

**DISCUSSION ON  
“THE ENTRY CAPACITY SUBSTITUTION  
METHODOLOGY STATEMENT”**

**CONCLUSIONS REPORT**

**15<sup>th</sup> September 2008**

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## Executive Summary

The “Discussion on the Entry Capacity Substitution Methodology Statement” issued on 7<sup>th</sup> July 2009 set out for discussion options on a range of issues relating to potential processes to be applied in the implementation of the entry capacity substitution obligation contained in the Licence.

The discussion document was produced following a series of workshops arranged by National Grid to raise awareness of the substitution obligation and to inform the industry of potential consequences. The workshops concluded with the production of the discussion document which is intended to capture industry views on the issues identified and the options put forward. This report summarises the responses.

### Summary of Responses

National Grid received thirteen responses to its consultation. None were marked as confidential and copies have been posted on the Gas Charging section of the National Grid information website.

Many of the respondents agreed with the principle of entry capacity substitution; none specifically expressed opposition. However, there was overwhelming concern that application of substitution could have damaging consequences, especially if the policy is developed in accordance with National Grid’s current interpretation of the Licence.

Considering these concerns all respondents were in favour of Ofgem undertaking a wide ranging Impact Assessment. More specifically respondents tended to agree with National Grid’s interpretation of the substitution object of:

*ensuring that entry capacity substitution is effected in a manner which minimises the costs associated with funded incremental obligated entry capacity*

as meaning that all available capacity should be substituted to meet the incremental signal, without placing any restrictions on the substitution process

However, respondents noted that this would conflict with other Licence obligations, specifically with regard to operating in an efficient and economic manner, and respondents consider that National Grid should take a more relaxed view. Hence eleven of the thirteen respondents called for limits on the amount of capacity made available for substitution and restrictions on the “inefficient” use of the capacity made available, (e.g. a cap on exchange rates).

Views on limiting capacity available for substitution varied with equal support for historic flows, TBE projections, or a fixed quantity of baseline being used as the basis for excluding capacity from substitution. There is also support for phasing in the substitution process, including from the two respondents opposed to any limits. This would allow Users to become familiar with the new regime before potentially severe consequences arise.

Most respondents favoured an exchange rate cap at, or close to, 1:1 in order to prevent excessive capacity destruction. Support was also given for pro-rating of substitution across all donor ASEPs within a zone so as to “share the pain”.

Respondents recognise the need for a simple, mechanical substitution methodology that can be applied in a transparent manner with little scope for challenge and dispute. However, considering the unease with which many Shippers view substitution, there is support for some discretion to be introduced into the process. Generally, the supporters of added discretion favour that discretion lying with Ofgem.

## **Way Forward**

National Grid will continue to engage with Ofgem to reach agreement on the meaning and intent of the substitution objective to minimise the costs associated with funded incremental obligated entry capacity and how this fits with wider obligations to operate in an efficient and economic manner.

Resolution of this issue will allow National Grid (and Ofgem) to consider how (and whether) capacity available for substitution should be limited and how (and whether) inefficient substitutions should be prevented. This will inform further drafting of the proposed methodology statement prior to formal consultation expected early in November 2008.

# 1. Introduction

- 1.1. Special Condition C8D of National Grid Gas plc's ("National Grid") Transporter Licence in respect of the NTS (the "Licence") sets out obligations to prepare and submit for approval by the Authority, by 6th January 2009, an entry capacity substitution methodology statement setting out the methodology that National Grid will use to carry out entry capacity substitution. In addition, National Grid is obliged to consult with relevant Shippers and interested parties prior to submitting the initial statement or revising the methodology.
- 1.2. The Licence defines entry capacity substitution as the process by which unsold non-incremental obligated entry capacity is moved from one or more NTS entry points to meet the demand for incremental obligated entry capacity at another NTS entry point. In simple terms, this means that where incremental entry capacity is required this should be met by reducing National Grid's obligation to make entry capacity available at other entry points (where capacity is unsold) before undertaking investment in new infrastructure. The full Licence condition is reproduced in Appendix 1.
- 1.3. National Grid recognises that the substitution obligation represents a significant change to the entry capacity regime and is therefore keen that Shippers and other interested parties are fully aware of potential consequences and understand the rationale for the development of the substitution methodology in the form that it will ultimately be proposed. To achieve this National Grid has run a series of workshops to develop understanding of substitution, to consider how it should be implemented and to identify issues and potential solutions. Details of these workshops can be found on the Joint Office website.
- 1.4. Having presented its understanding of the Licence obligation and how this directs its thinking on the requirements for substitution National Grid is now finalising its proposed methodology statement. However, before undertaking the formal consultation described in paragraph 1.1, National Grid wishes to capture, and consider, the views of interested parties. Hence National Grid invited views on a draft Entry Capacity Substitution Methodology Statement (discussion draft v0.2).
- 1.5. The discussion draft built on the draft statement upon which National Grid consulted in 2007. Included in the statement were a number of questions which National Grid sought responses to.
- 1.6. This report reviews the responses, summarises the points raised, and provides National Grid's view on specific issues. Further actions, by National Grid, will be influenced by these responses but are subject to on-going debate with the regulator and future consultations (see section 6 - Way Forward).
- 1.7. A copy of the Discussion Document and other related documents can be found on National Grid's website and the Joint Office website at:  
<http://www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ecms/>  
<http://www.gasgovernance.com/Code/Workstreams/TransmissionWorkstream/2008Meetings>

## 2. Summary of Responses

- 2.1. National Grid received 13 responses to its discussion on the draft Entry Capacity Substitution Methodology Statement. None of the responses were marked as confidential, and copies of the responses have been posted on the National Grid website.
- 2.2. Responses were received from the following organisations:
- |  |      |
|--|------|
| • BG Gas Services                      | BGGS |
| • Chevron North Sea Ltd                | Chev |
| • Centrica Storage Ltd                 | CSL  |
| • Centrica group (excluding CSL)       | BGT  |
| • Statoil (UK) Ltd                     | STUK |
| • Excelerate Energy                    | EE   |
| • Interconnector (UK) Ltd              | IUK  |
| • RWE group of companies               | RWE  |
| • Gassco AS                            | GSC  |
| • Scottish Power                       | SP   |
| • Scottish and Southern Energy         | SSE  |
| • BP Gas Marketing Ltd                 | BP   |
| • Association of Electricity Producers | AEP  |
- 2.3. Many of the respondents agreed with the principle of capacity substitution.
- IUK believes “it is sensible to utilize existing capacity that has become available through a decline in production from UKCS fields”;
  - BP believes substitution will enable National Grid “to run the NTS more effectively”;
  - CSL supports the concept and policy objectives of “maximising the use of existing Transmission network assets” and “avoiding both capacity sterilisation and unnecessary infrastructure investment”;
  - RWE, SSE and STUK express support for “the principle” of substitution; and
  - BGT “is not opposed to the concept” believing “it makes perfect sense for genuinely spare, unused and unwanted capacity to be utilised elsewhere”.
- 2.4. However, there was overwhelming concern that application of entry capacity substitution could have damaging consequences, especially if the policy is developed in accordance with National Grid’s current interpretation of the Licence. BP “questions whether the [Licence condition] is being interpreted correctly” and RWE believe the current draft proposals “reflect neither the spirit nor intent of Ofgem’s policy decision” in the area.
- 2.5. Industry concerns with substitution lie particularly in regard to the potential impact on system flexibility and security of supply. Adverse impacts on competition, gas prices and the attractiveness of the UK for new investment have also been expressed by various respondents.
- 2.6. The majority were, therefore, strongly in favour of Ofgem undertaking a wide ranging Impact Assessment (“IA”) to consider the likely consequences of substitution before its implementation.

- 2.7. Notwithstanding the results of an IA respondents favoured a gradual introduction to the substitution regime with constraints on the quantity of capacity that could be substituted for each ASEP. Such constraints would be based on National Grid considering a wide definition of its “economic and efficient” obligations ahead of the more literal interpretation of the substitution obligation to minimise investment costs.

