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Gas Entry Capacity Substitution Methodology – Initial Impact Assessment November 2009

Dear Bogdan,

We welcome opportunity to comment on this Initial Impact Assessment (IA). This response is provided on behalf of the RWE group of companies, including RWE npower and RWE Supply and Trading GmbH.

During the development of Gas Entry Capacity Substitution Methodology (the methodology), we have consistently endorsed the principle that investment in new infrastructure should not be undertaken unnecessarily and agreed that some form of transparent substitution mechanism to reallocate existing capacity between entry points might be one mechanism to achieve this objective.

However, we have also expressed our concern that an unfettered substitution mechanism would lead to significant capacity destruction. In turn, this could negatively impact security of supply by potentially limiting flows of gas into GB through interconnectors and making it harder for new projects to secure entry capacity.

We do accept that substitution will only occur in response to a signal for increased entry capacity elsewhere and that this may suggest additional supplies. But, it may also reduce flexibility in the NTS and this intuitively might be expected to lead to increased wholesale prices if price-responsive supplies are unable to acquire the necessary entry capacity to deliver gas in response to price signals.

The methodology does go some way to address these concerns and refinement of the methodology has been helped by Ofgem clarifying the principles that would underpin the licence

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condition which gives effect to the obligation on National Grid Gas (NGG) to implement substitution.

The proposed exchange rate cap will limit the extent of capacity destruction, but we remain to be convinced that the retainer itself will be used to any great extent. Although the retainer prevents unsold capacity from being substituted, capacity can still be purchased at the ASEP so it only provides a partial safeguard. Depending on specific project development timelines, this makes it difficult to assess the value of paying the retainer fee. This problem is exacerbated where a developer wishes to acquire capacity in the future, but may need to take out a retainer at early QSECs to prevent the capacity being substituted ahead of their requirements. Having to commit early will represent a barrier to certain projects and may not actually result in the capacity being protected in any case.

Ofgem's IA does not demonstrate a compelling case for implementing the methodology. The imputed quantitative benefits related to avoided capex are scenario-based and without incremental investment signals, these benefits will not be realised. The analysis is based on substitution within a static network, but ignores the consequence of subsequent signals and the fact that the future network capacity requirements are dynamic. It is this dynamic aspect that is not reflected in the methodology or evaluated in the IA.

We think that the IA is further undermined by the exclusion of any quantitative assessment of the impact on wholesale gas prices. This work has been requested during throughout the development process and its absence means that the IA is unbalanced. It should be for the sectoral economic regulator to undertake this piece of analysis. By way of example, the introduction of the Trade and Transfer Auction in November 2007 resulted in significant entry capacity destruction at Isle of Grain and Theddlethopre. A total of 592 GWh of entry capacity was substituted away from these two terminals in favour of 85GWh at Easington. At that time, anecdotal evidence suggested that suppliers to these terminals struggled to procure entry capacity which resulted in a knock-on impact on the wholesale price of gas.

Although we agree with Ofgem's assertion that a positive competition effect of substitution is that it broadens the market for capacity, the reality is that the methodology leads to only a limited number of viable donor ASEPs, due to their location and how they interact with other ASEPs. This differential risk is as much to do with history as design of the methodology and is discriminatory. When constructing the substitution merit order, the methodology should recognise the amount of unsold capacity at each ASEP. Introducing an additional criterion based on levels of unbooked capacity, rather than pipeline distance alone, will lead to a more equitable and efficient outcome.

Developing the methodology has been a tortuous process and confirms the practical problem of implementing an ill-defined policy in what is a complex area. The IA itself is not compelling and has serious omissions. We do not believe that retainer will deliver the envisioned benefits. Our preference would be not to introduce substitution ahead of the scheduled 2010 QSEC, but to consider how the policy might be delivered under TPCR5. This will allow time for the output from RPI-X@20 and the ERGEG work on short-term access arrangements to be properly included.

Our answers to the specific questions raised in the consultation document are included as an attachment.

We hope these views are helpful and would be happy to discuss them further.

Yours sincerely,

By email so unsigned

Charles Ruffell
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ATTACHMENT 1: CONSULTATION QUESTIONS

CHAPTER 3: NGG's Substitution Methodology

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

The methodology creates ASEPs that are more vulnerable to having unsold capacity substituted than others. This is largely due to their location and how they interact with other ASEPs. This discriminatory feature needs to be properly addressed.

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

The scenarios show mechanically how the methodology works. We cannot comment on whether the scenarios are based on credible assumptions of where incremental signals are likely to be seen.

CHAPTER: 4 Assessment of NGG's methodology

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

The assessment reflects the key licence obligations, although the analysis focuses upon qualitative, rather than quantitative benefits. The principal quantitative benefit arises as a consequence of assumptions made about the location of incremental signals and different assumptions would lead to a different outcome.

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

No. Avoided capex would appear to be the main quantitative benefit.

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

No, but the qualitative benefits claimed are marginal at best.

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

Intuitively, substitution will lead to a more constrained NTS, which will manifest itself in shippers being unable to flow as much gas as they want to and this could have a potential upward impact on the wholesale gas price and adversely impact on security of supply. As the sectoral economic regulator, we strongly believe that it is Ofgem's role to undertake analysis to quantify this effect.

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

The development of the methodology together with its implementation has adversely affected the perception of regulatory risk in the UK and may have undermined its attractiveness as a location to land gas.

Chapter 5: Alternative methodologies developed by NGG

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

The key difference used by Ofgem is the extent to which user commitment is necessary to prevent capacity being substituted. We are sympathetic to the view that user commitment should be a component of any access arrangements, but in this case the IA does not conclusively demonstrate that the relatively more sophisticated retainer methodology is any better than the Mechanical Approach. This is mainly due to the assumptions used to generate the benefits, which could be used for either of the methodologies that were under discussion. We would still prefer to see the Mechanical Approach implemented.