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## Response of Oil & Gas UK and Shippers' Gas Forum to ACER questions

### 1. The urgency and merits of the proposal

**1.1 Network code development process.** As you suggest, the harmonised gas day of 5am-5am has long been discussed in connection with the network codes. It was mentioned in ACER's CAM Framework Guidelines (FG) of August 2011 and even in the informal pilot FG issued by ERGEG in December 2010. However, the formal scope and informal focus of the CAM discussion between 2010 and 2013 was always on the Interconnection Points (IPs) only. CAM was designed to address cross-border trading of gas and was never presented publicly as having any impact on domestic networks receiving indigenous production. This is confirmed in the final CAM Network Code; it clearly applies to IPs only. Throughout the discussion of CAM, including the consultations and the comitology process, it could not have been reasonably anticipated by any UK producer or shipper that the process would culminate in a definition which would be later adopted in the BAL Network Code and have such a profound impact on the UK upstream-downstream interface.

It is the combination of the CAM and BAL network codes (not only CAM) which requires the change in the Gas Day in the GB downstream network and creates unintended, unanticipated consequences for the UK upstream sector. CAM defines the 'harmonised gas day' (Art. 3(7)) and BAL applies it to the GB downstream transmission network (Art. 3(1)).

We are not claiming that any 'new circumstances' justify the amendment we propose. The BAL network code will not come into effect in the UK until 1 October 2015 and the CAM network code a month later. We state simply that the process, timing and the evolution of each of the successive network codes was such that it was never possible for UK producers or shippers to foresee the outcome or to make appropriate representations during the development process. UK producers in particular were always assured that the network codes would not affect upstream operations.

In our view, the process of development of the EU network codes between 2011 and 2014 has been deficient in a number of respects. These deficiencies are most evident in the early network codes such as CMP, which required subsequent revision, and in CAM at a time when the political impetus to 'complete the single market by 2014' was still considered feasible. It is interesting to note that later network codes such as Tariffs have permitted more extensive discussion and stakeholder involvement, in an effort perhaps to avoid some of the mistakes in the earlier codes. We believe the process of development of CAM and BAL was deficient since it did not include a full impact assessment by any entity of the combined effect of the codes and did not consider consequences for the upstream sector. Impact assessments were conducted but were restricted to the networks themselves without proper regard for legitimate interests beyond the networks.

The legislation of the Third Energy Package and subsequent network codes apply only to the downstream networks. Participation in the process of code development was dominated the TSOs, ENTSOG and ACER, none of which has a direct responsibility for the upstream. The impact assessments which were prepared failed to consider the interests of EU upstream producers or to understand the implications for the upstream. They addressed the codes one by one and did not offer any external party a view of the combined effect of the codes. Furthermore, in the case of the

CAM impact assessment, we understand this was submitted to the Member States in December 2012 without prior public consultation. Once the opaque comitology process had begun, there was little or no opportunity to follow the process and certainly none to influence the outcome. After the agreement of the CAM NC in comitology and it became clear that BAL would simply adopt the CAM definition of the harmonised gas day, it was evident to UK upstream that EU law was being written without any opportunity to influence it at any stage. When UK producers and shippers sought clarification from UK authorities of the implications of CAM and BAL, they were assured that the codes did not apply to the UK upstream and did not create any obligations on upstream producers.

More important than the lack of appreciation of the upstream impact was the failure to understand that dual gas days in the UK would undermine the operation of the CVIA which underpins the NBP wholesale market. The CVIA is critical to ensuring proper attribution of legal title to gas in the NTS. Any erosion of liquidity in the NBP market would damage the interest of all UK participants, including consumers, contrary to the aims of the network codes. This downside risk for hub market liquidity was simply not recognised in the impact assessments.

It took UK producers, terminal operators and shippers several months after the adoption of the CAM NC to identify the full commercial consequences and costs of the Gas Day change. Since then, we have been active in seeking a derogation for the UK, a delay in implementation to allow a full impact assessment and, most recently, an amendment to EU law. Both our associations have also participated in searching with National Grid for a second-best UK industry 'solution' which allows the co-existence of two gas days in the UK.

**1.2 Financial costs, dual gas days and 'alternative solutions'.** Unfortunately, we have not identified any 'solution' which would allow the UK to operate with two different gas days and which preserves the operation of the Claims Validation Information Agreement (CVIA) and the integrity of the NBP market. After more than 12 months of consultation and industry discussions, there is no easy solution in sight. This is why we are seeking an amendment to the EU network codes.

