National Grid Gas NTS and other
interested parties

Promoting choice and value for all gas and electricity customers

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Dear Colleague

Authority decision on Gas Exit Capacity Substitution and Revision Methodology Statement

National Grid Gas plc ("NGG") is the holder of the Gas Transporter Licence (the "Licence") in respect of the National Transmission System ("NTS"). In accordance with the conditions of its Licence[1] (as amended[2]), NGG submitted a Gas Exit Capacity Substitution and Revision Methodology Statement[3] (the "Methodology") to the Authority for approval on 4 January 2011.

The Authority[4] has carefully considered NGG's Methodology, Consultation Conclusions Report[5], the responses to NGG's consultation and the matters raised during industry workshops and meetings which focused on the development of the substitution and revision methodology. Following this consideration, we undertook further analysis to assess the potential impact of implementing the proposed methodology. This analysis was published in our Initial Impact Assessment ("IA")[6] on 11 February 2011.

Having regard to the relevant objectives of the methodology[7], its principal objective[8], and statutory duties[9] , the Authority has decided, for the reasons set out in this letter that it will approve the Gas Exit Capacity Substitution and Revision Methodology Statement pursuant to paragraphs 4(b) and 4(c) of Special Condition C8E of NGG's Gas Transporter Licence for implementation with effect from 1 July 2011[10]. However we are instructing NGG to explore further the application of the methodology to interconnectors within the next 12 months.

[1] Specifically Special Condition C8E paragraphs 4 (b)(i) and 4 (c)(i)
[2] Derogation notice to NGG amending the date for submission and implementation, dated 23 February 2009
[3] The Exit Capacity Substitution and Revision Methodology Statement proposed is available to view on NGG's website at the following location www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ExCapSubMS/
[4] Ofgem is the Office of gas and Electricity Markets Authority. The terms 'Ofgem', 'the Authority' and 'We' are used interchangeably in this letter.
[5] Exit Capacity Substitution and Revision Methodology Statement Formal Consultation Conclusions Report, 4 January 2011: www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ExCapSubMS/
[6] Gas Entry Capacity Substitution Methodology – Initial Impact Assessment (Ref: 136/09), 4 November 2009
[7] As set out at Special Condition C8E paragraphs 4(b)(iii) and 4(c)(iii)
[8] Set out in Section 4AA of the Gas Act 1986, as amended.
[9] The Authority's statutory duties are detailed in a number of statutory instruments including the Gas Act 1986
[10] The methodology submitted by NGG on 4 January 2011 carried a date for implementation of 1 April 2011. NGG has indicated that this date was proposed in error, and consistent with the Authority's derogation notice of 23 February 2009, has confirmed in writing that the methodology should in fact be implemented from 1 July 2011. Implementation from July 2011 is intended to ensure that the methodology is applied with effect from the 2011 annual capacity application window.

This letter outlines the background to the development of NGG's Methodology, the Authority's Impact Assessment and its responses, and gives reasons for the Authority's decision.

Background

Exit capacity substitution is the process by which unsold baseline exit flat capacity[11] is moved from one or more NTS exit points (donor exit points) to meet the demand for incremental exit flat capacity at another NTS exit point (recipient exit point). Exit capacity substitution can avoid or defer the need for new investment to meet incremental capacity needs, and so help reduce the costs of gas transportation to consumers. Exit revision is the process by which exit capacity baseline levels are revised in the event that the release of incremental obligated entry capacity changes the availability of NTS exit capacity.

We introduced a new obligation on NGG to introduce an exit capacity substitution and revision methodology at the time of the last transmission price control[12]. This required NGG to establish a methodology which would need to be consulted on with interested parties and approved by Ofgem. Appendix one sets out more details on the nature of the obligations imposed on NGG.

The new licence obligations were intended to ensure that the exit capacity substitution and revision methodology was in place from the time of the reformed exit arrangements[13]. The Authority agreed to postpone the introduction of the exit capacity substitution and revision obligations on two occasions; the first, until 1 April 2009, to take account of the delay in implementing the reformed exit arrangements, and the second, until 4 January 2011,[14] to avoid a clash with the then ongoing entry capacity substitution debate.

