South Hook Gas Company Ltd
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By email: National Grid – box.gsoconsultations@nationalgrid.com

26th April 2022

Dear Sir/Madam

RE: National Grid Transmission's Consultation on Entry Capacity Release Methodology Statement

Thank you for the opportunity to respond to the above consultation on proposed amendments to the Entry Capacity Release Methodology Statement ("**ECR**"), such consultation being published by National Grid Gas plc ("**National Grid**") on 19 April 2022 ("**Consultation**"). This letter comprises the response to the Consultation from South Hook Gas Company Ltd. ("**SHG**").

SHG does not support the ECR changes proposed in the Consultation. The principal grounds for SHG's opposition to the proposed ECR changes are as follows:

a) Impact on security of gas supply to GB and EU;
b) Impact on wholesale gas prices; and
c) Practical impacts of the ECR changes that may ultimately increase costs to GB consumers.

Please find further details set out below.

SHG has tried to respond as fully as possible to the Consultation. However, given the limited consultation period of 7 days there may be further issues and clarifications that we may wish to consider at a later stage.

1. Effect of proposed changes

The Consultation notes that the proposed ECR change will allow National Grid to extend the right to stop or restrict the release of Obligated Weekly NTS Capacity and Obligated Monthly NTS Entry Capacity in a situation where a specific longer-term constraint is forecast were the full baseline to be made available, with this extended right to apply at the Milford Haven ASEP only and for the period between 30th May and 31st October 2022.

SHG and its capacity customers, in their capacity as shippers at the Milford Haven ASEP[1], are exposed to any negative effects of these ECR changes if implemented. In SHG's view, this proposed ECR change would create a two-tier classification of LNG terminals in GB, with Milford Haven LNG terminals and MH shippers users being subject to these restrictions and associated difficulties with attracting cargoes and providing committed gas send out profiles while the National Grid-owned Grain LNG terminal is unaffected.

2. Background to proposed changes

The proposed ECR changes are argued by National Grid to be required to mitigate a risk of aggregate capacity sales over the relevant period above resulting in flows at a sustained level above that which National Grid is able to accommodate, resulting in constraints and associated constraint management costs.

The Consultation indicates that this risk arises for the following reasons:

2.1. Geopolitical situation in Europe

2.1.1. Ongoing EU transition from dependency on Russian gas to other sources of energy to meet demand has contributed to continuing high gas prices.

2.1.2. Greater than anticipated volumes of LNG may be delivered to GB receiving terminals in summer 2022 for onward transmission of LNG-derived gas to the EU via the interconnectors to meet this existing and future demand.

[1] In this response we refer to SHG's customers that use the Milford Haven ASEP as "**SH shippers**", to all shippers using the Milford Haven ASEP as "**MH shippers**" and to licensed NTS gas shippers generally as "**NTS shippers**".

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2.2. UNC 0752S Introduction of Weekly Entry Capacity Auction

2.2.1. The Consultation indicates that the expected increased throughput from Milford Haven LNG terminals caused by 2.1 above presents risks around releasing weekly entry capacity that were not contemplated in the development of this UNC modification.

2.3. Capability and Maintenance Plans[2]

2.3.1. National Grid's planned maintenance and investment activities at the Milford Haven ASEP may impact its capability to transport large quantities of LNG-derived gas from the Milford Haven LNG terminals.

The Consultation claims that these changes will mitigate the risk of capacity sales exceeding capability over the relevant period, providing greater certainty to the market and protecting industry from potentially high constraint management costs.

3. SHG response to proposed changes

SHG does not support the ECR changes proposed in the Consultation.

SHG has a number of significant concerns with this proposed solution to National Grid's identified constraint risk. These concerns are as follows:

a) Impact on Security of Gas Supply to GB and EU (3.1 below);
b) Impact on wholesale gas prices (3.2 below); and
c) Practical impacts of the ECR changes that may ultimately increase costs to GB consumers (3.3 below).

