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Andrew Fox
Senior Commercial Analyst
Gas Charging and Access
Development
National Grid House
Gallows Hill
Warwick
CV34 6DA

Centrica Energy
Millstream East
Maidenhead Road
Windsor
Berkshire
SL4 5GD

Tel. (01753) 431061
Fax (01753) 431150

Our Ref.
Your Ref.

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Dear Andrew,

RE- Review of IECR and NTS Entry Capacity Substitution Methodology Statements

Thank you for the opportunity to comment on the options proposed.

British Gas Trading believes that in order to promote market-based efficiency and avoid creating undue risks it is necessary for development of both primary capacity substitution and secondary trading/transfers to take place in parallel. Whatever merit there may be in each of the four options proposed it would be wrong to create conflicting objectives by changes in the way in which users view the capacity auctions without due thought. Also the options are not mutually exclusive, as option 2 relates to quarters within investment lead times while options 3 & 4 mainly relate to the longer term. BGT does not support the implementation of substitution until the enduring process for trades and transfers is clear.

Movements in baselines must be predictable and transparent and the effect of possible substitution has to be taken into account in users' bidding strategies for QSEC auctions. The current situation has changed the signal given in these auctions from an 'average day' position to 'peak day' in order to avoid risks of capacity which is genuinely but infrequently required being inappropriately substituted away. The reasons for this are as follows:

Firstly at some entry points there is swing available from peak supplies and/or storage. Therefore in the past some capacity has been secured in QSEC auctions while the remaining capacity, which is required for far less than a whole quarter has been secured nearer to the day of delivery knowing that capacity will be available on a firm basis up to the baseline level. If the certainty of the baseline level is removed then more capacity will need to be secured in QSEC auctions in order to ensure that gas can flow at peak.

Secondly consider the example of an ASEP with declining supply but with the potential for new developments which could increase supply at some point in the future and also there

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is a competing ASEP within the same zone. There is a possibility that substitution could reduce the baseline at the first 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.

Thirdly consider the example of competing peak supplies at different ASEPs within a zone. Unless the users at all ASEPs bid for the peak capacity in QSEC auctions there is a risk that capacity substitution strands gas offshore at an ASEP with reduced baseline.

BGT supports the principle that capacity substitution can take place between terminals as an outcome of QSEC auctions, in line with long term demand. The signals from the QSEC auctions must lead to economic and efficient investment but at the same time the system must be able to cope with unexpected demands. Hence the rules for capacity substitution need to be consistent with those for capacity trades and transfers or else there will be scope for trade-off between the two. For example the same zones must be used for both purposes, the process for definition of the zones must be transparent and steps taken to avoid substitution being reversed by short-term trades and transfers.

Specific comments on the four options:

Option 1 – status quo – QSEC signals investment, permanent substitution is an economic and efficient lower cost option for National Grid. There is a need for more transparency on how substitutions would be applied while continuing to allow flexibility for users at peak.

Option 2 – shorter-term substitution. This avoids the downside of permanently reducing baseline capacity when that capacity may be required later. This option could also be used to delay investment until the overall increase in NTS capacity is required.

Option 3 - no investment means there is no need for an NPV test. This increases the risk of inefficient substitution taking place. NG NTS rightly identifies issues if substitution does not fully satisfy users' requirements but the remainder fails to pass the NPV test.

Option 4 – lower IECR with conditional bidding. The commitment must be two-way with financial certainty i.e. the user commits to pay for the 'capacity', whether it is provided through investment, substitution or being held whole in a buy-back process.

BGT believes that it may be possible for options 2 and 4 together to be developed into a workable solution but the current short-term proposal for secondary trading/ transfers during 2007/08 will need to be amended in the light of experience in order to be developed into longer-term solution. BGT strongly recommends that implementation of the enduring (primary) entry capacity substitution arrangements should take place at the same time as enduring secondary trading/transfer proposals are developed. It is not possible to do this in time for the QSEC auction in September 2007. BGT therefore proposes a fifth option, which is a delay in substitution until a fully defined change in methodology can be adopted.

Yours sincerely,

Clive Woodland
Planning & Analysis Manager