

Andrew Fox
National Grid
Transmission Commercial
NG House
Warwick Technology Park
Gallows Hill
Warwick
CV34 6DA
box.transmissioncapacityandcharging@uk.ngrid.com
andrew.fox@uk.ngrid.com

June 9th 2009

Dear Andrew,

Consultation Questions

Total E&P UK Ltd (TEPUK) welcomes the opportunity to respond to National Grid's (NG) informal consultation about substitution of NTS entry capacity.

As a general comment TEPUK fully supports the principle of a transmission system which is appropriate to demand for entry capacity and which is run in a cost efficient manner. We believe however that there is an unintended consequence with the current substitution proposals which envisage some form of early warning whereby capacity will not be removed from entry points with excess capacity before shippers have an opportunity to secure the capacity. When this is combined with the current perverse entry capacity charging regime where it is possible to buy entry capacity "short term" at a discounted price we believe that there is no incentive for shippers to secure entry capacity on a long term basis until such a substitution event is flagged. We are pleased to see that NG raises the question of pricing in paragraph 143 of the consultation.

TEPUK and others are currently developing new reserves in the West of Shetland area with gas delivery expected via a pipeline to St Fergus in 2014. With this in mind we are concerned to ensure that any proposal which might substitute entry capacity away from terminals where future gas is expected but for which no long term commitment signal has yet been made takes into account these future gas flows. We therefore support a soft landing approach to the implementation of substitution which does not rely solely on long term commitment signals but also takes into account future forecast flows

We submit replies to the questions raised by National Grid as follows:-

Paragraph 28

- a. Are there any other factors that National Grid should include in the Base Methodology?
- b. Are there any aspects of the Base Methodology that should be excluded or amended?



We believe that the Base Methodology which proposes substitution of all available uncommitted entry capacity is too extreme. It fails to protect expected future flows at existing entry points and ultimately could lead to the stranding of gas offshore. By failing to apply a sensible exchange rate for substitution between entry points there is a risk of a significant and rapid destruction of entry capacity.

Paragraph 52

c. Should the substitution methodology use an exchange rate cap to limit the impact of substitution on donor ASEPs?

Yes. We must avoid unnecessary capacity destruction.

d. Would the intended benefits of an exchange rate cap be better achieved through implementation of any of the options (Mechanical Approach, Option Approach or Two-Stage Auction) discussed in Section 6?

We believe a sensible and cautious exchange rate cap is vital to avoid capacity destruction and this is better achieved through implementation of the Mechanical Approach.

If an exchange rate cap is used:

e. At what level should the exchange rate cap be set? Respondents may consider that a different value is appropriate depending upon other factors of the methodology, e.g. whether any of the options discussed in Section 6 is implemented.

See comments below

f. Notwithstanding that National Grid is obliged to review the substitution methodology on an annual basis, should the exchange rate cap be set at a low level in the expectation of increasing in future years?

We would prefer to see a cautious approach to setting the exchange rate in keeping with a soft landing implementation. We think the level should begin at 1:1 and only be increased in light of actual experience. In this way we should see the impact of substitution but with limited capacity destruction. We believe that low exchange rates should be established and allowed to be in place for the remainder of this price control. Because the reviews for the next TPCR start as early as next year, the same year when Substitution is to be implemented, we believe that there will be little experience of how this works in practice until 2015 when the review for the following TPCR would start. With this in mind we believe that the low exchange rates should be allowed to remain for this and next TPC period unless there is significant evidence that change would better help to achieve Ofgem's and National Grid's obligations. In any event we would not wish to see an exchange rate higher than 4:1 allowed.

We believe it is safer to err on the side of caution, as the risks of too little capacity destruction are known to be minimal, while the risks of allowing great capacity destruction, leading to a very tight NTS have not yet been quantified. It has been reported in the Substitution consultation that the cost of transmission of



gas through the NTS represents only 2% of a consumer's bill. The small saving which can come from providing capacity through substitution rather than incremental funding has to be balanced against the risk of forcing indigenous gas resources such as West of Shetland to become stranded if entry capacity is no longer available due to capacity destruction through the use of too high an exchange rate

Paragraph 59

g. Do respondents consider that an economic test is appropriate or necessary for the substitution methodology?

h. Would an economic test add unnecessary complexity to the process?

i. What benefits, if any, would an economic test provide?

If an economic test was introduced

j. What parameters should be used for the donor and recipient ASEP values?

k. Are there any alternative tests that should be considered?

