



Making a positive difference
for energy consumers

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Dear Jenny,

Substitution Capacity Methodology Statements

Thank you for submitting proposed modifications to the Entry and Exit Capacity Substitution Methodology Statements ("the Statements") on 17 November 2016. After considering the proposed modifications and consultation responses you¹ also submitted to us², we consider that your proposed changes to the Statements are reasonably necessary to better facilitate achievement of the capacity objectives set out in your gas transporter licence.

Our reasons for this view are explained below.

Background

Special Condition 9A of your gas transporter licence requires you to have in place Capacity Methodology Statements that facilitate the achievement of the capacity objectives set out in Part C of Special Condition 9A ("the capacity objectives"), which include provisions relating to implementing Entry Capacity and Exit Capacity substitution. Broadly speaking, these Statements set out the methodology employed if unused National Transmission System (NTS) capacity is to be substituted from entry or exit points to meet demand for capacity elsewhere on the network.

Special Condition 9A.6 of your Licence requires you to review and if necessary seek to make such modifications to the Statements as are necessary to make sure capacity substitution is implemented in a manner consistent with the capacity objectives, which includes your duties under your licence and under the Gas Act 1986 ("Gas Act"), and which seek to minimise the reasonably expected costs of releasing Funded Incremental Entry or Exit Capacity. You are required to review the Statements at least once every two years or if directed by us. Any changes you propose to make to the Statements must be consulted on in accordance with the licence requirements and a report containing the information described in Special Condition 9A.8 must be submitted to us containing, among other details, a copy of the proposed modifications.

¹ The terms "the licensee", "NGG" and "you" are used to refer to National Grid Gas plc in this letter.

² The terms "the Authority", "Ofgem", "we", "us" and "our" are used interchangeably in this letter.

Unless we have consented otherwise, Statements submitted to us must be accompanied by a report from an Independent Examiner that confirms the extent to which the methodologies are consistent with your Gas Act duties and Licence obligations.³

In our letter dated 15 September 2016 we gave our consent that a statement from an Independent Examiner would not be required in this instance.

Proposed changes to the Statements and consultation responses

You consulted on changes to the Statements between 6 October 2016 and 3 November 2016. The changes proposed to each Statement were similar and included:

- lowering the lead times to deliver substituted capacity from 1 October Y+4 to 1 October Y+2
- prioritising capacity substitution from disconnected entry or exit points if the substitution exchange rate equals capacity from connected NTS points.

You received seven responses to the consultation, which we have reviewed.⁴ These responses were generally supportive of the changes albeit one respondent was explicitly against lowering the lead times. We had a meeting with this respondent on 9 December 2016 as they asked to further explain the concerns expressed in their consultation response.

Noted below is a summary of our understanding of the modifications to the Statements you proposed and the points made in the responses to your consultation.

Substitution lead times

These changes propose to reduce the lead times to substitute entry or exit capacity from around four years to around two years. Currently, entry or exit capacity substitution takes place on the 1 October that falls around four years after a successful request for additional NTS capacity has been made.⁵ This is the minimum lead time substituted capacity can be made available to meet the demand for additional NTS capacity.

You propose to shorten this lead time to the 1 October which falls around two years after a successful capacity request has been made.

Five of the respondents supported lowering the substitution lead times. A number of reasons were given for supporting the lower lead times including that the changes would align substituted capacity lead times with the lead times to release Funded Incremental Entry or Exit Capacity. They also stated the lower lead times will promote more efficient use of unused NTS capacity. One respondent thought this would be of particular benefit for new entrants.

Several of these respondents noted lower lead times could mean NTS sites have all their capacity substituted away more quickly than currently. However, shorter term capacity products could allow NTS users at these sites to meet their capacity requirements until network reinforcement takes place.

One respondent was against lowering the lead times. They thought this created a risk for Gas Distribution Networks (GDNs)⁶ meeting their peak day capacity obligations and

³ SC 9A.7

⁴ This includes a confidential response which the respondent agreed could be shared with us.

⁵ For entry capacity this includes a capacity signal passing the NPV test and meeting the substitution methodology requirements. For exit capacity this includes NTS users making sufficient capacity bids and meeting the substitution methodology requirements.

⁶ The respondent used the term Distribution Network Operators (DNO) in their response. We are using the term GDN. In the context of this letter both terms are interchangeable and refer to gas distribution network operators.

securing additional NTS gas capacity in response to an increase in demand on their network.

Prioritising substitution from disconnected entry or exit points

These changes would prioritise capacity substitution from disconnected entry or exit points in circumstances where they had the same substitution exchange rate as a connected NTS point.

Both the entry and exit capacity substitution methodologies calculate exchange rates that determine how much capacity needs to be substituted from donor points to meet demand for additional NTS capacity. Capacity is substituted from donor points with the lowest exchange rate in order to minimise how much capacity is 'lost' in the exchange.⁷ In circumstances where donor points have the same exchange rate, capacity is substituted from the donor point with the shortest pipeline distance to the point which requires additional capacity.

