

Mr. Julian Majdanski
Joint Office of Gas Transporters
Ground Floor Red
51 Homer Road
Solihull
West Midlands
B91 3QJ
enquiries@gasgovernance.com

Gas Storage Operators Group
36 Holly Walk
Leamington Spa
Warwickshire
CV32 4LY

20th November 2006

Dear Julian,

Re: Modification Proposal 0120: “Introduction of an SO Commodity Charge for NTS Storage Exit Flows”

The Gas Storage Operators Group wishes to submit a response to the above Modification Proposal Draft Report. The Gas Storage Operators Group is a trade association which was formed in May 2006 within the Society of British Gas Industries (SBGI). The group has 12 members and comprises almost all the active participants in the GB Gas Storage Market, and as such represents a wide range of interests. The group includes both established operators and developers of new storage projects, large multinational companies and smaller private ventures. The current members of the group are detailed in the Appendix.

The Gas Storage Operators Group (“GSOG”) does not support the implementation of this Modification Proposal 0120.

General Introduction

At the outset we believe it is important that this Modification Proposal is considered in the wider context of the future supply and demand position of the GB Gas Market. Events during the last winter have placed the GB gas market under close public and political scrutiny. Security of Supply has become a “hot topic” and is being considered, reviewed and consulted upon by a number of decision making entities, the latest being a DTI consultation launched on the 16th October¹. GB is fast becoming import dependent and as a result will require significant investment in new storage facilities and effective utilisation of current storage capacity, as set out in the Government’s Statement of Need in May.² It is incumbent on the industry to play its part in ensuring that both of these aims are upheld and that GB customers are not compromised, both in terms of supply security and the price of delivered gas.

¹ The Effectiveness of Current Gas Security of Supply Arrangements: a Consultation, DTI, Oct 2006

² Ministerial Energy Statement of Need for Additional Gas Supply Infrastructure, 16th May 2006

We find it unfathomable that National Grid is, at this critical time, considering a Modification Proposal which will increase costs in relation to the utilisation of storage facilities. We have set out a number of detailed comments on the proposal below, however, as a general principle we wish to make it clear that the imposition of additional costs will, to greater or lesser degree, have the following effects:

- Reduce storage cycling;
- Limit the “free” benefit provided by storage to National Grid Gas because of reduced storage cycling, and for reasons established later in this response;
- Increase wholesale gas prices as storage costs will either be passed through to the market or, limit storage response to only greater price differentials;
- Potentially inhibit further investment in expanding existing facilities due to relative increase in cost of using storage and/or uncertainty over future level of costs; and
- Potentially discourage the development of new storage facilities due to reasons stated above.

Detailed Comments

The imposition of a SO commodity charge on flows into and out of Storage Facilities has been the subject of a number of previous Network Code Modification Proposals, notably Proposals 0532, 0545 and 0547. Each of these Proposals was rejected by Ofgem at that time and in its combined decision letter³ it offered a number of observations. We have reproduced those observations we believe are relevant to this Modification Proposal 0120 and offer our views on each, in turn:

- *“storage flows may provide national and locational gas services to Transco within short delivery times, thereby assisting Transco in balancing the NTS, however, it considers that the storage sites are not necessarily unique in the benefits that they provide in terms of system operation.”*

GSOG view: We concur with the view that storage flows provide benefits to the system. In particular, storage flows tend to react to price and therefore, demand signals. This can be characterised as flowing gas into store during periods of low demand and out of store during periods of high demand. These demand periods range from seasonal cycles to shorter term variations, for example weekday/weekend. This would appear to provide a benefit to National Grid SO in terms of physical system balancing, for which no financial compensation is given by the SO.

The operation of GB storage facilities in this manner was commented on in the DTI October consultation:

“This is why the summer months consistently see steady injections into storage so that storage facilities are full going into winter. Within winter also, we have seen a good correlation between the direction of storage flows and the relationship between the spot price and the forward price.”