The current position in the UK is that the 5am-5am Gas Day defined in CAM and the GB Uniform Network Code (UNC) will be adopted in the downstream transmission network on 1 October 2015. There is no legal requirement to change the 6am-6am Gas Day in the upstream allocation systems or the terms of the Network Entry Agreements (NEAs) between National Grid and the terminal operators which govern the information flows from the onshore terminals to the TSO.

The upstream and downstream systems in the UK have always had a common gas day. It is clearly undesirable, inefficient and sub-optimal to operate with different gas days. The inevitable small discrepancies between daily flows measured 5am-5am and 6am-6am mean that from 1 October 2015 it will no longer be possible to operate the existing CVIA. This industry-wide legal agreement provides a means of reconciling upstream allocation quantities and downstream nomination quantities for each gas day. Since 1997, the CVIA has ensured proper attribution of legal title to gas entering the NTS. With two different gas days this will not be possible. Without a secure, reliable basis for establishing legal title, commercial disputes are much more likely to emerge. Unlike those who import gas into the UK, indigenous gas producers will no longer have a secure basis for establishing legal title to gas they supply to the NTS. Why then would they agree to sell gas at the NBP when they would not incur this risk if they sold offshore or 'at the beach'?

Why does the UK upstream not wish to change its operations to 5am-5am to maintain a common GB Gas Day? First, the change would be costly and disruptive and upstream operators are not legally obliged to do so. As we described in section 8 of our submission in July, the transition costs of the change are significant, amounting to £40-50 million (£50-60m) for all upstream companies to change their own IT operating systems, to change metering systems (including some fiscal meters) and to review and revise all bilateral commercial agreements involving production, transportation and processing of wet gas, dry gas and in some cases liquids, too. These cost estimates have not changed since our submission in July. In response to an enquiry from DECC, we verified our estimates in August 2014 through a more extensive survey of O&GUK members and upstream operators.

Secondly, the meters measuring gas flows from 140 offshore gas-producing fields cannot be re-programmed or physically modified simultaneously as they could onshore. Some offshore operators do not know whether it is physically possible to change old but functioning offshore IT systems to a new gas day. Thirdly, the cost of transition to a new 5am-5am gas day would not be borne equally by all companies. The 13 onshore terminals receiving and processing UKCS gas are not equally affected. One of the terminals with simple upstream operations involving few fields under common ownership can make the changes at relatively low cost and have indicated its willingness to do so. However, for most terminals which have many upstream users or complex contractual arrangements (sometimes involving oil streams), the cost of changing IT systems, contracts and meters are punitively high. Operators of small-volume, late-life, largely depleted fields in the mature Southern North Sea and independent terminal operators are most exposed. For most operators, changing the gas day would represent unproductive, compliance expenditure. Furthermore, unlike the transition costs incurred by the TSO, the costs incurred upstream and by shippers are not capable of being passed on to customers or consumers.

Since the adoption of the BAL network code, the UK industry has held several meetings to search for an acceptable, agreed solution involving National Grid and terminal operators. There has been no progress so far since National Grid has expressed its unwillingness to either delay implementation or to introduce new commercial balancing arrangements at onshore terminals receiving domestic gas. These discussions are due to continue in early November.

**1.3 Possible delay in implementation.** Most upstream operators are simply not in a position to change their operational information flows to 5am-5am by 1 October 2015, even if they were required to do so. The timetable for implementation of the Gas Day change was set out in UNC Mod 461, approved by Ofgem despite the failure of the industry panel to support the change. Many in the upstream warned that it was over-ambitious given the extent of the legal and operational changes needed. Unhelpfully, UNC Mod 461 does not allow for a delay of up to 12-month in BAL implementation mentioned in the NC. In our view, the over-ambitious timetable owes more to convenience for TSO IT system changes than it does to practical considerations.

A delay in the implementation of the change in the Gas Day would be helpful since it would allow more time for two things: (1) an assessment by ACER/ENTSOG of the costs and benefits of the change and our amendment application and (2) a search in the UK for a mutually acceptable industry agreement over how to address the costs and risks created by two gas days. The two UK-specific issues are (1) how to manage the commercial balancing risk at terminals which remain on a 6am-

6am gas day and (2) how to preserve or reproduce the benefits offered to the whole industry by the CVIA if it can no longer operate after 1 October 2015.

