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Dear Bob

BG Gas Services Response to "Transmission Price Control Review – gas entry baseline re-consultation."

Thank you for the opportunity to comment on the above consultation. BG Gas Services Limited ("BG") holds a shipper licence under the Gas Act. BG Gas Services is part of BG Group and sells gas on behalf of affiliate companies in the UK wholesale market. In order to do this BG books entry capacity at various entry points.

The comments in this response also include our views on the National Grid "Summary Report on Entry Capacity Baseline Workshops." I also attach two letters I have previously written on the subject ("BG Gas Services Limited Comments on Treatment of Spare / Sterilised Capacity", and "BG Gas Services Limited Response to Code Modification Proposal 129 "Delay to the 2007 Amsec Auction"") which should also be considered part of this response.

Q4.1: **Do you agree that the objectives of the TPCR baseline review were appropriate?**

BG agrees that reviewing baselines to reflect the physical capability of the network is an appropriate objective, given changes that may have occurred since the previous Price Control was set. The rationale set out in Paragraph 4.4 for such a review is also reasonable.

However this ignores the fact that the outcome of TPCR4 has caused unnecessary disruption in the UK entry capacity regime, because of failure to take other factors into account. These include:

- Changes to the commercial entry capacity regime will impact how shippers book capacity. Changing the baselines with very little notice[1] so that shippers do not have time to adjust their booking strategies (because of the lead times for the various auctions[2]) does nothing to encourage or strengthen investment signals to NGG since shippers do not have the opportunity to participate in the relevant

[1] Paragraph 4.56 states that Ofgem only received one response to the TPCR Final Proposals. This is hardly surprising since the relevant document was a Decision document, not a consultation.
[2] See BG Gas Services Response to Code Modification Proposal 129 for further details (attached).

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auctions. Shippers had a reasonable expectation that previous baselines would continue at similar levels, or that significant changes would be clearly signalled well in advance. Neither of these expectations were met.

- The baseline review failed to take into account how the different elements of the entry capacity regime interact. For example we have moved away from a world where there was ample capacity at each entry point and shippers could be sure that the capacity would be available until it was sold. Shippers also had the assurance that 20% of capacity would be held back for the shorter term auctions. Under the new regime there is less capacity at entry points, less is held back for the shorter term auctions, and it is no longer certain that the capacity will be available at an entry point as it can be substituted or transferred to another entry point. This has the effect of making entry capacity commercially (but not physically) scarcer and favours those who are able to book in the long term auctions[3]. This does not improve flexibility in the system, it weakens it.
- The review takes no account of how the charging regime for entry capacity influences shipper behaviour. The previous regime of high baselines and zero reserve prices for short term bookings will encourage short term bookings. Paragraph 2.13 of the consultation fails to take account of this pricing aspect.
- The focus on buyback costs is reasonable but it ignores the fact that *all* transmission costs (entry and exit) are only 2% of final consumers bills. (Ofgem Fact Sheet "Transmission Price Control – Initial Proposals" June 2006). Competition in gas supply to the UK, that is enabling as much gas to enter the system as possible, is likely to have a much greater impact on consumers because of its impact on the wholesale cost of gas, and the ability of different retail suppliers to source gas and compete for customers. An entry capacity regime which makes it more difficult commercially to book capacity does not improve competition in gas supply.
- The review did not take account of the impact of changes to the regime on security of supply implications for the UK. Again, a commercial regime which makes it harder to book entry capacity will not encourage supply to come to the UK. This problem is exacerbated by the step change, inadequately signalled to the market, which occurred between the 2002-2007 Price Control entry capacity regime and the new regime.

Q4.2: Do you agree with the modelling approach we asked NGG NTS to carry out? If not, why not?

It is difficult as a shipper to comment on NGG's modelling approach because of the asymmetry of information and knowledge between shippers and NGG. Shippers will therefore tend to judge the TPCR by its outcome, which includes baseline levels. From the various Transmission Workstream discussions of baselines it is clear that there is scope for considerable discretion and judgement in calculating baseline levels. NGG has a clear incentive to reduce baselines, as, ceteris paribus, this will reduce their exposure to buyback costs compared to the previous baseline level. It was for this reason that BG and a number of other shippers requested an independent audit of NGG's modelling, a request that Ofgem has declined.

However it would seem obvious that a monopoly provider has two means of maximising its profits. Firstly it can charge what it likes in the absence of competition or regulation. Secondly it can restrict the level of output to minimise its costs and risks. The first course of action is not open to NGG, but, without proper scrutiny of the

[3] See "BG Gas Services Limited Comments on Treatment of Spare / Sterilised Capacity" letter dated 31st August 2007 to for further detail (attached).

baselines, the latter course clearly is. It is not clear how consistent the outcomes of the modelling were with the wider objectives of the regime, as opposed to NGG's own interests.