The changes proposed to the Statements would prioritise substitution from disconnected entry or exit points if they have the same exchange rate as other potential donor points. The proposed changes also provide definitions for disconnected entry and exit points.⁸

Respondents supported prioritising substitution from disconnected entry or exit sites. One respondent noted this would make better use of existing system capacity. Another respondent thought more could be done to make use of capacity at disconnected points but accepted this was a suitable first step.

One respondent suggested that defining a disconnected site should be based on shipper actions, around registering and paying for capacity, rather than network operator actions around terminating connection agreements. You stated the definitions proposed in the Statements are sufficient as shippers could still hold capacity commitments at disconnected points.

Other issues

One respondent asked if capacity retainers will still work with the lower lead times. You confirmed the lower lead times would not affect NTS users' ability to withhold capacity from substitution through the retainer process.

Another user stated that Bacton Interconnector Point (IP) Entry Capacity should not be available for substitution. You emphasised the provisions in the Statements around the substitution of capacity from IPs.

Our views

We have carefully considered the Statements submitted by you and concluded that the modifications will better facilitate the achievement of the capacity objectives. Further details on our reasons for this view are set out below.

Substitution lead times

In our view, lower lead times will make more efficient use of existing system capacity. It will mean that unused capacity can be substituted across the NTS to points where there is

⁷ Capacity is not substituted from potential donor points with an exchange rate of 3:1 or greater.

⁸ A disconnected entry point is one where the connection to the NTS has been isolated and the associated connection agreement (e.g. Network Entry Agreement) has been terminated. A disconnected exit point is one where the connection to the NTS has been isolated and the associated connection agreement (e.g. Network Exit Agreement) has been terminated.

demand for it earlier than the current methodology allows. This will reduce the redundancy of existing unsold NTS capacity.

The changes will also reduce the need for you to release discretionary NTS capacity. We note a number of recent applications for additional capacity which can be met entirely through substitution have required you to release discretionary capacity for a short period due to the current lead times. Lower lead times should alleviate this issue and mean capacity substitution can be used to meet similar requests for incremental capacity in full.

We note the concerns about the possible effects of lower lead times especially on GDN users. However, we consider the risks associated with capacity substitution are faced by all NTS users. This includes the possibility that capacity can be substituted away from NTS points where NTS users have been active in the past.

NTS capacity is made available through transparent and open mechanisms to all NTS users. The only way to secure capacity is to acquire it through these mechanisms. If this is not done, then any unsold capacity is available for substitution. NTS users should be mindful of the possibility unsold capacity can be substituted when making decisions to secure their capacity requirements.

There were also concerns that lower lead times could impact on NTS users if assumptions or data used to forecast NTS demand changed. In our view, this risk is not particular to any one group of users. Changes to the assumptions used to forecast demand also tend not to have a uniform impact on users and can vary according to location or type of user amongst other things. These effects are an unavoidable outcome when factors used to estimate demand are changed but can be mitigated by full and early involvement in any change process.

A number of products or mechanisms may be available to help users in the short term should they require additional capacity at a point which has had existing capacity substituted away. This could also involve that NTS point becoming a recipient point for substituted capacity in the future. However, ultimately it is for NTS users to make sure they have bought a sufficient amount of capacity to meet their requirements.

While we do not consider lowering the lead times disadvantages one particular group of NTS users, we think it would be useful for NGGT to consider if the Planning and Advanced Reservation of Capacity Agreement (PARCA) process provides sufficient opportunity for NTS users at exit points to secure capacity before it is reserved for other users.

The PARCA process allows NTS users to purchase unsold entry capacity through an ad hoc Quarterly System Entry Capacity (QSEC) auction before capacity reservation occurs. This provides these users with a chance to purchase entry capacity that could be used for substitution. No such opportunity exists for NTS users at exit points. While we do not think this is a problem in the PARCA arrangements, it would be helpful if you can consider if the requirement to run an ad hoc long term capacity allocation mechanism should be extended to requests for additional exit capacity made through the PARCA process. This could give NTS users additional comfort that they can secure their exit capacity requirements, providing they make sufficient commitments, before that capacity is substituted to another point. We are happy to discuss this with you in more detail.

Prioritising substitution from disconnected points

We consider the proposals to prioritise substitution from disconnected points will make more efficient use of NTS capacity. At present, the Statements treat capacity at disconnected points is treated in the same manner as other NTS points.

These changes will make sure that capacity is substituted first in circumstances where the exchange rates between a disconnected and connected point are the same. This will make

sure redundant capacity at disconnected points will be substituted more readily for use at another point on the NTS.

Authority's view

Following consideration of the documentation you provided pursuant to Special Condition 9A of the Licence, and having regard to our principal objective and statutory duties, we consider that the Entry Capacity Substitution Methodology Statement and Exit Capacity Substitution and Revision Methodology Statement as submitted on 17 November 2016 are reasonably necessary to better facilitate the achievement of the capacity objectives.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Brown', is centered on a light grey rectangular background.

Chris Brown
Head of Gas Systems Integration