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## Entry Capacity Substitution Methodology Statement – Discussion Document July 2008

Dear Andrew,

We welcome the opportunity to respond to this discussion document. This response is provided on behalf of the RWE group of companies, including RWE Npower plc, RWE Supply and Trading GmbH and RWE Innogy.

### GENERAL COMMENTS

In its covering letter to this discussion document, National Grid correctly points out that substitution represents a significant change to the entry regime. While we support the principle of substitution, we strongly believe that the current draft Entry Capacity Substitution Methodology Statement (ECS) reflects neither the spirit nor intent of Ofgem's policy decision in this area. Whether this is a consequence of flawed licence drafting is unclear but in our view the Authority must be willing to contemplate amending the licence where this is shown to be necessary.

As it stands, the draft ECS reflects National Grid's interpretation of its licence obligation but it results in an extremely draconian methodology that has the potential for extensive capacity destruction. This will result in a loss of flexibility in the NTS and seems to be completely at odds with what Ofgem identified as the background to the 2007 - 2012 Transmission Price Control Review<sup>1</sup> "This review takes place at a time of high and volatile energy prices, with companies seeking huge increases in investment to replace ageing assets and to strengthen and extend the networks to connect new sources of imported gas and low carbon electricity generation. But it is uncertain where and when these connections are needed, so we have provided incentives for flexibility, as well as for efficient investment, so that investment can be adjusted to meet higher or lower demands for network capacity than the companies have forecast". In this context, we are incredulous that a mechanism that, under credible scenarios, could result in all

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<sup>1</sup> Transmission Price Control Review: Final Proposals Ref: 206/06 4 December 2006

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unbooked entry capacity being substituted away after the 2009 LTSEC could be implemented in its current unfettered form. Furthermore, such fundamental policy changes do little to reduce the perception of regulatory risk in a regime that is increasingly seeking to force long-term commitments and these drivers are contradictory rather than complementary.

In our detailed responses to the consultation questions we have set out alternatives for how substitution could work in practice. We believe that National Grid must consider more than the avoided investment costs when assessing “the costs associated with funded incremental obligated entry capacity”. At the very least the ECS should recognise that unbooked capacity does not equate to unwanted capacity and that shippers’ bookings over different time scales will reflect legitimate capacity acquisition strategies. Indeed, offering capacity for sale over a range of time periods to reflect different requirements was one of the key elements when the capacity regime was first introduced. Such flexibility allows shippers to manage their peak and baseline requirements and to respond to short and medium-term events.

We do accept that introducing additional flexibility into the allocation process, such as consideration of part investment, part substitution scenarios, will add delays into the allocation time table following the LTSEC auctions. We are willing to accept this more pragmatic solution if it produces a more credible outcome, although our preference would be to apply the substitution methodology at the time of the next periodic review and then consider whether it could be phased in.

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

Yours sincerely,

By email so unsigned

Charles Ruffell  
Economic Regulation

## Consultation Questions

1. *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.*

In our view, National Grid has interpreted the licence obligation too narrowly and that the “costs” associated with funded incremental obligated entry capacity should be broadened beyond simply avoided investment costs. Given its wider obligations regarding economy and efficiency, National Grid should be permitted to make this interpretation. If it is considered the licence drafting does not permit this latitude then it needs to be redrafted.

2. *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.).*

It seems intuitively correct that incremental obligated entry capacity released by substitution should be subject to a less stringent test to that where investment is required. However, it is not obvious to us how such a differential test could be applied in practice and we therefore agree with the National Grid proposal that the same NPV test should apply.

3. *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 only be considered subject to a minimum 42 month lead-time.

4. *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?

We think that there should be serious consideration given to resetting the held-back percentage to 20%, although we recognise that this requires a licence change. Absent such a change, we support restricting the level of capacity available for substitution. One option that is worthy of consideration is to establish a floor level of capacity based on historic maximum flow at each ASEP. If this was applied on, say, a historic two year rolling basis it would also reflect declining usage at certain ASEPs and progressively allow more capacity for substitution. Using historic flows would also avoid accusations of gaming. We also think that there is merit in considering how forecast flow data, collected as part of the 10 Year Statement, could be utilised. Under this option, we recognise that there may be an incentive to overstate future flows, but do not believe that this represents a significant risk.

