Andrew Fox
Senior Commercial Analyst
Gas Charging and Access Development
National Grid Transmission
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

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Your Ref:
Our Ref:
Direct Dial: 020 7901 7159
Email: andy.burgess@ofgem.gov.uk

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Dear Andrew

Approval of Gas Exit Capacity Substitution and Revision Methodology Statement

On 13 April 2012, National Grid Gas plc (NGG) submitted to Ofgem[1] the National Transmission System (NTS) Exit Capacity Substitution and Revision Methodology Statement (the "Statement"). This was submitted pursuant to Special Condition C8E paragraph 4 (the "Condition") of NGG's gas transporter licence (the "Licence"). Having regard to the exit capacity substitution objectives[2] set out in the Condition, and to our principal objective and statutory duties[3], we have decided to approve the Statement. This letter sets out the background and reasons for our approval.

Background

Exit capacity substitution is the process by which unsold baseline NTS exit capacity[4] is moved from one or more NTS exit points (donor exit points) to meet customer demand for new NTS exit capacity at another NTS exit point (recipient exit point). Exit capacity substitution can avoid or defer the need for new investment to meet incremental capacity needs, and so help reduce the costs of gas transportation for gas customers. Exit capacity revision is the process by which exit capacity baseline levels are revised in the event that the release of new NTS entry capacity changes the availability of NTS exit capacity.

At the last transmission price control review (TPCR4), we introduced a new obligation[5] on NGG to introduce an exit capacity substitution and revision methodology. Following consultation and development at industry workgroups during 2010, in accordance with the conditions of its Licence, NGG submitted an Exit Capacity Substitution and Revision Methodology Statement to the Authority for approval on 4 January 2011.

[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem', 'the Authority', and 'we' and 'our' are used interchangeably in this document.
[2] The exit capacity substitution objectives are set out in paragraph 4(b)(iii) of the Condition. They include ensuring that exit capacity substitution is effected in a manner which is compatible with the physical capability of the pipeline system; avoiding material increases in the costs (including NTS exit constraint management costs in respect of NTS exit capacity previously allocated by the licensee to relevant shippers or DN operators) that are reasonably expected to be incurred by the licensee as a result of substituting NTS exit capacity; and, so far as is consistent with these objectives, facilitating effective competition between relevant shippers.
[3] Set out in section 4AA of the Gas Act 1986, as amended.
[4] NGG's capacity release obligations are defined in paragraph 3 of Special Condition C8E. Baseline exit flat capacity is the amount of capacity which the licensee is required to offer for sale at an NTS exit point.
[5] This obligation is set out in Special Condition C8E of NGG's gas transporter licence.

We carefully considered NGG's methodology statement, Consultation Conclusions Report[6], the responses to NGG's consultation and the matters raised during the industry workshops and meetings which focused on the development of the methodology. Following this, we undertook further analysis to assess the potential impact of implementing the proposed methodology. This analysis was published in our Initial Impact Assessment (IA)[7] on 11 February 2011.

Following consideration of the responses to the IA, on 31 March 2011 we decided to approve the statement[8], subject to the condition that NGG explore further the application of the methodology to interconnectors as part of its 2012 review. This condition was designed to ensure that the methodology took appropriate account of European network codes concerning cross border trade being developed as part of the European Parliament and the Council of the European Union's Third Legislative Package[9] on the liberalisation of European energy markets ("the third package"). Pending the review, we instructed NGG to exclude all capacity at GB interconnectors from substitution.

Following discussion at the January 2012 Transmission Workgroup[10], on 24 February 2012 NGG initiated its consultation on its proposed changes to the Statement. The version of the Statement submitted to us on 13 April 2012 has been reviewed to take account of the issues raised in the consultation (see NGG's Consultation Report[11] for further detail). NGG proposes that the new Statement be applied from 1 June 2012. In the section below we summarise the substantive changes proposed, and in the subsequent sections we set out respondents' views and our views on the changes.

Proposed changes to the statement

NGG has proposed the following changes to the statement

- Treatment of interconnectors: NGG has proposed an amendment to the definition of Substitutable Capacity. The amended definition introduces the exclusion of all exit capacity at interconnectors, whether sold or unsold, up to the quantity of Technical Capacity[12] (in the NTS exit/interconnector entry direction) of the connected system as published by the interconnector operator.

- Recipient NTS Exit Points: in the event that incremental exit capacity is triggered at several NTS Exit Points a decision is required to determine at which exit point substitution analysis should start first. Criteria for reaching this decision have been added at paragraph 28 of the Statement. These specify that 'where there are two or more potential recipient NTS Exit Points with the same revenue driver[13], either as separate revenue drivers or through grouping, NTS Exit Points will be selected as recipient NTS Exit Points on the basis of the best exchange rate from available donor NTS Exit Points'.

