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Dear Bob,

Re: Transmission Price Control Review (TPCR) – gas entry baseline re-consultation

Scottish and Southern Energy plc (SSE) welcomes Ofgem's decision to re-consult on the gas entry baselines. We believe market confidence in the baselines is vital to ensure efficient use of the gas system.

As is recognised in Ofgem's consultation, we have significant concerns about the lack of process surrounding the scale of the revisions made to the entry capacity baselines between the updated proposals and the final proposals. Our particular concern relates to the Hornsea entry point. In all iterations leading up to the Final Proposals, Hornsea's baseline entry capacity was 175 GWh/day or greater and in the September 2006 QSEC auctions, we provided NGG with an incremental signal for entry capacity at Hornsea. Therefore, Ofgem's final decision to reduce Hornsea's baseline was not only last minute, but both contrary to market signals and inconsistent with the rationale that baseline entry capacities were being changed to reflect long-term auction signals.

More generally, by reducing overall system entry capacity from 8,064 GWh/day to 7,629 GWh/day, when the network appeared capable of managing 8,064 GWh/day, Ofgem raised wider questions as to the network's actual capability. Given the significant investment in entry capacity in the last five years, this reduction is surprising and raises concerns that NGG may be withholding entry capacity in order to ease its role of managing the system or in order to benefit from further incremental investment revenues. Questions were raised again at the point of implementation of the trade and transfer initiatives. Despite expecting the trade and transfer methodologies to deliver significant network efficiencies, in practice, very little capacity was able to be transferred or traded.

In short, we believe experience to date, coupled with Ofgem's re-consultation of the baselines, illustrates the complexities involved in capacity auctions. Indeed, we believe experience at entry demonstrates that an auctioning regime does not work. We therefore firmly oppose any moves to extend capacity auctioning to exit and/or the electricity market, where the implementation of an auctioning regime would be significantly more difficult. We would instead propose a move away from entry capacity auctions altogether. We would support the allocation of firm entry capacity rights paid for at the prevailing transportation charge. For incremental capacity, we would support a user-commitment approach, again based on the prevailing transportation charge.

That said, we recognise that the situation on entry capacity is current and complicated and needs to be resolved in a way that causes least disruption to the market. We therefore believe that it is imperative that the results of the recent long-term auctions are not subsequently undermined and we are concerned that a straightforward change in the baselines at this stage would have a detrimental effect. Similarly, we recognise that re-opening NGG's price control would have adverse consequences for incentives and we do not believe that introducing this level of uncertainty would be welcome at this stage.

However, we believe that Ofgem's priority must be to drive forward a review of the true capability of the gas network. We believe an independent review of the network's true capability would be extremely helpful to re-establish confidence in the baselines, and to ensure that the published baselines are consistent with NGG's obligation to offer for sale all obligated entry capacity and that NGG's incentives properly reflect the risks that NGG faces in managing the network.

If, as a result of its review of network capability, Ofgem consider that NGG has withheld entry capacity from the published baselines in an effort to help manage the system, the correct baselines should be established and made available to the market. Indeed, it is difficult to see how the market could progress without confidence in the baselines and knowledge that the published baselines are correct. Equally, we believe NGG should be made to utilise the existing network capacity and infrastructure to its full potential.

In addition, given that the capability of the network is inextricably linked to both the baseline and charging models, we believe that changing the baseline data will also require a re-examination of the transportation model. Despite improving on its predecessor, we believe early experience of the transportation charging model has highlighted a number of anomalies. Indeed, in August this year we raised concerns regarding the costs involved in securing additional entry capacity at the Garton entry point. Compared with 2003, when we underwrote half of the NPV cost of securing 280 GWh/day of entry capacity at Garton, discussions with NGG this time around suggest that costs would be circa six times greater. It does not seem plausible that this can be explained away by our receipt of a favourable price first time around. However, without greater transparency regarding the model, it is impossible for us to understand and rationalise the outputs.

As noted above, we believe we should move away from auctions altogether. However if abolishing entry capacity auctions is considered a step too far at this stage, we believe NGG will have to re-run the auctions in order to reflect any revised upward baselines. However, as already stated, we believe it is imperative that the results of the recent long-term auctions are not undermined. On this basis, we believe there is merit in re-running the auctions but with a safeguard for the previous successful bidders whereby their capacity is secured, at worst, at the price they paid in the original auction process. We believe this will provide already successful bidders with the certainty they require, whilst accommodating any upward baseline revisions.

In addition to the points made above, we have included responses to the specific questions asked. We hope both clearly set out our position, but should you wish to discuss anything in our response further, please do not hesitate to contact me.

Yours sincerely,

Robert Hackland,
Regulation Manager.

