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Dear Robert,

RE: Transmission Price Control Review – Gas Entry Baseline Re-consultation

Thank you for providing the opportunity for us to comment on the above consultation document.

Before answering the specific questions posed by Ofgem in this consultation, it might first be helpful to set out the background to this issue from British Gas Trading's perspective, and to offer thoughts on the original TPCR baseline process.

Background

As a shipper responsible for around 40% of NTS gas throughput, British Gas takes a very close interest in all matters connected with NTS entry capacity. Any changes to the prevailing regime, no matter how small these may initially seem, could result in a significant change to British Gas' cost base. We need to understand such changes, clearly and as soon as possible in the process, in order to assess their impact upon our business and the costs to our customers.

During the Transmission Price Control Review 4 (TPCR4) consultation process, our understanding – informed by Ofgem publications - was that, post the debate on the existence of any recognised baseline capacity, the likely changes to former entry capacity baselines would amount to very small reductions at a few entry points. It was therefore with significant surprise, and even dismay, that we read Ofgem's final proposals' document of December 2006, which signalled extensive changes to entry baselines at a number of locations. Most notable amongst these were reductions in excess of 50% at two key entry points, Teesside, and Barrow (where we are the primary capacity holder), with an overall reduction in NTS aggregate baseline capacity of 13%.

Changes of this order of magnitude were in no way consistent with the messages that had been given to the industry throughout TPCR4, and we consider the method of release of

this information at the final stage of the TPCR4 process to be a serious breach of good regulatory practice, coming as it did in the form of a *fait accompli* in a final proposals document, rather than proposals for discussion in a consultation.

We therefore welcome the fact that Ofgem has recognised the concerns of a number of industry players through the publication of this re-consultation document, and also through the various industry discussions that have been held in order to provide greater understanding of the complexities of this issue, and some thoughts on possible outcomes. We sincerely hope that the outcome of this re-consultation exercise will be to rectify the shortcomings of the TPCR4 process that have been identified.

The need for independent audit

What has come to light throughout this process is the lack of understanding by the industry of the actual capability of the NTS or, indeed, the underlying technical/commercial rationale for any particular set of proposed baselines. This lack of understanding results from an almost total absence of meaningful data being released by National Grid and Ofgem in this respect. We would cite as an example the very wide range of possible baselines that were considered by Ofgem when deciding on the new, aggregate system capability for TPCR4.

This situation is further compounded by the interaction felt by National Grid from sold system capacity, and the degree of risk it faces from capacity buy-back. This situation, we believe, has tended towards ensuring that NTS capability and operations are closely guarded processes completely opaque from industry overview.

Given that industry players are unable to scrutinise and police these aspects of the entry regime effectively, we believe it is essential that system capability is made transparent through a robust and thorough audit, carried out by a credible, independent auditor. Without this, there is a real danger that some players will continue to be unable to accept the final outcome of this re-consultation process.

In the light of recent and forthcoming developments, this is not simply a question of setting revised initial baselines, but also one of clarifying the basis on which capacity transfers between ASEPs can effectively amend those baselines over time, either via the processes involving shippers or via NGG's substitution decisions in response to longer term capacity auctions.

Recent and forthcoming developments to the transmission regime

Within its baseline re-consultation document, Ofgem clearly sets out the challenges facing the NTS, and indeed "UK plc" from the significantly changing supply patterns, as well as the arguably more predictable demand patterns. Ofgem, in our view correctly, surmises that such changes are likely to require a much more flexible network compared with the past. However, we disagree that the steps that Ofgem has taken through TPCR4 will achieve the required degree of flexibility and in some cases may actually remove flexibility.

We fully recognise that a balance needs to be struck between the ability of the network to cope with changing supply and demand patterns, and the need to ensure that customers,

ultimately, are only required to fund the efficient cost of providing that network. We are not convinced, however, that Ofgem has fully considered the cost to customers of a number of the developments that have emerged as part of TPCR4. We believe that the scope of TPCR4 should have been broad enough to fully cover these costs.

Ultimately, the interests of gas consumers are not related solely to the optimisation of gas transmission investment decisions – but rather to the overall cost of providing gas supply, including the much larger cost of commodity which can be influenced in turn by the level and extent of transmission constraints.

Substitution

We would point, for example, to the concept of permanent substitution of baseline capacity. Whilst this might appear to ensure that actual investment is only made where absolutely necessary, i.e. where it is not possible to satisfy the demand in question by removing capacity from another existing source, utilising this methodology even once will inevitably result in a “tightening” of the network. This is especially the case where capability is destroyed through the use of exchange rates between entry points. This outcome clearly runs counter to the stated principle of a more flexible network. Taking this to the extreme as a way of illustrating our general argument, prohibiting any investment whatsoever would appear to guarantee a cost efficient outcome, but viewed in the longer term this is clearly not in customers’ best interests.

We are also not aware of the costs and risks, if any, that Ofgem has factored in to its analysis resulting from the inability of the network to adapt at short notice to receive increased volumes of gas from existing sources, or gas from sources that are currently regarded as marginal. We believe that any “stranding” of gas off the system as a result of a tighter network will feed through directly to commodity prices, to the detriment of all end consumers.