In addition, Ofgem has noted that, even in the absence of this measure, the market appears to have used storage efficiently last winter, withdrawing gas in November when supplies were tight and re-injecting gas at weekends and holiday periods.”⁴

³ Ofgem Decision Letter for 0532, 0545, 0547, Ofgem, February 2003

⁴ The Effectiveness of Current Gas Security of Supply Arrangements: a Consultation, p37, DTI, Oct 2006

We would argue, however, that storage flows are more predictable than other system points and offer benefits to the system which at present are undervalued. For example, unlike other exit points, storage points arbitrage between gas prices over a period; the period being determined by the physical capabilities of the facility. Other exit points, such as generators, will arbitrage across potentially a number of commodities. In effect, this means that the response of storage facilities in terms of flows are more predictable and better reflect the demand variations within the gas network; during periods of lower demand storage sites will inject, whilst during periods of high demand they will withdraw. National Grid Gas will not contract for the benefits which it obtains from the flow variations of the storage facilities as, for reasons explained, the flow variations are a consequence of responses to demand induced price movements over a range of time periods.

Further, Commodity charges are intended to represent National Grid Gas's costs in transporting the gas from source to end user. Storage injection does not add to National Grid Gas's costs because it only occurs using interruptible off peak capacity. Upon production the commodity costs are incurred when the gas is finally delivered. Storage facilities incur high costs themselves to compress gas from the grid and redeliver at higher winter pressures and this action reduces National Grid's compression costs. Facilities near the end of the system support pipeline capacity and save transmission system investment. This value is only realised for a limited number of National Grid Gas's own facilities. Facilities near entry points utilise very little of the transmission system during injection.

In summary, National Grid Gas directly benefits in terms of cost effective system management because there is greater certainty at storage sites compared to other system points and because in many circumstances, storage operations actually act so as to reduce costs to the transporter. This service is provided to the NTS System **without charge** and any attempt to value the costs which storage facilities impose on National Grid must be offset by a robust examination of the intrinsic benefits generated by the unique manner in which they operate.

We appreciate that the level of charge is an issue which would be better directed at Pricing Consultation GCM03, however, we thought that it was important to consider this aspect of the "package" in this response as it is not clear whether as a result of any rigorous cost/benefit analysis, a charge should be applied at all. We propose that until it is clear that there is a justification for a charge to be applied to storage points then this Modification Proposal should not be progressed.

By way of further developing the argument that storage facilities provide under-valued benefits to the system we need look no further than the arrangements for Storage Monitors. These monitors restrict the ability of Storage Users to withdraw supplies, even though these supplies have been purchased under market conditions with the expectation of utilizing them to meet market demands. As we are all acutely aware, the levels of these monitors can vary year on year, and during the winter, month by month. These "security supply levels" can only be applied at storage facilities as it is recognized that only storage facilities can provide the supplies needed to support certain demand i.e. the supply is guaranteed to be available. As far as we are aware no provision is made for the maintaining these stocks unless there is a NEC Storage Curtailment, as provided for in implemented Modification Proposal 0071. Due to the arrangements put in place it is in the interests of the Users to ensure that a Monitor breach does not occur and that System Security is maintained. We would argue that the provision of this "Security" service by storage Users, many of which do not directly supply customers, goes

unrecognized and undervalued and should be considered before imposing costs on Storage Users.

- *“In Transco's final modification report, it has proposed to change the treatment of the interconnectors in the application of the SO commodity charge, to be consistent with the treatment of storage flows detailed in this proposal. Ofgem considers that this is an important issue, which needs to be fully consulted on before any change in treatment is made.”*

GSOG view: This Modification Proposal 0120 requires that charges are applied to each User in relation to its UDQO. The UNC already provides for charges to be applied to the Users UDQI. In effect, this means that in the event there are nominated counter flows at a facility the total charge will not reflect the physical flow at that facility. For example, if Shipper A “flows” 10 units into the facility and Shipper B “flows” 10 units out, the physical flow will be 0, but the Commodity Charge will be applied to 20 units. It was understood by Ofgem during its deliberations in relation to Modification Proposal 0532 that this approach, as deemed acceptable at interconnectors requires further consideration. Without reference to the charging methodology, as this is separate from the evaluation of the Modification Proposal, we are of the view that the issue of physical versus net flow charging application has not been duly considered and as a result has not met with the recommendation made by Ofgem.

