



To all interested parties

*Promoting choice and
value for all customers*

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The Introduction of National Transmission System (NTS) Entry Capacity Substitution

National Grid Gas (NGG) has recently consulted informally on its draft methodology for the introduction of NTS entry capacity substitution. Gas shippers have asked Ofgem to clarify certain aspects of the manner and timing of the introduction of capacity substitution. In particular, there have been requests for Ofgem to clarify whether the initial implementation of substitution could occur before a future Quarterly System Entry Capacity (QSEC) auction. These requests have been prompted by the fact that under the existing arrangements where a new Aggregate System Entry Point (ASEP) is created, a stand-alone auction can be held for that new ASEP alone. It is possible that such a stand-alone auction would take place before the 2009 QSEC auction. This would mean that the impending September 2008 QSEC auction might be the last opportunity for shippers to acquire baseline entry capacity prior to the introduction of the substitution methodology.

We are writing in response to these requests from shippers for clarification on the process and timetable for the introduction of NTS entry capacity substitution.

The legal obligation for NGG to implement NTS entry capacity substitution has been known by shippers since the Transmission Price Control Review (TPCR¹) Final Proposals on 4 December 2006 and the requirement was described in and is set out in NGG's transmission licence². The decision followed substantial consultation and discussion with shippers and NGG on the merits of substitution as part of that review. In March 2008 we published a direction to delay the introduction of the substitution obligation until 2009 and set out a timetable for doing so³. Since then there have been several workshops on substitution, run via the Joint Office of Gas Transporters, to work through the issues and to allow industry to better understand how it might work. We have attended all of these meetings and participated in the discussions and answered shipper queries wherever possible and appropriate. Our commitment to the introduction of substitution and to the timetable set out in the March letter has remained unchanged throughout; namely, that we would expect

¹ TPCR 2007-2012 Initial Proposals (ref 104/06) Section 11; Updated Proposals (ref 170/06) Section 10; Final Proposals (ref 206/06) Section 10

² NGG Gas Transporter licence Special Condition C8D paragraph 10

³ Letter from R. Hull, Ofgem to C Bennett, NGG 4 March 2008

NGG to submit an entry capacity substitution methodology to Ofgem by early January 2009 and we would make a decision on the methodology by early April 2009 at the latest.

A key principle that underpins the NTS entry capacity arrangements is that users face a choice. If users want financially firm rights to use the system they need to purchase them and make a financial commitment to pay for them. The arrangements allow them to secure rights for up to seventeen years into the future through a series of auctions that are held every year. Users can choose not to secure rights and rely on auctions of firm or interruptible capacity that are held for each gas day, but then they face the risk that entry capacity is not available if the system is constrained. The introduction of the substitution regime does not change these choices or risks in a fundamental way, but substitution may broaden the pool of parties who might bid for and secure the capacity at a particular entry point and increase the risk that a shipper who has not chosen to buy capacity is unable to access entry capacity on the day.

Since we first consulted on the proposals to introduce substitution arrangements as part of the TPCR, shippers would have been able to secure long term capacity through the QSEC auction process. There has been a 2007 QSEC auction following the introduction of the substitution licence condition and shippers now have a further opportunity to secure long-term capacity rights in the 2008 QSEC auction.

In response to shippers' requests for further clarification from Ofgem on the process for introducing substitution arrangements, we think that, in the first instance, this is a matter for NGG and its customers.

We understand that some of NGG's customers think that it would be inappropriate for substitution to take place prior to a further QSEC auction. Should shippers continue to hold this view, it will always be open to them or NGG to submit a proposal to modify the Unified Network Code to bring forward the date of the 2009 QSEC auction and make the case that this would better facilitate the objectives of the UNC. We would then decide, in the usual way, whether any such proposal would better facilitate the objectives of the UNC in the light of our duties, including our duties to protect the interests of customers and promote competition.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Stuart Cook', is written over a horizontal line.

Stuart Cook,
Director - Transmission
For and on behalf of the Authority