



29th February 2008

Andrew Fox
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Dear Mr. Fox

BG Gas Services Limited Response to Consultation on Entry Capacity Substitution

BG Gas Services Limited ("BG") welcomes the opportunity to comment on National Grid's ("NG") discussion document. The document is helpful in that it highlights a number of issues that need to be considered in developing a substitution mechanism.

Our overall comments are as follows:

- As experience with the development of Transfer & Trades has shown, it is difficult to make informed comments on the various options for structuring a substitution mechanism, without knowing the practical impacts of such choices. Without this knowledge it is impossible to make a proper judgement on the trade-offs involved. There needs to be further industry discussion on what the policy aims are, their relative importance and desirability and the different means to achieve these aims.
- In addition to the point above, it should be recognised that proposals for substitution must be seen in the context of the other elements of the entry capacity regime (baseline levels, percentage held back to short term auctions, pricing, trade and transfer arrangements etc.) Any entry capacity regime "package" is a combination of compromises and trade-offs. Our comments should be seen in this light.
- Because it leads to permanent movement of capacity rights between ASEPs, substitution has the potential to favour those projects which are able to book at the in the long term QSEC auctions. Substitution is meant to prevent capacity sterilisation; however a lack of long term booking does not equate to sterilisation. Shippers may wish to book capacity on a shorter term basis to optimise their positions. Indeed substitution could be seen as inefficient if it leads to capacity being substituted at an exchange rate of less than 1:1 in the QSEC auctions in Year 1, but in the following year a project requires additional investment at the donor ASEP to make up for the capacity "lost" through substitution.
- It is not clear why long term booking is a policy aim of the new regime. Certainly NG needs signals and a degree of user commitment to enable it to invest efficiently in capacity. However there is a trade off between the benefits that only allowing long term booking may bring, and the benefits of allowing some flexibility to enable medium and short term booking. We do not believe that this issue has been sufficiently discussed. It can be argued that pricing of capacity has an equally important role to play in influencing booking behaviour. Since NG is assured of its allowed revenue, whether it comes from capacity

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sales or commodity charges, it is not clear why NG requires capacity bookings to be made on a long term basis only.

- In the 2002-7 Price Control Ofgem argued that 20% of capacity should be held back for the short term auctions to enable new entrants to book capacity. A combination of substitution and a lower hold back of capacity will make it harder for new entrants to have access to capacity. In particular BG believes that the new framework could have a detrimental effect on incremental or marginal UKCS fields wishing to transport gas to the UK market. Companies are less likely to develop such fields if they do not have confidence that they will be able to access entry capacity. For further details please see our letter of 31st August 2007 "BG Gas Services Limited Comments on Proposals for the Treatment of "Spare / Sterilised" Capacity" (attached).
- The new Transfer & Trade mechanism does not compensate for the problems noted above. Transfer & Trade is a short term optimisation tool which allows capacity rights to be moved to where they are needed most on a monthly basis. Whilst this may help with some gas flows, it is unlikely to be sufficient to give certainty to projects such as incremental fields or new storage projects. Under the previous regime such projects had a degree of comfort that they could book capacity on a monthly basis for up to 2 years in the AMSEC auctions. There was a risk that this capacity would be expensive, if demand for such capacity was high and the supply was limited (for example, to the 20% held back for the medium and short term auctions). However shippers had a reasonable way of judging this by looking at forecast flows for an entry point and the amount of capacity booked in the QSEC auctions. With Substitution, this is much more complex due to the uncertainty as to how much capacity may be substituted elsewhere, which in turn depends on two variables – demand for capacity at other ASEPs and the exchange rates. This means that shippers can no longer rely on being able to buy capacity in the AMSECs, so long as they are prepared to pay the necessary price, to the same extent.
- BG remains concerned that a combination of recent developments mean that NG will not be required to release as much capacity as was previously was the case. Firstly baselines have been lowered, even though NG under-spent its capital allowance from the 2002-2007 Price Control by £97m. Because the service that NG is required to provide has changed via changes to the baselines, it is not possible to know if this under-spend was due to efficiency or that the lowering of baselines simply crystallises a windfall gain for NG. Secondly NG has discretion over the setting of exchange rates because of the way it judges the risk of a material increase in costs. In the case of substitution this could lead to capacity destruction. For example, under the old regime, NG had the ability to choose whether to invest in capacity following signals from the QSECs or to optimise use of the system to meet its obligations (i.e. implicit substitution). The under-spend of £97m could be seen as an example of the latter. However, whichever route it took NG was still required to meet its obligations up to the level of capacity rights sold, or the baselines. Under the new proposal for substitution, NG is relieved of its obligation to continue to meet baseline capacity obligations at the donor ASEP, *and* it sets the rate at which capacity at the donor ASEP is reduced in order to substitute capacity to the recipient ASEP. It is therefore able to control the amount of capacity it releases.

