

By email

Malcolm Montgomery  
National Grid  
National Grid House  
Warwick Technology Park, Warwick, CV34 6DA

14<sup>th</sup> May 2019

**RE: National Grid Gas' Consultation on Capacity Methodologies and Statements**

Dear Malcolm,

We welcome the opportunity to offer our opinion and views on the proposed changes described within National Grid Gas' (NGG) formal consultation on the Capacity Methodologies and Statements dated 16<sup>th</sup> April 2019<sup>1</sup> (**Consultation**).

South Hook Gas Company Ltd (South Hook Gas) manages and owns the primary capacity at the South Hook LNG terminal located at Milford Haven in South Wales. South Hook Gas applied for a PARCA<sup>2</sup> (Planning and Advanced Reservation of Capacity Agreement) in respect of incremental entry capacity for the Milford Haven ASEP on 24<sup>th</sup> April 2018 and is currently in Phase 2 of such application.

As a general point, we would expect the Entry Capacity Release Methodology (ECRM) to provide clarity and certainty for PARCA applicants in order to create a stable and transparent basis for investment in GB infrastructure projects. However, our experience in our application is that the processes and requirements as contained in the current ECRM statement have fallen short in this regard. In summary the current regime requires excessive amounts of capacity to be signalled, due to the unconstrained nature of the NTS, which results in an uneconomic and inefficient methodology. The changes proposed as part of the Gas Transmission Charging Review (**GTCR**) exacerbate this further. In light of these concerns, South Hook Gas has raised a UNC Modification<sup>3</sup> to insert the funded incremental entry capacity NPV user commitment test into the UNC.

We have previously raised our concerns in our response<sup>4</sup> to the preliminary NGG Capacity Methodologies and Statement review dated 16<sup>th</sup> January 2019 and, while we welcome the Consultation as potentially providing an alternative means of addressing our concerns above, from our detailed review of the Consultation we feel that the proposed changes still do not provide the requisite certainty to promote and facilitate investment into Great Britain.

We have summarised some of our high-level concerns below.

**1. Introduction of a 16 quarter minimum requirement for all PARCA applications, without prejudging whether that PARCA is met through existing, substituted or incremental capacity**

For the reasons set out below, South Hook Gas believes that the financial NPV test as currently implemented (i.e. a purely financial test<sup>5</sup>) is the most appropriate approach. We recognise however that the financial test needs to be made fit for purpose. Therefore we are supportive of a premium concept as proposed by NGG (more information in Section 3 below). We are however opposed to the NGG proposed introduction of a 16 quarter minimum requirement for all PARCA applications for a number of reasons. These reasons are summarised in the paragraphs below.

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<sup>1</sup> <https://www.nationalgridgas.com/capacity/capacity-methodology-statements>

<sup>2</sup> <https://www.nationalgridgas.com/document/126451/download>

<sup>3</sup> UNC Modification 0667 – Inclusion and Amendment of Entry Incremental Capacity Release NPV test in UNC

<sup>4</sup> <https://www.nationalgridgas.com/document/126311/download>

<sup>5</sup> Where incremental revenue is equal or greater than 50% of the project value

### 1.1. Differences between the User Commitment tests

- 1.1.1. We are not supportive of the change to introduce a 16 quarter minimum requirement for all PARCA applications irrespective of whether a given application is met through (1) existing or substituted capacity or (2) funded incremental capacity. We feel that there are separate and distinct principles underpinning the user commitment tests for each of (1) and (2). The user commitment test for (1) exists to ensure that an applicant is not moving capacity freely from one point to another on a regular basis, while for (2) it ensures that the applicant is contributing the required amount<sup>6</sup> towards any NTS investment costs.
- 1.1.2. Therefore the user commitment tests for (1) existing or substituted capacity and (2) funded incremental capacity are conceptually different. Seeking to achieve consistency between the tests could disincentivise investment for the reasons outlined below and create other fundamental misalignments with the objectives.
- 1.1.3. Imposition of the user commitment test for (1) on (2) would have unintended results that would seem to be contrary to the intent of the user commitment test for funded incremental capacity, namely that the funded incremental capacity NPV test should be reflective of the NTS investment costs required for the PARCA works. Inclusion of the minimum 16 quarter duration would create significant risk that capacity would have to be acquired with a value materially in excess of such investment costs.

