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Dear Andrew

Gazprom Marketing & Trading Response to “Informal Consultation on Entry Capacity Substitution”

Gazprom Marketing & Trading (“GM&T”) appreciates the opportunity to respond to the above consultation on Substitution. Whilst we support the aim of ensuring that the UK NTS gas network is fit for purpose as the pattern of UK gas flows changes, we also remain concerned that Substitution could adversely affect the UK gas market if incorrectly implemented. There is a clear balance to be maintained between ensuring that National Grid does not invest in additional capacity unnecessarily, and ensuring that there is sufficient capacity to enable supplies of gas to reach the UK market as the UK becomes increasingly import dependent. These arguments have been well rehearsed in the various industry meetings on Substitution, and I do not intend to repeat them here. However the industry has repeatedly asked for an assessment of the benefits of substitution to be weighed against the potential impact on the wholesale gas market, and such an issue should be addressed in any Impact Assessment undertaken by Ofgem.

With the above in mind we have the following comments on the informal consultation.

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?

One basic premise underlying Substitution is that it assumes that because capacity is not booked in a QSEC auction, this means that capacity is “unwanted” and therefore will simply be sterilised if it is not available for Substitution. This may be the case as flows into a particular ASEP decline, for example as a result of the decline of fields. However it is not definitely the case; there may be projects that are unable to make capacity bookings 2 years in advance of requirements because of other timing issues or uncertainties. Shorter term users of capacity at interconnectors or storage facilities may be unwilling to make such long term commitments because it requires being able to forecast the gas market so far in advance, but may then wish to book capacity if fundamentals in the gas market change, for example, failure of other key infrastructure.

Such factors need to be taken into account when reducing capacity at a donor ASEP as a result of substitution, since the impact of substitution limits the ability of gas to flow at donor ASEPs in the future. Whilst we recognise NG's comments that Trade & Transfer and short term release of discretionary capacity may help with the availability of capacity at donor ASEPs, such tools are insufficient to wholly replace the capacity lost as a result of substitution, since there is no guarantee that they will occur, nor that they will be of sufficient quantity and duration. The latter problem is due to the fact that there is a default 42 month lead time to replace capacity that has been substituted.

For these reasons there is inevitably an element of judgement required when deciding if substitution of capacity from a particular ASEP is in the best interests of the system, and UK gas consumers, overall. Unnecessary investment obviously increases costs overall; however it is equally clear that the inability of the system to accept gas in a timely manner can also have significant cost implications for consumers. We suggest that Ofgem, meeting its statutory obligation to protect consumers, should have the right to review proposed substitutions prior to implementation to take account of the factors noted above.

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?

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?

GM&T believes that use of a low (close to 1:1) exchange rate cap is appropriate to limit the potential for capacity destruction. It does not appear to make sense to significantly reduce capacity at a donor ASEP for only a marginal benefit at the recipient ASEP, particularly in light of the 42 month lead time required to "regain" capacity at the donor ASEP via signals for incremental capacity. Whilst we recognise that this will limit the potential for substitution, and that this may not always be appropriate, this must be balanced against the adverse consequences of capacity destruction.

For this reason we would support the idea of a soft landing, with a tighter exchange rate cap to start, with the potential to review it in future. There should not be an automatic assumption that the exchange rate cap would be increased, as this presupposes that a low cap is inefficient. It is only when there have been specific instances of "good" substitution proposals have been hindered by the exchange rate cap that we will know that the level of exchange rate cap is problematic. In any case, this is another instance where the need for judgement is required, i.e. a low exchange rate cap may be inappropriate at some ASEPs,

whilst a useful safeguard at others. For this reason some kind of review by Ofgem is desirable, as noted above.

GM&T believes that an exchange rate cap is a useful addition to the other options being considered for implementation, and therefore it is not a simple binary question as to whether an exchange rate cap is better or worse than the other options.

It is very important that NG and Ofgem recognise that Substitution represents a major change to the current entry capacity regime, and introduces a significant additional level of risk and uncertainty for all market players. For these reasons we believe caution in the early implementation of substitution is justified, as it is usually easier to improve a mechanism over its lifetime, rather than attempt to reverse the damage done by an initial poor design and implementation. Whilst Ofgem and NG can reasonably point to the degree of discussion that has taken place on the issue of substitution, the truth is no-one knows for certain how it will impact the UK gas market, until it is in place for real. This fact recommends a cautious approach when implementing such a change.

I. 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?

GM&T prefers the Mechanical Approach over the Option Approach and the Two Stage Auction Approach. For our comments on the Option Approach and the Two Stage Auction Approach please see below.

The advantages of the Mechanical Approach are as follows:

- It is simple and easy for all market participants to understand. As noted above and in industry discussions, Substitution introduces a significant element of complexity to the entry capacity regime. Under the existing regime potential bidders in an auction only need to know the likely demand for entry capacity at the ASEP where they intend to bid. With Substitution, they potentially have to know likely demand at all the other ASEPs, the likelihood that a signal for incremental capacity at other ASEPs will be given, where capacity may be substituted from and at what exchange rate. The Mechanical Approach has the benefit of enabling participants to know that, irrespective of what may be happening at other ASEPs, there is a guaranteed minimum amount of capacity that will be available at that ASEP.

