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Dear Andrew,

**RE: Informal Consultation on Entry Capacity Substitution**

Thank you for the opportunity to comment on these initial thoughts on entry capacity substitution.

**Background**

Much has been said and written on this subject during its somewhat troubled gestation, and whilst we are generally reassured by this current approach to the development of an acceptable solution, it is probably worth repeating our high level views and concerns about the concept of capacity substitution.

In the light of declining UKCS supplies, it makes no sense in maintaining NTS capabilities, and associated entry baselines, if in the future it could be demonstrated conclusively that current baseline levels were excessive and unlikely ever to be used again. To do so will lead to inefficient investment and unnecessarily inflated transportation costs. However, we do not necessarily believe that such a position has been reached yet.

The corollary, of course, is that removing capacity from ASEPs where it may potentially be required in the future brings immense risks of stranding gas offshore, impacts on security of supplies to GB customers, and elevated commodity prices.

As well as this longer term outlook, in the shorter term the gas supply mix is becoming much less predictable, for example with importation and or storage facilities being used to meet demand for short durations. Wind intermittency also means increased shorter term variations in gas demand most noticeably from CCGTs. The NTS needs to be flexible enough to cope with these scenarios.

In addition to these points, we believe that there is a risk that the advent of substitution may serve to further discourage investment in the further development and exploitation of UKCS supplies. There is, therefore, a delicate balance to be struck.

In striking this balance, we would automatically look for analysis that set out the potential reduction in transportation costs under various scenarios, and compare that to the risks of such actions bringing forward any of the detriments set out above. The problem faced by shippers is that such analysis does not appear to exist. A full RIA could help to rectify this deficiency. In undertaking an RIA, we would look for a clear and honest demonstration that this is the right time to implement substitution, and that the right model of substitution is being adopted, rather than this being a case of simply "ticking a box" because there happens to be a transporter licence obligation to do so.

Against this background, and in the absence of any such analysis, our intuition is that the magnitude of the downside risk has the potential to massively outweigh the upside benefits (bearing in mind that transmission transportation accounts for only around 2% of domestic consumers' bills). At best, substitution will save only a fraction off this 2%. We therefore err strongly towards a cautious commencement to any substitution regime, with options to ramp up substitutable quantities in the light of experience of capacity substitution, and greater information about the likelihood of future gas flows.

We also note the current discussions about use of parts the NTS for CCS purposes. That initiative also has the potential to constrain the NTS, in much the same way as substitution could. We therefore ponder the tension between these two processes, insofar as an NTS made "tight" through substitution may not be able to accommodate future CCS requirements and vice versa. It would be helpful if any analysis considered these two processes.

**Responses to specific questions**

***a. Are there any other factors that National Grid should include in the Base Methodology?***

***b. Are there any aspects of the Base Methodology that should be excluded or amended?***

Given the importance of network resilience, especially in the light of ongoing discussions within Europe of national fuel security, we would welcome consideration of a more severe test e.g. 1 in 50 winter. We also recall the debates around giving Ofgem/DECC rights to consider and veto proposed substitutions. Whilst we note comments within the consultation document that such a safeguard was a matter for Ofgem, and therefore not pursued within the realms of these discussions, we still consider the ability to intervene to be a vital safeguard against unwanted side effects.

***c. Should the substitution methodology use an exchange rate cap to limit the impact of substitution on donor ASEPs?***

***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?***

Whilst in principle we believe that that application of a low exchange rate cap would be a good thing, especially in the early years, we also recognise that incorrectly set exchange rate caps can lead to unwelcome results in either direction, e.g. too much or too little substitution. We therefore wonder whether there could be a role for an indicative exchange rate cap, combined with regulatory oversight and power to veto.

***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.***

***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?***

Inevitably, the setting of a cap is likely to be arbitrary. However, in the early years we could support a low cap in the order of 2 or 3:1 where this is combined with regulatory oversight and power of veto, or 1:1 where a purely mechanical approach is employed. Scope should remain for increasing the cap in the light of positive experience and better information about future gas flows.

***g. Do respondents consider that an economic test is appropriate or necessary for the substitution methodology?***

***h. Would an economic test add unnecessary complexity to the process?***

***i. What benefits, if any, would an economic test provide?***
***If an economic test was introduced***

***j. What parameters should be used for the donor and recipient ASEP values?***

***k. Are there any alternative tests that should be considered?***

An economic test certainly has an attraction, in principle. This is the ability to constrain substitutions based upon firm economic criteria. However, we agree with the general view of workshop attendees about additional complexities, especially when the key attraction of an economic test – this ability to constrain substitution – can be largely achieved through other, less complex means (e.g. exchange rate caps, human oversight etc). Whilst these may not drive the same level of confidence in an outcome as an economic test, we believe that the actual difference in financial terms is likely to be negligible.

***l. Do respondents prefer the Mechanical Approach over the Option Approach and/or Two-Stage Auction? Why / why not?***

***m. What features of the Mechanical Approach do respondents like / dislike; e.g. simplicity, lack of User commitment?***

***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)?***

***o. Is the use of deliverability, or similar, such that substitution is limited to major beach terminals acceptable? Would this be undue discrimination?***

***p. Are there alternative sources of data to the TBE, deliverability that would be reliable, transparent and readily available?***

***q. How could a soft-landing be applied to the Mechanical Approach?***

Each of the three options could deliver benefits, and we believe that any of them could be made to work, and work well. We also wonder whether there is scope to combine two or more options i.e. are they necessarily mutually exclusive.

