



To all interested parties

*Promoting choice and
value for all customers*

Your Ref:
Our Ref:
Direct Dial: 020 7901 7050
Email: Robert.Hull@ofgem.gov.uk

27 June 2007

National Grid Gas National Transmission System Entry Capacity: Development of the regime in the medium to longer term (capacity substitution)

As part of the Transmission Price Control Review (TPCR) NGG agreed to three new obligations to introduce mechanisms for NTS entry capacity trade, transfer and substitution.

We think that capacity trade, transfer and substitution will be increasingly important given the ongoing changes in the sources of supply to the UK gas market. The NTS and the associated commercial arrangements for securing entry capacity will need to become more flexible with the decline in gas supplies from the North Sea and increased dependence on gas imports from a diverse range of sources. Movements in the price of gas in the UK relative to prices in the US, NW Europe or Asia could lead to changes in the sources of gas supply to the UK. The commercial arrangements will need to allow for capacity to be transferred or traded between entry points, where this is physically possible, in response to these changes. In the longer term, it will be important that the arrangements allow for capacity substitution, where this is physically possible, from terminals where there is spare capacity for example because of declining production from the North Sea to terminals where additional capacity is required to meet new or existing sources of supply.

Last week we published a letter¹ setting out how we expected these challenges would be met in the short term by the development of transfer and trade mechanisms ahead of this winter. We also set out our views on how we would monitor and enforce NGG's role in making capacity available using existing commercial tools as well as transfer and trade to get all physically available capacity to where shippers valued it most. We also confirmed

¹ National Grid Gas Transmission System Entry Capacity: Development of the regime ahead of winter 2007/8 (148/07) <http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/Documents1/Open%20letter%20-%20National%20Grid%20Gas%20National%20Transmission%20System%20Entry%20Capacity.pdf>.

that NGG would be publishing more information about the physical capability of the system this winter².

Yesterday we published the Notice under Section 23(3) of the Gas Act 1986³ to modify NGG's licence for the Transmission Price Control Review (TPCR) package, setting out the full licence terms including those for capacity trade, transfer, and substitution. This is the final consultation as part of implementing the TPCR.

The development of a capacity trade and transfer regime will only address entry capacity issues in the short term (probably up to two years ahead), e.g. for this year (including this winter 2007/8) and next 2008/9. However, capacity substitution mechanisms will be required to deal with entry capacity issues further ahead (probably more than two years ahead).

We wanted to use this letter, prior to the transmission workstream meeting on 28th June, to clarify further our views on need for development of the commercial arrangements in the medium and longer term to address the introduction of the capacity substitution mechanism. Ofgem introduced this new obligation as part of the TPCR package. The objective of this new obligation is to reduce the risk of not fully utilising the existing network assets by enabling unsold baseline capacity at a certain point of the network to be moved to another point on the network where users have given a signal for incremental entry capacity through the LTSEC (long-term system entry capacity) auctions. Substitution will only occur if shippers do not purchase all baseline capacity at a specific entry point through buying long-term entry capacity rights at that entry point in the LTSEC auctions.

We also expect that there are clear interactions between the introduction of the capacity substitution mechanism and the level of financial commitment which shippers have to make in order to obtain incremental entry capacity. Under the current Incremental Entry Capacity Release (IECR) arrangements, bids in the LTSEC auctions have to pass a NPV hurdle in order for incremental capacity to be released. This capacity substitution obligation will have implications on how this NPV hurdle is determined. The NPV hurdle is linked to the projected costs of providing incremental capacity and assumes that the provision of incremental capacity will require investment by NGG to make the capacity available. This isn't the case if there is surplus capacity that can physically be substituted between terminals.

At a recent gas transmission workstream on 7 June 2007 NGG suggested that the existing NPV test would remain appropriate when considering capacity substitution. We think this needs further discussion and consideration by the industry before any substitution arrangements are proposed for implementation. If surplus capacity can be transferred to satisfy bids at another terminal without any additional investment costs being incurred, it is not clear to us why an NPV test should apply.

Ofgem expects NGG to progress with putting in place a capacity substitution methodology which can be implemented while also ensuring that its charging methodology adheres to the charging methodology objectives set out in its licence. We recognise that there will be a clear interaction between capacity substitution and the IECR.

We would like to stress that we are firmly committed to the implementation of the agreed TPCR package, which includes the introduction of the substitution mechanisms, together with capacity trade and transfer, as they form an integral part of the overall TPCR risk and

² 25 June 2007 Zonal Capability Data, http://www.gasgovernance.com/NR/rdonlyres/F189C9F3-AE7D-42C4-935F-82952152A20E/17984/ZonalCapabilities25_06_07.xls

³ Notice under Section 23 (3) of the Gas Act 1986 – 151/07
[http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses/Documents1/Notice%20Under%20Section%2023\(3\)%20of%20the%20Gas%20Act%201986.pdf](http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses/Documents1/Notice%20Under%20Section%2023(3)%20of%20the%20Gas%20Act%201986.pdf)

reward package. We firmly believe that it is still possible for these mechanisms to be introduced before this winter and we fully expect NGG to do so.

We understand that NGG will be discussing these issues at the Gas TCMF meeting on 5 July 2007. At this meeting, we expect NGG to set out how it would address the interactions between capacity substitution and the IECR, most notably the NPV hurdle. We would urge stakeholders to attend. We will also be attending this special workstream meeting.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'Robert Hull', with a horizontal line underneath.

Robert Hull
Director, Transmission