We believe that the economic test would add complexity to the process. There has been no consensus on this in industry workshops and given that there is no clear proposal on how this would work we are unable to comment at this stage. We believe however that where a "contentious" substitution is proposed it would be beneficial to have Ofgem and DECC involved in the substitution decision.

Paragraph 80

l. Do respondents prefer the Mechanical Approach over the Option Approach and/or Two- Stage Auction? Why / why not?

We prefer the Mechanical Approach over the other approaches. It is a relatively simple and less time consuming method compared to the other options. By using the annual TBE information as its base it uses an established data source. However care must be taken to validate the data to ensure that it is as comprehensive as it can be and in that respect we would welcome the involvement of DECC in performing a "sense check" of the gas flows.

m. What features of the Mechanical Approach do respondents like / dislike; e.g. simplicity, lack of User commitment?

The Mechanical Approach is a relatively simple system to implement requires no system changes and provides risk mitigation for long term, short term and marginal players. It provides some protection of capacity at the entry point where it is most likely to be needed, reducing inefficient substitution possibilities. It may lead to some missed opportunities, but we believe the risk of missing a substitution opportunity is minimal compared to the vastly unexplored potential risks of extensive substitution and tightening of the NTS. According to information published by NG, DECC and Ofgem gas will play a key role in the future UK energy mix, with increased gas demand for power generation, and a flexible and strong NTS will be crucial to delivering this.

It may be argued that this option, through its simplicity, requires no Shipper involvement or commitment.



We believe that Long Term booking provides certain benefits to National grid that are not provided by short term bookings. With this in mind we agree with Ofgem and NG that long term capacity booking should be encouraged. The most direct way of doing so is through pricing, as shippers are price sensitive. By using pricing rather than “artificial” constraints Shippers will not be forced to buy capacity ahead of project certainty, which would avoid giving false capacity signals to NG. At the same time shippers will have no incentive to wait for the short-term auction in order to pay less than Long Term Auction bidders for their capacity. Ofgem has tried through various indirect ways to push shippers to bid long term: reduction of baselines, trades and transfers, reduction of capacity withheld from the Long Term Auction from 20% to 10%. But, after creating a short lived fear of constraint and promoting price spikes in a few auctions and high volatility in the TO commodity charge many shippers appear to have reverted to the old ways of waiting for the short term auctions in order to avoid paying the price for the capacity they use.

Because National Grid has a fixed allowed revenue the money will be collected in any event, but instead of all shippers paying for the capacity that they use in the system, some shippers will pay for entry capacity, and then all of them will pay commodity charges to complete NG’s allowed revenue. This system is unfair, discriminatory, leads to cross-subsidies and does not promote competition amongst shippers.

If Ofgem wants to see shipper commitment, it is only reasonable that they should favour a system which rewards this behaviour. In line with this we believe long term capacity should be offered at a discount, whilst short term capacity should be offered at a premium. This is even more so now that the UNC Credit arrangements have been modified to request some form of security from shippers 16 years ahead of the capacity being utilized.

We also believe that a change in National Grid’s licence to end the obligation of a clearing auction is called for. In this way as soon as shippers have certainty of their flows, they will be inclined to book the capacity needed and will not have the expectation of obtaining capacity for free on the day.

n. What criteria should National Grid use to determine the level of protected capacity at each category of ASEP (e.g. beach terminal, storage etc)?

At Beach: peak flows

At others: % of deliverability

o. Is the use of deliverability, or similar, such that substitution is limited to major beach terminals acceptable? Would this be undue discrimination?

We are concerned that the use of full deliverability might be discriminatory and perhaps using a proportion of deliverability might be fairer.

p. Are there alternative sources of data to the TBE, deliverability that would be reliable, transparent and readily available?

We believe that it would be beneficial to involve DECC as a source of information. DECC plays a key role in promoting UKCS development and ensuring Security of Supply. As Substitution would have an impact on these issues it is crucial they are involved.



q. How could a soft-landing be applied to the Mechanical Approach?

The mechanical approach is in itself a soft landing as it limits the possible instances where substitution can take place by protecting capacity up to the level of expected flows at each entry point. When this is combined with a low exchange rate we believe this would be an appropriate means of implementing a soft landing. We believe that this is the most sensible way to implement such a substantial modification in the way capacity is used in the NTS.

Paragraph 94

r. Do respondents prefer the Option Approach over the Mechanical Approach and/or Two- Stage Auction? Why / why not?

We believe the Option model would be a valid choice if shippers could effectively actually reserve this amount of capacity for their own use. In this way, once the option is taken the shipper is sure that that amount of capacity will be there for their own gas.