Given that we are being asked to express a preference, however, at this stage we believe that the simplicity offered by a cautious Mechanical approach, with appropriate safeguards, is the best bet for the industry.

By “cautious approach”, we mean that National Grid should prevent substitution of capacity below the absolute maximum reasonably achievable flows. Naturally TBE data will play a role in this, but other sources of data should also be considered. These might include forecast flows from other credible industry commentators, recent historic peak flows where these can be attributed to repeatable circumstances etc. We would also push for more transparency around National Grid’s rationalisation of TBE data received from respondents.

***r. Do respondents prefer the Option Approach over the Mechanical Approach and/or Two-Stage Auction? Why / why not?***

***s. What features of the Option Approach do respondents like / dislike?***

***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?***

***u. Should the Option Approach be made available to non-Users? If so how should it be applied?***

***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?***

We believe that the Option approach has merits, and should remain as a possibility for adoption following a future review of substitution. At this stage, however, our view is that the Option approach is (a) likely to lead to a higher level of substitution than the mechanical approach, which goes against our underlying desire for a lower risk start to the substitution regime, and (b) could lead to parties making mistakes in their capacity bidding strategies due to unfamiliarity with a newly implemented substitution regime.

We are also concerned to ensure that any Option methodology limits the scope for game playing by shippers, and prior to implementation is developed in order to remove the arbitrariness of the Option fee.

Following a successful commencement, however, we believe that the Option approach could yield additional capacity efficiencies, since it removes the role for National Grid and/or another party to try and forecast where shippers may require capacity in the future, and places more of that responsibility with shippers.

Since this is not our preferred option, we have not commented in detail on all of the points raised.

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

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

***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?***

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

***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?***

As above, we believe the two stage auction approach should be retained as a possibility for the future. However, at this stage we believe that the additional complexity that would be introduced to the QSEC process, and the uncertainties of what information would be made available between the auction stages in order to inform shippers of where baselines were under threat, means that we continue to favour a more straightforward (e.g. mechanical) approach.

Again, we have not commented at length on this proposal as we believe that further consideration of its implementation, with development as necessary, should take place following experiences under a low risk Mechanical regime.

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

***dd. Would single quarter bookings only be a problem with a specific substitution methodology, if so which?***

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

The single quarter issue exists to the extent that a shipper books capacity up to baseline for a limited period at some point in the future. We hold the view that this could well be a legitimate course of action by reputable shipper. For example, declining UKCS supplies will see shippers undertaking a range of enhancements to existing fields in order to extract the maximum possible reserves. It could be that such an enhancement pushes volumes close to or at baseline levels for a limited period, before the natural decline reduces those volumes again. Another example could be the tying in of another field, temporarily pushing landed volumes higher.

We believe it will be impossible to distinguish between legitimate bookings of this nature, and other attempts to retain a baseline at an ASEP. Even then, we wonder why any shipper would wish to artificially retain a baseline through use of the single quarter anomaly, unless they had a genuine belief that it might be used in future.

To this end, we view the single quarter issue as a by-product of an imperfect system, and one that we should simply live with at this stage, and at least until it becomes clear that either there are abuses and that these are leading to high volumes of capacity being unnecessarily withheld from the substitution pot.

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

***gg. Should partial substitution be allowed for specific options outlined in Section 6?***

***hh. Should partial substitution be considered as an element of a soft-landing to be introduced at a later date?***

We see no reason why partial substitution should not be permitted, but would much prefer to wait in order that experience can be gained from all-or-nothing substitution, given the additional complexity that partial substitution is likely to entail.

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

***jj. Should the methodology be applied purely on the nearest donor ASEP?***

***kk. Do respondents favour pro-rating within zone?***

We believe that the use of entry zones may be beneficial in simplifying the process for users, and could support pro-rating within zone.

***ll. Whether respondents favour a soft-landing?***

***mm. If so, what parameter(s) should be used?***

***nn. Over what period should a soft-landing 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?***

As set out in our responses above, we tend to favour a cautious Mechanical approach because we believe that it offers simplicity as well as the ability to provide an appropriate soft landing approach to substitution. We would recommend that no attempt should be made to ramp up from a soft landing until there have been at least two real examples of capacity substitution, from which lessons can be learnt. We believe that substitution can be applied first to a regular or an ad-hoc auction, provided that any ad-hoc auction is held as part of a full QSEC process (i.e. does not involve just one ASEP).

***qq. Notwithstanding the current position, National Grid would welcome views on whether proposals should be put forward to amend the Licence to facilitate a pricing structure which incentivises long term entry capacity bookings.***

Centrica has ongoing concerns relating to reserve prices, and the high and apparently ever increasing level of TO commodity charge. This would tend to indicate a failing of the current capacity regime. It could be that the answer is to incentivise long term capacity bookings, but there could also be other options. We therefore caution against any attempt to amend changing structures solely on the basis of QSEC/substitution without full consideration of the effects of all charging policies.

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

No.

Please contact me if you would like to discuss this response

Yours sincerely,

Chris Wright
**Commercial Manager**