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26th February 2008

Summary Report and Discussion Document on Entry Capacity Substitution

Dear Andrew,

RWE npower welcomes the opportunity to comment on the above document and does so on behalf of all its licensed gas businesses and the GB interests of RWE Trading GmbH.

Whilst we have some sympathy with entry capacity substitution as a concept, to the extent that this has the potential to prevent unnecessary network investment, the issue is complex and interacts with other elements of the entry capacity regime such as baselines, pricing, transfers and trades. As clarity is starting to appear on some of these elements it is appropriate that the industry now considers carefully and thoroughly the manner in which entry capacity substitution should be applied.

The discussion document clearly demonstrates the complexity associated with entry capacity substitution. We are increasingly concerned that applying the principle may in practice result in perverse and unforeseen consequences, which negatively impact the overall efficiency of the wholesale gas market.

Substitution risks creating an apparent scarcity of capacity resulting in irrational behaviour and high prices, both of which we have seen occur before and are anxious to avoid. Also, it could change fundamentally the price of "peak" deliverability, or indeed availability. For example storage shippers typically do not buy entry capacity other than on the day of flow. This is true of other peak shippers and if these shippers become unduly concerned about the risk of substitution they might look to bid to secure this capacity in the QSEC/AMSEC auctions, which may in turn trigger investment which is inefficient. If they don't secure capacity then the risk is that it can be substituted away and so potentially on days when the system needs peak deliverability it will not be available.

We have attempted below to respond to the specific questions raised in the discussion document. However, as we have limited access to information necessary to form an opinion on some of these questions our comments are reserved at this stage. We hope that National Grid will arrange a number of workstreams in future and provide the necessary information to allow the industry to consider and develop these complex issues further.

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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%)?

As with a number of these questions it is difficult to answer this in isolation. For example, if capacity substitution is excluded based on forecast flows then withholding 10% may be appropriate. Also the reserve price that applies to withheld capacity is relevant to this question, as is the extent to which National Grid's reasonable endeavours licence obligation to release capacity up to baseline applies on constrained days.

At this stage we believe there may be a case for increasing the baseline capacity withheld above 10%. We believe this may be a more preferable way of addressing the concerns of shippers about the uncertainty of their future peak and baseload requirements than basing substitution on forecast flows. However, we would welcome greater analysis of the extent to which peak supplies may exist over and above baseline levels to better inform us about this issue.

Forecast Flows

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

National Grid have on a number of occasions over the over the last few years commented on the success of the TBE process and the improved level of information provided to them by shippers. It would be unfortunate therefore if the introduction of entry capacity substitution were to jeopardise the progress made in this area.

In our opinion forecast flows should be taken proper account of when setting entry capacity baselines for a price control period, taking into account the network capability at that time. However, if a proposed substitution spans more than one price control period it becomes more difficult to do this, although Ofgem will still be able to consider the implications of any proposed substitution prior to approving it.

Again we would appreciate greater analysis and information being made available about the extent to which this may be an issue in the medium to long term.

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

We believe there is a risk that basing substitution on forecast flows may lead shippers to over estimate, or be unduly optimistic about, their future gas flows. Bearing in mind National Grid have previously expressed concerns about this, and implicitly linked this behaviour with the apparent peak gas shortage of winters 04/05 and 05/06, this risk should not be discounted. However, the initiatives that have since been put in place to encourage timely and accurate information sharing may have reduced this risk, such that now it is far less of a concern.

Would an alternative limit be appropriate?

We have no views on the appropriateness of an alternative limit at this time.

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?

The example used suggests that capacity may be booked with the specific intention of thwarting any potential substitution and it is hard to imagine that shippers will not use this tactic if it is open to them, particularly at ASEPs with low reserve prices such as Isle of Grain and certain storage facilities. Such behaviour is contrary to the principle of what capacity substitution is trying to achieve and we believe steps should be taken to discourage it.

If yes:

what about two quarters?