On a more detailed level it is not clear whether the modelling approach and its outcomes were consistent and logical. For example, based on the Workstream discussions, it appears that Teesside capacity was cut to 361 GWhd to make the aggregate level of baseline "fit" with the modelling outcome. Paragraph 4.40 of the consultation appears to confirm this. However the reason that Teesside was cut to this level was simply that it had more un-booked capacity compared to other entry points. This was despite the fact that gas flows at Teesside have recently exceeded the new baseline level. If the modelling is based on flows, this does not appear consistent or a sensible outcome. The approach of scaling back entry points which had less booked capacity also did not take account of the fact that shippers had no incentive to book capacity long term when they could be reasonably certain of buying capacity short term at a low price. However this is a problem connected with the charging methodology, not the baseline level at Teesside.

Another example is the level of baselines for some of the peak shaving LNG storage facilities. The baselines for Dynevor Arms has been cut from 50 GWhd to 8 GWhd, and for Glenmavis from 99 GWhd to 28.5 GWhd. This would appear to sterilise the storage capacity at these peak shaving sites as they will no longer have the entry capacity to flow at the same level as they did before. It is not clear how this fits with security of supply considerations.

The June 2006 Initial Proposals for the Milford Haven Baseline also appear to show a worrying lack of consistency between the TPCR review approach to baselines and the 2002-7 Price Control capacity regime. Ofgem's Initial Proposals had a baseline of 877 GWhd for 2008/9 but this was not consistent with the capacity which had been booked at Milford Haven by shippers as part of the process of triggering incremental obligated capacity release. This was rectified in subsequent proposals, but it does illustrate an apparent lack of attention to other factors which lies at the heart of the current problems. As noted above it is not possible to simply view the modelling of baselines in isolation from other aspects of the entry capacity regime.

Q4.3: One of the main difficulties we faced in the run up to the Final Proposals was to account for zonal constraints. Are there any better ways accounting for zonal constraints?

It is difficult to comment on zonal constraints for the same reasons it is difficult to comment on the modelling performed by NGG. It is clear that such "constraints" have considerable impact on the level of baselines that can be made available. For this reason we would welcome greater scrutiny of the modelling.

We would also welcome greater scrutiny of why such constraints have occurred, if indeed they have. For example NGG was allowed £516m for load related entry capacity capex during the 2002-7 Price Control. However NGG only spent £419m[4]. There is a risk of a circularity of argument if NGG is able to avoid the consequences of any under-spend of capex allowances by simply lowering the bar when it comes to setting the baselines at the next Price Control. In this case NGG's under-spend could be due not to out-performance based on greater efficiency, but simply as a result of restricting output as described above.

Q4.4: Are there any other issues we should have considered in this chapter?

[4] TPA Solutions, TPA TPCR Efficiency Study & Forecast Opex: Final Draft 3. 29th September 2006

Greater consideration needs to be given to how the baselines fit in the overall regime. For example one approach can be to set high baselines with an allowance for buybacks in recognition that NGG may not always be able to honour capacity booking commitments. An alternative approach would be to set much lower baselines but couple these with a lower buyback allowance for NGG as it faces a lower buyback risk. The current package seems to fall between these two stools with the benefits of neither.

Despite requests during the industry discussions on the matter, neither NGG nor Ofgem have been able to explain adequately what were the benefits to shippers and consumers of lower baseline levels. For example at Teesside the proposed baseline in the Updated Proposals in September 2006 was 684 GWhd compared to the Final Proposals' level of 361 GWhd. It is not clear why Ofgem suddenly decided that a much lower baseline level at Teesside was consistent with other parts of the TPCR package.

Q5.1: Would you consider any of the alternative approaches for allocating the free increment as discussed in this chapter more or less appropriate than the approach adopted for the TPCR Final Proposals baselines, please give reasons why.

It is not clear that the calculation of the overall baseline level, and hence the level of free increment, is appropriate for the reasons we state above, the principal one being that they are subject NGG's own interpretation and modelling assumptions.

We do not agree with the assertion in Paragraph 5.8, that even were baselines to be reallocated between entry points , the overall level would need to be consistent with other parts of the TPCR package, as we do not accept that NGG faced greater risks compared to the previous Price Control baselines. Ofgem and NGG would need to show that NGG faces greater risk as a result of the other aspects of the regime in order to compensate for lower risk as a result of lower baseline obligations.

It has been suggested that NGG faces higher risk because of the obligation to trade and transfer capacity. However this ignores the fact that NGG is able to control the risk arising from transfer and trade via the exchange rates its sets, and the zonal maxima constraints. Without sufficient expert scrutiny of these it is not possible to know what level of risk NGG is really facing. It is in NGG's interest to exaggerate the level of risk. To date we only have NGG's word for how much risk it faces. Ofgem itself states in Paragraph 3.11 that it did not consider that the introduction of new obligations such as Substitution and Transfer and Trade should not materially alter NGG's risk profile. This simply begs the question even more as to what changed so much to NGG's risk profile between the 2002-7 Price Control and the 2007-12 Price control that such radical changes to the baselines was required.

