



To all interested parties

*Promoting choice and  
value for all customers*

Your Ref:  
Our Ref:  
Direct Dial: 020 7901 7050  
Email: Robert.Hull@ofgem.gov.uk

Date: 19 June 2007

**National Grid Gas National Transmission System Entry Capacity: Development of the regime ahead of winter 2007/8**

We have been concerned about a number of National Transmission System (NTS) entry capacity issues since May 2004. In particular, modelling at the time suggested the presence of 'sterilised capacity' on the network and associated buyback issues when moving baseline capacity to where it was valued most. The 'sterilised capacity' and associated buyback issues has been addressed as part of the Transmission Price Control Review (TPCR) through introducing an obligation on NGG (National Grid Gas) to enable capacity trade and transfer.

On 12 June we rejected UNC modification proposals 150(A) and 151(A) for the reasons outlined in the respective decision letters. We are, however, very conscious of the ongoing concerns that a number of shippers have about the ongoing development of the NTS entry capacity arrangements. These concerns relate to whether there may be physical constraints on the NTS at certain entry points or constraints caused by the commercial arrangements preventing shippers being able to purchase or trade capacity that could be made physically available at terminals where they wish to land gas.

The purpose of this letter is to try to help to reduce some of these concerns by setting out:

1. Further information that NGG will publish on the physical capability of the NTS to accept gas at nodal level at different levels of system demand by 6 July 2007 at the latest for all ASEPs<sup>1</sup> (see tables in Annex 1)
2. Further information that NGG will publish on the relationship between physical capacity within and between different zones (or collections of entry points) at different levels of system demand by 25 June 2007 at the latest (see table in Annex 2)
3. Ofgem's views on NGG's role and obligations in managing system entry capacity this winter (and more generally) and how we would intend to monitor and enforce this role if necessary

<sup>1</sup> This is the earliest date that NGG can complete and verify the network modelling that is necessary to produce this information.

4. Ofgem's views on the process and timetable to develop and implement arrangements to allow shippers to trade and transfer capacity between entry points ahead of this winter

## **Background**

The UK gas market is undergoing considerable change as the UK moves to becoming a significant importer of natural gas. This winter we will have a diverse range of sources of gas supply including three (or more) LNG facilities, four major interconnectors as well as supplies from the North Sea and UK storage that connect to the NTS at a number of different locations. The UK gas market is also much more dynamic and changes in prices in other European countries or in the US or Asia could lead to significant shifts in the sources of supply. This is placing increasing pressure on the NTS as it is no longer possible to forecast with any accuracy where gas is likely to be delivered. The current entry capacity regime is designed to deal with this uncertainty by enabling shippers to book long term entry capacity to secure their capacity needs and signal to NGG where capacity is needed to inform NGG's NTS investment plans. NGG typically has investment lead times of between three to four years to respond to signals and build additional capacity on the NTS.

In the shorter term, NGG may have some flexibility to increase capacity at certain entry points, in response to shipper demand, by reducing available capacity at other entry points on the system. Ofgem and NGG agreed as part of the TPCR settlement that new arrangements would be developed to introduce the ability for shippers to "transfer and trade" capacity between entry points. This would improve the efficiency and flexibility of the use of entry capacity by allowing shippers to trade and transfer capacity between entry points if there were physical constraints on the network in the period before NGG could invest to relieve the constraints.

However, the current arrangements already in place provide NGG with commercial incentives and a range of tools to respond to changing signals of demand from shippers in the short run and move capacity from one terminal to another in response to shipper demand. NGG can sell additional firm and interruptible capacity before or on each gas day in response to changing shipper demand. NGG can also manage the risks of selling more capacity than it can physically deliver by entering into forward or option contracts to "buy back" capacity.

There is some concern that there may be patterns of supplies and demand this winter that could give rise to physical constraints – particularly at the Easington terminal. A number of shippers think that developing the ability to transfer and trade capacity ahead of the winter is very important.

