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Mr. Andrew Fox
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24 August 2009

Dear Andrew,

RE: Consultation on "The Entry Capacity Substitution Methodology Statement".

Thank you for the opportunity to comment on the above Methodology Statement. This non-confidential response is sent on behalf of the Centrica Group of companies, excluding Centrica Storage Limited.

Background

It is extremely disappointing that, after months of constructive work and real progress between National Grid and shippers, we arrive at a position where the industry is presented with a *fait accompli* in the form of this proposed methodology. We recognise that this is primarily Ofgem's doing through its announcement that it expects to consider only a methodology(ies) which includes some form of "User Commitment".

That announcement, made by way of an industry open letter dated 3 July 2009, was the first such indication from Ofgem that the clear front runner – the "Mechanical Approach" – which attracted overwhelming industry support, would not be an acceptable methodology for substitution. It is puzzling to us why an industry regulator, who has been repeatedly asked to provide early guidance if it believes matters are not progressing along acceptable lines, should attend and take part in such an extensive development process covering many months, without giving any insight whatsoever into its thinking on a fundamental point such as User Commitment. At the very least, such action (or inaction) must be viewed as grossly inefficient.

It is also disappointing that the clear second favourite methodology – the two stage auction – has at the last minute been identified as unimplementable within the Ofgem prescribed timetable. We believe that with proper development the two stage auction approach offers real benefits over the mandated "retainer" option in terms of simplicity, accessibility, and likely uptake.

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The "Retainer" Option

Given that it was never the preferred option, the "retainer" (to give it its new name) has not received the amount of attention, and therefore development, that is necessary in order to instil confidence that it is fit for purpose. Rather, we now seem to be in a position whereby development will need to take place as part of this final consultation process, and following that through trial and error with those who are successful in understanding the process and persuading their financial controllers to put up cash in order to "retain" capacity.

Notwithstanding the above, we believe that the proposed methodology is fundamentally flawed. National Grid has a Transporter licence obligation to offer capacity products, the price of which is not arrived at through an auction, on a cost reflective basis. In order to meet that requirement, it appears that the fee for a retainer should be based upon the actual cost to National Grid of offering the product. This is likely to amount to a small administration fee only - we fail to see how a figure in the order of £32,000 per mcm of capacity reflects an actual cost. Indeed, given the significant difference between the proposed fee and the actual cost to NG, we would argue that the use of an arbitrary figure without proper underlying justification is likely to give rise to unintended consequences.

We set out below some thoughts on further areas where we believe this methodology is deficient, and how it might be improved.

1) Page 6, section 10, there is a statement that *"At the effective date of this statement no substitutions have been undertaken…"*. We question the accuracy of this statement. Whilst it may be true to say that no substitutions have taken place under this proposed methodology, we are of the opinion that the significant baseline revisions (cuts) that took effect at the last price control enabled implicit substitutions to take place where investment would otherwise have been required. One case that stands out to us, as the primary user at Barrow, is the loss of Barrow capacity, and the coincidental requirement for capacity at the (yet to be completed) Fleetwood storage facility.

2) Page 9, paragraph 22 b) and c). 22 b) states:

- "*Capacity that has previously been substituted to an ASEP will be available for substitution where future quantities of that capacity are unsold*".

While 22 c) states:

- "*Capacity that has previously been substituted from an ASEP will not be available for substitution*"

These statements are not clear, and appear to contradict each other. In order for capacity to be substituted to an ASEP, it must have been substituted from an ASEP. Effectively it is the same block of capacity (albeit possibly a different volume at the recipient due to the application of an exchange rate). Whilst we understand the statement at 22 b) and agree that this has been a long standing aim of substitution, 22 c) seems to state the opposite, i.e. where capacity has been moved from an ASEP, it is then protected from further substitution.

3) Page 11, paragraph 31. We do not agree that the arrangements set out at paragraph 31 are appropriate. Any user who is minded to take part in this "retainer" approach will do so based upon their own perceived needs for future capacity at an ASEP, and their perceived threat of that capacity being substituted away. Such a user will take into account what they know about likely gas developments until the next opportunity to buy capacity and/or take out a retainer.

It is not clear, however, why users will not have the ability to respond to the calling of an ad-hoc auction by taking out a retainer at that point. Ad-hoc auctions by their very nature could happen at any time during the capacity year, and may not have been "on the radar" when users were considering the need for a retainer ahead of a scheduled QSEC.

4) Page 11, paragraph 36. We do not consider that it is appropriate for "*retainer requests to be considered as received*". It is not unusual for faxes not to arrive, or to be printed and then mislaid. In the absence of a suitable systematised process, we believe that a robust process is required in order to provide users with confidence that their retainer request has been received and acted upon appropriately.

