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Jan Gascoigne
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June 13, 2007

Dear Jan,

Re: The Entry Capacity Substitution Methodology Statement – Draft Consultation

E.ON UK welcomes the opportunity to respond to this document. Many of the same fundamental concerns that we raised in respect of the transfer/trade methodology apply equally to capacity substitution – i.e. the potential for very poor exchange rates. Our detailed comments are described below.

Zones

We support the use of zones for capacity substitution. The same definition of zones should apply equally to capacity substitution as to capacity transfer and trade. In regard of Appendix 1, the list of Entry Capacity Zone ASEPs appears to be incomplete – the “South-West UK Zone” does not include Wytch Farm in the Appendix, but it is included in the NG 10YS.

Buy-back Risk

In para. 20, it is stated that *“the objective shall be to avoid incremental change in risk”*. We have a fundamental concern about the lack of clarity on what this actually means in practice. Allowing capacity substitutions only where it would lead to zero incremental risk is not satisfactory as it will severely restrict the

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amount of capacity that can be transferred through this, or any other transfer process. Zero incremental risk was the basis for the transfer and trade methodology but it is not expressly mentioned in respect of capacity substitution. Indeed the consultation text seems ambiguous on this point. Is this a deliberate difference? It is not clear. In any case, we would expect the interpretation to be consistent with that used for capacity trades and transfers.

E.ON UK's understanding of the latest NG Licence drafting and indeed all previous Licence drafts is that there is no mention of "zero" risk. The correct interpretation seems to be no "material" increase in risk and this is completely and fundamentally different from zero risk. We would, however, look to NG in the near future to quantify and demonstrate what this actually means in terms of capacity substitution and indeed, transfers and trades, so that Users are able to understand the difference between "zero" and "material" and the impact on the amount of capacity that can be transferred.

Transfer/Exchange Rates

If NG NTS transfer capacity on a poor exchange rate, there is a much greater chance that there will then be a requirement in a later QSEC to trigger incremental capacity at the ASEP from where the capacity has been taken. For example, if there is a requirement for an extra 50GWh/d from ASEP A, NG could take 100GWh/d from ASEP B on a 2:1 exchange rate. If the 100GWh/d is then needed at ASEP B (either because the shippers chose not to buy it, or because there is new gas at ASEP B), then NG will now be able to sell 100GWh/d of incremental capacity, on which they earn additional revenue, rather than only 50GWh/d originally. We do not believe this would amount to efficient and economic operation of the NTS.

We did consider whether 1:1 exchange rates should apply for substitution between zones, but because:

- (i) we are dealing with a few transfers here (in the last LTSEC only Cheshire, Fleetwood, Easington and Hornsea had incremental capacity triggered);
- (ii) there is more time to calculate exchange rates and for Ofgem to challenge the analysis; and
- (iii) the extended period over which the substitution applies;

it is probably better for a more accurate exchange rate to be calculated, which may not always be 1:1.

Therefore, we suggest that the following principles should underpin the entry capacity substitution mechanism:

1. Exchange rates would be calculated using peak flows (i.e. the same methodology as was used to derive the baselines), noting that they could be better than 1:1 in some cases;
2. Capacity would only be substituted if the exchange rate is good (for instance 1.5:1 or better);
3. Within-zone substitutions could be considered first (which would be in-line with current proposals in development for capacity trade and transfers).
4. National Grid would have to demonstrate to Ofgem how the exchange rate was derived;
5. Ofgem would be required to approve the substitution (considering the consequences of losing the capacity at the donor) and the applicable exchange rate.

Please feel free to contact me on 02476 181421, if you wish to discuss any of the points raised above.

Yours sincerely

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