### 3. Detailed Responses – Discussion Document Questions

- 3.1. In the workshops arranged by National Grid, National Grid explained its interpretation of the Licence obligation. This interpretation is to undertake entry capacity substitution, to the extent required and available, to minimise the requirement for investment to meet the need for incremental entry capacity. A consequence of this is that the loss of capacity at donor ASEPs would be higher than if a less strict interpretation was applied. An example was developed to illustrate potential consequences for donor ASEPs.
- 3.2. Through this interpretation and example, a series of issues were identified and these formed the basis of the discussion document.
- 3.3. In addition to consideration of the methodology by which substitution may be implemented many workshop participants continued to raise more fundamental question relating to the wisdom of the entry capacity substitution policy. Although outside the scope of National Grid’s workshops and discussion paper further questions were raised to capture these views.
- 3.4. This section of the conclusions report captures the responses to each of the main questions. The “general questions” are covered in section 4.
- 3.5. **Questions Raised in the “Discussion on the Entry Capacity Substitution Methodology Statement”.**
- 3.6. *Question 1 - National Grid has interpreted the requirement to “minimise” the costs associated with funded incremental obligated entry capacity in this objective as meaning that all available capacity should be substituted to meet the incremental signal, without placing any restrictions on the substitution process.*
- 3.7. *Hence National Grid has developed the substitution methodology with no restrictions on the quantities available to be substituted. This could lead to significant quantities of capacity being substituted in year 1. It may be argued that this is inefficient as “more economic” substitution opportunities may arise in subsequent years. Conversely, later incremental signals may not occur and substitution opportunities would have been lost – and unnecessary investment made.*
- 3.8. *Notwithstanding the subsequent questions raised in this document, National Grid would welcome views on whether its interpretation is appropriate.*
- 3.9. Those respondents who commented specifically on National Grid’s interpretation of the Licence tended to agree with the interpretation. However, conflict with other Licence obligations was noted and it is considered that National Grid should take a broader view. Some noted that the Licence may need re-drafting to facilitate a wider interpretation by National Grid.
- 3.10. BP “feels that National Grid’s interpretation of “minimising” the costs ..... is correct, in that there should not be a restriction on the process”. However, they continue: “it is very difficult to comment on whether a lack of restrictions will cause inefficient substitutions to take place, when more efficient ones could take place at a later date. As it is impossible to know exactly how the market will develop up to 14 years in advance, this is an area that NGG should ignore in its interpretation of the licence condition”.



- 3.11. Similarly BGGs state that “NG’s interpretation of the Licence condition may be correct in a narrow legalistic sense but it is inappropriate for the development of a well functioning UK gas market.
- 3.12. “CSL agrees with NGG’s interpretation” but consider that it “appears to be contrary to other Licence obligations” and that this is “a short-coming of the Licence drafting”. RWE take a similar view considering that “National Grid has interpreted the Licence too narrowly ..... Should be broadened beyond simply avoided investment costs. Given its wider obligations regarding economy and efficiency, National Grid should be permitted to make this interpretation.”
- 3.13. GSC sees National Grid’s interpretation as “an extreme interpretation” and BGT “one possible interpretation”. CSL, referring to the “wider obligation to maintain an economic and efficient system, believe that the licence obligation is unhelpful”. RWE also consider that the licence may need redrafting to permit greater latitude on interpretation.
- 3.14. STUK “sympathises with NG’s interpretation” and suggests that “the industry would benefit from the Authority’s view” considering “a broad set of guidelines, published by Ofgem would add clarity”.

**3.15. National Grid’s view.**

- 3.16. National Grid’s welcomes the views expressed. Clearly there is tension between the substitution obligation and the obligation to operate in an economic and efficient manner. National Grid will take these views into future discussions with Ofgem to ensure that the next draft of the methodology statement is consistent with the Authority’s view, taken in the light of industry concerns.
- 3.17. *Question 2 - National Grid has taken the view that all incremental obligated entry capacity released must satisfy the NPV test detailed in the IECR. Substitution will only be considered if the test has been passed. However, National Grid would welcome views on whether a less stringent test should apply for the release of capacity that would, after analysis, be satisfied through substitution. It should be recognised that whilst a different test could increase the quantity of incremental obligated entry capacity released it would add much complexity to Shipper bidding strategies, as National Grid would be unable to identify substitution opportunities in advance of the LTSEC auction, and to National Grid’s assessment of substitution opportunities (e.g. need to identify a merit order for incremental requests where available capacity is limited; consideration of part investment, part substitution scenarios etc.).*
- 3.18. Almost all respondents support the proposal to apply the same NPV test to capacity released as a result of substitution or investment. However, some respondents feel that a less stringent test should apply but the added complexity pushes them towards accepting the same NPV test.
- 3.19. Agreeing with the same test are; BP: “substitution and investment should be treated exactly the same”; Chevron: “the value of capacity is identical in both cases”; BGT; GSC; CSL: “as the value of capacity is identical in both cases”; BGGs: “a less stringent test would only serve to exacerbate the adverse effects of the proposed substitution mechanism”.

- 3.20. AEP agrees with the same NPV test “for the reasons of avoiding increased complexity. Similarly SSE considers it “appropriate that a single common user commitment test is applied.....different tests would add unnecessary complexity” and SP “would prefer to use the same NPV test .... [for] the avoidance of additional complexity”.
- 3.21. For RWE “it seems intuitively correct that .... a less stringent test .... is required.” However, as RWE cannot see how different tests would be applied in practice they agree with National Grid’s proposal. STUK seek a “stable regulatory environment” and consider that “a less stringent test than the NPV test would add complexity”. However, to STUK it is not “appropriate that NG should receive windfall gains”.
- 3.22. To EE “a lower hurdle” for substitution “seems appropriate”. EE believes that National Grid should try to develop a methodology to allow this to happen.
- 3.23. National Grid’s View.**
- 3.24. Considering almost unanimous support for applying the same test irrespective of how incremental capacity is released National Grid does not envisage changing its initial proposals in this area. However, National Grid believes that this area should be subject to review.
- 3.25. In respect of “windfall gains”, National Grid would like to clarify that it receives no financial benefit from substitution. National Grid receives funding in respect of the baseline quantities at each ASEP. Where capacity is substituted between ASEPs the “obligated” level of capacity will vary at the two ASEPs but the baselines, and hence National Grid’s allowed revenue, will be unaltered. The NPV test, regardless of the stringency, demonstrates a commitment by the Shipper and reveals a level of transportation income that National Grid can expect to receive. This is different from National Grid’s allowed revenue under the Licence which is determined independent of the Shipper’s commitment.
- 3.26. *Question 3 - The substitution obligation is to minimise funded incremental obligated entry capacity, which is released subject to a 42 month default lead-time. Hence substitution will only be considered subject to a minimum 42 month lead-time (as may be adjusted according to the IECR). Do respondents agree that it is appropriate to consider substitution opportunities consistent with the timing for the release of funded incremental obligated entry capacity? It should be noted that any move away from the standard mechanism to release funded incremental obligated entry capacity will produce similar issues to those outlined in Q2, particularly in terms of increased complexity.*
- 3.27. Respondents are generally supportive of applying a 42 month lead-time to substitution.
- 3.28. EE and RWE both agree that “substitution should only be considered subject to a minimum 42 month lead-time”. SP believe that for substitution “the same 42 month lead-time as funded incremental capacity” should apply and SSE believes that “substitution capacity should be made available at the same time as investment capacity”. SSE believes that consideration could be given to reducing this as experience develops. BP, GSC and BGGGS make similar statements.
- 3.29. AEP are in favour of “a standard 42 month lead time” “to avoid additional complexity”.