[6] Exit Capacity Substitution and Revision Methodology Statement Formal Consultation Conclusions Report, 4 January 2011: www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ExCapSubMS/
[7] Gas Exit Capacity Substitution and Revision Methodology – Initial Impact Assessment (Ref: 17/11), 11 February 2011
[8] Authority decision on Gas Exit Capacity Substitution and Revision Methodology Statement, Ofgem, 4 April 2011
[9] In July 2009, the European Parliament published Directive 2009/73/EC ("The Directive") and Regulation 715/2009 ("The Regulation"). The Regulation, in particular, addresses conditions for access to gas transmission networks across the EU, including at interconnectors.
[10] Transmission Workgroup is a monthly meeting chaired by the Joint Office of Gas Transporters. It is attended by signatories to the gas Uniform Network Code (UNC) including gas shippers and gas transporters and concerns discussion of matters relating to the use of and access to the gas National Transmission System.
[11] A copy of this report is available at the following location on NGG's website: http://www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ExCapSubMS/
[12] The Statement has a footnote which states that 'Technical Capacity' is as defined in Article 2 of Regulation (EC) 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and means 'the maximum firm capacity that the transmission system operator can offer to the network users, taking account of system integrity and the operational requirements of the transmission network.'
[13] Revenue drivers are conditions set out in NGG's licence which allow NGG's revenues to increase where analysis shows that system reinforcement is required to meet customer demand for new capacity.

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- Minor revisions and additional descriptive detail necessary to address minor issues identified when first applying the methodology in 2011. These changes include specification that the required incremental exit flat capacity amount will be rounded up to the nearest 0.01 GWh/d for the purposes of substitution analysis, on the basis that '0.01 GWh/d is the lower limit to which network analysis tools can meaningfully be implemented'.

Respondents' views

NGG received one response to its 24 February 2012 consultation. The response was from a system operator downstream of a GB interconnector exit point and concerned NGG's proposed definition of Substitutable Capacity at interconnector exit points. No responses were received about other aspects of NGG's consultation.

The respondent disagreed with NGG's proposals to define the quantity of capacity protected from substitution at interconnectors as the Technical Capacity of the connected system as published by the interconnector operator. The respondent considered that the level of capacity it would be appropriate to protect would be the Connected Systems Agreement ("CSA")[14] amount as specified in Annex B.2 section 2.8 of that document. The CSA value is derived from the maximum permitted instantaneous flow rate at the Connected System Exit Point (CSEP) and is therefore a measure of the capability of the assets owned by NGG on the GB side of an interconnector.[15]

The respondent considered that this approach would better protect connected system security of supply as it would protect a higher amount of capacity from substitution. The respondent also thought that it would be more consistent with European requirements on the provision of cross border capacity, although they did not fully specify why this was the case.

In its Consultation Report, NGG responded to the proposal expressed by the respondent. In NGG's view, protecting a level of exit capacity from substitution at interconnectors greater than the Technical Capacity of the connected system would not be appropriate as it would protect capacity greater than that available on the downstream connected system. Consequently, NGG proposed no changes to the version of the methodology statement it consulted on.

Ofgem's view

Exit capacity substitution is intended to promote efficient use of the NTS. The capacity bookings made by NTS users under the exit capacity commercial arrangements[16] provide NGG with important information about system use and investment needs. Where capacity which has not been booked can be substituted to meet demand for new capacity elsewhere on the system, this improves the efficiency of the NTS, and can help reduce the costs of gas transportation for gas customers. In our view, protecting unsold capacity at NTS exit points from substitution could result in unnecessary NTS investment and would not be consistent with the exit capacity substitution objectives.

Consideration of the security of supply implications of our decisions for other European Union Member States is an important part of our obligations as a national regulatory authority under the third package[17]. In particular, we are aware of the importance to

[14] The Connected Systems Agreement is a system operator to system operator agreement concerning such issues as measurement provisions, gas quality, pressures, rates of offtake, ramp rates, and communications processes. It does not determine firm capacity obligations at interconnection points.
[15] Following a request for clarification, this explanation of the CSA value was provided to us by NGG.
[16] These arrangements are set out in Section B of Transportation Principal Document of the Uniform Network Code.
[17] These obligations are set out in Directive 2009/73/EC. In reaching the decision to approve the Statement we have been in dialogue with the regulatory authorities of Belgium, the Republic of Ireland and Northern Ireland.

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security of supply of decisions concerning the Moffat interconnector, which provides a vital source of gas to the Republic of Ireland, Northern Ireland and the Isle of Man. In our decision to approve the Statement in 2011, we instructed NGG to explore further the application of the methodology to interconnectors as part of its 2012 review, and to exclude all capacity at interconnectors from substitution pending the review. We took this decision to ensure compliance with the European network codes being developed to implement the third package and in recognition of the fact that it might be appropriate to make separate provision for interconnector capacity within the statement.

The European network codes necessary to deliver the requirements of the third package relating to gas are currently being developed and consulted on, in conjunction with market participants, by the Agency for the Cooperation of Energy Regulators (ACER) and the European Network of Transmission System Operators for Gas (ENTSOG). On 6 March 2012, ENTSOG submitted the Capacity Allocation Mechanisms (CAM) network code ('the CAM code') to ACER[18]. The CAM code is the first European network code to be developed. It is based on the framework guideline[19] on CAM published by ACER on 3 August 2011 and the invitation letter from the European Commission dated 17 August 2011, both of which are informed by Directive 2009/73/EC ("The Directive")[20] and Regulation 715/2009 ("The Regulation")[21] published by the European Parliament in July 2009.