We jointly asked National Grid to delay implementation of the Gas Day change in June but they have declined to do so. National Grid says that BAL implementation, including the Gas Day change, has 'significant interactions' with the other network codes and that its EU delivery plan would be jeopardised if the Gas Day change were to be delayed. It has not provided any details of these interactions, nor has it indicated that a delay in the Gas Day is impossible or infeasible. In view of the legitimate concerns about what will happen in the GB gas market after 1 October 2015 with two different gas days (especially if there were to be a major supply interruption or gas emergency), it remains our view that it is more important to find the best possible 'solution' rather than to press ahead with an unrealistic and over-ambitious timetable.

Shippers' costs of changing to a 5am-5am Gas Day (estimated at £2-5 million) are unlikely to be materially affected by a moderate delay in implementation. National Grid has not disclosed to our associations the costs associated with its EU NC delivery plan, nor the cost attributable to the BAL NC or specifically the Gas Day change. We are therefore not in a position to assess their costs of a modest delay. However, we venture to suggest that they would be very small in comparison to the value of what is at stake in the upstream and in the potential increase in gas supply costs for all consumers if NBP liquidity is damaged by the change.

**1.4 Upstream difficulties: the position of onshore terminal operators.** Sections 3, 7 and 8 of our submission in July and our remarks in 1.2 above summarise the main legal and operational difficulties faced by the UK upstream sector if it had to change to a 5am-5am Gas Day. In addition, it is worth mentioning the position of the onshore terminal operators at the upstream-downstream interface. Most of the operators of the 13 onshore terminals will face difficulties if only the downstream gas day changes and they cannot continue to submit operational flow information to National Grid on a 6am-6am basis. National Grid indicated in April that it is willing to accept 6am-6am flow information on an interim basis but not as a permanent solution. We believe that if such information is acceptable on an interim basis and does not jeopardise the 'safe and efficient operation' of the NTS, then it should be acceptable beyond a transitional period.

Terminal operators formed a 'Technical Working Group' in April 2014 to explore the operational issues arising from the proposed Gas Day change. The ownership and commercial position of each of these 13 terminals is different but they share a number of common issues and problems in adapting to what might be two different gas days. The overwhelming majority remain opposed to the Gas Day change but they have jointly explored a possible new model of the interface with National Grid which will allow some discretion in how they adapt and avoid being forced to assume unsustainable business risks. We attach for your consideration a presentation by BP one of the terminal operators which addresses some of the issues and complexities. This remains 'work in progress'. The terminal operators' proposal for the introduction of new commercial balancing arrangements with National Grid will no doubt be discussed in the industry working group due to meet in early November.

## **2. The impact on trade and the internal market**

**2.1 Traders' and shippers' view of UK-continent trading.** The membership of our associations (see Appendix 1) includes many of the largest shippers on the NTS, on the Interconnector UK (IUK) and on BBL. We have not consulted other 'traders' before making this submission and we have not sought to elicit third-party support for our position. We propose to leave consultation to ACER and to ENTSOG. The issue of the efficiency of UK-continent cross-border arbitrage has already been openly discussed during the investigation of the interconnectors by Ofgem, CREG and ACM in 2012-13. There is wide industry agreement that the most price-responsive and efficient cross-border gas trade anywhere in the EU is the trade across the IUK between the UK and Belgium. This is supported by recent statistical analysis of hub markets by the Oxford Institute for Energy Studies.

The IUK-based trade may not be perfect but it is highly responsive to NBP-Zeebrugge and NBP-TTF spreads. This has been achieved since commissioning in 1998 with different gas days on the continent and in the UK in part because IUK operates efficiently with hourly nominations and hourly IT systems. None of our members believes that harmonising the EU gas day will make this arbitrage more efficient. Indeed, we believe that it is incumbent on those who might claim that harmonisation of the gas day will improve arbitrage efficiency to adduce appropriate evidence. In our view, it is a possible loss of liquidity in adjacent hub markets or inappropriate tariff design which present a much greater risk to arbitrage efficiency in NW Europe than a failure to harmonise the gas day.