- 3.30. Whilst supporting efforts to release capacity more quickly, BGT also support a 42 month lead-time as this will “provide all Users with the ability to purchase that capacity in advance of any substitution taking place”.
- 3.31. Chev would support a shorter lead-time for substitution, but this is conditional upon capacity available for substitution being based upon peak forecast flows. Chev would also like to be “alerted to the fact that capacity has been earmarked for destruction and given a further opportunity to secure that capacity”.
- 3.32. CSL considers that there is “only limited merit in applying the standard default lead-time” as this should “allow NGG to consider the most economically efficient use of substituted capacity”. CSL “believes that where capacity can be provided through substitution or otherwise ahead of the lead-time, then it should be made available as soon as it operationally can as non-obligated release”.
- 3.33. National Grid’s View.**
- 3.34. Considering almost unanimous support for applying the 42 month default lead-time for release of incremental capacity through substitution National Grid does not envisage changing its initial proposals in this area. However, National Grid believes that this area should be subject to review.
- 3.35. National Grid agrees with CSL’s contention that capacity should be released as soon as operationally viable as non-obligated capacity. The implementation of UNC modification proposal 0216: "Introduction of an Additional Discretionary Release Mechanism for NTS Entry Capacity" should facilitate this.
- 3.36. National Grid considers that it is not feasible to meet Chev’s request for early warning of capacity being “earmarked for destruction”. The methodology statement will detail the process by which capacity is identified as being available for substitution and the order in which potential donor ASEPs are selected. However, National Grid will only be able to identify substitution opportunities after the relevant LTSEC auction when incremental capacity requirements have been signalled.
- 3.37. *Question 4 - This condition limits the capacity available for substitution to 90% of the initial baseline quantity (10% being held back for MSEC auctions). It is not envisaged that this absolute quantity (i.e. GWh/day) will be reduced (within the current price control) to reflect capacity substituted from an ASEP. National Grid would welcome views on whether it is appropriate for any restriction to be placed on the availability of capacity for substitution or whether the level not available should be increased (or decreased). If an increase is suggested then views on what this level should be and whether it would be justified in relation to the licence obligations would be appreciated. For example, National Grid has identified the following options for decreasing the amount of capacity available for substitution:*
- *Increasing the baseline percentage with-held from LTSEC auctions (requires a Licence change);*
  - *Setting a fixed percent of baseline that, although available for release in LTSEC auctions, will not, even if unsold, be made available for substitutions;*
  - *Setting a fixed quantity (GWh/day) of capacity that will not be available for substitution from each ASEP;*

- *Setting a fixed quantity (GWh/day / percentage) of capacity that will not be available for substitution from all ASEPs in aggregate;*
- *Setting a maximum quantity (GWh/d or percentage) that can be substituted away at any ASEP*

3.38. *In answering this question, National Grid would like respondents to express their views on:*

- *Whether these approaches would be more efficient than maximising substitution from year 1?*
- *What are the advantages and disadvantages of these actions?*
- *Should such limits only apply for a limited duration, e.g. for years 1 [and 2], but be removed after experience of the first year of substitution? And if so how do respondents see substitution being phased in?*

3.39. *Supplementary question – Question 4, raised in the initial document, seeks views on whether more capacity should be with-held from the substitution process thereby increasing the quantity of capacity available for medium and short-term bookings. The current quantity held-back is 10% in accordance with National Grid’s licence. A number of options were put forward for comment.*

3.40. *National Grid would like consideration to be given to two additional options:*

- *Capacity available for substitution could be limited to that in excess of the peak daily flow identified within the TBE forecasts (from 42 months onwards).*

*Some participants believe that the substitution process should not move capacity away from ASEPs where it is required even though Shippers have been unable to confirm this requirement through long term capacity bookings. This may be because the capacity is (may be) required for new projects under development or for supply flexibility. Whilst acknowledging these concerns National Grid has previously expressed concern that this option could undermine the TBE process if some contributors are incentivised to overstate future flows at particular ASEPs.*

- *Capacity available for substitution could be limited to that in excess of the peak daily flow for the previous year (or 2 years) where this is lower than the quantity of unsold capacity.*

*This option would avoid the problems associated with using forecast values and may provide a greater level of capacity retention for the medium and short term compared to the draft methodology. However, historical gas flows are not always reflective of future capacity requirements, particularly considering the decline in UKCS gas.*

3.41. *National Grid would welcome views from respondents on these additional options.*

3.42. *All respondents supported, to some extent, a restriction on the amount of capacity that would be subject to substitution. However, two expressed support as an interim measure in recognition of wider industry concerns.*

- *“For clarity, BP does not believe a permanent restriction on available capacity for substitution would aid in achieving the objectives”, but “due to concerns raised by all shippers regarding the controversial nature of substitution, BP does support an initial transitional approach”.*

- BGT “is persuaded by the view that capacity held over from long term auctions reduces the scope for a liquid secondary market to develop” and “understand the position of other industry players.....”. “We might, for example, support an approach which set an initial limit on the amount that can be substituted.....Such an approach would allow Users to acclimatise to the new regime”.

3.43. Preferences for the means by which capacity available for substitution might be restricted varied considerably with no apparent consensus. However, the justification for a restriction was consistent, including:

- “maintaining a level of flexibility” – STUK;
- “20% of baseline should be retained on a prompt basis to encourage new entrants” – SSE;
- to “book long term capacity ahead of finalising investment decisions for their projects is just not practical” – GSC;
- “it is based on the fundamental flaw that assumes that capacity not booked in Year 1 LTSEC auctions is not required and therefore sterilised” – BGGs.

3.44. Individual responses are summarised in the table below.

<b>Q4 - Potential Restrictions on Quantity of Capacity Available for Substitution</b>						
	<b>Potential methodology</b>					
<b>Respondent</b>	<b>Limit based on historic flows</b>	<b>Limit based on TBE forecasts</b>	<b>Changes to the 10% held back rule</b>	<b>Quantity withheld from substitution</b>	<b>Other</b>	<b>Should limits be phased?</b>
<b>CSL</b>	3 years data			20%	Incremental capacity should be provided by max 50% substitution	Yes
<b>IUK</b>					Restriction preferred, but method not specified	Yes
<b>Chev</b>		Yes				
<b>BGT</b>			Decrease	50%		Yes, gradually reduced quantity held back.
<b>AEP</b>	Yes	Yes				
<b>BGGs</b>			30%		No substitution until next PCR	No substitution until next PCR
<b>Gassco</b>		Yes				
<b>BP</b>	No	No	At least 20%	50%		Yes, gradually reduced quantity held back.
<b>SSE</b>	No	No	20%	20%		Yes
<b>SP</b>	Yes	Yes			Place limit on aggregate across all ASEPs	Pilot scheme
<b>RWE</b>	2 years data	Yes	20%	20%		Yes, from next PCR.
<b>EE</b>	Yes	Yes			No substitution for 5 years at ASEP providing flexibility.	No substitution for 5 years at ASEP providing flexibility.
<b>STUK</b>			Increase	Yes		

3.45. Opponents to using forecast or historical values mention the possible adverse impact on the TBE process or changing supply patterns as reasons. However, supporters of TBE forecasts do not foresee upstream operators exaggerating their potential supply flows.

- 3.46. A number of respondents support an increase to the quantity held back from LTSEC auctions and would support a Licence change to facilitate it. Regardless of whether this quantity is revised there is support for withholding a quantity of capacity from the substitution process even though it would be available to Users in the LTSEC auction (at the relevant ASEP).
- 3.47. Most respondents expressed a preference for a degree of transition to introduce substitution processes. Three respondents (EE, RWE and BGSS) suggest that substitutions should not be undertaken for 5 years or until the next PCR.
- 3.48. National Grid's view.**
- 3.49. The relevance of this question arises from the outcome of the consideration of question 1. Should a strict interpretation of the substitution obligation be adopted then this question is irrelevant. However, if a more relaxed approach is taken then National Grid would seek to apply any restriction in a manner that would be:
- Transparent and simple to apply;
  - Non-discriminatory; and
  - Reflective, notwithstanding the absence of auction bids, of anticipated future capacity requirements.
- 3.50. National Grid has previously expressed concerns that the use of forecast flows could undermine the value of TBE process and that historic flows can be a poor indicator of future requirements, particularly in the context of declining UKCS supplies.
- 3.51. However, National Grid notes the views of respondents and will take these into account when developing the methodology further in the event that the Licence interpretation allows.
- 3.52. *Question 5 – This paragraph highlights the “single quarter” issue, whereby Shippers can “protect” capacity at an ASEP by booking capacity for a single quarter in a future year. National Grid does not propose any actions, at this time, to prevent Shippers making such capacity bookings. Do respondents consider this to be appropriate or should action be taken to limit single quarter bookings in the future? if so what action is considered appropriate?*
- 3.53. The majority of respondents recognise the potential for Shippers to obtain future capacity with the intent of protecting baselines from possible substitution, thereby retaining capacity at “their” ASEP for possible future commitments at later LTSEC auctions or to be accessed in short / medium-term auctions.
- 3.54. Despite recognising the problem, most prefer National Grid's approach which is to permit single quarter bookings (i.e. to do nothing) whilst monitoring bidding behaviour and to review at a later date to see whether action is necessary.
- EE “support National Grid's proposals”;
  - AEP agree “this issue should not be addressed at this time”;
  - SP agree that “National Grid should monitor .... but take no action at present”; and
  - CSL think National Grid's approach is “appropriate at the introduction of the regime”.
- 3.55. Other respondents justify their support for National Grid's approach.

