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Dear Andrew

**Entry Capacity Substitution Methodology Statement: Draft Discussion**

Thank you for the opportunity to respond to the “Entry Capacity Substitution Methodology Statement” as part of the informal consultation.

In principle BP supports the objectives of Entry Capacity Substitution in enabling National Grid Gas (NGG) to run the NTS more effectively. However, BP questions whether the Special Licence Condition C8D, which states the specific obligations for substitution of entry capacity, is being interpreted correctly in the development of the substitution methodology. From its initial inclusion in the TPCR, few stakeholders expected a process that would create so much uncertainty and doubt. This has resulted in a number of objections being raised throughout the consultation process.

As a key objective of substitution is to minimise the cost associated with funded incremental obligated capacity, this could lead to excessive capacity destruction, as well as capacity constraints at key entry points. This was successfully highlighted by NGG’s Easington 10mcm Substitution Example from 11 June 2008. Heightened uncertainty would result in more long term bookings by shippers, further removing flexibility in the market and harming competition – once all capacity has been booked-up there is no room for new entrants. Furthermore, there could be a serious impact of artificial constraints on total costs of shippers as well as gas prices – this is something that has not been analysed.

As a means to dealing with the uncertainties encountered, BP’s preference is for a ‘transitional’ approach in implementing substitution of entry capacity. In the first two years only 50% of the total capacity (certified by the NPV test for incremental release) should be substitutable, with an increase to 75% and then full exposure in the next two years. Although this may temporarily increase the complexity of calculations, it is a necessary step in developing and adapting the methodology in the face of uncertainty. Additionally BP advocates Ofgem’s discretion in over-ruling or amending the release of incremental obligated entry capacity. This provides a last resort option for preventing unintended consequences. Finally, we strongly urge that an Impact Assessment is completed, including

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the quantification of potential benefits and costs of substitution, specifically including the impact on gas prices, investment decisions, and new storage sites.

Please do not hesitate to contact me if you have any questions.

Yours Sincerely,

**David Linden**  
Regulatory Analyst

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## **Answers to Specific Discussion Draft Questions**

*See National Grid website for full questions*

### **Q1, Q4, Q9, Q12**

BP feels that National Grid's interpretation of "minimising" the costs of fundamental obligate entry capacity is correct, in that there should not be a restriction on the process, and in particular the availability of capacity for substitution. Without further analysis, it is very difficult to comment on whether a lack of restrictions will cause inefficient substitutions to take place, when more efficient ones could take place at a later date. As it is impossible to know exactly how the market will develop up to 14 years in advance, this is an area that NGG should ignore in its interpretation of the licence condition.

However, due to concerns raised by all shippers regarding the controversial nature of substitution, BP does support an initial 'transitional approach, to mitigate the risks of unintended consequences of the process, as well to allow stakeholders in the entry capacity regime to adapt to the new structure. As stated above, BP suggests that in the first two years only 50% of the total capacity (certified by the NPV test for incremental release) should be available for substitution. This creates a balance between investment and substitution, and provides room for developing an understanding of how the regime is being affected by the new process. The level of (NPV certified) capacity available could then follow a step increase to 75% in the third year, with the fourth year reaching 100%.

BP feels this is a necessary step to take as it will allow NGG and the industry to reflect on and adapt to the impact of substitution, and it will also give time to annually adjust the methodology statement as is deemed necessary.

Although a number of other suggestions have been raised in the consultation document and substitution workshops, we feel the 50 / 75 / 100 step approach can claim an important difference in that it is a temporary, clear and simple tool, which can be easily applied and universally understood.

One particular area which has been heavily discussed in the recent substitution workshops is the use of an exchange rate. Consistent with the above argument on substitution without restrictions, BP's view is that an exchange rate cap should not be used. Setting such a rate would be almost totally arbitrary and may be beneficial for one ASEP but not another. This is not only discriminatory, but also inconsistent with the economic and efficient objectives of the substitution process.

For clarity, BP does not believe a permanent restriction on available capacity for substitution would aid in achieving the objectives of the substitution process. Instead temporary 'softening' measures (such as the 50 / 75 / 100 approach described above) would provide a buffer to the potential negative impacts of substitution, allowing shippers to adapt their behaviour, and the Entry Capacity Substitution Methodology to be reviewed and adjusted as necessary.

Furthermore, BP is in agreement with NGG that historical flows or TBE data should not be used to calculate substitutions. Historical data alone is not a good indicator of what is likely to happen in the future, especially as the supply portfolio of the GB market is currently in a state of flux. Additionally, NGG correctly pointed out that the use of TBE data may result in contributors overstating historical flows, devaluing the TBE process.

Outside of the scope of this consultation, yet still relevant, NGG should consider an early discussion on increasing, rather than decreasing the 10% held back after QSEC auctions for short term auctions to at least 20%. Such a move is not intended to mitigate the effect of substitution, but is necessary to facilitate effective competition in the GB market. The additional capacity would provide opportunities for smaller shippers and new entrants to secure supplies for the GB market, as well as provide the necessary source flexibility in a fast changing environment.