We share this view and remain committed to playing our part in implementing a scheme ahead of this winter. But we also think it is important to recognise that even if such a scheme is introduced – it will remain important that the regime allows shippers and NGG to continue to move capacity from one terminal to another throughout the winter as far as is practicable. Shippers may well have views on where they would like to bring gas onto the system based on current prices in the UK, US, Asia and NW Europe but these may change as winter approaches if relative prices change. We therefore think it is very important that the arrangements are as flexible as possible. Although we recognise that it may not be feasible to develop systems and processes to allow continuous trading and transfer of capacity between shippers for this winter. If this is the case, it will become even more important that NGG uses the existing tools it has its disposal (i.e buy backs and incremental sales) to release capacity in response to changing shipper demand.

## **Provision of nodal and zonal information on physical capability of the NTS**

Given shipper concerns about potential physical constraints this winter and lack of certainty about whether transfer and trade mechanisms will be in place, we welcome NGG's commitment to publishing information on the physical capability of the NTS this winter. We have attached as an annex illustrations of the information that NGG will provide.

We expect that information in the tables in annexes 1 and 2 to this letter will provide greater clarity on the physical capability of the NTS to accept gas at different entry points at different levels of system demand. NGG has agreed to publish this information at the latest by 6 July 2007 for all ASEPs.

Table 3 (see annex 2) will be published on the relationship between physical capacity within and between different zones (or collections of entry points) at different levels of system demand by 25 June 2007.

We hope that publishing this information will provide shippers with a better understanding of the likelihood of constraints and reduce some of their concerns.

We would also suggest that NGG and shippers consider whether this information should be published annually or for the next few years – based on NGG's current investment plans to help improve transparency and understanding of the arrangements. We would also encourage shippers and NGG to consider whether there is further information that could be published to improve transparency and understanding.

### **NGG's role**

Under Section 9 of the Gas Act (amended), NGG has a duty to develop and maintain an efficient and economical pipeline system for the conveyance of gas. NGG has a licence obligation to operate an economic and efficient pipeline system. NGG also has commercial incentives set out in its licence that are designed to encourage NGG to act in this way.

These obligations and duties mean that NGG has to ensure that all physically available capacity is released to shippers. If the network is constrained, NGG should seek to release capacity where users value it most. In situations where actual network capability is greater than baseline capacity we would expect NGG to make the difference available as either non-obligated firm capacity or interruptible capacity.

Given its duties and obligations NGG is required to provide physical capacity in line with network capability and not below network capability. NGG has tools at its disposal to manage the risks of selling more capacity than it can physically deliver by entering into forward, option contracts or spot purchases to "buy back" capacity.

We will monitor NGG to ensure that they act in accordance with their duties and obligations. We will investigate where there are reasons for concern and take enforcement action where necessary.

### **Transfer and trade**

As outlined in the previous section, NGG has a number of obligations under its Gas Transporter Licence. These licence obligations are currently in the process of being modified to reflect the outcome of the recent Transmission Price Control Review (TPCR).

As part of the TPCR Final Proposals, which NGG accepted in principle in December 2006, we introduced a number of new obligations on NGG in relation to capacity trade and transfer.

The objective of these new obligations is to reduce the risk of not fully utilising the existing network assets by enabling capacity that is not being used at a certain point of the network to be moved to another point on the network where users value it most. This could either refer to unsold capacity or capacity which has been sold but shippers would like to trade for capacity at another point on the network. From NGG's perspective, this might involve ensuring that systems are designed and operated in such a way as to facilitate this.

As pointed out in Final Proposals, we had expected NGG to put forward a methodology for capacity trade and transfer by end of February 2007. We also expected NGG to present implementable proposals to modify the UNC to introduce these new mechanisms in line with what was agreed as part of the TPCR package.

We are disappointed that this has not happened yet. One of the issues which NGG has raised is that introducing these mechanisms could increase its buyback risk depending on what methodology for determining "exchange rates" between points and the networks and the maximum amount of capacity that will be released at each entry point. NGG has on a number of occasions expressed the view that these mechanisms should result in zero incremental buyback risk to NGG. This is not our view of what has been agreed in Final Proposals or what NGG is obliged to do under its various licence obligations.

In paragraph 10.8 of Final Proposals we said the following: "An important element of the new licence obligation will be the objectives for the capacity transfer methodology, and how these objectives might reasonably be interpreted by NGG NTS. The purpose of the new obligation is to guard against the risk that capacity is 'sterilised' at an entry point where it is not needed, and where by reducing the obligation at that entry point additional capacity can be made available elsewhere. In calculating the transfer rates it would be reasonable for NGG NTS to factor in any changes in buy back risk as a result of the transfer. It is also reasonable for NGG NTS's methodology to result in a zero capacity transfer rate where this reflects genuine physical constraints on the network."

