



4 August 2008

Andrew Fox
NG House
Warwick Technology Park
Gallows Hill
Warwick
CV34 6DA

Dear Andrew

**BG Gas Services Limited Response to Consultation on Entry Capacity Substitution
Methodology Statement Discussion document.**

BG Gas Services Limited ("BG") welcomes the opportunity to comment on National Grid's ("NG") discussion document. The document is helpful in that it highlights a number of issues that need to be considered in developing a substitution mechanism. We welcome the opportunity to comment on a draft methodology statement when there is still the opportunity for the methodology to be amended prior to the formal approval process by Ofgem. The workshops held by NG have also been helpful in exploring the potential impacts of substitution.

However it is unfortunate that many of the issues raised in this consultation simply repeat the concerns that have been raised in previous consultations on Substitution (for example in August 2007 and in February this year). It has become clear that this is as a result of the way the current Licence Obligation is drafted. NG has put forward its interpretation of how the Obligation should be interpreted, and explained that it is obliged to implement its Licence obligations. Many shippers, including BG, have raised concerns as to the effect that NG's interpretation and implementation of its Licence conditions will have on the entry capacity regime, and the wider UK gas market. NG's response has been that such concerns are about the policy of substitution which it cannot change and which Ofgem has said will not change, not about its implementation. Despite several requests Ofgem has not given any indication as to whether NG's interpretation is correct, or indeed if it shares any of the concerns raised by shippers.

This has meant that the workshops were not able to discuss alternative ways of implementing substitution because of NG's view that they would not be compatible with its Licence obligations. NG's approach is understandable as it faces legal sanctions if it does not obey its Licence obligations. However, in the absence of any feedback from Ofgem, it means that the industry is left facing a proposed substitution mechanism which is seriously flawed, and the industry has not been able to develop viable alternatives. This is particularly worrying given the desire of Ofgem to implement substitution early in 2009. The difficulties in developing substitution highlight the problems of developing policy (i.e. drafting licence conditions) in the absence of detailed discussions as to how such a policy can be implemented. This is a point we have raised elsewhere and we would urge NG and Ofgem to take this into consideration when developing policy in the future. We would also urge that the concerns and issues raised by shippers should be fully considered in an Impact Assessment conducted by Ofgem. We

BG Gas Services Limited
Thames Valley Park
Reading Berkshire
RG6 1PT UK
www.bg-group.com
Tel 0118 929 3442
Fax 0118 929 3273
alex.barnes@bg-group.com

believe it desirable that Ofgem engage consultants to analyse the various concerns raised by examining the potential benefits of investment saved in certain scenarios against the potential costs in terms of lost flexibility or adverse impacts on the wholesale gas market. Ofgem should also clearly set out when it expects Substitution to be implemented because of its impact on shippers' bidding strategies at future QSECs.

In a number of answers we refer to previous responses to consultations. Specifically these are

- "BG Gas Services Limited Response to Consultation on Entry Capacity Substitution" 29th February 2008
- "BG Gas Services Limited Comments on Proposals for the Treatment of "Spare / Sterilised" Capacity" 31st August 2007.

These are attached. We do not believe the concerns or proposals we have made in these responses have been adequately addressed by either Ofgem or NG, and would ask that they are considered when reviewing responses to this latest consultation.

Our views on the current proposals for substitution can be summarised as follows:

- The proposal is flawed because it makes the assumption that capacity not booked in the QSECs will be sterilised. This is not the case. Implementation of the proposal will have an adverse impact on the UK gas market.
- If NG's interpretation of the current Licence conditions regarding substitution is correct, then the drafting of the Licence is flawed. Ofgem should consider redrafting the Licence to enable a more practical substitution mechanism to be put in place. This should include consideration of other Licence conditions (e.g. the hold back of 10% of capacity for short term auctions should be increased).
- The amount of capacity that may be used for substitution should be limited based on some or all of the following:
 - An exchange rate cap to limit the degree of capacity destruction;
 - A limit of the amount of capacity that can be substituted away from any single individual ASEP;
 - A review of likely future needs for capacity at an individual ASEPs to take account of factors other than the capacity booked in the QSEC auctions;
- There should be consideration of how targeted investment can increase flexibility in the system. For example investment in a few key points on the system could increase overall flexibility at small cost but without being attributable to an individual ASEP;
- Review of NG's substitution and investment decisions by Ofgem should be taken over a longer time period e.g. at a Price Control Review. This will require Ofgem to have sufficient understanding of NG's network model, something which it has said currently does not have.
- Ofgem will need to be able to audit NG's decisions with regard to the exchange rates used when substituting capacity, because of the discretion NG has in calculating exchange rates. Again this will require Ofgem to have expertise in understanding NG's network model.

Our detailed answers to your questions are below.

Q1 - 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.

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.

