



31st August 2007

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Dear Martin

BG Gas Services Limited Comments on Proposals for the Treatment of "Spare / Sterilised" Capacity

BG Gas Services Limited ("BG") welcomes the opportunity to comment on the above proposals raised as part of the on going Transmission Workstream discussions on the entry capacity regime.

Before commenting in detail on the proposals I would like to make the following observations. Firstly the rules on Substitution and Transfer & Trade cannot be considered in isolation from other aspects of the entry capacity regime, for example baselines or charging methodology (including rules on over-recovery of revenues). Expectations about the likely availability of capacity and its cost will inevitably drive shippers' behaviour when bidding in the various entry capacity auctions, and therefore impact the nature of any "market signals" which National Grid receives. Therefore BG's comments are conditional on the understanding that shippers will have the opportunity to comment on the whole "package" of changes to the entry capacity regime. This will enable shippers to analyse the various trade-offs within the package, and respond accordingly.

Secondly any reform of the entry capacity regime needs to take into account its effect on the overall UK gas market, not just on transportation costs. BG does not consider that sufficient thought has been given to this aspect. BG understands and supports the aim underlying the proposals, namely ensuring that NG only invests in entry capacity where it is efficient to do so. However both NG and Ofgem need to recognise that entry capacity is only a means to an end, namely the means to enable gas producers and importers to move their gas to market. The cost of entry capacity is relatively small compared to the cost of gas from a consumer point of view. However lack of certainty of entry capacity can be a major issue for those supplying gas to the market. If inappropriate entry capacity rules mean that gas that would have come to the UK market no longer does so, there is a very real risk that the impact of high gas prices on consumers may far outweigh any benefits to consumers from lower transportation costs. This issue has not been sufficiently addressed so far; for example Ofgem does not appear to have done a cost benefit analysis of its proposed changes to the entry capacity regime.

Lastly it is worth noting the potentially significant changes that have occurred to the entry capacity regime. Under the 2002-2007 Price Control there was a widespread understanding (encouraged by Ofgem) that there would be stability to the regime for entry capacity, in particular for entry capacity baselines. Changes to baselines would be as a result of shippers

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booking capacity. The set level of baselines meant that shippers had the assurance that a given level of capacity would always be available to the market. If capacity was not sold out shippers had several opportunities to book it. At any one entry point shippers only had to worry about likely flows into that terminal, and hence likely usage or bookings of entry capacity. Furthermore shippers had the added comfort that, if they were unable to book capacity in the long term QSEC auctions, 20% of capacity was held back for the shorter term auctions. This contrasts starkly with the proposed changes where baseline are no longer certain due to Substitution and the amount of capacity held back has been reduced to 10%. Effectively this means that, if the changes go through, the entry capacity regime will favour those who are able to book for several years in the long term (QSEC) auctions. As I explain below this may not be desirable from a UK wholesale gas market point of view. The different proposals on Substitution affect the scale of this impact on shippers.

As I stated in BG's response to the previous consultation on the Entry Capacity Substitution Methodology (15th June 2007), BG is concerned that Substitution increases the risk of stranding UKCS gas reserves. New UKCS fields will not necessarily be able to book capacity in a timely manner in the long term QSEC auctions before substitution has occurred, which is the only way to guarantee that capacity will be at an entry point in the future. Nor will such fields be able to book sufficient capacity to trigger the release of incremental capacity under the IECR rules, once substitution has occurred. The reasons for this are as follows.

Uncertainty.

Exploration for gas has always been an uncertain business. The majority of prospects drilled will not result in discoveries that are commercially viable. Fields now tend to be smaller and with shorter life-spans. They are therefore reliant on using existing upstream infrastructure to be economically viable, as they are not large enough to justify investment in their own infrastructure. In the absence of Substitution there was a much higher degree of certainty that new projects would be able to book sufficient entry capacity in downstream pipelines. Changes to the regime which make the availability of NTS entry capacity less certain heighten the risk for new fields and increase the risk that such projects will not go ahead.

Lead times.

Given the risks that new fields already face, and the probability that most wells drilled will be unsuccessful, it is not reasonable to expect field developers to book capacity before they are sure their fields are commercial. It can take a number of years from the first exploration wells on a field to declaring a field commercially viable. Once this milestone is passed, it can take as little as 2 years to reach the point of first gas flow for a simple fast track tie back. It is therefore unlikely that such a new field would be able to book capacity in the QSEC auctions to trigger incremental capacity because the period in which a developer would want to book entry capacity is less than the lead time for delivery of incremental capacity (currently 42 months). For fields that come on more quickly, or at a time which does not fit with the QSEC timetable which allows booking of capacity only for Y+2 onwards, the only alternative is to book capacity in the AMSEC auctions. However Substitution creates the risk that there will not be capacity left for the AMSEC auctions if capacity unsold in the QSEC is substituted to another entry point.