Our detailed answers to your questions are below.

A. Capacity Available for Substitution.

What proportion of baseline capacity should be withheld from QSEC auctions (and substitution) for use in later auctions (the current Licence requirement is 10%)?

For the reasons outlined above, we believe a higher proportion would be appropriate, for example 20%. This would help solve some of the problems we see with substitution, such as the

disadvantage it causes players who cannot book long term. However this would need to be discussed to take account of the Substitution mechanism and the new baseline levels. For example the “easier” it is for substitution to take place, the higher proportion of capacity should be held back.

Forecast Flows

Should National Grid exclude from substitutions capacity up to the level of forecast (as specified in the TYS) flows?

Would this have an adverse impact on the quality of data provided in the Transporting Britain’s Energy process which feeds into the TYS?

Would an alternative limit be appropriate?

Whilst expectation of flow levels obviously has a bearing on the discussion, it is difficult to comment on this issue in the absence of a better understanding of the parameters of any substitution mechanism.

Single Quarter Problem

Where capacity is currently booked at an ASEP for a single quarter in the future should this prevent capacity at that ASEP, to the level booked, being available for substitution in the period prior to that booking?

If yes, what about two quarters?

Should rules be introduced to prevent short-term, distant, bookings in future QSEC auctions?

Should the substitution of capacity be time limited, i.e. substituted capacity reverts back to the original ASEP after a set period?

Should a mechanism be established to allow Users to surrender capacity, i.e. similar to that proposed for Transfer and Trades but for a distant time frame?

These questions simply illustrate the complications inherent in the design of any substitution mechanism. There needs to be further discussion as to the trade-offs between various options. It would appear to be contradictory to want a regime that encourages long term booking, and then set rules as to what sort of long term booking is acceptable.

B. Lower NPV Test

Considering the complexity of potential solutions, should different User commitment tests be applied for incremental capacity satisfied from substitution and from investment?

If yes, how should a dual-test be implemented?

If yes, what should the “substitution test” be (as a percentage of NPV or other alternative)?

The NG Discussion Document has highlighted a number of concerns with a lower NPV test. As noted above a failure to book capacity long term is not necessarily an indication of sterilisation of capacity. BG would be concerned if substitution was to occur as a result of a lower NPV test at the recipient ASEP, and in a later period a shipper would face a higher hurdle to book capacity at the donor ASEP. This could be seen as inefficient on two counts. Firstly such an approach could lead to a shipper at a recipient ASEP obtaining capacity rights in a way that uses capacity less efficiently because of an exchange rate of less than 1:1. This would not matter if the capacity that was substituted was never required again at the donor ASEP, but this cannot be guaranteed. Secondly it could require a shipper at a Donor ASEP to pay more for entry capacity (P_1 or higher instead of P_0) as a result of having to trigger incremental capacity if that shipper booked after the capacity had been substituted to the recipient ASEP.

Such an approach (a lower NPV test) could also be seen as problematic, if it means that shippers at a donor ASEP have to pass a higher hurdle to trigger incremental capacity to replace capacity which has been substituted away, simply because they booked in the following year's QSEC auctions. (This is in addition to the point above that substitution uses capacity less efficiently where exchange rates are less than 1:1). This could have an adverse impact on competition if projects did not go ahead because they could not trigger incremental capacity but would have been able to use capacity had it not been substituted.

For the above reasons we are not currently in favour of different user commitment tests / lower NPV tests for substituted capacity.

