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Dear Chris,

Decision to direct NGG to implement proposal to release non-incremental obligated entry capacity at Barrow

Summary

The Gas and Electricity Markets Authority (the "Authority")¹ has considered the proposal submitted by National Grid Gas (NGG) on 16 April 2010 to release non-incremental obligated entry capacity at Barrow (the "Proposal"). This proposal is pursuant to Special Condition C8D, Part C (9)(f) of NGG's gas transporter licence in respect of the NTS (the "Licence"). The proposal involves the substitution of entry capacity in accordance with the approved NGG Entry Capacity Substitution methodology. The Authority has carefully considered the proposed substitution, taking account of the relevant objectives and the Authorities wider duties. For the reasons set out in this letter the Authority has decided that NGG should implement the proposal.

The proposal is expected to result in customer savings of around £6 million.

This letter outlines the background to the Proposal and the Authority's reasons for its decision.

Background

On 15 July 2009, the Authority approved NGG's Incremental Entry Capacity Release (IECR) methodology². This methodology, required by Special Condition C15 of the Licence, describes the process by which NGG determines whether to make incremental entry capacity available for sale to gas shippers.

Between 15 March 2010 and 16 March 2010 NGG conducted the Quarterly System Entry Capacity (QSEC) auctions whereby it invited shippers to bid for entry capacity to the National Transmission System (NTS) at a number of Aggregate System Entry Points (ASEPs).

NGG uses the information from the QSEC auction to allocate entry capacity to shippers and for planning purposes. The IECR methodology is applied to the results of the QSEC auction

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this letter. Ofgem is the Office of the Gas and Electricity Markets Authority. ² Version 9.3

for determining whether or not to allocate potential obligated incremental entry capacity rights to users.

The IECR methodology allows for a Net Present Value (NPV) test to be conducted if at any ASEP a minimum quantity of incremental capacity is demanded i.e. demand exceeds supply. The NPV test assesses whether the NPV of revenue from the bids of incremental entry capacity over a period of 8 years equals at least 50% of the 'estimated project value'. If it does, then NGG would propose to the Authority that the quantity of additional firm entry capacity be treated either as funded incremental obligated entry capacity or non-incremental obligated entry capacity (provided by entry capacity substitution) as defined in the Licence.

On 7 December 2009, the Authority approved NGG's Entry Capacity Substitution (ECS) methodology pursuant to paragraph 10 (a) of Special Condition C8D of the licence. Entry capacity substitution is the process by which unsold entry capacity is permanently moved from one or more entry points to another entry point, to meet the demand for incremental entry capacity identified by the IECR Methodology Statement. The ECS methodology describes the circumstances in which NGG will make such substitutions and the process to determine its proposals to substitute capacity and revise baseline quantities.

The ECS methodology sets out the rules which define the capacity available for substitution. Under the methodology, the substitutable capacity is the lowest value of unsold entry capacity for any quarter following the default lead times. The methodology also provides for the use of an annual retainer product through which shippers can retain entry capacity. Capacity retainers provide users with the ability to exclude capacity from substitution at potential donor ASEPs without having to buy and be allocated that capacity. A capacity retainer can be taken out at a retainer window opened by NGG. Potential opportunities for substitution, where capacity can be created at one ASEP by reductions in flows at other ASEP(s), are validated through network analysis. This seeks to ensure that the substitution does not increase the incremental risk on the network.

On 16 April 2010 NGG submitted a proposal pursuant to Special Condition C8D, Part C(9)(f) of the Licence for additional firm entry capacity at Barrow to be treated as non- incremental obligated entry capacity. This is for the release of 30.91 GWh/day of non- incremental obligated entry capacity at Barrow from 1 January 2015. The entry capacity requirement is all to be met by substituting non-incremental obligated capacity from the Teesside ASEP at a 1:1 exchange rate, with a substitution date of 1 January 2015.

Criteria used in assessing the proposal

The basis on which the Authority can approve an application for substitution is set out in NGG's gas transporter licence (Special Condition C8D, Part C (9)(k) (i). This states that the Authority needs to evaluate whether the application is consistent with:

- the licensee's incremental entry capacity release methodology
- the licensee's entry capacity substitution methodology, and
- the licensee's duties under the Act and the standard, Standard Special and Special Conditions.

Ofgem's view

Ofgem considers that the application is consistent with the licencee's incremental entry capacity release methodology. The information submitted by NGG on 16 April provided the Authority with sufficient information to determine whether the relevant criteria of the IECR methodology had been met.

We also consider that the application is consistent with the licensee's entry capacity substitution methodology. Further information was requested from NGG on the way that the substitution methodology had been applied. In particular we requested confirmation that the substitution methodology was followed and asked for evidence to demonstrate that

2 of 3

this was the case, including consideration of any material changes in costs; details of the inputs into the network model and its results; indication that potential substantive security of supply issues have been fully considered in NGG's deliberation; and an explanation of exchange rates calculated for the relevant donor ASEPs.

Teesside was chosen as the donor ASEP in this instance, in accordance with the methodology. The methodology requires that the donor ASEP is selected according to the "shortest pipeline distance criterion". 3

Finally, we consider that the application is consistent with the licensee's duties under the Act and the standard, Standard Special and Special Conditions.

As additional capacity has been provided by substitution the revenue driver allowance that NGG would otherwise be entitled to no longer applies. We calculate that this represents a saving to consumers of around $\pounds 6$ million over the 5 years for which the revenue driver would have applied.

Prior to the March 2010 QSEC, capacity retainer windows were available on 25 and 27 January 2010. Some retainers were purchased at another ASEP but no retainers were purchased at Teesside. This suggests that shippers using Teesside did not foresee potential substitution as affecting their ability to flow gas. In addition, NGG indicated in their response to our information request that their analysis showed that the proposed substitution has no impact on the NTS's capability in meeting the peak day demand. For these reasons we do not believe that substitution of capacity between Teesside and Barrow will adversely impact on security of supply.

In our approval of the ECS methodology we stated that we expect NGG to provide and make public a report setting out its assessment of the impact of the substitution following the initial application of the methodology. Shortly, we expect NGG to implement this review and make known its findings.

For the avoidance of doubt, the absence of a direction to NGG not to implement the Proposal, does not fetter the discretion of the Authority on other issues leading up to the submission of the Proposal, arising out of the Proposal, or required for the successful implementation of the Proposal.

The Authority's decision

The Authority has carefully considered the Proposal submitted by NGG pursuant to Special Condition C8D(9)(f) of the Licence. The Authority has decided that NGG should implement the proposal for the reasons set out above, and directs NGG to implement the Proposal pursuant to paragraph 9(I)(i).

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Stuart Cook Senior Partner, Transmission and Governance Duly authorised on behalf of the Authority

³ NGG's methodology states that all within zone donor ASEPs will be considered before out of zone donor ASEPs. In the event of two or more donor ASEPs providing equal exchange rates then the donor ASEP will be selected on the basis of the nearest ASEP, determined according to pipeline distance from the recipient ASEP.