In granting the second delay, we instructed NGG to publish a timetable of planned workshops and to submit two interim reports setting out the progress of the development of the methodology. NGG has developed its proposed exit capacity substitution and revision methodology in a manner consistent with the derogation requirements, and, consistent with its licence, submitted its methodology to the Authority for approval on 4 January 2011.

The Authority's Initial Impact Assessment

We considered that a decision in relation to the substitution methodology was important for the purposes of section 5A of the Utilities Act[15] and that an IA would be necessary. The IA was published on 11 February 2011 and assessed the Methodology against the exit capacity substitution and revised licence objectives. We also gave detailed consideration to wider impacts in accordance with our statutory duties.

In our IA we analysed the way in which the proposed methodology would impact on two separate potential signals for incremental capacity; namely, in the South East zone close to Isle of Grain and in the North East zone. These scenarios were developed by NGG at the industry workshops during 2010 and, in conjunction with our analysis of the incremental

[11] NGG's capacity release obligations are defined in its GT licence. Baseline exit flat capacity is the amount of capacity which the licensee is required to offer for sale at an NTS exit point.
[12] Exit Capacity Substitution and Revision obligations are contained in Special Condition C8E of the Gas Transporter (GT) Licence in respect of the NTS.
[13] Reform of the NTS Exit Capacity arrangements, 'Exit Reform', was progressed following the Authority's decision in 2005 to approve the sale of four of NGG's distribution network businesses and concluded in January 2009 with the implementation of the Uniform Network Code modification (UNC) 195AV 'Introduction of Enduring NTS Exit Capacity Arrangements'[13]. The objective of Exit Reform was to develop appropriate commercial arrangements and incentives in a divested industry structure.
[14] http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/ExitSub/Documents1/C8E%20derogation%20090204.pdf.
[15] Appendix two sets out the criteria against which issues are assessed for importance

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exit capacity forecasts submitted by NGG for the years 2014/15 to 2017/18 in its Forecast Business Plan Questionnaire (FBPQ) submission for the TPCR4 adapted rollover[16], formed the basis of our quantitative analysis.

Initial Impact Assessment - Respondents' views

We received a total of eight non-confidential responses to our Initial Impact Assessment consultation and these are published on Ofgem's website[17]. We summarise the issues raised by respondents and set out our views on the points raised in the sections below.

Application of the methodology to interconnector exit points

Three of the responses received were from stakeholders with an interest in the application of the substitution methodology at the Moffat interconnector connecting the GB transmission system to Ireland, Northern Ireland and the Isle of Man. Each of these respondents restricted their comments on the IA to this issue.

In our IA we explained that the methodology does not treat interconnectors differently from other exit points. We indicated broad support for this stance, but noted that pending the development and implementation of European network codes concerning cross border access to the gas transmission networks it would be appropriate for NGG to keep the application of the methodology at interconnectors under review and to respond appropriately in the event that modification of the methodology was required. We also noted that in the event that NGG submitted a substitution proposal under the methodology for approval by the Authority which we considered adversely affected the security of supply of either GB or another member state, the Authority would have the ability to veto the change.

Each of the three respondents commenting on this issue considered that application of the methodology at Moffat had the potential to undermine security of gas supply for the island of Ireland and the Isle of Man. Two considered that our view that NGG should keep the application of the methodology to interconnectors under review, pending the development and implementation of European network codes, was insufficient and that the methodology as proposed was inconsistent with Article 13 of Directive 2009/73/EC.

To safeguard security of supply downstream of the Moffat interconnector, one respondent considered that it would be appropriate to exclude the possibility of capacity substitution at Moffat from the implementation of the methodology. The other two respondents considered that it would be appropriate to amend the methodology to preclude the possibility of substitution of capacity away from Moffat to the extent necessary to maintain downstream security of supply standards. Both of these respondents considered that forecast downstream demand levels as set out in the Joint Capacity Statements issued annually by the Commission for Energy Regulation (CER) and the Northern Ireland Authority for Utility Regulation (NIAUR) could provide a useful basis for setting substitution limits. Two of the three respondents considered that in the event that substitution of capacity from Moffat was not excluded under the methodology, it would be appropriate for the final decision on any substitution proposal submitted to the Authority to be subject to review by all affected regulatory authorities.

