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4th August 2008

Dear Andrew,

RE: NGG's Draft Entry Capacity Substitution Methodology Statement

Centrica Storage Ltd (CSL) welcomes the opportunity to offer comments on the above draft methodology statement (MS) proposal.

Our response is in two parts; first we offer some general observations on entry capacity substitution and the recent workshops, we then provide answers to the questions contained within the MS.

Firstly, CSL supports the concept of entry capacity substitution and the stated policy objectives of:

- Maximising the use of existing Transmission network assets for the benefit of consumers; and
- Avoiding both capacity sterilisation and unnecessary infrastructure investment while accommodating changing flow patterns,

However, the way in which NGG appear intent on implementing substitution does cause us serious concerns.

In addition, whilst CSL was disappointed with Ofgem's decisions in September 07 and in March 08 to allow NGG a temporary licence derogation postponing the introduction of this policy, as this allowed NGG to capture further windfall gains through implicit substitution, we were encouraged by the prospects of further workshops to facilitate the development of a robust process.

However, on the conclusion of those workshops CSL's overall view is one of disappointment; disappointment in NGG's approach and disappointment in the level of regulatory engagement

CSL believes that NGG's commercial incentive to limit the impact of capacity substitution is distorting NGG's pursuit of developing an acceptable economical and efficient solution and this is reflected in the proposal which it has presented. Further, CSL believes that the commercial incentive has led to NGG changing approach in the interpretation of its new licence from one of considering a spectrum of options – from that of a phased, controlled and measured manner through to a 'fast and furious' approach – to a narrowed approach of 'fast and furious' only.

NGG's reasoning for this narrowing of options stems from its interpretation of the new licence obligation to minimise the costs associated with funded incremental obligated entry capacity i.e. all unsold entry capacity should be substituted to meet an incremental signal without any restrictions on the amount of capacity destruction that results.

In summary, CSL is concerned that there is significant commercial incentive for NGG to pursue a strategy that either results in the proposals being so unacceptable that Ofgem has no choice but to veto, or if accepted, proposals that lead to all unsold entry capacity being destroyed in the shortest time leaving NGG benefiting from potential gold plating of the asset base.

The problematic outcomes of NGG's approach are now well rehearsed and have been discussed several times at the various work streams; however NGG appears set on its interpretation of its licence. This then leaves the question of how Ofgem interprets the licence. This question has been asked several times to Ofgem in different work streams, but the responses have not been illuminating. Indeed there has even been confusion as to what ability Ofgem has to influence the substitution process, once the methodology has been approved. CSL urges Ofgem to consider redrafting the licence obligation to better consider the objectives of NGG's other licence obligations and to consider issuing good practice guidelines on the use of substitution.

CSL now provides comments on the following questions:

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.

CSL agrees with NGG's interpretation however the MS appears to be contrary to other licence obligations. We see this ultimately as a short-coming of the licence drafting

CSL believes NGG's approach is one focussed on seeking the maximum commercial incentive for NGG rather than pursuit of economic efficiency in the overall operation of the system. As stated previously, CSL's view is that NGG is pursuing a strategy that either results in the proposals being so unacceptable that Ofgem has no choice but to veto, or if accepted, proposals that lead to all unsold entry capacity being destroyed in the shortest time so a period

of potential gold plating of the asset base follows. CSL believes NGG should follow a more controlled and measured approach and be mindful of its other licence obligations in minimising the costs associated with funded incremental obligated entry capacity, otherwise the excessive degradation of entry capacity and the 'tight' network will lead to the undesired opposite.

In addition, CSL has concerns regarding the impact of NGG's approach to substitution on the development of new gas storage facilities. The absence of flexibility in the network is a significant deterrent to investment. Given the national need for more storage and the decline in UKCS gas, it is important that a positive investment climate is maintained.

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.).

CSL believes that the same test should apply for the release of incremental capacity, irrespective of whether it is delivered through investment or substitution as the value of the capacity is identical in both cases. Furthermore, given that substitution will permanently reduce baselines at donor ASEPs and the potential consequences of this in the light of NGG's approach to substitution, CSL believes that at least the same level of user commitment should be should be required where capacity release is satisfied through substitution.

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.