GSOG would argue that it cannot be appropriate that a commodity charge which should be constructed to recover costs, which by their very nature are directly linked to throughput, can be levied on paper rather than physical flows. In the event that costs are not throughput-driven, then we fail to understand how it can be deemed appropriate to levy a charge on an effective nominated quantity.

We recommend that the treatment of all bi-directional sites is revisited and this Modification Proposal is not considered until such time as the results of such a review are available. This review should also consider the benefit to National Grid Gas derived from the use of the storage monitor regime, compared to the cost of booking storage or building its own facilities.

Finally, we note in the legal drafting that it is expected that Storage Facilities are able to apply for application of the NTS Optional Commodity Rate. The application can only relate to the Storage Facility as an Exit Point as it will not qualify as an Eligible Entry Point. We note that no reference is made to the potential for a NTS Optional Storage Commodity Rate which we believe should be provided for in the event that a Storage Commodity Rate is introduced. We request that National Grid Gas considers this omission and responds accordingly.

Extent to which implementation of the proposed modification would better facilitate the relevant objectives

We do not believe this Modification Proposal would better facilitate the relevant objectives, in particular and with reference to the individual objectives we would make the following observations:

- For reasons established above it is unclear whether the application of a charge is appropriate. We would argue that due to potentially undervalued benefits, it could be that the users of storage should receive payment for services provided to National Grid Gas.
- The levying of the charge at UDQOs (and UDQIs) is not cost reflective. Commodity charges by their very nature must have a direct linkage with throughput; otherwise they should be levied at the point at which the cost is incurred. The methodology by which the charge is calculated is not relevant to the UNC Modification Proposal as the UNC only requires the application of the charge and not the formation or the level of the charge itself. It is apparent that a commodity charge which is not related to the actual flow of the commodity is an anomaly.
- The imposition of the charge will limit storage cycling which in turn will limit the responsiveness of storage flows to price/demand signals, reducing the efficiency of the system's operation as a whole and increasing prices to customers.
- Reducing or removing the incentives to invest in further storage facilities is harmful for the development of a competitive GB storage market, and hence could ultimately limit the amount of Storage which can be developed in GB.
- Similarly, reducing or removing the incentives to invest in further storage facilities could also undermine competition amongst Shippers by increasing costs on those shippers who only have access to storage as a balancing tool, rather than offshore linepack, etc.
- National Grid Gas claim in the Draft Report that "*the implementation of the Proposal would avoid inconsistency with the Gas Transmission Charging Methodology*". We find this to be a peculiar statement as it infers that the Charging Methodology has precedence over the UNC and Modification Proposals should be considered in respect of a Charging Methodology (which in this case is still under consultation!).

In light of the above comments we believe that implementation of this proposal would lead to less efficient and economic operation of the pipe-line system, limit the development of Storage and will fail to secure effective competition between relevant shippers.

The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation

We are clear that this Modification Proposal will have negative implications on Security of Supply and operation of the System. The impacts on Security of Supply are detailed in the General Introduction section of this submission. In addition we would argue that the misallocation of charges to Storage Users through the use of UDQOs (and UDQIs) will further limit storage cycling.

The impacts on the operation of the Total System are captured in our comments relating to the undervalued benefits provided by storage facilities and misallocation of charges to non-physical flows.

