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The Joint Office, Relevant
Gas Transporters, shippers and other
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Dear Colleague

Consultation on "The Exit Capacity Substitution Methodology Statement".

Special Condition C8E of National Grid Gas plc's ("National Grid") Gas Transporter License in respect of the NTS (the "Licence") sets out obligations to prepare and review an exit capacity substitution methodology statement.

Throughout 2010 National Grid has held a series of workshops to help develop the initial methodology statement. In addition to the workshops National Grid also undertook an informal consultation. This informal consultation reviewed the output from the workshops and sought views on a range of issues and a possible methodology.

Following the informal consultation, at workshop 5 on 7th September National Grid presented the findings from the consultation. At this workshop two issues dominated discussions.

Capacity Release Date with Substitution
In earlier workshops National Grid suggested that exit capacity substitution should be applied in respect of incremental exit capacity released no earlier than 1st October Y+4 for an application in year Y. This view was put forward on the basis that substitution is intended to provide an alternative to investment. Hence substitution should be applied consistent with investment lead times, i.e. from Y+4 onwards. This approach was agreed for entry capacity substitution. Unfortunately, this issue was not adequately covered in the informal consultation and in response to a comment received, National Grid suggested that substitution may be applied in respect of earlier capacity releases. National Grid agreed to re-consult on this issue before making final proposals.

There are two approaches available.

i) Substitution to apply from Y+4.
With this approach substitution will only be considered if incremental exit capacity is requested with a release date of 1st October Y+4 or later.

With this rule in place any application for incremental capacity before Y+4 that cannot be satisfied through existing capability is likely to be rejected even if there is unallocated baseline capacity at an adjacent exit point.

This may result in a delay to a proposed development, or increased risk if the development relies on off-peak capacity until Y+4. This risk should be low if the unallocated baseline is genuinely not needed at the adjacent (potential donor) exit point. This would be because there is likely to be sufficient capability available pre-Y+4 which could, in effect, be made available on a daily basis. However, this availability would not be guaranteed.

Notwithstanding that the Shipper at the potential donor exit point may be reliant upon off-peak capacity, baseline capacity at that exit point could, at Y+4, be substituted away. In this event, the Shipper may be concerned that the loss of baseline capacity, and resultant tightening of the system, would lead to a greater risk of curtailment. Hence they may wish to switch to firm capacity by "recovering" the baseline through a request for incremental capacity. Application of the Y+4 rule would ensure that the increased risk of curtailment for the off-peak using Shipper, pending delivery of the necessary works to release incremental capacity, is limited to one year[1].

ii) Substitution to apply from any Date.
This rule would see substitution considered (provided that there is no existing system capability that can be used) in respect of any application for incremental capacity. Hence, for an ad-hoc or ARCA application in month M, substitution could occur as soon as M+7.

For a donor exit point, this rule would mean that, in the scenario described above, the off-peak using Shipper may not be able to recover the baseline quantity, and hence, will be exposed to additional risk, for almost four years. This is illustrated in the attached diagram.

In addition to the extended period of increased risk of curtailment, the Shipper would have much less time to consider any mitigating actions. With no limit on the date of application of substitution, the effects of substitution could be felt at the donor exit point almost immediately the substitution is confirmed (i.e. not vetoed by Ofgem).

However, without the Y+4 rule substitution may allow unnecessary costs to be avoided. For example, an application may be received for incremental capacity with a release date of 1st October Y+3 that could be satisfied through substitution. Without substitution, National Grid would consider investment as a means to release incremental capacity. Although it is unlikely that new infrastructure projects could be delivered by Y+3, incremental capacity may be available through enhancement of planned projects or through contractual alternatives, the cost of which will be passed on to the industry.

National Grid believes that consideration of the Y+4 rule consists of a balance between limiting the risk to consumers at donor exit points against either the risk to new projects or the possibility of unnecessary investment being incurred. National Grid would appreciate views on which of the two approaches is preferred. Although the consultation draft of the methodology has been based on the "Y+4" approach, National Grid will review responses to the consultation and may amend the methodology before submitting formal proposals to the Authority.

Treatment of Interconnectors

At each workshop, time has been spent considering whether interconnector exit points (specifically Moffat) should be treated differently to other exit points, i.e. whether a level of capacity should not be available for substitution even if it is unsold.

Existing differences in the treatment of different types of exit point have been discussed; further details can be found in workshop minutes. Debate has mainly centred on European legislation

[1] This period may be extended if National Grid plays a permit to delay capacity release. The period may be decreased if National Grid identifies opportunities to release capacity earlier than the default lead-time, e.g. through contractual arrangements.

and the future requirement to cooperate in terms of cross-border provisions and a “bundled” (NTS exit / downstream entry) product.

National Grid, supported by some workshop participants, has put forward the need to avoid discrimination. Ofgem, has repeatedly stated the need for a User commitment (e.g. capacity should be sold for it to be excluded from substitution).

The fact that much of the detail to implement the European legislation remains to be decided presents National Grid with two potential approaches. National Grid could put forward proposals that:

- are based on consistency and User commitment and which include interconnectors. The methodology could be reviewed and revised if necessary when European legislation becomes clearer; or
- include a transitional arrangement to exclude all exit capacity at interconnectors (up to a level to be defined[2]) from being classed as Substitutable Capacity. This would avoid the risk of capacity substitution creating a situation that could put National Grid in conflict with its future capacity obligations if those obligations, when clarified, require more capacity to be made available than is the case post-substitution.

