

UK Government Energy Policy Review

Submission by TotalFinaElf Gas & Power Limited (TFEG&P)

TFEG&P has a significant presence in the UK Gas Market, being both a shipper and supplier of gas to large numbers of Industrial & Commercial gas consumers and a very active trader of both gas and electricity in the UK, Europe and the US. Through our holding in Humber Power we also have experience of the electricity generation market and are a recent competitor in the electricity supply market.

As one of the earliest entrants to the competitive gas market, we have substantial experience of how the market has developed and have been an active participant in much of the discussion that has taken place to determine the infrastructure (Gas Network Code, NETA, NGTA etc) that supports the competitive energy markets in the UK.

We look forward to continuing to be a significant player in the UK and welcome the Energy Policy Review as a vital opportunity to develop the UK energy policy up to 2050, recognising that global policy initiatives will require significant changes to all areas of energy production and consumption.

Whilst we have read the various papers issued to date by the PIU (including the initial scoping notes) this submission is intended to focus on some quite specific areas related to the contribution of the regulatory regime and the need for maintenance and development of the gas and electricity infrastructure. We believe it does address a number of the questions raised by yourselves, particularly with respect to Gas, Security and Electricity and Gas Networks.

Our paper focuses on the following key areas of energy policy:

- ◆ The interaction between UK government policy and Regulatory policy – The Government's role to set clear and unambiguous policies, Regulation's role to demonstrate how the actions it takes support these policies
- ◆ Security of supply is now of utmost importance and should be the focus for regulation. It is essential that the UK has a flexible transportation infrastructure capable of providing alternative routes for gas entry allowing the continuation of producer on producer competition and thus ensuring the continuation of the important traded NBP market
- ◆ Reducing the gas balancing period (down to an hour or less) will introduce significant volatility into the gas market which will damage its current liquidity and potentially result in regional oligopolies
- ◆ The UK needs an improved planning process which together with an appropriate price control, will encourage the monopoly transporter to provide the necessary investment knowing that it is going to be allowed an adequate return on such investment

The Contribution of the Regulatory Regime

Full competition has been introduced into the UK for both gas and electricity over a relatively short timescale. This has been achieved by considerable emphasis on regulation and the enforcement of standardised procedures, licences and contractual arrangements whilst necessitating very significant expenditure on new systems in both gas and electricity. Currently, the UK continues to operate a highly regulated structure that affects both the monopoly transportation companies and those private companies operating in the trading, shipping and supply of energy.

With regard to gas, UK end consumers have some of the lowest (if not the lowest) gas prices in Europe. There is a very active and liquid market for the trading of gas albeit the futures market is relatively short term. This provides benefits for marketers, traders and producers through benchmark pricing. Transportation price control has continued to lower real prices for the movement of gas from the beach to the end consumer. Whilst regulation can take some of the credit for these reductions through encouraging supplier competition, a significant proportion has come from the fact that during the 1990's, the UK market has been over supplied, oil and gas prices were weak and asset-sweating rather than investment, has been the priority for Transco. The flexibility in the transportation network that came from an oversized system at the time of privatisation has also supported producer competition to bring their gas to market.

TFEG&P's main concern that we believe the PIU should address is the interaction between UK government policy and Regulatory policy. It is our belief that it is the role of Government to set clear and unambiguous policies and for Regulation to demonstrate how the actions it takes support these policies.

The introduction of NETA has been heralded by the Regulator as a significant success but it is clear that renewable generators and CHP owners do not believe this to be the case. Coal fired plant has recently seen its share of generation increase reflecting its supposed reliability, whilst turbines on wind farms lie idle not because of a lack of wind but so that the farm is not penalised by punitive imbalance charges. All this despite the fact that for a number of years the government has set strong targets for the introduction of renewables and CHP in the UK.

Whilst it is possible currently to envisage modifications to NETA that will accommodate the present levels of renewables, changes are required that anticipate both the 2010 target of 10% that is government policy and at the same time, many coal and nuclear plants coming to the end of their life. To manage the problems that follow from these events, NGC should be required to purchase the required level of flexibility from the market in advance.

This approach has a number of benefits:

- The cost of renewable will be obvious.

- NETA will be less volatile, this is essential to generation and marketing, the extreme volatility associated with a small gap between supply capacity and demand will reduce competition as companies decline the risks and increases the probability of an electricity supply crisis.
- A very clear signal will be given of the need for investment in more generation capacity which is important since otherwise the investment would be based on unpredictable price spikes.
- The threat from greater modulation required from the gas system could be anticipated.

In gas, the regulatory price control focus continues to be on providing the minimum base level infrastructure with an expectation that market forces via capacity auctions, will provide the appropriate investment signals to Transco. The Regulatory direction appears to be to minimise investment in a continuing drive for economic efficiency and minimum transportation costs whilst the Government wants to encourage the maximisation of production from the North Sea resources. It is our view that because of the price control risk, the differing asset lifetimes between offshore and onshore investment and the increasing uncertainty about the sourcing of the future supplies of imported gas, this reliance on auctions to determine investment signals will not work.

Instead the UK needs to recognise that in order to encourage security of supply it needs to have a flexible transportation infrastructure capable of providing alternative routes for gas entry and thus allowing the continuation of producer on producer competition. If this flexibility is destroyed, the UK will be left at the end of the European gas supply chain rather than an integral part, with consequent increases in risks to security of supply and price. It is essential that the price control framework supports this flexibility.

