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

Dear Robert

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

Electricity Price Control

We are not in a position to provide detailed comments on many of the issues on the form and structure of the price control which were raised in the consultation. We will instead focus on the proposals for reform of the access arrangements and the System Operator incentive scheme. However, we do have a particular point that we wish to make relating to the possible adoption of locational revenue drivers.

3.1: Do you agree with our conclusion that the use of locational revenue drivers is the most appropriate way to set allowances for the electricity transmission licensees in the context of significant uncertainty over the future demand (and location of that demand) for network capacity?

Whilst the use of locational revenue drivers may be sensible to reflect the different levels of cost associated with accommodating a given level of generation at different locations on the system, it is important that the arrangements are not set up in such a manner so as to distort any existing locational incentives. The signals which are provided to generators through the present

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TNUoS charging methodology provide some incentive for generators to locate at more appropriate parts of the network. It is questionable whether these signals are currently strong enough, as a significant amount of plant has applied to connect to the transmission system in Scotland despite clearly significant limitations of the network to be able to accommodate it.

We do not wish to see these incentives undermined further. Therefore, if location revenue drivers are adopted, they should be set so that there is no incentive on the transmission companies to favour building infrastructure at a particular location simply because the level of the relevant revenue driver makes it a more lucrative option than to invest in a more appropriate location.

3.5: Do you agree that, in the current market context, it is important to explore options to change transmission access arrangements? Do you agree with the process we have set out to progress this work?

Clearly there are a number of challenges in the present market relating to the provision of new connections and associated infrastructure. For us these can be distilled into two main issues:

- Financial liabilities incurred on signing a connection offer
- Management of the GB Queue

We do not believe that a significant change to the access arrangements to introduce a model based on greater user commitment is necessary to solve these issues. Moreover, we believe that such arrangements would actually prove detrimental. We address each issue in turn below.

Financial liabilities incurred on signing a connection offer

As we mentioned in our response to the second consultation, as well as in our presentation to Ofgem's seminar in February and at the Access Reform Options Development Group (ARODG), we believe that the main issue facing new connecting generators relates to the financial liabilities they incur on signing offers for connection. At the February seminar we outlined our concerns relating to National Grid's Final Sums Liability (FSL) provisions and raised two main risks:

- **Consent risk**: Where significant risks are incurred by potential new connecting parties prior to consents such as Section 36 being granted.

- **Third Party risk**: The inability of a party to predict how its FSLs will change in relation to other parties, with which it is grouped, terminating their agreements.

We continue to believe that the appropriate solution to these risks is to set FSLs at a fixed level per KW prior to the granting of Section 36 consent to the project concerned and thereafter charging a profile of FSL which is set out in the construction agreement of the relevant party and which can only be altered with the agreement of both the party and National Grid.

We do not believe that a user commitment model which requires the user to commit to paying a number of years' worth of TNUoS will adequately address these issues. It could possibly address the third party risk element if the amount of TNUoS is fixed up front, rather than being a commitment to pay the prevailing rate in the relevant year. However, it is likely that the level of commitment would be higher than presently required under the early stages of the present FSL arrangements, so would mean that the consent risk is actually increased.

If the level of TNUoS was fixed up front, a separate issue would be created as to who would bear the risk of the fixed level of TNUoS being different from the actual level which outturns in subsequent years. At present, the TNUoS charges are set in order to recover the allowed revenue of the transmission companies more or less exactly. If there is an over or under recovery then the charges for the following year are adjusted to compensate. If the fixed revenue caused by such a commitment results in an under recovery in one year then other parties' charges will presumably be increased to compensate. Therefore, these other users will be underwriting the volatility risk associated with the fixed charge.

In the event that all users, both new and existing, would be required to commit for a number of years, the only users with flexible charges who could bear this risk would be those paying demand charges. This would mean that the requirement to recover a set proportion of revenue through demand charges as whole would need to be removed, as the proportion would rise and fall in reaction to any under and over recovery. This would not appear to be an equitable situation.

In short, we do not believe that the user commitment model will address the issue with financial liabilities that users are presently facing.

Management of the GB Queue

At present we believe that there is around 10GW of generating capacity connected to the network in Scotland with a maximum demand in the same area of 6GW. Therefore, the minimum plant surplus represents around 4GW of generating capacity. The capacity of the wires between Scotland and England is 2GW; therefore there is already a significant pinch point on the system. As part of the introduction of BETTA a deadline was created before which any applications for new connections would be assessed ignoring the work that would be required to solve this pinch point. Around 13GW of new applications were forthcoming for Scotland. Therefore, we are not surprised that there is presently a queue for access.

