NATIONAL GRID GAS – OFFTAKE ARRANGEMENTS
FINAL IMPACT ASSESSMENT ON MODIFICATION PROPOSALS

CONSULTATION RESPONSE OF E.ON UK PLC

This document should be read with E.ON UK's responses to the June TPCR Consultation and to the UNC Consultation, which form part of our present submission. 'FIA' references below are to the numbered paragraphs of Ofgem Consultation Document Ref 23/07 'National Grid Gas – Offtake Arrangements / Final Impact Assessment on Modification Proposals'. This document focuses on central points, and absence of comment on any point does not indicate agreement.

CONTENTS

INTRODUCTION

E.ON UK submits that there is an overwhelming case that the Authority should approve Modification Proposal 0116A.

We also submit that there is a very clear case that the Authority should not approve Modification Proposals 0116V, 0116BV, 0116D or 0116CV.

THE UNC PROCESS

These Modification Proposals have now been considered by the UNC modification processes. Both the Panel decisions and the UNC Consultation process clearly support adoption of 0116A.

The only Modification Proposal which obtained a majority recommendation from the UNC Panel was 0116A. Nine of the ten Panel members voted in favour of adopting 0116A. In ranking the Modification Proposals, seven Panel members ranked 0116A as their preferred option against any other option. These included all five of the members representing shippers together with two members representing transporters.

By contrast, adoption of 0116V attracted only two votes – both from Panel members representing NGG (in its NTS and its RDN capacities). No member representing shippers or independent DNs voted in favour of adopting 0116V. The claim that 0116V is necessary to prevent discrimination by NGG against other industry parties is simply not supported by the potentially affected industry parties.

The UNC Consultation Process also produced very clear evidence of overwhelming support among affected industry parties for the adoption of 0116A, and their opposition to the other Modification Proposals - and in particular 0116V. Of the 27 Consultation responses, 21 were in favour of adoption of 0116A. These include the Association of Electricity Producers, the Chemical Industries Association, the Gas Storage Operators Group, GdF, Statoil, RWE-NPower, Shell, EdF, BGT, Centrica Storage, Conoco Philips, EdF Trading, International Power, E.ON UK, SSE, Total E&P, Total Gas & Power, Bord Gais Networks (Ireland), Viridian Power & Energy (N.I.), the Northern Ireland Authority for Energy Regulation, and the Electricity Supply Board (Ireland). This is a very wide cross-section of affected industry parties, including shippers, generators, representative organisations of large industrial consumers, and affected parties both in Northern Ireland and the Republic of Ireland. [1]

We submit that the Authority should give very considerable weight both to the result of the Panel voting and to the overwhelming result of the UNC Consultation. Industry parties are in a good position to assess the likely effects of alteration in the present

[1] Energywatch expressed no preference. MP 0116A was supported by every other respondent which was not affected by a Licence Condition requiring best endeavours to introduce new off-take arrangements.

arrangements on their own activities. Their considered views should not be lightly dismissed.

SECTION 4AA(5A) GAS ACT 1986

Section 4AA(5A) of the Gas Act 1986 requires that the Authority, in carrying out its functions, "must … have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed."

The current off-take arrangements have the support of a majority of the UNC Panel and of the affected industry parties. We and other affected parties have explained in our consultation responses why the proposed alterations to these arrangements are neither necessary nor proportionate. Having regard to the principles in Section 4AA(5A), the most appropriate course is for the Authority to approve 0116A.

PROCESS

Chapter 2 of the FIA invites comments on the process leading up to the present position. Our response is at page 5 below.

In our view, the process has had a number of important defects. There is a substantial concern that Ofgem's proposals to alter the current off-take arrangements have been effectively pre-judged in the process, that the industry has had too little opportunity to influence the Authority's thinking at a sufficiently early stage, and that insufficient weight has been given to the concerns of the industry.

For this reason we do ask that the Authority at this stage fully re-assess the issues, in the light of the UNC Panel recommendation and the industry responses.

BENEFITS AND COSTS

Chapter 3 of the FIA identifies three main quantitative benefits of the proposals to change the current arrangements: (1) efficient investment signals; (2) non-discrimination; and (3) reduced costs from the reduced incidence of ARCAs. It also contains an analysis of costs.

Chapter 4 of the FIA contains what is described as a qualitative analysis of benefits and costs.

The investment signals argument is in our view fundamentally flawed because it is based on an incorrect understanding of the entry-exit system and its relationship to NG's investment planning. We explain this, and our other objections to the investment signals argument, at page 6 below.

We address together all the non-discrimination issues raised in the FIA at page 9 below. This includes both the supposed quantitative benefits stated in Chapter 3 and the supposed qualitative benefits stated in Chapter 4. We are concerned that the basic approach which has been taken to non-discrimination questions does not accord with the correct legal meaning of the relevant non-discrimination provisions. Non-discrimination provisions do not require that all NTS users are treated identically – indeed, that may of itself be discriminatory. The two central questions are: (i) comparability and (ii) objective reasons for different treatment. The FIA does not contain any proper analysis of these questions. The supposed quantitative benefits do not concern the off-take arrangements which apply to shippers / TCCs and cannot justify altering those arrangements.

We consider the supposed ARCA benefits at page 17 below.

We consider the FIA's assessment of quantitative costs at page 18 below. This assessment is in our view seriously understated and defective, in particular because it excludes relevant costs. Our own analysis is that the net effect of the quantitative benefits and costs of altering the current off-take arrangements is negative. See page 19 below. This indicates again that the Authority should approve 0116A.

Finally, we consider the remaining Chapter 4 'qualitative' issues, at page 20 below. These include competition and security of supply issues, and risks and unintended consequences. In our submission, these also show a negative effect of altering the current off-take arrangements. The competition analysis in the FIA (as in earlier documents on these proposals) is very unsatisfactory: see page 22 below..

E.ON UK

E.ON UK will be potentially seriously adversely affected by the proposed alterations in the off-take arrangements, as a major gas consumer, as a major supplier and shipper of gas, and as a result of our storage interests.