5. *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?*

Although it has been highlighted because of its consequence under the substitution framework, booking a single quarter of capacity is a legitimate strategy under current rules and we believe that it would be wrong to limit single quarter bookings. System users will take their own view of the costs and risks of making a single quarter booking and will also factor in the prospect of future regulatory changes undermining their decisions. This regulatory risk is a feature of the current arrangements and there have been changes to the regime under the periodic price control settlement that have had material effects. The perception of regulatory risk will affect the extent to which system users are willing to commit long-term.

6. *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.*

Based on the analysis presented by National Grid, and provided that zones are not required elsewhere in the methodology, it is not clear what benefits they deliver. However, relying solely on pipeline distance to determine the order of donor ASEPs seems arbitrary and does not take into account any measure of economic efficiency.

7. *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 National Grid's criteria for assessing multiple recipients.

8. *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?*

We would favour more discretion and believe that this could be achieved by placing additional criteria into the methodology statement. National Grid should bring forward examples of additional criteria, for example ones based on relative capacity utilisation, rather than rely on a rigid approach based solely on pipeline distance.

9. *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.*

We agree that the use of substitutable capacity should be managed using either explicit exchange rates or some other form of capping. From the analysis presented by National Grid, certain ASEPs are more vulnerable to being donors than others simply due to where they are located and how they interact with other ASEPs and we believe that this requires that substitution should be shared across donor ASEPs rather than taken in sequence. One approach would be to calculate the capacity available for substitution based on the amount unsold at each ASEP so those with a greater level unsold would contribute more to the requirement. The quantity could be defined in percentage or volumetric terms.

Fundamental changes in the demand/supply mix are expected to occur over the remainder of the current Transmission Price Control which are creating market uncertainty. It is vitally important therefore to ensure that GB retains its access to gas from international markets and that flexibility exists to import gas at certain import terminals, such as Bacton and Teeside, on peak days. To this extent it would seem to us that taking a cautious approach to the newly introduced concept of substitution is one which is likely to be in the best interest of GB consumers until such time as the current market uncertainty has dissipated.

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

We agree that it is necessary to have a transitional rule that prevents the substitution methodology being applied in an ad hoc auction that is held soon after the substitution methodology comes into force but before the next scheduled LTSEC auction. There is no need for an enduring rule as system users will understand the potential risk in subsequent auctions.

## 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 Ofgem should undertake an IA. This must include the wider implications of substitution, such as the cost to GB consumers resulting from the risk of capacity being unavailable to import gas on a peak day, as well as the narrow focus of investment efficiency.

*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.*

An assessment of “economic and efficient” in respect of substitution should include as criteria investment efficiency (both in the immediate term and in relation to potential future investment required), wholesale gas market volatility, security of supply and barriers to market entry resulting from further complexity.

*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.*

Whilst substitution will not alter the physical capability to flow gas at an ASEP the uncertainty as to whether capacity will actually be available to flow gas at an ASEP where capacity has been transferred away could adversely impact security of supply. Having to secure capacity on an ad hoc discretionary or interruptible basis carries significantly more risk than knowing there is unsold baseline capacity available to be booked on a short term basis when the need arises and this could deter or delay decisions to import gas, thereby increasing the likelihood of an emergency occurring.

*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.*

The GB market has already experienced the consequences that can arise from a failure or delay in importing gas during times of supply/demand tightness and it is not unreasonable to assume that such occurrences could increase in the event a draconian approach is taken to entry capacity substitution. We understand that a number of shippers have commissioned a study attempting to quantify this impact and Ofgem should take account of this in their IA.

*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.*

As previously stated we are willing to accept delays in the allocation time table following the LTSEC auctions if it produces more credible outcomes. Allowing time for National Grid and

Ofgem to properly consider the wider consequences of any substitution opportunities thrown up by the LTSEC auctions seems eminently sensible and if this results in notification of incremental allocations being delayed then so be it, although it might be pertinent to review the LTSEC auction timetable in light of this.