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Our Ref.
Your Ref.
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Dear Andrew,

RE: Summary Report and Discussion Document on Entry Capacity Substitution

Thank you for the opportunity to comment upon National Grid's latest thinking in respect of entry capacity substitution.

We remain nervous about the whole subject of entry capacity substitution, but recognise that it is an Ofgem requirement upon National Grid. There is still significant uncertainty around much of the entry capacity regime – e.g. auction timings, Trade & Transfer implementation, ASEP baseline capacities etc – and we believe that remedies to these issues have been considered too much on an individual basis with insufficient thought being given to the interactions between the subjects.

In particular, with regard to substitution, many of the concerns already expressed by numerous industry participants bear repeating. These include, in particular:

- Likelihood of extremely limited savings on transportation costs;
- Uncertainty around availability of entry capacity an any particular ASEP, which in turn will undermine the effectiveness of the User Commitment/auction market mechanism;
- Unexplained/un-quantified "benefit" of driving towards longer term capacity booking;
- Detrimental impacts upon security of supply i.e. potential for stranding gas offshore;
- Overall a "tighter" NTS, with both this and the above point leading to;
- Increased commodity costs for all consumers.

Responses to specific questions posed by National Grid

Below are responses to the specific questions raised in the National Grid consultation paper.

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%)?

Centrica has long held the view that no capacity should be withheld from the QSEC auction. Whilst we understand the view that this could prevent new supplies being landed in a timely manner, we believe that withheld capacity prevents the development of a liquid secondary capacity market, instead with Users relying on primary capacity from the Transporter. Our preference is therefore for a 0% withhold.

Forecast Flows

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

A review of previous TYSs highlights the extent to which National Grid's views can change and in some cases can prove to be notably inaccurate. Given this, and the degree of discretion that National Grid has in interpreting the information or lack of information received from shippers, we would be reluctant for substitution to be based on Ten Year Statements. We would also repeat what we have often been advised – this being that National Grid relies solely upon auction signals to trigger incremental investment. It would therefore seem inequitable to include TYS data, and we believe that only auction signals should be considered.

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

If the TYS was used as a tool in assessing potential for substitution, then we believe that shippers would have the ability and indeed a motive to manipulate the data that was fed into the TBE process. This would clearly be undesirable, and underlines why TYS data should form no part of the substitution methodology.

Would an alternative limit be appropriate?

We believe that establishing any kind of limit on the extent to which capacity is substitutable raises the spectre of discrimination between entry points. Whether or not any such discrimination is due or undue depends upon whether there is a strong and justifiable case for that discrimination. We believe that without any limits some ASEPs - constrained LNG sites or those providing Ops Margin gas for example - may find that all capacity was substituted away in advance of any party being in a position to want to buy it. That said, we are as yet undecided whether in this instance such sites should be protected by a limit, but this issue clearly needs further debate.

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?

No. We believe that all available capacity prior to the booked period should be available for substitution, to be returned to the original donor ASEP to take effect for the booked period.

If yes, what about two quarters?

See above.

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

Absolutely not. As set out above, National Grid's long standing position is that it relies upon signals from established auctions with unfettered booking rules. There are legitimate reasons why a shipper may want to book entry capacity short term, some way into the future. This is especially so with declining UKCS supplies, where a variety of successive investments could be used in order to temporarily offset the decline. Introducing rules to prevent this would be to adversely manipulate the existing entry regime in order to fit the requirements of capacity substitution.

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 where capacity substitution takes place, it should be a permanent move of baseline to a recipient ASEP until such time as that new recipient no longer signals a need for that capacity – in effect becoming a donor – and a new recipient is identified through the auction processes. We do not believe that it makes sense to revert baseline capacity back to the donor unless the donor has signalled a need for that capacity.

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 strongly support the concept of capacity surrender providing this is done through an open and transparent market based mechanism with no artificial constraints on surrender prices. We believe that this might help to avoid problems associated with short term, distant booking, raised as an issue above.

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?