CSL believes that there is only limited merit in applying the standard default lead-time equally for all cases of incremental obligated entry capacity regardless of whether it is delivered through investment or substitution. This lead-time should allow NGG to consider the most economically efficient use of substituted capacity in the delivery of incremental capacity as new and competing requests are made which could be satisfied through substitution. However, CSL is also concerned that in practice, projects make a financial commitment to entry capacity when the final investment decision is made and this is typically only 1 year to 18 months before the project becomes operational. 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, because any potential delay will have a serious impact on project revenue streams and hence project viability.

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?

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.

In CSL's view, there is merit in starting substitution slowly due to the associated uncertainty and to mitigate the risk of any unintended consequences. This could be achieved by the following:

CSL suggests NGG should not substitute capacity which has been flowed against in the last 3 years in order to protect ASEPs which traditionally have opted for short term entry capacity products. In particular shippers using sources of supply flexibility such as storage do not hold long term capacity bookings.

CSL also believes NGG should make 20% of baseline at each ASEP unavailable for substitution even if unsold, as the lack of capacity at AMSEC auctions acts as a disincentive to invest in new storage projects and to bring small UKCS production fields online. The lack of availability of capacity for short and medium term bookings could act as a barrier to development. Given the national need for more storage and the decline in UKCS gas, it is important that a positive investment climate is maintained.

In addition, CSL would prefer that NGG limits the proportion of each incremental obligated entry capacity request satisfied through substitution is limited to 50% of the request in the first 5 years rather than maximising substitution in year 1. This could then be reviewed and possibly removed after the industry has comfort in the regime.

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?

CSL believes that this is appropriate at the introduction of the regime given the associated uncertainty, however it we would consider it sensible to revisit the suitability of this as part of the next price control review process after the industry has comfort in the regime.

Q6 - 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.

CSL supports the use of zones, even given the surprising and disappointing failure of zonal transfers at Easington during the interim trade and transfer process. CSL believes that Zones are appropriate given ASEPs use common assets within a zone. This commonality facilitates the pro-rating of substitution on unsold capacity across all ASEPs within a zone which CSL views as a non-discriminatory way of capacity reduction.

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.

CSL believes there is merit in considering an approach based on favourability of exchange rates however this should still be considered as part of a pro-rata reduction mechanism within zone. CSL believes that NGG should avoid unnecessary destruction of network capacity where possible but to avoid discrimination, should pro-rate the reduction across all ASEPs within the zone. If within zone substitution cannot satisfy the increment, then the same process should be applied out with the zone.

Q8 - Do respondents favour an approach that requires National Grid to follow a set methodology or should National Grid have some discretion to select more favourable donor ASEPs?

CSL believes NGG should follow a methodology and good practice guidelines set by Ofgem as mentioned above given the commercial incentive to be had by NGG potentially clouding its decision making.

CSL is also uncomfortable with the 'nearest to' rule as it is potentially discriminatory. ASEPs use the same assets within a zone and we therefore believe that substitution should be pro rated on unsold capacity across all ASEPs within a zone, taking into account exchange rates. If this cannot satisfy the increment, then substitutions out with the relevant zone should be considered according to the same process.

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 give more favourable exchange rates 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.

CSL believes that the introduction of an exchange rate cap would be prudent. CSL recognises any exchange rate cap will be arbitrary and recognises that exchange rates capped too low would severely limit substitution and that conversely, a high rate cap would lead to excessive destruction of network capacity and an extremely tight network.

CSL also believes that where a cap for one scenario may be appropriate, the same cap may not be suitable for another. For example, if the Saltfleetby project was to require entry capacity in the Theddlethorpe zone, then an efficient outcome may be to have a high cap at Theddlethorpe, however, the same may not be true if the Bains project required entry capacity at Barrow.

CSL also recognises that the exchange rates are calculated by NGG in a 'black-box' fashion using network models and has low confidence in the rates which NGG arrive at. Without fully understanding NGG's model and without undertaking additional analysis, CSL finds it difficult to specify a cap level. Perhaps a starting cap of 1:4 or 1:5 may be a sensible starting point given that a request at Easington for 16mcm/d rated at 1:10 would destroy all available capacity on the system.