While SHG notes that Ofgem describe the proposed ECR change as "not complex" in their derogation decision letter of 19 April 2022, SHG respectfully disagrees with that characterisation. While the drafting amendments to the ECR may be limited, implementing these changes is likely to have impacts on a number of processes which could change market behaviours. This consequently could have very significant detrimental effects on SHG's business, SHG's efforts to maximise utilisation of the exempted primary processing capacity at the South Hook terminal and on progress to achieve the objectives stated in the Government's British Energy Security Strategy (see below) to promote energy pricing stability and to support GB and EU security of gas supply.

Although we agree with National Grid that the industry finds itself in a "unique and unprecedented situation" that gives rise to certain risks, including the constraint risk identified in the Consultation, SHG believes an unintended consequence of this proposal will have a greater cost impact, ultimately on consumers, than the status quo.

3.1. Impact on Security of Gas Supply to GB and EU

SHG has been actively selling cargo slots and has both firm and flexible cargoes already contracted, including June to October 2022. While the actual level of flows at Milford Haven from June to October 2022 inclusive are currently unknown (partly as a result of this consultation), existing and potential users of LNG terminal capacity at the South Hook terminal this summer are extremely concerned that insufficient NTS entry capacity will be available to accommodate their gas send out in respect of their LNG cargoes. Directly as a result of this Consultation, a potential SHG counterparty has ended negotiations for an LNG cargo delivery over the relevant period, specifically citing its concerns around NTS entry capacity unavailability and cost that would be created by the proposed ECR amendment. Moreover, the publication of the Consultation has resulted in an SH shipper enquiring about the cancellation of its firm cargo deliveries for summer 2022.

[2] SHG's view is that capability is the key driver here, rather than planned maintenance. We note that the period to which the ECR change would apply extends through October 2022, notwithstanding that no planned maintenance works are scheduled for that month.

SHG's concern is that the proposed ECR change will discourage or reduce deliveries of LNG to the South Hook terminal over the relevant period and potentially over a longer term if SH shippers expect this "precautionary and temporary provision" in the ECR to become iterative or permanent (see 3.3 and 4 below). Further information on this can be found in our comments under 3.3.

SHG believes that the risk of reduction of LNG deliveries to Milford Haven as a result of this uncertainty is greater than the constraint risk identified by National Grid that is the origin of the proposed ECR change. We cannot reconcile, on one hand, the reduction in LNG deliveries and gas send out that we would expect would follow the ECR amendment with, on the other hand, the stated objectives of the Government in the British Energy Security Strategy[3] as set out below:

"It is crucial we work with international partners to maintain stable energy markets and prices. This will help protect UK consumers and reduce the use of fossil fuels globally. Similar to our domestic strategy, we have a dual approach to reduce global reliance on Russian fossil fuels whilst pivoting towards clean, affordable energy.

To reduce global reliance on Russian fossil fuels, the UK is:

- *[...] building on our important partnerships with non-Russian OPEC countries, and the US, to promote market stability through the availability of alternative supplies of oil and gas*
- *[...] working closely with the US on gas, particularly on how we can leverage UK LNG infrastructure to support European supply*
- *[...] providing a key EU entry point for non-Russian supplies of gas. We are examining our infrastructure to ensure gas flows efficiently between the UK, Europe and the global market through our interconnectors and LNG terminals and promote gas infrastructure to be hydrogen-ready"*

A reduction of LNG deliveries to Milford Haven would result in the underutilisation of the South Hook terminal, which would:

3.1.1. be contrary to the strategy of leveraging UK LNG infrastructure to support European supply (particularly in the context of receipt of US-originating LNG);

3.1.2. cut across the stated aim of GB acting as a key EU entry point for non-Russian supplies of gas as reduced gas volumes from the South Hook terminal would ultimately be transmitted via the interconnectors to the EU; and

3.1.3. self-evidently reduce the availability of alternative supplies of natural gas to GB and the EU.

To proceed with this proposed amendment would likely set an unhelpful precedent and undermine LNG shippers' confidence in the UK regulatory regime.

