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Entry Capacity Substitution Methodology Statement – Discussion Document July 2008

Dear Mr. Fox,

Thank you for the opportunity to respond to the Substitution Methodology Discussion Document. Excelerate Energy's detailed responses to the questions posed therein are attached; however, our main points fall outside the narrow scope of the National Grid Licence obligation in respect to substitution, which provides the basis for the National Grid Entry capacity Methodology Statement. We are copying this response to Ofgem as our concern is that the substitution obligation on National Grid is something that appears to be operating counter to the interests of consumers and the operation of an effective UK gas market.

Experience in the UK in the last few years has provided a number of important lessons:

1. UKCS is in severe decline and the UK market must attract investment in new importation facilities such as LNG terminals and new pipeline capacity.
2. Planning issues for UK onshore gas storage facilities mean that there is a significant shortage of storage in the UK which leads to higher gas prices for UK consumers.
3. The planning and construction of NTS capacity expansion projects take less time than the planning and construction of major LNG and storage infrastructure.

Excelerate Energy and Interconnector (UK), owners of facilities at Teesside and Bacton respectively, have made significant investments to provide additional capacity to deliver gas to the UK. The facilities constructed are designed to allow UK consumers to access LNG and pipeline natural gas supplies from overseas, increasing competition in supply and supporting security of supply. At both Teesside and Bacton, as a result of UKCS decline, sufficient onshore NTS capacity exists to move this gas to market.

At Teesside, Excelerate Energy is able to respond to market signals not just from the UK, but elsewhere in Europe and overseas. For us, the flexibility to bring gas to the UK at times when UK customers require such gas is critical. The UK market should encourage such investment and maintain capacity in the NTS to move such gas, rather

than consider substituting such capacity to new onshore UK gas storage projects. Existing NTS capacity should be considered to be an asset that acts in the interests of competition and security of supply and it should not be substituted away from flexible sources of gas such as those that exist at Bacton and Teesside.

Experience shows (in relation to projects such as at Aldbrough, Easington and Milford Haven) that it is possible to build new NTS capacity more quickly than it is possible to develop new storage projects, with no examples of the upstream project being completed ahead of the pipeline. As such, there is no timing benefit from substitution, but rather it is entirely a device to reduce the flexibility available to move gas through the NTS.

At new LNG facilities such as Isle of Grain and Milford Haven, we also believe that capacity should not be substituted away. This is not discrimination as it reflects the nature of world gas markets and is wholly different from facilities such as pipelines and storage facilities that can only provide delivery capacity into a single market. If there are concerns about providing firm capacity at a zero price (as under present rules), then such rules should be changed to ensure all firm capacity has a cost. This is a more efficient process and more beneficial to UK consumers than allowing the substitution of capacity away from flexible delivery points such as those noted above.

Given that the substitution obligation exists in National Grid's licence, we believe that there does need to be an appropriate methodology, and it is on that basis that we make our comments. However, in respect to Teesside and Bacton, we believe that the methodology should recognize the enormous value to consumers from maintaining the potential to bring in flexible gas. Therefore, such baselines should not be reduced for at least a 5 year period. The justification is the promotion of competition in gas supply and support to security of supply.

We hope these views are helpful and would be happy to discuss them further.

Yours sincerely,

A handwritten signature in black ink that reads 'Rob Bryngelson'.

Rob Bryngelson,
Chief Executive Officer

Consultation 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 may be lost – and unnecessary investment made.

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

- A1. As in our covering letter, we do not believe any capacity should be substituted away from Teesside and Bacton for at least a 5 year period as these entry points provide access to flexible gas that supports the efficient operation of the UK gas market and helps to maintain security of supply.

- 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 to the release of capacity that would, after analysis, be satisfied through substitution. It should be recognised that while a different test could increase the amount 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.).*

- A2. It seems appropriate that incremental obligated entry capacity released by substitution should be subject to a lower hurdle compared to that where investment is required. National Grid should try and develop a methodology to allow this to happen.

- 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.

A3. We agree that substitution should only be considered subject to a minimum 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?*

- A4. As above, with respect to Bacton and Teesside, we do not believe there should be any capacity substituted away for at least 5 years.
- 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?*
- A5. We support the National Grid proposals to allow single quarter booking. This rule should be reviewed in 5 years time.
- 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.*
- A6. The use of zones can be helpful in indicating that certain ASEPs utilize the same NTS assets. We do not support the ‘nearest ASEP by pipeline distance’ rule as this is too simplistic and does not take into account any measure of economic efficiency.
- 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.*
- A7. We agree with National Grid's proposals.
- Q8. *Do respondents favour a rigid approach [to identify donor ASEPs that require 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 ASEPs?*
- A8. As in our covering letter, we do not believe that any capacity should be substituted from Bacton or Teesside for at least 5 years. For other ASEPs, we

believe National Grid should take into account other factors to ensure the most efficient overall outcome.

- 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:
 - i. *how should the level be determined? What should be the level of an exchange rate cap?*
 - ii. *Should a cap be applied in aggregate across all donor ASEPs or for each recipient/donor ASEP combination?*
 - iii. *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.

- A9. *As above, we do not believe it is appropriate to Substitute any capacity from Bacton and Teesside for at least 5 years. For other ASEPs, we believe National Grid should take into account actual flows and TBE forecasts.*

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

A10. We agree.

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.

A4. As stated above, we do not believe any capacity should be substituted from Teesside and Bacton for at least 5 years.

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.

A11. As in response to Q10

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?*

A12. Whilst we believe that Teesside and Bacton should not have capacity substituted away, we accept that limiting this to 5 years may be appropriate. After that time, it may be that additional importation facilities, for example at Isle of Grain and Milford Haven, may also be added to the sub-group of ASEPs were there is no substitution.

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.

- QA. *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.*
- AA. We believe there should be an IA and it must take into account the impact on the UK gas market if there is insufficient firm capacity at Bacton and Teesside (due to substitution) and the UK gas market needs imports at these facilities to satisfy UK demand. As part of this, Ofgem should encourage BERR to make a contribution as it is the Energy Minister who is in the front line in respect to gas prices and encouraging investment in gas infrastructure.
- QB. *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.*
- AB. We believe it is manifestly obvious that if the UK market cannot access additional FIRM gas supplies at Bacton and Teesside at times of high gas demand or system stress, then UK gas prices may be significantly higher than otherwise would be the case. At a time when BERR is promoting investment in gas storage and new gas power generation, it makes no sense at all to be reducing investment in the NTS.
- QC. *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.*

AC. BERR has produced a National Emergency Plan that sets out how UK market participants are expected to respond in the event of a shortfall of gas supplies. 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.

QD. *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.

AD. If there is no FIRM capacity available at Bacton and Teesside and shippers want to bring in gas, there will inevitably be a high risk premium in the price due to the risk of interruption and being out of balance. These supplies will impact critically on the price for gas on such days and the succeeding days and weeks.

QE. *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.*

AE A rigid and time constrained process is not appropriate. More ability for discussions between National Grid and Ofgem and possibly the wider industry, is desirable and can be achieved by bringing the LTSEC forward.