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Dear Bogdan

Response to “Gas Entry Capacity Substitution Methodology - Initial Impact Assessment”

This response is on behalf of National Grid Gas plc (“National Grid”) in its role as holder of the Gas Transmission Licence (the “Licence”) in respect of the National Transmission System (“NTS”). It is structured in two parts: the main section summarises our views on some of the key issues for the consultation, and the appendix provides our specific responses to the individual questions raised in the consultation document.

We note that the Authority is minded to accept the proposed methodology; a decision that we would support and believe is in the best interests of consumers and other industry participants. Ofgem have provided details of National Grid’s proposed entry capacity substitution methodology, the alternative methodologies that were developed, and the issues raised and considered by the participants in the substitution workshops and consultations. We believe that this information highlights that the process followed was extensive and completed in full and open consultation with the industry. We expect that the Impact Assessment (IA) will allow industry participants to provide further comments that support the Authority’s current “minded to” position so that approval of the proposed methodology statement, and associated proposals, can be given.

After careful consideration of the information provided within the IA, National Grid continues to support implementation of its proposed entry capacity substitution methodology. We believe that the proposed methodology fully meets the requirements of the Licence, specifically the entry capacity substitution objectives.

National Grid has been sensitive to concerns expressed by certain industry players and has, in conjunction with the industry, developed the “retainer” as a fundamental part of the proposed methodology. We agree with Ofgem that this development provides considerable flexibility for Users. The retainer allows Users who are unwilling or unable to purchase capacity to protect (i.e. retain), at a relatively low cost, capacity at a specific ASEP that may be obtained later. It is a short term measure, covering all QSEC auctions held in a 12 month period, that enables Users to manage any timing conflicts between the auctions and their own projects. The retainer charge ensures that only capacity that is subject to a financial commitment from a User is excluded from substitution. This will minimise the risk of capacity being unnecessarily excluded from substitution, and hence minimises the potential for unnecessary investment, for less certain future developments.

Key issues

Our position on core issues covered within the consultation is as follows:

- **Substitution Policy**

We agree with Ofgem's view that the substitution policy is in the interests of consumers as it provides a mechanism to limit sterilisation of capacity at locations where it is not needed. A reduction in the obligated capacity level at ASEPs where capacity is not needed, to free up capability at ASEPs where incremental capacity has been signalled, will aid efficient and economic decisions regarding investment which should reduce the requirement for new infrastructure. This saving will be reflected in reduced allowed revenues (compared to if funded incremental entry capacity is released) for National Grid and hence reduced costs to Users which should benefit consumers. However, a number of workshop participants have expressed concern that substitution could have unwelcome effects, which Ofgem are seeking to quantify through this IA. It is National Grid's view that substitution must be introduced with due consideration of such effects.

National Grid believes that the proposed methodology takes due account of the risks expressed by giving Users, who may not be in a position to commit to purchasing capacity, a low cost opportunity to protect capacity from substitution. It is National Grid's opinion that the proposed methodology strikes an appropriate balance between the extremes of "unsold equates to unwanted", which could lead to planned projects not having access to the capacity they expect, and "substituting capacity only in excess of long-term forecast requirement" which could lead to unnecessary investment if forecasts prove inaccurate.

- **Competition**

Ofgem rightly points out that substitution will increase competition for capacity. Currently, Users entering gas to the NTS can be certain of obtaining capacity in the short term auctions, sometimes at zero cost, at ASEPs where:

- upstream supplies are significantly lower than obligated levels, or
- they have access to all upstream gas supplies such that there are no competing Users,

This under values capacity; as Ofgem states "the provision of any resource for free leads to inefficiency and waste", as well as inhibiting the provision of accurate, timely signals of future supply patterns to National Grid.

Substitution extends competition from within an ASEP to across ASEPs. As a result Users need to give greater consideration to the value that they place on capacity and whether to obtain more capacity earlier. Hence substitution will constrain, by creating added risk that capacity might not be available, the ability of Users to obtain capacity in the short term at a lower cost than those buying long-term. This should strengthen long term signals for capacity which are used to inform National Grid's investment decisions.