We are one of the two largest consumers of gas in the UK, owning and/or operating five gas fired generation plants and two Combined Heat and Power (CHP) plants connected to the NTS and a further seven CHP plants connected to DNs. We are a major gas supplier, shipping gas to numerous large I&C customers, one of which is connected to the NTS, as well as to domestic and SME gas consumers. We are one of the largest users of the various storage facilities connected to the NTS, including the Rough and Hornsea facilities, and we are also developing a new 'fast churn' storage facility at Holford. Our sister company, E.ON Ruhrgas, is a major user and stakeholder in both the Bacton to Zeebrugge and Bacton to Balzgand interconnectors.

If the proposed alterations to the off-take arrangements were to be introduced, we will suffer added costs for managing flows to our TCCs, and for use of interconnectors and storage. We have also identified a number of further particular sources of disadvantage compared to the current arrangements, arising from our generation activities and future storage activities. We refer to these below at page 28 below. Other industry parties are

likely to face similar issues. They constitute further disadvantages of altering the current off-take arrangements. In our considered judgment the disadvantages are clear and they far outweigh any speculative benefits of these proposed changes.

We do ask the Authority to pay serious regard to our considered assessment that the introduction of the proposed alterations will cause us to suffer detriment. This is in our view relevant to the principal objective of the Authority under Section 4AA(1), to protect the interests of consumers, wherever appropriate by promoting effective competition.

COMMENTS ON THE PROCESS
(FIA Chapter 2)

We have serious concerns with the process leading up to the present Modification Proposals.

The proposals for alteration in the off-take arrangements were originally introduced in the context of the very much larger DN sales issue, which was already stretching the resources both of Ofgem and of industry consultees. This adversely affected the consideration which Ofgem and industry consultees could give to the off-take proposals. Linkage of the issues was not necessary (only some 5% of the estimated benefits from the DN Sales were claimed to be related to the off-take proposals). The Public Accounts Committee of the House of Commons criticised this in its Report: "*As part of its sale approval process, Ofgem introduced unnecessary additional changes to the way gas networks operate*." [2]

The proposals have been presented by Ofgem from the start as very much a pre-judged position. The appropriate regulatory approach, of identifying a potential issue, analysing whether it represented a real problem which required to be addressed, and scoping possible solutions, was not adopted. Impact assessments, including the current FIA, bear strong hallmarks of exercises in justification of a pre-adopted position. The 'best endeavours' licence conditions imposed on NG and the DNs as terms of the sale consent tied the hands of the transporter side of the industry. Strong opposition from other industry parties has been simply sidelined.

Even the current FIA, tested by the standards set out in the Regulatory Policy Institute's Review of Regulatory Impact Assessments, does not conform to best practice.[3] The 'applicable objectives' section (2.30 to 2.34) is a bare and incomplete list of the legal framework. There is no developed or coherent analysis or development of the objectives or how they relate to the substantive content of the FIA. The competition assessment, which should be central, is wholly unsatisfactory. The assessment of benefits and costs bears all the signs of ex post justification: speculative benefits are assigned spurious

---

[2] Report HC 110 (27 November 2006), Conclusions and Recommendation 2.

[3] The FIA is also defective when measured against Ofgem's own Guidance on Impact Assessments: Ofgem 229b/04, September 2004, see especially sections 2.13, 2.14, 4.2, 4.5, 4.10, 4.12, 4.13, 5.2 with Appendix 1, 5.4, 5.5 to 5.8, 5.9 (competition), 5.16 (security of supply), 5.20 to 5.22, 6.1 to 6.4.

values; costs are excluded, or diminished, on unsatisfactory arguments. Arguments and objections previously raised by industry parties are not taken on board, and considered as valuable input into the assessment of the proportionality of the proposals, but are simply dismissed, often with little or no justification. The competition analysis does not accord with the guidance in the OFT Guidelines, and the cost assessments (especially the exclusion of relevant costs) do not comply with the Treasury Green Book. These defects are serious: not least because a Regulatory Impact Assessment is required by Section 5A(2) of the Utilities Act 2000, and Section 4AA(5A) of the Gas Act 1986 requires the Authority to have regard to the regulatory principles prescribed by the statute and to best regulatory practice.

INVESTMENT SIGNALS
(FIA 3.11 to 3.25)

The largest single quantified benefit shown in the FIA is the estimated gain from potential efficiency savings which are claimed to result from better investment signals. The argument is that requiring users to make a significant financial commitment to guarantee ongoing access to the NTS "may increase the efficiency of NTS investments and reduce the risk of stranded assets" (FIA 3.11) because NGG "will receive more robust information to inform its planning process" (FIA 3.15).

We consider that this point rests on fundamental misapprehensions as to the real characteristics and purposes of the NTS exit-entry model and of the nature of the investment decisions that NGG must make. We agree with the technical analysis on these points contained in the Gas Forum's response to the FIA. The analysis in the FIA is fundamentally flawed by errors of fact and by wholly implausible assumptions.

NGG's fundamental investment parameter is its 1 in 20 peak day obligation. NGG does not include interruptible customers in that analysis, because it assumes that they can be interrupted during peak periods. NGG also does not plan to invest to create flexible capacity on the NTS. Flexible capacity on the NTS is simply a by-product of NGG's planned investment to meet the 1 in 20 peak day obligation. NGG's 10 year Statement 2006 (at para 5.3.8, page 60) makes it clear that NGG's investments are planned by reference to the 1 in 20 peak day criteria together with NGG's other statutory obligations. There is no provision for investment for the creation of flexibility capacity. So the proposed creation of a flexibility exit capacity product, which TCCs must book, cannot be justified by any arguments from efficient investment signals.

The exit-entry model was adopted to simplify charging for third party access and to facilitate energy trading at the National Balancing Point (a notional point). It does not model physical gas flows through the system. It was not designed to facilitate investment decisions, and nor can it be effectively used for planning investment decisions. The physical flow consequences of particular levels of off-take at particular nodes on the NTS depend upon the configuration of the system as a whole, and on interactions with other off-take points and indeed with input points. In reality the exit-entry model is a 'black box'. Only NGG has the 'key to the box' – the knowledge, understanding and expertise

to model actual physical flows. Investment decisions in the NTS must continue to be planned by NGG so as to meet the objectives placed on NGG, and in particular the 1 in 20 peak day obligation. NGG must continue to use all their system knowledge and expertise and all relevant information in carrying out their investment planning so as to meet their set objectives.