[16] In 2009 the Authority decided to rollover the fourth transmission price control review (TPCR4) by one year to allow the conclusions of Ofgem's RPI-X@20 project to inform the next price control. The next transmission control (RIIO-T1) is scheduled for implementation from 1 April 2013.
[17] www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=10&refer=Networks/Trans/GasTransPolicy/ExitSub

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Ofgem's view

As part of its Third Legislative Package on liberalisation of European energy markets, in July 2009, the European Parliament published Directive 2009/73/EC ("The Directive")[18] and Regulation 715/2009 ("The Regulation")[19]. The Regulation, in particular, addresses conditions for access to gas transmission networks across the EU, including at interconnectors.

Article 40 of the Directive sets out the general objectives of the regulatory authority in carrying out the regulatory tasks specified in the Directive, including that the regulatory authority shall, in cooperation with Council of European Energy Regulators ("the Agency"), regulatory authorities of other Member States, and the Commission, promote the development of competitive regional markets within the Community; and promote the development of cross-border transmission capacities to meet demand and enhance the integration of national markets to facilitate natural gas flow across the community.

Article 13 of the Directive sets out the tasks of transmission, storage and/or LNG system operators, including that 'system operators shall build sufficient cross-border capacity to integrate European transmission infrastructure accommodating all economically reasonable and technically feasible demands for capacity and taking into account security of gas supply'.

The requirements applying to cross-border arrangements are further defined in Article 16 of the Regulation. Article 16 concerns the 'Principles of capacity allocation mechanisms and congestion management procedures concerning transmission system operators' and sets out, amongst other things, that system operators must ensure that the maximum capacity at all relevant points (referred to in Article 18(3)) shall be made available to market participants, taking into account system integrity and efficient network operation. Additionally, as set out in Article 16(2), the transmission system operator shall implement and publish non-discriminatory and transparent capacity allocation mechanisms, which shall:

> (a) provide appropriate economic signals for the efficient and maximum use of technical capacity, facilitate investment in new infrastructure and facilitate cross-border exchanges in natural gas;
>
> (b) be compatible with the market mechanism including spot markets and trading hubs, while being flexible and capable of adapting to evolving market circumstances; and
>
> (c) be compatible with the network access systems of the Member States.

The Directive and the Regulation came into force for all member states on 3 March 2011, however the European codes necessary to deliver the requirements of the Regulation have yet to be developed. This work will be progressed and consulted on during 2011 and beyond by the European Regulators' Group for Electricity and Gas (ERGEG), with a view to implementation by 2014.

In our IA we set out our view that it would be appropriate for NGG to monitor the development of this work and, following its conclusion, to make any modifications to its substitution and revision methodology as may be necessary. We remain of the view that it would be appropriate for NGG to monitor the development of this area. We note that

[18] Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009, concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC.

[19] Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005

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interconnectors are currently neutral to the application of this methodology, in that Moffat capacity is fully booked and Bacton only has virtual exit capacity. But, this position could change going forward, and so it is important to ensure that the methodology pays specific attention to the unique issues around interconnected capacity.

Accordingly we consider that NGG should consult with system operators of other Member States connected to GB interconnectors on a methodology for determining the technical capacity upstream and downstream of GB interconnectors, and on the level of capacity at GB interconnectors (if any) that it would be appropriate to protect from substitution. We consider that the obligation to cooperate with other system operators is consistent with the duties imposed on system operators by the Regulation and believe this will enable compliance with the European Codes being developed to meet the requirements of the Regulation. We expect NGG to submit a report on the conclusions or development of this work to the Authority by the time of the next annual review within the next 12 months. Pending the conclusion of NGG's consultation and any modification proposals to its exit capacity substitution methodology, we consider that it would be appropriate to exclude capacity at GB interconnectors from exit capacity substitution.

Respondents' views on methodological issues

Of the responses received concerning the wider aspects of the methodology, each indicated support for the broad principle of substitution. Several commented that the methodology would promote efficient utilisation of the existing transmission network and could defer or avoid the need for new investment. A number of responses carried the caveat that the extent of the benefits realised would be dependent on gas supply flow assumptions. One respondent considered that the realisation of the benefits would be dependent on close regulatory scrutiny of the modelling assumptions used by NGG in operating the methodology and that NGG should be incentivised to optimise the amount of capacity released through substitution.

