Transmission Workstream Minutes

Substitution Workshop 1

Tuesday 08 April 2008

Ofgem, 9 Millbank, London SW1P 3GE

Attendees

Tim Davis (Chairman)	TD	Joint Office
John Bradley	JB	Joint Office
Andrea Altenkamp	AA	E.ON Ruhrgas
Alex Barnes	AB	BG Group
Andrew Fox	AF	National Grid NTS
Angus Paxton	AP	Poyry
Christoph Hoft	CH	E.ON Ruhrgas
Charles Ruffell	CR	RWE
Christiane Sykes	CS	Statoil
Chris Wright	CW	British Gas Trading
Debra Hawkin	DH	National Grid NTS
David Linden	DL	BP Gas
Eddie Blackburn	EB	National Grid NTS
Gerry Hoggan	GH	ScottishPower
John Baldwin	JBa	CNG Services
Jeff Chandler (by telephone)	JCh	Scottish and Southern Energy
John Costa	JCo	EDF Energy
Jemma Spencer	JS	National Grid NTS
Joanne Tedd	JT	xoserve
Martin Watson	MW	National Grid NTS
Peter Dickinson	PD	Ofgem
Paul O Donovan	POD	Ofgem
Richard Fairholme	RF	E.ON UK
Roddy Monroe	RMo	Centrica Storage Limited
Richard Miller	RMi	Ofgem
Rekha Patel	RP	WatersWye
Sofia Fernandez Avendano	SFA	Total
Shelley Rouse	SR	Statoil
Tim Walls	TW	ConocoPhillips

1. Introduction

TD welcomed attendees to the meeting

2. Licence Obligations

POD gave this presentation on behalf of Ofgem. MW asked whether Ofgem intend to undertake an Impact Assessment when the Substitution Methodology is sent to them for approval. PoD replied that Ofgem were still to decide this, but would welcome views from the industry on the merits or otherwise of carrying out an Impact Assessment. It was clarified that, if undertaken, the Impact Assessment would not be on the principle of substitution but restricted to the methodology proposed by National Grid NTS in accordance with its Licence obligations.

MW stated for clarity that National Grid NTS did not intend developing Exit Substitution prior to Ofgem announcing a decision on the options for exit reform, and Ofgem confirmed that a Licence derogation had been issued accepting this.

3. Entry Capacity Substitution

AF gave this presentation on behalf of National Grid NTS. POD confirmed that Ofgem were looking towards to receive the methodology for approval in early January 2009, allowing for a decision no later than March. MW indicated that he was aiming to be ahead of this timetable. In the absence of the UNC being modified, the first QSEC auction incorporating substitution would be held in September 2009. A number of attendees asked about bringing QSEC forward - to March 2009 for instance, as in Ofgem's open letter on the substitution timetable. Issues were acknowledged with any date changes and Ofgem undertook to discuss the matter with National Grid NTS.

RMo suggested that National Grid NTS already substitute implicitly in their planning process. MW acknowledged this was possible but the baseline is not consequently adjusted and hence he did not view it as substitution as defined in the Licence. RMo brought up the possibility of windfall gains if National Grid avoided investment due to implicit substitution following a pre-substitution QSEC auction. MW believed this was covered in the price control.

AB asked whether Ofgem disallowance of proposed substitution would be the same as Ofgem not approving investment in response to an IECR signal. National Grid NTS responded that there was a difference: if substitution is approved the baseline will reduce at the donor ASEP and National Grid will not be entitled to retain additional revenue. However, if release of incremental capacity under the IECR is sanctioned, this permits additional revenue but does not necessarily lead to physical investment. POD acknowledged a long standing action from TCMF to consider publishing the criteria by which Ofgem will evaluate whether or not to approve any substitution proposal put forward by National Grid NTS. While he believed this could not be discharged in the absence of the methodology, he was happy to retain the action.

Action SUB001: 37 Ofgem to consider producing a document, prior to the first substitution auction, setting out its rationale for approving substitution applications.

RMo then raised the prospect of increased risks for industry players. MW believed there would be benefits as well, and that was why the policy had been implemented. SFA asked whether Ofgem could approve the methodology but reject the exchange rate. POD believed Ofgem would have 28 days (RMi suggested this may be 5 days) in which to exercise the right of either complete or partial veto: MW believed the right was either complete acceptance or veto and emphasised that it would not be practical to expect Ofgem to select from a range of proposals. Ofgem agreed to take an action to clarify the licence provisions with respect to veto.

Action SUB002: Ofgem to clarify licence provisions with regard to vetoing substitution proposals

CS asked whether substitution being subject to "safety" considerations was a reference to the 1 in 20 criteria. MW confirmed this would fall under that heading. MW also believed that National Grid had to abide by the licence limit of non-substitutable capacity of 10%, and not transferring incremental capacity. AB suggested that incremental capacity is automatically absorbed into baseline at the onset of the next price control and so would become substitutable. MW responded that this depended when the incremental capacity came into effect and the timing of moving into the baseline was not straightforward. A number of scenarios were then discussed, such as an unexpected termination of an offshore field making capacity redundant, an what level of capacity might be substitutable.