## **Q2, Q3**

BP believes that the same NPV test should apply when determining investment versus substitution opportunities. Furthermore, the 42 month lead time should also apply to both.

As alternatives, substitution and investment should be treated exactly the same. It is important to ensure that the methodology offers the same basic commercial right to any successful incremental entry capacity bid, no matter what tool (investment v substitution) is used to satisfy it. In addition to this, using a different framework for substitution would add an unnecessary layer of complexity for NGG's calculations, as well as for Shipper bidding strategies.

## **Q5, E**

The impact of booking a single quarter, as well as finding a possible solution to prevent ASEP protection, continues to be a complex issue that has lacked focus in the last round of Substitution Workshops.

If, as NGG suggest, single quarter bookings should be allowed, substitutions could be halted by shippers determined to protect the capacity at an ASEP, which would result in the economic and efficient workings of the network being undermined. As capacity is only a small part of the overall cost of operating, shippers are less likely to be discouraged from taking part in this practice. Preventing substitution and forcing NGG to invest would ultimately raise the cost to all shippers, as investment costs would need to be recovered through increases in TO charges. Conversely, using restrictive measures to prevent single quarter bookings is not only discriminatory, but would require further changes to the QSEC rules and practices.

There have been several calls in the recent workshops for Ofgem to have some discretion in over-ruling or amending National Grid's proposals for the release of incremental obligated entry capacity. BP feels that such discretion may not only provide a useful safety measure against unexpected consequences (see C, D, E), but potentially also against the blatant misuse of the process, such as shippers booking single quarters simply to protect an ASEP without the intent of use. Ofgem could have the right to question such single quarter bookings by requesting an explanation from the relevant shipper, and then veto the booking if it feels that the actions can not be justified by the shipper.

Overall the single quarter issue is a complex matter that could have a major impact on the substitution process, but has not been thoroughly discussed in the recent substitution workshops. Therefore BP proposes an additional in-depth consultation, so that an appropriate solution can be found.

## **Q6**

BP believes that the use of zones would be beneficial in the substitution assessment process. In comparison to the current suggestion of using pipeline distances to select donor

ASEPs, inter-zone donors should be sought first before moving onto the next relevant zone. As ASEPs within a zone are deemed to interact with one another and are considered by NGG to provide more favourable exchange rates<sup>1</sup>, it makes far more sense to use zones in seeking relevant donors. Within a zone the substituted volume should be pro-rated from each ASEP, depending on the volume available, as well as the relevant exchange rate. Not only would the burden of substitution be shared, but this would occur in a context of the most interactive and therefore most appropriate ASEPs. In contrast, using an ASEP individual pipeline-distance approach would be discriminatory, and provides no assurance that the 'optimal' ASEP is being used to satisfy substitution requirements. The result of a zone-based pro-rated approach would be a fairer substitution process, which is more reflective of the workings of the network.

## **Q7**

Licence Revenue Drivers (LRDs) are a sensible economic assessment criteria for choosing recipient ASEPs (lowest driver first) in the substitution methodology. However, it is questionable how long the economic argument for LRDs would hold. LRDs do not change with each substitution (as they are fixed in licence), which means that their value is only accurately reflected in first year, as after substitution has occurred, the drivers are not reflective of the network any more. NGG have conceded in the Substitution Workshops that this would mean having to re-visit and adjust the Methodology statement each year.<sup>2</sup> NGG does note (that despite the additional workload) whatever method is chosen, all available capacity will be substituted away, regardless of the order.

All in all BP supports using LRDs as the assessment criteria for choosing recipient ASEPs on the grounds of initial ease of use and economic sense, but suggests monitoring the impact of a constant need to revisit the methodology statement, with the intent of finding a more desirable long term solution in the near future.

## **Q8**

As is the case with the whole substitution process, NGG must follow a set scientific methodology when selecting the most favourable donor ASEP. Discretion should be avoided to ensure that a clear, consistent and non-discriminatory approach is taken.

## **Q10, Q11**

It is sensible to prevent substitution for "new ASEP specific auctions" in the transitional period, until all ASEPs are considered for substitution in a regular QSEC. Central to this argument is that all ASEPs should be treated equally.

Once substitution has been incorporated into regular QSEC auctions, then substitution should also be included in each and every stand-alone auction for new ASEPs. Once again, this ensures that all ASEPs are treated without discrimination.

One issue that may cause confusion is the large number of (mainly storage) projects that could request their own stand-alone QSEC auctions, in order to market capacity rights as soon as possible. The result would be a number of QSEC auctions in one year, each with their own capacity requests and substitution opportunities. This may create a very complex situation, where capacity is substituted back and forth. The outcome of these actions is difficult to judge or even to calculate. However, the result could be more destructive than intended. As a counter measure NGG should attempt to limit the number of additional stand-alone QSEC auctions within a year.