A further concern with the proposed capacity substitution approach is the very real likelihood that shippers will be required to book and pay for incremental capacity at a terminal in order to restore some or all of the baseline that has been moved away. There are clearly lead time and cost implications for shippers stemming from this, and it seems even more perverse when the physical pipeline and associated systems probably still exist in order to restore capacity. To give just one example, there appears to be the potential for this issue to arise as between Barrow and Fleetwood, depending on the actual progress of potential gas storage projects at each location. Costs resulting from this will also eventually feed through to consumers.

We also believe that the introduction of a permanent baseline substitution methodology will significantly alter the signals that National Grid is expected to interpret from capacity auctions. For example, we consider that during the price control period 2002-2007, a QSEC capacity booking is likely to have indicated a shipper’s reasonable estimate of its minimum capacity requirements for the booked period, to be supplemented in later auction processes. However, under the new regime, we believe that this is going to change.

With capacity potentially becoming more “at a premium” within a tighter overall NTS, shippers are likely to start booking much longer term, and at volumes that might either represent closer to their peak requirements, or alternatively could be to protect against substitution away from a particular ASEP.

We believe that substitution combined with 10% capacity retention for shorter term auctions is also likely to have a detrimental impact on the ability of new entrant to acquire capacity, and even to understand the market rules.

Finally, we consider that a much greater degree of transparency – subject, as mentioned above, to the possibility of independent audit – is required around the substitution process. This would help to ensure, in particular, that NGG decisions are made against criteria which are both clear to the market and consistent with the enduring rules applicable to shipper trades and transfers (e.g. as regards exchange rates for capacity transfer between ASEPs).

Limitation of National Grid Incremental Buy-Back Exposure

We have also noted with interest Ofgem’s decision to cap National Grid’s exposure to buy-back where incremental capacity is not delivered on time. This raises an interesting and fundamental point about Ofgem’s role as a regulator. On the one hand, Ofgem states that it believes in and champions competition as the primary means of protecting consumers. It is accepted that in order to achieve this role, Ofgem needs certain tools available to it, in particular powers under the Competition Act.

Against this background, by setting a limit on National Grid’s buy-back risk Ofgem seems to be not only further limiting National Grid’s risk exposure, but also expressing a lack of confidence that the market, with its associated regulations, would arrive at a fair price for capacity buy-backs, should National Grid fail to deliver capacity against that which has been sold.

We recognise that the planning and development process is uncertain in respect of building new pipeline capacity, but believe that National Grid has already been provided with adequate protection against these uncertainties, for example through the move to a 42 month incremental lead time. We therefore see this buy-back cap as being largely a protection mechanism for National Grid against the outcome of its own decision making.

Capacity Trades and Transfers

We agree with Ofgem’s sentiment that the Trades and Transfers methodology and calculations must be transparent and fair to Users. That said, we have been surprised by some of the outcomes of this process. One example is the exchange rate between Theddlethorpe and the Easington Zone. We note that this has been published at 19.5:1 for this winter period, yet when originally proposed Theddlethorpe shared a Zone with Easington and would therefore have benefited from a 1:1 exchange rate.

We also note that the adoption of a merit order in the National Grid methodology gives rise to significant scope for the management of buy-back risk. Further to our comments above in respect of a lack of system data to inform understanding, it is very difficult or even

impossible for shippers or other industry players to robustly challenge any of the outcomes from this process due to the lack of transparency. We would also add that a degree of stability – or at least predictability – of relevant business rules is required, in practice, for markets in capacity to operate in the desired effective and efficient manner.

Capacity holdback

British Gas agrees that it is necessary to hold back some obligated firm capacity from the long term auction rounds, for the benefit of new entrants or new developments, but only insofar as there is no liquid, secondary market for capacity. However, we also consider that excessive capacity hold-back could frustrate the development of such a secondary market.

We therefore agree with Ofgem's position on holding back 10% from the long term capacity auction rounds, with a view to reducing this to zero at such time as a liquid secondary market for capacity is established. We consider that even where capacity has been bought as primary capacity, players who do not intend to flow against that capacity will respond to financial incentives to sell on the capacity rather than lose their investment.

Responses to Ofgem Questions

Chapter 4

1) Do you agree that the objectives of the TPCR baseline review were appropriate?

Whilst we agree that Ofgem should oversee an efficient network investment and operation regime, we do not believe that Ofgem's thinking has been broad enough in respect of the implications of the baseline reductions imposed on the industry, or the effects of introducing permanent baseline substitution. For example, we do not believe that costs to consumers from potentially stranded gas, or the damage to confidence from sudden and unexpected baseline movements, have been fully considered.

2) Do you agree that the modelling approach we asked NGG NTS to carry out was appropriate? If not, why not.