### 1.2. Impacts of imposing a minimum duration on the funded incremental user commitment test

- 1.2.1. Under the proposed methodology only the revenue associated with incremental capacity and any premium (on incremental or unsold baseline) contribute towards the NPV test. As a result of this, where an applicant does not have 16 quarters of incremental capacity signalled (but meets the requirement to signal incremental capacity, as discussed below), it is required to determine at the outset of PARCA Phase 2 when to commit to additional unsold capacity in order to meet the 16 quarter minimum requirement. This would always result in revenues being signalled in excess of those required under the NPV test, irrespective of the project cost used. This is consistent with the findings of NGG's analysis<sup>7</sup> which also notably highlights in its first two scenarios that an applicant would be required to signal at least double the required investment cost as a result of the minimum duration<sup>8</sup>.
- 1.2.2. It is counterintuitive that a mechanism designed to optimise the delivery of capacity could result in an outcome where a user is required to commit to capacity at a certain time in order to fulfil incompatible investment hurdles. Given the increased cost of capacity under the proposed GTCR modification, capacity purchasers are incentivised to buy only capacity they know they will use. By its nature, incremental capacity signalled under a PARCA is peak capacity and, for flexible supplies of gas, the timing of requirement for peak capacity is not known at the NPV test stage. We are concerned that NGG may not be complying with its own Licence requirements to facilitate competition and non-discriminatory access to the network by requiring users to book capacity in excess of their requirements.
- 1.2.3. Given that these additional unsold capacity bookings do not contribute towards the financial commitment aspect of the NPV test, being only required to satisfy the minimum duration requirement, the imposition of the minimum duration requirement could lead to inefficiencies and uneconomic impacts being driven into the capacity booking system (as there may be no commercial rationale for a PARCA applicant to acquire this excess capacity other than to satisfy the NPV test). This requirement may have a significant impact on the

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<sup>6</sup> Currently 50% of the estimated project value

<sup>7</sup> Slide 12 - <https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2019-03/8.0%20Capacity%20Methodologies%20Review%200667%20v2.0.pdf>

<sup>8</sup> The prices used for scenario 1 and 2 are in the range of expected prices from GTCR

financial modelling underpinning decision-making by potential and existing PARCA applicants, especially when combined with the expected changes to the Gas Transmission Charging Regime<sup>9</sup> where capacity charges are proposed to have a floating reserve price and an unknown revenue recovery charge is proposed to apply to all capacity holdings. This increases the amount of uncertainty and potential cost relating to acquiring incremental capacity and could disincentivise investment in GB.

1.2.4. It is also worth noting that the prices generated from the GTCR are based on a cost allocation model and not marginal costs. Therefore, having a minimum duration requirement alongside a cost allocation model could result in different System Entry Points contributing different amounts of revenue which are unrelated to the project costs and seems discriminatory against certain Entry Points on the NTS<sup>10</sup>.

### 1.3. Priorities between release of funded incremental capacity and existing/substituted capacity

1.3.1. In the Consultation cover letter<sup>11</sup> NGG have made it clear that the 16 quarter minimum duration is being applied to avoid creating an incentive for applicants to pursue funded incremental capacity where capacity can be released via existing or substituted capacity. Given (1) the user commitment tests have differing objectives (as discussed in Section 1.2 above) and (2) the NGG licence condition to release capacity through substitution prior to funded incremental (see below) we query whether there is a real risk of creating such an incentive.