In our view, there are substantial risks with the approach apparently taken in the FIA to NGG's investment planning functions. The FIA gives a wholly inappropriate weight to what it describes as "financially backed user commitments". In our view, the information which may be obtained about exit capacity requirements at particular exit points do not improve to any real degree on the information already available to NGG for its investment planning. Such information goes nowhere near identifying the required physical investment in the NTS. And we are concerned by the indications in the FIA (e.g. at 3.16) that Ofgem apparently consider that this not very useful information should be inappropriately elevated to serve as the basis for regulatory decisions striking down and disallowing investment actually considered to be necessary by NGG itself to meet its required objectives.

This is likely in our view to have a chilling effect on NGG's investment decisions, with potentially serious adverse consequences both for competition and for security of supply.

Regulatory pressure from Ofgem on NGG NTS to support its investment decisions with 'user signals' (reinforced with the sanction of disallowing NGG investment) is likely, in our view, to have negative effects on system investment and operation. NGG NTS will be incentivised to adopt an overly cautious, risk-averse investment strategy.

The NTS is the crucial transportation link for Britain's energy. It is central to gas and to electricity supply and to the competitive wholesale markets for the supply both of gas and of electricity. We consider that attempts to fine-tune or second-guess or over-ride NGG's informed investment planning decisions, on the basis of this wholly inadequate type of information, would be detrimental both to the need to protect the interests of consumers by the promotion of competition in wholesale gas and electricity markets, and to the interests of consumers in secure supply both of gas and electricity.

The central challenge facing both NGG and, we submit, the Authority as regulator, is to ensure that the NTS has the capacity to meet these challenges. The analysis in the FIA is more concerned with (unrealistic and misplaced) fears about the risk of stranded assets rather than with the efficient development of the network as a whole and the over-riding importance of the competition and security of supply objectives. The absence of any serious analysis in the FIA of these questions is remarkable.

Investment in the NTS supports more competitive gas and electricity wholesale markets by ensuring the right assets are in the right place at the right time (with sufficient flexibility) to ensure gas from a diverse range of locations can be brought to market when needed. With an annual UK gas demand of around 4 btherm/annum, a 0.25p/therm increase in gas prices would cost £10m. Under-investment, investment in the wrong place

or investment delays will all restrict the supply of gas that can be brought to market and supplied to customers. This could cost customers dear. It is not hard to see that the alleged benefits Ofgem ascribe to the reforms could easily be offset by even the smallest increase in wholesale gas prices arising from constraining access to available gas supplies.

NGG's 10 year statement shows that NGG itself would not undertake its investment planning on a nodal basis. Paragraph 5.3.9 shows that investment sensitivity analyses, which are conducted in the light of the 1 in 20 peak day criteria, would be analysed on a zonal not a nodal basis. This is because "*the interconnected nature of the NTS means that it is appropriate to consider entry point capability in terms of zones … Within the zones, the maximum and minimum capabilities can be used to flex gas inputs …*"

Paragraph 5.3.9 of NGG's 10 year statement also states that "*National Grid is unable to take long term auctions as the definitive signal from shippers as to their intentions to flow gas on any particular day.*"

Even in respect of new connections, the proposed alterations to the current exit arrangements are wholly unnecessary to avoid the supposed risk of stranded assets. The risk of such stranded assets is itself wholly exaggerated – no examples have in fact been identified. The current ARCA commitments are sufficient to provide a financial commitment on the part of the user requiring a prospective new connection to the NTS. The current ARCA commitments are a more proportionate way of addressing this issue, and a way which is more consistent with the promotion of competition. The ARCA commitments are capable of bilateral negotiation between NGG and the prospective connecting party, so that NGG does not incur investment or impose costs in advance of the user's actual development timetable. They enable a flexible and efficient alignment of the planning timetables of NGG and the user. The proposed new arrangements on the contrary, would be date-fixed, without the ability to adjust start times. The new commitments would also be substantially larger in amount than the current ARCA commitments. The effect would be to deter or delay some investment decisions, and to create an unnecessary barrier to new entrants. [4]

The proposed new arrangements have no merit from an efficient investment perspective. They would have an unnecessarily chilling effect on new investment in generation and storage. They would adversely affect the ability of users to make efficient use of the flexibility capacity that does exist in the system (and for which, under the current arrangements they pay cost-reflective bundled carriage charges).

These proposals are in sharp conflict with the Authority's standing policy in favour of a 'shallow connection' regime, and generally limiting the current ARCA commitments to a

[4] FIA 3.63 at page 31 contains an account of a significant cost relating to the risk of CCGT delay brought about by the inflexibility of the timing issues resulting from the proposed new arrangements. We consider that this is a clear case of a cost of the proposals. Ofgem's disagreement, recorded in FIA 3.63, indicates that Ofgem have not in fact appreciated the point that such costs result from the loss of timing flexibility.

one year commitment (see the recent Langage and Marchwood determinations). These decisions were taken to promote competition and to minimise barriers to new entry. The current proposals are simply inconsistent with the policy behind these decisions, and represent an incoherent and inconsistent regulatory approach.

NON-DISCRIMINATION
(FIA 3.26 to 3.36, 4.30 to 4.38)

A number of different 'non-discrimination' considerations have been advanced as one of the main reasons why it is claimed that it is necessary to alter the current off-take arrangements.

The FIA Summary (page 4) claims that the "potential benefits" of the new off-take arrangements include the reduction of the "potential for discrimination" in three identified cases:

(1) "Reforms to the NTS interruption arrangements should reduce the potential for discrimination between firm and interruptible customers." (See also FIA 4.30 to 4.35).

(2) "Modification Proposals 0116V, 0116BV and 0116VD should also reduce the potential for discrimination as between GDNs and shippers by establishing equivalent access arrangements for NTS flexibility rights." (See also FIA 4.36 to 4.38).

(3) "Establishing transparent and non-discriminatory allocation processes should reduce the risk that NGG's retained GDNs are treated more favourably than independently owned GDN networks." (See also FIA 3.26 to 3.36 and 4.42). [5]

The PV of the quantitative benefit associated with non-discrimination is estimated as approximately £20m for 0116V, 0116BV and 0116VD and £10m for 0116CVV: see FIA 3.26 to 3.36. (These are PV amounts, not amounts per annum, as wrongly stated in the FIA Summary, at page 4). These amounts in fact relate only to case (3) above (i.e. the alleged potential for discrimination by NGG NTS in favour of NGG's retained GDNs against the independent GDNs), and are based on a 'subjective assessment' of a 5% potential compromise to comparative regulation: see FIA 3.26 to 3.36. No quantitative benefit is estimated in the FIA for cases (1) and (2) above: these are simply discussed as 'qualitative benefits' at FIA 4.30 to 4.38.