The implications for Transporters and each Transporter of implementing the Modification Proposal, including

a) implications for operation of the System:

We have established that there will be implications on the operation of the system, most notably due to the potential differing flows patterns at storage facilities.

b) development and capital cost and operating cost implications:

There are clear reductions in National Grid Gas operating and capital costs as a result of there being storage facilities located close to sources of demand. Any change that reduces the incentive for such facilities to be built and operated will reduce the overall economic and efficient nature of the system.

c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:

We believe for reasons established that National Grid Gas is likely to over-recover costs from storage users.

d) analysis of the consequences (if any) this proposal would have on price regulation:

We do not believe that a commodity charge on Storage utilisation is appropriate for reasons stated and therefore believe that National Grid Gas will be acquiring revenue from charges which are not being imposed on a cost reflective basis.

e) The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party

We believe for reasons stated in the General Introduction and the Relevant Objectives Sections that the Modification Proposal will have negative impacts for storage owners, developers and operators. It will also have a negative impact for Suppliers and Consumers due to the additional and mis-targeted costs on the Users of the facilities.

The proposal is significantly disadvantageous to storage operators and represents a major redistribution of transportation costs onto the storage community, for the first time since the first charges were established by the then British Gas in 1991-2

As a general principle which should be applied to all Modification Proposal Reports, this section should include Gas Storage Operators as a specific interested and potentially impacted Party.

f) Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

No comment.

g) Analysis of any advantages or disadvantages of implementation of the Modification Proposal

We have identified the following advantages:

None.

We have identified the following disadvantages:

Increased costs for storage Users;

Inappropriate and non-cost reflective method for recovering costs (if any) via UDQOs (and UDQIs);

Will limit the cycling of storage;

Will limit the “at no-cost” benefits provided by storage flows and currently enjoyed by the System and customers;

Will limit the responsiveness of storage to price/demand signals which will increase the overall cost of supply flexibility; and

Will add another cost item and forward looking cost level risk which may deter future storage developments/expansions.

Yours sincerely

Adrian Fernando
Chairman

On behalf of the Gas Storage Operators Group

Appendix 1

List of Members of the Gas Storage Operators Group

Canatxx Gas Storage Limited

Centrica Storage Limited

EdF Trading Gas Storage Limited

E.On UK Ltd

Ineos Enterprises

National Grid LNG Storage

Portland Gas Ltd

SSE Hornsea Limited

Star Energy Group

Statoil (UK) Limited

Warwick Energy

Wingas Storage UK Ltd

All the members of the Gas Storage Operators Group actively oppose the implementation of this modification proposal, with the exception of National Grid LNG Storage, who felt it was inappropriate to comment, given their position as part of the National Grid organisation.

Appendix 2 – Response to National Grid Pricing Consultation NTS PC03

Mr. Dominic Harrison
Regulatory Frameworks
National Grid
NG House
Gallows Hill
Warwick
CV34 6DA
dominic.j.harrison@uk.ngrid.com

20th November 2006

Dear Dominic,

Re: Consultation Document NTS GCM03: “Introduction of an SO Commodity Charge for NTS Storage Exit Flows”

The Gas Storage Operators Group wishes to submit a response to the above Consultation Document. The Gas Storage Operators Group is a trade association which was formed in May 2006 within the Society of British Gas Industries (SBGI). The group has 12 members and comprises almost all the active participants in the GB Gas Storage Market, and as such represents a wide range of interests. The group includes both established operators and developers of new storage projects, large multinational companies and smaller private ventures. The current members of the group are detailed in the Appendix 1.

The Gas Storage Operators Group (“GSOG”) does not support proposed revision to the Gas Transmission Transportation Charging Methodology (the “Charging Methodology”) as detailed in the above consultation document.

General Introduction

In our response to UNC Modification Proposal 0120 we made it clear that we did not support the introduction of a Commodity charge on Storage Users and for this reason we do not support the proposed change to the Charging Methodology.

A number of the points raised in our response to the Modification Proposal are relevant to this consultation and in the interests of ensuring that you are aware of those points we have attached that response in Appendix 2 of this submission. The arguments presented in that response should be considered as part of the overall contribution to this response.

