

## **CONSULTATION CONCLUSIONS REPORT**

**Review of the Incremental Entry Capacity Release  
Methodology Statement and Consultation on the  
Entry Capacity Substitution Methodology  
Statement: Further Consultation on Possible  
Reduced User Commitment.**

**9<sup>th</sup> August 2007**

**Final**

## Table of Contents

<b>1</b>	<b>EXECUTIVE SUMMARY .....</b>	<b>1</b>
<b>2</b>	<b>INTRODUCTION .....</b>	<b>1</b>
<b>3</b>	<b>PROPOSALS FOR CAPACITY SUBSTITUTION .....</b>	<b>2</b>
	Original Proposals for Capacity Substitution .....	2
	Alternative Proposals for Capacity Substitution.....	3
<b>4</b>	<b>RESPONSES.....</b>	<b>3</b>
	Respondents' Views.....	4
	National Grid NTS's Response.....	6
<b>5</b>	<b>CHANGES TO THE ORIGINAL PROPOSAL IN LIGHT OF REPRESENTATIONS MADE .....</b>	<b>7</b>
	<b>TABLE 1: POTENTIAL OPTIONS FOR ALTERNATIVE INCREMENTAL ENTRY CAPACITY RELEASE MECHANISM WHERE ENTRY CAPACITY SUBSTITUTION IS AVAILABLE. ....</b>	<b>8</b>

## 1 Executive Summary

- 1.1 This document sets out National Grid NTS's conclusions on its consultation on the possibility of setting, through the Incremental Entry Capacity Release ("IECR") Methodology, a reduced User commitment in circumstances where incremental entry capacity requests can be met by substitution of capacity from other Entry Points rather than by investment in new infrastructure.
- 1.2 There is unanimous support for a delay in the implementation of entry capacity substitution until after thorough industry consideration has been undertaken, with several respondents linking development of substitution to an enduring transfer and trade process. The consensus is that there is insufficient time to adequately develop substitution processes for September 2007 QSEC auctions.
- 1.3 National Grid NTS welcomes Ofgem's decision to postpone the requirement on National Grid NTS to implement entry capacity substitution for the September 2007 QSEC auction and supports its proposal for a broader entry capacity regime development project.
- 1.4 Considering this postponement National Grid NTS proposes to make only a slight further modification to the approved IECR Methodology Statement. This will be to delete paragraph 15 and the first three lines of paragraph 37 which state that National Grid NTS will consider whether capacity substitution can satisfy requests for the release of incremental entry capacity.
- 1.5 Following the proposed entry capacity regime development project National Grid NTS will consider any relevant changes as part of the review of the IECR in 2008.

## 2 Introduction

- 2.1 Special Condition C15 of National Grid's Gas Transporter Licence in respect of the NTS, "the Licence", sets out obligations to prepare and annually review the Incremental Entry Capacity Release ("IECR") Methodology Statement. As part of the review, National Grid NTS is obliged to consult with shippers on proposed changes. On the 8<sup>th</sup> May 2007 National Grid NTS provided notification of its proposed changes to the IECR Methodology Statement and invited views on those revisions. A subsequent letter, dated 23<sup>rd</sup> May 2007, invited views on two specific issues relating to the proposed IECR.
- 2.2 In its letter of 16<sup>th</sup> July 2007<sup>1</sup> Ofgem approved the proposed IECR which was submitted to the Authority for approval following consideration of industry comments.