The 'non-discrimination' arguments in support of the proposed new off-take arrangements appear to be based on a fundamental error of law as to the meaning and

[5] See also FIA 2.3 (third bullet); 2.17, 2.18 (second bullet); 2.32 and 3.4. FIA 4.39 to 4.41 discuss potential discrimination issues as between existing and new users, but the FIA does not advance this issue as a substantial benefit of the proposed arrangements.

effect of non-discrimination obligations, both under English law and under EU law. The relevant 'discrimination' issues have not been properly investigated, assessed or weighed, and the relevant issues have not been properly identified for consultation. These two central, and related, defects are especially marked in respect of cases (1) and (2) above.

Legal principles

Non-discrimination obligations are contained in Section 9(2) of the Gas Act 1986 ('***Section 9(2)***'); Standard Special Condition A6 ('***SSC A6***') of NGG's Licence; EC Directive 2003/55/EC on common rules for the internal market in natural gas ('***the Directive***'); Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks ('***the Regulation***'); and the general principle of non-discrimination in European Community law.

None of these non-discrimination obligations prohibit offering different terms to different classes of user for access to the NTS; nor do they require that identical capacity charging arrangements must be applied at all NTS exit points. The non-discrimination obligations do not preclude offering different terms to different classes of user for access to the NTS. Different terms may be offered where there is a material difference between classes of user or a good reason for the difference in terms.

Proper application of the non-discrimination provisions requires answering two questions: (a) are the users or classes of user materially comparable; and (b) is there a valid reason, or objective justification, for any difference in treatment. Where there is a material difference between two cases, or a good reason for treating them differently, different treatment will not constitute prohibited discrimination. Proper application of the non-discrimination provisions may not only permit but actually require that material differences between classes of user be reflected in appropriately different treatment. Applying a non-discrimination provision to particular situations always requires considering the actual facts and circumstances.

The assumption that non-discrimination requires that different types of user must be offered identical access terms is an error of law.

Section 9(2) requires NGG "to avoid any undue preference or undue discrimination". The English case law on similar provisions establishes that:

(1) The prohibition of undue discrimination or undue preference in provisions similar to Section 9(2) does not require identical treatment of different classes.

(2) Identical treatment of different classes may indeed itself constitute undue discrimination or undue preference: materially different classes should not be treated alike.

(3) The inquiry in each case as to whether a difference in treatment (or identical treatment) amounts to "undue discrimination" or "undue preference" as between two classes requires analysing the facts of the particular case, and the reasons for the different (or identical) treatment.

(4) All relevant circumstances should be taken into account in deciding whether different (or identical) treatment amounts to undue discrimination or undue preference. [6]

Standard Special Condition A6.1 requires that NGG "shall conduct its transportation business in the manner best calculated to secure that neither – (a) the licensee or any affiliate or related undertaking …; (b) any gas shipper or gas supplier; nor (c) any DN operator … obtains any unfair commercial advantage including, in particular, any such advantage from a preferential or discriminatory arrangement …" Sub-paragraph (a) is directed at preventing the NTS operator from unfairly advantaging itself or its associates. Sub-paragraphs (b) and (c) are aimed respectively at preventing unfair commercial advantage to any gas shipper or supplier, or to any DN operator. SSC A6.1 does not automatically require identical treatment of different classes of user of the NTS, without regard to the different characteristics and situations of these classes of user, or the reasons for different treatment. The application of the condition requires analysis of the particular facts of particular situations. Relevant questions will include:

(1) Is there a 'commercial advantage'? This requires considering comparability questions. Advantage compared to what base-line? Compared to what comparator?

(2) If so, is the commercial advantage "unfair"? This requires analysing the reasons for the terms alleged to constitute an "unfair" commercial advantage, whether those reasons are justifiable; and whether they give rise to "unfairness".

(3) The words "preferential or discriminatory arrangement" require analyzing the standard non-discrimination questions identified above as to comparability and objective reasons.

In EU law, the general principle of equality and non-discrimination is one of the fundamental principles. It requires that comparable situations must not be treated differently, and different situations must not be treated comparably, "unless such treatment is objectively justified." The existence of a comparable situation is a question of fact, which must be proved, not alleged. [7]

---

[6] See e.g. *Pickering Phipps v LNWR* [1892] 2 QB 229 (CA), *South of Scotland Electricity Board v British Oxygen Co. Ltd* [1956] 1 WLR 1069 (HL); *South of Scotland Electricity Board v British Oxygen Co. Ltd* [1959] 1 WLR 587 (HL); *London Electricity Board v Springate* [1969] 1 WLR 524 (CA).

[7] See e.g. Case T-571/93 *Lefebvre v Commission* [1995] ECR II-2379.

The ECJ has consistently held that particular non-discrimination provisions in EU legislation are specific expressions of the general principle of equality.[8] This applies to the non-discrimination obligations in both the Directive and the Regulation.

The Directive and the Regulation are designed to create an internal competitive gas market in the European Union. This is explained in the Executive Summary contained in the Technical Annex to the Commission's 2005 report to the Parliament and Council on progress in creating the internal gas market:

> "The gas and electricity Directives were adopted by the European Parliament and by the Council in order to create competition. The key element is the introduction of non-discriminatory and transparent third party access to the networks with ex-ante supervision by regulators."

There is a fundamental structural distinction between the monopoly infrastructure operators (including transmission and distribution system undertakings) and the competitive part of the market (including shippers and suppliers):

> "… networks are largely natural monopolies providing the basis and the fundament upon which competition among gas and electricity suppliers is to develop. This means that there is a non-competitive and a competitive part of the gas and electricity sectors. The former is made up of the necessary infrastructure and its operation, which should work to facilitate the market, while the latter is represented by suppliers and producers, often with traders and big customers contracting directly with the producers. These market participants should compete with each other for market shares in both the wholesale and retail market enjoying non-discriminatory use of the necessary infrastructure." (page 9).

