

**Draft Note of Gas Quality Economic Regulation Work stream  
09 November 2006**

**Chair: Sonia Brown**

**Regulated Work strand**

**Ofgem Facilitator: Jason Mann**

Julie cox	AEP
Dick Stamsnieder	Gas Terra
Alison Russell	Centrica
David Odling	UKOOA
Andrew Knights	Knights consulting
Matt Golding	National Grid

David Odling (DO) stated that his group's discussion had been based upon the assumption that gas of any specification could be entering the GB system but that it was likely that gas quality would fall within the Easeegas specifications. DO stated that the group had looked at both the advantages and disadvantages associated with the regulated solution.

With respect to the potential advantages of the approach, DO outlined that his group had concluded that:

- It would provide greater certainty to the market by placing an obligation upon National Grid to construct and operate a processing facility. However DO noted that the obligation would simply require National Grid to provide this service not to construct an overly engineered facility.
- A regulated approach would provide a degree of simplicity as the obligation would be on National Grid to construct the facility and, as such, National Grid would be accountable for the outcome.

Sonia Brown (SB) highlighted that only certain arrangements and relationships would be simplified in this approach, while others may become more complex. For example it could lead to a more complicated relationship between the regulated company and the regulator. DO responded that this would provide the clearest boundaries of responsibility.

- With respect to security of supply DO stated that the provision of a processing facility supported by a regulated regime would make more gas available to the GB market and enhance security of supply.

With respect to the potential disadvantages of the approach, DO outlined that his group had concluded that:

- Parties could free-ride under this approach providing an incentive to procure and ship non-GS(M)R compliant gas to the GB market.
- As the scale of the problem was undetermined it was difficult to ascertain whether a monopoly framework would be the most efficient framework to support a processing facility as there may be incentives to over-invest.

- The approach did not provide enough flexibility to respond to possible future changes to gas quality and to the supply/demand balance in the gas market.
- There would not be any easy way of measuring economic signals suggesting the need for development of this facility.

DO outlined that the group had considered some potential remedies. In this respect he stated that costs could be more appropriately targeted if they were directed towards users of a particular terminal or sub-terminal. He also suggested that a trawl of the market could be undertaken to determine user commitment and provide market signals to National Grid.

**Hybrid Work Strand**  
**Ofgem Facilitator: Raihana Braimah**

Stefan Leedham	EDF energy
Alan Coulson	IUK
Alex Barnes	BG Group
Steve Ladle	Waters Wye
Peter Taff	Independent consultant

Alex Barnes (AB) outlined that one of the issues that his group had debated was the size of the potential gas quality problem and the likelihood that a gas processing facility would be needed.

With respect to the specific questions posed in the slides AB stated that his group had concluded that:

- If a gas processing facility were to be built this would reduce incentives to secure gas within GB specifications but would enhance security of supply.
- In relation to cost recovery, it would be sensible for those parties that book to use the facility to bear the costs associated with construction and operation. However, he stated that the group had questioned how much user commitment would be needed.
- With respect to any stranding risk this would fall on the user if they had booked capacity and did not need to use it but that it would fall on National Grid if there were under utilisation of the facility.
- There would be investment signals under this approach but these signals may not be sufficient. In this respect he stated that, due to uncertainty as to whether gas would fall outside of the GB specification in the future, parties may not take the decision to book capacity at the facility and this would not therefore provide appropriate signals.
- National Grid would have an incentive to minimise costs as Ofgem would not permit inefficient investment. He stated that this incentive may be greater than under a fully regulated approach but pointed out that the efficient size of the facility may remain an issue.
- Anti-hoarding mechanisms would need to be put in place. He stated that it would be appropriate for arrangements to be in place to allow primary capacity holders to offer capacity to third parties on an interruptible basis.

- This solution would be relatively more complex than a regulated solution but that this would be dependent upon the size of the problem.

To summarise, AB stated that the group considered that the solution would; assist the economic and efficient operation of the market due to signals of user commitment; facilitate competition through the provision of greater levels of gas to the GB market; minimise costs to customers; provide a proportional regulatory approach; and assist security of supply (dependent on the size of the facility).

However AB also outlined that the group had concerns regarding whether the hybrid approach would provide sufficient user commitment to trigger investment in the first place or guarantee that the size of any future processing facility would appropriately meet industry demand, given the uncertainties surrounding the gas quality issue. This could adversely impact UK security of supply.

Peter Taff (PT) highlighted that if it was agreed that a processing facility was needed at the Bacton terminal then Interconnector shipper contracts would need to be changed. At present the contract only permits gas that is within GS(M)R specifications to flow through the Interconnector. To facilitate the use of a processing facility this will contract will need to be amended and agreed by all Interconnector shippers.

**Unregulated Work Strand**  
**Ofgem Facilitator: Hannah Cook**

Charles Ruffell	RWE npower
Fiona Lewis	BP
Angela Love	Poyry Energy Consulting
Juan Vazquez	Fluxys
Paul Roberts	National Grid

Fiona Lewis (FL) outlined that the group discussion had focussed upon the potential development of a gas processing facility at Bacton. She stated that with respect to the questions posed in the slides the group had concluded that:

- The unregulated approach would place a huge incentive on parties to obtain gas within GB specification as, if they did not, they would have to pay for the required processing services. She set out that the group had assumed that the relevant gas quality specification would be the Easeegas specs. She therefore outlined that the decision on whether to secure gas within the GB specifications would be dependent on the premium of gas within GB specs as compared with the costs associated with processing out of spec gas.
- A key concern was the difficulties associated with determining which shippers were flowing gas which fell outside of GB specifications and therefore being able to appropriately target the costs. She outlined that the group considered that aggregate smearing of costs across all shippers using the relevant pipelines, based on the relative volumes flowed, would be most appropriate.
- As it would be a commercial service all of the risks of stranded assets would sit with the third party responsible for construction of the facility.
- If gas quality were to become a huge issue for the GB market then it was likely that the appropriate investment signals would be provided to a third party. However, she set out that the investment may arrive too late and that this could pose a risk to addressing gas quality issues appropriately.

