

10th June 2009

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

Centrica Storage Limited
Venture House
42-54 London Road
Staines
Middlesex TW18 4HF
Telephone +44 (0)1784 415300
Facsimile +44 (0)1784 415318
www.centrica-sl.co.uk

box.transmissioncapacityandcharging@uk.ngrid.com

Dear Andrew,

RE: NGG's Informal Consultation on Entry Capacity Substitution

Centrica Storage Limited (CSL) welcomes the opportunity to offer comments on the above informal consultation. Our response is in two parts; we first offer some general comments on the substitution policy and process, secondly we provide our views to the questions raised in the consultation.

Over the past 18 months, CSL has, together with other industry participants, committed a considerable amount of time and effort to developing a workable solution to challenges presented by the policy which introduces an entry capacity substitution obligation on NGG. The policy is aimed at delivering the twin objectives of maximising the use of existing gas National Transmission System (NTS) assets for the benefit of consumers and avoiding both capacity sterilisation and unnecessary infrastructure investment. It is believed that entry capacity substitution will achieve this through relocating capacity that is not required at its current entry point (at a given point in time) to a different entry point where it is needed. However, relocating capacity has its cost; it is understood that the exchange rate (the rate at which capacity is moved from a donor entry point to the recipient entry point) will generally be less than 1:1, i.e. for one unit of additional capacity to be created, greater than one unit will be destroyed. As a consequence this policy will inevitably lead to the destruction of the overall level of NTS capacity, and hence flexibility. Herein lies the dilemma: network efficiency versus network flexibility; to what extent should 'spare' capacity be used to offset NTS investment at the expense of present and of future NTS flexibility?

Whilst we accept that there are too many unknowns to find the right answer to this dilemma, Ofgem does have freedom to implement this policy in such a way that favours one outcome more than the other. Over the past months we have witnessed just how susceptible the GB gas market is to supply shocks with events in Eastern Europe having a significant impact on GB gas storage behaviour. As we move forward in time and the indigenous supplies from the UKCS continue to decline, the GB gas market will become increasingly dependent on imported supplies: with this move to increased import dependency, the GB gas market will become increasingly vulnerable to supply shocks. We need to be prepared to meet these

challenges and CSL believes that transmission flexibility will play a crucial role in mitigating the risks that accompany uncertain gas supply. Indeed we understand that the importance of flexibility has been recognised by a number of industry commentators; we believe that responses to Ofgem's Project Discovery, which has highlighted a number of recent events that pose new threats to the efficient operation of the GB energy market, recognise the need to maintain or enhance NTS flexibility. We wholly support this view and urge both Ofgem and NGG to consider the wider picture of the future requirements that will be placed on the NTS when considering the extent to which efficiency gains are pursued through this policy.

With regard to process, CSL believes that it is worth noting the considerable effort that NGG has committed in developing the options that are now under consideration in this informal consultation. This marks a stark change in approach to that which was adopted during the second series of workshops and has been broadly welcomed within the industry. NGG should be congratulated on this. However, CSL does have concerns regarding the time it has taken to reach this position; the substitution policy was agreed as part of the TPCR package implemented in April 2007 and the current proposal is for Ofgem to direct on the Methodology Statement in December 2009, some 21 months into this control period. Whilst CSL recognises that substitution is a complex issue we are concerned that the process could have been more expeditious. CSL urges Ofgem to undertake a 'lessons learnt' exercise on the development of substitution policy to identify what went well and what could improved upon. This, it is hoped, will provide useful insight into future policy implementation.

CSL now provides comments on the following 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?**

CSL agrees with the fundamentals outlined in section 27 of the informal consultation. However, in addition to these we would like to make the following observations.

Firstly, CSL has previously argued against the view that if capacity is not booked in a QSEC auction it is "unwanted" and therefore will be sterilised if it is not made available for substitution. The NTS has different Users with different requirements and these different requirements prompt different behaviours when it comes to acquiring entry capacity. For example it would be legitimate for a producer delivering gas to a single entry point to purchase minimum required capacity in the long term auctions with a view to finessing its holding once production schedules become more certain, through the annual, monthly and daily auctions. Furthermore, Users of storage tend to book storage capacity on a year ahead basis; it is unreasonable to expect these Users to make entry capacity commitments for periods beyond their storage holding. NGG's base methodology should recognise the need to maintain the flexibility to accommodate different Users' requirements: CSL would not support the arguments presented for the unconstrained approach to substitution.

Secondly, irrespective of the outcome of the substitution consultation, we understand that the model adopted will follow a mechanistic process and as such will contain the risk that unintended outcomes will result. We believe that this threat is best mitigated through providing Ofgem with the discretion to veto undesirable proposals. NGG will recall that this has received considerable support in previous consultations.

Finally, we would add 'securing the reliability of energy supplies' to the criteria used to assess the substitution options.

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?

The entry capacity substitution obligation introduces a major change to the existing entry capacity regime and with it brings additional uncertainty and risk to NTS Users. CSL therefore recommends that a cautionary approach is adopted for the introduction of this obligation.

CSL believes that a 1:1 exchange rate cap should be adopted for the remainder of this control period. This approach would limit the potential for capacity destruction and provide a soft landing ahead of the 2012 price control where the opportunity will present itself for a thorough review of this policy and how it fits in with Ofgem's wider agenda.

CSL believes that this cap is appropriate irrespective of which of the 3 options is implemented.

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?