The objective of the internal market reforms is a market structure where the (largely monopoly) infrastructure providers (including the transmission and distribution system operators) facilitate competition between the competitive market participants (including shippers, suppliers, traders and large consumers):

> "operators of transmission and distribution grids would act as market facilitators allowing system users (suppliers, traders, large consumers etc) to exploit market opportunities to the extent possible." (page 10).

The requirements in the Directive and Regulation for non-discriminatory access to the infrastructure system are designed to achieve this objective. Their central purpose is to secure the objective of a functioning competitive market for the competing market participants. The fundamental object of the non-discrimination provisions is to facilitate competition among the competitive market participants (shippers, suppliers etc). In

[8] See e.g. Case C-17/03 *Vereniging voor Energie, Milieu en Water and Others v Directeur van de Dienst uitvoering en toezicht energie*.

applying these rules, the central focus should be on whether measures discriminate as between these competitive market players. This applies both to the comparability and the objective justification issues.

The Directive's recitals link non-discrimination to the Directive's competition objectives. The structure of the Directive makes a fundamental distinction between infrastructure (including transmission, distribution, storage and LNG facilities) and the competitive parts of the market (including the shippers and suppliers). Undertakings in the infrastructure part of the market are not in comparable situations with undertakings in the competitive part of the market.

Regulation (EC) No 1775/2005 concerns conditions for access to the natural gas transmission networks. The fundamental objective of the Regulation is "to tackle remaining barriers to the completion of the internal market in particular regarding the trade of gas." The non-discrimination provisions of the Regulation, like those of the Directive, are intended to further the basic objective of developing the competitive market.

Application to the present case

It is not appropriate to categorise DNs and shippers/suppliers as competitors or to assume that they are comparable for the purposes of non-discrimination provisions. They occupy fundamentally different positions. DNs are part of the largely monopoly infrastructure of the market; while shippers and suppliers are part of the competitive part of the market. Directly connected users, such as generators and large industrial plant, are consumers.

Since DNs and shippers are in structurally different parts of the market, this is a strong indication that they are not in a comparable position for the purposes of non-discrimination provisions. And it is also relevant to any assessment of the reasons for differential treatment, and objective justification for such treatment.

Where the design of access conditions is based on reasons which relate to encouraging efficient infrastructure investment by distribution system operators, such reasons will not apply to shippers / suppliers or TCC users, since they have no infrastructure investment functions. Similarly, reasons for designing access conditions to reduce the risk of discrimination as between Retained and Independent DNs are not relevant to shippers / suppliers or to TCC users. In both cases, non-discrimination obligations cannot justify applying these access conditions to shippers / suppliers or TCC users. The short points are (1) the two cases are not in fact comparable; and (2) the reasons for treating one class in a particular way do not apply to the other. There can be no assumption that non-discrimination provisions automatically require identical treatment of two classes. This would be fundamentally wrong. Everything depends on analysing the comparability of the two classes; and the reasons for differential treatment.

The basic division between infrastructure and the competitive part of the market also points to the need to consider the comparative position of competitive market players in

relation to the infrastructure network as a whole: for example, some shippers and suppliers off-take gas from the transmission system, and others from distribution networks. Non-discrimination rules do not mandate that shippers / suppliers connected to the transmission system must be treated in the same way as distribution networks connected to that system. In considering the off-take conditions for shippers / suppliers connected to the transmission system, it is necessary to consider the corresponding situation for shippers / suppliers connected to the distribution networks. This is so even if it would support treating different classes of user of the transmission system (i.e. DNs and directly connected customers) differently. The difference arises again because of their fundamentally different positions in the market structure: they are not in comparable positions; and the reasons which apply to one class do not apply to the other.

Comparability and justification issues also arise as between other classes of NTS User. In particular, interconnector access to the GB NTS raises such issues. The non-discrimination provisions do not justify an automatic assumption that interconnector access to the NTS must be on identical terms to access by DNs. The relevant comparability and objective justification issues need to be investigated on the facts. Relevant matters would include the overall EU objective of establishing a single internal market in gas, and security of supply considerations: these affect the question whether interconnector undertakings are in a comparable position to distribution network operators and/or provide objective justification for different treatment.

It does appear that the discrimination issues have been approached on a basis that is not correct in law.[9] There has been no proper analysis of the comparability or objective justification issues in Ofgem's treatment of the non-discrimination arguments. The failure to analyse these issues undermines Ofgem's conclusions on the point. There has also been no proper consultation on these arguments. Since the relevant analysis was not undertaken, or published, there has been no proper opportunity for consultees to comment on it.

Alleged discrimination (1) between 'firm' and 'interruptible' customers and (2) between GDNs and shippers in access arrangements for NTS flexibility rights

These discrimination arguments are the only arguments which affect the position of shippers. The arguments are unconvincing, and provide no support for introducing the proposed new arrangements. In addition to the points above, we make the following points.

NGG has no incentive to discriminate in favour of shippers, as against DNs, as it has no affiliated shipper business. There is therefore no real risk of impermissible discrimination.

[9] See e.g. paragraph 2.21 of the Authority's Decision of February 2005: "… to ensure equality in treatment of all users connected to the NTS these arrangements should also apply between NTS and directly connected customers. This will serve to ensure that access to the NTS is provided to all network users in a manner which is not unduly discriminatory."

No industry party has in fact made any complaint that these issues constitute undue discrimination against its position.

The discrimination obligations themselves (including NGG's licence obligations) provide satisfactory mechanisms for controlling any undue discrimination. If any industry party did consider that there was a case of undue discrimination, any such complaint (if and when made) should be properly considered on its merits, with all relevant legal and factual points properly addressed.

No quantitative benefit has been – or could be – ascribed to the discrimination arguments in Cases (1) or (2). The points are fanciful. They do not amount to any "qualitative benefit". There is no sensible basis for asserting that any benefits will accrue to consumers from these points.

Alleged discrimination between 'firm' and 'interruptible' customers

E.ON does not accept the contentions in FIA 4.30 to 4.47.

There is no proper discrimination issue here. There is an objective distinction between 'firm' and 'interruptible' customers. They are not comparable, and there is an objective reason for different treatment. NGG are not required to invest to meet interruptible demand as this is not covered by the 1 in 20 obligation. There is no discrimination between different classes of interruptible users under the current arrangements.