We recognise that Ofgem and National Grid have sought to provide clarity around the modelling process that was used as part of TPCR4. However, it has become clear that any number of modelling exercises undertaken could result in an equal number of different outcomes, almost any of which could be argued to be appropriate. Scarcity of information available to industry players other than Ofgem and National Grid means that it is extremely difficult for us to assess the validity of the current baseline allocations – in particular the overall size of the cake.

We would, however, question whether it was appropriate to place so much weight on the data collected as part of the ten year statement. Evidence provided has shown that National Grid's own assumptions about flows into the network can and do change significantly between consecutive years, and reliance upon such data for a task as critical as setting baselines is likely to result in questionable outcomes, as

has been the case here. This is especially the case where industry players were not aware in advance that data they provided to inform the ten year would be used for this purpose.

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 of accounting for zonal constraints?

We do not have sufficient information about the NTS to comment on zonal constraints. However, we understand that National grid was given an allowance in the 2002-2007 price control, which could have been used to alleviate zonal constraints. We note that not all of those allocated funds were spent.

4) Are there any other issues we should have considered in this chapter?

As set out above, we believe that greater thinking, or greater emphasis on the evidence of that thinking, should have been undertaken around the cost of regulatory uncertainty, gas stranding etc resulting from the TPCR4 outcome.

Chapter 5

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 Proposal baselines. Please give your reasons.

We agree that the allocation of the free increment is not an easy matter. The TPCR4 outcome placed significant emphasis on ensuring that baselines were not reduced below the level of capacity sold at each terminal into the future. However, the capacity regime in place during 2002-2007 permitted, and indeed encouraged, shippers to top up their capacity holdings nearer to the date of expected flow.

It would therefore seem appropriate to have told shippers of Ofgem's intentions with regard to baselines – both the reduction and substitution of baselines - in advance of a long term auction process, such that shippers could purchase capacity with these future changes in mind. Ofgem would then have received a much more up to date and accurate picture of sold baselines, and this would have made the allocation of the free increment potentially much simpler, since there in our view there would be a significantly smaller free increment to allocate.

One possible option which could act as a proxy for this would be to take account of 2007 long term auction results when allocating the free increment.

2) We allocated Caythorpe and Blyborough (Welton) free increments to Hornsea and Theddlethorpe respectively, do you agree with this approach or should these free increments have been allocated in a different way and if so, how and why?

We have no particular views on this point, other than to stress the apparently arbitrary nature of the allocation process, and the fact that Theddlethorpe does not

appear to be in the same desperate need of additional capacity as certain other ASEPs.

3) NGG NTS presented three principles in order to allocated [sic] baseline capacity, namely to (i) allocate in line with physical capability; (ii) constrain not to exceed previous obligated levels; and (iii) be broadly commensurate with the buy-back target. Do you agree with these principles? Please explain why or why not.

We do not feel that we have the relevant information to enable us to comments on the network's physical capability or, indeed, the overall level of National Grid's buy-back risk. Therefore, whilst these seem like reasonable principles, we are unable to assess the extent to which they were followed.

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 your reasons.

Within the scope of TPCR4, we can see how the different approaches could appear reasonable. However, we have questioned above (answer 2, chapter 4) the reliance placed upon ten year statement data, and note that these alternatives place similar emphasis upon that same data. We are therefore not convinced that any of these provide an appropriate solution.

5) Are there any other considerations which we have not highlighted which we should have taken into account?

None that have not been covered elsewhere in this response.

Chapter 6

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 mentioned elsewhere, we have little useful information on network physical capability or zonal constraints. Therefore, whilst these aims seem reasonable, we are unable to provide a meaningful response as to the outcomes of this approach.

2) Are there any other factors that we have not considered which should be addressed in considering an appropriate adjustment to baselines?

None that have not already been covered elsewhere in this response.

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?

Our response to chapter 5, question 4 is relevant to this question, but would repeat that we don't necessarily agree that keeping the TPCR baseline at 7629 GWh/d is the correct outcome.

4) What are the advantages and disadvantages of keeping baselines unchanged at their current TPCR Final Proposals level?

Our instinctive reaction is that the current aggregate baseline level is too low, and should be raised. However, we again have to make these observations without being fully informed about the implications of such an increase on buy-back risk faced by the shipping community, or indeed other detriments that may accompany such a rise. Overall, however, we believe that there is scope for some additional capacity to be made available, without any material impact upon buy-back risk.

5) If we were to increase the aggregate baselines how could we quantify possible increases in buy-back costs and / or capex allowances also given the timescales involved?

As above, we do not consider that we have sufficient information available to us to assess impacts on buy-back risk or capex allowances. However, Ofgem must have had tools available to it when assessing the overall TPCR4 package and if we could understand how these work, we might be better placed to assess the relevant merits or otherwise.

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

As commented above, we consider that taking into account levels of sold capacity, for example through the 2007 QSEC process or indeed trying to assess what shippers may have booked in 2006 had they been aware of the impending changes, would help to limit the scope of this question.

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

None that have not already been covered in this response.

Should you have any queries with regard to this response please do not hesitate to contact me.

Yours sincerely,

Chris Wright
Commercial Manager