12 June 2009

Andrew Fox
National Grid
Transmission Commercial
NG House
Warwick Technology Park
Gallows Hill
Warwick
CV34 6DA

Dear Andrew

BG International Ltd (BG Gas Services Ltd) are pleased to respond to the Informal Consultation on Entry Capacity Substitution, 15 May 2009

BG supports the concept of entry capacity substitution as a way of avoiding unnecessary investment and agrees it has the potential to contribute towards maintaining an economic & efficient system. However we consider it is essential that sensible operational & commercial decisions are made to avoid excess capacity degradation. As such, we believe the mechanical approach best fulfils these criteria.

Our concerns centre around terminals where future predicted peak flows are potentially at the existing baseline even though the sold levels of capacity may only currently be a fraction of that. Not protecting capacity at terminals such as Bacton for IUK and Easington for Rough flows, and hence restricting the ability for peak gas flows could endanger the ability for the system to respond on days of high demand or in times of gas supply deficits & emergencies. This may lead to gas prices rising above otherwise expected levels which in turn could have the undesired effect of raising consumer costs.

In response to the argument that Users should make the commitment at these terminals; we would suggest that Users are not always in a position to make the necessary financial commitment at the appropriate time to protect against the potential negative effects of substitution and hence the requirement & responsibility to ensure this happens should sit within the methodology - the mechanical approach addresses our concerns on this point.

In order to determine whether substitution is indeed fulfilling the criteria of contributing towards and economic & efficient system, we believe an economic test is required. Whilst the economic test proposed does address the benefit of avoiding unnecessary investment it fails to consider the potential value/cost of lost flexibility. We believe this is a necessary consideration and remain to be convinced that the true savings from future avoided incremental investment are greater than the value of lost system flexibility.

In order to limit any unforeseen consequences, we believe a “soft landing” is appropriate. This would include:

- Maximum exchange rates of 2:1
- No partial substitution
- Protection of capacity up to the maximum Interconnector Import and Storage withdrawal flows.

Consultation Questions

Paragraph 28

a. *Are there any other factors that National Grid should include in the Base Methodology?*
   Consideration be given to how much flexibility will be left in the system for any "behind the scenes" informal configuration that happens on a daily basis, for example on days of high demand or at times of operational constraints caused by e.g. compressor failures.
b. *Are there any aspects of the Base Methodology that should be excluded or amended?*

Paragraph 52

c. *Should the substitution methodology use an exchange rate cap to limit the impact of substitution on donor ASEPs*?
   Yes, to reduce capacity destruction and to enable a "soft landing" such that not all available capacity is substituted in one hit. It might be more efficient to save some for another year that might see a new development achieving better exchange rates due to it closer proximity to an ASEP with capacity spare. This would also reduce the risks of unintended consequences from the process.
d. *Would the intended benefits of an exchange rate cap be better achieved through implementation of any of the options (Mechanical Approach, Option Approach or Two-Stage Auction) discussed in Section 6?*
   Should apply in all cases

If an exchange rate cap is used:

e. *At what level should the exchange rate cap be set? Respondents may consider that a different value is appropriate depending upon other factors of the methodology, e.g. whether any of the options discussed in Section 6 is implemented.*
   Should be no more than 2:1, to limit capacity destruction
f. *Notwithstanding that National Grid is obliged to review the substitution methodology on an annual basis, should the exchange rate cap be set at a low level in the expectation of increasing in future years?*
   Yes – should be low to start and then reviewed after each auction or as necessary, with the benefit of experience.

