emergency lower limit of 46.5 MJ/m³ and the specification of 47.2 MJ/m³ and therefore requires blending with declining indigenous gas fields to enable export to National Grid. This has resulted in the loss of 8 billion cubic feet of gas supply to the UK network from Cygnus in its short producing life, due to downtime of fields from which blend gas is sourced. During the recent 'beast from the east' cold snap, while National Grid issued a Gas Deficit Warning, Cygnus production was curtailed due to lack of blend gas. There was similar significant curtailment of Cygnus production during the Forties Pipeline System outage in December and February due to blend gas unavailability.

If the gas quality lower limit was reduced to the existing emergency limit, already within the scope of the Regulations, this would enable an increased, lower cost and secure supply of indigenous gas for UK domestic, industrial and commercial users. A reduction in the lower end of the GS(M)R limit would also assist in the supply of 'Green' gases such as biomethane and other lower carbon sources to the network.

Cygnus is designed as a hub in an under-developed area of the Southern North Sea. It has a field life of 25+ years and is already providing the potential to unlock previously stranded reserves of gas, both for Neptune Energy and for 3rd party Operators, through access to infrastructure. The issue of blending for this field threatens future investment and ultimately MER UK. Neptune Energy are therefore working with the Oil and Gas Authority to assist with reducing the impact of this problem.

Following the Opening up the Gas Market Project by SGN, there is an intent to increase the acceptable GS(M)R Wobbe Index range in the near future, however the initial aim is to only increase the upper limit. This is helpful to those bringing LNG and gas from Norway and the Continent into the UK network but not for UKCS indigenous gas fields such as Cygnus. If the opportunity is not taken in this first GS(M)R update to include even a small reduction in the lower limit, then the impact will be felt by many stakeholders both locally and nationally



Cygnus Gas Field

- First Gas achieved: Cygnus Alpha December 2016 and Cygnus Bravo August 2017.
- Cygnus Alpha is composed of three bridge-linked platforms.
- Cygnus Bravo is a normally unattended installation 7km from Alpha.
- 10 Wells (7 drilled to date).
- Development and Exploration drilling programme in progress.
- Original design capacity 250 MMscf/d – debottlenecked in September 2017 and currently producing 300 MMscf/d.
- The export route is via a new 50km pipeline to the Esmond Transportation System (ETS) pipeline.
- Cygnus gas is exported to the Perenco Operated Terminal at Bacton (215 km).