- **Short-term Capacity**

National Grid believes that the enduring capacity transfer and trade regime has provided greater scope for Users to access capacity closer to the time of use; all requests for capacity in the RMTNTSEC auction have been satisfied, either through the use of surrendered capacity at the same ASEP or through transfer/trade from a different ASEP. It should be noted that the surrender mechanism introduced as part of the transfer and trade regime allows increased quantities of unsold capacity to flow through to the daily auctions.

It is not clear whether the implementation of substitution will increase demand for capacity through transfer and trade, i.e. whether substitution will encourage Users to buy more capacity in long-term auctions to avoid the risk of capacity being obtained by competing Users elsewhere. However, to the extent that capacity that has been substituted to an ASEP is not required, it will (if unsold) or can (if surrendered) increase the availability of capacity for transfer/trade, in accordance with the Entry Capacity Transfer and Trade Methodology Statement, at a later RMTNTSEC auction.

- **UNC Modification and Gas Charging Modification Proposals**

In chapter 3 Ofgem describes the proposed methodology. Paragraph 3.12 identifies that the retainer charge is subject to separate consultations (UNC modification proposal 265 and Gas Charging modification GCM18). Ofgem states that any decision taken on the substitution methodology does not fetter the discretion of the Authority in respect of the UNC modification proposal. Whilst we do not dispute that the Authority can and will make independent decisions regarding the three proposals, it is important to recognise that the proposals are complementary. A veto of the UNC and/or Charging proposals would not allow full implementation of the substitution methodology, if approved.

- **Implementation date**

Since the last delay to the implementation of the substitution obligations National Grid has been focused on delivering proposals such that substitution could be applied from the March 2010 Long-Term System Entry Capacity ("QSEC") auction and we submitted our proposed methodology to the Authority on 7th September 2009. Related UNC and Charging modification proposals have been developed to the same deadline.

In order to implement the proposed substitution methodology the retainer process needs to be undertaken prior to the March 2010 QSEC. This will require an invitation to participate in the retainer window to be sent to Users which is required to be sent with at least 28 days notice. Hence, taking into account appropriate notification to the industry before the Christmas period, National Grid is targeting 18th December 2009 for this invitation letter to be issued which can only occur following approval by the Authority of all three proposals. Whilst we note that the "Authority currently anticipates that it will publish its decision towards the end of 2009" any decision later than 17th December 2009 will present implementation difficulties for National Grid.

If you need further clarification on any of the points raised in this response, please do not hesitate to contact me.

Yours sincerely

Andrew Fox
Senior Commercial Analyst

Appendix 1 - Response to specific questions

Chapter 3

Question 1: Are there additional aspects of the methodology that should be highlighted?

No - we believe that the Impact Assessment highlights the salient points.

Question 2: Are the scenarios analysed appropriate and relevant to system development? If not, why not?

Throughout the substitution workshops we presented examples of how we envisaged substitution will be applied, specifically the impact on donor ASEPs. These examples were identified as:

- representing a reasonable expectation of where incremental entry capacity requests could be made in the next year or so; and
- providing a range of examples covering different parts of the NTS where incremental signals might be received, and hence allowing assessment of the potential impact on different donor ASEPs.

These examples form the basis of the scenarios presented in the IA. We continue to believe that the scenarios analysed are appropriate and relevant to system development in line with National Grid's expectations. However, only individual Users (and developers) know with any certainty where incremental entry capacity requests are to be made and their magnitude.

The analysis of the scenarios, whether using network analysis or theoretical exchange rates, has been based on existing capacity "sold" levels. Except as indicated in one example, the scenarios assume no increase in the peak sold level at each ASEP and that no retainers are taken out. Due to the difficulty in predicting future User behaviour we consider this approach to be appropriate.

We note that the Barrow scenario contains a typographical error that overstates the potential impact on St Fergus ASEP as a donor ASEP. Paragraph 3.16 states a Barrow to St Fergus capacity exchange rate of 1.6 to 1. Based on analysis undertaken by National Grid for Ofgem the exchange rate should be 1.39 to 1.