3.2. <u>Impact on wholesale gas prices</u>

SHG notes that a stated aim of the British Energy Security Strategy is to "maintain stable energy markets and prices". The Consultation notes the current extended period of high gas prices in relation to the geopolitical situation in Europe and suggests that the ECR changes need to be implemented in order to "both provide greater certainty to the market and to protect the industry from potentially high constraint management costs in this unique and unprecedented situation".

SHG's view is that the likely reduction of LNG cargo deliveries to the South Hook terminal (and thereby gas supply to GB) as a result of the proposed ECR change may provide supply/demand signals to an already extremely volatile wholesale gas market. This may in turn exacerbate this volatility, which may complicate or jeopardise the Government's objective of maintaining stable

[3] https://www.gov.uk/government/publications/british-energy-security-strategy/british-energy-security-strategy

energy prices and undermine National Grid's aim of providing greater certainty to the market.

SHG believes that this is a more material risk than the risk of industry being subject to potentially high constraint management costs. The latter risk is capable of being mitigated practically as set out in 3.3 below albeit that the current constraint management tools have not been developed for longer term constraints and thus are suboptimal in this situation.

There has been a fall in the NBP price and an increase in the spread versus TTF since the Government published their British Energy Security Strategy (please see Charts 1 and 2). The wholesale price of gas has fallen by over £1/th and SHG believes this is now approaching the level of the price cap for Summer 2022. SHG believes that this fall in price is largely attributable to LNG being contracted for unloading during these periods. Chart 3 shows a significant drop in NBP monthly market prices following the contracting of LNG volumes by SHG.

