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Our Ref.
Your Ref.
4 August 2008

Dear Andrew,

RE: Discussion on "The Entry Capacity Substitution Methodology Statement"

Thank you for the opportunity to comment upon National Grid's latest thinking in respect of entry capacity substitution. This response is submitted on behalf of the Centrica group of companies excluding Centrica Storage Limited.

We have commented before on our nervousness around the whole subject of entry capacity substitution. Whilst we appreciate the effort that National Grid has put in to the series of substitution workshops in order to keep the industry appraised of its latest thinking, in our view these workshops have reinforced the potential that exists for unwelcome outcomes to result from any ill-conceived approach to entry capacity substitution.

To be clear, Centrica is not opposed to the concept of capacity substitution *per se*. Indeed, we believe it makes perfect sense for genuinely spare, unused and unwanted capacity to be utilised elsewhere, in doing so saving the cost of unnecessary infrastructure investment. This is especially the case in the light of declining indigenous gas supplies.

Having considered the matter in some significant detail, our concerns lie in the difficulties of arriving at an appropriate methodology which will ensure that the most detrimental aspects of capacity substitution are avoided, while ensuring that potential substitution benefits are captured.

To this end, and additional to the specific responses set out below, we would support a regime where Ofgem had greater power to reject proposed substitutions that were evidently inefficient. In doing so, we believe that Ofgem should be required to consult industry stakeholders on their views of the merits of each particular substitution proposal.

Summary of views

In summary, our views are:

- National Grid's interpretation of its licence condition is legitimate, but there are other, less extreme interpretations. Better licence drafting would have left less room for interpretation and avoided this confusion;

- In order to militate against the most unwanted impacts of substitution, Ofgem should have powers to veto individual substitution proposals. Such a decision should be taken after seeking views on those individual proposals from industry players, and following due consideration of the impacts upon commodity prices that may result from that substitution;

- It is not appropriate to interfere with the established user commitment regime linked to capacity auctions in order to maximise substitutable capacity volumes (the "single quarter issue");

- It is appropriate to consider limiting the scope of substitution following its introduction, and our preferred method would be a restriction on the percentage of capacity that could be transferred from any ASEP:

- We have previously voiced support for a capacity surrender mechanism linked to long term substitution, and while from previous conversations that concept appeared feasible, we note that it no longer features in the draft methodology. We believe that a surrender mechanism, similar to that featured in RMTTSEC, could have a useful role:

- Towards the end of this response we put forward a further possible approach to substitution that could avoid the most detrimental results of substitution while at the same time enabling the beneficial results to be captured.

Specific responses

Below we provide responses to certain specific questions posed by National Grid. Where no response is given, it is because we have no specific views at this stage.

Q1. We believe that National Grid's interpretation of the licence – i.e. substituting the "nth degree" and destroying significant capacity in the process – is one possible valid interpretation. We also believe that in the context of the difficulties exposed during capacity substitution discussions, an alternative but equally valid interpretation could include placing some parameters around the extent to which substitution is employed. Given the extent to which tension is created between this licence condition and the wider obligation to maintain an economic and efficient system, we believe that the licence wording is particularly unhelpful and are disappointed that Ofgem has not provided any clear steer on how it believes the relevant condition should be interpreted.

To this end, if National Grid's interpretation of its licence is correct, no sort of restriction to full substitution e.g. limitation of volumes of percentages of substitutable capacity, would be possible without a formal derogation from Ofgem. If, in the other hand, no formal derogation is required for limitations to be permissible in the shorter term, such limitations should also be permissible in the longer term.

Q2. We believe that a same NPV test for substituted capacity is appropriate. We also believe that where a different NPV test is considered, other rules may also be needed in order to avoid unwelcome behaviour.

Q3. Whilst we would support efforts to deliver all incremental capacity more quickly than the 42 month lead time – be this funded or not funded – we believe that a key principle must be to provide all Users with the ability to purchase that capacity at an ASEP in advance of any substitution taking place. Under the current regime this would point towards maintaining the 42 month lead time.

