PIU Response from Conoco

1. Conoco welcomes the opportunity to comment on the PIU note on Energy Policy. Our response follows the format of the scoping note. We have not attempted to answer individual questions per se, focusing instead on issues that both affect us as an energy company and where we can bring experience. These cover the areas of Gas, Electricity and Gas Networks and Energy Efficiency and CHP.

Gas

2. Conoco believes that there is a question in this area not raised by the PIU. This is, 'Are there any policy changes mooted or actual currently impacting on the extraction of gas reserves from the UKCS?' We consider the answer to be yes and outline our view in paragraphs 3 through 7 below.

3. As an upstream company Conoco specialises in the finding, production and marketing of hydrocarbons. As such we focus primarily on the exploration and production (E&P) risks when assessing offshore investment decisions. In the UK this has been the case until about 1998.

4. In 1998 the National Transmission System, Transco's high pressure system of pipelines and terminals transporting natural gas across Great Britain, suffered major constraints for the first time in its history. As a consequence of this and other factors such as daily balancing of gas inputs and outputs, the industry regulator Ofgem instigated a far-reaching review of the entry capacity and gas balancing regime in the UK. Hence the New Gas Trading Arrangements (NGTA) were born. Auctions for entry capacity in the NTS were and remain an important feature of the NGTA.

5. At this point Conoco's and no doubt other upstream participants' consideration of E&P risks changed. In addition to considerations of technical and market risk was added downstream market regulatory risk, which had always been present but much lower down the scale. Now companies such as Conoco have to consider what and when changes to the downstream gas market will be introduced. The impacts of the NGTA are still being felt and adapted to by the industry. Modifications to the NGTA are and will continue to occur through industry discussion. However, more significant changes to the NGTA are apparently on the way.

6. Amongst such proposed changes are for the offshore gas industry to balance its inputs into the NTS with its outputs, not on a daily basis at present but potentially as frequent as half hourly[1]. The costs involved in bringing what is a mature industry attempting to find and develop marginal fields, up to this standard are very high. What is far less certain are the benefits.

7. These far-reaching changes to the downstream gas market are now impacting the upstream industry by bringing in uncertainty and the threat of higher costs just at a time when lower costs and certainty are required. Conoco is not against change and is often a leading proponent of it, however, major change without

[1] The New Gas Trading Arrangements. Further Reform of the Gas Balancing Regime: A Consultion Document, Ofgem 28/02/01

costs and benefits analysed and explained will not encourage development of an optimum long term industry solution. We note that the DTI have an obligation to carry out cost/benefit analyses for policy changes whereas Ofgem have no such duty.

8. The PIU paper raised a question (#35) – Should the gas-oil contractual link be broken (in UK gas contracts)? Conoco's view is that existing contracts should be left alone. Liberalisation of the UK gas market led to a natural process of contract renegotiation for those parties that saw value in such a process. Those that did not renegotiate may still do so in the future. It is also questionable if contract renegotiation could be forced onto the contracting parties and if so it is likely that further regulatory uncertainty, leading to a lack of investment, would result. The UK's reputation as a place to do business would also be harmed.

Electricity and Gas Networks

9. Conoco is of the opinion that Transco has failed to invest in the NTS in step with the needs of the gas industry. We believe this to be an outcome of the form of regulation that currently applies. Transco is incentivised to flow as much gas as it can and yet to minimise investment, at least until the end of its five year review period. Such investments need to be 'economic and efficient' though this term is rather uncertain in practice. Transco has been placed in the position of investing and the regulator discounting this or previous investments ('stranded assets') on economic grounds or failing to invest and suffering only relatively minor costs under NGTA. The result is underinvestment in the NTS away from St Fergus and south towards the major gas markets of Great Britain.

10. What are the consequences of such underinvestment? The likelihood is one of a gas price increase, either as a price shock where a gas source in the south is temporarily lost and St Fergus cannot make up the difference, or a sustained rise in the price of gas through a longer term shortage of gas. It would be more prudent to alter regulation policy such that it encourages a longer term view with pre-emptive investment at relatively lower cost to the UK rather than face price increases resulting from lack of investment.

11. It is not just Transco that is wary of infrastructure investment however. As upstream companies that face very high investments with uncertain reward it has been our policy to reduce risk through forming joint ventures with other E&P companies. Such an approach has been followed since the start of exploration in the North Sea. However, recent European Competition legislation has outlawed a number of joint approaches including the sale and purchase of gas. Joint investment in and marketing of transportation capacity is now in question. In the past such investment has been for the investors' own oil and gas fields. However, as the need for imports grows so too will be the need for investment in speculative pipeline transportation capacity. The development of such capacity, if and when it does occur, will be that much later than otherwise, due to the increased risk and complexity of contracting such capacity in competition with the other joint developers.

12. We do not believe that market forces alone can bring about the necessary infrastructure developments required to facilitate gas imports from the continent into

the UK. Continued UK pressure through the various EU initiatives will be required to ensure that deregulation of the continental gas industry continues, bringing with it access to both gas and transportation on terms that are fair and reasonable.

Energy Efficiency and Combined Heat and Power

13. Conoco takes an interest in energy efficiency through its sustainable development policies and activities, some of which involve power generation. In carrying out such work Conoco has become aware of a number of discrepancies in the Combined Heat and Power (CHP) development area. It would appear that a Good Quality Large Scale CHP scheme[2] suffers from drawbacks when compared to either combined cycle gas turbine (CCGT) generated electricity or Good Quality small scale CHP that could inhibit further development of such projects in the UK. These are:

- Liability for Climate Change Levy. In the cases where CHP operators are themselves licensed suppliers, direct sales of electricity generated from Good Quality CHP would be "levy exempt". However any licensed supplier incurs the proposed Renewables Obligation. Our calculations suggest that this would more than cancel out the benefit of the CCL exemption.

- Liability for business rates. The Government have announced that good quality CHP would be exempt from business rates.[3] These statements may be valid for the generality of small CHP plants but in practice does not apply for large "stand alone" CHP plants. The application of the formula rating on large CHP plants is to raise an additional rate on the steam generation plant that is required to maintain operational efficiency and capture the benefits of CHP.

- Enhanced Capital Allowances (ECA). The Government also announced that CHP would be eligible for the ECA scheme. Again, in practice it appears that this will only apply to CHP plant installed to supply heat and power to "clearly identified end users". This may well be a condition satisfied by the majority of small CHP plants. Yet, for some large CHP plants, part of the drive is to export electricity to the grid and as such end users cannot be identified.

Summary

14. From the foregoing it should be clear that Conoco has concerns on future energy policy including and extending beyond the UK. We see the need for continued liberalisation of the continental gas markets coupled with the need for a pragmatic approach to joint activities involving significant pipeline capacity development and gas marketing. The UK itself requires relatively stable and far-sighted gas and electricity regulation that encourages energy efficient schemes such as large scale CHP, renewables and long term infrastructure development. Finally, such regulation needs to be in step with a mature North Sea oil and gas industry and the challenges therein.

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[2] CHPQA Standard Issue 1, November 2000 and CHPQA Guidance Note 41, 2001.
[3] 8 March 2001 Minister for the Environment Announcement in Parliament.