Chart 1: Market Price and Spread: NBP vs TTF May-22

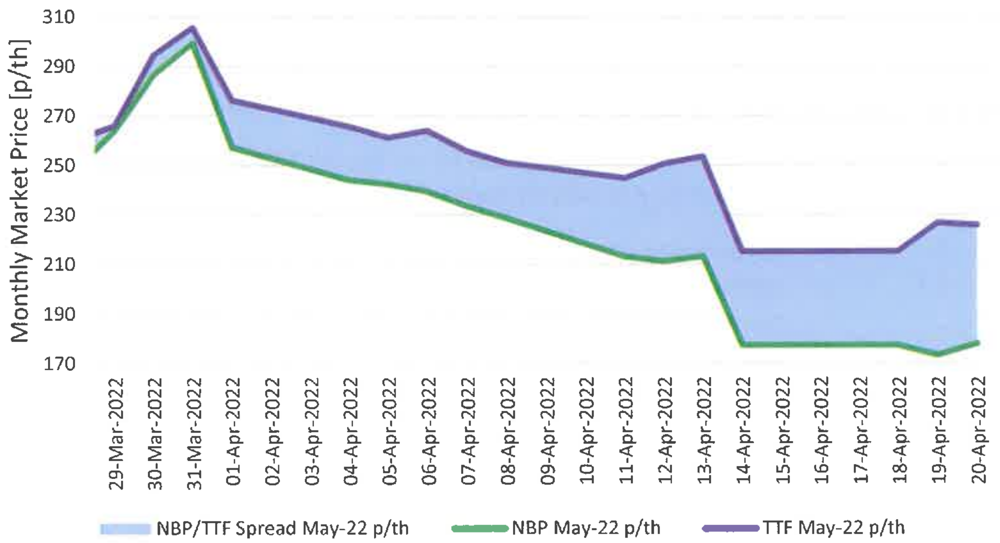


Chart 2: Market Price and Spread: NBP vs TTF Jun-22

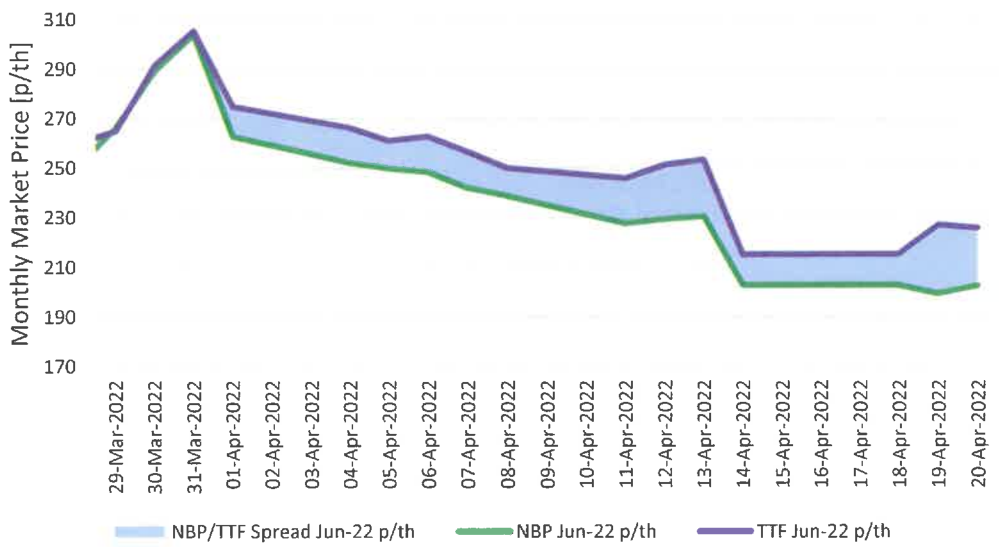
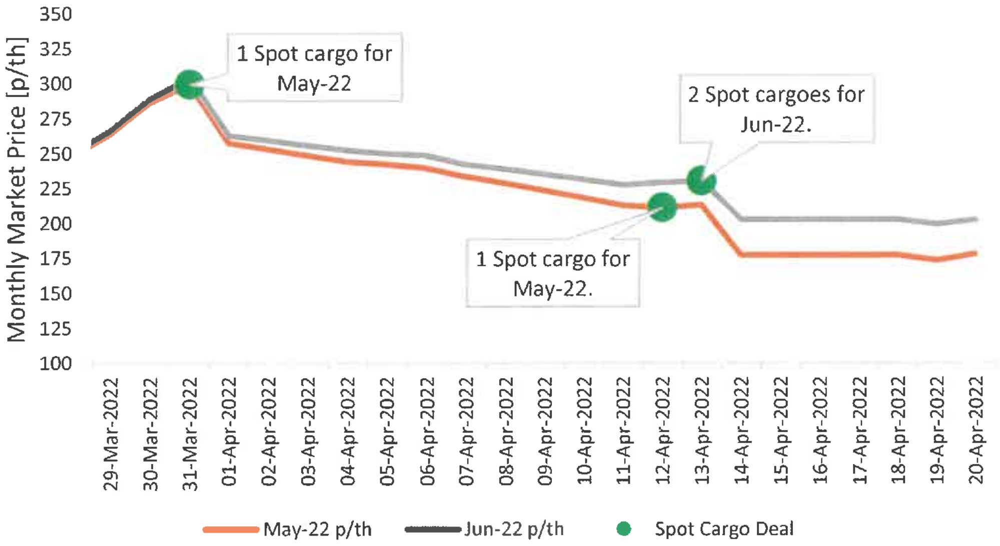


Chart 3: Monthly Market Price Vs. New LNG Spot Cargo Deals



Cargoes being removed as MH shippers try to mitigate their own risks in light of the proposed ECR amendments is likely to reverse this trend and lead to a higher NBP price. As noted above and as further detailed in 3.3 below, many of these mitigating actions are likely to be unnecessary and inefficient.

3.3. <u>Practical impacts of ECR changes that may ultimately increase costs to GB consumers</u>

3.3.1. Issue: Capability Assessment

The manner in which National Grid will assess the monthly System Entry Capacity ("**SEC**") availability is not clear. The numbers set out in the Appendix to the Consultation are stated to be the median capability over the past 3 years. They are also similar to those contained with the maintenance plan which SHG has been told by National Grid is reflective of the lowest capability in that month. However National Grid forecast the capability, it is dependent on daily demand and it is not clear that either of these indicative numbers take account of the increased demand from interconnectors exporting to Europe.

Although National Grid has indicated that it would offer additional SEC in the daily auctions, SHG believes that this will not achieve the desired result due to an inability to attract cargoes at short notice, along with the requirement to purchase SEC for an entire cargo in order to do so.