Chapter 4

Question 1: Do you agree with our assessment of the methodology (within the framework of the current licence)?

Subject to responses to subsequent questions, National Grid broadly agrees with the assessment presented of the proposed methodology.

The study rightly identifies the avoidance of investment costs as the key benefit of substitution. Ofgem has identified a "deemed capital expenditure" of five times the revenue driver for the specific ASEP. We are unclear as to how the figure of £50.7m presented for Isle of Grain has been obtained as this is inconsistent with the annual figure of £7.7m stated in table 7 of appendix 5. However, this does not detract from the fact that savings will be made by substitution.

It should be noted that, based on the scenarios and assumptions presented in the IA, National Grid's allowed revenue could be reduced (compared to a non-substitution scenario) over a five year period by the quantities stated (subject to indexation). These savings would materialise in Transmission Transportation charges and could be passed on to consumers. However, longer term (after five years) benefits could arise when any economic and efficiently incurred investment would be expected to be added to the regulatory asset base to which on-going revenue would be allowed. With substitution there would be no investment and no increase to the regulatory asset base.

The assessment identifies potential costs associated with the implementation of the proposed methodology. Since National Grid presented its interim report on the substitution options in March 2009 the retainer approach has been developed significantly, particularly with the introduction of refunds. The potential for refunds increases the need to track retainers and to match them to future capacity allocations. This has increased complexity. Whilst this will not prevent implementation for

March 2010 QSEC auction additional systems development may, subject to the extent to which retainers are taken up, be required.

Question 2: Are there any quantitative benefits that have not been included in our assessment?

We have not identified any additional quantitative benefits.

Question 3: Are there any qualitative benefits that have not been included in our assessment?

The retainer approach allows Users to protect capacity from being available for substitution, for the 12 month duration of the retainer, without actually buying capacity. This provides National Grid with increased intelligence on potential future supplies and capacity requirements that would not normally be identified until the Users were in a position to buy that capacity. This would improve long term investment signals for National Grid.

Question 4: Are there any quantified costs that have not been included in our assessment?

Throughout the series of substitution workshops a number of participants have suggested that substitution, regardless of the specific methodology, will result in a tightening of the system with less flexibility to respond to shorter term capacity issues. This, they suggest, will result in an increase in wholesale gas prices. However, we note, as described in paragraphs 1.10 and 4.17, that Ofgem have not been provided with any evidence to support this view and invite other respondents to present any evidence that they have.

Question 5: Are there any qualitative costs that have not been included in our assessment?

We have not identified any qualitative costs.

Chapter 5

Question 1: Do you agree with our assessment of the relative differences between the capacity retainer methodology and the other methodologies?

The IA correctly identifies the primary difference between the proposed methodology and the mechanical approach as being the way that they allow future capacity needs to be signalled. It then identifies two concerns with the mechanical approach:

- the absence of a financial user commitment which leads to the conclusion that this approach is not consistent with National Grid's Licence obligations; and
- the reliance on TBE data.

National Grid acknowledges the potential problems with using TBE data, particularly the absence of a financial commitment behind the forecast data. However, we believe that processes used to develop supply forecasts are sufficiently robust to discourage Users and developers from overstating their requirements. In addition, we are not convinced that the use of maximum deliverability for storage and LNG sites will overstate future utilisation, particularly as, unlike beach terminals, the capability to deliver to the maximum deliverability will exist. As stated in paragraph 5.4, the mechanical approach effectively limits substitution to specific beach terminals. As substitution has been introduced primarily in response to declining UKCS supplies it is not clear that such a limitation would be inappropriate. However, as the methodology is not consistent with the Licence obligations we have not pursued this approach as our proposed methodology.