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<sup>1</sup> Incremental Entry Capacity Release "IECR" Methodology Statement, Ofgem ref 182/07 dated 16/07/07

- 2.3 Special Condition C8D of the Authority's proposals for National Grid's Gas Transporter Licence in respect of the NTS<sup>2</sup> sets out obligations to prepare and submit for approval by the Authority a capacity substitution methodology statement setting out the methodology that National Grid NTS will use to carry out capacity substitution. In addition, National Grid NTS is obliged to consult with relevant shippers and DN operators prior to submitting the initial statement or revising the methodology. On the 18th May 2007 National Grid NTS provided notification of its proposed Entry Capacity Substitution Methodology Statement ("ECS") and invited views on the proposal.
- 2.4 Prior to approval of the IECR in discussions with Ofgem and between Ofgem and industry players it was suggested that Entry Capacity Substitution could be used to facilitate the release of incremental entry capacity without the need to pass the economic test detailed in the IECR. This was the subject of an Ofgem open letter<sup>3</sup> dated the 27<sup>th</sup> June 2007 and was also raised by a respondent to the ECS consultation.
- 2.5 In order to gauge industry opinion National Grid NTS presented, at the Transmission Charging Methodology Forum ("TCMF") of 5th July 2007, a review of the IECR (as submitted to the Authority) and potential options for a "relaxed" IECR test where Entry Capacity Substitution is possible.
- 2.6 Subsequent to the TCMF, on 12<sup>th</sup> July, National Grid NTS issued a letter seeking views on the potential options.
- 2.7 This report outlines the original proposals made in the IECR, the alternative options presented at TCMF and summarises the representations received from interested parties. It concludes with recommendations in respect of changes to the approved IECR and any other actions considered necessary following consideration of representations received.

### **3 Proposals for Capacity Substitution**

#### **Original Proposals for Capacity Substitution**

- 3.1 In the IECR consultation letter of 8th May, National Grid NTS described the likely impact that Entry Capacity Substitution would have on the release of incremental entry capacity. Specifically it stated

"The Authority's proposals for the Licence include a new obligation in respect of the substitution of NTS Entry Capacity. This condition will require National Grid NTS to use reasonable endeavours to undertake capacity substitution where proposing to release capacity incremental to the prevailing level of obligated entry capacity. This is intended to promote the economic and efficient sizing of the NTS by seeking to minimise the amount of investment that is required to satisfy incremental demand. Unsold capacity could be identified as suitable for substitution from "donor" locations where it appears not to be required due to the absence of signals in the long term (QSEC) auctions".

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<sup>2</sup> Notice under Section 23(3) of the Gas Act 1986 Ofgem ref 195/07 and NGG NTS Proposed Licence Mods Ofgem ref 195/07a.

<sup>3</sup> Ofgem: Open letter substitutions, 27<sup>th</sup> June 2007, ref 157/07

### 3.2 The letter continued:

“The release of incremental capacity will not be affected by this new condition; release will still be subject to the tests defined in the methodology statement. However it will impact on whether National Grid NTS invests to meet the incremental demand and may impact on the availability of capacity at the donor locations in future auctions.”

### 3.3 The effect of National Grid NTS’s proposal in the IECR is that all requests for incremental entry capacity will be treated equally and all will need to satisfy the economic test described within the IECR. Only after an incremental capacity request has been accepted will capacity substitution be considered; and then only as an alternative means to satisfying the request. The proposed process should have no direct impact on the party requesting incremental capacity.

### **Alternative Proposals for Capacity Substitution**

3.4 At TCMF on 5<sup>th</sup> July National Grid NTS outlined three potential alternatives for release of incremental capacity where capacity substitution is possible. These were included in the letter of 12<sup>th</sup> July and are repeated in table 1 below. Each of the alternatives was presented as high level initial thoughts and none had been subject to rigorous assessment of the consequences of their implementation.

3.5 Option 2 would extend the proposed transfer processes beyond winter 2007/08 to include the 42 month investment lead time. The key advantage of this would be to limit “substitutions” to defined periods thus avoiding long term loss of capacity from the donor ASEP.

3.6 Option 3 acknowledges that where incremental capacity is met through substitution, i.e. there is no investment; there should be no need for an economic test. Thus the 50% NPV test could be reduced or removed. However, this does raise issues in relation to User bidding strategies if the potential for substitutions is not known in advance. A further complication arises where requests are met by a mixture of investment and substitution.