A majority of respondents agreed with our assessment of the methodology against the framework and objectives of the current licence, but one respondent queried whether NGG's proposal only to undertake exit capacity revision following two years of confirmed gas flows in respect of the release of funded incremental entry capacity was consistent with its obligations under Special Condition C8E paragraph 3(c).

Respondents broadly considered that the quantitative and qualitative benefits of the methodology had been adequately captured by the IA, but one respondent considered that the proposed methodology would not fully deliver the benefits capable of being realised by capacity substitution and revision. This respondent considered that greater benefits could be realised if the methodology was also employed to meet capacity requests on lead times shorter than y+4, and if it permitted NGG to seek unused capacity from potential donor points as well as unbooked capacity.

Ofgem's view

We agree with the view that the extent of the benefits realised from application of the methodology will be dependent on the location of incremental exit capacity signals received and the gas flow modelling assumptions used in conducting the analysis. We acknowledged this point in our IA, but we continue to hold the view, that implementation of the methodology could reasonably be expected to deliver a net positive benefit.

Any substitution proposals submitted to the Authority by NGG following implementation of the methodology will be subject to regulatory scrutiny and this will entail analysis of the gas flow modelling assumptions used. We note that the licence places a reasonable

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endeavours requirement on NGG to substitute unsold exit capacity in order to minimise incremental exit capacity; on this basis, we do not think it is necessary to incentivise NGG to optimise the amount of capacity released through substitution.

Special Condition C8E paragraph 3(c) requires NGG to revise the level of NTS baseline exit capacity in the event that the release of incremental entry capacity changes the availability of NTS Exit Capacity. We do not consider that NGG's proposal only to revise the level of NTS baseline exit capacity following two years of confirmed gas flows in respect of the release of incremental entry capacity is inconsistent with this obligation. By definition, a methodology is required to determine the process for conducting exit capacity revision and, in our view, NGG's proposals regarding confirmed entry capacity flows can be viewed as compatible with this. However, notwithstanding this point, consistent with the view expressed in our IA, we consider that the licence obligation on NGG to annually review its methodology would provide an appropriate opportunity for NGG to review its stance on this issue.

NGG proposes that substitution will only apply in respect of the release of incremental capacity compatible with investment lead times. Because NGG has an obligation to meet incremental capacity requests within 38 months this effectively means that substitution will only be considered for incremental exit capacity requests from y+4 at the annual application window. This approach was supported by a majority of respondents to NGG's formal consultation and in the IA we set out our view that NGG's approach strikes an appropriate balance between efficient use of the system and providing adequate user protection. We continue to hold this view.

In NGG's formal consultation it was noted that substitution was intended to reduce or avoid the need for new investment and that incremental capacity released earlier than y+4 would, in a majority of cases, be capacity for which investment was not required. We recognise that situations may arise where an incremental request for capacity could have been satisfied through substitution earlier than y+4, but we note that if such capacity is available for substitution, daily off-peak capacity is likely to be available in that location, which may allow the incremental capacity request to be satisfied until the enduring exit (flat) capacity can be released. In our view NGG's obligation to review its methodology should allow it to monitor any issues arising from this aspect of its proposals and to propose any modifications it considers appropriate.

<u>Respondents' views on the cost and benefits identified</u>

A majority of respondents agreed with the quantitative and qualitative costs identified by the IA, but a number of respondents identified additional qualitative and quantitative costs which they did not feel the IA had adequately captured. These costs centred on two common themes. These themes relate to:

- the impact of substitution on security of supply; off peak capacity and flexibility within the NTS; and
- the costs to shippers and developers associated with the risk that capacity may be substituted; potentially having to commit to paying for capacity earlier; and the additional regulatory uncertainty that implementation of the methodology may carry.