- BGT believes “there are legitimate reasons why any User may want to book a single quarter” to match the seasonal pattern of flows”;
  - STUK agree that “shippers may book single quarters in a future year in such a way that reflects their genuine capacity needs”;
  - RWE considers that “booking a single quarter of capacity is a legitimate strategy”; and
  - BGGs think that “second guessing shippers’ motives for any particular pattern of capacity booking would not be helpful”.
- 3.56. The remaining respondents were in favour of more specific actions.
- GSC believes that because of the “major risk to new connections” the single quarter issue should be addressed “at the outset” such that “if this is to be prevented then all parties should be aware before decisions are made on the rules for substitution”.
  - Chev suggest that, if substitution is based on capacity bookings, Shippers “should be required to book capacity for a minimum of four quarters over two consecutive years”.
- 3.57. BP believe that “as capacity is only a small part of the overall cost of operating, shippers are less likely to be discouraged from taking part in this practice” (i.e. single quarter bookings to halt substitution). However, BP recognises that “using restrictive measures to prevent single quarter bookings is not only discriminatory, but would require further changes to the LTSEC rules and practices”. As a solution, BP feels that Ofgem discretion to question and veto single quarter Shipper bookings may provide a useful safety measure.
- 3.58. BGT also commented on the possibility of a surrender process which National Grid raised in earlier discussions and which BGT supported.
- 3.59. STUK and BP both said that they would welcome further discussion in this area.
- 3.60. National Grid’s view.**
- 3.61. National Grid appreciates the support for its current proposals. It has, in early discussions, highlighted the problem in preventing Shipper behaviour intended to undermine substitution at specific ASEPs. These include system issues, UNC modifications, and separating genuine capacity bookings from “blockings”. One option National Grid put forward was to facilitate capacity surrender. Upon further consideration it was recognised that facilitating surrender would not provide a solution to the problem of single quarter bookings as National Grid would not have the certainty that capacity would be surrendered many years in the future. In addition, surrender mechanisms would add a further level of complexity that would outweigh any benefit. However, National Grid accepts that this could be reviewed at a later date.
- 3.62. National Grid is willing to explore the “single quarter” issue further at a workstream meeting if a workable solution can be identified. However, this will be constrained by the existing timeline which requires formal consultation to commence no later than early November 2008. In the absence of further developments National Grid envisages progressing with the current proposals, i.e. it is anticipated that no UNC modifications will be raised to reject any Shipper capacity bookings covering a single quarter or other short duration.

- 3.63. *Question 6 - Considering that the substitution process is identical within and out-with zones, do respondents feel that the use of zones is beneficial? By dispensing with the within zone process the order in which donor ASEPs are identified may change slightly but may become less transparent.*
- 3.64. *Clarification note issues with respect to the use of zones*
- 3.65. *In respect of question 6 National Grid is asking for views on the benefit of using zones to group ASEPs as part of the substitution assessment process.*
- 3.66. *The draft methodology considers donor ASEPs primarily in order of increasing pipeline distance from the recipient ASEP. The variation from this principle is that donor ASEPs within the same zone as the recipient ASEP are considered before any ASEPs in other zones. Zones are groups of ASEPs that utilise common parts of the NTS and hence are considered by National Grid to offer more favourable exchange rates. As an example, Barrow as a recipient ASEP would consider Teesside, Glenmavis and St Fergus as donor ASEPs before the closer ASEPs at Fleetwood, Partington, Cheshire are considered.*
- 3.67. *National Grid is seeking views on whether a simpler methodology without zones, i.e. solely based on pipeline distances would be preferable.*
- 3.68. Respondents almost unanimously supported the continued use of zones. However, SP have a “concern that a product that has been acquired for many years and is allocated on a completely nodal basis should be subject to zonal arrangements”. SP “believe that the within-zone process could be dispensed with”.
- 3.69. All other respondents either supported the use of zones, citing the use of common assets within a zone, or queried the use of pipeline distances. Both RWE and EE consider pipeline distances too simplistic as it “does not take into account any measure of economic efficiency”. Disagreeing with SP, SSE point out that the “use of in-zone transfers first is likely to lead to more efficient exchange rates”.
- 3.70. In addition to supporting the use of zones to sequence potential donor ASEPs both CSL and BP believe that the commonality facilitates “pro-rating” of substitution across all ASEPs within a zone. This would provide a “fairer substitution process”.
- 3.71. A further development is suggested by STUK of “limiting substitution to within zones to avoid excessive capacity destruction” (see question 9).
- 3.72. National Grid’s view.**
- 3.73. Considering the support for the use of zones National Grid expects to retain them within the proposed methodology. National Grid will consider whether pro-rating of capacity across donor ASEPs within a zone can be achieved without adding excessive complexity. However, whilst agreeing that within zone substitutions will have similar exchange rates due to common infrastructure used, it would be incorrect to assume that all within zone substitutions will be achieved at the same exchange rate.
- 3.74. National Grid notes the suggestion from STUK that substitution should be limited to within zone. This would require an extremely loose interpretation of the substitution obligation and may be too restrictive, and potentially discriminatory, in some cases, e.g. single zone ASEPs.



3.75. *Question 7 – In order to create an order for assessment of multiple recipient ASEPs National Grid is proposing Licence Revenue Drivers (LRDs) as the assessment criteria. National Grid believes that the ASEP with the lowest LRD will facilitate more efficient substitution, i.e. less capacity needed from donor ASEPs. Alternative criteria could be used and National Grid would welcome alternative proposals. It should be noted that, in the absence of any constraints on capacity available for substitution, that if sufficient incremental obligated entry capacity is released, all available capacity, where beneficial, will be substituted regardless of the recipient ASEP order.*

3.76. BGGs, EE and RWE agree with National Grid's proposals. STUK and BP also offer support but STUK would welcome "further analysis" and BP question whether LRDs would be "reflective of the network" after the first year of substitution as LRDs would remain unchanged.

3.77. Two other respondents questioned whether it is appropriate to prioritise on the ASEP with the lowest LRD. SSE understands "that this will actually result in the highest possible investment cost" and AEP questions whether the use of the lowest LRD is consistent with the Licence obligation to minimise costs associated with funded incremental obligated entry capacity.

**3.78. National Grid's view.**

3.79. National Grid does not propose to amend the methodology for prioritising on the recipient ASEP with lowest licence revenue driver. The use of LRDs is purely a means to create a sequence for undertaking substitution analysis where there is more than one incremental capacity signal.

3.80. In practice there should be little difference between focusing on the lowest or highest LRD. Using the lowest LRD should result in more favourable exchange rates being achieved. This will result in more efficient use of available capacity increasing the possibility of capacity remaining for subsequent recipient ASEPs (at an inferior exchange rate). Using the highest LRD will reduce "higher cost" investment but will result in available capacity being exhausted quicker, due to the poorer exchange rate, hence resulting in more capacity need to be provided by (lower cost) investment.

3.81. The benefit of using lowest LRD is that it is more likely to result in fewer individual recipient ASEPs requiring investment. It would be reasonable to expect, if fewer, larger, investment projects are required, that these should be delivered more efficiently, at lower overall cost, due to the benefits of scale.