Our understanding is that the User commitment test is based upon meeting 50% of the actual cost of delivering a required amount of incremental capacity. We see no reasons not to extend the same methodology to also apply to substitution, providing that the new test is to cover 50% of the actual cost of undertaking the substitution.

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

N/A - see above.

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

N/A – see above.

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 above, it would seem appropriate to us that the User commitment is 50% of the actual cost of the substitution cost plus 50% of the investment required to deliver the incremental capacity.

Competing Bids for Substitutable Capacity

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

We believe that a single NPV test is appropriate, providing that this is based upon the actual cost of the delivered capacity. In these circumstances, we believe that the full extent of the substitutable capacity should be used, with investment to complete the remaining requirement.

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?

N/A – 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?

N/A – 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 that it is appropriate to place a limit on the exchange rate allowed for substitution. This is based upon the principles discussed as part of the related Trade and Transfer debate.

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

In principle, we do not foresee a compelling reason to differ from the 10:1 rate agreed under the Trade and Transfer regime, although it must be recognised that the effects of that exchange rate have yet to be tested in practice. The 10:1 rate could therefore prove to be too high or too low, and be subject to revision.

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 that in principle it is appropriate for National Grid to release substituted capacity at the earliest opportunity, providing that under all circumstances Users have had the opportunity to purchase the capacity in at least one AMSEC auction.

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

As set out above, rather than specifying a time limit, we believe that the limiting factor should be that Users have had the opportunity to purchase the capacity in an AMSEC auction.

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

Apart from offering in at least one AMSEC, the subject of protecting donor ASEPs has been covered above in this response. We believe that to introduce limits for some ASEPs may be discriminatory. We are undecided whether in our opinion any ASEPs would merit such protection.

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.

We believe that combinations should be used.

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)?

We believe that the current 50% NPV test is appropriate in meeting the need for a User commitment test. We would, however, support a change to the methodology for arriving at the 50% test, which we believe is too complex and carries too much risk of failing the test where a number of Users are separately trying to indicate a need for incremental capacity at the same entry point (some Users believe that Competition Law prevents Users from discussing their individual bidding strategies).

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

It is possible that the application of alternative tests could be appropriate, however we believe that this point needs more consideration.

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

As set out elsewhere in this response, treating different entry points in different ways could suggest discrimination. That said, we can foresee possible problems with constrained LNG entry points, but would need to be convinced that such entry points warrant special consideration.

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

We do not have a view on this at this stage.

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

If alternative tests can be demonstrated to deliver benefits, these should be introduced as soon as possible.

New Entry Points

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

We believe that holding separate QSEC auctions has worked well in the past, and would cite as an example the new Milford Haven ASEP. However, in a post substitution world we can foresee that a new ASEP – where capacity could be made available at a reduced rate by substituting – could receive preferential treatment if the release mechanism was outside of the normal QSEC timetable. Alternatively, the QSEC for the new entry point should be expanded to a full QSEC with all shippers able to bid at all entry points.

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?

We believe that substitution should align with a QSEC auction – whether this was a regular scheduled auction or a special event – in order to provide the opportunity for a final purchase prior to substitution taking effect.

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?

Providing that any special QSEC is open to all shippers to bid at all ASEPs, there would be no reason to exclude substitution.

Reserve Price Discounts

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

We believe that the discount reflects the risk to the User of attempting to acquire capacity at a late stage of the process. It should therefore remain.

Other Issues

In addition to the well aired concerns set out at the beginning of this response, we also have an over-arching concern that the uncertainties and complexities of capacity substitution and capacity trades and transfers, when considered together with the intricacies inherent in the current entry regime, may make the UK an unattractive proposition or new gas supplies. This would clearly be detrimental to consumers and UK plc as a whole, and we are keen that these potential commodity downsides are considered alongside the relatively small capacity cost benefits that may derive from these new initiatives.

In summary, we believe that while auctions remain the primary mechanism for acquiring entry capacity, substitution should be allowed only in so far as it is completely transparent to Users, and does not undermine or detract from the auction/market mechanism.

Please do not hesitate to contact me if you need any clarifications or details relating to this response.

Yours sincerely,

Chris Wright
Commercial Manager