Ofgem's view – security of supply, off-peak capacity and flexibility

We addressed the potential interaction of the methodology with security of supply, the availability of off-peak capacity, and the availability of flexibility capacity in Chapter One of

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the IA. We explained that NGG is required under licence[20] to plan and develop its pipeline system to enable it to meet '1 in 20' peak aggregate daily demand[21], and that NGG is required to offer entry and exit capacity in accordance with the capacity baseline obligations set out in its licence and in accordance with any signals for incremental capacity received through the entry and exit capacity commercial arrangements. The policy objective of substitution is to improve the efficiency of capacity utilisation within the NTS but this is not intended to be at the expense of security of supply. In our view the introduction of substitution will not affect NGG's firm capacity obligations and we continue to consider that the introduction of the methodology will not affect security of supply.

In our view it is appropriate for NGG to consider the potential interaction between a specific exit substitution proposal and its wider system flexibility needs, but in our view direct trade-offs between the two are likely to be limited. NGG has indicated that there is a relationship between the allocation of spare capacity on the system and the amount of flexibility capacity which could be made available. However, substitution is concerned with the allocation of unsold baseline capacity, which is capacity (substitution notwithstanding) that NGG is obliged to make available on a daily basis regardless of whether it is sold in long term auctions. From a planning point of view it is not clear that unsold baseline capacity should be considered the same as spare capacity and therefore tradeable with flexibility capacity. Further, where substitution takes place, it involves the movement of unsold capacity in response to an incremental capacity signal, which, following Exit Reform, will be for Enduring NTS Exit (Flat) Capacity carrying a four year user commitment. Therefore, even where discrete trade-offs can be made, we would not anticipate that substitution would be detrimental to investment efficiency.

NGG's obligations in respect of off-peak capacity are set out in the UNC. The introduction of substitution will not affect the rules concerning the availability of off-peak capacity. If substitution results in a more efficient use of the network it is possible that in some locations the probability that off-peak capacity may be curtailed could increase. The availability of off-peak capacity is valued by a number of NTS users, including gas storage operators, but by definition, the product carries no guarantee of being firm. Under the UNC, NTS users who require firm capacity are able to signal their long-term willingness to pay for such capacity via the annual capacity application window.

In our view it is appropriate that storage users – like any others - face the costs they impose on the system. Storage sites can choose to book firm capacity or to rely on off-peak capacity; if their costs rise as a result of booking firm capacity then they would seek to recover these in the charges they levy. We think this is an efficient outcome; otherwise we would be favouring one form of storage over others by not properly reflecting their capacity costs. Other forms of storage and substitutes for storage include the use of back-up fuels at generation plant and the utilisation of storage in Europe which can be accessed via gas interconnectors.

Ofgem's view – additional costs associated with the methodology

Some respondents considered that the IA should have taken into account the costs to shippers of the potential change in the risk premium of holding off-peak capacity relative to long term capacity associated with the risk that unsold baseline capacity could now be substituted. In our view, it is correct that shippers who currently rely on the shorter term availability of capacity may now have to reconsider their booking strategies in the light of substitution. None of the respondents who commented on the need to take account of these costs provided an indication of the scale of the costs. However, in our view the

[20] Standard Special Condition A9 of the GT Licence

[21] '1 in 20' peak aggregate daily demand is defined as the peak aggregate demand level which, having regard to historical weather data derived from at least the previous 50 years, is likely to be exceeded (whether on one or more days) only in 1 year out of 20 years.

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potential benefits gained for consumers through avoided investment costs are likely to be greater than the costs incurred by those shippers who rely on the availability of off-peak capacity.

Some respondents have also argued that the development of the methodology will adversely affect the perception of regulatory risk in the UK. We do not think that the proposed methodology will affect regulatory risk or create a barrier to development. The price of exit capacity is small relative to the development costs of a project to offtake gas; in this context it would seem unlikely that an efficient developer would risk a project being stranded by not booking capacity in advance. Further, we note that, in the context of entry capacity substitution (where a more complex methodology was consulted on and implemented), scant evidence of developers being reluctant to invest in new projects was observed. In the period since the introduction of the substitution obligation was announced in the TPCR4 Final Proposals in December 2006, a total of 501 GWh/d of incremental capacity was triggered via the quarterly system entry capacity auctions between 2007 and 2009. Developers continue to bring forward proposals at various stages of development and we believe that contrary to the views expressed, substitution will enhance the attractiveness of the UK market, because it offers the potential for new supplies to connect without the need to construct as much new network reinforcement.