- As this solution would be based upon a commercial initiative there would be incentives to maintain costs at a low level.
- Users of the relevant pipelines would bid in for processing capacity and, if they were not intending to use this capacity there should be some anti-hoarding mechanism through which they could offer this up to other interested parties.
- The unregulated scenario would be a relatively complex approach to address issues of gas quality.

DO stated that it appeared that the group had only considered a potential scenario in which gas quality was at the top end of the GB specification and pointed out that there were potential scenarios in which the gas quality fell outside of the lower bounds of the GB specifications.

FL responded that the group had talked about the fact that indigenous supplies would likely have a lower wobbe number and that European sources would likely have a higher wobbe index suggesting that commercial arrangements could be put in place to co-mingle these supplies and bring them within GB spec.

SB asked what the group considered to be an appropriate way forward. Charles Ruffell (CR) asked whether they would hear feedback from the scenario development workstream. SB stated that the two workstreams would be running independently.

DO outlined that there were two separate interests to consider – the economic interests of individual users and the wider public interest and that both of these needed to be explored. SB stated that Ofgem would be happy to have this discussion but clarified that Ofgem did not consider that the development of a strategic gas quality facility would be appropriate as this would be inconsistent with its policies in other areas. Angela Love (AL) asked whether SB was stating that the regulated option would not be considered by Ofgem as a potential option. SB responded that Ofgem may be able to envisage a hybrid regulated approach in which user commitment was involved.

Paul Roberts (PR) stated that the regulated approach would not be any different to the current approach of regulating pipes and compressors. DO pointed out that one slight difference was that it would be more difficult to get a user commitment or an indication of potential usage and that this may change over time. SB questioned who would likely have information regarding gas quality and requirements over time. DO responded that this would likely be those sourcing the gas as well as those contracting for the gas.

SB asked FL what the arrangements were at the Isle of Grain and FL stated that the ballasting facilities were paid for by the primary capacity holders. SB asked how these primary capacity holders would feel about other shippers having access to free processing facilities at Bacton if the regulated approach were to be adopted and the costs were smeared across all. FL stated that it would be hard to say how BP would feel given they would be affected by the Interconnector but that she did not think that it would cause huge problems. SB asked whether, if the primary capacity holders were to want to build a new facility for LNG processing and a regulated approach had been approved at Bacton, what arrangements they would want for their facility. FL stated that her personal opinion was a preference for a regulated approach.

AL asked whether Ofgem had an opinion with respect to the appropriate outcome of the economic regulation workstream. SB pointed out that although all parties had outlined that there was a great deal of uncertainty regarding the potential scope of gas quality issues, Ofgem did not have a better understanding of this. She stated that both the hybrid and unregulated approaches appeared to be worthwhile exploring further as potential solutions. She outlined that both models would need to incorporate some method of user commitment. She outlined that Ofgem did not want to foreclose any discussion as part of the workstream and stated that this was why the groups had been asked to also discuss the regulated approach.

FL suggested that one potential hybrid approach could involve National Grid providing estimates of the costs associated with construction of a facility and third parties would then be able to determine whether they could provide the same service cheaper. SB stated that it would be important to obtain cost estimates from National Grid in the event that the group decided that any regulated approach would be appropriate. She stated that it would then be possible to make these prices available to third parties to see whether they would be able to beat these prices.

AL asked whether it would be necessary to have another meeting to explore further the hybrid and unregulated approach. SB suggested that it would involve exploration of two hybrid approaches and an unregulated approach. Matt Golding (MG) asked what the two hybrid approaches would look like. SB responded that they it was likely that they would both include user commitment but that under the first approach National Grid would be told what to build and would receive a corresponding cost of capital while under the second approach National Grid would have more discretion as to the specification of the facility that it built. She explained that under the second approach National Grid would receive an upside if it invested appropriately and a downside if it did not.

AB asked whether National Grid had any idea as to the scale of costs involved. MG responded that National Grid have a proposal in place to obtain these but highlighted that if the group were more interested in indicative numbers these were available as part of the DTI/Advantica study. SB asked whether National Grid would be able to circulate these cost details.

### **The Way Forward**

The group agreed the most appropriate way forward was to focus discussions on the development of the two hybrid<sup>1</sup> and unregulated models discussed in the meeting. The group agreed that it would be helpful if Ofgem developed a strawman of the three remaining approaches and circulate it in advance of the next meeting.

SB outlined that the next meeting of the economic regulation workstream would be on 1 December in the morning.

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<sup>1</sup> As discussed in the meeting there would be one model where a processing facility was constructed solely based on user commitment and another where National Grid would respond to user commitment signals as well as having some discretion as to the size of investment they made, thereby potentially earning an increased rate of return. In both models National Grid would receive a corresponding cost of capital on the investment they made in response to user commitment signals.