

1st December 2009

Bogdan Kowalewicz
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London, SW1P 3GE.

Dear Bogdan,

Gas Entry Capacity Substitution – Initial Impact Assessment, ref 136/09

Thank you for the opportunity to comment on Ofgem's impact assessment. Clearly, this whole matter has been under review for an extensive period, but we have a few points to make at this late stage.

1. It remains a considerable disappointment that Ofgem, with its open letter of 3rd July 2009, rejected the mechanical option, even though this was the most preferred of the three being considered. Ofgem should have stated its position much earlier, particularly given the request by the chairman of Workshop no. 8 on 7th April and Ofgem's reply: "TD then asked DECC and Ofgem to advise the meeting if they were of the opinion that any of the options put forward were clearly unacceptable at this stage. BK responded that Ofgem had set out some principles that it expected to be applied to a network, that these had not changed and there was nothing further to add. Ofgem had expected a clear range of options to be developed for the parties to consider and this expectation had been met." In the light of subsequent events, this represented a lack of proper engagement with market participants.
2. The savings in capital expenditure quoted in the IA are very small indeed, when compared with the value of gas being transmitted through the NTS which is typically of the order of £10 billion a year. This concentration on short term cost savings is a significant weakness of the IA; it should be matched by an analysis of the adverse effects of less flexibility in the NTS and possible consequences for the security and prices of gas and, therefore, electricity supplies. Even if the principle of substitution is reasonable – and we agree that it is – it is doubtful if such minor savings can justify the cost and complication of the proposal, especially if due regard is given to substitution's adverse effects which the IA fails to do.
3. It is far from clear to us how substitution and its consequences will fit with Project Discovery, particularly when Ofgem has written "The greatest risk to security of supply appears to be maintaining gas supplies through a severe winter" and "The range of uncertainty facing the market is huge" in paragraphs 1.17 and 3.24, respectively, of its recent consultation about Project Discovery.

4. West of Shetland gas and another possible Norwegian pipeline should deserve special consideration in terms of security of supply, because of their strategic importance to the economy.
5. NGG is in an unacceptably strong position for a regulated monopoly. Everyone else, including Ofgem, is dependent on NGG for the numbers upon which decisions about substitution will be made. This cannot be right, as we have written previously.
6. Even if the retainer model is now a *fait accompli* for 2010, two stage auctions should be more fully considered by the industry, or perhaps a hybrid method, for possible introduction in 2011.
7. We support a cautious approach to the introduction and use of substitution; learning through experience should be paramount. If there are any significant doubts about an individual proposal for substitution, it should be rejected. Ineluctably, substitution will lead to a smaller NTS in commercial terms, a trend that, in our opinion, is most unwise in current, uncertain circumstances.

We naturally remain available to discuss these points further with you, should you so wish. Please do not hesitate to contact us.

Yours sincerely,

A handwritten signature in black ink that reads "David." with a horizontal line underneath.

David Odling,
Energy Policy Manager.

Copy: Simon Toole)
John Havard) - DECC
Peter Kershaw)