FIA 4.30 - There is no evidence that the alleged risk of a flight from firm to interruptible status is a real issue in practice.

FIA 4.31 - If the probability of interruption is low, this may mean that the level of discount should be reviewed, but it does not dictate that this radical change is required. Nor does it support any discrimination complaint. The probability of interruption has not been tested under prolonged cold winter conditions. Since the Network Code was introduced in 1996, weather conditions have not been severe enough to test the 1 in 20 peak demand license obligation.

FIA 4.33 – Interruptible capacity should not be priced in accordance with the probability of interruption, because this does not reflect the cost of providing the service. Where the system has a large amount of capacity (due to the 1 in 20 obligation) the cost of providing interruptible capacity is close to zero.

FIA 4.34 – There is an important practical effect on generators who are currently interruptible users for back-up supplies. Under the proposed new arrangements, current interruptible users must either purchase long term firm capacity or they must risk relying on bidding for day ahead interruptible capacity. If they choose the former they may have the opportunity to enter into bilateral interruption contracts with NG, and they may receive some compensation in terms of option and exercise fees. But this will not be available to those that use the NTS for back-up supplies – because, unless NGG have the

prospect of interrupting gas, no such contract will be agreed. This is a particular concern for E.ON and a number of other generators. There is no good reason, either of investment planning or of non-discrimination, which justifies this result.

FIA 4.34 – There is no available information on the form or content of the proposed bilateral interruptible contracts or how they will operate in practice. The change is a leap in the dark.

FIA 4.35 – There is no discrimination in the present interruption arrangements. There is no discrimination between different classes of interruptible users under the current arrangements.

Alleged discrimination between GDNs and shippers in access to flexibility rights

E.ON does not accept the contentions in FIA 4.37.

TCCs and GDNs are simply not comparable for discrimination analysis (see above). There is no warrant for regarding different treatment of these as prohibited by a non-discrimination obligation.

GDNs, by their nature as part of the pipeline infrastructure, have an inherent flexibility capacity within their own networks. TCCs do not have such flexible capacity and their flexibility requirements depend upon access to the flexibility capacity of the NTS.

In respect of access to NTS flexibility capacity, the proposed new arrangements are in fact likely in practice to disadvantage TCCs and their shippers as against DNs. DNs are monopoly price controlled regulated businesses with firm 1 in 20 licence obligations. TCCs / shippers will be at a serious disadvantage if required to bid against DNs for access to flexibility capacity.

The proposed new arrangements are likely themselves to create non-discrimination issues in relation to access to flexibility capacity as between generators (and other industrial / commercial users) connected to the NTS and those connected to DNs. This is not considered by Ofgem.

Alleged discrimination by NGG in favour of NGG's retained GDNs as against the independently owned GDN networks (FIA 3.26 to 3.36)

This is the only discrimination argument for which the FIA estimates a quantified benefit.

The argument does <u>not</u> concern any allegation of potential for discrimination in favour of shippers / TCCs. The alleged issue does not require, or justify, altering the access arrangements for shippers / TCCs. The proposed alteration in shipper / TCC access arrangements is not a necessary or a proportionate response to this alleged issue. There is simply no explanation in the FIA as to why this point requires applying the same arrangements to TCCs / shippers, or to storage and/or interconnector users.

E.ON considers that the potential risk of undue discrimination by NGG NTS in favour of its retained DNs is very seriously overstated in the FIA. Licence conditions are already in place to protect against preferential treatment of the retained DNs, with recourse to the regulator in the event of dispute or their breach, and incentive arrangements are already in place to reward appropriate behaviour. As NGG would be in serious breach of its licence, we would not expect NGG to discriminate in this way, given the serious consequences of this being discovered.

Nor would we expect the Independent DNs to engage in over-investment in their own networks because they feared such licence breaches by NGG. The hypothetical example given in FIA 3.31 is in our view entirely theoretical, not real.

The alleged potential for undermining the benefits of comparative regulation is based on a wholly unrealistic assessment of the likelihood of NGG breaching its licence conditions, and an equally unrealistic assessment of the behaviour of the Independent DNs.

E.ON also considers that the estimated value placed in the FIA on the 'incremental reduction in the scope for undue discrimination' is speculative and highly exaggerated. The FIA itself describes it as "a subjective assessment" (FIA 3.33) and recognizes that "there are uncertainties regarding the degree of benefits provided by non-discrimination" (FIA 3.36). We consider that the estimated value of a PV of £21m has no serious basis. We also consider that the FIA does not adequately deal with the point made by NERA that even under the proposed new arrangements NGG's pricing of capacity products could equally bring about the possibility of discrimination.

REDUCED INCIDENCE OF ARCAs.
(FIA 3.37 to 3.46)

We do not accept that there is any basis for the claim that the proposed new arrangements are likely to result in reduced dispute costs, still less that there is any substantial basis for ascribing a PV of £10 m (or any other figure) to this supposed benefit.

Far from improving the transparency of the arrangements, the fragmentation of the rules across the UNC and the ExCR statement will make life more difficult and uncertain for shippers The ExCR will not be subject to UNC governance and shippers will be unable to propose changes to many key terms and conditions. This will increase the likelihood of disputes if National Grid unilaterally seeks to implement change. The new regime will be more complex and less transparent than the ARCA regime. This is also likely to lead to greater not less potential for disputes.

The FIA also exaggerates the likelihood of ARCA disputes under the present arrangements. Precedents have been set in the Marchwood and Langage directions which are very likely to reduce the likelihood of further contentious disputes. Some of the

existing ARCA disputes also appear to have been caused by NGG receiving conflicting messages from Ofgem with respect for the need for and the extent of user commitments.

In our view there is simply no reason to ascribe any positive PV to this supposed benefit. It could equally easily be a detriment.

QUANTITATIVE COSTS
(FIA 3.51 to 3.89)

The analysis of costs in FIA 3.51 to 3.89 is based on responses by industry parties to Ofgem's own cost survey. Ofgem provided a Guidance Document that stressed that cost estimates should represent the most likely outcome (i.e. base case / median estimates) and that the costs of introducing new systems and processes should only be included where introduction of such measures is efficient and necessary. Ofgem followed up with clarificatory meetings with half of the parties who responded.