5) Page 12, paragraphs 39 and 40. The methodology does not include any step to advise individual users, ahead of the issuing of an ad-hoc invoice, of the amount of "retained capacity" they have been successful in securing, and their cost liability arising from placing the retainer in the event that no capacity is bought. This information will not be evident from what National Grid intends to publish, in the event that a number of users take out retainers equal to or exceeding all available capacity at an ASEP. It is not appropriate for users to have to wait months for this information.

6) The methodology does not make clear whether all capacity available at a specific ASEP in the forthcoming QSEC can be "retained" on the first day that the retainer window opens, or whether 50% of that available capacity is can be retained on the first day, with the other 50% plus any left over from day one being available for retention on the second day.

7) Page 12 and 13, section headed "Capacity Retention Fee Refunds". As far as we can see, neither this methodology nor the associated charging methodology GCM 18 make provision for interest to be added to any refunds given to users for retainers that they have paid. It is our understanding that refunds could happen a matter of years after the original retainer was paid by the user. Holding tens of thousands of pounds for a period of years without paying any interest would appear to represent a benefit to National Grid; this is a benefit that should be returned to the user(s) who paid the retainer.

8) Page 12, section headed Capacity Retention Fee Refunds. It does not seem equitable that no refund will be granted if protected capacity is bought in an RMTTSEC auction. That could lead to NG selling all of the baseline capacity at an ASEP, and retaining all paid retainer fees. This would lead to a TO over-recovery at the relevant ASEP compared to a "non-retainer" world, and further underlines the deficiencies identified above in respect of cost reflective nature of this proposal.

9) There is also no reference to progressive refunds, which we assume means that National Grid does not intend to make them. By "progressive" we mean that a refund is issued to the user immediately following the sale of any part of the capacity that has been protected by a retainer fee. If we are correct in our belief on this point, we do not consider this to be appropriate as it will lead to a further benefit to National Grid (especially in the light of the apparent lack of interest payments on retained fees) versus a detriment to the retainer payer.

10) Page 13, paragraph 47. We are puzzled why, when calculating a refund, that refund will be based upon the proportion of the <u>total</u> capacity covered by retainers that the user holds (i.e. implied at all ASEPs), rather than in proportion to the user's retained capacity at the specific ASEP in question. Should this paragraph have the words "…*at the relevant ASEP*" added to the end of it?

11) Page 14, paragraph 51. National Grid proposes to publish any revisions to entry zones ahead of each QSEC auction. We are concerned that any such alterations need to be known about by users ahead of the opening of the retention window. This is because users will make a decision about capacity retention based upon their expectations of their expected future requirement for capacity at an ASEP and the likelihood of that capacity being substituted away; the entry zone that each ASEP finds

itself in has a direct bearing upon the likelihood of substitution and will therefore affect a user's decision. Publication after the retainer window will result in either retainers being paid where they are not necessary, or retainers not being put forward where they should have been.

12) Page 15, paragraph 59. We find this paragraph vague. It refers to avoiding *…incremental increase in risk*. It is not clear whether this refers to increase in National Grid's capacity buy-back risk, or risk that capacity that can reasonably be foreseen as being required but has not been booked, is substituted away from where it is needed. Similarly, the same paragraph refers to avoiding *…the capability of the NTS being reduced below that required*. Again, it is not clear whether the capability in question is the capability to maintain buy-back risk levels, or the capability to accommodate all reasonably foreseeable requirements for capacity at all ASEPs, or indeed some other definition of capability.

13) Page 15 and 16, section on Donor ASEP Order, Network Analysis, and Substitution Analysis. It is not clear from these sections whether, in the event that the first donor ASEP considered cannot fully satisfy the substitution requirement, that ASEP is left untouched and the next possible ASEP is considered for the full requirement, or whether whatever capacity can be removed from the first considered ASEP is removed, with the balance then sought from other ASEPs.

14) Page 16, paragraph 69. We believe there needs to be a third bullet point to the effect that*…or an exchange rate of 3:1 has been exceeded.*?

15) Page 18, paragraph 80. For the purposes of completeness, we suggest clarifying within this paragraph that there will be no option to place a retainer ahead of an ad-hoc auction.

16) Page 18, paragraph 81. If we have understood paragraph 80 and 81 correctly, we would suggest amending paragraph 81 to read *"…where capacity can be obtained at all ASEPs excluding the specific ASEP that has triggered the ad-hoc auction."*

In summary, this response highlights two broad issues. The first, and most important, is that the proposed substitution methodology is either flawed or imperfect in a number of aspects. We would include in this category the absence of progressive refunds, the apparent absence of interest payments on retainer fees, and RMTTSEC capacity sales being excluded from the refund calculation.

In the second category we would include other issues set out in this document, where wording and often the intention behind the wording, is unclear.

Yours sincerely,

Chris Wright
Commercial Manager