CSL has a strong preference for the Mechanical Approach over both the Option Approach and the Two Stage Auction Approach. CSL believes the advantages of the Mechanical Approach are as follows:

It is relatively low risk and easy for Users to understand the level and location of capacity that will be protected from transfer. We believe that this will tend to produce a more efficient outcome when compared to either the Option or Two Stage Auction models. Both the Option and Two Stage Auction models require Users make an assessment of the risk that their entry capacity is exposed to. As this level of risk is dependent on other Users actions it will be near impossible to predict with any degree of confidence. Therefore, Users will tend to err on the side of caution (as the commercial impact of getting it wrong and losing their capacity may be catastrophic). This will lead to inefficient and unnecessary over protection of network capacity.

The likelihood of unintended consequences is also reduced as it does not rely solely on NTS Users having to take actions to protect capacity. For example it would protect capacity at the major import terminals of St Fergus, Bacton, Barrow and Teesside together with capacity at existing and proposed storage facilities. We accept that it will restrict the amount of capacity made available for transfer and whilst this may prevent occasional legitimate transfer opportunities it will maintain higher levels of NTS flexibility which CSL views as essential.

The mechanical process is transparent and easy to understand. It is forward looking and will complement the changing pattern of gas supply as GB increases its dependence on imports. Further the model will provide certainty ahead of the long term auctions. This will be of particular value to new entrants who may, for example, be concerned with bringing new supplies and gas projects to market.

We do not share NGG's concerns regarding potential gaming of the TBE data; NGG are experienced operators in this field and are best placed to decide the levels of capacity that should legitimately be protected from substitution. By way of soft landing, NGG may wish to exercise caution on the levels made available with agreement from Ofgem.

We understand that Ofgem (Networks Division) may not favour the Mechanical Approach because it requires a lower level of User commitment when compared with the Option and Two Stage Auction Approaches. We do not share these concerns and remind Ofgem that Users acquiring capacity, post the introduction of new credit arrangements (albeit pending the outcome of an impact assessment), can expect a far higher level of financial commitment than they are currently required to post. Further, User commitment may be demonstrated in a number of ways; for example through capital investment. For existing infrastructure this is already captured in the TBE reporting process, for new projects, we believe that NGG has the expertise to develop a set of guidelines that can be employed to differentiate between probably and improbable developments.

CSL believes that it would be highly regrettable if the User commitment arguments were considered to outweigh the significant benefits that are presented by this model.

- 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?**

CSL prefers the Option Approach to the Two Stage Auction Approach, but does not believe it to be a sensible way forward.

Our concerns with the Option Approach are two fold; firstly the rate at which capacity destruction will take place; this will be far greater than the Mechanical Approach as any capacity that is not protected by an option will be potentially at risk of transfer. This could, for example, lead to the destruction of entry capacity at key locations such as Bacton, St Fergus, Teesside and Barrow which we believe would not be sensible and potentially very detrimental to GB's ability to cope with supply shocks. Secondly, we have concerns relating to the endemic level of risk that all Users will be exposed to if, for whatever reason, an option is not taken out to protect capacity. The reasons why a User may not be in a position to take out an option may be perfectly legitimate i.e. related to the availability of finances as a project is development, and whilst the option cost is less than the full cost of booking capacity, they are not trivial e.g. £2.3m to protect TBE forecast levels at St Fergus.

We also have concerns that the way the Option price is calculated is arbitrary and bears no relationship to the value of capacity at the entry point where the option is placed.

- 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?**

CSL views the Two Stage Auction as the least preferred option as we do not believe that it is appropriate that capacity can only be protected from substitution if a User makes a commitment to buy the capacity. It is hugely expensive; NGG estimate that it would cost £27.6m to protect a single quarter of capacity at TEB forecast levels at St Fergus. It is inefficient; it will force Users to acquire entry capacity ahead of when they would normally do so under normal commercial conditions. It is uncertain; once an incremental signal for new capacity has given, potentially all unbooked capacity will be at risk of transfer and so Users will have no choice but to book their full requirement in the long term auction (at least for one quarter). It is high risk; if capacity is unintentionally not acquired at the second auction it will not be protected from transfer.

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?

CSL agrees that the single quarter booking does present entry capacity substitution with a particular challenge and unfortunately we can offer no ideal solution to this. However, we do believe that if the Mechanical Approach together with a limit on the exchange rate caps as suggested above were adopted then the issues surrounding the single quarter booking would be reduced.

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?

CSL believes that where substitution can minimise the cost of the system whilst retaining sufficient flexibility to allow gas to enter the NTS then it should proceed. We remind NGG that it has considerable experience of part investing part substituting (albeit implicitly) to meet incremental signals. We would however, reiterate our previous comment that we believe that Ofgem should exercise discretion over all substitution, part or otherwise, proposals.

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?

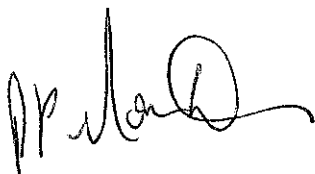
CSL supports a soft landing approach. Please see our comments made previously under the section concerning the Mechanical Approach.

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.

CSL believes that there are a number of legitimate concerns relating to the current pricing structure and in particular the incentives on acquiring capacity closer to the time of need. We have seen a number of changes to the entry regime since the conclusion of the last price control which have an impact on User's behaviour and would welcome a thorough review of the regime.

I hope the above comments are useful and if you have any queries please do not hesitate to contact.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Roddy Monroe', written in a cursive style.

Roddy Monroe
Regulation Manager