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Our Reference:

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Dear Andrew,

Discussion Document on Entry Capacity Substitution

Thank you for providing Scottish and Southern Energy plc (SSE) with the opportunity to comment on the above Discussion Document.

In response to the General Questions:

SSE is generally supportive of the principles underlying Entry Capacity Substitution proposals. However, the proposals are a material change to the Entry capacity regime; they introduce additional complexity at a time when the UKCS production is declining and the UK is increasingly dependent on imports.

SSE is concerned that new developments may be discouraged due to the complexity of the regime and uncertainty regarding treatment of unbooked capacity. Overall this could reduce the attractiveness of the UK as a place for investment at a time when we are increasingly dependent on imports, impacting adversely on security of supply and commodity prices.

SSE believes that it is essential that Ofgem undertakes a detailed Impact Assessment (IA) prior to implementation to ensure any regime is robust and the long term benefits outweigh potential costs. In particular, full account should be taken of the impact on; commodity prices, security of supply, operating costs, and the wider network including Exit.

Different terms of reference can be applied to economic and efficient assessment. SSE believes the widest possible consideration should be analysed to include the terms in the IA assessment described above. Although efficiencies can be made by “sweating” the Entry capacity assets the savings are likely to be modest when compared to the potential impacts on commodity prices that arise through lack of new import facilities or failure to develop marginal fields.

SSE is concerned that as things stand, proposals to allocate capacity based on the lowest Licence Revenue Driver actually maximise the costs associated with funded incremental obligated entry capacity and contradict the licence obligations.

SSE recognises difficulties associated with trying to define a comprehensive and prescriptive methodology for such a complex area. Consequently, as substitution will be an untried process with potential to fundamentally change entry capacity baselines permanently, it may be prudent to allow Ofgem discretion on powers of veto when determining capacity substitution even when NGG have followed the approved methodology. We would however expect that over the longer term, as experience develops, the methodology could become more prescriptive to avoid such discretion being necessary.

In response to the specific questions:

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.

To avoid potentially sub optimal long term outcomes a cap should be applied on exchange rates. However, at this time SSE is not in a position due to lack of information regarding NGG capacity modelling as to what the exchange rate cap should be. The short-term trade and transfer process has a cap of 10:1. SSE believes this would be too high for the longer term Substitution process.

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.)

As the Licence condition is written it is our understanding that the objective is to minimise the cost of funded incremental entry capacity, not maximise use of available entry capacity. As such it seems appropriate that a single common user commitment test is applied to both incremental investment and substitution. Implementation of different tests would add unnecessary complexity to an area that is already too complicated. This complexity may act as a barrier to entry at a time when the UK is dependent upon increasing imports.

Proposals should aim to be as simple as possible based on the principles that user commitment tests should be evaluated at the same time, with the same “hurdle rates”.

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.

SSE believes that substitution capacity should be made available at the same time as investment capacity i.e. 42 months. As experience develops it may be appropriate to consider reducing this period in order to maximise use of spare capacity but we believe this is a secondary issue.

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?

SSE responded in the TPCR and still maintains that 20% of baseline capacity should be retained on a prompt basis to encourage new entrants. This is required to encourage the development of the remaining marginal upstream projects in the UK.

SSE believes that unsold capacity up to 80 % of the baseline level should be available for Substitution. Forecast flows should not be used to determine Substitution levels, as these are open to error and manipulation under the TBE process. Historical flows will not be reflective of future flows as the UKCS declines.

Being mindful of the unforeseen consequences of capacity Substitution in terms of commodity price increases and adverse impacts on security of supply there might be merit in a phased approach over the initial years with caps on inefficient exchange rates.

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?

SSE would not be supportive of a ban on specific bidding behaviours at this time. Should there prove to be an issue with “single quarter bidding behaviour” then appropriate action can be taken in the future. However, for any future changes we should strive to avoid introducing unnecessary complexity and bear in mind that users of seasonal storage products may only bid for one quarter of capacity in each year.

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.

The use of zones seems logical and is helpful in the understanding of how the substitution process works. From a user’s perspective this transparency is important in verifying understanding and having confidence in the process. Also, the use of in-zone transfers first is likely to lead to more efficient exchange rates even though in specific cases the donor ASEP may be physically more distant than an out-of-zone donor ASEP.

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.

SSE does not have a comprehensive understanding of how capacity substitution can be optimised, primarily because we don’t have access to the assumptions & models that NGG have at their disposal.

However, we are concerned that the proposal states ASEPs with the lowest LRD will be allocated first. Our understanding is that this will actually result in the highest possible investment cost, rather than the minimum as required under the Licence. Existing capacity will be substituted to the lowest RD ASEP first, leaving the most expensive projects to be financed by new investment. This appears to be in contradiction to Licence Special Condition C8D, part C, Section 10: “ensuring that entry capacity substitution is effected in a manner which minimises the costs associated with funded incremental obligated entry capacity.”

SSE believes that other proposals should be investigated for determining the recipient order and if necessary examples produced to show the relative benefits.

Q8 - Do respondent favour an approach that requires National Grid to follow a set methodology or should National Grid have some discretion to select more favourable donor ASEPs?

Whilst SSE recognise there is potential risk with a new process for unintended consequences; we favour a robust, detailed and transparent methodology. It is better that all industry participants understand the process and ensure that it is applied in a fair and consistent manner. As such we do not support any proposal to give NGG discretion. Any issues or amendments should be dealt with through the existing industry forums and change processes.

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:*

- o how should the level be determined? What should be the level of an exchange rate cap?*
- o Should a cap be applied in aggregate across all donor ASEPs or for each recipient/donor ASEP combination?*
- o Are there any scenarios where different caps should apply?;*

• *limiting substitution to within zone only. Although such a limit is likely to give more favourable exchange rates 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.*

To avoid excessive transfer of capacity by Substitution a cap should be applied on exchange rates. However, at this time SSE is not in a position due to lack of information regarding NGG capacity modelling as to what the exchange rate cap should be. The short term trade and transfer process has a cap of 10:1 and SSE believes this would be too high for the long term substitution process where there is more uncertainty over future gas flows. The same lower exchange rate cap should be implemented for each donor/recipient combination pair.

SSE does not believe that Substitution should be restricted to within zone transfers only as this will be overly restrictive and minimise opportunities for releasing capacity. Nor does SSE believe that a limited capacity should be taken from every possible donor ASEP, this is likely to be inefficient compared to starting with and exhausting the most efficient donor before progressing to the next.

Q10 – Q12 – Do respondents agree with this transitional rule?

SSE agree that as a transitional and a permanent rule, Substitution should not be considered in respect of “new ASEP specific auctions” where these auctions occur after implementation of this methodology and before a regular QSEC auction where capacity can be obtained at all ASEPs. i.e. capacity at a new ASEP could not be substituted until shippers at that ASEP had had the opportunity to purchase it.

If you would like to discuss any of the above points please do not hesitate to contact me.

Yours sincerely

Jeff Chandler
Gas Strategy Manager
Energy Strategy