1.3.2. NGG is required pursuant to its Transporter Licence<sup>12</sup> to consider releasing substitution capacity prior to releasing Funded Incremental Obligated Entry Capacity. If a PARCA application can be met through existing unsold or substituted capacity, no funded incremental capacity would need to be released. The PARCA would then be subject to the Entry Capacity Substitution Methodology (ECSM). This is referenced in Paragraph 36 of the ECRM where it states that “To minimise the need for investment, before releasing Funded Incremental Obligated Entry Capacity at an ASEP National Grid will consider opportunities to substitute unsold capacity from another ASEP. In addition, substitution will only be considered if the existing capability of the NTS is insufficient to satisfy requests for additional capacity at an ASEP”<sup>13</sup>. Therefore there is an existing prescribed decision making process that determines how the capacity associated with the PARCA application is to be released and which prioritises the release of other sources of entry capacity ahead of funded incremental entry capacity.

1.3.3. The Consultation suggests that the misalignment between user commitment tests potentially incentivises Users to connect to constrained/congested parts of the NTS in order to realise cost savings by accessing cheap funded incremental capacity instead of substituted capacity. However we do not believe that this is as a result of the funded incremental user commitment test (which, as stated above, should be based on a financial test). We note that NGG’s analysis<sup>14</sup> clearly shows that the minimum duration aspect of the substitution/non-funded incremental capacity user commitment test results in scenarios which cost a User more than the actual cost of building any NTS reinforcements

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<sup>9</sup> More detail can be found in UNC Modification 0678

<sup>10</sup> This is not applicable where a Postage Stamp model is used

<sup>11</sup> Entry Capacity Release Methodology Change Section – Bullet 4

<sup>12</sup> Special Condition 9A - <https://epr.ofgem.gov.uk/Content/Documents/National%20Grid%20Gas%20Plc%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

<sup>13</sup> Entry Capacity Release Methodology – Paragraph 36

<sup>14</sup> Slide 12 - <https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2019-03/8.0%20Capacity%20Methodologies%20Review%200667%20v2.0.pdf>

to release the capacity, despite substitution having zero, or minimal, costs associated with it.

1.3.4. Therefore we are concerned that the substitution/non-funded incremental capacity user commitment test may inherently be flawed, creating uneconomic or inefficient results that would seem to be contrary to NGG objectives. As a result, we do not consider that the minimum duration element of this user commitment test is appropriate for application to the funded incremental user commitment test.

1.3.5. We would however note that the NGG analysis also highlights that the funded incremental user commitment test, without a minimum duration, achieves its objective by ensuring at least 50% of the project cost is committed<sup>15</sup>. If the minimum duration is to be applied to the funded incremental user commitment test then the user is committing revenues greater than the whole NTS estimated project cost in 2 of the 3 scenarios. It is also worth stating that these 2 scenarios use prices which are most reflective of anticipated post-GTCR levels. Therefore we believe that NGG's proposed funded incremental user commitment test (without the inclusion of the duration element) would achieve its objectives and the NGG analysis would seem to support that conclusion.

1.4. In summary, as a result of the above, we do not support the introduction into the NPV test of a minimum duration element of 16 quarters on the grounds of alignment of the user commitment tests. Doing so would result in a funded incremental user commitment test that is uneconomic and inefficient. We believe that the requirement to signal incremental capacity over a minimum of 4 separate years (Section 4 below) provides the necessary assurance to NGG of the PARCA applicant's sustained requirement for incremental capacity.

## 2. Change to the determination of project cost for the purposes of the economic test

2.1. We welcome NGG's reversion to a more "generic" project cost calculation that is based on a simplified LRMC methodology. A generic project cost allows for greater alignment with the current PARCA methodology. However, it is widely accepted that the LRMC methodology is volatile and unpredictable<sup>16</sup> which is likely to result in the estimated project costs associated with the incremental capacity changing unpredictably year on year. It is unlikely that the required NTS investment will change in lockstep with the LRMC. Therefore, we believe it would be more appropriate to fix the project cost at the end of PARCA Phase 1 and index such costs in accordance with RPI to allow for greater certainty around any investment.

