



National Grid Gas NTS and other interested parties

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Dear Colleague

Notice of approval of the Entry Capacity Substitution Methodology Statement

Entry capacity substitution (ECS) is a mechanism that facilitates the permanent transfer of unsold entry capacity on the gas transmission system at one or more entry points to meet the demands for capacity elsewhere. This is in the interests of consumers as, by signalling available capacity on the system, it may mean that the need for additional system investment is avoided. The arrangements governing the entry capacity substitution process are contained in the Entry Capacity Substitution Methodology Statement (ECSMS).

National Grid Gas National Transmission System (NGG NTS) has a licence obligation to maintain and develop the ECSMS, and has recently consulted on the methodology. Following consideration of the two shipper responses to its consultation, it has now submitted a revised ECSMS to Ofgem¹ for approval². At the same time it also submitted a report detailing its response to the points raised by consultees.

Having regard to the entry capacity substitution objectives³, the principal objective and statutory duties of the Authority⁴, and for the reasons set out in this letter, the Authority has decided that it will approve the ECSMS submitted by NGG NTS. The revised methodology will take effect from 1 November 2010. This letter outlines the background to NGG NTS's submission of the ECSMS and gives reasons for our decision.

Background

The current ECSMS was approved by Ofgem on 7 December 2009⁵ and the ECSMS was subsequently applied in respect to the March 2010 Quarterly System Entry Capacity (QSEC) auction. As a result, a total of 30.91GWh/day of unsold non-incremental capacity has been substituted from Teesside, on a 1:1 basis, to meet the need for incremental capacity at Barrow. This has led to the avoidance of £1.21m/year costs (in 2004/05 prices) through the non-application of the revenue driver at Barrow⁶. These costs would have been passed through to shippers and potentially to consumers. In addition, a shipper took out a retainer⁷ to preserve a total of 97.83GWh/day at Theddlethorpe for Gas Year October 2013 to September 2014, as a means of protecting this unbooked capacity from being

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem', 'the Authority' and 'We' are used interchangeably in this letter.

² Pursuant to paragraph 10 (a) of Special Condition C8D of its Gas Transporter Licence ("the Licence")

³ Set out in paragraph 10(c) of Special Condition C8D of the Licence

⁴ Set out in Section 4AA of the Gas Act 1986, as amended, most recently by the Energy Act 2010.

⁵ Authority decision on Gas Entry Capacity Substitution Methodology Statement, 7 December 2009

⁶ There is also an avoided cost from the annual allowed revenue from year six through application of a rate of return on the avoided investment. However, this has not been considered in the above.

⁷ A retainer is a low cost means of preserving capacity from being substituted

substituted. In this way, the retainer allows the shipper to consider future projects which utilise this capacity, but for which the shipper is not yet ready to commit to financially.

Following the March 2010 QSEC, NGG NTS published a report assessing the initial impact of the entry capacity substitution methodology⁸ in which it concluded that the application of the ECSMS for QSEC 2010 successfully met the Licence objectives⁹. Consequently, it considered there was no requirement for fundamental changes to the methodology and consulted on a largely unchanged version of the ECSMS in August 2010.

Respondents' views

NGG NTS received two responses to its August ECSMS consultation. Neither response commented on specific aspects of the methodology consulted upon. Rather, the responses related to both the potential adoption of the two-stage auction approach¹⁰ to substitution (which is an alternative methodology that was discussed during the entry substitution workshops prior to approval of the retainer approach) and understanding the implications of the substitution undertaken following the March 2010 QSEC auction.

One respondent stated, in line with their previously expressed views, that it did not believe the current retainer approach was appropriate and they reiterated their view that the two-stage auction approach would fit best with the principles underpinning the substitution obligation. They suggested that NGG NTS should look at developing a two-stage methodology immediately, given the complexities involved.

The other respondent noted that the methodology was successfully applied earlier in the year but still expressed a preference for the two-stage auction methodology. They raised a number of issues specifically relating to the 2010 substitution. They expressed concern about the process where capacity is being transferred from a terminal that they considered could reasonably be required in later years. They also queried the relationship between incremental project costs and revenue drivers at Barrow. They also suggested that the methodology should add an explanation as to what would happen when subsequent incremental capacity signals occur at the transferor terminal.