As far as cross border capacity is concerned, Article 13(2) of the Directive states that 'transmission, storage and/or LNG system operators shall build sufficient cross-border capacity to integrate European transmission infrastructure accommodating all economically reasonable and technically feasible demands for capacity and taking into account security of gas supply.' Consistent with the approach set out in the framework guideline, the CAM code specifies rules for the determination of 'bundled capacity'[22] services at cross border connection points. Paragraph 5.1.1 of the CAM code specifies that all firm capacity must be offered as bundled capacity on both sides of an interconnection point. The definition of capacity is not specified in the paragraph, but the code adopts the term Technical Capacity throughout. Technical Capacity is defined in Article 2 of Regulation (EC) 715/2009 as 'the maximum firm capacity that the transmission system operator can offer to the network users, taking account of system integrity and the operational requirements of the transmission network'.

Having considered our obligations on security of supply, and the requirements of the Directive, the Regulation, and the CAM code, we have decided that NGG's proposal to define the quantity of capacity protected from substitution at interconnectors within the Statement is appropriate. In our view, NGG's proposals will ensure that, at a minimum, an amount of capacity equivalent to the Technical Capacity of the connected system will be available at GB interconnector points. In so doing, we consider that the Statement will provide that a level of interconnector capacity capable of satisfying technically feasible demand is protected from substitution. We consider that the extant provision within the Statement that booked capacity will not be substitutable should ensure that a level of interconnector capacity capable of satisfying economically reasonable demand is protected. Assuming that the Technical Capacity of the downstream connected system is capable of meeting forecast demand, we also consider that these provisions take appropriate account of security of gas supply.

[18] A copy of the CAM code is available to view on ENTSOG's website at the following location: http://www.entsog.eu/publications/camnetworkcode.html
[19] Framework guidelines are policy papers prepared by ACER which interpret the requirements of the Third Package in order to guide the development of European network codes by ENTSOG.
[20] Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009,
[21] Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005
[22] 'Bundled Capacity' means corresponding entry and exit capacity on a firm basis at both sides of an interconnector.

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In our view, protecting an amount of capacity higher than the Technical Capacity of the connected system would not enhance compliance with the third package or the CAM code, as a capacity amount greater than the Technical Capacity of the connected system could not be supplied to the downstream system. This would be the case if the alternative to Technical Capacity proposed by the respondent to NGG's consultation was adopted. This is because the capacity amount stated in the CSA reflects the capability of the assets owned by NGG on the GB side of an interconnector, and does not reflect the technical ability of the downstream network to support capacity flows. We also consider that in the event that the CSA value was greater than the booked capacity level, this could result in an inefficient protection of capacity, which could result in unnecessary NTS investment if demand for new capacity was signalled elsewhere on the system.

We note that NGG's proposal is intended to ensure that, if the Technical Capacity of the connected system as published by the interconnector operator is increased, the level of capacity protected from potential substitution under the methodology would increase accordingly. In respect of the Moffat interconnector, we also note that the level of booked capacity currently exceeds the Technical Capacity of the downstream connected system and the CSA value. Consequently, NTS users would require to reduce their capacity holdings before any capacity became eligible for substitution at the interconnector. Consistent with its Transmission System Operator (TSO) obligations[23] under the third package, we would also expect NGG to consult with the TSOs of GB connected systems in the event that they proposed to substitute eligible capacity from a GB interconnector exit point.

For the reasons set out above, we support NGG's proposals on the definition of Substitutable Capacity at interconnectors. Following submission of the CAM code to ACER, ACER is scheduled to opine on the code in June 2012. If the CAM code is approved by ACER, it will enter into force on the twentieth day following its publication in the Official Journal of the European Union. If ACER does not approve the CAM code it will be subject to further consultation or amendment. In approving NGG's Statement, we therefore consider it appropriate that, as part of its 2013 review of the Statement, NGG reviews the final version of the CAM code to ensure that the Statement remains compliant with European requirements relating to the allocation of interconnector capacity.

In reaching this decision we have also reviewed NGG's proposals on 'Recipient NTS Exit Points' and the minor changes proposed following the first application of the Statement in 2011. In our view, these changes represent appropriate amendments to the Statement.

Authority's decision

Following consideration of the documentation provided by NGG pursuant to Special Licence Condition C8E of the Licence and having regard to our principal objective and statutory duties, we approve the Gas Exit Capacity Substitution and Revision Methodology Statement as submitted on 13 April 2012.

Yours sincerely

Andrew Burgess
Associate Partner, Transmission and Distribution Policy

[23] Article 13(1)(c) of Directive 2009/73 requires each Transmission System Operator (TSO) to provide other TSOs with sufficient information to ensure the transportation of gas takes place in a manner compatible with secure and efficient operation of the interconnected system.

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