31st October 2007

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Mr Robert Hull
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Email:- Robert.hull@ofgem.gov.uk

Dear Robert

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

Thank you for providing the opportunity for CSL to comment on the above consultation document. This response is not confidential.

As you will no doubt be aware, CSL together with seven other major gas shippers wrote to Ofgem requesting an independent audit of National Grid Gas (NGG) modelling work and inputs. This request was made in order to help provide confidence in the baseline setting process and help to ensure that NGG assumptions are not unduly conservative with capacity withheld from the market. Unfortunately Ofgem did not support this request believing that *"given the practicalities involved we are sceptical of the benefits..."*.

CSL was both surprised and disappointed by this response; surprised as this decision appears to sit uncomfortably with Ofgem's usual pursuit and encouragement of market transparency and disappointed that a real opportunity to re-engage the shipper community in this consultation process was missed. Furthermore, accompanying the shipper letter was attached a suggested scope of the audit, the output of which would still be extremely valuable in informing responses to this consultation; we see the absence of the audit output as a missed opportunity.

CSL sincerely hopes that when it comes to the review of this winter's trades and transfers process Ofgem reflects fully on the merits that stem from independent audit and in particular the benefits of an independent review of the key assumptions that, we believe, unduly constrained this winter's transfer process i.e. inter and intra zone exchange rates and zonal maxima. At this week's workstream discussing the enduring solution for trades and transfers of entry capacity we observed overwhelming support for such an audit.

For completeness the shippers' letter requesting the independent audit and Ofgem's response are attached in Annex A.

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Responses to Ofgem Questions

Chapter 4: TPCR approach to baseline determination

Q4.1: Do you agree with the objectives of the TPCR baseline review?

CSL agrees with Ofgem's stated objectives that baselines should be set to reflect physical capability, taking into account changing flow patterns on the network and to reduce the risk of buyback costs having to be borne by consumers. However, we believe that other objectives need to be considered alongside the two above. Ofgem's Initial Proposals document outlined the objectives for the review which included the allocation of risk, transparency and inclusiveness. We believe that Ofgem needs to widen its objectives to include these.

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

Our concern is with the lack of transparency; the work undertaken to identify this capability has not been published and has not been subjected to critical review. In the setting of entry baseline capacity it must be recognised that the commercial incentive on NGG is to keep the amount of obligated capacity to as low a level as possible thus reducing its risk and increasing the opportunity for out performance.

We understand that NGG modelled different supply assumptions based on the 2005 Ten Year Statement (TYS) and that NGG's assumptions on flows patterns is critical in deriving baseline capacity. The TYS is meant to provide a review of transportation system usage and likely system developments, we question the merit of the sole reliance NGG has placed on this information to derive baseline capacity. We feel that a robust transparent modelling approach would have included alternative supply assumptions and therefore been more appropriate.

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 of accounting for zonal constraints?

Given the 'black box' nature of NGG's modelling we do not have sufficient information to comment on better ways of accounting for zonal constraints. We are however extremely concerned about the effects these apparent constraints are imposing on the level of baseline capacity and further, why these constraints still remain on the NTS. With investment for Milford Haven, Isle of Grain, BBL, Langeled etc, there is new gas at high pressure in all south/midlands LDZs apart from the South West and at the same time declining flows means that there is lots of linepack available in the north. This should mean that there is a capacity/flexibility windfall. This is not evident in the analysis we have seen.

The Easington Zone is constrained. This was evidenced by the disappointing results of the recent trades and transfer process where no transfers were allowed within the zone and only minimal transfers from the South East Zone (at 2.47:1 exchange rate) and in November only from the Theddlethorpe Zone (at 19:1 exchange rate). Gas was kept off the network last winter and we unfortunately anticipate similar restrictions this winter.

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This apparent constraint was not due to a funding shortfall; during the previous price control it appears that NGG was allowed £516m for load related entry capacity capex; it chose to spend only £419m[1] i.e. NGG chose to 'out perform' the control by just under £100m. However, there is clear evidence from NGG's TBE documents that the Easington Zone was going to become extremely constrained with the arrival of Langeled gas. We believe that NG had sufficient funds to provide the flexibility that is now missing from the NTS especially at Easington and Bacton. This begs the question why did NGG choose not to invest to alleviate this constraint and instead is relying on Ofgem to reduce baselines in order to reduce buy-back risk?