Other issues identified from consultation responses

In its response, NGG commented specifically on aspects of the IA relating to our qualitative assessment of their capacity revision proposals. In the IA, we queried the impact entry capacity substitution could have on exit capability, with a view to considering whether it would be appropriate to consider undertaking exit capacity revision following entry capacity substitution. We also queried whether an approach other than two years of confirmed entry flows against investment for incremental entry capacity could be used as a basis for conducting exit capacity revision.

In its response, NGG set out that in the event that incremental entry capacity is released at auction and satisfied through entry substitution, baseline capacity at the donor entry point would be reduced and this would be expected to offset any increased exit capacity capability associated with increased flows at the recipient entry point. As a consequence NGG do not consider that it would be appropriate to conduct exit capacity revision following an entry capacity substitution. NGG consider that waiting for two years of confirmed entry flows before conducting exit capacity revision is a proportionate measure necessary to manage the risk that exit capacity is made available and sold without the associated entry flows to support it and, to the extent that it still presents a risk of buy-back costs in the event that confirmed entry flows change, they do not consider the approach to be conservative.

NGG also commented on our view that it would be appropriate for them to provide indicative charging impacts as part of submitting an exit substitution proposal. NGG consider that in the event that this was a requirement they would have to review whether the data requested could be provided within the necessary timeframe for conducting the substitution analysis. NGG also query the benefit of conducting this analysis and providing this information given that the impacts of a substitution, as demonstrated in Appendix 2 of our IA, are likely to be very small. Further, NGG note that following a non-veto of an exit capacity substitution proposal, exit capacity charges would be recalculated and submitted to the Authority for approval, consistent with the Uniform Network Code (UNC) and Licence obligations, based on the revised data.

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Ofgem's view

We set out our view above that it would be appropriate for NGG to monitor and review its decision only to conduct exit capacity revision following two years of confirmed entry capacity flows. We note that the decision not to consider exit capacity revision following entry capacity substitution was taken by NGG, with the consent of industry participants, at an early stage in its 2010 Exit Capacity Substitution and Revision Methodology workshops. Given NGG's further explanation of the reasons why it would be inefficient to conduct exit capacity revision following entry substitution, we are content that exit capacity revision is conducted according to the conditions set out in NGG's methodology submission.

We recognise the point that given the very small charging impacts anticipated from substitution it may not be proportionate to require NGG to submit revised exit capacity charges for all exit points as part of making a substitution proposal under the methodology. However, charging disturbances can have far reaching implications for NTS users, and in developing any substitution proposals we consider that NGG should take steps to identify, and bring to our attention, any charging implications of an order of magnitude higher than expected, in submitting any substitution proposals.

The Authority's decision

The Authority has carefully considered the Methodology Statement and supporting documents submitted to the Authority on 4 January 2011. The Authority has considered and taken into account the responses to NGG's consultation on the methodology. The Authority's IA assessed the Methodology against the exit capacity substitution and revised methodology objectives of the licence. Following publication of our IA, we considered carefully all of the responses to that consultation in coming to our decision. The Authority has also had regard to its principal objective and statutory duties and for the reasons set out below, Ofgem has decided that it will approve the Gas Exit Capacity Substitution and Revision Methodology Statement pursuant to paragraphs 4 (b)(i) and 4 (c)(i) of Special Condition C8E of its GT licence for implementation from 1 July 2011.

We also consider it appropriate for NGG to consult on a methodology for determining the level of capacity at GB interconnectors (if any) that it would be appropriate to protect from substitution. We expect NGG to submit a report on the conclusions of this work to the Authority by the time of the Methodology's next annual review. Pending NGG's consultation and any modification proposals to its exit capacity substitution methodology, we consider that it would be appropriate to exclude capacity at GB interconnectors from exit capacity substitution. Since 3 March 2011 EU Regulation 715/2009 has been legally binding on GB energy market arrangements. In our view this condition is an appropriate safeguard to ensure GB compliance with the Regulations pending the development of the European Codes necessary to deliver the Regulation's requirements.