Chapter 4: TPCR approach to baseline determination

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

We do not support Ofgem's decision to move away from the 'theoretical maximum physical capacity' approach applied under the 2002-07 price control. We believe this approach, combined with the 90% scaling factor, suitably took account of network effects and resulted in baselines that NGG was able to manage. Moreover, we believe it is important that baselines remain relatively stable, although they should not be constrained by previous maxima. We do not, therefore, support Ofgem's 'practical maximum physical capacity' approach.

We also believe that baselines should remain nodal. Zonal baselines would place ASEPs with different characteristics in direct competition with each other, i.e. peak storage and baseload interconnectors. The capacity to one is worth much more than it is to the other, which would be reflected in the bidding and, under a zonal scenario, could result in stranded storage assets. This would be detrimental to security of supply.

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

We concur with Ofgem that supply substitution based on 'least helpful substitution first' is a more realistic approach than load growth for balancing the network. However we do not believe that turning down storage sites out of sequence of the merit order is reflective of how the network would operate in practice.

We do not consider it valid to average the three different scenarios from the 2005 TYS. The three scenarios are uniquely different and applying an average destroys any value/insights that they might show individually.

We believe the 'Auctions+' scenario lacks credibility because in 2005 a significant amount of capacity was booked on a short-term basis. This scenario should be removed from the analysis or updated to use auction results up to and including 2007 when industry participants were aware of the importance of long-term auctions in determining the baselines.

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

We believe Ofgem's previous approach, which relied upon the 'theoretical maximum physical capacity' combined with a 90% scaling factor, suitably took account of network effects, including constraints, and resulted in baselines that NGG was able to manage.

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

We remain concerned by the way in which the new baselines have been derived, both in terms of due process in publishing the Final Proposals and the lack of notice and transparency surrounding the fundamental changes, which have created winners and losers.

We also have difficulties reconciling the significant network investment for entry over the last five years with the reduction in baselines and the maintenance of buy-back risk at the same level. We have significant concerns that by artificially constraining the network, future investment in new sources of gas may be curtailed. As a consequence, by saving a yet to be defined amount through transmission efficiencies, much larger wholesale energy costs might occur. Ofgem's own analysis suggests that this could be in the order of billions of pounds. We would therefore welcome an independent review of the network to ascertain the true capability. This should go further than the allocation of capacity between entry points. We believe Ofgem's re-consultation must include an independent review of the aggregate level of baseline entry capacity.

Chapter 5: Sensitivity analysis

- 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.**

Due to insufficient data and knowledge surrounding NGG's network modelling, it is difficult to comment on the implications of the different approaches taken to apply the free increments. We do however believe that the baselines at some ASEPs are too low compared with previous capabilities.

Again, we believe an independent review should be undertaken to ascertain the true capability of the network.

- 2. We allocated the 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?**

Prior to the new price control, gas was withdrawn from Hornsea on a regular basis in excess of 195 GWh/day. To reduce the capacity to 133 GWh/day as per table 5.3 is not reflective of peak day flows. In addition, in September 2006 an incremental investment signal was given in the QSEC auction to increase Hornsea capacity to 222 GWh/day. We were unable to book capacity in excess of 140 GWh/day due to NGG's obligation to hold back 20% from the long-term auctions. On the basis that the re-allocation of free increments to Hornsea was consistent with market signals and efforts to increase entry capacity, we support Ofgem's decision to allocate free increments to Hornsea.

However, we have a concern that by allocating free increments to Hornsea, which had just signalled an incremental investment, NGG avoided allocating capacity to another ASEP and thereby increasing the capacity of the overall network (despite being suitably reimbursed through the long-term auctions).

- 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) broadly commensurate with buy-back target. Do you agree with these principles? Please explain why or why not.**

We believe that baselines should reflect the theoretical maximum physical capability of the network, not the physical maximum. Moreover, we believe it is important that baselines remain relatively stable, although they should not be constrained by previous maxima.

We believe that buy-back targets should be consistent with the baseline entry capacities offered. For example, if NGG has offered a reduced baseline, buy-back targets should be tightened as NGG's risk of buy-back is much reduced. However, we do not believe that this has been achieved in the latest price control and we have concerns that NGG has withheld entry capacity from the published baselines, without this being reflected in the buy-back targets.

- 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 do not believe that baselines should be based on historic flows as there is no certainty that the past will accurately represent the future. We believe it would be more appropriate to base allocations on NGG's TYS, and in particular the 2006 forecast given that it is both forward looking and based on the most recent information.

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

At a fundamental level, if baselines are reduced, but NGG's target in managing constraint costs remains the same, NGG should be exposed to less buy-back risk. This is especially true if substitution is limited and capacity movement facilitated under the trade and transfer initiatives remains poor. We therefore consider the current arrangements to be lenient relative to the previous price control.

Chapter 6: Way forward

(a) Reallocating TPCR Final Proposals aggregate baseline capacity

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?

Again, we do not believe that we are in a position to comment on the allocation of the free increment due to the lack of data and knowledge surrounding NGG's network modelling.