Action SUB003: National Grid NTS to clarify licence arrangements for incremental capacity becoming baseline.

AB asked whether setting a high exchange rate, and the resultant quick alignment of the obligated level to allocations, would lead to competition issues as capacity would not be available at other ASEPs if and when new supplies became available. MW referred to the protection provided by the 10% retention. He also acknowledged a trade-off between so-called capacity destruction and the ability to respond to new requirements at ASEPs without investing. JBa tracked the relationship between the revenue driver and the NPV test where substitution led to lower levels of investment, and felt this reduced investment could imply shorter lead times. MW did not see that a reduction of pipe length would lead to a reduction in lead times – the 42 months would continue to apply.

TD asked for confirmation that the licence obligation of minimising funded obligated incremental capacity led to the conclusion that there should be no exchange rate cap? MW confirmed this was the National Grid interpretation and the Ofgem representatives did not disagree. Concern was expressed that there could be unintended consequences if National Grid NTS was obliged to put forward a Substitution Methodology on this basis, and that attendees had not realised how tightly the Licence constrained the methodology.

MW expressed the view that this was the reason for these sessions – to explore possible methodologies within the constraints imposed by the Licence. RMo put forward the possibility that all baseline capacity would be allocated so that further auctions would lead to investment - this might not be economic and efficient and so could conflict with other Licence obligations. MW did not believe that there would be such extreme exchange rates for this to be a problem. RMo felt it would be a useful exercise to develop scenarios on how substitution might work in practice based on information available through the Transporting Britain's Energy (TBE) process.

AB suggested that a satisfactory explanation had not been made for reduction of the capacity held back from 20% to 10%.

AP asked whether exchange rates less than one could result, for example if substitution occurred in the opposite direction to the original transfer. MW didn't think it would be likely but PD didn't see anything in the Licence prohibiting this capacity creation.

AF asked for views if capacity had been reserved for one quarter only with all substitution consequently prevented. It was acknowledged that Licence provisions indicate this would happen, leading to sterilisation of capacity and hence to potentially inefficient investment. JBa pointed out that a party that booked the capacity for a future quarter may not need to fund this booking for many years.

National Grid NTS had concluded that there should be a 42 month lead time before any substitution was proposed as this was consistent with the time scale for investment and would facilitate a single auction process. RF asked whether exchange rates could be calculated 42 months beforehand with any confidence? MW acknowledged the difficulty and that this might lead to more adverse exchange rates than for, say, short term trades and transfers.

National Grid NTS expressed the view that all ASEPs should be treated the same. RMo acknowledged that any due discrimination argument might be difficult to sustain.

In response to a question from CS, MW suggested that substitution should reduce the TO Commodity Charge.

AF asked for views on whether a single NPV test would be appropriate. No attendee argued for any different test.

AF did not believe that there would be an impact on NTS Exit (Flat) Capacity as these were evergreen capacities. CS asked about effects on zonal flexibility, even though this was not sold as a product. MW acknowledged that there might be an effect. AP suggested that any effect would be negative i.e. would reduce zonal flexibility.

AF presented a graph that demonstrated the potential impact of substitution on Transportation Charges. EB confirmed that reducing obligated capacity to zero would not affect the illustration.

RMo remained concerned about windfall gains – delaying the substitution mechanism might allow National Grid NTS to carry out implicit substitution. National Grid NTS responded that it was meeting its obligations based on the regime at the time and disputed whether windfall gains were an appropriate term to use. TD suggested that delays in substitution might lead to either gains or losses. It was acknowledged that this would be difficult to evaluate as criteria such as bidding behaviour would be relevant. Ofgem confirmed that it had not identified any windfall gain but had listened to the arguments.

AP asked about the effect of substitution on flexibility. MW responded that the current 22 mcmd criteria would still apply and substitution would not be proposed if it compromised National Grid NTS's ability to meet this.

4. Diary Planning

The next Substitution Workshop meeting has been arranged for 10:00hrs on 7 May 2008 at Elexon's offices. (Details of future meetings may be found on the Joint Office website at: www.gasgovernance.com/Diary).

RMo suggested that the meeting consider scenarios based on TBE information to demonstrate any unintended consequences of no exchange rate cap. MW suggested that it look at an end to end analysis based on one large project rather than seeking to model multiple scenarios. This would include the charging aspects. This was agreed.

It was suggested that the meeting should also go through the Licence obligations in more detail in order to understand the flexibility these permitted in terms of developing a methodology and how Ofgem's veto would operate in practice. Ofgem and National Grid NTS agreed to review this jointly.

Following this, the third meeting could work through a draft methodology.

Action Log – Substitution Workshops: 08 April 2008

Action Ref	Meeting Date(s)	Minute Ref	Action	Owner	Status Update
SUB 001	08/04/08	3	Ofgem to consider producing a document, prior to the first substitution auction, setting out its rationale for approving substitution applications	Ofgem (POD)	Transferred from TCMF
SUB 002	08/04/08	3	Ofgem to clarify licence provisions with regard to vetoing substitution proposals	Ofgem (POD)	
SUB 003	08/04/08	3	National Grid NTS to clarify licence arrangements for incremental capacity becoming baseline.	National Grid NTS (MW)	