

The Joint Office, Relevant
Shippers, Gas Transporters, and other
interested parties.

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Dear Colleague

Discussion on “The Entry Capacity Substitution Methodology Statement”

Special Condition C8D of National Grid Gas plc’s (“National Grid”) Transporter Licence in respect of the NTS (the “Licence”) sets out obligations to prepare and submit for approval by the Authority, by 6th January 2009, an entry capacity substitution methodology statement setting out the methodology that National Grid will use to carry out entry capacity substitution. In addition, National Grid is obliged to consult with relevant Shippers and interested parties prior to submitting the initial statement or revising the methodology.

The Licence defines entry capacity substitution as the process by which unsold non-incremental obligated entry capacity is moved from one or more NTS entry points to meet the demand for incremental obligated entry capacity at another NTS entry point. In simple terms, this means that where incremental entry capacity is required this should be met by reducing National Grid’s obligation to make entry capacity available at other entry points (where capacity is unsold) before undertaking investment in new infrastructure.

National Grid recognises that the substitution obligation represents a significant change to the entry regime and is therefore keen that Shippers and other interested parties are fully aware of these consequences and understand the rationale for the development of the substitution methodology in the form that it will ultimately be proposed. To achieve this National Grid has run a series of workshops to develop understanding of substitution, to consider how it should be implemented and to identify issues and potential solutions. Details of these workshops can be found on the Joint Office website. Having presented its understanding of the Licence obligation National Grid is now finalising its proposed methodology. However, before undertaking the formal consultation described above, National Grid wishes to capture the views of interested parties. Hence National Grid invites views on its draft Entry Capacity Substitution Methodology Statement (discussion draft v0.2).

This discussion draft builds on the draft statement upon which National Grid consulted in 2007. Included in the statement are a number of questions which National Grid would welcome responses to. These are duplicated in the appendix to this letter. The key questions relate to balancing the specific substitution Licence obligation with National Grid’s wider obligation to develop and maintain an economic and efficient system. Although many of these questions have been raised in previous consultations, National Grid believes that as a consequence of the workshops understanding of entry capacity substitution has advanced and respondents should now be better placed to comment on the implementation of the obligation.

A copy of the discussion document can be found on National Grid's website and the Joint Office website at:

<http://www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ecms/>

<http://www.gasgovernance.com/Code/Workstreams/TransmissionWorkstream/2008Meetings/>.

Responses to this discussion document should arrive at National Grid by 17:00 on 4th August 2008. They should be sent to:

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Alternatively they can be sent by e-mail to:

box.transmissioncapacityandcharging@uk.ngrid.com.

Please ensure that they are copied to andrew.fox@uk.ngrid.com

A further substitution workshop has been arranged for 9th July 2009. This session will review the discussion draft and address any initial questions. This will be held at Ofgem's offices at 9 Millbank commencing at 10am.

Any subsequent questions can be directed to me on 01926 656217 or to Martin Watson at martin.watson@uk.ngrid.com or 01926 655023.

Yours sincerely

Andrew Fox

Appendix 1

Questions Raised in the Entry Capacity Substitution Methodology Statement: Discussion Draft

Q1 - National Grid has interpreted the requirement to “minimise” the costs associated with funded incremental obligated entry capacity in this objective as meaning that all available capacity should be substituted to meet the incremental signal, without placing any restrictions on the substitution process.

Hence National Grid has developed the substitution methodology with no restrictions on the quantities available to be substituted. This could lead to significant quantities of capacity being substituted in year 1. It may be argued that this is inefficient as “more economic” substitution opportunities may arise in subsequent years. Conversely, later incremental signals may not occur and substitution opportunities would have been lost – and unnecessary investment made.

Notwithstanding the subsequent questions raised in this document, National Grid would welcome views on whether its interpretation is appropriate.

Q2 - National Grid has taken the view that all incremental obligated entry capacity released must satisfy the NPV test detailed in the IECR. Substitution will only be considered if the test has been passed. However, National Grid would welcome views on whether a less stringent test should apply for the release of capacity that would, after analysis, be satisfied through substitution. It should be recognised that whilst a different test could increase the quantity of incremental obligated entry capacity released it would add much complexity to Shipper bidding strategies, as National Grid would be unable to identify substitution opportunities in advance of the QSEC auction, and to National Grid’s assessment of substitution opportunities (e.g. need to identify a merit order for incremental requests where available capacity is limited; consideration of part investment, part substitution scenarios etc.).