For the avoidance of doubt, we have never said that as part of the TPCR package, the implementation of capacity trade, transfer and substitution should be buyback neutral. However, as part of the TPCR settlement we did consider that the introduction of these mechanisms should not materially alter NGG's risk profile.

Ofgem's principal objective is to protect the interests of consumers. We recognise that there might be occasions when NGG should take the risk of overselling capacity and potentially incurring buyback costs as the reduction in wholesale gas prices could more than offset any increased buyback costs. This would be fully consistent with operating an economic and efficient pipeline system. It therefore follows that a proposal supported by stakeholders potentially might be in consumers' interests even if such a proposal would materially change NGG's risk profile compared with that agreed under TPCR.

We wanted to make clear that if discussions between NGG and shippers on proposed transfer and trade arrangements produce a proposal that would lead to more economic and efficient operation but would materially alter NGG's risk profile, we would be happy to consider and implement, subject to consultation, on changes to NGG's incentive package.

Having clarified this issue, we expect NGG to progress with implementing these new mechanisms before this winter through raising relevant UNC modifications and through submitting an appropriate capacity trade and transfer methodology to Ofgem which takes into account concerns raised by Ofgem and interested parties. Implementation would have to involve the provision of realistic exchange rates which do not result in physical capacity being withheld from the network.

Given the increasingly challenging timeline, it may be advisable for NGG and stakeholders to develop a number of potential UNC modification proposals that are capable of being implemented ahead of the winter that reflect the different views that have already emerged from industry discussions to date. This would enable a rapid but nevertheless full consultation on all the feasible options for this winter.

We would like to stress that we are firmly committed to the introduction of these mechanisms as they form an integral part of the overall TPCR risk and reward package. We firmly believe that it is still possible for these mechanisms to be introduced before this winter and we fully expect NGG to do so.

We understand that NGG will hold a special transmission workstream meeting on 28 June 2007. At this meeting, we expect NGG to present a range of feasible options for this winter for discussion and to invite alternatives to be presented and discussed as well. We would therefore urge stakeholders to attend in order to ensure that all feasible different options for introducing the capacity trade and transfer mechanisms for this winter can be developed and consulted on. We will also be attending this special workstream meeting.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'R Hull', written in a cursive style.

Robert Hull

Director, Transmission

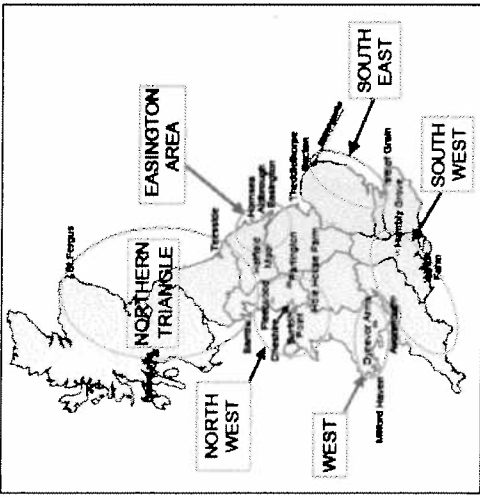




Annex 2

TABLE 3

Zonal Capability	Zone	Total System demand												
		Low Demand (<350mcm)			Medium Demand (350 - 450 mcm)			High Demand (>450mcm)						
		Max (mcm/day)	Min (mcm/day)	Aggregate baseline	Max (mcm/day)	Min (mcm/day)	Aggregate baseline	Max (mcm/day)	Min (mcm/day)	Aggregate baseline				
<p>Please complete the table to provide data showing the total zonal capability for each of the demand scenarios, low, medium and high. The maximum values assume lower demands in adjacent zones, which serves to increase the zonal capability. The minimum value assumes higher demands in adjacent zones, which serves to decrease the zonal capability. Outputs to be displayed in a graph for each zone.</p> <p><b>Data</b></p> <p><b>Period</b></p>	Northern Triangle													
	Easington Area													
	North West													
	West													
	South West													
	South East													



**NOTE** The tables are indicative. Please provide maximum and minimum values for demand increments of 25 mcm/day from 250 mcm/day through to 150% baseline.