Paragraph 59

g. *Do respondents consider that an economic test is appropriate or necessary for the substitution methodology?*
   Given that Substitution is all about saving costs on unnecessary development of new capacity. It's hard to see how an economic test could not be applied.
h. *Would an economic test add unnecessary complexity to the process?*
   It would if applied after the methodology has been applied (and also create uncertainty on the part of participants if it becomes a second, although justifiable, hurdle). There is merit in an economic test to demonstrate the overall benefit of entry capacity substitution and this test needs to properly value the existing system flexibility, an element that is excluded from the current National Grid proposal.
i. *What benefits, if any, would an economic test provide? If an economic test was introduced*
   Some value should be given to the spare/unsold capacity given that you can't guarantee that it will never be needed in the future for e.g. a new development/increased Capacity in IUK and hence requiring investment to replace what was lost through substitution. The higher the exchange rate cap the more likely it won't be economic.
j. *What parameters should be used for the donor and recipient ASEP values?*
k. *Are there any alternative tests that should be considered?*
   A value on flexibility/having spare capacity in the NTS compared to the costs saved by avoiding unnecessary investment

Paragraph 80

l. *Do respondents prefer the Mechanical Approach over the Option Approach and/or Two-Stage Auction? Why / why not?*
BG favour the Mechanical approach, as less user commitment is required (where shippers may not be in a position of knowing when to commit) to protect capacity that should obviously not be substituted. Assuming the levels of protected capacity are set correctly, this approach would be the safest to guard against capacity being substituted inappropriately.

m. *What features of the Mechanical Approach do respondents like / dislike; e.g. simplicity, lack of User commitment?*
The mechanical approach offers a simple solution however a robust and accurate method for determining the volumes to be protected isn't obvious. It would seem that some judgment either from NG or OFGEM might be necessary which isn't ideal, as any decision could be open to criticism.

n. *What criteria should National Grid use to determine the level of protected capacity at each category of ASEP (e.g. beach terminal, storage etc)?*
Storage and Interconnectors should be protected up to maximum possible flows (Firm and Interruptible capabilities) because such flows will be required under GDE conditions. Beach flows should be as per TBE. Existing and new flows should be recorded separately in the TBE, so NG could consider its own analysis & validation of the likelihood of new developments and future supplies.

o. *Is the use of deliverability, or similar, such that substitution is limited to major beach terminals acceptable? Would this be undue discrimination?*
Substitution may impact some shippers more than other, but the objective is to make efficient use of any sterile capacity, which won't be fairly spread across terminals. We are interested to understand National Grid and Ofgem's view on the locations of this perceived sterile capacity and how much they really think exists.

p. *Are there alternative sources of data to the TBE, deliverability that would be reliable, transparent and readily available?*
Not aware, but consideration could be given to an independent audit for determining capacity / transportation model validation.

q. *How could a soft-landing be applied to the Mechanical Approach?*
By limiting the exchange rates - as see paragraph 52 C

Paragraph 94

r. *Do respondents prefer the Option Approach over the Mechanical Approach and/or Two-Stage Auction? Why / why not?*
The Mechanical approach is preferable to the Option approach provided the capacity protected is to the correct level. Otherwise the option approach could be beneficial, giving shippers back some control over what should be held back

s. *What features of the Option Approach do respondents like / dislike?*
We are not clear from the proposed methodology whether shippers should each bid for the full amount to be protected or just their share.

t. *Bearing in mind the substitution objectives do respondents believe that it is appropriate that capacity can be protected from substitution with only a relatively small commitment from the User?* Yes

u. *Should the Option Approach be made available to non-Users? If so how should it be applied?*
No

v. *Is the option fee set correctly?*
   i. *Is it correct to have the same fee for all ASEPs?*
   ii. *Are the minimum reserve price and 8 year period appropriate parameters for setting the option fee; i.e. is a fee set at approximately £300,000 for 10 mcmd correct?*
   iii. *Are refunds in the circumstances described appropriate?*

w. Should the option fees and refunds be dealt with through TO charges? If not, how should they be accounted for?

Paragraph 106

x. Do respondents prefer the Two-Stage Auction over the Mechanical and Option Approaches? Why / why not?

BG does not support this approach as it is likely to unnecessarily restrict capacity for gas flows that can be expected on a day. By their nature, these flows are not necessarily baseline, so forcing shippers to purchase this capacity in advance is likely to lead to higher gas prices being passed through to consumers.

y. What features of the Two-Stage Auction do respondents like / dislike?

