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Dear Lewis

Response to “Gas Transmission Exit Capacity Substitution and Revision 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 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 exit capacity substitution and revision methodologies and the issues that were 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 decision making process so that approval, or veto, of the proposed methodology statement can be given.

After careful consideration of the information provided within the IA, National Grid continues to support implementation of its proposed exit capacity substitution and revision methodologies. We believe that the proposed methodologies fully meet the requirements of the Licence, specifically the exit capacity substitution objectives and the exit capacity revision objectives.

National Grid has been sensitive to concerns expressed by certain industry players and has, in conjunction with the industry, revised its initial proposals to:

- Select potential recipient NTS Exit Points with highest revenue driver before lower ones;
- Remove the exchange rate collar; and
- To apply substitution from October Y+4 consistent with capacity release obligations requiring investment.

However, we have not proposed any changes to facilitate different treatment of specific categories of NTS Exit Point, i.e. interconnectors.

Key issues

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

- **Substitution and Revision 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 baseline capacity level at NTS Exit Points where capacity is not needed (as evident by capacity remaining unsold), to free up capability at other NTS Exit Points where incremental capacity has been signalled, will aid efficient and economic decisions regarding investment. This should reduce the requirement for, or magnitude of, new infrastructure. This saving will be reflected in reduced allowed revenues for National Grid and hence reduced costs to Users which should in turn benefit end 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.

It is National Grid's opinion that the proposed methodology fully satisfies the objectives stated in the Licence and the additional objectives agreed in the first industry workshop. Namely that:

- ◆ Substitution opportunities are realisable;
- ◆ There should be no significant increase in cost / risk to DNO's, Shippers, connected parties, and/or consumers;
- ◆ The solution is workable without excessive implementation and operating costs.

National Grid believes that the proposed methodology takes due account of the risks expressed by Users and is proportionate in the balance it strikes between complexity and the potential benefits.

We recognise Ofgem's acknowledgement that exit capacity revision will not provide any quantitative benefits. Whilst this may lead some stakeholders to question the need for exit capacity revision, we accept that the increased transparency that exit capacity revision provides may result in benefits to end consumers. Commensurate with this, we believe a simple revision methodology, as proposed, is appropriate.

- **Publication of Capacity Information**

Throughout the development of the exit capacity substitution and revision methodologies there has been discussion on the availability of so called "spare" capacity and the publication of technical capacity as required by Gas Regulation (EC) 715/2009.

As Ofgem point out in paragraph 1.5 *"This [transparency of exit capacity information] is an important issue, but one which we do not consider is central to any specific aspect of the methodology proposed."* National Grid agrees with this view. Whilst transparency is important it is not relevant to the proposed methodology: the intention of the methodology is to satisfy the Licence requirements irrespective of the quantity and detail of separately published information. Notwithstanding this, National Grid has, independent of the work on substitution and revision, published information that meets the requirements of the Regulations, including the obligation to publish the technical capacity of the NTS at relevant points.

We note Ofgem's consultation on relevant points (paragraph 1.12) and that they "do not currently anticipate implications from this piece of work for implementation of the substitution and revision methodology". This is a view we share.

In respect of exit capacity revision, Ofgem note (paragraph 1.10) that some parties believe that National Grid should undertake the same analysis for existing entry points, for prevailing entry flows, as is proposed for new supplies. The perceived benefits being: increase in transparency of spare capacity on the system and ensuring compliance with Gas Regulation (EC) 715/2009. As National Grid is already compliant with the Regulations, "ensuring compliance" should not be considered a benefit of the additional workload.

Whilst the additional analysis may increase awareness of unsold system capability, this information will have limited value. Throughout the development of the methodology, National Grid has stressed that analysis of system capability is limited by the supply and demand scenarios analysed. Publication

can, therefore, be as misleading as it is informative. As this view applies to the basic principles of exit capacity revision, National Grid has proposed an exit capacity revision methodology that meets the well defined requirements of the Licence in respect of “incremental obligated entry capacity”, but not any other, i.e. existing, entry capacity. We believe that extending analysis to existing capacity would be an inefficient use of valuable resources. However, in accordance with the exit capacity substitution and revision methodology, for any NTS Exit Point at which incremental exit flat capacity requests can be met without undertaking NTS investment, National Grid will propose the release of this existing capacity prior to consideration of exit capacity substitution opportunities.