We strongly disagree with the repeated assertion in this section that the costs emerging from this process represent a worst case scenario. We strongly object to the attempt to massage down the costs by excluding higher costs estimates as 'outliers' which can be ignored. There is no statistical validity to this approach. The fact that these points are made, and indeed pursued after criticism, is a further indication that much of the analysis in the FIA suffers from ex-post justification.

We also object to the suggestion that 'little weighting' should be given to the gas transporters' costs and to the decision to exclude these costs from the assessment of the overall costs and benefits (FIA 3.77 to 3.80). This is flatly contrary to the purpose of a Regulatory Impact Assessment. It undermines the utility of the RIA both as a measure of the economic efficiency of the introduction of the proposed new arrangements, and as a measure of the proportionality of introducing them. It is simply artificial to assume that the DNs will not in fact pass on these costs. The FIA itself leaves open the possibility that this will in fact be considered in the current price review, and does not rule it out (FIA 3.80). We cannot understand how the FIA can submit that it is appropriate for the Authority to take a decision on the Modification Proposals at its March meeting, excluding the transporter costs from consideration, when the relevant decision under the GDPCR process has not been taken. This appears to us to be wholly irrational and contrary to the principles of public law. Finally, the Authority's duties under Section 4AA(2)(b) of the Gas Act 1986 include the need to secure that licence holders are able to finance their statutory activities, and this may affect the Authority's legal ability to implement decisions in this or a future price review which are aimed at preventing a pass-through of these costs.

We also object to the exclusion of costs incurred in Northern Ireland and the Republic of Ireland (FIA 3.83 to 3.86). The exclusion of these costs is inconsistent with the development of the internal competitive gas market in the European Union. It is also based on an error of law as to the relevant provisions of the Gas Act 1986. The Authority's principal objective under Section 4AA(1) is to protect the interests of

consumers in relation to gas conveyed through pipes. There is no territorial limitation which limits this to consumers in Great Britain and excludes consumers in Northern Ireland or in the Republic of Ireland. Such a limitation is inconsistent with the policy of EU law in this context, including the Directive.[10] The only express territorial limitation in Section 4AA is found in subsection (2)(a).

OVERALL OUTCOME OF THE QUANTITATIVE BENEFITS AND COSTS ANALYSIS (FIA 3.90 to 3.91)

When the transporters' costs and the Irish costs are added back to the calculation, the overall outcome of the quantitative benefits and costs analysis is, even on the FIA's own figures, negative for all the Modification Proposals other than 0116A.

NPV (£m, 05/06) (at 6.25%)	0116V	0116A	0116BV	0116CVV	0116VD
Table 3.17, Benefits	72.4	0	72.4	62.2	72.4
Table 3.17 Costs (Shipper, TCC, Storage)	64.1	0	59.6	15.0	58.1
Transporter Costs (Table 3.13)	56.4	0	56.9	49.9	56.7
Irish costs (FIA 3.85)	6.2	0	6.2	6.2	6.2
	(54.3)	**0**	**(50.3)**	**(8.9)**	**(48.6)**

Three of the Modification Proposals show very substantial negative PVs. We submit that these amounts plainly show, even on the FIA's own figures, that these Modification Proposals are neither proportional nor efficient. They are simply irrational.

The point becomes even plainer in the light of our analysis above of the purported benefits. In reality the supposed quantitative benefits are non-existent, while the costs are all too real. Our own assessment is that the negative PV of these Modification Proposals are over £120m for each of 0116V, 0116BV and 0116VD, and over £70m for 0116CVV.

It is not surprising that there is such deep and widespread opposition in the industry to the introduction of these proposed arrangements, in any of their variant forms. Imposition of

[10] Under the *Marleasing* doctrine the provisions of the Gas Act 1986 should be construed consistently with all relevant EU obligations.

these off-take arrangements on the industry would be a serious waste of economic resources.

There is a further important point. As we have explained above, the alleged quantitative 'non-discrimination' benefits do not actually require that shippers / TCCs are subjected to any change in their current off-take arrangements. Even if it were thought appropriate to change the off-take arrangements affecting the DNs to seek to achieve the alleged non-discrimination benefits, the proportional way to do this would be to apply any change only to the DNs. This would avoid imposing unnecessary costs on the shippers / TCCs.

QUALITATIVE ASSESSMENT
(FIA 3.4 to 3.6 and Chapter 4)

We note the comments about the difficulty of quantifying some of the costs and benefits.

However we do not agree that the issues analysed in Chapter 4 are reasonably capable of over-riding the negative quantified assessment of the costs and benefits of the proposed alterations to off-take arrangements (which we have discussed above).

Chapter 4 of the FIA accepts that on "simplicity and transparency", the current arrangements are preferable, and introducing the proposed new arrangements would be a cost. Two further Chapter 4 issues (promotion of competition and security of supply) also, on proper analysis, clearly involve negative consequences, as we explain below. The discrimination issues referred to in Chapter 4 have no merit, as we have explained above. The 'efficient network development' issue is largely a repetition of points already made in Chapter 3 (which we have discussed above) and has no net positive effect.

FIA 3.4 states that "*the potential benefits of non-discrimination, competition and by implication well functioning markets are, for practical purposes, diffuse and difficult to calculate*." This may be correct as a general proposition. But in the context of the present proposals this statement is in our view misleading, because it suggests that there are potential benefits in the present case. In fact, the proposals do not have any potential benefits either from 'non-discrimination' or for 'competition'. The effects on competition are in fact detrimental.

We note that the NERA qualitative assessment has not been addressed in detail in the FIA.

We also note that the FIA appears not to ascribe any benefits to Modification Proposal 0116A. This is of course not correct. The benefit analysis should take as its starting point the UNC Code as it stands at present. There can be no doubt that 0116A, by removing the 'sunset clauses', and allowing the current off-take arrangements to continue as the enduring arrangements, reduces uncertainty and regulatory risk for market participants. This should be recognized at least as a qualitative benefit.

EFFICIENT NETWORK DEVELOPMENT AND SYSTEM OPERATION (FIA 4.2 to 4.10)

We disagree with FIA 4.3 to 4.7. The points here raise similar issues to the points we have already addressed under Investment Planning (above). We do not accept that the proposed alterations in off-take arrangements will produce any benefits for network development or system operation. On the contrary, they will be detrimental.