Reasons for the Authority's decision

We believe that substitution is in the interests of consumers and consistent with our principal objective and statutory duties. We consider that exit capacity substitution and revision will guard against the risk that capacity is sterilised at an exit point where it is not needed. By reducing the obligation on NGG to provide capacity at such exit points, additional capacity can be made available elsewhere. Where this occurs, the need for investment in new network reinforcement may be avoided. We consider that this has three advantages:

(1) lower costs to customers as a result of the avoided capex,

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(2) environmental benefits associated with avoidance of constructing cross-country pipelines, and

(3) avoiding potential delays and costs associated with the planning process linked to investment projects which can impact the timing of the delivery of new infrastructure.

We have considered the benefits and costs that arise from the application of the proposed substitution methodology and we set these out in our Impact Assessment. The primary benefits are the avoidance of sterilised capacity and savings in capital expenditure because construction of network reinforcement is avoided. The reduction in the capex needed by NGG would represent a clear and tangible benefit for consumers. Savings in capital expenditure will depend on the pattern of incremental signals received and on their size and location.

The proposed methodology has, at its core, the establishment of exchange rates which define the ratio of capacity moved from one exit point to another, and ways of prioritising which exit points receive capacity and which exit points provide capacity. The methodology also provides for the use of an exchange rate cap, which will limit the amount of capacity which can be substituted to a rate of 3:1. We consider that the exchange rate cap provides a "soft landing" for the introduction of the proposed methodology, which will reduce the risk of large-scale unanticipated consequences.

We consider that the proposed methodology is likely to deliver the benefits anticipated from substitution while minimising the risk that inappropriate levels of capacity are substituted. We also understand that the methodology is simple to administer, does not need major changes to IT systems and that its implementation will not give rise to significant costs.

Yours sincerely

Hannah Nixon

Partner, Transmission and Governance

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

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Appendix One – obligations in respect of exit substitution and revision

Following statutory consultation, in 2007, we modified NGG's GT licence for the TPCR4 package. The modified licence conditions contained the following obligations in respect of exit substitution and revision:

- Special Condition C8E paragraph 3 (c) requires NGG to use reasonable endeavours to:
    - substitute unsold NTS baseline exit capacity between NTS Exit Points such that the level of NTS obligated incremental exit flat capacity (ie necessary investment) is minimised.
    - revise the level of NTS baseline exit capacity in the event that the release of incremental entry capacity changes the availability of NTS Exit Capacity;

- Special Condition C8E paragraphs 4 (b)(i) and 4 (c)(i) require National Grid to prepare:
    - an exit capacity substitution methodology statement, setting out the exit capacity substitution methodology which it shall use to substitute NTS exit capacity.
    - an exit capacity revision methodology statement, setting out the exit capacity revision methodology which it shall use to revise the level of NTS baseline exit capacity; and

- Special Condition C8E paragraphs 4(b)(iii) and 4(c)(iii) set out that the objectives of the methodologies are:
    - ensuring that exit capacity substitution / revision is effected in a manner which is compatible with the physical capability of the NTS;
    - avoiding material increases in the costs (including NTS exit capacity constraint management costs in respect of NTS exit capacity previously allocated) that are reasonably expected to be incurred by National Grid as a result of substituting NTS exit capacity or revising the level of NTS baseline exit capacity; and
    - in so far as is consistent with the above objectives, facilitating effective competition between relevant shippers.

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Appendix Two – importance of proposals under section 5A of the Utilities Act 2000

Where section 5A of the Utilities Act 2000 applies, the Authority must either carry out and publish an Impact Assessment or publish a statement setting out its reasons for believing that it is unnecessary for it to carry out an Impact Assessment. Section 5A (2) sets out the matters which determine whether or not a proposal is "important" for the purposes of section 5A. These are where the implementation of a proposal would be likely to do one or more of the following:

a. Involve a major change in the activities carried out by the Authority

b. Have a significant impact on persons engaged in shipping, transportation or supply of gas conveyed through pipes or in the generation, transmission, distribution or supply of electricity;

c. Have a significant impact upon persons engaged in commercial activities connected to the gas or electricity sectors;

d. Have a significant impact on the general public in GB or in a part of GB; and

e. Have significant effects on the environment.

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