Q3 - The substitution obligation is to minimise funded incremental obligated entry capacity, which is released subject to a 42 month default lead-time. Hence substitution will only be considered subject to a minimum 42 month lead-time (as may be adjusted according to the IECR). Do respondents agree that it is appropriate to consider substitution opportunities consistent with the timing for the release of funded incremental obligated entry capacity? It should be noted that any move away from the standard mechanism to release funded incremental obligated entry capacity will produce similar issues to those outlined in Q2, particularly in terms of increased complexity.

Q4 - This condition limits the capacity available for substitution to 90% of the initial baseline quantity (10% being held back for MSEC auctions). It is not envisaged that this absolute quantity (i.e. GWh/day) will be reduced (within the current price control) to reflect capacity substituted from an ASEP. National Grid would welcome views on whether it is appropriate for any restriction to be placed on the availability of capacity for substitution or whether the level not available should be increased (or decreased). If an increase is suggested then views on what this level should be and whether it would be justified in relation to the licence obligations would be appreciated. For example, National Grid has identified the following options for decreasing the amount of capacity available for substitution:

- Increasing the percent of baseline with-held from QSEC auctions (requires a Licence change);
- Setting a fixed percent of baseline that, although available for release in QSEC auctions, will not, even if unsold, be made available for substitutions;
- Setting a fixed quantity (GWh/day) of capacity that will not be available for substitution from each ASEP;
- Setting a fixed quantity (GWh/day / percentage) of capacity that will not be available for substitution from all ASEPs in aggregate;
- Setting a maximum quantity (GWh/d or percentage) that can be substituted away at any ASEP

In answering this question, National Grid would like respondents to express their views on:

- a. Whether these approaches would be more efficient than maximising substitution from year 1?
- b. What are the advantages and disadvantages of these actions?
- c. Should such limits only apply for a limited duration, e.g. for years 1 [and 2], but be removed after experience of the first year of substitution? And if so how do respondents see substitution being phased in?

Q5 – This paragraph highlights the “single quarter” issue, whereby Shippers can “protect” capacity at an ASEP by booking capacity for a single quarter in a future year. National Grid does not propose any actions, at this time, to prevent Shippers making such capacity bookings. Do respondents consider this to be appropriate or should action be taken to limit single quarter bookings in the future? if so what action is considered appropriate?

Q6 - Considering that the substitution process is identical within and out-with zones, do respondents feel that the use of zones is beneficial? By dispensing with the within zone process the order in which donor ASEPs are identified may change slightly but may become less transparent.

Q7 – In order to create an order for assessment of multiple recipient ASEPs National Grid is proposing Licence Revenue Drivers (LRDs) as the assessment criteria. National Grid believes that the ASEP with the lowest LRD will facilitate more efficient substitution, i.e. less capacity needed from donor ASEPs. Alternative criteria could be used and National Grid would welcome alternative proposals. It should be noted that, in the absence of any constraints on capacity available for substitution, that if sufficient incremental obligated entry capacity is released, all available capacity, where beneficial, will be substituted regardless of the recipient ASEP order.

Q8 - Do respondent favour a rigid approach [to identify donor ASEPs] that requires National Grid to follow a set methodology regardless of the outcome, i.e. pipeline distance, or should National Grid have some discretion to select more favourable donor ASEPs?

Q9 – Following on from Q1, although the current draft methodology does not place any restriction on the quantity of capacity that can be substituted. National Grid would welcome views on alternative approaches and how these may better meet National Grid’s licence obligations.

Alternatives that National Grid believe merit consideration include (respondents may propose further alternatives);

- an exchange rate cap. It should be recognised that this option would not prevent all capacity being substituted away from a donor ASEP even with a 1:1 exchange rate cap. In the event that an exchange rate cap is considered appropriate:
 - how should the level be determined? What should be the level of an exchange rate cap?
 - Should a cap be applied in aggregate across all donor ASEPs or for each recipient/donor ASEP combination?
 - Are there any scenarios where different caps should apply?:
- limiting substitution to within zone only. Although such a limit is likely to ensure that only reasonable exchange rates are generated it could also severely limit the scope for substitutions, particularly in zones with few ASEPs (e.g. Theddlethorpe, West UK zones):
- reducing all potential [within zone] donor ASEPs together by equal amounts (% or mcmd) instead of exhausting donor ASEPs in sequence. It should be recognised that a sufficiently high level of signalled incremental capacity would still exhaust all potential donor ASEPs under this option. However, where all donor ASEPs are not exhausted the outcome would be sub-optimal substitutions, i.e. less favourable exchange rate overall. This option is also likely

to be more complicated to undertake; an important issue considering the limited time that National Grid has to assess investment and substitution proposals.

These potential measures should be considered as a way of “managing” the use of substitutable capacity. This differs from, and is complementary to, the options in Q4, which limit the quantity of capacity available for substitution.

Q10 – Do respondents agree with this transitional rule [in respect of new ASEPs]?