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RE: Summary Report and Discussion Document on Entry Capacity Substitution

Dear Andrew,

Total E&P UK Ltd. appreciate the work that National Grid has carried out with regards to Substitution, and we continue to share our views with you, Ofgem and the industry in general to ensure that any changes to the Transmission System are a step forward for a more transparent and stable regime. In line with this we respond to your detailed questions and hope to contribute to NG's work in preparing the Initial Proposal Document for March 2008.

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%)?

Along with several other gas shippers and producers, we advocate for a higher proportion of baseline capacity to be withheld from QSEC auctions. We maintain our view that 20% held back should be reinstated and this becomes ever more important once Substitution is implemented. The QSEC auctions would still offer 80% of baseline, allowing shippers to commit to their known requirements well in advance, but by keeping at least 20% for the short-term auctions shippers would be able to optimize their capacity needs when they have more accurate flow data. It is exceedingly difficult for shippers to have a clear and precise view of future flows for the 16 year period that the QSEC auction covers. Creating a system where shippers feel forced into buying "excess" capacity just to ensure that it remains at that entry point is not the most efficient way forward and may well have adverse impact on NG's planning process and consumers.

Forecast Flows

Should National Grid exclude from substitutions capacity up to the level of forecast (as specified in the TYS) flows? Would this have an adverse impact on the quality of data provided in the Transporting Britain's Energy process which feeds into the TYS? Would an alternative limit be appropriate?

We believe that it is extremely dangerous to consider all unsold capacity as "available for substitution". The UK is dependent on gas flows from the UKCS, imported flows and LNG cargoes. It is important to understand that producers and importers will not be able to have a complete view of flows sixteen years in advance, and hence, may not be able to secure capacity they will eventually need.



We understand NG's proposal of excluding from substitution capacity up to the level of forecast as this will allow for a more realistic picture of capacity needs. Still we have to point out that sometimes shippers may have potential flows which they are unable to signal through forecasts as the projects have not been sanctioned therefore these additional volumes will not necessarily appear in the TBE process or the TYS, this is because producers may only have certainty of these projects once they are sanctioned, and so will be unable to commit to any capacity beforehand.

Another way to limit the amount of capacity subject to substitution without the risk of corrupting the TBE and TYS process would be to use the past year flows at each entry point. Again this method is not perfect but would at least limit the amount of capacity that could be moved away to a more reasonable level. This may avoid unnecessary moving of capacity back and forth, provide more stability on baselines and limit the need for shippers to overestimate their needs for capacity, all of which reduce unnecessary costs being passed on to consumers.

In the future, once Substitution has taken place, we should be able to review these limits, but at present we believe that Substitution should be implemented in a way that restricts its application and impact, limiting the chances of substitution taking place, but also limiting any possible adverse side effects which have yet not been considered and which may become evident with 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?

If yes, what about two quarters? Should rules be introduced to prevent short-term, distant, bookings in future QSEC auctions?

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

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We believe that first we should deal with the implementation of substitution, and only later deal with the "single quarter problem" if indeed we see this behaviour in shippers bidding once substitution is in place. Introducing even further changes to the QSEC auctions at this time and for a problem which may not arise seems hasty.

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?

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

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

We do not believe that different user commitment tests should be used for the release of incremental capacity. Having different tests would be extremely complicated to implement and may lead to discrimination. Substitution is a mechanism which brings flexibility to the way NG provides incremental capacity, but before that there has to be a trigger to signal the release of such incremental capacity, which is the key role of the NPV test.

As mentioned in the paragraph above, we believe that in time this issue as well could be revised. Moving away from the NPV test would trigger changes in the QSEC's process which, given the

sizeable reforms the industry has seen from the 2002-2007 TPCR, may prove too much for shippers, consumers and NG to incorporate in a short period of time.

C. Exchange Rate Cap.

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

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

Substitution may be a valuable mechanism if indeed it allows capacity which would have been otherwise unused at entry point A, to be used at entry point B. For its application to create value, it is crucial that the capacity in question would have remained unused at entry point A.

If this is the case, it may even be acceptable to tolerate some degree of capacity destruction. But we have to keep in mind that any level of capacity destruction will translate in an unnecessary cost to consumers if that capacity is required at some later date at entry point A.

Because of this concern we consider exchange rates should be capped at 1:1 or 1.5:1. Anything higher may prove detrimental to the industry as a whole.