CSL would also request NGG conducts its substitution analysis as detailed in our responses to questions 7 and 8.

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

CSL agrees with this transitional rule as the QSEC auction will allow NGG to consider requests across all ASEPs, facilitating substitution most efficiently taking into account all capacity requests. This also ensures that other shippers have fair opportunity to request the capacity.

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.

CSL believes that this should be a permanent rule for the reasons specified in our answer to question 10.

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?

CSL has detailed the measures that should be taken in the answers to the above questions.

General Questions

At the last substitution workshop participants raised a number of additional questions relating to areas outside the scope of the entry capacity substitution methodology. Although unlikely to impact on the development of the methodology it was felt that

obtaining respondents' views on these issues would be beneficial to Ofgem in considering these wider issues.

A – Ofgem has 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.

CSL believes an IA is essential to inform both Ofgem and NGG of the risks and consequences of NGGs suggested ‘fast and furious’ approach to substitution. This impact assessment should consider a range of approaches to substitution and should include a cost benefit analysis of each, perhaps using readily available information on likely storage projects and small UKCS field production projects and their likely capacity requirements. In essence, the IA needs to determine the value of flexibility within the NTS and how does the tightening of the network impact on commodity prices.

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.

CSL has a tendency to consider the merits of both ‘economic’ and ‘efficient’ and understands that the optimum solution is the one which is ‘economically efficient’ i.e. a solution which optimally provides the best exchange rates but similarly is pro-rated across the zone and the network to minimise the reduction of capacity from occurring at one ASEP and shares the burden of substitution proportionately. This is non-discriminatory and seeks not to strand potential new gas supply assets.

A thorough IA will help to identify what an efficient and economic substitution policy should look like.

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.

Given the current commentary on the UK’s national need for more storage and gas supply, CSL believes that it would be a strategic error if NGG’s approach to substitution would restrict the development of these projects. Substitution has the potential to remove all spare capacity from the network and CSL recommends that 20% of baseline at each ASEP is excluded from substitution as the lack of capacity at AMSEC auctions acts as a disincentive to invest in new storage projects and to bring small UKCS production fields online. The lack of availability of

capacity for short and medium term bookings could act as a barrier to development. Given the national need for more storage and the decline in UKCS gas, it is important that a positive investment climate is maintained.

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.

CSL believes that NGG's approach to substitution will undoubtedly lead to a tight network with very little spare capacity and this will lead to a variety of undesired outcomes.

It has been well documented recently by various commentators that the UK has a vast need for gas storage facilities for reasons of security of supply and market efficiency. Without more gas storage, there is a genuine risk that in some circumstances, gas will not be available as demand outstrips supply, and ultimately a shortage of storage tends to lead to rising prices, which in turn increases the costs of gas suppliers which are then passed on to gas consumers. As previously mentioned, a lack of capacity at AMSEC auctions acts as a disincentive to invest in new storage products, as well as small UKCS fields which are much needed in the current climate.

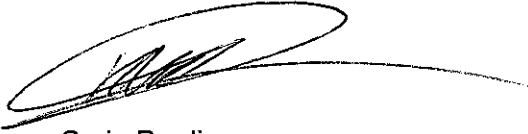
Tightening of the network could also result in more flows of gas on interruptible capacity. CSL has experienced curtailment of interruptible capacity at Easington on numerous occasions last winter and we believe that this locking-out of gas has an undesirable effect on the spot commodity price. On 14 December 2007, it was quoted that interruptions had caused the same-day gas price to jump as much as 6.7%.

CSL also has concerns that a significantly large amount of capacity could be substituted away from an ASEP to provide a small amount elsewhere, and then could be required in a subsequent QSEC auction. This would result in a greater cost of investment at one ASEP which could have been avoided by less costly investment at another. Ultimately, these increased costs will have to be recovered by the investor through increased costs to gas suppliers which are then passed on to gas consumers.

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.

CSL believes that Ofgem should have more discretion but NGG have indicated that this will take time and could result in capacity allocation not being made. We believe NGG should consider bringing the LTSEC auction forward to April/May thus providing NGG with the required time to provide options to Ofgem and to the industry for consultation.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Craig Purdie', with a long horizontal flourish extending to the right.

Craig Purdie
Regulatory Analyst