3.82. *Question 8 - Do respondents favour a rigid approach [to identify donor ASEPs] that requires National Grid to follow a set methodology regardless of the outcome, i.e. pipeline distance, or should National Grid have some discretion to select more favourable donor ASEPs?*

3.83. This question was raised specifically in relation to ranking potential donor ASEPs. However, some respondents have broadened their answers to cover the methodology in its entirety. Also, the question specifically asks for opinions on whether National Grid should have discretion to deviate from the detailed methodology. Respondents that consider discretion is necessary have, in some cases, suggested that this discretion should lie with Ofgem (see also question E).

- 3.84. There is no consensus evident from replies to this question.
- 3.85. Chev, BP, and SSE favour a rigid approach.
- 3.86. SP and RWE favour more discretion. RWE believes that “this could be achieved by placing criteria into the methodology statement”. EE “believe National Grid should take into account other factors”.
- 3.87. BGGS and AEP also favour more discretion but would look for review and possible veto by Ofgem. GSC ask whether National Grid would be audited on how it uses any discretion.
- 3.88. Conversely, BGT favour “a tighter methodology combined with increased powers for Ofgem”.

**3.89. National Grid’s view**

- 3.90. National Grid recognises the tension between:
- a rigid methodology that is transparent, simple to apply and offers minimal opportunities for discrimination or disputes, but might lead to unforeseen and potentially inefficient outcomes; and
  - a flexible approach that, whilst allowing adjustment to avoid inefficient outcomes, would be open to challenge which could eat into already tight timescales for submission of incremental entry capacity proposals to Ofgem.
- 3.91. National Grid is concerned that there is insufficient time between the close of the LTSEC auction and the submission by National Grid of its incremental entry capacity proposals to Ofgem for any debate on the outcomes. Any delay to submissions may result in incremental capacity not being allocated. However, National Grid will consider whether additional rules can be defined that provide National Grid with greater flexibility to assess substitution opportunities.
- 3.92. *Question 9 – Following on from Q1, although the current draft methodology does not place any restriction on the quantity of capacity that can be substituted. National Grid would welcome views on alternative approaches and how these may better meet National Grid’s licence obligations.*
- 3.93. *Alternatives that National Grid believe merit consideration include (respondents may propose further alternatives);*
- *an exchange rate cap. It should be recognised that this option would not prevent all capacity being substituted away from a donor ASEP even with a 1:1 exchange rate cap. In the event that an exchange rate cap is considered appropriate:*
    - *how should the level be determined? What should be the level of an exchange rate cap?*
    - *Should a cap be applied in aggregate across all donor ASEPs or for each recipient/donor ASEP combination?*
    - *Are there any scenarios where different caps should apply?:*
  - *limiting substitution to within zone only. Although such a limit is likely to ensure that only reasonable exchange rates are generated it could also severely limit the scope for substitutions, particularly in zones with few ASEPs (e.g. Theddlethorpe, West UK zones):*

- *reducing all potential [within zone] donor ASEPs together by equal amounts (% or mcmd) instead of exhausting donor ASEPs in sequence. It should be recognised that a sufficiently high level of signalled incremental capacity would still exhaust all potential donor ASEPs under this option. However, where all donor ASEPs are not exhausted the outcome would be sub-optimal substitutions, i.e. less favourable exchange rate overall. This option is also likely to be more complicated to undertake; an important issue considering the limited time that National Grid has to assess investment and substitution proposals.*
- 3.94. *These potential measures should be considered as a way of “managing” the use of substitutable capacity. This differs from, and is complementary to, the options in Q4, which limit the quantity of capacity available for substitution.*
- 3.95. *Clarification note with respect to Donor ASEP merit order*
- 3.96. *Question 9 presents possible options for placing a restriction on the quantity of available capacity that is substituted, e.g. by applying an exchange rate cap. A further option is to consider several (or all) potential donor ASEPs together rather than in sequence; thereby sharing the impact across donor ASEPs. National Grid suggests that this could lead to a sub-optimal solution, i.e. some donor ASEPs that offer a less favourable exchange rate would be used before more favourable ASEPs are exhausted. National Grid recognises that the “sharing” principle would not lead to sub-optimal solutions where the donor ASEPs considered simultaneously gave the same exchange rate, however this would not be known until the analysis was undertaken.*
- 3.97. *Notwithstanding this, National Grid would appreciate views on whether grouping donor ASEPs for analysis would be a preferred option. Respondents may wish to consider any rules that might be applied for grouping donor ASEPs, e.g. limited to zones.*
- 3.98. Most respondents expressed concerns at the possibility of excessive loss of capacity through substitution and supported approaches to limit any losses. The majority of responses focused on exchange rate caps with additional references to placing limits on potential donor ASEPs.
- 3.99. The only opposition to an exchange rate cap came from BGT who “do not now support a cap” and BP who believe any rate cap would be “totally arbitrary, and may be beneficial for one ASEP but not another. This is not only discriminatory, but also inconsistent with the economic and efficient objectives of the substitution process”.
- 3.100. SSE favour an exchange rate cap but do not specify a value except that it should be lower than the 10:1 used for Transfer and Trades. STUK believe a cap would “minimise some of the risk” of substitution and suggest 1:1. CSL also believe “an exchange rate cap would be prudent” but, recognising that “the same cap may not be suitable” for all ASEPs, do not specify a value. Chev is concerned to avoid “significant destruction of aggregate baseline capacity” and believe an exchange rate cap “in the region of 1:1 is not unreasonable”. GSC agree and propose a rate of “1:1 or very close”. AEP favour “initially a cautious approach” and suggest “an exchange rate cap in the low single figures”. BGGs and IUK also favour a cap without specifying a value.

- 3.101. In addition to an exchange rate cap STUK are in favour of limiting substitutions to within zone only, believing that such a limit would “avoid excessive capacity destruction”. However, both SSE and BGT are opposed to restricting substitution to within zone only.
- 3.102. SP are in favour of “reducing all potential donor ASEPs together by equal amounts” However, SSE oppose sharing substitution across all donor ASEPs. Neither makes any comment regarding sharing across all within zone donor ASEPs, but BP are in favour of pro-rating from each donor ASEP within a zone. RWE note that “certain ASEPs are more vulnerable to being donor ASEPs than others simply due to where they are located”. This leads RWE to also favour sharing across donor ASEPs.
- 3.103. BGGs want to “prevent individual ASEPs from taking all the “hit”” and suggest limits on how much capacity can be substituted from individual donor ASEPs or discretion on the choice of donor ASEP.
- 3.104. National Grid’s view.**
- 3.105. The outcome of this issue is also dependent upon National Grid and Ofgem’s consideration of “economic and efficient” in respect of the substitution obligation. National Grid agrees with BP that, in taking a strict interpretation of the substitution obligation, any exchange rate cap, or any other restriction, would be contrary to the substitution objective to minimise investment costs. However, assuming a more relaxed approach is justified one or more of the suggestions could be progressed.
- 3.106. National Grid recognises the majority favour an exchange rate cap to ensure excessive loss of total system capacity is avoided and the preference for a gradual introduction to the substitution processes.
- 3.107. National Grid is concerned that application of an exchange rate cap could have inconsistent results. In some donor/recipient ASEP pairs a 1:1 cap would prevent any substitution from being undertaken whilst for other combinations the same cap could see the substitution of all available capacity. Clearly these two scenarios do not either; align to the intent of the substitution policy to reduce (“minimise”) investment, nor meet Shipper concerns to avoid excessive capacity loss at donor ASEPs.
- 3.108. Whilst not dismissing an exchange rate cap, Shipper concerns may be better addressed through limiting capacity available for substitution (question 4).
- 3.109. National Grid also recognises concerns that some ASEPs may take all the “hit” and that substituting all available capacity from an individual donor ASEP before considering other ASEPs may be considered discriminatory. Hence it may be appropriate to pro-rate across multiple donor ASEPs. National Grid considers that pro-rating across all donor ASEPs would be inefficient but pro-rating across all within zone donor ASEPs may be acceptable due to exchange rates being similar across all donor/recipient pairs. However, in considering any process that includes pro-rating National Grid would seek to avoid introducing excessive complexity.
- 3.110. *Question 10 – Do respondents agree with this transitional rule [in respect of new ASEPs]?*