3.7 Option 4 tries to address some of the issues of option 3. The existing (option 1) NPV test is required to be satisfied before incremental entry capacity is released, but where capacity substitution is available the User Commitment can be reduced. This will be in line with conditions placed on the auction bids by the relevant User, e.g. bids placed for the longer term may be withdrawn.

## **4 Responses**

### **Summary of Responses**

4.1 National Grid NTS received nine responses to the consultation. These are summarised in the table below and considered in greater detail in the following paragraphs.

4.2 Some respondents referred to their earlier comments provided in response to the ECS consultation which can be found on the National Grid website.

<b>Respondent</b>	<b>Short Code</b>	<b>View</b>	<b>Preferred option</b>
British Gas Trading	BGT	Support principle of substitution. Delay implementation.	None specified.

Statoil (U.K.) Limited	STUK	Concerned with all options (including option 1). Delay implementation.	None.
BG Gas Services	BGGS	Delay implementation.	Option 1.
EDF Energy	EDF	Delay implementation.	Option 1.
RWE npower	RWE	Delay implementation.	Option 1.
Total E&P UK Ltd	Total	Support for mechanism to limit capacity sterilisation. Delay implementation.	Option 1.
Conoco Phillips	CoP	Much fuller discussion required before proposals are formulated.	None specified.
E.ON UK plc	Eon	Delay implementation.	Option 1.
ExxonMobil Gas Marketing Europe Ltd	Exx	Complete industry-wide review needed	Option 1

### **Respondents' Views**

4.3 There is clear support (from all respondents) for a delay in the implementation of any Entry Capacity Substitution processes at least until significant consideration has been given to the potential consequences. Respondents feel that there has been insufficient consideration of the options and potential consequences of capacity substitution.

- BGT recommends a delay “until a fully defined change in methodology can be adopted”.
- STUK wants time for “the industry to better prepare for their [the changes] implementation and ensure the new regime is fully formed and workable.”
- BGGS wants “a thorough review of the entry capacity regime” before substitution takes place. BGGS “does not believe that the potential impacts have been adequately discussed by the industry..... or fully considered by the Regulator”.
- EdF want a delay to “allow the industry to develop robust procedures that will allow the QSEC auctions to operate as intended”.
- RWE consider that “option 1 would allow further time to consider these issues properly”.
- Total believe that substitution is “significant enough to merit a thorough consideration of the risks involved and we believe this has not been allowed”
- CoP believes that “capacity substitution requires much fuller discussion”.
- Eon “do not believe it is appropriate to introduce further changes to the QSEC auction at this late stage” and
- Exx think “there is a higher possibility of knock-on consequences that are not yet revealed” and it is “imperative that a complete industry-wide review ..... is carried out”

- 4.4 A number of respondents feel that the enduring process for transfers and trades must be known before capacity substitution is implemented.
- BGT “does not support the implementation of substitution until the enduring process for trades and transfers is clear”.
  - STUK “believe the implementation ..... would be premature .... With an enduring regime for transfers and trades likely to be implemented for October 2008”.
  - BGGs notes “that the current proposals for Transfer and Trade of capacity are for the period October 2007 to March 2008 only, prior to discussion of a more enduring regime”.
  - Total believe that “ Substitution Arrangements should be considered in parallel to the Transfer and Trade arrangements..... As the enduring Trade and Transfer arrangements will not be discussed until April 2008, it seems hasty to implement....”
- 4.5 The potential adverse impact of substitution on Security of Supply is an issue for some respondents. Two respondents (EdF and Total) consider that National Grid NTS should not rely totally upon market based signals to trigger incremental capacity release and that other information should be considered as part of the process.
- BGT highlights the problem “of an ASEP with declining supply but with the potential for new developments..... Substitution could reduce the baseline at the ASEP and the requirement for additional capacity then has to be signalled and paid for at a higher price than otherwise would have been required”. However,
  - RWE “doubt the extent to which this [option 1] will create a significant barrier to entry for new projects”. RWE acknowledges that “reviewing these arrangements next year will provide an opportunity to assess this more fully”.
  - STUK identifies that “the current IECR and substitution methodology does not take into account the changing profile of the UKCS and NCS fields”.
  - EdF considered that a benefit of the previous regime was that “NGG had the discretion as to whether to release incremental capacity even if the auction signals were not present”. They are concerned with Ofgem’s comments on the IECR. In particular EDF state that “in Ofgem’s IECR decision letter they suggest that any incremental capacity that is released on a discretionary basis could be viewed as discriminatory, not in line with their licence conditions, and likely to be viewed as inefficient and therefore unlikely to be funded”. EdF continues “By constraining NGG in this manner the UK’s security of supply could be threatened”.
  - Total considers that substitution “can have such a significant impact on shippers and security of supply”. Moreover they consider that “when analysing Substitutions National Grid should ..... include information made available to them through the Transporting Britain’s Energy Process”.
- 4.6 In regard to potential alternative tests for release of incremental entry capacity (i.e. option 3) respondents were in favour, at least until after further consideration, of retaining the existing NPV test regardless of whether requests are satisfied by investment or substitutions.