As we do not support the introduction of a Commodity Charge to Storage Users we reject any proposal to modify the current methodology to establish a charge and the resulting level of that charge, however and with this firmly in mind, we will attempt to provide comments on the Questions for Consultation detailed in Section 7 of your Document.

The reasoning behind our unconditional rejection of a charge being applied to Storage Users is stated in our response to Modification Proposal 0120. The key points laid out in the response are detailed below, however, for a fuller commentary please see the [Mod Proposal Response.]

The imposition of a storage commodity charge will:

- Reduce storage cycling
- Limit the “free” benefit provided by storage to National Grid Gas because of reduced storage cycling, and for reasons established later in our response to Modification Proposal 0120
- Increase wholesale gas prices as storage costs will either be passed through to the market or, limit storage response to only greater price differentials
- Potentially inhibit further investment in expanding existing facilities due to relative increase in cost of using storage and/or uncertainty over future level of costs
- Potentially inhibit the development of new storage facilities due to reasons stated above.
- Limit the responsiveness of storage to price/demand signals which will increase the overall cost of supply flexibility
- Add another cost item and forward looking cost level risk which may deter future storage developments/expansions

In addition, the proposed method for recovering the SO Commodity Costs, proposed to be on the basis of UDQOs (and UDQIs) is inappropriate and non-cost reflective.

Detailed Comments

As a general point, we are very disappointed by the lack of detail provided in the Document. The “analysis” produced is purely qualitative in nature which prohibits the reader from ascertaining how the final charge level was arrived at. In our view, National Grid Gas must provide further evidence to justify the proposed cost allocation, in particular the actual portions of costs being applied to the Storage Commodity under each cost element and the associated cost drivers.

In terms of the methodology itself, it appears that the only two cost elements not included in the overall charge are Compressor Costs and Operating Margins, the remaining elements are included and apportioned, purportedly in a cost reflective manner.

The resultant charge means that for every kwh of gas theoretically cycled through the storage facility a total charge of 0.013p/kWh is levied. This compares to the standard SO Exit Commodity charge of 0.0112p/kWh. The inference, therefore, without even examining the validity of the charge and the cost allocation, is that it is more expensive to move a theoretical unit of gas into and out of storage than to deliver it to NTS Exit Point. This seems, at face value, extremely unlikely, although of course we are unable to examine this for ourselves due to the paucity of data provided in the Document.

In terms of the validity of methodology we refer you to the comments made in our response to Modification 0120 and in particular those comments which relate to the “benefits afforded by storage sites to the System in general”. We do not intend to repeat the details of this argument and would simply state that on the basis that the “analysis” neglects to consider those benefits generated by the operation of the storage sites then we would suggest that it is invalid and the charge, if any, is greatly overstated.

With regards the individual cost elements we offer the following comments:

Shrinkage Unaccounted for Gas – It is stated that storage meters will contribute to unaccounted for gas. We have no reason to dispute this, as storage meters are no different to meters at other System Points, however, as the application of the charge is proposed to be on UDQOs and UDQIs and not the net physical flow at any storage point, we would argue that it is likely that there will be an over-recovery from storage Users. A net flow of zero will still attract charges even though no gas has actually flowed through the meter.

Compression – We concur with the conclusion that compression costs should be excluded from the cost base for the reasons stated in the document. However, consistent with our firm belief that storage provides unappreciated benefits to the system we would argue that in terms of compression, storage provides invaluable assistance to the operation of, and investment in, the transmission network. During the summer months, when gas is predominately injected into store, a number of entry point flows will be able to move gas into store without the need for compression e.g. Langedel flows at Easington, Milford Haven LNG, BBL and IUK at Bacton and Isle of Grain LNG. Elsewhere, at such locations as St Fergus and Teeside the need for compression will be minimized. Conversely during periods of withdrawal, the need for compression again will be minimized due to the proximity of storage facilities to areas of demand. By way of illustration, GSOG estimates that if Peterborough is adopted as a proxy location for the NBP, then over 95% of storage facilities are located within a 100 mile radius of this hub. This compares extremely favourably with other more “remote” entry points such as St Fergus or Milford Haven. As a result and by way of concluding our views on this particular element, we believe that rather than simply excluding any costs associated with compression it would be more “cost reflective” to more accurately value costs foregone/benefits accrued by the very existence and operational behaviour of UK storage facilities.