Notwithstanding the subsequent questions raised in this document, National Grid would welcome views on whether its interpretation is appropriate.

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.

Firstly NG's approach assumes that simply because capacity is not booked in long term auctions, any un-booked capacity is “unused” and therefore “sterilised”, and hence should be substituted. This takes no account of either the price drivers that have affected shippers booking strategies or that shippers may only wish to book in the shorter term when relative market prices make it economic to do so.

For example potential users at the Interconnector, may wish to book capacity in the short term when relative price differences between continental European markets and the NBP make it worthwhile to import gas into the UK. As various European Commission and ERGEG reports have shown that it is difficult to source gas and transportation capacity in mainland Europe in order to move the gas to the Interconnector. A policy of substitution which removed the ability to book UK entry capacity in the short term would have the effect of deterring marginal supplies of gas just when it was most needed to prevent prices rising further. Given the difficulties in sourcing gas and transportation capacity on the continent, and the tight margins when arbitraging between markets, it is hard to see why companies would book capacity in the QSEC auctions and commit to pay for quarterly capacity when they face uncertainty as to how often they will use such capacity, and what margin they will make. Instead it will be end consumers who will suffer if supplies of gas into the UK are constrained at the margin.

We have already explained several times, both in consultation responses and in the various workshops, how substitution could have a detrimental effect on future supplies from remaining UKCS gas reserves. Again it will be consumers and the UK which will suffer if substitution undermines the exploitation of remaining UKCS reserves.

Secondly, the NG interpretation takes no account of the impact of the entry capacity regime on the wider gas market, for example the wholesale market, and ultimately the retail market. Entry capacity is simply a means to an end, namely the enabler of access to the wholesale market at the NBP. By employing substitution in the way NG proposes, it will remove any flexibility in the system since all entry capacity will have to be booked in the long term or risk being substituted. Worse, NG has shown that demand for an additional capacity at Easington of 10 mscmd would lead to a total of 92.6 mscmd capacity destruction at nearby ASEPs including 41.7 mscmd of Bacton capacity. NG also said that if Easington received a signal for an increment of 16 mscmd or more then **all** NTS spare entry capacity would be destroyed. This destruction of flexibility is not mitigated by Trade & Transfer (as explained in previous responses) and is indeed exacerbated by the reduction the quantity of baseline capacity held back for short term auctions from 20% to 10%. This means that if users of entry capacity are unable to bid, for whatever reason, at the last QSECs before substitution is implemented, they will face a minimum 42 month lead time for entry capacity, and only then if they meet the various IECR tests. This makes it harder for new entrants or new projects to bring gas to the UK, at precisely the time that they should be encouraged. It is somewhat ironic that, through its interpretation of the substitution requirement, that NG are implementing an entry capacity regime that will resemble some of those in mainland Europe where requirements for long term booking have helped prevent the emergence of competitive wholesale markets.

It should be noted that a regime which does not require or force shippers to book in the long term only does not equate to a free option to those who book in the short term, or a risk to NG's financial viability. NG recovers its revenue one way or another via capacity or commodity charges. The pricing of different capacity products (long term, medium term and short term) is a more flexible way to encourage more long term booking of capacity (if that is a valid policy aim), than the blunt instrument of substitution. Again this is a point we have made in previous consultations.

In summary therefore BG does not believe that NG's interpretation is appropriate. However debate at the workshops as to how to develop a workable substitution mechanism has been stifled by NG's reluctance to discuss the *policy* of substitution, based on its own legal interpretation of the licence. It is unfortunate that to date Ofgem has proved unwilling or unable to give its opinion on NG's interpretation of the licence, despite several requests to do so. Ofgem has also proven unwilling or unable to give its view on how the changes to the capacity regime could impact the wholesale gas market in light of the concerns raised by shippers. Until these issues are addressed it will be difficult to devise a sensible substitution mechanism. Should NG's interpretation of the licence prove technically correct, this obviously points to the need to redraft the Licence to enable a more sensible outcome.

Q2 - 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 QSEC 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.).

We agree that all incremental obligated entry capacity should satisfy the NPV test detailed in the IECR. Were capacity that was to be met by substitution have to meet a less stringent test, it would only serve to exacerbate the adverse effects of the proposed substitution mechanism.

Q3 - 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.

We agree that substitution should be subject to a default 42 month lead time.

Q4 - 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 percent of baseline with-held from QSEC auctions (requires a Licence change);***
- ***Setting a fixed percent of baseline that, although available for release in QSEC 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***

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

- a) ***Whether these approaches would be more efficient than maximising substitution from year 1?***
- b) ***What are the advantages and disadvantages of these actions?***
- c) ***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?***

For the reasons set out in the answer to Question 1, and in previous responses, we believe that there should be limits placed on the amount of capacity available for substitution. We do not believe that substitution should be maximised from Year 1 because it is based on the fundamental flaw that assumes that capacity not booked in Year 1 QSEC auctions is not required and therefore sterilised.

