

Andrew Fox
National Grid
Transmission Commercial
NG House
Warwick Technology Park
Gallows Hill
Warwick
CV34 6DA

4 August 2008

Dear Andrew

Re: The Entry Capacity Substitution Methodology Statement

Please find Statoil (U.K.) Limited's (STUK) response to the consultation questions, below.

Q1 – National Grid (NG) has interpreted the requirement to “minimise” the costs associated with funded incremental obligated entry capacity in this objective as meaning that all available capacity should be substituted to meet the incremental signal, without placing any restrictions on the substitution process...NG would welcome views on whether its interpretation is appropriate.

STUK sympathises with NG's interpretation of the requirement to minimise costs. However, given the significant capacity destruction, which would occur as a result of this interpretation of the licence, STUK believes that the industry would benefit from the Authority's view on how they would expect to enforce this licence obligation; a set of broad guidelines, published by Ofgem would add clarity. We would also like further understanding of how this new licence condition corresponds with the licence obligation to operate the pipe-line system in an efficient and economic manner. NG state in the methodology that no restrictions in the quantities available to be substituted could be inefficient as “more economic” substitution opportunities could arise in subsequent years.’ NG goes on to state that unnecessary investment might also be made if substitution opportunities are lost. Clearly, both approaches lead to inefficiencies, regardless of whether there is or is not a cap on exchange rates. Given the long-term implication for the system (up to 16 years ahead) these inefficiencies need to be clearly understood, an Impact Assessment will go some way to achieving this.

Q2 – NPV Test - NG would welcome views on whether a less stringent test should apply for the release of capacity that would, after analysis, be satisfied through substitution.

A stable regulatory environment is essential when booking capacity several years in advance; applying a less stringent test than the NPV test would add complexity to the Entry Capacity auction process, with a negative affect on shippers' bidding strategies, the outturn of which would be inefficient investment signals. It does not however, seem appropriate that NG should receive windfall gains, without undertaking the associated investment. STUK would welcome further analysis of the options for reimbursing shippers once the decision to substitute capacity has been taken.

Q3 – Do respondents agree that it is appropriate to consider substitution opportunities consistent with the timing for the release of funded incremental obligated entry capacity?

STUK agrees that the timing of the release of capacity made available through substitution should be consistent with the release of funded incremental obligated entry capacity. A departure from the standard mechanism would add further complexity and be detrimental to competition as shippers booking capacity through the QSEC auction and obtaining it at an earlier date than other shippers booking in the same auction would create an un-level playing field; moreover, shippers, which have taken the decision not to book long-term capacity on the basis that it will be available on the day would be discriminated against if that capacity was to be made unobtainable, through substitution, outside of the usual auction window.

Q4 – NG would welcome views on whether it is appropriate for any restriction to be placed on the availability of capacity for substitution or whether the level not available should be increased (or decreased).

In answering this question, NG would like respondents to express their views on:

- a. Whether these approaches would be more efficient than maximising substitution from year 1?
- b. What are the advantages and disadvantages of these actions?
- c. Should such limits only apply for a limited duration, e.g. for years 1 [and 2], but be removed after experience of the first year of substitution? And if so how do respondents see substitution being phased in?

STUK considers it appropriate to restrict the amount of capacity, which could be made available for substitution. This is more appropriate than maximising substitution from year 1 as it maintains a level of flexibility to shippers to maximise their portfolio in the short, medium and long-term and minimised capacity destruction. If the capacity made available for substitution is not restricted, then capacity, which could otherwise be made available in the short-term, could be restricted from entering the system, with a detrimental impact on security of supply. If only 10% of baseline capacity is held back from the long-term auctions, substitution increases the likelihood of this being reached. Not only does this affect security of supply but would also put an upward pressure on prices at the NBP at times of peak demand.

Increasing the percent of baseline withheld from the QSEC auctions is the most appropriate option for maintaining flexibility in the short-term market and STUK would support a licence change to achieve this. Of the other options presented, setting a fixed percent of baseline that would not be made available for substitution, even if unsold, works towards limiting the degree of capacity destruction, which could otherwise occur if maximum capacity is substituted without a cap on exchange rates and also limit the flexibility in the short-term market. STUK would also support setting a percentage of capacity that would not be available for substitution from each ASEP as a means to achieving the same goal. Setting a fixed quantity from all ASEPs in aggregate seems a less efficient option as it would be difficult to determine how this would be reflected at each individual ASEP. Furthermore, setting a fixed quantity on a percentage basis, rather than a GWh/day basis is the more appropriate method as percentages would have a more accurate correlation to the baseline than a fixed GWh/day and will remain appropriate even if the baseline changes.