One suggestion is that NGG has deliberately left a constraint in the Hatton-Peterborough area in order to be able to demonstrate that the network is constrained and thus ensuring that the system operator's (SO) incentive allowances, buy-back in particular, remain high. The incentive is currently set at £18m per annum; any increase in flexibility would reduce this figure. We do not know how close NGG will be to having to buy-back capacity this winter but, given the new lower baselines, investment in NTS capacity and decline in UKCS flows, we have not seen any evidence that there will need to be any buy-backs. This is where an audit would be helpful in assuring the community that there are real buyback risks and not theoretical ones associated with implausible flow patterns.

However, the capex invested for the above projects has led to significantly higher transportation charges with NGG's regulated asset value now at £3.3bn earning a return of some £490m per annum. Shippers now have the worst of both worlds; they have high transportation costs coupled with high SO costs.

Unless the level of transparency is increased and provided to the market the risk remains that NGG will continue to earn healthy returns on its network, healthy returns on operating it and shippers will be restricted in their ability to land gas.

Chapter 5: Sensitivity analysis

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 Proposal baselines. Please give your reasons.

We view the calculation of the free increment as arbitrary as it is dependent on flow assumptions and constraints that are at the discretion of NGG's interpretation and not based on assumptions and modelling that has withstood the rigours of independent challenge. We do not believe that the allocation of free increments should be capped at the previous baseline level. Investment during the 2002 – 2007 control may have led to instances where baselines may be increased. We see the introduction of a negative free increment at the Easington ASEP as particularly harsh.

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

Q5.2: We allocated Caythorpe and Blyborough (Welton) free increments to Hornsea and Theddlethrope 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.

Q5.3: NGG NTS presented three principles in order to allocate 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.

As stated above we do not believe that the allocation of free increments should be constrained by the levels of previously obligated levels. NGG invested over £400m during the 2002 -07 price control on load related network capacity; the network capacity may have increased beyond 2002 baseline levels.

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 your reasons.

We are not convinced by any of the approaches given the reliance placed upon ten year statement data and the discretion this provides to NGG to achieve an outcome suited to its commercial advantage and not one that is consistent with the stated objectives of the review.

Q5.6: Are there any other considerations which we have not highlighted which we should have taken into account?

With regard to sensitivity analysis CSL is concerned that no analysis has been provided on how the risk profile changes with changes to the aggregate level of baseline capacity. We understand that NGG's modelling identified a range of aggregate baseline capacity of anything between 7729 GWh/d to 8976 GWh/d commensurate with £18m buyback target. Ofgem's Final Proposals proposed 8814 GWh/d. We have no feel for how buyback risk increases as the aggregate level of capacity increases and believe that it is essential that this information is provided in the forthcoming consultation.

Chapter 6 Way forward

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?

Please see our response in the above sections. We are confused as to why zonal constraints have appeared, particularly in the Easington area, especially given the capex invested over the previous price control.

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

We believe that the re consultation on baselines needs to address the aggregate level of capacity as well as the allocation of capacity and that the modelling of both need to be independently reviewed and the outputs published.

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?

By allocating a very high baseline at Bacton, Theddlethorpe and St Fergus, with no prospect of flows anywhere near those levels, NGG is able to accept apparently higher number but it is meaningless. The baselines should take into account UKCS declines which mean that there is no prospect of using capacity built for earlier peak years. Given this, Baseline should be focused in areas were there is gas and hence Easington and Teesside should have a greater allocation.

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

We cannot comment on this as we have not been provided with the sensitivity analysis requisite to inform this answer. We do note however, that by leaving the current high baselines at Bacton, Theddlethorpe and St Fergus, gas may be constrained at Easington and Teesside. This is not economic and efficient.

Q6.5: 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. We would like to understand however the benefit to NGG from not having substitution involving Isle of Grain and Bacton. If NGG is going to see a windfall gain, then they should provide more capacity at Easington and Teesside in return.

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

As above, capacity should only be allocated to ASEPS with prospect of gas flows. So, if an ASEP like Theddlethorpe has a 150% margin, this can be reduced with no impact on shippers, similarly for Bacton and St Fergus.