Whilst the table in paragraph 31 of the document suggests that the financial costs of shippers booking capacity up to 90% of baseline for a single quarter may be prohibitive at the main beach entry points, this is unlikely to be the case at certain low reserve price ASEPs, such as Isle of Grain. Also when one considers the cost on an NPV basis the financial disincentive reduces significantly.

We do think therefore that extending the level of booking to two quarters will necessarily create a sufficient disincentive to prevent shippers thwarting capacity substitution in all cases, and so think other measures should be considered to address this concern.

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

Whilst not a great supporter of the entry capacity auction regime that has developed over the last 7-8 years we are concerned that such a measure risks undermining the QSEC auctions and creating distortions.

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

We believe that such a measure warrants further consideration. A mechanism whereby National Grid are required to reconsider whether substitution that has previously taken place remains appropriate going forward is perhaps the most equitable way of balancing the conflicting concerns of capacity destruction and network inefficiency.

National Grid could for example be restricted to using capacity substitution for an agreed set period of time, say five years. If the incremental demand at the recipient ASEP was for longer than this set period National Grid would, at some point prior to expiry of the set period and consistent with investment lead times, evaluate whether substitution from the same donor ASEP was appropriate for a further period (capped at the agreed set period for substitution) some time prior to the expiry of the set period. Such a mechanism would allow National Grid to take account of any QSEC bookings and other relevant developments (e.g. buy back opportunities) during the intervening 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?

We do not think such a mechanism is necessary bearing in mind National Grid's current ability to enter into long term entry capacity buy back contracts and shippers ability to trade capacity on the secondary market.

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?

We are still of the opinion that that only one user commitment test should apply to incremental entry capacity release, regardless of whether it is being met by investment or substitution. Bearing in mind that substituted capacity will permanently reduce the baseline at a donor ASEP, we believe that shippers at the recipient ASEP should be required to show the same level of user commitment as any other shipper at an existing or new ASEP before such capacity is released.

Also if substitution is time limited National Grid may be required to meet some of the incremental demand by investment at a later date, albeit in the first instance this investment requirement is postponed.

Finally, as the discussion document makes clear, introducing a separate NPV test for capacity met by substitution is likely to result in even greater complexity to the QSEC auction and allocation processes. This would further denigrate their already tarnished image and undermine what confidence shippers have left in the entry capacity regime.

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

N/A

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

N/A

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?

As stated above we favour a single NPV test, partly because of complexities that would arise from introducing a dual NPV test.

Competing Bids for Substitutable Capacity

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

See above

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?

See above

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?

See above

C. Exchange Rate Cap.

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

We believe there is merit in such an approach. However application of a cap, or the extent of such a cap, cannot be considered in isolation and may be less relevant if other constraints are applied (e.g. time limits on substitution or substitution based on forecast flows).

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

We have limited information on which to answer this question but instinctively consider that an exchange rate cap of around 2:1, if combined with other constraints, may be appropriate.

We would however appreciate greater analysis and information being made available about the extent to which an exchange rate cap might impact National Grid's ability to substitute capacity based on a variety of credible forecast flows.

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?

We believe National Grid should be able to release incremental capacity signalled in the QSEC auctions through substitution ahead of the 42 month notional investment lead time where no investment is required. In the event incremental capacity is met partly by substitution and partly by investment however, it would be necessary to consider the extent to which part allocation of incremental capacity is appropriate.

This question cannot not be divorced from the issue of National Grid being able to earn incentive revenue for incremental capacity which is released earlier than the notional investment lead time and the lead time permitting scheme recently introduced as part of their current price control. Industry discussions may conclude that the in order to give effect to the most efficient solution for entry capacity substitution these arrangements will need amending, and we trust that Ofgem and National Grid would remain open to such a possibility.

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

We do not believe that incremental capacity signalled through the QSEC auctions should be released through substitution until after the capacity release period in the AMSEC auction has expired. Although a set percentage of capacity will always be held back for the AMSEC auctions, we believe that the principle of unsold baseline from the QSEC auctions cascading down to the AMSEC auctions should be protected, which would not be the case if substitution allowed that capacity to be assigned to other ASEPs after 18 months.