Having to pay for an option and still be unsure of obtaining capacity is not an attractive proposal. Even if NG suggests it may pay back the option fee, this would only take place if the capacity is sold (to that shipper or any other) during the one year that the capacity is protected through the auction. After that period the money would, we assume, go to fund the TO revenue pot. On balance we therefore prefer the mechanical approach.

s. What features of the Option Approach do respondents like / dislike?

We like the idea of having some form of user commitment however there is still much uncertainty over several aspects of this methodology.

t. Bearing in mind the substitution objectives do respondents believe that it is appropriate that capacity can be protected from substitution with only a relatively small commitment from the User?

We believe that it is correct that the price is lower than the price that would be paid in the Long Term Auction. The protection of that capacity from substitution is temporary, and the option presents a level of risk for the shipper so the price should reflect this.

u. Should the Option Approach be made available to non-Users? If so how should it be applied?

If the option is non transferable we believe that it should be open for non users. But we believe that access to options should be restricted to shipper licence holders.

v. Is the option fee set correctly?

i. Is it correct to have the same fee for all ASEPs?

Yes, if the option provides no certainty of the capacity for the shipper who takes it, it should be equal for all entry points and not linked to the price of entry capacity at individual ASEP's but as outlined in r above it is meaningless for the buyer/seller so an irrelevant question.

ii. Are the minimum reserve price and 8 year period appropriate parameters for setting the option fee; i.e. is a fee set at approximately £300,000 for 10 mcmd correct?



We agree with a minimum reserve price but see no rationale for the 8 year period. The 32 month period makes sense for the NPV test and release of incremental capacity, but there is no reason to apply it here and would support a shorter period.

iii. Are refunds in the circumstances described appropriate?

Yes.

w. Should the option fees and refunds be dealt with through TO charges? If not, how should they be accounted for?

We do not see another option than dealing with the fee through the TO commodity charge.

Paragraph 106

x. Do respondents prefer the Two-Stage Auction over the Mechanical and Option Approaches? Why / why not?

We believe that the Two Stage Auction could work however it appears to be time consuming and does not guarantee that Shippers will have the right signals to react if incremental capacity is required. It also assumes that shippers are ready to make the long term commitment for entry capacity which is not always the case, e.g. if projects have not yet been sanctioned. On balance as mentioned above we prefer the Mechanical Approach.

y. What features of the Two-Stage Auction do respondents like / dislike?

See comments above

z. Bearing in mind the substitution objectives, do respondents believe that it is appropriate that capacity can only be protected from substitution if the Shipper makes a commitment to buy the capacity?

Substitution is intended to make the system more efficient, for the benefit of consumers so that unnecessary investment is not made, by working under the premise that “unsold means spare” NG and Ofgem may approve substitutions which may be very detrimental and inefficient, and may be forced to do so even whilst having knowledge of the risks created. For example if there is public knowledge of a future project which is highly likely to take place but which has not yet been sanctioned and hence is unable to buy entry capacity.

The security of UK gas flows relies on the balance between long term and short term flows. Whilst we promote long term commitment and are active participants in the LTA we understand that flexibility in the system is key for the security of gas supplies to the UK market. If all shippers were forced to buy all their capacity needs LT, this would create unrealistic investment signals, which after some substitution takes place may lead to inefficient investment and increased costs passed on to consumers. We have to accept that for the UK to cope with base case gas demand scenarios, and peak gas demand scenarios a certain flexibility is required in the system, a degree of resilience is needed.

If all spare capacity in the system is taken away through substitution there is limited ability of coping with peak demand incidents. Spare capacity provides swing flexibility which shippers use to increase flows to the UK when there is



uncommitted gas and there is a strong price signal from the UK. Moreover, the Emergency Procedures from NG state that in the Amber Status National Grid has to seek additional gas supplies from shippers if available (under the wider range of the emergency GSMR specifications). In order to comply with this shippers are requested to increase nominations if gas is available (Box 24 of Emergency Procedures) How is capacity going to be available for shippers who have available gas to comply with this obligation is hard to imagine if we move into a system where the NTS is squeezed out of any spare capacity. It has been established that transportation represents less than 2% of the consumer bill. It has not been established yet, but it should be part of any Impact Assessment done by Ofgem, how the consumer bill will be impacted if there is no spare capacity available for shippers to respond at short notice with increase gas supplies in order to satisfy a constrained gas scenario. It is the ability to respond quickly that will ensure such scenario does not evolve into National Grid declaring a Gas Deficit Emergency (Stage 2) and the subsequent suspension of the UNC commercial arrangements

aa. Do respondents consider the timeline to be an issue, e.g. would five (or less) stage 1 auction bid windows create a problem?

