



National Grid NTS and other interested parties

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Your Ref:
Our Ref: NET/GTP/CAP/4 PT3
Direct Dial: 020 7901 7050
Email: Robert.Hull@ofgem.gov.uk

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Dear Colleague

Incremental Entry Capacity Release ("IECR") Methodology Statement

Ofgem¹ has considered the issues in the IECR methodology statement annual review consultation report submitted by National Grid Gas ("NGG") on 12 June 2007 in respect of its proposed revisions to the IECR methodology statement. Additionally, Ofgem has considered the findings of the auditor statement along with the submission of the IECR methodology statement by NGG on 29 June 2007 for approval by the Authority. Having regard to the principal objective and statutory duties of the Authority², and for the reasons set out in this letter, the Authority has decided:

- it will consent to the proposed revisions to the IECR methodology statement, pursuant to Special Condition C15(7)(c) of NGG's National Transmission System ("NTS") gas transporter's licence; and
- it will approve the IECR methodology statement pursuant to Special Condition C15(2) of NGG's NTS gas transporter's licence

This letter outlines the background to NGG's submissions of the IECR methodology statement annual review consultation report for consent from the Authority to revise the IECR methodology statement and for the IECR methodology statement for approval by the Authority and gives reasons for the decisions.

Background

The IECR methodology statement describes the methodology by which NGG determines whether or not to propose to the Authority to make incremental entry capacity available for sale to users of the NTS.

On 8 May 2007 NGG initiated a consultation as part of its annual review of the IECR methodology statement pursuant to Special Condition C15(7)(a) and as a result is proposing a number of revisions to the IECR methodology statement. The main proposed changes are:

- to reflect the changes to the gas charging methodology statement (primarily the implementation of NTS GCM 01³);

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this letter.

² Set out in Section 4AA of the Gas Act 1986, as amended.

³ NTS GCM 01: Alternative Methodologies for Determination of NTS Entry and Exit Capacity Prices which the Authority chose not to veto on 24 April 2007

- to account for meeting incremental capacity release through entry capacity substitution;
- to revise the investment lead times; and
- to clarify the role of planning and user commitment in the triggering of investment.

On 12 June 2007, following the close of NGG's consultation on the proposed revision of the IECR methodology statement, NGG submitted the IECR annual review consultation report to Ofgem consistent with the provisions of Special Condition C15(7)(b)(i) for the Authority to consent to such revisions.

On 29 June 2007 NGG submitted the IECR methodology statement (which was the same as was submitted on 12 June 2007) along with an auditor statement to the Authority in order to seek approval of the IECR methodology statement pursuant to Special Conditions C15(2).

Respondents' views

NGG received three responses to its consultation as part of the annual review of the IECR methodology statement. All three respondents were in favour of the revisions to the methodology, but raised a number of points relating to the detail within the methodology and in some instances requested clarification of specific issues.

One respondent thought Ofgem's shallow connections policy made it inappropriate to include connecting pipelines in the NPV test as this could result in shippers collectively picking up the cost for such a pipeline to new entry points. However, it also questioned the presumption that shippers using a new entry point will not buy further capacity in subsequent auctions. Though, in principle this respondent agreed with strengthening the economic test. NGG responded that the shallow connections policy only applies to exit and would be concerned with a strengthened NPV test as could be discriminatory in favour of current entry points and may discourage new supplies.

Two respondents thought that the text regarding the investment lead times should be clarified as it seemed to suggest that NGG could have more than the 42 months investment lead time which the licence allows.

Two respondents did not support the inclusion of a discount to incremental price steps should NTS GCM 06 (Further Revision to Obligated NTS Entry Capacity Reserve Price Determination) be implemented. NGG agreed on this point, but since Ofgem vetoed NTS GCM 06 this is no longer an issue.

Following these comments NGG revised the IECR methodology statement before it submitted it to the Authority on 12 June 2007.

Auditors' views

The auditors reviewed the model which was developed and is maintained by NGG for the purpose of calculating incremental price steps. The auditors noted no exceptions.

Ofgem's view

Ofgem accepts the revisions to the IECR methodology statement which accounts for the implementation of NTS GCM 01 as this will result in the calculation of the price steps which are consistent with the gas transmission transportation methodology statement.