The fact that the free increment calculation relies on NGG forecasts – and not auction signals – means that there is nothing wrong with a hybrid approach that takes into account a number of factors.

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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?

As we discuss above, we believe it is important to understand the relationship between NGG investment in 2002-07 and the new baselines, specifically looking at the Easington constraints and the timing for NGG NTS projects. NGG have had the return and depreciation on investment not made, shippers are now paying a high SO incentive charge and at the same time seeing reduced baselines with baselines allocated to ASEPs with declining UKCS gas.

The entire picture is unsatisfactory and we believe Ofgem should ask NGG to identify were there are constraints and ask why they have not been removed.

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

Yours sincerely,

Roddy Monroe
Regulation Manager

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Annex A: Shipper request for an independent audit of National Grid's baseline modelling and Ofgem's response.

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31st August 2007

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On behalf of the following Shippers:
Alex Barnes, BG Group
Jeff Chandler, Scottish and Southern Energy
Richard Fairholme, E.ON UK
Charles Ruffell, RWE Npower
Andrew Pearce, BP Gas Marketing Ltd
Chris Wright, British Gas Trading Ltd
Phil Broom, Gaz de France ESS
Bruce Walker, Centrica Storage Ltd

Dear David,

Requirement for independent audit of National Grid's Baseline modelling

At the two recent Entry Baseline Transmission Workstreams, Ofgem and National Grid Gas NTS provided previously undisclosed details of the events which occurred between Ofgem's Update Proposals published 25th September and Final Proposals 4th December 2006. This included a more detailed explanation of the modelling work undertaken to arrive at the current entry baseline figures.

That discussion, and the associated heightened level of transparency, was strongly welcomed by the participants. In particular, industry stakeholders heard two key points:

- that the setting of baselines is extremely complex; and
- that the outcomes are highly dependent on National Grid's decisions and modelling assumptions, such as forecast supply patterns (in some cases informed by Ofgem's own thinking)

A prime example of the extent by which outcomes may vary is National Grid's own proposals for aggregate final baselines, which varied by more than 2000GWh/d (ranging from 6940GWh/d to 8976GWh/d).

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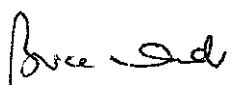
We therefore believe that the scope of the ongoing Ofgem re-consultation must include a review of the aggregate level of baseline capacity, as well as the allocation of that capacity between system entry points Further we believe that in order to provide the requisite level of assurance that the aggregate level of baseline capacity reflects the appropriate balance of risk and reward, it is essential that the modelling work and inputs be subject to independent audit to help restore confidence in the baseline setting process

We believe it would be particularly helpful, and lend significant authority, if Ofgem could support and assist this external audit. We have considered some of the aspects which the external audit would need to address and these are contained in Annex A below.

Without the reassurance that only a rigorous external audit can provide, we believe that the industry will continue to regard any final decision on entry baseline capacities with suspicion. Uncertainty in the regime does not breed confidence and may discourage full participation with the potential for gas being stranded off the system, and resulting wholesale price volatility

We would be pleased to discuss with you our further thinking on the scope of the external audit, or indeed any other aspect of this letter – please do not hesitate to contact any of the signatories.

Yours faithfully



Bruce Walker
Managing Director

c c. Steve Smith Managing Director, Markets. Ofgem

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Annex A – Suggested Scope of Independent Audit of National Grid's Baseline modelling

The output from this audit should include an assessment of the level of discretion that NG have adopted in determining the zonal capabilities and free increments with a view to establishing how much sensitivity there is in the final determination of the baseline levels. Also to establish if there are other approaches that could have been considered that have any material difference to the outcome. Having established the full range of sensitivities assess any material impact of these on the level of buy-back risk that NG could face and compare to the target buy-back risk.

We would like to provide reassurance that the purpose of the audit is not specifically to find fault or apportion blame, but to provide an independent assessment of the modelling assumptions and inputs adopted in the baseline setting process and to determine if these were, and continue to be, the most economic and efficient for the industry as a whole.

An audit of the NG NTS modelling work should include a critical look at the following aspects of the modelling techniques.