- 3.111. All 11 respondents to this question favoured excluding substitution from stand-alone auctions for new ASEPs until after a regular LTSEC auction has been held whereby Shippers at all ASEPs would have an opportunity to obtain capacity at “their” ASEP.
- 3.112. **National Grid’s view** – see below.
- 3.113. *Supplementary question 11 – Question 10 asks respondents for views on whether a transitional rule excluding stand-alone auctions for new ASEPs should be applied. This would mean that capacity would not be available to be substituted from an ASEP until Shippers at that ASEP had had an opportunity to obtain it. National Grid would welcome views on whether this proposed transitional rule should be a permanent rule. For the avoidance of doubt, incremental capacity requests at new ASEPs in the “regular” QSEC auction would initiate the substitution process.*
- 3.114. Six respondents (SSE, STUK, CSL, Chev, GSC, and BGGS) were in favour of the new ASEP rule being made permanent. The main argument being that all capacity could be substituted from an ASEP without incumbent Shippers having an opportunity to obtain that capacity first.
- 3.115. However BP is against a permanent rule “to ensure that all ASEPs are treated without discrimination” and RWE agree as after the initial “substitution QSEC” “system users will understand the potential risk in subsequent auctions”.
- 3.116. National Grid’s view.**
- 3.117. National Grid intends to progress with the transitional rule as proposed.
- 3.118. However, National Grid does not support extending this to a permanent rule. Substitution is a response to Shipper requests for incremental capacity. As a significant proportion of these requests could occur at new ASEPs it would appear contrary to the intent of the substitution principle to apply a permanent restriction on a significant proportion of substitution opportunities. Provided the transitional rule is applied, Shippers will have an opportunity, at the regular QSEC auction, to obtain capacity at an ASEP before it can be substituted to a new (or existing) ASEP.
- 3.119. *Supplementary question 12 – In addition to the proposal for new ASEPs, do respondents consider it necessary to apply any other transitional rules? And over what timeframes would the transitional rules apply?*
- 3.120. No specific transitional rules were raised except that substitution should be phased in. This would increase understanding of the possible effects of substitution before high levels of substitution are undertaken, thereby allowing the methodology to be adapted to avoid excessive loss of capacity.
- 3.121. Potential areas for phasing would be:
- a gradual increase in an exchange rate cap;
  - a gradual decrease in the quantity not made available for substitution;
  - temporary rules on use of forecast or historic flows; or
  - a gradual relaxation of discretionary powers (whether with National Grid or Ofgem).

**3.122. National Grid's view.**

- 3.123. National Grid has an obligation to review the substitution methodology at least annually. It is not appropriate therefore to include "phasing" rules within the methodology. Instead, the methodology should include rules that are appropriate at the time. At each annual review rules can be relaxed or tightened depending upon industry views based on the previous year(s) experience.

## 4. Detailed Responses - General Questions

- 4.1. At the fourth substitution workshop held on 9th July 2009 National Grid presented and expanded upon the questions that it had raised in the discussion document. The meeting thought that it would be useful if National Grid also sought views on a number of additional issues. Although these relate to wider policy issues outside the scope of the discussion document; i.e. to seek views on the substitution methodology, National Grid agreed to seek and record views on these additional issues. The questions raised and responses are presented below. As these questions fall outside the scope of the discussion document National Grid has not added any further comments.
- 4.2. *Question A – Ofgem have indicated that they may undertake an Impact Assessment (“IA”). A decision has not yet been taken on whether to undertake an IA or, if one is undertaken, the scope. Workshop participants believed that it would be useful, in informing Ofgem’s decision making, to gather industry opinion. Hence National Grid would welcome views on whether an IA is needed before capacity substitution is implemented and what the scope of an IA might include.*
- 4.3. There is overwhelming support for Ofgem to undertake an IA before implementation of the entry capacity substitution policy. For example:
- SSE, Chev and CSL believe it is “essential” or “imperative”;
  - SP “strongly believe that an impact assessment should be undertaken”
  - BP refer to the Utilities Act 2000 and BERR’s Better Regulation principles in suggesting that an IA should be an integral part of the implementation procedure of Entry Capacity Substitution.
- 4.4. The scope identified by respondents for an IA are wide and varied, and include:
- Commodity prices, security of supply, operating costs and the wider network including Exit – SSE
  - Costs to individual holders of capacity, the effect on prices by the addition of potential new participants in the capacity allocation regime, the impact on recovery and re-distribution, and the qualitative impacts on security of supply, the development of long-term competition and innovation/new entry - SP
  - Long term implication for the system – STUK
  - The IA should consider a range of approaches (not just “fast and furious”) to substitution and should include a cost benefit analysis of each..... the IA needs to determine the value of flexibility within the NTS and how does the tightening of the network impact on commodity prices - CSL
  - The effect of other recent changes to the entry regime (adjustment of baselines, capacity Transfer and Trades, reduction in capacity withheld from QSEC auctions, etc) – Chev
  - The IA must include an analysis of the costs and benefits. This should cover the impact on consumers, including expected gas price movements, as well as on competition in the GB market. It is clear that a focus on risks and uncertainties is required, including highlighting and assessing possible unintended consequences – BP
  - the cost to GB consumers resulting from the risk of capacity being unavailable to import gas on a peak day, as well as the narrow focus of investment efficiency – RWE
  - the relative merits of substitution and investment, competition in gas supply and security of supply including prices both in the near future but

also beyond the 5-10 year normal planning horizon, the potential impact on the availability of exit capacity especially close to entry points that may be donor ASEPs, impacts on the availability of linepack which could restrict NG's operating envelope, impact efficient system operation and the management of customer demand profiles – AEP

- the consequences on all foreseen developments taking into account projects, supply sources and regulatory change – GSC
- the impact on UK gas market if there is insufficient firm capacity at Bacton / Teesside – EE
- the cost to consumers resulting from the risk of capacity being unavailable to import gas on a peak day; the impact on new projects such as storage projects, UKCS fields and connections to other sources of supply (e.g. pipelines to Norway, interconnectors, LNG); and the impact on the traded wholesale markets. It should address the concerns raised by Shippers in response to this and other consultations, and the concerns raised in the workshops – BGGs.

- 4.5. *Question B – In the workshops, and specifically in question 1, reference has been made to “economic and efficient“. National Grid has interpreted this from a system perspective, i.e. a low exchange rate would be considered economic. Also, the avoidance of the need for investment through substitution, even if this was as a result of a much higher exchange rate, would be considered economic. An alternative view would be that to substitute capacity from an ASEP when that capacity may be required in a subsequent LTSEC auction would be uneconomic. In addition, “economic and efficient” could be viewed from a wider perspective, e.g. how it impacts on UK plc (see C and D). National Grid would appreciate views on what criteria could be included in any assessment of “economic and efficient” in respect of substitution.*
- 4.6. Consistent with comments made in question 1 (interpretation of the substitution obligation) respondents to this question see “economic and efficient” in a wider context covering the whole operation of the gas market. Some respondents recognise the conflict between “system efficiency” and “market efficiency” and seek a compromise, possibly through a role for Ofgem.
- 4.7. CSL considers the merits of both “economic” and “efficient” and understands that the optimum solution is the one which is “economically efficient”, i.e. one that provides the best exchange rates but shares the burden through pro-rating. “This is non-discriminatory and seeks not to strand potential new gas supply assets”.
- 4.8. BP feel that both views mentioned by National Grid need to be considered. This is why they are against restrictions on substitution but in favour of Ofgem intervention to prevent unintended consequence.
- 4.9. RWE believe economic and efficient should look at wider effects, such as market volatility, security of supply and barriers to entry.
- 4.10. EE believes that whilst BERR is promoting investment in gas storage and gas power generation it make no sense at all to be reducing investment in the NTS. In their response RWE also referred to “investment efficiency”.
- 4.11. BGGs refers to its comment on the flawed assumption that un-booked capacity will not be used. Hence account should be taken on the “wider functioning of the gas market”.



