



Bogdan Kowalewicz
Gas Transmission &
Governance
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Bogdan

Gazprom Marketing & Trading Response to “Gas Entry Capacity Substitution Methodology – Initial Impact Assessment”

Gazprom Marketing and Trading Limited (“GM&T”) welcomes the opportunity to comment upon Ofgem’s Impact Assessment for Gas Entry Capacity Substitution. Gazprom Marketing & Trading is the UK registered wholly-owned subsidiary of Gazprom Group (“Gazprom”), responsible for the optimisation of Gazprom’s energy commodity assets through GM&T’s marketing and trading network.

Whilst we welcome Ofgem’s efforts in conducting an Impact Assessment (“IA”), it is disappointing that the IA does not take account of all the issues that have been raised during the various workshops, or the responses to the various consultations on the subject over the last two years. It is odd that the section of the IA assessing the costs and benefits is so short on potential costs. Even if Ofgem does not agree with the arguments raised by shippers, it should at least ensure that these are properly reflected in the IA. It is notable that Ofgem appears simply to have ignored comments made in previous responses, for example my letter to Ofgem of 29th July 2009, or my response to NGG’s Informal Consultation on Entry Capacity Substitution of 5th June 2009. It is not clear, therefore, how much reliance can be placed on the IA as a robust assessment of the costs and benefits of the proposals. Whilst the goal of substitution is a worthy one, namely ensuring that capacity is not sterilised at points at which it is not needed, its cause is not helped by such a poor document.

In the following sections, I highlight GM&T’s concerns with the IA in more detail.

Gazprom Marketing & Trading Limited
Gazprom House, 60 Marina Place
Hampton Wick, Kingston upon Thames KT1 4BH
United Kingdom
T: +44 (0)20 8614 3036
F: +44 (0)20 8614 1313
E: alex.barnes@gazprom-mt.com
www.gazprom-mt.com

NGG's Substitution Methodology.

Are there any additional aspects of the methodology which should be highlighted?

Ofgem identifies correctly that substitution will not apply to the 10% of capacity held back for the AMSEC auctions. In Paragraph 1.12 of the IA Ofgem notes this condition in conjunction with concerns that short term availability of capacity will be reduced. In the past Ofgem has indicated its aim to remove the 10% withholding requirement. It would be helpful if Ofgem could clarify its intentions in this regard.

A key aspect of NGG's methodology is that it will limit the exchange rate used to calculate substitutions of capacity to a maximum of 3:1. However there is no indication in the IA as to how Ofgem will police this effectively. As a monopoly provider NGG has an incentive to limit the service it provides, as its revenues are regulated, as this will limit NGG's costs and risks. Use of an exchange rate of more than 1:1 means that, following a successful substitution, NGG will have to make available less financially firm capacity than previously. Only NGG truly understands the "black box" model which calculates available capacities; without a rigorous audit of such calculations Ofgem, and shippers, cannot be assured that NGG has underestimated the capacity that it can make available. This argument has been well rehearsed during the discussions on Transfer and Trade, as well as on Substitution, and it is disappointing that Ofgem does not appear to recognise the issue.

Assessment of NGG's methodology.

Do you agree with our assessment of the methodology (within the framework of the current licence)?

It is insufficient to narrow Ofgem's analysis in the way described in Paragraph 4.1. The whole point of an IA is that it should test a proposal's fitness for purpose for the whole network and its users. Simply arguing that "it is difficult to anticipate when incremental signals . . . will arise on the network", does not reassure readers that Ofgem has undertaken a thorough analysis. At the very least one would expect a reasoned justification as to why further analysis is not required.

Are there any qualitative benefits that have not been included in our assessment?

Given Ofgem's insistence of the importance of User Commitment and its benefit for clear signals to NGG, it is surprising that Ofgem has not included it here. Given the greater risk of capacity not being available (see below for more on this), one consequence is that NGG may see a greater proportion of capacity being booked in the QSEC auctions. However Substitution is a very blunt, and

therefore probably not very efficient, way of achieving this goal. As has been noted previously the pricing framework would be a simpler way to achieve this.