1. The criteria used when making adjustments to supply patterns within the multiple cases used on each scenario. Were there any artificially imposed constraints either through design of the criteria or by accident?
2. Basis for the 1 in 20 peak day demand figures used to set the supply flows (i.e. was diversity applied in calculating supply flows? What about adopting 90% of 1 in 20 and then examining the outputs? When did we last have a 1 in 20?
3. Network analysis technique - assumed to be steady state due to the number of analyses required but was there any sample testing using transient analysis to validate the calculations. How radical was the analysis e.g. was system re-configuration used to maximise capacity or was configuration fixed in every case?
4. Extent of analysts interpretation of results and consistency of interpretation both between analysts and network analysis runs.
5. Level of design margin applied and effect of removing that margin.
6. Validity of the underlying supply assumptions for the different scenarios. Comparison between scenarios and planning assumptions actually used for network design
7. Validity of the network structure. What projects were assumed to be completed for the year modelled compared to actual projects in place? If different how significant could this be?
8. Criteria for selecting the least favourable node for the supply balance. Is this the same node in all analyses?
9. Methodology for assessing buy-back risk
10. Clarity that the exchange rates and associated level of risk that NG is using to facilitate "shipper" capacity transfers between ASEPs are the same as it uses/will use when NG moves unsold capacity between ASEPs.

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Date: 25 September 2007

Dear Bruce

Re. Requirement for independent audit of National Grid's Baseline modelling

Thank you for your letter dated 31st August 2007. We are pleased that the Ofgem and NGG presentations at the recent Entry Baseline Transmission Workstreams have been helpful.

As you are aware we intend to publish a further consultation on the TPCR entry baselines by November 2007 at the latest. As we explained in our open letter dated 27 July 2007, we believe that it would be appropriate to re-consult on the TPCR baseline numbers as implemented in the March 2007 Decision.

The TPCR was a major piece of work carried out over more than eighteen months. There were many component parts to the TPCR package of which gas entry baselines formed a part. We consulted widely on these issues and we published several consultation documents and held industry workshops on several topics. Additionally we commissioned reports from several consultants to provide further analysis in several key policy areas, and published these reports. The changes to baselines were not considered separately but were developed as part of a much wider package of measures.

Given the practicalities involved we are sceptical of the benefits of undertaking an audit as you suggest at this moment in time. Any such audit would need to be conducted by parties sufficiently skilled and experienced in network modelling so as to be able to comment objectively and provide a considered view about the approach adopted and the assumptions made.

Nevertheless, we do recognise that it would be desirable for greater transparency in NGG's approach to network modelling and network planning. As part of the TPCR we have therefore introduced a number of new obligations on NGG in relation to this, e.g. Special Condition C24 Network Model and Special Condition C11 Transmission Planning Code. In addition, we introduced new obligations on cost reporting (Special Condition C14B Price Control Revenue Reporting and Associated Information) and output measures (Special Condition C13 Network Model). Broadly speaking, the rationale behind these new obligations is to enable ourselves as well as industry to better monitor NGG's performance.

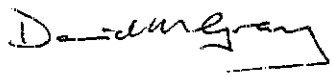
We have set out the rationale for these new obligations in greater detail in the Section 38A notice in respect of reasons for the decision to modify the licence of National Grid Gas plc (Ref 217/07(b)) which we published on 5 September 2007.

Also, as we have indicated in our 6 September 2007 decision letter on the Entry Capacity Transfer and Trade Methodology Statement, in our view it would be desirable to have an audit next year to review how effective the capacity trade and transfer arrangements have been for the coming winter and what improvements should be made in the light of this experience. We would welcome a discussion with you about parties who might be able to fulfil such a role. We would also be interested in your views on the practical difficulties of such audits and how the scope should be defined so as to ensure that such an audit was focused and addressed the appropriate issues. This would also help to facilitate the identification of key parameters to be used in developing a Transmission Planning Code, which will underpin future modelling work undertaken by NGG NTS.

We take your comments seriously and would like to work with you and with industry to ensure that baselines have greater transparency and can be audited effectively in future, where such a need arises. We would be very grateful for your input (as well as the input of other interested parties) in the development of output measures and the network planning code.

My team would be pleased to meet you to discuss this in more detail.

Yours Sincerely,



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Jeff Chandler, Scottish & Southern Energy
Richard Fairholme, E.ON UK
Charles Ruffell, RWE npower
Andrew Pearce, BP Gas Marketing Ltd.
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