- 4.12. *Question C – In the workshops National Grid has demonstrated how the methodology might materialise in terms of reduced availability of capacity at donor ASEPs. Respondents are encouraged to identify whether, and to what extent, substitution will impact on security of supply.*
- 4.13. Many respondents expressed concerns relating to the potential adverse effects of substitution on security of supply. Few were able to quantify the extent of such affects. An overall view is perhaps best illustrated by the comments from BGGs:
- 4.14. *“As currently drafted, the proposed substitution mechanism could impact security of supply in the following ways:*
- *By preventing the flow of gas into the UK on peak days because there are no capacity rights available at interconnector terminals or at other entry points linked to flexible sources of supply;*
  - *By undermining or delaying the viability of incremental UKCS reserves;*
  - *By adversely impacting the timing of new infrastructure projects and thereby threatening their viability; and*
  - *By undermining the competitiveness and liquidity of the wholesale gas market by making it difficult for new players or project accessing the market. (In effect replicating the same type of conditions that have prevented the emergence of competitive markets in continental Europe).*
- The problem with the current approach is that it reduces flexibility in the system by artificially restricting capacity rights even though the physical pipeline network remains the same.”*
- 4.15. RWE note that “whilst substitution will not alter the physical capability to flow gas at an ASEP the uncertainty ..... could adversely impact security of supply”. Having to secure capacity on an ad hoc discretionary or interruptible basis could increase the likelihood of an emergency occurring. EE also refer to emergencies, commenting that “it is clearly inappropriate to be increasing the risk of a supply shortfall by taking away spare capacity at Bacton and Teesside which are the main ASEPs with capability to bring in additional gas at times of high demand or following supply failures elsewhere.”
- 4.16. CSL comment that whilst there is a need for more storage and gas supply it would be an error if substitution restricted these developments. CSL add that “it is important that a positive investment climate is maintained”.
- 4.17. BP repeat the comment that loss of supply flexibility could damage security of supply. However, they expand with “heightened uncertainty and risk would result in more long term bookings further removing flexibility and harming competition”.
- 4.18. *Question D – National Grid has provided through the workshops examples of how substitution may impact on entry capacity charges. However, workshop participants have suggested that substitution may have a greater impact on gas prices to the consumer. National Grid would welcome views on whether consumer prices will be affected by implementation of the methodology as currently drafted.*
- 4.19. *Respondents are requested to provide a rationale for their views and should attempt to quantify any impacts.*

- 4.20. Few respondents addressed this question specifically. BP believes that “it is near impossible to fully quantify the impact due to the complexity of the issues”. They and BGGs reiterate that this should be addressed as part of an IA.
- 4.21. BGGs, BP, EE and CSL each comment on the effect on marginal supplies, reduced flexibility, loss of firm capacity, and a tightening of the network (all broadly similar criteria) increasing risk for which a premium may be paid which will in turn increase end-user prices.
- 4.22. RWE notes that “the GB market has already experienced the consequences that can arise from a failure or delay in importing gas during times of supply/demand tightness and it is not unreasonable to assume that such occurrences could increase” with substitution.
- 4.23. *Question E – Following the QSEC auction National Grid will assess whether it has received a signal to release incremental entry capacity. Where there is a signal, National Grid will determine, in accordance with the substitution methodology, whether to meet the incremental requirement through substitution or investment. National Grid will then, as required by its licence, submit its proposals to Ofgem for approval. Ofgem has limited scope to reject the proposals: specifically where Ofgem believes that National Grid has not followed the methodology. Some workshop participants considered that the draft methodology may lead to unexpected consequences, which National Grid and Ofgem would be obliged, having adhered to the methodology, to accept. National Grid would welcome views on whether Ofgem should use discretion to over-rule National Grid’s proposals for release of incremental obligated entry capacity. It should be noted that National Grid has limited time to submit its proposals to Ofgem. Hence any revisions required as a result of Ofgem using its “discretionary” powers to veto could result in capacity allocation not being made.*
- 4.24. In addition to earlier comments on Ofgem discretion to veto certain substitution proposals a number of respondents added further comments.
- 4.25. Each recognised that providing Ofgem with discretion to over-rule National Grid’s proposals would require discussions with National Grid which could not be accommodated within the current timetable for notification of capacity allocations. In response EE favours a less “time constrained process” and RWE would “accept delays in the allocation time table” provided that this led to more credible outcomes. Both, plus BGGs, BP and CSL suggest that the LTSEC timetable (or Licence) could be reviewed<sup>1</sup> to facilitate further iteration between National Grid and Ofgem. Discretionary powers for Ofgem to over-rule potentially destructive proposals would further justify extending the LTSEC timetable.
- 4.26. BP raises a further concern with providing Ofgem with greater discretion to veto National Grid’s proposals. They ask what criteria Ofgem would use to assess good or bad allocations, suggesting that such discretion should be used as a last resort and might be subject to appeal.

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<sup>1</sup> This would probably require an increase in the default lead-time for release of incremental capacity with associated changes to the Licence and UNC.

## 5. Alternative BGT Proposal

- 5.1. The main concern expressed in responses and in the workshops is for the possible consequences resulting from the loss of capacity at donor ASEPs. Although there is support for the principle of substitution of “un-needed” capacity the problem arises with the definition of “un-needed” as discussed above. The problem materialises when Shippers at the donor ASEP wish to access capacity that is no longer available. In this situation the Shippers need to trigger incremental entry capacity at the donor ASEP. This will be in accordance with the IECR and will be subject to the NPV test and 42 month default lead-time.
- 5.2. BGT have identified this as a key concern and put forward a proposal to address this issue. Their proposal is reproduced below.
- 5.3. *“One of our concerns is the IECR signal which is required in order to restore capacity which has been substituted away from an ASEP. One approach which we believe deserves consideration is that the capacity which has been substituted away is removed from the months concerned on a rolling basis i.e. the substitution initially affects the results for months 43 to 54 of a LTSEC auction and the baseline is adjusted in all subsequent auctions involving those months (LTSEC, AMSEC, RMTTSEC and daily auctions). For months 55 onwards, however, the capacity would still be available at P0 in LTSEC auctions. Months 55 to 66 become months 43 to 54 in the next LTSEC auction and if the substituted capacity is not booked then the baseline is adjusted in all subsequent auctions involving those months and so on. Only if the capacity is booked in a LTSEC auction can the original IECR signal which gave rise to the substitution be used in order to activate either investment or an alternative substitution as appropriate.*

*The advantage of this approach is that it removes the uncertainty surrounding capacity availability while ensuring that inefficient investment does not need to ever take place if the 42 months lead time rolls forward by 12 months each time the capacity is not booked in LTSEC auctions. This should ensure that the maximum benefits of substitution are still captured.”*

- 5.4. This proposal can be broken down into stages as follows:
- a. An incremental capacity signal is received in LTSEC 1 at the recipient ASEP “A” and capacity is substituted from the donor ASEP “B”.
  - b. For the first year of substitution (months 43 to 54) the available capacity is adjusted at both ASEPs in the AMSEC etc.
  - c. In LTSEC 2 Shippers at ASEP B can signal a requirement for capacity up to the level available in LTSEC1, i.e. before substitution. This capacity can be obtained at reserve price without the need to pass the NPV test. The investment (if any) at ASEP B is justified on the back of the initial user commitment (NPV test) at ASEP A.
  - d. If no capacity is booked at ASEP B in LTSEC2 the opportunity to obtain capacity without the NPV test falls away, i.e. NPV test applies in LTSEC 3.

### 5.5. National Grid’s view.

- 5.6. Application of the substitution principle is extremely complex and contentious. National Grid welcomes proposals from Shippers that can mitigate some or all of the issues arising.