We are also concerned about the implications of moving the gas balancing system into line with the electricity balancing system. Our belief is that the design of the gas transportation infrastructure supports the current daily balancing period. To shorten this period (down to an hour or less) will introduce significant volatility into the gas market, which will damage the current liquidity in the market. The impact could spread far wider than gas or electricity as the demand responds to short term price signals. Significant action by consumers in switching to alternative fuels over very short time periods could further impact on the physical balancing of the system and potentially introduce far greater risk with implications for both increased costs and safety of the system. If this were to happen we would then see significant additional investment required in the gas transportation system with a consequent increase in overall costs. Our view is that balancing of the gas supply and demand should continue as at present on a daily basis in line with the physical characteristics of the network.

In general we believe that regulatory policy must be subject to the same guidelines as that of any other government policy. As such we are particularly disappointed that Ofgem continue to dismiss the need for cost benefit analysis

despite continued requests from the industry and from other learned bodies. Without this discipline there is a concern that many regulatory inspired initiatives do not have adequate justification and eventually result in increased costs much of which is likely to eventually be passed on to the consumer.

We also believe there is adequate provision under the licensing conditions and general competition law to ensure that anti-competitive practices are prevented. We support the principle which we believe is shared with Ofgem, that as markets make the transition from monopoly to competitive, so the regulation of those markets should also make the transition to the regulation applicable to normal competitive markets in the UK. There is much evidence of increasing competition but there has been little evidence of real consideration of the regulatory transition. As an example, the industry receives regular advice from Ofgem as to how it should bid in competitive markets. As Ofgem has achieved very wide ranging and ill-defined powers under the licenses, and as Ofgem has the power to levy heavy penalties, with (almost) no right of appeal, this is a significant increase in the detail and burden of regulation. The adoption of the approach of the OFT in these competitive markets would allow them to develop in a way which to date has brought major benefits to the UK in terms of cost efficiency of the energy industry and has considerably improved the level of service to customers, at the same time as delivering a real reduction in their energy prices.

The need for maintenance and development of the Gas and Electricity infrastructure.

Through the period 1992 to 2000 gas demand increased by 66%. This demand is projected to increase by 20-30% of the 2000 demand by 2020 due to increasing use of gas for generation (CCGT's and CHP) and increased domestic usage.

Over this same period the investment in the transportation infrastructure has been of a far smaller magnitude with most investment occurring in the local distribution zones to cater for new connections. The result of this has been a significant reduction in transportation costs over the period with UK end consumers benefiting from these.

Over the last 2-3 years we have seen increasing evidence that any spare capacity in the network has now disappeared not only at times of peak winter demand but also at other times of the year. Whilst there is an opportunity to increase the capacity in the Bacton-Zeebrugge interconnector, as well as the potential for further interconnectors, it is clear that the Northern terminals, particularly St Fergus will be the preferred landing place for much of the UK gas, either from continuing UK off shore development or from imported Norwegian gas.

However this will need significant investment to improve the gas transportation infrastructure, particularly with respect to its ability to bring increased volumes of gas from north to south.

The Regulator's view is that tight price control be continued to further reduce transportation costs and that Transco should be set investment incentives to meet market demand which is to be signalled via long term auctions of network capacity.

The risks of this approach are significant and, we feel, far outweigh the potential benefits to existing consumers of continuing small reductions in transportation costs:

- ◆ The signals for increased capacity if forthcoming (and that will very much depend on the structure of the long term auction mechanism) may not be strong enough (over the full asset life) for Transco to respond
- ◆ A strict policy of only providing infrastructure to meet proven demand will make investment in potential production fields far riskier and deter potential importers. It will also remove any flexibility from the network that is needed to cater for short term fluctuations in offshore deliverability
- ◆ In order to maximise indigenous production producers will need confidence that gas can be both landed and that entry costs will allow the gas to compete with that brought in at other entry points. Without this certainty the risks of new investment will be too great and will discourage full recovery of N Sea assets, resulting in earlier and larger import volumes.
- ◆ We have already seen very significant increase in entry costs incurred when the market felt that the available entry capacity was insufficient to meet the total potential supply/demand. If these high costs continue then they will eventually have to be absorbed in to the costs paid by consumers, easily negating any benefit from the general lower transportation costs
- ◆ When looking at protecting end consumer prices, the overall price chain from the consumer to the source of gas needs to be understood. The changing structure in the UK has resulted in a number of smaller players as opposed to a single national champion. When negotiating future gas supplies this reduced buying power will be further damaged if there is no choice as to the route by which the gas can be imported and the marginal savings in entry costs could be eroded by the consequent increase in gas costs
- ◆ With an increasing proportion of the UK generation reliant on gas there may be times when stations cannot run because of supply problems or because of excessive product costs leading to problems for the security of the electricity supply network

- ◆ If the interruption risk is perceived to be greater this may encourage wider use of alternative fuels, oil, coal etc with an increase in end consumer investment and a significant impact on the environment.

The focus for regulation should now switch to security of supply and network resilience to ensure that there remain viable alternatives for the sourcing of beach gas supply. The UK needs an improved planning process which will sufficiently encourage the monopoly transporter to provide the necessary investment knowing that it is going to be allowed an adequate return on such investment. We recognise that this could imply the potential for some under utilised infrastructure in order to provide supply flexibility and resilience but this will always be the situation in an infrastructure that has an asset life of 40-60 years. The upside is that it will continue to allow terminal to terminal competition resulting in lower gas costs than would be the case if the UK were overly constrained in its supply options.

Assuming the overall UK infrastructure is determined at a UK level we have no fundamental objection to the use of auctions as a means of allocating capacity either on a short or long term basis. However we will continue to be concerned if auctions are used as a means of ensuring that monopoly networks invest enough to meet the demands of their networks. To date there has been no practical method found of resolving the conflict arising from the use of a market based solution for the sale of a product the revenue for which is regulated.

We trust that you will find the above comments of use in your review. If there are areas that you would like further discussion or clarification on then please contact either myself or Steve Ladle, Strategy Manager (0207 318 6814).

Yours faithfully,

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