- STUK argues that deviation from “the existing NPV test” “could be considered to create discrimination between users”.
  - EdF believe that “maintaining the current NPV test remains the appropriate test .... for this September’s QSEC auction”.
  - Similarly, RWE “do not believe it is appropriate to alter the current criteria for triggering release of incremental entry capacity at this time” and
  - Total says “that it [substitution] should be undertaken only if the signals are there to justify such an action, we believe that the action could be justified only if the economic test detailed in the IECR is passed”.
  - CoP say that “application of the economic test is fundamental to any proposals”.
  - Eon “favours option 1..... Unless NG is explicitly able to tell us what the lower than 50% hurdle would be, before the auction, then we could not support this”.
- 4.7 Specific comments<sup>4</sup> have been made by respondents to some or all of the four options outlined. Generally these identify additional issues and support the respondents’ cases for a delay to implementation of any substitution processes or, where substitutions are to be introduced, the option with potential for least adverse impact (option 1).
- 4.8 Additional comments were received from respondents, but these relate more to the impact of capacity substitutions as a principle rather than the timing of its implementation or the User commitment. These include:
- BGT is concerned with the impact on User bidding strategies if they have to bid to secure “peak” rather than “average” capacity levels.
  - STUK is concerned with the potential for substitutions for short periods to “lock out” Users at certain ASEPs resulting in uneconomic investment for incremental capacity at the locked-out ASEP.
  - BGGs is concerned that there is lack of clarity on the criteria Ofgem will use when deciding whether to approve a substitution.

### **National Grid NTS’s Response**

- 4.9 National Grid NTS welcomes respondents’ comments on this consultation and continues to believe that its original proposal (option 1) not only satisfies its licence obligations but best meets the concerns and requirements of Users. National Grid NTS continues to believe that option 1 is the best approach.
- 4.10 However, National Grid NTS agrees that the implementation of such a fundamental change in the entry capacity regime as is presented by capacity substitutions requires thorough industry review. National Grid NTS has consistently stated that because capacity substitutions are permanent their impact will be much more significant than that of transfers and trades and hence should not be introduced without due consideration.

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<sup>4</sup> See individual responses

- 4.11 National Grid NTS welcomes, therefore, Ofgem's decision to postpone the requirement on National Grid NTS to implement entry capacity substitution for the September 2007 QSEC auction<sup>5</sup> as part of a broader entry capacity regime development project.
- 4.12 National Grid NTS acknowledges the support for the existing NPV test and continues with the opinion, until assessed further, that the same test should apply for the release of incremental capacity regardless of how that capacity is provided.
- 4.13 The economic test to be applied, and other issues raised (4.5, 4.7 and 4.8) will be issues for development as part of the project referred to in 4.11.