- 5.7. National Grid notes that the proposal from BGT will allow Shippers an opportunity to respond, i.e. to regain “their” capacity, after it has been substituted away. This should remove the need for Shippers to obtain capacity long-term, possibly before upstream projects are proven. Shippers at “swing” ASEPs would only need to respond if their capacity is substituted away.
- 5.8. The proposal has the advantage of reducing the commitment required to regain capacity. Hence marginal projects that could become unviable if the NPV test needs to be passed would not be undermined.
- 5.9. However, the proposal does not address the lead-time issue. When Shippers obtain capacity at ASEP B in step c this will only be available from 42 months, i.e. 1 year after it has been substituted to ASEP A. Hence Shippers at ASEP B would have to rely on discretionary release, Transfer and Trades or interruptible capacity for that one year. This is unlikely to be satisfactory to Shippers at Bacton, Teesside etc (see comments from EE).
- 5.10. The alternative would be to release capacity at ASEP B (following LTSEC 2) after 30 months. However, this would expose National Grid to obligations at both ASEPs without sufficient time to install adequate capacity. Whilst National Grid will release capacity after 30 months, where viable, this would be non-obligated capacity and would provide no certainty to Shippers.
- 5.11. At the substitution workshops National Grid has demonstrated how substitution will impact on reserve and incremental step prices. The alternative proposal states that capacity can be regained at the donor ASEP at reserve price. However, it is not clear whether this is the initial reserve price or a reduced reserve price, consistent with the reduced obligated level. Intuitively, it is the initial reserve price that appears logical, but this would be inconsistent with the revised (increased) reserve price at the recipient ASEP. This is further complicated by the need to produce incremental price steps, which could increase capacity above the original baseline level.
- 5.12. Whilst these pricing issues are not insurmountable they add further complexity to LTSEC and substitution processes, which is unlikely to be appreciated by most Shippers.
- 5.13. Whilst National Grid accepts that this alternative proposal addresses the capacity cost aspect of a key industry concern with substitution, it is concerned that it is unable to address the lead-time problem. Hence, National Grid concludes that the benefits would not out-weigh the additional complexity created to LTSEC processes. National Grid does not consider it appropriate to progress this proposal further at this time. However, should a solution to the lead-time issue be identified further consideration may be justified.

## 6. Way Forward

- 6.1. Currently National Grid is obliged to submit its proposed Entry Capacity Substitution Methodology Statement to the Authority for approval by 6<sup>th</sup> January 2009. This requires formal consultation with the industry to commence no later than early November 2008.
- 6.2. In addition, National Grid is required to “use reasonable endeavours” to have an approved methodology statement in force by 6<sup>th</sup> April 2009.
- 6.3. As it is the Authority that provides approval National Grid interprets “reasonable endeavours” as requiring National Grid to obtain a reasonable level of consensus with Ofgem prior to submission. Hence an agreed (between National Grid and Ofgem) interpretation of the Licence is critical to progression of the substitution methodology.
- 6.4. National Grid will continue to engage with Ofgem to reach agreement on the meaning and intent of the substitution objective to minimise the costs associated with funded incremental obligated entry capacity and how this fits with wider obligations to operate in an efficient and economic manner.
- 6.5. Resolution of this issue will allow National Grid (and Ofgem) to consider how (and whether) capacity available for substitution should be limited (question 4) and inefficient substitutions should be prevented (question 9).
- 6.6. Subject to time constraints National Grid intend to report on progress at Transmission workstream meetings prior to commencing the formal consultation.

## Appendix A: Relevant Licence Section

**Special Condition C8A** contains the following defined term:

entry capacity substitution

means the process by which unsold non-incremental obligated entry capacity is moved from one or more NTS entry points to meet the demand for incremental obligated entry capacity at another NTS entry point, in accordance with the obligations set out in paragraph 10 of Special Condition C8D;

**Special Condition C8D: NTS gas entry incentives, costs and revenues** (as amended by Direction of the Authority dated 3 March 2008) includes

10. Entry capacity substitution obligation

(a) The licensee shall:

(i) by no later than 6th January 2009:

(aa) prepare an entry capacity substitution methodology, in such manner that is necessary to facilitate the achievement of the entry capacity substitution objectives (as set out in paragraph 10(c) of this condition), which the licensee shall apply for the purposes of fulfilling its obligations in respect of entry capacity substitution; and

(bb) submit to the Authority for its approval a statement setting out the methodology prepared in accordance with paragraph 10(a)(i)(aa) of this condition (“the entry capacity substitution methodology statement”);

(ii) use reasonable endeavours to have in force, by no 6th April 2009, an approved entry capacity substitution methodology statement.

(b) The licensee shall, unless and insofar as the Authority may otherwise direct from time to time in writing, use reasonable endeavours to substitute entry capacity in accordance with the approved entry capacity substitution methodology statement prepared pursuant to paragraph 10(a) of this condition, as may be modified from time to time in accordance with paragraph 10(e) of this condition.

(c) For the purposes of paragraph 10(a)(i)(aa) of this condition, the licensee shall use reasonable endeavours to ensure that the entry capacity substitution methodology facilitates the achievement of the following objectives (the “entry capacity substitution objectives”):

(i) ensuring that entry capacity substitution is effected in a manner which minimises the costs associated with funded incremental obligated entry capacity;

(ii) ensuring that entry capacity substitution is effected in a manner which is compatible with the physical capability of the pipeline system to which this licence relates;

(iii) avoiding material increases in the costs (including entry capacity constraint management costs in respect of obligated entry capacity previously allocated by the licensee to relevant shippers) that are reasonably expected to be incurred by the licensee as a result of substituting entry capacity; and

(iv) in so far as is consistent with (i), (ii) and (iii) above, facilitating effective competition between relevant shippers and between relevant suppliers.

(d) For the purposes of paragraph 10(a)(ii), the entry capacity substitution methodology statement shall be deemed approved from the earlier of:

- (i) the date of receipt of a notice by the licensee from the Authority approving the entry capacity substitution methodology statement; or
- (ii) the date being two months after the entry capacity substitution methodology statement was submitted to the Authority, unless the Authority otherwise directs the licensee (such direction to be made within two months of the receipt by the Authority of the entry capacity substitution methodology statement) that the entry capacity substitution methodology statement has not been approved.

(e) The licensee shall, if so directed by the Authority, and in any event at least once a year, review the entry capacity substitution methodology set out in the entry capacity substitution methodology statement in force, in consultation with relevant shippers and interested parties and seek to make such modifications to the entry capacity substitution methodology as it considers reasonably necessary to better meet the entry capacity substitution objectives set out in paragraph 10(c) of this condition.

(f) Except where the Authority otherwise directs in writing, before submitting the entry capacity substitution methodology statement pursuant to paragraph 10(a) of this condition or before modifying that statement, the licensee shall:

- (i) when modifying its entry capacity substitution methodology statement, send a copy of the proposed modifications to the Authority and to any person who asks for one;
- (ii) consult relevant shippers and interested parties and allow them a period of not less than 28 days, which for the avoidance of doubt may commence before the date on which the Authority issues a decision giving effect to this licence condition, in which to make representations;
- (iii) within 14 days of the close of the consultation referred to in paragraph 10(f)(ii) of this condition submit to the Authority a report setting out:
  - a. the modifications originally proposed (if any);
  - b. the representations made by relevant shippers or interested parties (if any) to the licensee and not withdrawn; and
  - c. any changes to the modifications proposed as a result of such representations;
- (iv) where the Authority directs that sub-paragraphs (i), (ii) and (iii) of this paragraph or any of them shall not apply, comply with such other reasonable requirements as are specified in that direction.

(g) The licensee shall be entitled to modify its entry capacity substitution methodology statement at any time pursuant to paragraph 10(e) of this condition, save that it shall not modify such statement:

- (i) if within 28 days (or 3 months if the Authority intends to undertake an impact assessment, the intent of which the Authority shall notify the licensee in writing within a reasonable time after receiving the report referred to in paragraph 10(f)(iii) of this condition) from the date on which the Authority receives the report referred to in paragraph 10(f)(iii) of this condition the Authority directs the licensee not to make the modification; or
  - (ii) where there is no such direction, until the expiry of 28 days (or 3 months if the Authority intends to undertake an impact assessment, the intent of which the Authority shall notify the licensee in writing within a reasonable time after receiving the report referred to in paragraph 10(f)(iii) of this condition) from the date on which the Authority receives the report referred to in paragraph 10(f)(iii) of this condition;
- or

(iii) where paragraph 10(f)(iv) in this condition applies, before the day specified in any direction made pursuant to that paragraph.

(h) The licensee shall make the entry capacity substitution methodology statement from time to time applicable to the pipeline system to which this licence relates available on its website (and in such other manner as appears to the licensee to be appropriate).