Having considered the above options, National Grid is proposing a methodology that allows for consistent treatment of all NTS Exit Points, i.e. no exception for interconnectors. Supporting this view, National Grid is aware that exit capacity substitution cannot occur at Moffat unless Users relinquish their current capacity rights. If this does not occur, Moffat will remain “sold-out” and there will be no Substitutable Capacity.

National Grid would appreciate views on the proposed approach to interconnectors.

In addition to these two major issues, three further issues merited attention at workshop 5.

Exchange Rate Collar.

Whilst National Grid has argued that substitutions should be permitted where the exchange rate is less than 1:1 (i.e. the decrease in baseline capacity at the donor exit point is less than the increase in baseline at the recipient exit point) it has also argued that application of a collar would simplify the substitution analysis. This would reduce the significant risk of analysis not being completed within the limited time available under rules defined in UNC and the Licence. However, National Grid recognises (but does not agree with) concerns expressed by some workshop participants that a collar would be inefficient. As a result National Grid’s proposed methodology does not include an exchange rate collar. This is an area that National Grid will review following initial application of exit capacity substitution in 2011.

Partial Substitution.

National Grid is proposing a methodology that allows partial substitution and partial investment. The methodology makes clear that any partial investment will be dependant upon a satisfactory revenue driver having been agreed for the partial investment. How this might be achieved will be the subject of Ofgem’s proposed consultation on “generic revenue drivers”.

Capacity Available for Sale.

National Grid has previously explained that following capacity allocations there is uncertainty as to the quantity of capacity available at an exit point. This is due to the fact that some unsold capacity will be considered for substitution to meet requests for incremental capacity elsewhere.

[2] The level could be set according to previous peak offtake rates, forecast demand, or corresponding entry capacity allocations with the downstream system operator. Other options may be considered.

Some of this will later form part of substitution proposals to Ofgem. Hence there is a period of a few months when unsold capacity may or may not be identified for substitution and, as a result, may or may not be available for sale via ad-hoc applications or for reservation via ARCAs.

National Grid has sought a way of defining how capacity requested via an ARCA or ad-hoc application might be incorporated within the substitution process. For example, a User may seek to prevent exit capacity substitution by applying for capacity through an ad-hoc application made on 1st October. If National Grid excludes that capacity from substitution and the offer is subsequently rejected, then capacity will have been sterilised and unnecessary investment may have been triggered.

To overcome this problem National Grid is proposing that any unsold capacity for which there is an outstanding financial commitment, e.g. works are ongoing through a Preliminary Works Agreement (in respect of capacity or a new connection) will be excluded from the definition of Substitutable Capacity. Any ad-hoc and ARCA requests received during this period of uncertainty, for capacity not covered by a financial commitment, will not be satisfied through the allocation or reservation of baseline capacity. Only if, and when, it is confirmed (through National Grid's analysis or the Authority's veto) that such baseline capacity is not required to be substituted to meet incremental requests elsewhere will it be considered in respect of the ad-hoc application or ARCA.

In accordance with the above mentioned Licence condition, National Grid is required to consult on its proposals before submitting them to the Authority for approval. This letter therefore provides notice of the proposed Exit Capacity Substitution Methodology Statement and invites views on the proposal. Responses need not be limited to the issues described above.

A copy of the proposed Methodology Statement (v0.2) accompanies this letter.

Respondents may refer to workshop material and the informal consultation all of which can be found on National Grid's website at
http://www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ExCapSubMS/

Responses to this consultation should arrive at National Grid by 17:00 on 3rd December 2010. They should be sent by e-mail to:

lesley.ramsey@uk.ngrid.com and copied to
box.transmissioncapacityandcharging@uk.ngrid.com.

Please request a "read receipt" to confirm delivery.

Alternatively they can be sent by post to the above address marked for the attention of:
"Lesley Ramsey
UKT Commercial – Floor B3"

Responses will be placed on National Grid's website and incorporated within the consultation conclusions report. If you wish your response to be treated as confidential then please mark it clearly to that effect.

Yours sincerely

Andrew Fox

Capacity Release Date with Substitution
Potential risk to “off-peak” Shippers from loss of baseline capacity at donor exit points through substitution.
Two scenarios: limit at Y+4; and no limit.
Timelines are indicative.

	Feb to July Year Y	Sept Year Y	Dec Year Y+1	Jan Year Y+1	Jan Year Y+2	Jan Year Y+3	Oct Year Y+4	Oct Year Y+5
Y+4 Rule.								
Recipient Exit Point	Application triggering release of incremental capacity	Capacity allocated					**Capacity released** **One year risk**	
Donor Exit Point			Substitution of baseline confirmed	Ad-hoc application to recover baseline. Triggers release of incremental capacity		**Default lead time for incremental exit capacity**		**Capacity released**
No date limit to Substitution.								
Recipient Exit Point	Ad-hoc application triggers release of incremental capacity	Capacity allocated – subject to non-veto of substitution proposals	Capacity allocation confirmed	**Capacity released**		**Over three years risk**		
Donor Exit Point			Substitution of baseline confirmed	Ad-hoc application to recover baseline. Triggers release of incremental capacity				**Capacity released**