3.3.2. Issue: Lack of assurance re available SEC prompting mitigation decisions to divert/cancel cargoes

The proposed ECR amendment would lead each MH shipper to individually assess the risk of non-availability of SEC for the coming months independently with no knowledge of overall flows and constraints (note that LNG cargoes are generally contracted well ahead of the time that National Grid will share their view of available SEC) and either decide to sell the cargo elsewhere or price that risk of unavailability into their economics (impacting the wholesale price). As this risk of unavailability is likely to be high, cargoes that are already contracted at Milford Haven therefore may be diverted unnecessarily.

By way of an example for the above, SHG and Dragon LNG shippers do not discuss their respective commercial activities, in compliance with competition law. If the proposed ECR amendment were implemented, MH shippers in both terminals might therefore independently elect to reduce their respective send out by diverting LNG cargoes to mitigate the risk of incurring liabilities for delivery shortfalls as a result of insufficient SEC holdings, leading to cargo diversions from both terminals. In this scenario, it is possible that MH shippers overestimated flows and more cargoes could have been accommodated, potentially using existing constraint mechanisms to accommodate specific maintenance requirements. Should flows be such that gas deliveries need to be reduced then it makes sense for National Grid to co-ordinate this activity. SHG therefore considers it to be essential that market-based tools are used wherever possible to ensure the most cost effective and efficient mitigations of constraints are undertaken.

Once the Monthly SEC auction has taken place, we believe remaining SH shippers who are not able to secure SEC for their entire cargo will again consider diverting their cargo.

3.3.3. Impact: LNG volumes to UK

Due to information sharing prohibitions and National Grid's proposed unilateral decision-making rights, we expect that MH shippers will have no option but to take decisions to divert on a siloed basis, without knowing the full picture around overall projected flows at the Milford Haven ASEP, in turn leading to unnecessary cargo diversions.

SHG has concerns that even if there is increased transparency around predicted flows, this information is not available in a timely enough basis to prevent earlier diversions and will act as a deterrent for any additional cargoes even if there would be sufficient capacity closer to or within the delivery month.

It should be noted that the nature of LNG deliveries is such that MH shippers may cancel entire cargoes when only a small proportion of the cargo cannot be easily accommodated. A small reduction in offering monthly SEC may mean a loss of one or more whole cargoes. A single cargo will deliver gas upwards of 30GWh/day rateably over a month (~1mth/d). A published reduction of SEC of 5GWh/d may trigger the cancellation of a number of cargoes, as separate MH shippers do not know the wider picture, depriving the UK of numerous LNG cargo deliveries.

3.3.4. Impact: Cost of National Grid tools vs ECR amendment

Given current market dynamics, the associated costs in managing constraints are likely to be trivial compared to the costs of reducing LNG deliveries, as shown in section 3.2. There are a number of tools to help manage short term constraints by changing gas flows including building/depleting inventory, changing cargo berthing schedules and, ultimately as a last resort, diverting cargoes (please see below). Each activity will have an associated cost for each MH shipper and a centrally co-ordinated mechanism would seem the best way to minimise cost to the consumer.

SHG has no reason to believe that short term constraint costs will be dissimilar to those costs faced during previous constraints provided they are subject to a competitive process such as existing constraint mechanisms. In addition to this, there are potential costs associated with longer periods of constraint which could include the delaying of an LNG vessel, at a cost of around $100,000/day. This may ultimately result in a cargo diversion. While SHG would normally view a cargo diversion as an extreme remedy, with current market prices the financial impact is likely to be much more benign than in more normal circumstances and may even have a net positive outcome for an SH shipper due to the existence of higher priced markets. While enhancements to the existing systems would likely improve the effectiveness in dealing with longer term constraints, SHG believes the existing system will be a better solution in the short term than the ECR amendment.