We do not see a problem with reducing the auction window period to 5 days. But we do, as explained above see a problem with this methodology as a whole.

bb. Bearing in mind the level of commitment required, do respondents think that this proposal would encourage Shippers to obtain capacity for a discontinuous quarter (see section 7.1)? If so, is this a problem?

Considering the amount of change involved in implementing Substitution we believe it is prudent to address this issue only if and when it materializes.

Hence we believe that nothing should be done at present. If there is evidence of consistent single quarter booking and if it proves to be detrimental to the system with no strategic reason from the shipper, Ofgem may be able to look into the issue.

Paragraph 117

cc. Do respondents believe that single quarter bookings present a problem that requires specific rules to prevent them?

We believe it is more appropriate to see how substitution works in practice, and if the problem arises deal with the relevant Shipper involved. Trying to prevent this behaviour could lead to complex regulation and system changes which might not be needed.

dd. Would single quarter bookings only be a problem with a specific substitution methodology, if so which?

We believe the risk exists with the option and the two stage auction methodologies.

ee. What is the preferred action, if any, to prevent single quarter bookings?

See above.



Paragraph 124

ff. Do respondents believe that the substitution methodology should only allow substitution to proceed where an incremental signal can be met fully from substitution?

Yes. Substitution is already quite complex. Trying to provide incremental capacity which combines part funded/ part substituted capacity will take this to an even higher degree of complexity. If there is not enough capacity in the system to allow for the needed increment, it is a clear signal that investment in the system is needed, and allowing partial substitution may lead to a high degree of capacity destruction on a system that is showing signals of being already tight.

gg. Should partial substitution be allowed for specific options outlined in Section 6?

No

hh. Should partial substitution be considered as an element of a soft-landing to be introduced at a later date?

No

Paragraph 129

ii. Do respondents believe that the use of entry zones in the substitution methodology is appropriate? Or

We believe that because substitution was introduced to make the most efficient use of the existing entry capacity in the NTS, the only criteria for deciding upon a donor entry point has to be that which leads to the least capacity destruction. Any other criteria (zone etc) will be arbitrary and may be seen as undue discrimination.

jj. Should the methodology be applied purely on nearest donor ASEP?

Again, we believe that the key is to choose that donor which provides the best exchange rate and the least capacity destruction. The problem we foresee though is that given the complexity and lack of transparency of National Grid's model it would be difficult to audit NG's exchange rates. We believe that crosschecking NG's models and assumptions is a key element of Ofgem's role and would like to see further work on this.

kk. Do respondents favour pro-rating within zone?

We believe that because substitution is implemented to make the most efficient use of the existing system capacity, it would be contrary to this principle to apply any other criteria than that which leads to the least capacity in the system being destroyed. At each possible substitution NG should analyse which option leads to the least capacity destruction in the system. If several possible donor entry points provide the same exchange rate then the capacity removed should be prorated amongst them, if not it would be undue discrimination. But if one entry point can provide capacity at a better exchange rate than others, be it within or out with zone, the least destructive one should be used. Applying any other policy would be undue discrimination and would certainly not be in favour of the most efficient use of the NTS or the protection of consumers, who may eventually have to pay for capacity that is unnecessarily destroyed. Forcing the sharing of the impact of



substitution amongst all entry points in an area, regardless of the distance to the recipient entry point and the capacity destroyed to complete the substitution will be discriminatory towards those entry points which are isolated or far from other possible donors.

Paragraph 139

ll. Whether respondents favour a soft-landing?

Yes. We believe that when change as substantial as this is introduced, which may require behaviour/planning changes from shippers, system changes from NG etc. it is sensible to introduce the change in the most restricted application possible, so that any unintended consequences can become apparent during the first years, while there is limited application of the new tool. It is true this does limit the possibilities for substitution, but in doing so limits the number of mistakes that can be made, or inefficient substitutions undertaken, thus limiting the possible adverse financial impact on consumers. We have seen that currently transportation charges only represent a minimal part of the consumer's bill, but if due to inefficient substitutions capacity is destroyed and subsequently requested at one entry point, and if this happens more than once, this will lead to consumers paying the price for National Grid's "testing" of the new Licence Obligation.

