



Robert Hull
Director, Transmission
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

E.ON UK plc
Westwood Way
Westwood Business Park
Coventry
CV4 8LG
eon-uk.com

Tuesday 31 January 2006

E.ON UK response to Transmission Price Control Review, second consultation

Dear Robert

Please find E.ON UK's response to the price control review, below.

Electricity Incentive Options

We agree that the existing situation regarding new investment in the network is less than ideal. As major users of the system with a number of prospective generation projects we are concerned about how certain aspects of the present regime can act as a barrier to new generation investment. However, we are equally concerned that proposed solutions in the consultation document could act as a greater barrier rather than improving the situation.

As Ofgem notes in the paper, there is presently a large demand for new connections to the transmission system. New generation is required to replace the large amount of capacity which is expected to close reasonably soon and to meet renewables targets. This has to be accommodated on a system which has very little spare capacity. Therefore, it is likely that works will be required on the transmission system in order to cope with most new connections.

The present arrangements place significant risks on projects by requiring Users to underwrite large levels of costs, or Final Sums Liabilities (FSLs), whilst infrastructure reinforcement work is undertaken. A particular contributory factor to this risk is the fact that usually the generation projects and the respective transmission reinforcements have to proceed in parallel.

E.ON UK plc
Registered in
England and Wales
No 2366970
Registered Office:
Westwood Way
Westwood Business
Park

As the number of projects wishing to connect increases the more reinforcement work is required. In order to avoid excessive delays infrastructure works have to commence earlier. Therefore, parties can find themselves exposed to significant financial liabilities at an early part of the project lifecycle, when they have yet to reach critical stages such as receiving the relevant consents.

These FSLs are required so as to minimise the likelihood of unnecessary reinforcement work being carried out should projects not commission and therefore creating stranded assets, resulting in additional cost for consumers. Therefore, the consequences of a project not commissioning are underwritten by the party requesting the relevant connection. We fully support the aspiration to avoid stranded assets wherever possible. However, the present arrangements by placing all of the risk on the party wishing to connect, are either preventing projects from proceeding or creating delays as parties wait for the relevant consents to be received before committing to connection works.

We believe that there is scope for the balance of risk to move away from sitting entirely with the connecting party to being shared with either the transmission companies or other Users. However, we do not support the removal of all risk from the connecting party. A substantial number of applications have been made for connection over the past few years, a significant amount of which presumably will not commission. We therefore believe that some degree of financial commitment should accompany the acceptance of a connection offer. The problem with the present system is that this level is too high.

We note the options which have been suggested for providing incentives for new investment. We agree that it is desirable that the arrangements are able to provide flexibility to respond to changing circumstances through the duration of the price control and that the adoption of investment drivers may be the answer.

We are less certain however about the User commitment approach to ensure that there is a link between investment and the demand for connections. Such provisions as a requirement for projects to commit to say ten years' worth of TNUoS charges, is likely to increase the risk for new projects above that presently caused by the Final Sums Liability approach.

Instead, we would support a lower level of commitment. For instance, parties seeking a new connection could be required to commit to pay a set sum per kW should the connection fail to commission. An appropriate level might be £1/kW. This would dissuade highly speculative projects as there would be a significant liability, but would be affordable to allow serious projects to proceed. Should this be regarded as insufficient for the entire commissioning process, then liabilities could be ramped up as the project receives the relevant planning consents.

Of course, such an approach means that the risk is shared with other parties. We believe that there are two options for this. One option is for all

Users to share the risk by recovering any stranded asset costs through TNUoS charges along with other infrastructure costs. Alternatively, transmission companies could be exposed to the risk of stranded assets, but be compensated through an appropriately adjusted rate of return.

We believe that the construction programme can be managed so as to minimise the chances of highly localised stranded assets. Much of the work that the transmission companies have to carry out to accommodate new connections could be used to accommodate other Users at a later date should the generation connection fail to connect. By focussing on this work first and delaying the dedicated infrastructure investment until the generation project becomes more certain, it is more likely that spare capacity rather than stranded assets will be created should the generator fail to commission.