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<sup>1</sup> Appendix 1; Entry Capacity Substitution Methodology

<sup>2</sup> It should be noted that only the parameters of the methodology require a change, and so there is no need to consult!

## **Answers to General Discussion Draft Questions**

*See National Grid website for full questions*

### **A**

Following Section 5A of the Utilities Act 2000, and BERR's Better Regulation principles, an Impact Assessment (IA) should be an integral part of the implementation procedure of Entry Capacity Substitution. The changes proposed by the entry capacity substitution process have the potential to have a major impact on the GB Gas Market. The high number of concerns raised in consultation documents and in discussions held at substitution workshops have shown that entry capacity substitution satisfies the criteria of an "important" proposal, in that it is likely to "have a significant impact on persons engaged in commercial activities...[as well as] the shipping, transportation or supply of gas". Ofgem also notes in its 2008 guidance document on IAs that "effective consultation is at the heart of good policy development and that IAs have a significant role to play in this". All in all the "importance" of the proposed changes, combined with the published guidance for an IA, give enough weight to support the necessity for such a process to be included in assessing Entry Capacity Substitution.

Broadly, as required by Ofgem's statutory duties, an IA must include an analysis of the costs and benefits of entry capacity substitution. This should cover the impact on consumers, including expected gas price movements, as well as on competition in the GB market. Competition may be negatively affected because shippers could be forced to book all their potential capacity requirements in the long term, leading to a continental style gas market, which often leaves no capacity free for smaller users or new entrants. Capacity could also be fully substituted (and destroyed) in one QSEC, threatening the efficient workings of the GB market, as well as the intended purpose of the substitution process. It is clear that a focus on risks and uncertainties is required, including highlighting and assessing possible unintended consequences. Importantly, an attempt should be made to quantify the costs and benefits of substitution. Not only would this help to justify why substitution should be implemented in the first place, but the calculations would help to develop an appropriate approach to implementing substitution, ensuring the key benefits are captured and unnecessary costs are avoided.

### **B**

When attempting to assess "economic and efficient" in respect of substitution, National Grid have correctly recognised that there are two clear sets of criteria. The first is the system perspective, which justifies avoiding incremental investment and having no exchange rate. The second is the economic and efficient impact of substitution on UK plc, including issues relating to security of supply and the knock-on effect of potential reduced flexibility on consumer gas prices.

BP believes that both sets of criteria need to be taken into consideration when assessing whether substitution is "economic and efficient". This is consistent with our arguments in Q1, Q4, Q9 and Q12 for no exchange rate cap, as well as the argument in Q5 for Ofgem's intervention or discretion to prevent unintended consequences on the industry as a whole. For clarity, economic and efficient assessments should only apply to the particular QSEC period in question, as you have no way of knowing whether one substitution may be more economic and efficient at a later stage.

### **C, D**

As already discussed in the opening paragraphs of BP's response, we are very concerned that substitution may have a negative impact on the security of supply situation of the GB market. In short, the key fear is that in avoiding funded incremental obligated capacity, substitution will lead to excessive capacity destruction, as highlighted by the Easington 10mcm Substitution example from NGG. This removes a vital source of supply flexibility, and could have adverse effects on the security of supply situation in the GB market.

Heightened uncertainty and risk would result in more long term bookings by shippers, further removing flexibility in the market and harming competition – once all capacity has been booked-up there is no room for new entrants. As seen in continental Europe, and confirmed by the European Commission and National Regulators, excessive long term capacity bookings have a far more negative than positive impact.

Theoretically the artificial constraints imposed by capacity destruction and longer term bookings could increase gas prices to the consumer. However, BP lacks the required information to further comment on such a claim, and believes it is near impossible to fully quantify the impact due to the complexity of the issue at hand. Therefore, BP would welcome the inclusion of consumer gas price analysis in the Impact Assessment.

## **E**

Ofgem discretion is welcomed as a last-resort check on unexpected consequences of substitution. As previously highlighted, the full consequences of substitution are not known. By giving Ofgem some discretion in over-ruling or amending the release of incremental obligated entry capacity, potentially destructive actions could be prevented (including single quarter bookings, see Q5). Additionally, Ofgem's use of its discretion would also become part of the process for adapting the methodology on an annual basis as problems / issues are identified.

Naturally there are some concerns on involving the regulator in such decision making. A key question is what criteria Ofgem would use in assessing what is a 'good' or 'bad' capacity allocation? BP suggests that such discretion ought to be used as a last-resort and should be as transparent as possible. NGG and Shippers should also have the opportunity to appeal a decision to the Authority. However, it should be noted that the additional process could be very time consuming and, as a minimum, would require a change in the QSEC timetable to allow for additional scrutiny.