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This is in contrast to National Grid's analysis in the Consultation, which represents an extreme worst-case scenario and which is unlikely to occur under the current market dynamics. National Grid are assuming a £1/therm price spread on a 20mcm/d constraint over 30 days. Within month gas pricing tends to be, at any point in time, at similar levels between prompt periods to the next and any price volatility tends to move the majority of pricing periods. We currently do not see a £1/therm spread between short-term products. Usually the difference between these is a few pence/therm and even when adverse events occur, such spread is less than half this amount. . Any significant constraint (such as the one used for the example in the Consultation as noted above) would likely be managed by a cargo diversion (see above).

SHG believes that the ECR amendment could lead to any remaining MH shippers potentially paying a premium on already excessively high SEC prices to secure access to the market, which would lead to higher costs for delivery of LNG to GB (and ultimately risks higher prices for consumers).

While the ECR amendment seeks to regulate the number of cargoes that can be accommodated to reduce the use of constraint mechanisms, SHG believes that it will also deter additional cargoes that could be accommodated, leading to an overall increase in wholesale prices. If SHG's concerns are ungrounded and it does not prevent cargoes from arriving then the sole function of the ECR proposal will be to move costs from the constraint mechanism to individual MH shippers. These MH shippers will in turn increase their expectation of costs at Milford Haven which will in any case ultimately filter down to consumers.

3.3.5. Summary

In summary, for the reasons outlined above, the proposed ECR amendment is not considered the appropriate means of mitigating the constraint risk identified by National Grid.

SHG believes that National Grid pro-actively predicting constraints in order to withhold SEC is likely to reduce cargoes received at Milford Haven LNG terminals in the short term and could be expected to increase wholesale gas prices and likely lead to an on-going lack of confidence in the UK as an LNG destination.

Instead, National Grid's use of well-established commercial remedies to balance flows where necessary will offer the best value resolution to the end consumer since this is a competitive process that seeks to find the lowest overall cost of managing a constraint and would result in constraint costs during the period that are lower than those indicated in the Consultation. In any event, the associated costs would be immaterial compared with the impact on wholesale gas prices as a result of the reduction of LNG supply to GB.

4. Wider implications of the ECR

SHG has concerns that the ECR changes may set a precedent for future periods of constraint, either at Milford Haven or elsewhere on the network. Running the network, including decisions on how to maintain and enhance capability, are taken by National Grid in conjunction with Ofgem. While we accept there is a decision to be taken in terms of unnecessary network enhancement to ensure capability in all scenarios, this work is undertaken by way of a cost-benefit analysis (as SHG saw during the recent Needs Case for its on-going PARCA application). SHG believes that, should costs be stripped out of National Grid's cost-benefit analysis if capacity can be reduced to avoid them, this would drastically change the incentive National Grid has to maintain the system appropriately to the detriment of NTS shippers and therefore ultimately the end consumer.

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5. Proposed next steps

SHG believes that the overall constraint risk is likely to persist for a longer duration than this summer and would strongly encourage National Grid to urgently investigate system reinforcement of the Milford Haven line to deal with the capability issue. For the avoidance of doubt, SHG is not suggesting that additional new pipelines be built but more cost-effective solutions (such as uprating) be utilised by National Grid. SHG would also propose that National Grid develop its constraint mechanisms by adding tools that can cost-effectively manage longer term constraints including, as a last resort, cargo diversions.

In respect of the coming summer, SHG's view is that the constraint risk identified in the Consultation can be more efficiently mitigated and managed with National Grid's existing tools than by implementation of the proposed ECR changes, while allowing SHG to continue to maximise the utilisation of the primary exempted processing capacity at the South Hook terminal and to support the security of supply objectives stated in the Government's British Energy Security Strategy.

SHG would therefore recommend that we continue with the status quo and ensure that regular and transparent communications (in full compliance with competition law) are maintained between each of the LNG terminals at Milford Haven and National Grid (but not between the terminals themselves), with National Grid being best placed to effectively manage gas flows.

We hope this response is of assistance. Should you wish to discuss further or have any questions please contact Adam Bates on abates@southhookgas.com or +44 (0)20 7234 3505.

Yours faithfully

Simon Hadlington

General Manager

South Hook Gas Company Ltd