- By holding back some capacity from substitution it helps counter some of the problems with substitution, for example the timing issue (capacity not booked in the QSECs is not necessarily going to be unused), and the problem of excessive capacity destruction.
- It enables the regime to take account of the way the UK gas market is changing with greater reliance on imports and storage, as opposed to relying on UKCS swing contracts. A mechanical approach should enable there to be sufficient capacity at ASEPs to match the deliverability of storage facilities or interconnectors. The nature of the market is such that it cannot be assumed the connected entry capacity will be booked in the long term. By holding back capacity to ensure there is sufficient to match the deliverability of connected facilities, the mechanism would ensure such facilities' capacities were not sterilised.
- Any sensible business, whether it be a factory making widgets, or a network operator, will wish to ensure there is a degree of spare capacity margin to take account of unforeseen circumstances. The key is to ensure that there is not excess "spare" capacity. The mechanical approach enables such an approach to be taken, with the ability of review by the industry and Ofgem at an appropriate time if required.

Whilst we recognise that there are problems with deciding how much capacity to hold back, we do not believe they are insurmountable. Taking these in turn:

- Use of TBE data may provide the opportunity for "gaming" of information, but this assumes that the quantity of capacity to be held back is slavishly based on what participants at different ASEPs tell NG as part of TBE. Both Ofgem and NG could have the ability to use their judgement as to how much capacity to hold back, based on all the information available to them, and by "stress testing" the claims of different parties. Other companies, such as Woodmac, have views on likelihood of flows from fields and other infrastructure projects. It is important to recognise that it will never be possible to have a simple mechanistic approach to determining how much capacity to substitute because of the various trade-offs involved. What is important is that there is a process to enable such trade-offs to be taken into consideration.
- It is not clear why it would be discriminatory to hold back capacity based on percentages or fixed quantities, or on the basis of deliverability of connected facilities. This would need to be discussed further.

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?

GM&T prefer the Option Approach compared to the Two Stage Auction Approach, but we do not believe it is the best way forward. Although it helps address some of the issues of Substitution, it has problems of its own. The Option Approach enables shippers to prevent capacity being substituted away without the need to pay the full cost of booking that capacity, and as such represents a kind of “half way house”. However shippers will still have to pay the cost of the option, even though the option does not give the right to actually buy capacity, as another shipper may buy the capacity, having benefitted from the first shipper paying the option to prevent substitution. Although the shipper who paid the option will receive a refund if another shipper buys the capacity, that shipper will still have to fund the cost of the option. In addition it is not clear why the shipper buying an option only receives a refund if another shipper books capacity in the year that the option was granted, and not in any subsequent years.

As NG have admitted, the way the Option Price is calculated is arbitrary. The driver behind the option approach is to ensure that there is some form of User Commitment. It is not clear why there needs to be a long term User Commitment for all capacity; again this seems to be making the mistake that, just because shippers do not make some form of commitment in a QSEC auction, that capacity will not be used. The issue of how capacity is paid for is a different issue. As has been noted elsewhere the charging methodology for entry capacity may influence shippers’ long and short term booking strategies. As it is, the relative high cost of the proposed Option Price may still cause problems for shippers who are not yet in a position to make a final commitment to their projects. As such the option price simply raises the hurdle for such projects, and may therefore favour larger players with deeper pockets. For this reason consideration should be given to making the option fee a smaller, more nominal amount.

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?

The key advantage of a two stage auction approach is that it enables a shipper to buy capacity at a potential donor ASEP once it is clear there is a threat of substitution. However, because NG does not propose to give any information between the two stages of the auction regarding which ASEPs will be donors, likely exchange rates etc., the utility of the two stage auction approach is severely reduced. As NG has also noted it does not remove the need for shippers to pay the full cost of capacity to safeguard it, at a time when the shippers may not be in a position to commit to their projects requiring capacity. Therefore the two stage auction approach only partially reduces the drawbacks of substitution, without addressing the key problem of timing.

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 is a direct consequence of the additional complexity being introduced to the entry capacity regime. It is inevitable that shippers will try to manage the additional risk and uncertainty imposed by substitution in the most cost effective way possible. It may be that this is by a single quarter booking. However, rather than attacking the symptom of single quarter booking, NG and Ofgem should address the underlying cause of the nature of the substitution regime. By limiting the downsides of substitution via the Mechanical Approach and exchange rate caps, or even by the use of low cost options, the potential attractiveness of single quarter booking would be much reduced.

The problem of trying to introduce rules to prevent single quarter booking is that such an approach will simply introduce yet more complexity, with the inevitable increases in the risk of unforeseen consequences, and potential for yet more “gaming”. For this reason GM&T recommends that NG and Ofgem design the Substitution regime correctly, taking into account our comments elsewhere in this letter.

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?

Subject to our comments above about Substitution, the aim of the regime should be to minimise the cost of the system whilst retaining sufficient flexibility to allow gas to enter the system and meet UK demand. It may be that partial substitution can help achieve this. However, given the complexity of the system, we would support a review of partial substitution once further experience has been gained. Please note that this issue also demonstrates the need for sensible judgement by NG and Ofgem on whether a substitution should go ahead.

II. 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?

We are in favour of a soft landing approach because of the significant impact that substitution will have on the entry capacity regime. This should take the form of measures to restrict substitution such as more capacity held back, lower exchange rates, and in the case of the Option model, low option prices to see how the regime might work. The soft landing period should last for a minimum of 3 QSECs, given the long term nature of the entry capacity regime.

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.

As has been argued by other shippers in previous consultations, the use of Substitution to encourage long term bookings can be regarded as the wrong large sledgehammer to crack the wrong nut, since the reserve prices set in capacity auctions could also be thought to have an effect on booking behaviour. However Ofgem has decided to pursue the Substitution approach. It is therefore not clear what the advantage is to the industry in looking at the pricing structure now that the wrong approach has been taken.

I hope the above comments are useful. If you have any queries please do not hesitate to contact me on ++ 44 20 8614 3036 or at alex.barnes@gazprom-mt.com.

Yours sincerely

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