This is a critical element in our argument to allow the UK and Ireland to retain their existing gas day. There will be benefits to EU consumers of forcing the UK and Ireland to adopt the harmonised EU gas day only if the efficiency of UK-continent gas trade improves as a result of such harmonisation. If an improvement in arbitrage efficiency is not realised, then there will be no cost to EU consumers of letting the UK and Ireland retain a different gas day from the continent.

**2.2 Harmonised gas day and cost and benefits.** We have not made any general observations about the value of gas day harmonisation across the whole EU, only about the specific case of the UK-continent cross-border arbitrage. Removing a 6-hour difference in gas days between, for example, France and Spain could make a very important contribution to cross-border trade if it is accompanied by other reforms. In the case of the UK, the small one hour difference with the near-continent has not acted as barrier to trade because of the operating models adopted by the interconnectors.

We do not believe that there will be any 'negative financial effects on other players in the European market'. In discussion with UK and NW European shippers, no individual company has suggested that they, or more importantly any EU consumer, would be worse off if the UK retained its existing gas day. If, as we expect, there is no effect of changing the UK gas day on the efficiency of UK-continent arbitrage, then there is no consequent economic benefit or cost to shippers. Some shippers might welcome the convenience of a harmonised gas days in routine operations. However, if the interconnectors have an operating model which allows the management of a one hour difference through the flexibility offered by their linepack, then there is neither an economic benefit nor an economic cost from harmonisation.

**2.3 Impact of our amendment on TSOs.** We have had some limited contact with IUK and BBL on this issue but we do not seek to represent their views in this submission. Neither are we well-placed to describe accurately the likely impact on them if the UK retains its existing Gas Day. We understand that both TSOs have some discretion as to how they adapt their operating models to comply with the new EU network codes. All we can do is to observe that IUK and BBL have operated broadly to the satisfaction of their shippers and, it appears, of their respective regulators under the regimes in operation so far. Our reading of the new EU NCs is that IUK and BBL would be able to comply fully with the obligations on TSOs in the network codes, including those concerning the bundling of capacity, and to continue to operate with a different gas days at each end of the pipeline. Both have the flexibility provided by linepack but they currently have different operating models. Based on the information disclosed so far, it appears that a 'two-IP' operating model would be entirely consistent with maintaining a different gas day in the UK. After a transition period, in a world of fully bundled capacity, capacity at Bacton would be bundled 6am-6am and capacity at the continental end of the pipelines would be bundled 5am-5am. Both TSOs have obviously been preparing for a harmonised gas day of 5am-5am since the adoption of CAM. However, in our view, it remains true to say that both interconnectors could continue to comply with CAM and operate efficiently if our amendment were approved. We would welcome your comments on this point to confirm our reading and understanding of the EU NCs.

### **3. The parties and their interests**

**3.1 Information concerning our respective members.** In response to the enquiry about the membership of our respective associations, we include as an appendix a list of all the members of O&GUK with interests in upstream gas production and onshore gas terminals (44) and the members of the shippers' Gas Forum (11). There is wide range of interests represented from 'pure downstream shipper' to 'pure upstream gas producer'. Unsurprisingly, there is an overlap between our respective memberships since many larger gas producers are also licensed shippers or have sister companies which hold a shipper licence. Please note that CVSL is not a member of either of our associations since it exists only to operate the CVIA drawn up as a voluntary industry agreement by all NTS shippers. You will see from our membership list that some of our members are not 'traders' of gas; some of our producer members are not licensed shippers and at least one of our terminal operators has no interests in upstream production or downstream trading of gas.

Broadly speaking, the impact of the proposed Gas Day change is greatest on terminal operators and operators of offshore gas pipeline systems. All shippers will incur the costs of adapting IT systems but do not face the extensive legal and operational costs likely to be incurred by upstream operators of various sizes. Among the upstream operators who contributed to our updated cost survey in August, the range of estimates of the full costs of the change ran from £0.2m to £9.5m. Regardless of their cost exposure, all our members share a common interest in preserving the integrity of the settlement and reconciliation process provided by the CVIA and in protecting the liquidity of the NBP wholesale market.

There have been differences of emphasis among our members depending on the direct financial impact of the Gas Day change on their operations. However, it is striking that none of our members,

nor any other UK-based company, has suggested that anyone in the UK will benefit from the change; it imposes simply a deadweight cost on the UK gas industry without any benefit to UK consumers.