The concept of shippers having to judge if their ASEP is at risk creates significant uncertainty. How can shippers be sure if capacity they may wish to use in future is at risk from being taken away through this auction mechanism? Shippers at ASEPs out of zone may be safe, but could be at risk if within zone shippers have taken steps to protect their capacity, although they wouldn't know this. It would be essential that NG publish their proposed substitution plan with volumes and exchange rates for shippers to make an informed choice. This mod also requires full user commitment and is complicated with tight deadlines. BG also has concern with respect to how this proposal fits with Mod 246 and the QSEC User commitment.

z. Bearing in mind the substitution objectives, do respondents believe that it is appropriate that capacity can only be protected from substitution if the Shipper makes a commitment to buy the capacity?

Commitment is being sought for the long term for capacity that may not be required. This will end up being unnecessarily incorporated in the gas price, passing on increased costs to the consumer. The existing arrangements are more likely to be economic and efficient, balancing as it does the risks and rewards for Shippers in respect of entry capacity purchases. Where there is a clear need for baseline supplies from a new development, we would consider that User commitment will be forthcoming.

aa. Do respondents consider the timeline to be an issue, e.g. would five (or less) stage 1 auction bid windows create a problem?

It would create uncertainty for participants.

bb. Bearing in mind the level of commitment required, do respondents think that this proposal would encourage Shippers to obtain capacity for a discontinuous quarter (see section 7.1)? If so, is this a problem?

Single quarter booking maybe considered by shippers as an alternative, if this proposal is the preference, because otherwise shippers are being forced into making a full commitment when they are not sure of their needs. That situation will just create additional costs which will ultimately be borne by the end user.

Paragraph 117

cc. Do respondents believe that single quarter bookings present a problem that requires specific rules to prevent them?

We believe they should only be permitted in the circumstances of a Two stage auction.

dd. Would single quarter bookings only be a problem with a specific substitution methodology, if so which? Two stage see Paragraph 106 bb.

ee. What is the preferred action, if any, to prevent single quarter bookings?

Have National Grid considered the compulsory buy back on non-incremental capacity up to the volume purchased by shippers no further out than say 5 years or substitution only applied.

Paragraph 124

ff. Do respondents believe that the substitution methodology should only allow substitution to proceed where an incremental signal can be met fully from substitution?

Yes

gg. Should partial substitution be allowed for specific options outlined in Section 6? No.

hh. *Should partial substitution be considered as an element of a soft-landing to be introduced at a later date?* Yes, once initial rules have been laid down, more attention can be given to overcoming any license revenue driver issues and the rules for partial substitution.

Paragraph 129

ii. *Do respondents believe that the use of entry zones in the substitution methodology is appropriate?* Yes *or*

jj. *Should the methodology be applied purely on nearest donor ASEP?*
Substitution should be applied to the donor ASEP that will give the most efficient exchange rate, working through ASEPS that give lower Exchange rates until the cap is reached

kk. *Do respondents favour pro-rating within zone?*
Pro-rating can be with ASEPS that give the same exchange rate

Paragraph 139

ll. *Whether respondents favour a soft-landing?* A Soft landing approach would be viewed as a sensible precaution.

mm. *If so, what parameter(s) should be used*? 2:1 exchange rate cap. No partial substitution

nn. *Over what period should a soft-landing apply?* A review after the first QSEC and then decide over what period it should apply

oo. *Are there any other ways that a soft-landing could be introduced?*

pp. *Should a transitional rule be included to ensure that substitution is introduced first to a regular QSEC auction?* Yes

Paragraph 143

qq. *Notwithstanding the current position, National Grid would welcome views on whether proposals should be put forward to amend the License to facilitate a pricing structure which incentivises long term entry capacity booking*s.
Lower reserve price in long term auctions would incentivise long term bookings.

Paragraph 163

rr. *Do respondents have any concerns or comments regarding aspects of the Base Methodology not discussed above?*
Covered in our opening statements.

Yours sincerely

Emma Hayes
Gas Operations Manager
&
Mark Dalton
Commercial & Regulation Manager

BG GROUP
Thames Valley Park
Reading Berkshire
RG6 1PT UK
www.bg-group.com

emma.hayes@bg-group.com

Tel +44 (0)118 929 2018
Fax +44 (0)845 084 8908