- **Exit Capacity Revision Methodology**

In paragraphs 4.42 to 4.46 Ofgem have provided comments on the exit capacity revision methodology. Whilst recognising the importance of reliable gas flows to the creation of exit capability, Ofgem “*tend to agree that NGG’s approach appears conservative*”. We agree, and it was made clear during workshop 4, that it will be some years before the proposed methodology reveals additional exit capacity at actual, or notional, exit points. However, National Grid believes the approach, which relies on two years of established flows, is not conservative, but introduces significant risk of exit capacity being made available and sold without the associated entry flows to support it. This could lead to substantial buy-back costs and risk of exit loads being unable to operate. It should be noted that new entry supplies are less likely to originate from the UKCS than previously. LNG cargoes can readily be diverted to other countries; storage flows are seasonal or merchant and are potentially unpredictable, Norwegian gas may be diverted through continental Europe at times of constraint. This uncertainty creates risk. National Grid believes that two years of flows gives a level of operational experience that provides an appropriate level of risk.

Ofgem enquire as to the effect on exit capability in the event of entry substitution: National Grid is proposing to apply exit capacity revision only where funded incremental obligated entry capacity is released. The suggestion is that if exit capability is driven by entry flows, then exit capacity revision should also be applied when entry capacity is released through entry substitution. In both cases there should be increased flows at the recipient ASEP. Consistent with the investment (funded) scenario, in the case of entry substitution, there should be no corresponding decrease in flow at the donor ASEP. This is because only unsold capacity can be substituted. As it is the baseline and not physical flows that is reduced, it is implied that there should be no reduction in exit capability in the vicinity of the donor ASEP. This issue was discussed in the exit substitution workshops.

In the event of incremental entry capacity being released through entry substitution, it could be expected that the resultant increase in entry flows would facilitate additional exit capability adjacent to the recipient ASEP. However, to accommodate this increase the baseline at a donor ASEP will be reduced and the system capability near this ASEP will decrease accordingly: if the system capability did not decrease there would be no need to undertake the entry substitution and it would not be progressed. Notwithstanding that entry flows should not be altered at the donor ASEP, there will be a reduction in capability adjacent to the donor ASEP. It is because of the potential reduction in unsold capacity adjacent to donor ASEPs that workshop participants accepted the proposal to limit exit capacity revision to the release of funded incremental entry capacity.

Ofgem also notes that “*risk is inherent in any release of incremental exit capacity following exit capacity revision, as even where gas flows are confirmed over a two year period, such flows provide no certainty as to the level of gas flows in the future.*” This comment highlights the problem, not just with exit capacity revision, but with the concept of enduring obligations. As has been observed with declining flows at St Fergus, exit capacity obligations persist beyond the time when entry flows become unable to support those obligations. In regard to exit capacity revision, this is a risk National Grid is aware of. National Grid accepted this level of risk as a consequence of agreeing the Licence and associated funding arrangements. If a higher level of risk was taken by National Grid, which we believe would be inconsistent with the exit capacity revision objective to “avoid material increases in the costs (including NTS exit capacity constraint management costs...)”; we may seek additional funding to cover this additional risk.

Whilst minded to approve the proposed methodology statement, Ofgem states that as a condition of such approval “*it would be appropriate for NGG to reconsider this aspect [application to entry substitution, two year flow history] of the revision methodology following implementation.*” As the

Licence requires National Grid to review the methodology statement each year, it will be the case that these aspects will be reconsidered.

- **Treatment of Interconnectors**

As stated above National Grid believes that it is compliant with all relevant current EU Regulations. Whilst we are aware of EU regulatory developments, we agree with Ofgem that *"it is appropriate that NGG continues to monitor the development of ERGEG's (now ACER's) work and respond appropriately"*. It would appear premature to exclude interconnectors from exit capacity substitution without defined rules in respect of future obligations: we believe that work is still progressing to agree the rules for cross border capacity processes.

In regard to Moffat NTS Exit Point we believe that we have demonstrated, in our consultation conclusions report, that the risk of substitution of unsold baseline capacity is low. This is mainly because there is currently no unsold capacity available for substitution from Moffat. Further, if circumstances arise such that substitution of Moffat capacity is proposed in line with the methodology, National Grid may discuss with Ofgem whether the proposal should be excluded. Even where National Grid does not exclude those substitution proposals, Moffat Shippers would have additional comfort that if the Authority considered the proposals would *"adversely affect the security of supply of either the GB or other member state, the Authority would have the ability to veto the change"*. We remain of the opinion that different treatment of interconnectors, or any other category of NTS Exit Point, is not justified at this time.

