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Dear Andrew

Discussion On “The Entry Capacity Substitution Methodology Statement”

Chevron North Sea Limited welcomes the opportunity to comment on National Grid’s Entry Capacity Substitution Methodology Statement (Discussion Draft) issued under cover of your letter dated 7 July 2008.

With regard to the questions posed within the document and the supplementary questions contained in your letter dated 17 July 2008 (both summarised here for ease of reference in italics), we are pleased to offer the following responses.

Q1 - National Grid’s interpretation of the requirement to “minimise” the costs associated with funding incremental obligated entry capacity – should all available capacity be substituted to meet the incremental signal without placing any restrictions on the substitution process?

In determining the amount of substitutable capacity available it would seem short-sighted to focus solely on known user commitments (ie booked capacity), ignoring market knowledge of future field developments. Taking that into account, we are firmly of the view that only capacity above the peak forecast gas flows identified in the annual Ten Year Statement should be available for substitution.

As we stated in our 26 February 2008 response to National Grid’s Summary Report and Discussion Document on Entry Capacity Substitution dated 1 February 2008, we are one of a number of companies currently involved in exploration activity to the West of Shetland. Prior to project sanction, it is not viable for us to make the financial commitment necessary to procure entry capacity for West of Shetland gas through the QSEC auction process because, as with any exploration activity, the uncertainty envelope on the potential reserves, production levels and timing is still too wide. If all unbooked entry capacity is made available for substitution from the effective date of

the substitution obligation (currently expected to be 6 April 2009), this could cause West of Shetland gas reserves to become stranded due to lack of entry capacity at St Fergus.

Q2 – Should a less stringent NPV test apply for the release of capacity that would, after analysis, be satisfied through substitution?

We do not believe that a less stringent test should apply for capacity satisfied through substitution. Our view is that one test should apply for the release of all incremental capacity, irrespective of whether it is satisfied through substitution or investment, as the value of that capacity is identical in both cases. This is an area, however, which should be revisited in a year or so once the industry has seen the results of the initial period of operation.

Q3 - Do respondents agree that it is appropriate to consider substitution opportunities consistent with the timing for the release of funded incremental obligated entry capacity (ie subject to a 42 month lead-time)?

If peak forecast flows are used to determine the amount of substitutable capacity then we would be comfortable with incremental obligated capacity which can be satisfied through substitution being released on a shorter lead-time than 42 months.

Irrespective of the lead-time, however, we would like to see existing shippers at the donor ASEP(s) being alerted to the fact that capacity has been earmarked for destruction and given a further opportunity to secure that capacity if required. Through the TBE process, contributors supply National Grid with data in good faith to enable National Grid to plan appropriately and the same principle should be applied to any data which would allow producers to plan effectively.

Q4 - National Grid would welcome views on whether it is appropriate for any restriction to be placed on the availability of capacity for substitution.

As stated in our response to question 1, we are firmly of the opinion that the capacity available for substitution should be limited to that in excess of the peak daily flow identified within the TBE forecasts (from 42 months onwards). We do not share National Grid's concerns that this option could incentivise contributors to overstate future flows at particular ASEPs and hence undermine the TBE process. Gas producers like ourselves put a significant amount of technical effort into producing the data used in the TBE process and any individual contribution can easily be cross-checked by National Grid using a variety of industry sources to ensure the data is in the right ballpark.

Q5 - Should National Grid take any action to prevent Shippers "protecting" capacity at an ASEP by booking capacity for a single quarter in a future year?

If the substitutable capacity is to be based on capacity bookings (and not peak daily flows), it would appear appropriate that National Grid should take some action to prevent a shipper from making a single quarter booking in a future year as a means of preventing that capacity from being substituted away. Our suggestion would be that

shippers should be required to book capacity for a minimum of four quarters over two consecutive years in order to “protect” the capacity.