However, we do believe that baselines should reflect the 'theoretical maximum physical capacity' approach. Historically under this approach, the network has been able to manage the required flows and we are not aware that the disadvantages listed in Appendix 2 of the consultation (para. 6.22) have materialised. We believe that the 'maximum physical capability' approach leads to under-utilisation of the network, or over-charging by NGG for system capability that is already in place. On this basis we favour theoretical maximum physical capacity baselines.

Consistent with this, we have a specific concern relating to NGG's efficient and full use of the existing entry capacity. In October 2003, we signalled incremental entry capacity at Garton and by October 2006, NGG had, to the best of our knowledge, put in place the measures to deliver this capacity. Given that we were paying for this capacity but not in a position to utilise it ourselves, we offered it to the market through the new trade mechanism. However, despite a shortage of entry capacity in the Easington zone, NGG subsequently announced:

*"There will be no within zone process for the Easington zone and it is not a donor zone. Therefore there is no capacity available for allocation."*¹

We were unable to rationalise this decision given our investment in additional and unused capacity at Garton and it raised further questions as to the network's actual capability and whether NGG is withholding entry capacity in order to ease its role of managing the system.

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

Under the previous baselines, there was a concern that there was little incentive for shippers to bid for entry capacity through the long-term entry capacity auctions and therefore much capacity was bought through the short-term entry capacity auctions and, in particular, on-the-day at zero cost. The introduction of a substitution obligation should, in principle, encourage longer-term signals. However, we believe a simpler and more effective change would be to remove the discount that currently incentivises on-the-day use of capacity.

We also have concerns that by artificially constraining network capacity through reduced baselines, future investment in new sources of gas may be curtailed. As a consequence, by saving

¹ Transfer and Trade System Entry Capacity Auction, National Grid Gas' invitation to participate in auction for monthly NTS entry capacity for period November 2007 to March 2008, 25 September 2007.

a yet to be defined amount through transmission efficiencies, much larger wholesale energy costs might be experienced. Ofgem's own analysis suggests that this could be in the order of billions of pounds.

Importantly, by incentivising NGG to minimise buy-back costs, NGG is, in effect, encouraged to withhold capacity for reserve purposes. This is contrary to efforts to ensure that the existing network and infrastructure is utilised to its full potential and it may be worth considering how this conflict can be mitigated or removed going forward.

Finally, in addition to any changes to the baselines, we believe NGG should re-visit its transportation charging model. Despite improving on its predecessor, we believe early experience of the transportation charging model has highlighted a number of anomalies. The baseline and charging models are inextricably linked and we have concerns that changing the baseline data without addressing inaccuracies in the transportation model will result in spurious results.

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 7,629 GWh/d?

We do not believe that baselines should be based on historic flows as there is no certainty that the past will accurately represent the future. We believe it would be more appropriate to base allocations on NGG's TYS, and in particular the 2006 forecast given that it is both forward looking and based on more recent information.

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

If, as a result of its review of network capability, Ofgem consider that NGG has withheld entry capacity from the published baselines in an effort to help manage the system, we believe reasonable steps should be taken to determine the correct baselines. Indeed, it is difficult to see how the market could progress without confidence in the baselines and knowledge that the published baselines are correct. Equally, we believe NGG should be made to utilise the existing network capacity and infrastructure to its full potential.

Failure to put in place correct baselines will result in either inefficient use of the network or over-charging by NGG for system capability that is already in place.

(b) Increasing aggregate baseline capacity

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

If, as a result of this review, Ofgem identifies that not all available capacity has been made available through the published baseline entry capacity figures, and Ofgem, in turn, instigates amendment of the baselines, NGG's buy-back risk will increase. However, we do not believe that this increased risk should be passed on to industry. NGG's initial buy-back targets set by Ofgem did not account for this 'slack' in the system and therefore the principles upon which the buy-back targets were set would not have changed.

Similarly, an increase in the baselines caused by Ofgem's decision/perception that NGG has withheld capacity from the currently published 'final' TPCR baselines should not have an impact on NGG's capex allowance.

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

Our support is to move away from entry capacity auctions altogether. We support the allocation of firm entry capacity rights paid for at the prevailing transportation charge. For incremental capacity, we support a user-commitment approach, again based upon the prevailing transportation charge.

If, however, abolishing entry capacity auctions is considered a step too far at this stage, we believe NGG will have to re-run the auctions in order to reflect the revised baselines. However, as already stated, we believe it is imperative that the results of the recent long-term auctions are not undermined. On this basis, we believe there is merit in re-running the auctions but with a safeguard for the previous successful bidders whereby their capacity is secured, at worst, at the price they paid in the original auction process. We believe this will provide already successful bidders with the certainty they require, whilst accommodating any upward baseline revisions.

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

We believe Ofgem should sanction a review to ascertain the true capability of the network. We have difficulty reconciling significant network investment for entry over the last five years with the reduction in baselines and the maintaining of buy-back risk at the same level.