2.2. The inclusion of a transition rule is also welcomed. However, for the same reasons as above, we feel it is more appropriate to fix the project cost at the time PARCA Phase 1 is completed and the PARCA is signed.

## 3. Introduction of a capacity price premium for PARCA project requiring incremental capacity

We support the introduction of a capacity price premium which is payable in addition to the reserve price to allow the NPV test to be passed. It is generally accepted that, in contrast to the situation when the current NPV test was first implemented, most NTS users are now no longer booking long term capacity. Therefore, it has become increasingly difficult to pass the NPV test. The concept of a premium is already used within the NPV test for incremental capacity at interconnection points<sup>17</sup> and

<sup>15</sup> Slide 12 - <https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2019-03/8.0%20Capacity%20Methodologies%20Review%200667%20v2.0.pdf>

<sup>16</sup> <https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/Conclusion%20of%20sensitivity%20analysis%20modelling%20v1.0.pdf>

<sup>17</sup> As per EU CAM Network Code

therefore we would support the proposal to follow the same approach for domestic incremental capacity release.

#### 4. Introducing a rule to determine the amount of incremental capacity required

While we are generally not supportive of a minimum duration within the NPV test associated with incremental capacity (for the reasons set out in Section 1 above) we understand NGG's concerns that using a premium without any minimum duration could result in a scenario where incremental capacity is released uneconomically. As such, we would consider that the introduction of a requirement to signal incremental capacity over a minimum of 4 separate years represents a pragmatic compromise. We believe this is a suitable minimum duration as it ensures there is a sustained commitment for incremental capacity, in contrast to the excessive commitment under the 16 quarter minimum duration as proposed in the Consultation.

#### 5. Inconsistencies between the Uniform Network Code (UNC) and Methodology Statements

5.1. It is noted that in the Consultation NGG have inserted the Estimated Project Cost calculation into the ECRM. Currently this calculation is included within the UNC<sup>18</sup> with the ECRM referencing instead to the relevant section of the UNC<sup>19</sup>. This change is not highlighted anywhere within the Consultation cover letter but is a significant change to the governance regime. Removing the reference to the estimated project cost in UNC effectively makes this section of code redundant. We do not feel this change is appropriate and highlights the governance issues associated with the capacity methodology statements.

5.2. We note that there are other inconsistencies, for example the user commitment test for incremental capacity met through substitution or existing capacity is within the UNC<sup>20</sup> while the user commitment test for incremental capacity is exclusively set out in the ECRM.

5.3. These inconsistencies create disconnects in the governance processes and made the review of the statements extremely difficult. Therefore we believe that it would be more appropriate for the methodology statements to be incorporated into the UNC to avoid conflicting governance processes. It would also allow for a more open and efficient process for any future changes.

We greatly appreciate that NGG has allowed this opportunity for industry to provide comments on its proposed changes to the capacity methodologies and statements. We believe the proposed changes to the Entry Capacity Release Methodology go some way to resolve the current issues associated with the incremental capacity user commitment test. However, we remain strongly of the opinion that the issue of inefficient and uneconomic bookings arising from the minimum requirement to signal 16 quarters of capacity must be resolved. We would also like to note that the issues above were discussed during the development of UNC Modification 0667 and the final modification seeks to address them<sup>21</sup>.

We hope this response is of assistance and should you wish to discuss further or have any further questions please contact me on [abates@southhookgas.com](mailto:abates@southhookgas.com) or +44 (0)20 7234 3505.

Yours sincerely,

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<sup>18</sup> UNC TPD Section Y Part A1

<sup>19</sup> ECRM Chapter 5 Paragraph 136

<sup>20</sup> UNC TPD Section B 1.17.7(c)(ii)

<sup>21</sup> Draft Modification Report can be found at <https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2019-04/Draft%20Modification%20Report%200667%20v1.0.pdf>