NGG NTS response

NGG NTS propose no fundamental change to the existing methodology in response to the support shown for the two-stage auction methodology. It suggests that the existing methodology was successfully applied in 2010. It notes that previous industry discussion has expressed opposition to full user commitment (as proposed in the two-stage auction methodology) for avoiding substitution and that the experience with the current methodology in 2010 showed the retainer system is a simple alternative.

NGG NTS does not consider that material changes to the ECSMS are required in response to the other issues that were raised by respondents to the consultation. It indicates that specific concerns about capacity retention relate back to the issue of user commitment. It also states that the difference between project costs and revenue drivers is not relevant to the substitution methodology. With respect to subsequent signals, NGG NTS indicates that it will always respond to incremental entry capacity requests with the most economic and efficient solution for the network and that the revenue drivers they receive are a feature of the current price control.

The ECSMS submitted to the Authority includes routine changes of dates and a number of other minor changes. These include: clarification of the application of Entry Zones; the addition of new Aggregate System Entry Points (ASEPs) in appendix 1; clarity in identifying the least interactive ASEP for supply/demand balancing; and, the deletion of transitional

⁷ Available at <http://www.nationalgrid.com/NR/rdonlyres/7C7E8E66-745E-402A-BAB3-0FA77A598AB1/41575/EnrtySubstReview2010FINAL.pdf>

⁹ As specified in Special condition C8D 10 (c)

¹⁰ In a two-stage auction methodology the existing QSEC auction would be shortened. NGG would publish the size and location of any incremental capacity bids passing the user commitment test in the Incremental Entry Capacity Release methodology statement. A second stage auction would then be triggered where baseline capacity (i.e. no incremental) could be purchased by shippers who consider that this capacity is at risk of being substituted.

rules. In response to one comment, NGG NTS has added additional columns to Appendix 1 to show Baseline (in GWh/day) and Substitutable Capacities (GWh/day as at 01/10/14).

Ofgem's view

This approval letter concerns the ECSMS submitted to Ofgem by National Grid by e-mail of 23 September 2010. Having considered the ECSMS, we note that the methodology is largely unchanged from that submitted on 7 September 2009 and approved by Ofgem. We note that the changes made are an updating of the ASEPs that constitute each Entry Zone in Appendix 1, the inclusion of baseline and substitutable capacity to Appendix 1 for information and general housekeeping changes. We believe that it continues to meet the entry capacity substitution objectives and deliver benefits in terms of savings in capital expenditure. This view is also strengthened by NGG NTS's assessment of how the first application of the methodology has met the entry capacity substitution objectives as described in its consultation document.

NGG NTS suggest that the methodology has not been tested by numerous, or substantial, incremental capacity release. We note that the March 2010 substitution was comparatively minor and that capacity was exchanged on a 1:1 basis. We agree that this was not a significant test of the methodology and so it would be inappropriate to make any major changes to the methodology on the basis of this example.

In our previous approval letter, we indicated that we expected NGG NTS to give active consideration to whether enhancements to the existing methodology or other methodological approaches would be better suited to meeting the licence condition. The two-stage auction approach remains a potential way in which the methodology could be developed. NGG NTS suggest that a variation on the two-stage auction approach is effectively available through existing mechanisms however we do not see this as ruling out an alternative and more formalised approach. The recent decision on credit arrangements¹¹, has also removed the concern previously expressed by NGG NTS that the credit arrangements make it unfeasible to hold a two-stage QSEC auction. However, the industry consultation only elicited two responses which expressed support for further development of this approach. We would expect a stronger signal of interest from the industry to justify the development of the method. We also consider that further testing of the existing retainer approach should occur before further development of a two-stage auction approach.

Ofgem's decision

Following consideration of the documentation provided and having regard to the entry capacity substitution objectives, the Authority's principal objective and statutory duties and for the reasons set out above, Ofgem has decided that it will approve the Entry Capacity Substitution Methodology Statement prepared and submitted by NGG NTS on 23 September 2010.

Yours sincerely

Hannah Nixon
Partner, Transmission

Signed on behalf of the Authority and authorised for that purpose.

¹¹ UNC 246 , 246A, 246B 'Quarterly NTS Entry Capacity User Commitment': www.gasgovernance.com/code/modifications