Combined Substitution / Investment

In the event that incremental capacity is able to be released as a result of a combination of substitution and investment what test should be applied to trigger capacity release?

This requires further industry discussion.

Competing Bids for Substitutable Capacity

Where capacity available for substitution is limited and a lower NPV test applies, how should such capacity be used?

Where there are two or more incremental capacity requests that only satisfy the lower (if any) substitution test what rules should apply to prioritise requests? Should this be based on the relative NPV of the relevant bids? Are there any alternative measures that could be used?

Should capacity be substituted to support incremental capacity requests satisfying the investment test only after consideration of those requests that only satisfy the lower (if any) substitution test? Or vice versa? Or should the same rules applying above apply to all requests?

As noted above we are not convinced that there should be a lower NPV test for substitution capacity.

C. Exchange Rate Cap.

To avoid excessive capacity destruction should capacity substitutions be prohibited if the exchange rate exceeds a specified value?

If yes, what should the cap on exchange rates be?

It is not possible to give a meaningful answer to this question without a better understanding as to how an exchange rate cap would work in practice. However BG is concerned about capacity destruction and therefore some form of exchange rate cap would seem sensible.

D. Availability of Capacity for Substitution

Assuming that substitution will be triggered by User bids submitted in the QSEC auctions for which capacity can be requested from 18 months ahead (e.g. April 2009 QSEC for October 2010 release) but substitution is intended to minimise investment (42 month lead time – October 2012 release) should National Grid substitute capacity to release incremental capacity ahead of 42 months?

If yes, should any limit be placed on the timing of such release, e.g. 18 months, 30 months?

If yes, should any measures be taken to protect (some/any) capacity at donor ASEPs?

Should substitution be limited to single donor ASEP or should combinations (substituted at different times) be allowed? All but the last would be time limited substitutions, e.g. Donor ASEP used from year 2 to 4 but not available after year 4, donor ASEP B used from year 5.

Again greater understanding of how these different options would work in practice is required before a meaningful response can be made.

E. Other Issues

Alternative Economic Test / User Commitment

Would Users support replacement of the current NPV test to trigger release of incremental capacity (irrespective of substitution)?

What alternative tests, e.g. four year booking commitment, would be appropriate?

Should different categories of entry point be treated differently, e.g. storage?

How should substitution and investment be distinguished (if at all) under any alternative test?

Ideally, when should an alternative test be introduced; i.e. for April 2009 QSEC or Sept 2008 QSEC or later?

It is worth considering a different form of economic test / user commitment if this means that it is possible to have the same test for triggering incremental capacity and substitution.

New Entry Points

Do respondents consider that undertaking separate QSEC auctions for new ASEPs is unduly preferential? Are there any discrimination issues?

Should the timing of the introduction of the substitution obligation align to a regular QSEC auction where all Users have access in respect of all ASEPs?

Bearing in mind that these auctions could trigger the release of significant quantities of incremental capacity at new ASEPs, should substitution be excluded from these auctions?

Separate QSECs for new ASEPs can be helpful in enabling new sources of gas to enter the UK market sooner than might otherwise be the case. It also enables NG's project planning and timing to align better with that of new projects. However the introduction of substitution means that, if separate QSECs for new ASEPs were make use of substitution, shippers at potential donor ASEPs would have no opportunity to keep capacity at the donor ASEP prior to the substitution taking place. This would be discriminatory.

Reserve Price Discounts

Notwithstanding the May 2007 discussion, do respondents support removal / relaxation of the reserve price discounts?

Such an approach could well influence shipper behaviour with regard to long term bookings, and could be an alternative to the need to use the blunt instrument of substitution to encourage long term bookings. However any changes need to be considered in the context of the overall entry capacity regime.

Other Issues

In previous discussions on substitution we have favoured Option 5 where Substitution occurs every 5 years as part of the Price Control Review process. This would seem to be a way of balancing the need to avoid unnecessary investment in the network with the need for a degree of flexibility as to the capacity booking regime (i.e. not forcing only long term bookings). BG would welcome further discussion of this option.

I hope the above is helpful. Should you have any queries please contact me at the address above.

Yours sincerely,

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