Internal costs – We are concerned that the application of charges in relation to this cost element will lead to some degree of double charging. Given that the Standard Commodity charge contains an element of these costs it is unclear how they should be apportioned to ensure that a User which utilises storage and delivers gas to an end user is not paying a greater contribution than is appropriate. We would argue that to ensure there is no discrimination and on the basis that all gas which is cycled through storage is delivered to an end-user, the recovery of these costs is best aimed at a non-storage NTS exit point.

Exit Capacity TO costs – We believe that due to the flow characteristics of storage sites which result in direct benefits to the operation of the System (as discussed in our Mod 0120 response) then it is inappropriate that this cost element is targeted at storage sites. Storage sites, in fact, reduce the need for investment in the transmission system as they provide effective linepack services via their flow characteristics. They are not interruptible in the same way as other interruptible offtakes, as during periods of system stress storage sites will be entering gas into the system rather than exiting it. As a result, storage sites are not required to be interrupted and, as stated previously, provide a direct substitution for pipeline investments needed to support seasonal and peak demand patterns.

Revenue Adjustments – The points we raise in the previous paragraph are relevant to the application of this particular cost element.

Assessment against EU Gas Regulations

National Grid Gas states that it believes that its charging proposals are consistent with the principles for network access tariffs, or the methodologies used to calculate them, as laid out in EC Regulation 1775/2005.

GSOG disputes this for the following reasons:

- *Shall be transparent*

The lack of detail contained in this proposal means that it is far from transparent as it is impossible to challenge the final commodity rate produced.

- *Take into account the need for system integrity and its improvement*

As stated previously, costs are not correctly apportioned, the method of recovery is non-cost reflective and no account is taken of the benefits provided by the pattern of storage flows. Furthermore, such a charge can only act as a deterrent for future investment in storage assets at a time when it is widely acknowledged that more storage capacity is required.

- *Reflect actual costs incurred for an efficient and structurally comparable network operator*

See comments provided under the previous bullet.

- *Be applied in a non-discriminatory manner*

Due to the points raised in the previous bullet we believe that storage users will pay charges which greatly exceed the costs incurred by the System Operator and therefore, discriminate against Users which use Storage.

- *Facilitate efficient gas trade and competition*

The application of non-cost reflective and therefore, discriminatory charges will damage competition. As stated in our response to Mod 0120 we believe that the imposition of a charge will limit storage cycling and discourage investment in storage. This will inhibit gas trading and competition.

- *Avoid cross-subsidies between network users*

Considering the comments made under previous bullets with regards cost reflectivity, non-appreciation of System benefits and the application of the charge this principle will not be achieved

- *Provide incentives for investment and maintaining or creating interoperability for transmission networks*

Not strictly relevant but consideration must be given to the utilization of existing storage and investment in future facilities.

- *Not restrict market liquidity*

Increased costs will inhibit cycling which in turn will damage market liquidity.

- *Not distort trade across borders of different transmission systems*

This is not particularly relevant except to say that if costs are imposed on storage gas, and those costs are unjustifiable then it will skew the market for flexible supplies which are increasingly likely to be met by imports.

Finally, and in parallel with the point we raised in our response to Modification Proposal 0120 we believe that it is essential that the charging recovery mechanism currently employed at interconnectors is reviewed. National Grid's assertion that the Storage Commodity Charge will apply to commercial rather than physical flows to "ensure consistency with bi-directional interconnectors" is a poor justification. In our opinion it is far from clear that the methodology adopted at such System Points is valid and should not be simply accepted as such.

Yours sincerely,

Adrian Fernando
Chairman

On behalf of the Gas Storage Operators Group