Q5.3: NGG NTS presented three principles in order to allocate baseline capacity, namely to (i) allocate in line with physical capacity, (ii) constrain not to exceed previous obligated levels and (iii) broadly commensurate with buyback target. Do you agree with these principles? Please explain why or why not.

(i) As noted above physical capacity is difficult to define as it is subject to modelling assumptions.

(ii) It can be reasonable to constrain baselines not to exceed previous obligated levels, dependent on other factors. For example the logical corollary of such a rule is that there should not be a significant reduction below previous obligated levels as shippers had a reasonable expectation that baselines would remain

broadly consistent across price controls. To have a rule that baselines at entry points cannot exceed previous baselines but can be significantly below it seems one sided. Furthermore if NGG has been undertaken investment during a Price Control which increases network capacity it does not seem unreasonable that baselines can be increased to reflect this.

(iii) It is difficult to assess whether the allocation of baseline capacity is commensurate with the buyback target due to the lack of data on buyback risk. At the industry workshops neither Ofgem nor NGG were able to explain how NGG's buyback risk had increased from the previous Price Control such that a cut in baselines was required.

Q5.4: NGG NTS presented slightly different ways of reallocating entry capacity to different entry points, would you find these approaches more or less appropriate? Please give reasons why.

We are concerned that none of NGG's proposed approaches address the key issues which is the overall baseline level of 8814 GWhd and whether this is appropriate.

Reallocating on the basis of the old obligated levels has some merit because it is consistent with what shippers might have expected, but it still leaves Teesside with only an allocation of 397 GWhd compared to a previous level of 761 GWhd.

Q6.1: Is our approach for allocating the free increment, taking zonal constraints into account appropriate given the premise that baselines need to reflect the physical capability of the system?

As noted above the relationship between the physical capability of the system and the baseline capacity that can be offered at an entry point is subject to the judgement and assumptions of the person modelling the system. There needs to be greater scrutiny of the level of buyback risk and physical constraints on the system to ensure that the assumptions about system capability are appropriate.

Q6.2: Are there any other factors that we have not considered which should be assessed in considering an appropriate adjustment to baselines?

Please see the responses above. Of particular importance are greater scrutiny of the modelling of system capability, and whether the aggregate level is appropriate.

Q6.3: What are your views on the different options outlined for allocating capacity in a different way, whilst maintaining aggregate baselines at the current TPCR Final Proposals level of 7629 GWh/d.

Please see our responses above.

Q6.4: What are the advantages and disadvantages of keeping baselines unchanged at their current TCPR Final Proposals level?

We see no advantages in keeping baselines unchanged. The net effect of the baseline changes has simply been to create greater uncertainty and increase the possibility that gas will be unable to enter the system as a result of changes to the commercial entry capacity regime, rather than any underlying physical constraints.

Q6.5: If we were to increase the aggregate baselines how could we quantify possible increases in buyback costs and/or capex allowance also given the timescales involved.

Independent expert scrutiny of NGG's modelling and assumptions would assist in this task.

Q6.6: If we were to increase the aggregate baselines how should we allocate the additional capacity? Which mechanism, if any, should we use.

An approach which reinstated capacity at those terminals which had suffered the greatest reductions, and which were more likely to flow gas, such as Teesside would be appropriate. However this question can only be properly answered when there is sufficient information (on issues such as buyback risk, the capability of the system etc.) to give a considered response.

Q6.7: Are there any other considerations which we have not highlighted which should be taken into account if we were to increase aggregate baselines.

Consideration should be given to how the whole entry capacity regime fits together and how it will work in practice, namely baselines, transfer and trade arrangements, substitution arrangements, and pricing. For example high baselines can be consistent with incentives to book entry capacity where there are appropriate reserve prices for booking capacity in the short term. Alternatively low baseline levels, coupled with a lower level of capacity held back for shorter term auctions, exacerbate the problem that substitution could lead to stranding of UKCS gas reserves.

Another consideration is the amount of capacity to be held back for shorter term auctions. In a world of lower baselines coupled with Substitution, the amount of capacity held back for shorter term auction should be increased from the current level of 10%. Contrary to what is stated in Paragraph 3.13, Transfer and Trade does not make it easier for new entrants to gain access to capacity because of the impact of exchange rates and zonal maxima on the ability to move capacity between entry points.

Lastly consideration needs to be given to the timing of any changes to ensure they are consistent with shippers ability to book capacity in the various capacity auctions.

Should you have any queries please do not hesitate to contact me on 0118 929 3442 or at alex.barnes@bg-group.com.

Yours sincerely,

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