Field life and plateau.

Even for those projects which have longer lead times from being declared commercial to first gas flow, field characteristics will impact on their ability to book capacity in advance. New fields tend to have shorter life-spans (on average between 4 and 7 years in the southern north sea). In addition they do not have long plateau periods which means that the amount of gas they flow, and hence the quantity of entry capacity they need, will decline year on year. Unfortunately this means that it is unlikely that new fields will be able to trigger the IECR tests needed for the release of incremental capacity at

an entry point. If an entry point has no unsold capacity because capacity that was spare has been substituted, this heightens the risk that gas from new fields will be stranded.

The field profile for existing fields is also uncertain. As the field is produced, the operator gains knowledge about the field. The amount of reserves that are recoverable and the fields life-span can be increased via infill drilling and incremental investments. This could mean a field needs additional entry capacity to any already booked. It will not be possible to foresee this when the field is originally developed, and it is therefore important that there is the opportunity to book additional capacity to enable delivery of gas to the NBP. However there is also the risk that the field may contain less gas than originally thought. Developers will be reluctant to book additional capacity speculatively in the hope that more reserves will be recoverable.

Economics of small fields / incremental investments.

Small fields, and some incremental investments in existing fields, often have marginal economics and can be very susceptible to gas prices. Rapid monetisation of such fields, and the ability to flow on high price days (e.g. in winter) are key to the success of such fields. Some fields now require greater swing (low flows in summer, higher flows in winter) to capture the marginal value. Delays to commercialisation of such fields due to lack of entry capacity, or the inability to flow in winter due to lack of firm entry capacity will discourage developers from pursuing such projects.

The above issues reflect the changes that have occurred in the UKCS as it has become a mature province. Nonetheless there remain substantial quantities of gas in the North Sea that remain to be exploited. The recent Government Energy White Paper states that "*The UK still has significant oil and gas resources. While some 37 billion barrels of oil equivalent (boe) have been produced to date, estimates of the hydrocarbons remaining to be produced from the UK Continental Shelf (UKCS) range from 16 to 25 billion boe.*" (Chapter 4.15). Furthermore the white Paper has stated that the UK can reduce its import dependence by maximising recovery of our reserves. To this however "*we must maintain a supportive regulatory environment that attracts a wide range of companies to exploit existing and prospective fields.*" (Chapter 4.16). As I have explained above there is a risk that the Substitution mechanism may create a set of commercial rules which will inhibit the exploitation of remaining UKCS reserves. This could have a significant impact on gas supplies to the UK. For example Oil & Gas UK, in their 2007 Economic Report say that "*Current production plans would meet about 10% of the UK's gas demand in 2020, but, with the right conditions and sustained investment, this could be 20-25% of such demand.*" (Page 16) Changes to the commercial rules governing entry capacity that restrict the ability of UKCS gas to enter the system would not, prima facie, appear to be conducive to encouraging competition in the wholesale market or facilitating security of supply for the UK. In particular BG is concerned that the effect of the proposals will be to favour large scale projects, in particular import projects, simply because of their ability to book large quantities on a long term basis.

In light of the above BG would favour options that do not make substitution too easy. At the least substitution should require the same types of test as the trigger of release of incremental capacity. This would indicate either Option 4 or Option 5 of the Options presented. One way of ensuring that there was sufficient capacity for the short term would be to increase the percentage of capacity held back for the AMSEC auctions to more than the previous figure of 20% given that in the old regime unsold QSEC was guaranteed to be available in the AMSEC auctions; with substitution this is no longer the case. Alternatively there could be a maximum of capacity that is available for substitution in addition to any rules concerning retention of capacity for the AMSEC auctions. This would help ensure there was a level playing field between different sources of gas for the UK.

Consideration should also be given to the issue of Use it or Lose it. For example capacity may be substituted to a recipient terminal, taking capacity away from the donor terminal. If the substituted capacity is not used however, there is no means for shippers at the donor

terminal to access the unused capacity, even though they would have been able to do so if the capacity had not been substituted. It would be ironic if Substitution lead to increased sterilisation of capacity.

Lastly the issue of substitution methodology cannot be considered in isolation from the aggregate level of baselines. NG has asked for comments on how to allocate the 1554 GWhd of unallocated capacity. However this ignores the question of whether the aggregate level of the baselines is correct. There has been a significant shift from a regime where NG had high baselines but no substitution. If substitution is limited, and this is coupled with new lower baselines, this means that NG is facing much lower risk than in the previous regime. Therefore if substitution is limited to resolve the problems outlined above, it needs to be accompanied by higher baselines to maintain the same level of risk.

I hope the above comments are helpful to the debate. I look forward to further discussion at the next industry Workstream meeting on 12th September.

Yours sincerely,

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