Some participants have complained that they have been offered connection dates as late as 2012 even though they have been granted planning consent. It may appear unfair that projects which do not have such consents are placed ahead in the queue. However, these rules were clearly set out and it would seem equally unfair to change them post event, given that participants had applied in good faith assuming that they would prevail.

Additionally, the last of the offers have only recently been made to these applicants. Participants have a further 3 months in which to accept these offers. It is highly likely that a number will not be signed if they relate to schemes which are of questionable viability, as to do so would incur financial liabilities for the parties concerned. Therefore, a process of rationalisation should occur whereby parties leave the queue and other parties have their connection dates brought forward. Therefore, it is too early to conclude that the present first come first served process is not working.

It is not clear that the user commitment model would adequately address the GB queue issue. It would certainly ensure that only those who were very confident in their projects actually proceed. However, given the potential size of the obligation, the risks introduced could be disproportionate and have the effect of excluding some perfectly sound schemes. Therefore, it is not clear that it would improve information on the level of new connections without creating a barrier to entry.

Another aspect of the GB queue issue relates to whether it is possible to improve information on when plant is likely to decommission, thereby possibly freeing up transmission capacity for new connections. The idea appears to be that existing plant, by committing to paying for access for a number of years, would

be giving clearer signals of their intentions. We believe that the only improved information will be regarding revenues for the transmission company. How soon to be decommissioned plant will react depends on the particular circumstances each station is in. In some instances the commitment to pay TNUoS will not make any difference to when the station decommissions. The TNUoS obligation will have been incurred anyway and the generator may decide to decommission the plant in the middle of the committed period in response to market conditions such as fuel prices. In this instance false comfort may be provided if the commitment is relied on to provide an indication of the closure decision. In other instances changing the TNUoS charges from being a variable cost in the closure decision to a fixed cost, may bring forward or delay a closure decision depending on the circumstances. For instance, a generator may, on being confronted with the decision to commit to say 10 years' of TNUoS, decide to close the station now rather than in two years time, as the additional 8 years of TNUoS changes the economics of the closure decision. Alternatively, having already committed to a number of years' TNUoS costs, a generator may close later than it would have, had the potential to avoid future TNUoS costs been part of the closure decision as would be the case now.

Therefore, in only one of the cases above is the signal potentially improved and that is when the closure decision is brought forward. In this instance it would appear that the improvement in information could be offset by the security of supply implications of unnecessarily bringing forward the closure decision.

Therefore, we remain unconvinced of the benefit of moving to a user commitment model and indeed believe that the effects could be detrimental to security of supply and competition in generation.

Process

We believe that the consultation process that Ofgem has adopted so far is satisfactory. We would have preferred a more urgent addressing of the FSLs issues, but the discussions at the ARODG have proved useful in terms of understanding the options further. Our views have been confirmed that it does not seem necessary to undertake significant changes to the present access arrangements to introduce a user commitment model. Instead we believe that the changes proposed to the FSLs arrangements should be implemented instead. To that end, we will be seeking to address these issues through National Grid's review of the arrangements.

In the short term we believe that the FSL provisions can be changed quickly, as there is no formal governance covering these arrangements. In the long term we believe that the FSL requirements should be formally included in the CUSC. This perhaps could be achieved in line with the timetable for progressing the changes to the price controls.

2.5: Should the current form and scope of System Operator (SO) incentive schemes be adopted in the next price control period?

We are not aware of a form of incentive scheme which would provide improvements on the current form. That said, we believe that parameters of the existing scheme could be altered to improve its overall effectiveness. In terms of timing, a case could be made to extend the duration of the scheme in order to increase certainty. However, this is likely to increase the likelihood of Income Adjusting Events being raised, particularly for later years. These are likely to counteract any certainty created particularly as they are raised after the event. Therefore, on balance we would prefer a one year scheme.

Where we would recommend a significant change is in the setting of the sharing factors in the scheme. Under past schemes the asymmetry in information held between Ofgem and National Grid has meant that they have easily met their targets and earned significant returns. We believe that such high sharing factors are necessary to provide National Grid with an incentive to manage balancing costs and that the sharing factors should be reduced allowing more of the benefits to flow to the end user.