In addition more work is needed to understand what would happen if that capacity is needed at some future date at entry point A (donor). We believe that Substitution should be temporary and revert back to the donor entry point if shippers signal a need there, as this would be the best use of the existing infrastructure. If this is not the case, would NG build incremental capacity at entry point A? This may not be the best investment, as the capacity already exists. In this case possibly the best investment would be at entry point B as this is where infrastructure may be needed. This creates issues with the cost of capacity, which is not the same at any two entry points, and which may mean that shippers at point A could pay a price for capacity which will in effect be built at point B, but which could have had a different cost if the increase had been triggered from entry point B itself.

We reiterate that more work is needed to further understand the impact of implementing Substitution. To this end we have asked for an Impact Assessment to be conducted by Ofgem ahead of implementation, as we believe along with several other industry players that this is the correct way forward.

Other Issues

Reserve Price Discounts

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

The transmission rules in place for the TPC period 2002-2007 were such that they provided an incentive for shippers to bid for capacity in the short term, not so much because of the high baselines, but more importantly because the fact that the price of capacity reduces closer to the date of use. In this way, shippers who actively bid in the QSEC auctions, pay very different prices for capacity than other shippers at the same entry point who chose to use the day-ahead auctions. Total E&P UK Ltd has actively participated in the QSEC auctions since their introduction in February 2003. Not only have we paid the full cost of capacity at St. Fergus, but we have also been subject to ever increasing T.O commodity charges, introduced by NG because of under-recovery of their allowed revenue from entry capacity. We believe that correcting this perverse incentive is crucial to achieving a fair Transmission System, and that this issue should have been tackled ahead on any other changes (such as Baselines etc). Currently the T.O Commodity charge is set at zero, but this is due to a rush for capacity in the latest AMSEC auctions resulting in NG

over-recovering, which just highlights the volatility that having the reserve price discounts introduces into the system.

In particular, we would be interested in people's thoughts as to how the substitution process may impact upon other elements of the entry capacity regime.

As mentioned above we are concerned that there is a rush to implement Substitution even though a thorough analysis of possible consequences is still due. This consultation document focuses on technical issues regarding the implementation of Substitution, but we believe that there are still fundamental concerns about Substitution which have to be addressed. We believe it is Ofgem's role to carry out an impact assessment, and we detail below some issues that we believe have not been yet addressed:

- Has there been due consideration of the effect that moving to a system where all capacity can be substituted away if not yet bought through the QSEC may have on the viability of remaining undeveloped reserves in the UKCS? There are important gas reserves West of Shetland, but there is currently no pipeline to deliver this gas to St Fergus; however, a collective solution is being examined by an industry task force in conjunction with BERR. We believe that Ofgem and BERR should work together in "securing a diverse and viable long term energy supply"¹. Making sure that the Transmission System rules favour the full recovery of UKCS hydrocarbons and the full use of existing infrastructure is indeed part of these duties.
- Another issue with Substitution which has not yet been addressed by NG or Ofgem is the effect of capacity substitution to the integrity of the system infrastructure. If capacity is substituted away from an entry point and flows there reduce, will NG stop maintaining or even decommission compressors and other equipment which may have become temporarily redundant? This could lead to increased costs of bringing capacity back to the original entry point (donor), to the detriment of shippers and consumers. We understand that NG has no obligation to keep such equipment and therefore can provide no guarantee as to its integrity.
- In the Energy White Paper, the UK Government addresses the need to maximise the UK's oil and gas resources and ensure that access to appropriate infrastructure is in place. To ensure that exploration and development is maintained and indeed stimulated in certain regions it is important that infrastructure is available to evacuate potential gas discoveries. The current work with the West of Shetlands Task Force is a good example of Government addressing this key question of infrastructure. However it would be counter to the long term objectives of maximising production from the UKCS if existing onshore capacity was removed before companies were in a position to commit to securing that capacity due to the immaturity of the basin. Short and medium term price signals can be appropriate in some circumstances, however in the long term NG should take a wider view before implementing substitution.

¹ Ofgem's duties under Section 4 of the 1986 Gas Act as amended under Part II of the Utilities Act 2000

Conclusion:

- We believe that more work is needed ahead of the implementation of Substitution and we request Ofgem engage on a full Impact Assessment which includes the issues/risks we have highlighted.
- We believe that change should be implemented in a phased and controlled manner. We have yet to see the full impact of the substantial changes introduced through the latest TPCR. Once this is clear and we have a stable system we can then introduce further changes, so as to perfect the working of the UK Gas Transmission system through fine tuning rather than complete overhaul.
- Substitution, if implemented during this price control period, should be implemented under the most restrained scenario possible (limit on capacity and exchange rates, full NPV test, applicable at the TPC process etc.) with the possibility for review in later years.

We trust our comments will be given due consideration and we look forward to your March document.

Yours sincerely,

Iain McCombie

Commercial Operations Manager

Total E&P

(This document has been sent electronically and therefore it is not signed)