STUK would suggest a limit on capacity available for substitution remains for the enduring period as a means to maintaining flexibility in the short and medium-term, which will better allow shippers to respond to peak day constraints, with an associated downturn on prices, which will ultimately be to the benefit of the consumer.

Q5 – Should action be taken to limit single quarter bookings in the future? If so, what action is considered appropriate?

STUK accepts the principle of substitution, to the extent that it proposes to maximise the use of the existing transmission system. Allowing shippers to 'protect' capacity by booking a single quarter in a future year appears to be in conflict with this principle, however, shippers may book single quarters in a future year in such a way that reflects their genuine capacity needs and so limiting future single quarter bookings would not seem to be an appropriate way forward. STUK would welcome further discussion in this area.

Q6 – Considering that the substitution process is identical within and out-with zones, do respondents feel that the use of zones is beneficial?

STUK would suggest limiting substitution to within zones, to avoid excessive capacity destruction.

Q7 – Licence Revenue Drivers (LRDs) – Alternative criteria could be used and NG would welcome alternative proposals.

STUK agrees with the principle of NG using LRDs as the assessment criteria, if it will facilitate more efficient substitution, however, we would welcome further analysis in this area, to ensure it does not lead to inefficient outcomes.

Q8 – Do respondents favour an approach that requires NG to follow a set methodology or should NG have some discretion to select more favourable donor ASEPs?

STUK believes that more work is required in this area to assess the risks and benefits of the either approach, preferably through an Impact Assessment. Generally, following a set methodology provides the most transparent mechanism for allocating capacity, however, STUK recognises that Trade and Transfers allows NG a degree of discretion, to ensure the maximum amount of capacity is available for transfer; this may not be appropriate for substitution, given the longer-term implications of capacity transferred.

Q9 – NG would welcome views on alternative approaches and how these may better meet NG's licence obligations.

STUK believes that an exchange rate cap is appropriate to avoid excessive capacity destruction. Substitution may lead to a 'tighter' system, which could cause disruptions to supply and demand, limiting the flexibility on the system to manage constraints. A cap on the exchange rate will, at least, minimise some of this risk, although NG has identified in previous meetings that capacity destruction could still occur. For example, transferring a relative small amount of capacity to Easington could substantially limit short-term availability at Bacton and, thereby, flows to the UK, through the interconnector. Trades and transfers will not necessarily mitigate this risk as interconnector shippers may lack certainty to book capacity 1 month ahead and so will depend on it being available on the day, if this is not the case, there is the risk that the majority of interconnector capacity is exported, hindering the ability for the UK to compete with demand on the continent. A 1:1 cap on all ASEPs would best avoid capacity destruction.

Q10/11 – Do respondents agree with the transitional rule?

STUK agrees with the transitional rule, with respect to not applying substitution to new ASEP specific auctions. Otherwise, an un-level playing field would be created, whereby shippers bidding in an ASEP specific auction would be given a competitive advantage over those waiting to bid in future auctions. STUK believes this should be a permanent rule to avoid the risk of anti-competitive behaviour.

Q12 – In addition to the proposal for new ASEPs, do respondents consider it necessary to apply any other transitional rules? And over what timeframes would the transitional rules apply?

It is STUK's opinion that the two additional options for limiting capacity available for substitution to that in excess of the peak daily flow identified within the TBE forecasts or limiting it to that in excess of the peak daily flow for the previous year (or 2 years) warrant further consideration, as a transitional rule and a permanent rule. These options would mitigate some of the risk of unnecessarily constraining the system and preventing shippers from responding to peak day prices. Without this, import capacity could be constrained, with a detrimental impact on security of supply, with the consequential uplift to within day prices.

A further point to note is Ofgem's limited scope to reject the proposals, specifically where Ofgem believes that NG has not followed the methodology. STUK shares concerns that the draft methodology may lead to unintended consequences; Ofgem should have the discretion to over-rule NG's proposals to release incremental obligated entry capacity, through substitution, where the outcome would clearly have a damaging affect on, for example, the economic and efficient operation of the system or competition between shippers.

Please do not hesitate to contact me if you wish to discuss any of the above.

Yours sincerely

Christiane Sykes
UK Regulatory Affairs Advisor
Statoil (UK) Ltd