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

Subject to the time limit above we do not believe it appropriate to introduce any further measures to protect capacity at a donor ASEP. Providing the basis on which National Grid will undertake capacity substitution is clearly understood, shippers can factor this into their bidding strategies for capacity in the QSEC and AMSEC auctions.

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 A used from year 2 to 4 but not available after year 4, donor ASEP B used from year 5.

Once again this question cannot be answered in isolation as it depends on the extent to which other constraints are applied. However, limiting substitution to single donor ASEP's will make it easier for shippers to better understand how substitution has been effected. It will also provide reassurance that baseline capacity will not be whittled away over time but will be only substituted away en mass, in response to identifiable bids in the QSEC auctions.

To this extent we believe this idea deserves further consideration.

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)?

In the absence of entry capacity substitution we see no reason to replace the current NPV test for release of incremental entry capacity. However, in light of the incremental capacity release obligation currently pertaining at Fleetwood we believe it is appropriate to consider the extent to which National Grid's obligation to invest and/or release incremental capacity (and for that matter the extent to which a shipper's obligation to pay for capacity and/or provide security) persists when the project requiring that capacity is undeliverable, or significantly delayed. In considering such circumstances it would be appropriate to consider how these might impact capacity substitution were it to apply.

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

We see no reason why user commitment at entry should mirror the arrangements that are expected to apply at exit purely for consistency's sake. However, in light of the issues raised by entry capacity substitution (particularly in the absence of a dual NPV test) we believe it is appropriate to consider whether the current NPV test at entry is still appropriate.

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

If appropriate, for example due to the peak loading nature of an ASEP, this should not be discounted. Whilst we do not necessarily regard storage facilities as special cases, because of their potential cycling capability, we do think it appropriate to consider whether storage users should still be required to make user commitments at both entry and exit when the investment required to provide that entry and exit capacity may well be one and the same.

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

As previously stated we do not see any merit in applying dual user commitment tests to distinguish between substitution and investment.

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

In the event it is considered appropriate to amend the current NPV test we do not believe this should apply until after the implementation of enduring exit arrangements, currently anticipated to be in April 2009.

New Entry Points

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

No. Restricting shippers ability to signal their requirement for incremental capacity within the confines of an annual application window introduces the potential for inefficiency in shipper investment programmes, which may ultimately affect security of supply. In our opinion this argument is equally applicable to the exit capacity regime and should be recognised in the enduring exit arrangements.

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?

Yes

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?

By this we assume you mean separate ad hoc QSEC auctions relating to new entry points. This being the case we see no reason why substitution should not be applied to these auctions providing that the first instance of substitution is applied is following a regular QSEC auction.

Reserve Price Discounts

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

We believe that as a consequence of wider regime changes (e.g. reduced baselines, NG's reasonable endeavours obligation to release capacity, transfer and trades and substitution) the availability of daily firm capacity is likely to reduce such that there will be more competition for that which is available. In our opinion this strengthens the basis for applying a discount to daily firm capacity sales and selling daily

interruptible capacity at a zero reserve price, as shippers are exposed to a greater risk of capacity not being available on the day.

Other Issues

Respondents should not limit their comments to the above questions. National Grid encourages respondents to raise any additional issues that require consideration prior to implementation of the substitution processes.

We believe there may be merit in considering limits, on a GWh or percentage basis and possibly seasonally adjusted, on the extent to which substitution can take place in aggregate or at specific ASEPs. It might also be appropriate to vary such limits at specific ASEPs to reflect their supply characteristics, e.g. peak storage facility, inter-connector, baseload supply terminal.

Should you wish to discuss our response in more detail please do not hesitate to contact me.

Yours sincerely,

Steve Rose
Economic Regulation

Sent by e-mail and therefore not signed