Q6 - Considering that the substitution process is identical within and out-with zones, do respondents feel that the use of zones is beneficial?

It is difficult for us to answer this question without a greater understanding of the implications of the use of zones. As an overriding principle, however, consideration should be given to any option which offers more favourable exchange rates, and hence minimises the capacity destruction at the donor ASEP.

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. Alternative criteria could be used and National Grid would welcome alternative proposals.

As stated in our answer to question 8, consideration should be given to any option which offers more favourable exchange rates, and hence minimises the capacity destruction at the donor ASEP.

Q8 - 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?

The inclusion of any element of discretion in the substitution process would only increase the lack of transparency which already exists in National Grid’s network modelling. We would favour a strict mechanistic process which is auditable and subject to regular review.

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.

We believe it is imperative that capacity substitution should not result in significant destruction of aggregate baseline capacity and that the key to this lies in the use of appropriate exchange rate caps. Without these, industry could see situations such as the example presented by National Grid at the 11 June 2008 entry capacity workshop in which 93 mcm/d of capacity would be destroyed (over four donor ASEPs) in order to create just 10 mcm/d at a recipient ASEP. Given the information available to us it is difficult to assess what an appropriate exchange rate cap should be, however a figure in the region of 1:1 does not seem unreasonable.

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

Yes – if a separate QSEC auction is held for a new ASEP after implementation of the substitution methodology but before a regular QSEC auction, then substitution should not be used in that situation. It would be unreasonable for shippers at a new ASEP to be able to access “substitutable” capacity prior to shippers at existing ASEPs.

Q11 – 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.

Our view is that incremental capacity requests should only be satisfied through substitution in the “regular” QSEC auctions.

Q12 – 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?

Provided the substitution methodology is subject to regular review (and revision where necessary), we do not consider any other transitional rules to be necessary.

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. 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.

Given the level of industry concern on the potential consequences of the implementation of capacity substitution, we believe it is imperative that Ofgem undertake a comprehensive Impact Assessment and seek a wide range of stakeholder views. The scope of the Impact Assessment should include the effect of other recent changes to the entry capacity regime (adjustment of baselines, capacity Transfer and Trades, reduction in capacity withheld from the QSEC auctions, etc), not just substitution.

B – National Grid would appreciate views on what criteria could be included in any assessment of “economic and efficient” in respect of substitution.

See response to question “D” below.

C – Respondents are encouraged to identify whether, and to what extent, substitution will impact on security of supply.

If substitution results in indigenous gas resources such as our West of Shetland gas becoming stranded through lack of entry capacity, that will inevitably have a significant impact on security of supply as it will increase UK plc’s reliability on gas imports. Similarly, if Interconnector flows are forced to move from a firm to an interruptible basis because Bacton capacity has been substituted away, that also raises security of supply concerns.

D --National Grid would welcome views on whether consumer prices will be affected by implementation of the methodology as currently drafted.

Although other parties are better placed than ourselves to comment on consumer pricing, it has been widely reported in the context of the substitution discussions that the overall cost of transmission of gas through the NTS only represents 2% of consumers' bills. The small cost saving which may be achieved through the creation of incremental capacity by substitution rather than investment has to be weighed up against the risk that indigenous gas resources such as our West of Shetland gas may become stranded if entry capacity is no longer available at certain ASEPs, with the resulting impact on security of supply and loss of taxation revenue for the UK Government.

E 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 (where the draft methodology leads to unexpected consequences).

Given the complexity and lack of transparency in National Grid's network model, it is quite possible that the draft substitution methodology could lead to unexpected consequences. In that situation, our view is that Ofgem should have the ability to use its discretion to over-rule any outcome which is plainly not economic or efficient. Additionally, there should be provisions to review and adjust the methodology at the earliest opportunity if it is found to produce a course of action which is clearly not the optimum one.

We hope that you will find these comments useful.

Yours sincerely



for **Geoff Freter**
Commercial Manager