The IA also correctly identifies the primary difference between the proposed methodology and the two-stage auction as being the way that they allow future capacity needs to be signalled. In a two-stage auction Users would be able to buy capacity in response to a perceived vulnerability in capacity at an ASEP to being used to satisfy an incremental capacity signal elsewhere. As Ofgem note, to fully implement this approach would require a major UNC modification. Whilst this, in itself, is insufficient reason not to progress the approach, the fact that a re-design of the QSEC auction processes would be required, which may be unacceptable to some Users, is sufficient reason to make this approach less feasible than the proposed methodology.

In order to create two distinctive auction stages, with sufficient time between for review of bidding strategies, the number of stage one auction rounds would need to be reduced from ten at present to just five. Five stage one rounds was the minimum number acceptable to workshop participants.

As the two-stage auction was being developed interacting proposals were being developed in UNC Review Group 221 (Review of Entry Capacity and the Appropriate Allocation of Financial Risk) and the associated UNC Modification Proposals (246 and variant). If implemented, these proposals will also lead to a change to QSEC timelines such that the number of stage one auction rounds would need to be reduced to less than five. This was demonstrated at substitution workshop 9 on 7th July 2009. Although the changes to QSEC required by UNC modification proposal 246 are likely to be temporary (pending implementation of a systems solution) at least one response to the consultation indicated a desire for a prompt reversion to ten auction rounds. This indicates that even the initial two-stage auction timeline would be unacceptable to some.

The IA identifies that under the two-stage auction Users are required to make a full financial commitment to prevent capacity being available for substitution. This highlights a further problem with this methodology that the retainer approach addresses; that projects may not be sufficiently developed to justify buying capacity. The retainer offers a lower cost alternative, which could be refunded, to protect vulnerable capacity. Where projects are insufficiently developed Users will, under the two-stage auction, be forced to commit to buying capacity at full price. This could lead to increased User costs and/or sterilisation of capacity. Alternatively, Users may decide to take no action and risk substitution occurring. Although the two-stage auction limits this risk, because action would only be required if incremental bids are received in stage one, it would also reduce the quality of market signal provided to National Grid for planning purposes that pre-QSEC retainers would provide.

As much of the two-stage auction process is already available the benefits of following this approach would be limited. By reviewing the results of each auction round Users can identify whether incremental capacity has been requested and respond, if considered necessary, by bidding for capacity in the next round. We acknowledge that this option is not ideal (incremental capacity bids may be withdrawn or made in the final window) however; as the probability of these events occurring is low, we believe that the current QSEC process allows Users a reasonable opportunity to buy capacity in reaction to incremental capacity requests.

In substitution workshop 5 on 5th December 2008 National Grid presented a range of 11 options for substitution. One option that received much support was for "Ofgem Discretion". This option was not supported by Ofgem and was not progressed. National Grid agreed that the option was unsatisfactory because any methodology that includes discretion is open to lobbying and is likely to extend the period of uncertainty between incremental capacity release and substitution proposals being made and the subsequent confirmation of investment plans. Any extension of, or uncertainty around, this timeline would be of concern to National Grid. Notwithstanding the early support for Ofgem Discretion, we anticipate that the majority of Users would expect transparency in the way that substitution proposals are progressed. The uncertainty that a discretionary and potentially, opaque, process would create could hinder Users in formulating their auction strategies.

National Grid agrees with Ofgem's expectation that for the purposes of the retainer approach substitution proposals would be rejected if the methodology had not been followed (we would expect the same would apply for any substitution approach). We expect that any proposal for substitution that is consistent with the approved methodology, and hence is consistent with the amended entry capacity substitution objectives, would not have "foreseeable and substantive security of supply implications". Therefore we consider that there is no need for additional criteria, beyond consistency with the methodology statement, which the Authority would need to take into account when considering National Grid's proposals for substitution. To do so would risk that a rejection (or, more likely, a request by Ofgem that National Grid implement a revised proposal pursuant to paragraph 9 I) (ii) of Special Condition C8D), for any reason other than failure to follow the approved methodology, may be perceived as implementation of a methodology which is inconsistent with the approved methodology. Such an approach might be seen as consisting of a combination of the discounted methodologies of "Ofgem Discretion" and the "Mechanical Approach".