The revision of the investment lead times from 36 to 42 months reflects changes to NGG's gas transporters licence, which has been revised as a result of the Transmission Price Control Review (TPCR).

NGG also proposes that it will investigate opportunities to satisfy demand for incremental capacity following signals from the Quarterly System Entry Capacity auctions by substituting capacity from other entry points with unsold baseline capacity.

We had expected NGG to consider the interaction between capacity substitution and the NPV hurdle in this methodology statement. We also raised this as an issue for consideration in our open letter "National Grid Gas National Transmission System Entry Capacity: Development of the regime in the medium to longer term (capacity substitution)" published on 27 June 2007.

This issue clearly needs to be addressed as a matter of urgency but we understand that NGG is now consulting on how the current net present value hurdle might be affected by capacity substitution.

We note that as a result of the policy changes and revised licence conditions resulting from the TPCR a number of terms have changed. The IECR methodology statement therefore needs to be updated to reflect these non-material changes. Ofgem expects NGG to update the IECR methodology statement accordingly.

Further clarification

We also believe that it might be helpful to share our view in relation to a number of points which NGG has raised in this methodology statement.

In its methodology statement NGG argue that capacity substitution can only be processed sequentially. We note that a lower NPV hurdle in situations where capacity substitution takes place, has implications for sequencing. The sequencing process could potentially be discriminatory. However, we would expect that there are ways of sharing the benefits of substitution among (potential) parties.

Also, at the time of the next price control it will be up to NGG to provide evidence that capacity substitution has been used at the most appropriate location in an appropriate way. Further, in the case of the delivery of incremental capacity through capacity substitution, we expect the additional capacity to be delivered by the date the capacity has been bid for and we do not expect NGG to obtain permits for 'early' delivery as we are dealing with existing capacity.

We would also like to reiterate that any approvals of the release of incremental capacity by the Authority, be it regarding investment or substitution, do not constitute an endorsement of the efficiency of the proposed approach or the associated costs. In line with past practice, we will conduct such assessments at the time of the next price control.

We also note the following new paragraph in this methodology statement:

"National Grid might consider it necessary to invest in the absence of an unambiguous auction signal should it be deemed necessary to satisfy its wider statutory duties or, in its opinion, a clear commercial case can be made for such an investment".

We recognise that it is open to NGG to do this but wanted to make clear that we would struggle to anticipate any circumstances where NGG statutory duties would require it to make an investment in the absence of an unambiguous auction signal. NGG's primary duties are to meet all "all reasonable demands" and we find it hard to foresee a set of circumstances where NGG could conclude there were "reasonable demands" in the absence of any clear commitment to pay for capacity from shippers via the auction mechanism.

We would also remind NGG that they have licence and statutory obligations that prevent them from offering an unfair commercial advantage or discriminating unduly. If NGG decided to invest in the absence of auction signals this would carry a very high risk of being found to be in breach of these obligations. As shippers who wanted capacity at the point

on the network where NGG had invested would enjoy capacity without having to commit to pay for it through the long term auctions as shippers at other entry points would have to (or would have had to in the past).

Finally, we would note that if NGG chose to make such an investment in the absence of clear auction signals, our presumption would be that any investment had not been efficiently incurred when assessing whether to include it in the regulatory value at the subsequent price control unless NGG could provide compelling evidence of long term demand for that capacity.

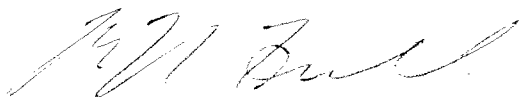
Ofgem's Decision

Following consideration of the documentation provided and having regard to the Authority's principal objective and statutory duties and for the reasons set out above, Ofgem has decided that it will give consent to the proposed revisions to the IECR methodology statement pursuant to Special Condition C15(7)(c).

Following consideration of the documentation provided by NGG pursuant to Special Condition C15(2) and C15(3) and having regard to the Authority's principal objective and statutory duties and for the reasons set out above Ofgem has decided that it will approve the IECR methodology statement.

Any proposals to revise the IECR methodology statement which may arise outside the annual review process, as described in Special Condition C15(7) can be made pursuant to Special Condition C15(5).

Yours sincerely



Robert Hull
Director, Transmission

Signed on behalf of the Authority and authorised for that purpose.