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Dear Bogdan,

**Gas Entry Capacity Substitution Methodology - Initial Impact Assessment**

Thank you for providing Scottish and Southern Energy (SSE) with the opportunity to comment on the above consultation. We have detailed our responses to the consultation questions in an attached annex; however we would take the opportunity to reiterate our high level views.

**Retainer Methodology**

We are disappointed that the substantial effort invested by the industry in seeking an enduring solution to entry capacity substitution has been foreshortened, with only one method of substitution being fully assessed as part of this impact assessment. Considering the wide spread industry preference for a methodology other than the Retainer approach (Conclusions Report to the May 2009 Informal Consultation on Entry Capacity Substitution 10 July) we question whether the views of industry have been appropriately considered. This is a particular concern given the majority of participants believe the Retainer approach to be inferior to the other Substitution methodologies that have been developed.

The implementation of Substitution is intended to avoid sterilisation of capacity and consequently ensure efficient investment. We support this principle, but do not believe that the Retainer methodology is the most efficient method of achieving this. We believe that the 2 Stage Auction methodology would have provided a better, more efficient solution and that it would be better to implement this first time round rather than an inferior solution to an arbitrary deadline. We do not have any confidence in the suggestion made in the consultation that it would be considered as part of any future review of the substitution methodology.

In the consultation document, Ofgem put forward the principles that would apply to consideration of a substitution methodology. It highlighted that: i) if users want financially firm rights to use the system they need to purchase them and make a financial commitment to pay for them; and, ii) where users choose not to secure rights and therefore rely on daily auctions, they face the risk that entry capacity is not available. By comparison with these two ends of the spectrum, the Retainer methodology creates a halfway house, where, through an option payment (not full financial commitment), capacity can be held back from Substitution, leaving it available for use on the day (given there is spare capacity for Substitution, this is a likely outcome). It is not clear therefore that the Retainer methodology meets the principles set out by Ofgem.

Whilst the Retainer methodology has been reasonably assessed as part of this impact assessment, the lack of detailed comparison with the 2 Stage Auction methodology leaves it open to criticism. For example, it would have been appropriate to assess the efficiency of the two methodologies in relation to their efficiency of Substitution and the impact this would have on wholesale prices. The impact on wholesale costs through inefficient Substitution could cost much more than the savings made, by ensuring that all capacity is used.

Two final points on the Retainer approach are i) it allows Users to pay a nominal fee for capacity that is not cost or value reflective of the reserve price of all ASEPs and ii) the exchange rate cap of 3:1 is wholly arbitrary. These leave the methodology open to criticisms of being non-cost reflective, arbitrary and not meeting the relevant objectives.

### **Consultation Questions**

#### **Q3.1 Are there additional aspects of the methodology that should be highlighted?**

It would be helpful to explain: how the exchange rate cap of 3:1 was arrived at; whether there was any subjective justification behind its choice; and if not how this could be considered cost-reflective.

#### **Q3.2 Are the scenarios analysed appropriate and relevant to system development? If not, why not?**

Given they were raised through workshop discussion, they appear representative.

#### **Q4.1 Do you agree with our assessment of the methodology (within the framework of the current licence)?**

The assessment presented for the Retainer methodology is reasonable.

#### **Q4.2 Are there any quantitative benefits that have not been included in our assessment?**

The quantitative benefits appear reasonable, however we believe these could equally be achieved via the more efficient 2 Stage Auction process. In addition, it would have been appropriate to consider the efficiency of substitution of the different methodologies and their impact on wholesale prices.

#### **Q4.3 Are there any qualitative benefits that have not been included in our assessment?**

The qualitative benefits appear reasonable; however, again we believe these could equally be achieved via the more efficient 2 Stage Auction process.

#### **Q4.4 Are there any quantified costs that have not been included in our assessment?**

As noted above, a comparison between the two methodologies, their efficiency and the impact on wholesale prices would have been appropriate.

#### **Q4.5 Are there any qualitative cost that have not been included in our assessment?**

No.

#### **Q5.1 Do you agree with our assessment of the relative differences between the capacity retainer methodology and the other methodologies?**

No. We believe the 2 Stage Auction methodology is a better solution and should be implemented for the following reasons:

1. It will make use of the existing QSEC process which is more efficient. It avoids the added complexity of retainer payments in a regime that is already too complex and creates a barrier to new entrants.
2. Users will only have to bid to protect capacity from substitution once an incremental capacity has been signalled. The Retainer method is less efficient as Users lack certainty and will have to make untargeted retainer payments due to lack of transparency about future investment signals.
3. The User commitment to buy capacity is more cost reflective being based on the ASEPs specific reserve price, rather than an arbitrary, low value and generic retainer payment.

We recognise that this methodology could require UNC modifications to re-design the auction processes. However, we believe it is preferable to take the required time to implement the best solution first time round rather than put in place an inferior solution to meet an arbitrary deadline.

I hope that our comments are helpful. If you would like to discuss any of the points raised in more detail, please do not hesitate to get in contact.

Yours sincerely,

Claire Rattey  
Regulation Analyst