Q4. We agree that given the potential impacts of substitution, applying some sort of restriction on the extent to which substitution is used is appropriate, at least in the shorter term.

As mentioned in previous responses, Centrica is persuaded by the view that capacity held over from long term auctions reduces the scope for a liquid secondary capacity market to develop. We understand the position of other industry players who argue that greater than 10% should be held over to shorter term auctions to facilitate the landing of new gas production, but believe that a liquid secondary market would satisfy that requirement. That would be our preferred outcome.

Of the further proposals put forward to restrict the impacts of substitution, we consider the most favourable to be the setting of a fixed percentage of baseline at each ASEP which, irrespective of whether it is sold or not, will not be used to satisfy an incremental signal at another ASEP. We might, for example, support an approach which set an initial limit on the amount that can be substituted from each ASEP at 50% for the first year, 75% for year 2, increasing to 100% from year 3. Such an approach would allow Users to acclimatise to the new regime, and allow time for reflection and methodology amendment depending upon experiences.

One disadvantage could be that investment is undertaken which with hindsight could have been fully satisfied by substituting, with no detrimental impacts. However, it is only some years after the event that such a judgement could be made. These arguments embody the difficulty of trying to arrive at a satisfactory mechanised approach to a methodology that must deal with a large number of different circumstances (hence our support, as set out above, for a regulatory approval of each proposal).

Q5. We do not support any action to prevent the booking of single quarters. There are legitimate reasons why any User may want to book a single quarter to match the seasonal pattern of flows. Additionally, the current regime is established around User Commitment, and since its inception Users have been advised that it is primarily their capacity purchase behaviour that sends signals to National Grid. We would therefore see any attempt to prevent single quarter bookings as an unjustified attempt to skew the current arrangements because they present an inconvenience to the substitution regime.

Further, when this subject was raised in a previous consultation, the idea of surrender was also raised. Centrica supported the surrender concept, but notes that it no longer features as a possible solution to either the single quarter issue or indeed as a mechanism for ensuring maximum efficiency in capacity utilisation in the wider sense. Any surrender mechanism would need further development by industry participants.

Q6. We remain open minded to the use of zones, but have seen no compelling evidence one way or the other.

Q7. We do not understand all of the implications of this issue sufficiently at this stage, and therefore are unable to offer a view one way or the other.

Q8. Again, this question highlights the difficulties in arriving at a fixed, mechanised approach to a subject as potentially complex and contentious as substitution. We are instinctively cautious about a loose methodology, considering that this could add to uncertainty and greater scope for challenge of National Grid's decision making. On the other hand, requiring adherence to a rigid methodology increases the potential for unwanted outcomes. On balance, we believe that a tighter methodology combined with increased powers for Ofgem to veto inappropriate proposals, is our preferred approach.

Q9. See previous responses setting out our thinking on an Ofgem power of veto for inappropriate individual proposals. In contrast to our previous thinking, however, we do not now support a cap on exchange rates for substitution, nor do we believe that within-zone-only substitutions are appropriate, especially given that likely candidates e.g. Theddlethorpe and Easington could be in separate zones, and that zones may move over time.

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 QSEC auction and the baseline is adjusted in all subsequent auctions involving those months (QSEC, AMSEC, RMTTSEC and daily auctions). For months 55 onwards, however, the capacity would still be available at P0 in QSEC auctions. Months 55 to 66 become months 43 to 54 in the next QSEC 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 QSEC 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 QSEC auctions. This should ensure that the maximum benefits of substitution are still captured.

Q10. Given the impacts of substitution, and the need to retain as much certainty as possibly over capacity availability, we agree that it is not appropriate to apply substitution to new ASEPs until all players have had a chance to buy capacity at all ASEPs.

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

Yours sincerely,

Chris Wright
Commercial Manager