4. Gas Entry Incentives

We recognise Ofgem and National Grid concerns with respect to the optimisation of entry capacity and the implications of capacity, potentially being held back unnecessarily. We have reservations, however, with National Grid Gas having discretion to release available capacity on the network. This could potentially lead to perverse incentives on NGG to release less capacity through baseline allocations and release more capacity, through the incremental regime, in order to receive more money under their revenue allowance.

If an underlying problem with baselines does exist, then we accept that changes may need to be made to the method used to set baselines or consideration given to changing the definition of a baseline, which might be a more appropriate, and require a less fundamental, change. It would seem sensible that the Initial Proposals document also considers changing the definition of baseline entry capacity, alongside the option to remove explicit capacity allocations obligations entirely. Analysis from NGG to illustrate the likely outcome from different baselines definitions would assist the industry's understanding and aid transparency. We would also seek clarification as to why baselines are being considered for removal in the entry regime and are being proposed for the exit regime.

Key concerns with respect to NG removing explicit capacity allocation obligations are the effect this might have on the long-term capacity auctions, with respect to capacity already booked and whether the concept of 20% held back capacity concept will be retained. In order to facilitate new entry to the gas market, we would strongly urge that mechanisms to hold back 20% of capacity are maintained.

In the event that the explicit capacity allocation mechanism is removed, however, transparency will be best served through incorporating any methodology for the release of that capacity in the UNC, at the very least, as an Ancillary Agreement. This will ensure good governance and transparency of any such methodology.

With respect to proposed changes to buying-back rights to cover late delivery of incremental capacity, we have serious concerns with setting an administered price, potentially set one year in advance. Setting an administered price in advance will very unlikely reflect the true value of that gas on any given day. NGG already have option contracts to buy-back capacity at fixed rates. These were only exercised for the duration of 4 days last year and

do not impose significant costs to the industry, to the extent that of justifying fundamental reform of the buy back arrangements.

We welcome Ofgem's intention to seek to simplify the current complex set of arrangements to calculate revenue drivers. Any change, however, must be considered in light of the knock on effect of current baselines.

We would welcome further analysis with regards to changing reserve prices more frequently. As the nature of the System is changing, we recognise the importance of having cost-reflective charging but this must be weighed against stability.

5. Gas Offtake incentives

We acknowledge the considerable work that Ofgem and the industry have engaged in, in exploring and developing the enduring offtake regime. Whilst we appreciate that the arrangements as currently proposed, are an improvement to the arrangements proposed under the TANIF model, we remain concerned that adequate evidence has not been brought forward to support fundamental reform to the offtake regime. We remain unconvinced that all classes of Users connected to the NTS must be offered identical access terms when the characteristics of those offtake points very clearly differ.

In the interests of informing this consultation on the arrangements proposed, we offer the following observations. We support prevailing rights for existing offtake points and we believe that setting nodal baselines based on practical maximum physical capacity would be the most appropriate method, given the arrangements proposed.

We appreciate the requirement to create sufficient investment signals and avoid stranded assets for new and incremental capacity, however, the associated lead times must be carefully considered. Locking in customers to fixed long term contracts could have the unintended consequence of inhibiting demand side response for certain industrial TCCs. If customers are committed to pay for a sustained period, their willingness to sell-back that gas may be thwarted as they are no longer price sensitive in peak periods. A more ARCA based approach would resolve this concern as Users are only committed to pay if they don't turn up.

We also have concerns with regards to the reduction period with a 2.5 year lead time. An unreasonable allocation of risk would have to be borne by a shipper in the event that a customer no longer

requires supply of gas at a given NTS offtake point. Again, a more ARCA based approach, where the developer underwrites such risk, would resolve this.

For constrained capacity allocation, we are concerned that annual and daily allocation of capacity may not be flexible enough to enable Users to manage their positions, for example, injection or withdrawal for storage sites. A monthly capacity allocation may go some way to alleviating this problem. Further consideration of this seems prudent.

We look forward to discussing proposals within the TPCR further. As much of the detail of the proposals put forward has yet to be developed, we hope to offer a more robust response, through the ongoing discussions with Ofgem. It remains difficult, at this stage, for Users to fully understand the impact of proposals until more detail has been put forward.

Please do not hesitate to contact either Paul Jones or Peter Bolitho to discuss our comments, with respect to the proposed changes to the electricity incentives and either Christiane Sykes or Peter Bolitho, with respect to the gas incentives.

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Yours sincerely

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