We believe that a higher risk of spare transmission capacity and some stranded assets is preferable to the risk that there is insufficient generation capacity on the system in a number of years' time.

Gas Incentive Options

Focus on 'user commitment' model

We accept, in principle, the concept of a user commitment model, which could ensure an appropriate allocation of risk between network users, transmission companies and consumers. This could be achieved through a number of mechanisms under the framework of a user commitment model, for example, using ARCAs as a means of providing appropriate investment signals to NG NTS, ensuring financial commitment, and thus a share of the risk, from both counterparties, with respect to the costs associated with that investment.

Revenue Drivers

A revenue driver, fixed for the price control period would give Users and NG NTS more stability and certainty, when compared to one that changes during the price control period.

Our initial response inclines towards a nodal product, which would result in greater certainty at a specified entry/exit point, with respect to setting the baseline and more cost reflective revenue drivers, as indicated by Ofgem in the consultation paper.

Any change to this approach must be subject to a full analysis. Whilst conceptually, other options may seem sensible, the cost and complexity involved in changing them may far outweigh any perceived benefit.

Charging and reserve prices

We are of the opinion that UCAs should continue to be set within the price control. This will better facilitate stability and certainty in charges, minimising regulatory risk.

Changing the UCAs on an annual basis could lead to a change in bidding behaviour, for example, inhibiting parties' willingness to book in the LTSEC auctions, thereby further weakening potential signals to NG NTS. Transparency can still be achieved through Ofgem effectively setting prices in the context of a price control review.

Incremental capacity

The key cost drivers for incremental capacity are those directly related to the cost of the pipeline (linked to the price of steel) and the costs of putting the pipe in the ground, which will vary depending on the location, timing and the size and type of increment. NG NTS will also assess whether a compressor station is identified as being required along a route, all of which is detailed in NG's Incremental Entry Capacity Release Methodology Statement.

Entry Capacity Baselines

We believe baselines should be set as they are now, ex ante for each existing entry point for the duration of the price control. This would result in more cost reflective revenue drivers, when compared to aggregated revenue drivers.

Approaches to Offtake Reform

As we have indicated throughout the DN sell-off process, we do not consider that fundamental changes to the Gas Offtake regime are appropriate. We accept that certain parties are concerned about particular issues but these could be resolved through far less complex and costly changes to the regime.

We welcome the establishment of the Enduring Offtakes Working Group, enabling Users to openly discuss the options put forward and to consider any alternatives. It is also important that this group carefully considers the nature and extent of defects, if any, inherent in the current regime. Only then should mechanisms to address the defects be considered. The extent of any identified defects must also be weighed up against the costs and benefits of any changes proposed, with due consideration to simplicity and transparency.

In view of the work that is yet to be undertaken to fully assess the issues surrounding the offtake arrangements and the most appropriate changes that can be taken forward to address those issues, we feel it is too state a preference.

Moreover, the proposals remain at a very high level and it is, therefore, difficult to determine how they will work in practice. Without knowing how baselines and zones, for example, might be defined, it is difficult to know which option put forward will best satisfy requirements.

Any preferences that Users put forward at this stage could unduly close out or favour proposals before they are properly understood and before alternative proposals are considered. This may lead to a misleading outcome in the third consultation. It is important, at this early stage, not to close out any options before they are fully assessed relative to each other and relative to the issues they are attempting to address.

We look forward to participating in future industry debate on the above matters so we can take a view of the suitability of all of the options once we are fully informed.

Buy-back incentives for entry and offtake

There may be some value in treating buy-backs from operational constraints differently compared with buy-backs resulting from delayed investment for incremental capacity. We accept that the system as a whole is changing and much may depend on the direction the gas is flowing at any given time, affecting the imbalance of the system. Any further analysis in this area must consider the benefits of separating buy-back incentives against the complexity involved in such a separation.

If you wish to discuss the views expressed above please do not hesitate to contact Christiane Sykes for gas transmission issues or Paul Jones for electricity transmission issues. Alternatively please give me a call.

Yours sincerely

Peter Bolitho
Trading Arrangements Manager