We believe that an approach which either increases the quantity of capacity held back for shorter term auctions, or which limits the amount of capacity which can be substituted from an ASEP, would be helpful. For example the quantity held back could be increased to 30%. This takes account of the fact that the quantity held back was 20% in the old regime where there was no threat of substitution. The advantages of such an approach would be that it would mitigate the problems identified above, whilst enabling a certain amount of substitution to take place to minimise “unnecessary” investment. (Note investment which increases system flexibility and the ability of the NTS to receive gas from different sources is not necessarily “unnecessary” even if capacity is not booked in the long term. The value of such investment depends on the value that is placed on such flexibility.)

An approach which limited the amount of capacity that could be substituted over a time period, or which reviewed the amount of capacity to be substituted over a longer time period would also be helpful. For example we have supported NG’s “Option 5” in the past for these reasons (see previous responses).

We would welcome further discussion of these options to enable development of a sensible substitution mechanism. To date such discussion has not been possible because of the impasse over NG’s interpretation of its Licence obligations.

Q5 – 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?

We agree with NG's approach. Second guessing of shippers' motives for any particular pattern of capacity booking would not be helpful or practical. For example why would some single quarter bookings be viewed as "legitimate" and others not in a regime which is aiming to encourage booking of capacity in the QSECs?

A better approach is a design of a system which is practical and which therefore enables sensible outcomes.

Q7 – 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.

We agree with NG's proposals.

Q8 - Do respondent 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?

We believe that NG (and Ofgem) should take into account other factors when determining which ASEPs should act as donors. For example it may be the case that a project is unable to bid in a certain QSEC due to other constraints (planning permission, Article 22 exemption, etc.) but would be able to come on stream prior to the 42 month lead time. However any discretion by NG would need to be subject to review and possible refusal by Ofgem.

Q9 – 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.

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.***

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.

We believe that exchange rate caps would form a useful part of a sensible substitution mechanism to prevent unnecessarily high levels of capacity destruction.

Limits on how much capacity could be substituted from donor ASEPs, plus some form of discretion as to which donor ASEPs to use, would prevent individual ASEPs from taking all the “hit” from a particular substitution requirement. Ofgem would be able to review such discretion during Price Controls, in the way that it currently reviews NG’s investments and revenue requirements. This would help keep NG “honest” in terms of its approach.

We would welcome further discussion on the advantages and disadvantages of such approaches and combinations thereof, as we recognise that there will be trade-offs. Experience has shown that it is essential to see working examples of how substitution could work with a given set of rules. It is unfortunate that the recent workshops were unable to do this because of the impasse over the issue of NG’s interpretation of the Licence Condition.

Q10 – Do respondents agree with this transitional rule [in respect of new ASEPs]?

Yes.

Supplementary Questions

Q4 – Question 4, raised in the initial document, seeks views on whether more capacity should be withheld 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.

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

Both approaches that NG has identified have merit as part of an informed decision process. However, as NG points out, they cannot be relied upon totally as they may understate or overstate future capacity requirements. Dependent on the framework (i.e. other measures such as exchange rate caps etc) such approaches could provide a useful sense check on any substitution decisions.

Q11 – Question 11 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.

The rule should be made permanent so that all shippers have an equal opportunity to bid for the capacity that might be subject to substitution.

General Questions

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.

We believe that Ofgem should undertake an Impact Assessment. This should include the wider implications of substitution, such as 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.

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 QSEC 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.

As noted above NG’s interpretation of economic and efficient is flawed because it is based on the assumption that capacity which is not booked in the QSEC auctions will not be used. For the reasons highlighted elsewhere in this response NG and Ofgem should take into account the impact that its decision will have the wider functioning of the gas market.

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.

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 (see previous responses for details);
- 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.

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. Respondents are requested to provide a rationale for their views and should attempt to quantify any impacts.

Basic economics dictates that it is the marginal supply of gas which will set the price of gas on a day. If that marginal supply, from whatever source, is prevented from reaching the market (see answer to question D above) then, ceteris paribus, prices will be higher. Ofgem was asked in the workshops how it saw changes to the capacity regime affecting the wholesale gas market, but did not answer the question. This question should be addressed in Ofgem's Impact Assessment.

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.

This question simply highlights the need to consider more fully the various trade-offs between different approaches. For example a longer decision period to enable some discretion from NG and / or Ofgem would be worthwhile if it resulted in a better overall outcome for the UK

gas market. Again the problem would seem to be the way that the Licence Condition has been drafted, or the way that NG interprets the Licence Condition. As noted Ofgem has been silent on the subject.

I hope the above is helpful. Should you have any queries please contact me at the address above.

Yours sincerely,

Alex Barnes

**Commercial and Regulation Manager
Europe Downstream**