In the event that National Grid was to put forward a level of capacity at Moffat below which substitution would not occur National Grid would need to justify that level. The current justification for exclusion of capacity at any NTS Exit Point from substitution, emphasised by Ofgem, is the user commitment principle. Assuming current Shipper capacity allocations are reduced, protecting capacity to baseline level or forecast flows would not be consistent with this principle. The only justifiable level would be to protect capacity equal to the booked downstream entry capacity. Currently this is considerably below the level of booked NTS exit capacity. In addition, to protect unsold capacity from substitution would retain system capability at that exit point effectively guaranteeing its availability as off-peak capacity which could be obtained at zero reserve price.

- **Implementation date**

In paragraph 2.8 Ofgem refers to the Authority's letter of February 2009. This letter agreed to a delay to the implementation of exit capacity substitution and revision obligations until 2011, consistent with an implementation aligned to the July application window. This is consistent with the statement in 4.14 that *"if the substitution methodology is approved it will be applied from 1 July 2011."*

The methodology submitted to the Authority for approval on 4th January 2011 has an effective date of 1st April 2011. This is inconsistent with the Authority's letter and Ofgem's impact assessment. We believe that the date of 1st April 2011 included in the submission is incorrect and that implementation should be from 1st July 2011 as stated by Ofgem.

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?

During the exit substitution workshops we presented examples of how we envisaged substitution will be applied, specifically the impact on donor NTS Exit Points. These examples were identified as:

- representing a reasonable expectation of where incremental exit capacity requests could be made in the next year or so; and
- providing examples covering different parts of the NTS where the effect of different levels of entry flows would demonstrate the availability of unsold system capability as well as how donor NTS Exit Points might be affected.

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. Notwithstanding the data provided by National Grid to Ofgem as part of the FB PQ submission, only individual Users (and developers) know with any certainty where incremental exit capacity requests (and reduction requests) are to be made and their magnitude.

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 IA rightly identifies the avoidance of investment costs as the key benefit of substitution and uses appropriate data to provide what we believe is a reasonable projection of possible savings.

The IA is also correct to identify that exit capacity revision "*will not change the way in which NGG evaluates whether it can meet incremental exit capacity needs without investment*", i.e. it will not lead to any additional savings through avoidance of investment.

As stated in paragraph 4.54, Ofgem "*would expect NGG to model any charging impacts on the NTS exit points affected by substitution.*" This would be with a view to possible veto of any proposals "*considered to have an inappropriate effect.*" Following non-veto of substitution proposals exit capacity charges will be recalculated, consistent with UNC and Licence obligations, based on revised data. This revised data will include latest supply/demand forecasts and pipeline infrastructure, as well as revised baseline quantities (where appropriate to the charging methodology).

If Ofgem requires additional charging calculations to be submitted with the substitution proposals, these could be produced. However, we would question their value.

- We are not convinced of their relevance to Users as they will only show the effect of incremental exit capacity release and associated baseline reductions: actual prices are affected by other variables; and
- As illustrated in appendix 2, the impact of substitution on capacity prices is likely to be small, although this will be subject to the number and magnitude of substitutions proposed. Hence, this additional data is unlikely to provide any significant additional information to help inform the Authority's decision on any specific proposals.

In addition, we believe that Special Condition C8E paragraph 4(e) of the Licence, which states the information that National Grid must provide with its substitution proposals, may need to be amended if additional charging information is required as part of the submission. We would also need to review whether the data requested, which would need to be clearly defined, could be provided in the necessary timeframe. This is because charging analysis could not be undertaken until analysis to

determine substitution proposals have been concluded. We have already commented, in early workshops, that there is limited time allowed in the Licence to undertake the necessary analysis work.

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?

We have not identified any additional qualitative benefits.

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

We have not identified any additional quantitative costs. We believe that the most significant cost will be felt by Shippers and DNOs who wish to change their capacity booking strategies by changing from reliance on off-peak capacity to Enduring Annual Exit (Flat) Capacity.

A tightening of the system, i.e. higher obligations within the same network infrastructure, could lead to greater curtailment of downstream flows. Ofgem address the issue of security of supply in the IA, but any risk to gas flows, whether actual or perceived, could result in a “risk premium”. This would be for Shippers and/or DNOs to quantify.

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

We have not identified any qualitative costs.