Are there any quantified costs that have not been included in our assessment?

It is disappointing that Ofgem has made no attempt to quantify the potential impacts on wholesale gas prices. As an independent and impartial regulator, Ofgem should ensure all sides of the argument are properly represented. We would also note that there has been a longstanding request from the Transmission Workstream that Ofgem perform such analysis. Substitution has the potential to shrink the quantity of capacity that NGG has to offer to the market as a result of exchange rates, and therefore could lessen the flexibility of the system to accept gas supplies. Whilst it is true that NGG's proposed methodology mitigates the risks of Substitution to some extent, it does not eliminate them. Given Ofgem's work on Project Discovery, and its concerns the UK's ability to access gas supplies, it is odd that Ofgem does not consider this aspect more fully.

Are there any qualitative costs that have not been included in our assessment?

Given the amount of debate, and the fact that Ofgem has had to delay the implementation of substitution until March 2010, it is surprising that it could not identify any qualitative costs.

Even with the proposed NGG methodology, the process for booking entry capacity is more complicated, and therefore more risky. As noted in my letter of 29th July 2009, we fundamentally disagree with your assessment that Substitution does not change the risks or choices facing shippers in a fundamental way. Firstly it dramatically increases the number of shippers who could bid for entry capacity, as it potentially includes all shippers at all ASEPs, rather than just those at a shipper's "home" ASEP. Secondly it does not only affect shippers' ability to buy capacity on the day, but also their ability to do so in the AMSEC and RMTTSEC auctions. It is disappointing that Ofgem has again failed to address these concerns.

Comments on "Other considerations."

In Paragraph 4.12 Ofgem argues that capacity which is available on the day for free will lead to inefficiency and waste. We would note that it is as a result of Ofgem's own decisions that there is a 100% discount for on the day capacity. It therefore seems perverse that Ofgem uses this to justify Substitution. In any case shippers are still required to pay for capacity bought in the AMSEC or RMTTSEC auctions, and have to pay for all capacity they use via the TO Commodity Charge. It is therefore wrong to think that any entry capacity which shippers use is available for free.

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www.gazprom-mt.com

Furthermore Paragraph 4.12 seems to argue in favour of creating artificial constraints or, at the very least, scaring shippers into booking capacity, so that they do not under value it. This seems a very odd approach to use when regulating a monopoly, as one of the common complaints against monopolists is that they do just that in order to maximise their revenues.

With regards to paragraph 4.26, the concern is simply explained as NGG's ability to minimise its exposure to buybacks through clever use of exchange rates to minimise the quantity of capacity it has to offer to the market. As noted above, Ofgem needs to explain how it intends to police this.

Alternative methodologies developed by NGG.

Do you agree with our assessment of the relative differences between the capacity retainer methodology and the other methodologies?

As we do not believe Ofgem has done a fair assessment of the costs of the proposed NGG methodology, we do not believe Ofgem has reasonably assessed the relative merits of the alternatives.

In the case of the Mechanical Approach we note that Ofgem made a substantial change to the final licence drafting following the informal consultation on Licence drafting in July 2009. Only then could the Mechanical Approach be considered incompatible with NGG's Licence. As the final licence condition represents at least the third form of words since 2007, it could be argued that Ofgem was shifting the goalposts as the discussions on Substitution progressed.

Although Ofgem's concerns about the use of TBE data with regards to the Mechanical Approach have some legitimacy, Ofgem's concerns are soluble, as noted in my response to the NGG Informal Consultation on Entry Capacity Substitution on 5th June this year.

I hope the above comments are useful. If you have any queries please do not hesitate to contact me on ++ 44 20 8614 3036 or at alex.barnes@gazprom-mt.com.

Yours sincerely,

Alex Barnes

**Head of Regulatory Affairs
Gazprom Marketing & Trading.**

Gazprom Marketing & Trading Limited
Gazprom House, 60 Marina Place
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United Kingdom
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