It is only sensible that, as consumers may be more at risk from the excessive use of substitution than from it being limited, it should be introduced in a very moderate and controlled manner. We believe it is sensible that a very restricted application is implemented during this price control period and possibly the next. By 2015 we will have had 5 QSEC auctions under Substitution, which should be enough to be able to provide National Grid and shippers with sufficient information to assess what needs to be reviewed for the subsequent TPCR (2017).

mm. If so, what parameter(s) should be used?

Low exchange rates and high level of protected capacity is the best way to ensure that any unintended effect of substitution is of limited impact to the integrity of the NTS and Security of Supply to consumers.

nn. Over what period should a soft-landing apply?

Over this TPC and the next. As the review would start by 2015, it would allow 5 years of application of substitution.

oo. Are there any other ways that a soft-landing could be introduced?

pp. Should a transitional rule be included to ensure that substitution is introduced first to a regular QSEC auction?

We assume this is in regards to QSEC for new entry points. It would make sense that substitution is first applied to the general QSEC auction when most shippers are active and aware.

Paragraph 143

qq. Notwithstanding the current position, National Grid would welcome views on whether proposals should be put forward to amend the Licence to facilitate a pricing structure which incentivises long term entry capacity bookings.



As we have stated in our response to paragraph 80 m above we believe (and moreover this is being demonstrated in practice) that the current pricing structure for entry capacity does not incentivise long term entry capacity bookings.

Since the early 2000s Ofgem and National Grid have sought a system to deliver long term price signals from shippers to support network investment. Today at entry points where there is an excess physical capacity, it is possible to buy entry capacity short term at a discounted price, or zero. It seems perverse in a system which is looking for long term investment signals that short term capacity is sold at a discount to long term capacity. In addition all shippers pay the same commodity charge. The current pricing mechanism ensures that National Grid receives its regulated income with any shortfall from entry charges collected from the commodity charge. We have seen the share of revenue collected from the commodity charge increase in recent years and have just seen a proposed 120% increase in the commodity charge effective from 1 October 2009.

Shippers booking long term capacity are effectively subsidising short term players by paying firstly an entry charge and secondly the same commodity charge a short term shippers paying no entry charge. This system is unfair, discriminatory, leads to cross-subsidies and does not promote competition amongst shippers. We very much look forward to working with Ofgem and National Grid to have an amendment put forward to change the current pricing structure to ensure that it incentivises and does not unfairly penalise shippers who make long term capacity bookings.

Paragraph 163

rr. Do respondents have any concerns or comments regarding aspects of the Base Methodology not discussed above?

As explained above we believe the Base Methodology is an extreme application of the licence obligation which does not help achieving the greater policy objectives. We would like to take the opportunity of NG consulting on the Substitution Methodology to put forward the issues we believed need to be addressed by Ofgem's Impact Assessment.

Substitution's impact can not just be valued by the amount of funding that has been avoided in providing the capacity needed at the recipient entry point by substitution rather than investment. The costs are much greater than this avoided investment, and involve security of supply, ability to cope with gas constraint events, stability of the NTS framework and regulatory certainty which are crucial to make the UK an attractive investment region. We would like Ofgem to look into these issues to understand how the benefit of avoiding some investment in the NTS balances against the issues mentioned above. We would also like to understand Ofgem's views on the possible effects of a tighter gas transmission network on security of supply and how this policy fits in with the current review of the Security of Gas Supply Directive.



The Impact Assessment should try to quantify the cost for consumers if capacity is not available to bring gas into the UK on a peak day if the system is too tight to allow this.

The impact on commodity prices and operating costs should be assessed, as well as the effect on UKCS maximization and investment in offshore infrastructure which may lose value if the entry point that it connects to loses entry capacity through substitution before shippers at that entry point have enough certainty to buy it. Once these costs are clear a comparison against the costs of avoided investment by the use of substitution will allow shippers to see if it is the correct policy to implement.

Finally the Substitution Licence Obligation was introduced in the 2007 TPCR, Since then a considerable amount of time and effort has been spent by both NG and industry participants in countless meetings held to discuss what the right interpretation of the licence should be, in order that NG can introduce Substitution and fulfil its wider licence obligation of maintaining an economic and efficient transmission system. In our opinion not only was the licence obligation poorly drafted but Ofgem failed to provide clear guidance as to how the relevant condition should be interpreted. Regulatory change which creates uncertainty and demands years of industry debate is costly to the UK as a whole and should be avoided. Greater care should be taken in future Transmission Price

Control reviews to ensure that any new licence obligations are clearly drafted and have been fully discussed by NG and Ofgem prior to issue for industry consultation

Yours sincerely
Iain McCombie
Comercial Operations Manager