**3.2 Financial costs of transition and economic costs.** In the discussion of economic costs of the Gas Day change, it is essential to distinguish the direct 'one-off' financial costs of the transition in the upstream and downstream sectors from the economic costs which are likely to arise if the UK tries unsuccessfully to operate with two different gas days. The one-off financial costs of transition are capable of reasonable estimation but the longer-term economic costs are not so easily quantified since they depend on the size of the resulting misallocation of gas and the loss of liquidity in the NBP market marked by a widening of bid-ask spreads. System users and consumers will ultimately bear the transition costs incurred by the regulated TSO and DNOs but the real risk to consumers arises from a permanent erosion of wholesale market liquidity which will, other things being equal, raise gas supply costs in all future periods.

In our earlier submission, we described the estimated financial costs of transition which will be incurred in the whole UK gas industry (£65-100m or €80-125m) if the entire UK gas chain is required to change its gas day. Much of these costs will be passed on to UK consumers. As we described in our July submission, the costs among shippers arising from the change of the downstream Gas Day are relatively modest, amounting in total to an estimated £2-5 million. These costs comprise mainly the IT changes associated with the modification of the GB UNC of which the Gas Day change is just one part. If the change can be restricted to the downstream network only, then the cost to terminal operators and upstream producers can also be contained. In other words, if National Grid is willing and able to accept information (delivery flow notifications and end-of-day notifications) from terminal operators (TOs) on a 6am-6am basis, then the impact on TOs and upstream gas producers will also be contained.

It is important to remember that even if the UK industry were successful in reconciling two different gas days, thereby avoiding the financial transition costs upstream, there remains a significant risk to the integrity and liquidity of the NBP because the CVIA would be unworkable in its current form. CVSL, which operates the CVIA, estimates that if there were an unresolved mismatch of only 0.3% between producers' and shippers' aggregate claims, there would be a recurring cost to the industry of £37 million (€46m) per annum at a price of 60 pence/therm (section 10 of our July submission).

The potentially greatest economic cost of a gas day change is the cost of a loss of NBP liquidity reflected in a widening of bid-ask spreads. It is also the most difficult to estimate reliably and it would not be appropriate to make such an estimate in this submission. We have no insight into how the NBP might respond but the recent work on market liquidity presented to ACER by consultants Wagner, Ebling & Co. highlights the impact that lower liquidity could have on transaction costs and gas procurement costs by suppliers to end-users. These higher transaction costs would inevitably be passed on to consumers to some degree, which makes the Gas Day issue a matter of concern for consumers and regulators, not just for gas producers.

**3.3 'Technical and operating margins' of producers.** We have set out the issues and costs we anticipate in changing the UK Gas Day as required by the EU network codes. This is not an issue only for UK producers; it has implications far beyond short-term upstream operations to the NBP market on which UK and EU security of supply depends. Europe needs hub market liquidity to attract uncontracted gas, and in particular uncontracted LNG, to Europe in view of the way uncertainty over



future gas demand and market liberalisation are making it more difficult to sustain long-term supply contracts in continental Europe. We do not seek to represent the position of all our members with generalisations about what they are willing to accept or how they will respond. We seek only to alert ACER to the costs of the proposed change, the risks to NBP market integrity and liquidity and the absence of discernible likely benefits for any EU consumers.

**3.4 Upstream and downstream companies.** Although the anticipated financial transition costs of the proposed change lie mainly in the upstream sector, the risks of longer-term economic loss lie with all UK market participants upstream and downstream. Offshore gas discoveries and production in the 1960s and 1970s gave birth to the expansion of the UK downstream gas market and the emergence of a liquid wholesale market in 1995-97. The UK may become more import-dependent in the future but the need for a soundly-based, competitive, well-functioning wholesale market will persist. The harmonisation of the gas day will do nothing to promote the continued health of the NBP market; indeed, in our view, it carries grave risks that it will undermine the wholesale market.

The fundamental difference between UK gas producers and those in other EU countries is that no other major gas-producing Member State faces the costs and disruption of the unnecessary and misguided EU harmonisation of the gas day. We repeat our claim that we do not believe this was anticipated or intended by the authors of the network codes. We ask ACER to ensure that the harmonisation of the gas day is reviewed and that our amendment is put into the comitology process after a thorough cost-benefit analysis is conducted on its behalf.



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