## **5 Changes to the Original Proposal in Light of Representations Made**

- 5.1 Having considered the respondents' views, and taking into account the points put forward, National Grid NTS remains of the view that the original proposal, included and approved in the IECR, satisfies the licence obligations and best meets the needs of Users.
- 5.2 However, considering Ofgem's decision to postpone the requirement on National Grid NTS to implement entry capacity substitution for the September 2007 QSEC auction National Grid NTS will:
- a) propose to modify the approved IECR Methodology Statement to delete paragraph 15 and the first three lines of paragraph 37 which state that National Grid NTS will consider whether entry capacity substitution can satisfy requests for the release of incremental entry capacity. However, the IECR Methodology Statement was drafted such that relevant sections would only apply if the Licence became effective as envisaged at the time of proposing the IECR Methodology Statement. National Grid NTS will issue a clarification note prior to making necessary amendments to the statement;
  - b) reconsider its proposals for Entry Capacity Substitution in the light of the proposed entry capacity regime development project and include any relevant changes as part of the review of the IECR in 2008.

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<sup>5</sup> Further consultation on NTS Entry Capacity Baselines, Ofgem letter ref 192/07 dated 27/07/07.

**Table 1: Potential options for alternative incremental entry capacity release mechanism where Entry Capacity Substitution is available.**

Options	Description	Advantages	Disadvantages
<p><b>1. Current proposal in the IECR. (with review next year)</b></p>	<p>Substitution only applies where the current IECR test is passed. Experience is gained of the process and in reviewing its impact revised proposals may be brought forward for next year.</p>	<p>Provides a degree of stability ahead of this year's September QSEC. Allows time to fully consider and consult on the implications of changing the IECR test. Trade and transfer provides a route to manage the requirement and ensure the efficient and economic use of the system</p>	<p>The existing IECR test may create a barrier to entry for some projects. Trade and transfers may not provide the certainty that some projects require.</p>
<p><b>2. Extension of transfers (i.e. option 1 plus transfers for the shorter period)</b></p>	<p>It could be possible to extend the proposed capacity transfer process to cover the 42 month investment lead time. This would allow quarterly periods of capacity to be transferred, driven either through the QSEC or separate auction.</p>	<p>Allows capacity to be moved for a defined duration with no long term capacity destruction. Medium / long term capacity available for increased demand at the donor or for further transfers.</p>	<p>Significant development work required to determine transfer rates for each quarter. More distant transfers increase uncertainty. Short term implementation would be problematic. The transfer process is largely ex-ante unlike substitutions. Does not meet the objective of avoiding investment as it occurs within investment lead times.</p>

<p><b>3. Lower NPV test</b></p>	<p>Incremental capacity could be released where auction signals do not meet the 50% NPV test provided that the incremental capacity can be satisfied through substitutions.</p>	<p>Satisfies greater User demand for release of capacity where needed. Can be a simple test to apply where no investment is required. Transparent. Provides clarity of requirements before bidding in auctions for new ASEPs</p>	<p>Usually the ASEPs where substitution opportunities exist are not known in advance so bidding against a lower test would not guarantee release of capacity. A different test would need to apply where there is a mix of investment and substitutions; potentially confusing. Additional post QSEC network analysis. Need to distinguish between bids (i.e. existing test vs lower test, and bids satisfying the lower test). Lower test may be satisfied without long term bookings, so capacity may be substituted away again in the longer term. This would create greater uncertainty by maximising capacity movement and potential destruction.</p>
<p><b>4. Lower User commitment (with conditional auction bids)</b></p>	<p>Incremental capacity is only released where the current IECR test is passed, but where incremental capacity is met through substitution the relevant User commitment could be reduced according to conditions within placed bids. <math>P_0 - P_n</math> prices remain unaltered.</p>	<p>User commitment aligned to associated investment risk. Still provides certainty on capacity being released</p>	<p>Complicated with significant impact on systems. Reduces User's allocations, with the potential for the capacity to be substituted away during the period of the original bookings contained within the placed bids. Provides no benefit to "marginal" developments.</p>