We do not agree with FIA 4.3. The proposals for alteration in the off-take arrangements themselves contain a prevailing rights process. Moreover, it may be expected that a substantial number of interruptible status customers will choose to 'go firm' if the proposed new regime is introduced, rather than risk relying bidding for day ahead interruptible capacity.

Far from facilitating more capacity for new entrants the proposals are likely to sterilise capacity that others might be willing to make available.

Far from encouraging early entry of efficient generation plant, the more onerous and inflexible user commitments will worsen the climate for investment, and make market entry more difficult. The 14 months notice requirement to reduce, after the user commitment has been satisfied, hinders market exit and encourages sterilization of capacity that could be made available to others. Users will inevitably see this 14 months of charges as a sunk cost. Any impediments to entry or exit undermine competition.

This is the very reason that the shallow connection policy and the limitation on the amount of the ARCA commitment was established by the Authority - to overcome barriers to entry (see e.g. the Marchwood ARCA determination which firmly established this principle). The proposed new user commitments will simply re-erect barriers to entry.

FIA 4.4 does not represent the real situation. There have been no difficulties in CCGT plant accessing flexible capacity under the current arrangements. The new arrangements will if anything create difficulties. FIA 4.5 is in our view wrong. It will always be necessary for NGG NTS to undertake the residual role of system balancer, and the costs of this are not likely to be reduced under the new proposals.

We add that if any incremental improvements were thought to be appropriate to any aspects of the current network development and system operation, they could be introduced without the radical changes, and major costs, of the present proposals. What would be needed is a simple identification of the alleged problem, and a proper scoping of all potential solutions, so as to identify the most proportionate and the cheapest.

This is not what Ofgem has done in the present case. Ofgem appears to have committed itself to the target of changing the off-take arrangements, and then cast around to produce a list of alleged benefits from this. It appears to have worked backwards from the solution

to the problem, rather than forward from the problem to the solution. The points made in this section of the FIA are a good illustration of this.

PROMOTION OF COMPETITION
(FIA 4.8 to 4.10)

The competition analysis in the FIA is wholly inadequate. The FIA Summary states that the proposed alterations in NTS off-take arrangements "should promote competition" (FIA page 4). This is wrong and misleading. So is the reference to the "potential benefits" of competition in FIA 3.4. The true position is that the proposals clearly have negative consequences for competition – in both the gas and electricity markets. The FIA itself acknowledges that the proposals have negative competition effects. We are very concerned that the negative competition effects are not highlighted in the FIA Summary, or given proper weight in the overall assessment.

The competition consequences of the Modification Proposals should be a central factor in the Authority's decision. The Authority's principal objective, under Section 4AA of the Gas Act 1986, is to protect the interests of consumers in relation to gas conveyed through pipes, "*wherever appropriate by promoting effective competition between persons engaged in … the shipping, transportation or supply of gas so conveyed*". Section 9(1A) of the Act provides that NGG NTS (and indeed the GDNs) are under a duty to facilitate competition in the supply of gas. Competition effects in the electricity markets may also be considered, and we submit that it is right that they should be considered: see Section 4AA(4)(a) of the Gas Act 1986.

The competition analysis should have formed a central part of the FIA's assessment of the Modification Proposals: see both the Report of the Regulatory Policy Institute on RIAs, and Ofgem's own Guidance on Impact Assessments. As Ofgem's Guidance states (section 5.9)*:* "IAs will assess whether there are significant positive or negative impacts on competition in relevant markets. If any of the options are likely to have a significant effect on competition (either positive or negative), this impact will be included in the summary section on costs and benefits." The competition analysis should have followed the guidance published by the OFT. [11]

The first step is to identify the relevant markets where competition occurs, and to consider what effects the proposals would have on the operation of competition in those markets. We have described above the basic structural distinction between the largely monopoly infrastructure of the gas industry (including NTS and the DNs) and the competitive parts of the market (shippers, suppliers and consumers).[12] The key question

[11] Ofgem recognizes that it should have regard to the guidance in the OFT Guidelines: see Ofgem Guidance on Impact Assessments (229b/04) section 5.2 and Appendix 1. See also Section 5A of the Utilities Act 2000.

[12] See the section on Discrimination above, and in particular the European Commission's analysis of the structure of the industry.

for a competition assessment is whether the proposals will promote competition between shippers / suppliers, or will hinder it. Competition in shipping and in supply is identified in Section 4AA of the Act, and competition in supply is identified in Section 9(1A). This question has not been systematically or seriously addressed in the FIA.

FIA 4.8 and 4.9 contain the only discussion of allegedly positive consequences on competition. The claims are that "the proposals might be expected to promote competition between NTS users in that all participants will be able to secure access to the same defined products in the long and short term" (FIA 4.8) and that there will be competition for long run interruption services, or for flexibility capacity (FIA 4.9) and that this may avoid the risk that flexibility capacity may be allocated in an arbitrary manner so distorting competition (FIA 4.9).

This analysis is simply not a proper competition analysis for the purpose of the Authority's or NGG's statutory duties. It fails to understand what the competition objectives of the relevant statutory duties actually mean, and it is not an orthodox economic competition analysis. The statutory duties concern promoting competition between suppliers in the supply of goods or services to consumers. Analysing the relevant competition effects requires defining the relevant market and identifying the competing suppliers. DNs and TCC/shippers are not competing suppliers in any relevant market. The DNs are part of the largely monopoly transportation infrastructure, the shippers and suppliers are part of the competitive section of the market; the consumers are the purchasers in the competitive sector of the market. There is in our view a complete failure to understand and apply the relevant competition provisions in FIA 4.8 and 4.9.[13]

The real effects on competition of the proposed alteration to the off-take arrangements are wholly negative.

First, the additional complexities and transaction costs of the proposed new arrangements increase barriers to entry, with negative effects on competition in the shipping / supply of gas. This is recognised in the June RIA at 1.64 and in the FIA at 4.10 and 4.55. Yet it has not been reflected in the FIA Summary. [14]

We add that these additional complexities and transaction costs may also accelerate exit from the market, which also has negative effects on competition in shipping / supply. Competition in gas supply to large I&C customers, some of which are TCCs, is very

[13] The points made in FIA 4.8 and 4.9 appear to be nothing to do with competition in supply. The points are also very odd in another way. There is not in fact a shortage of flexibility capacity on the NTS and there is not in fact any need to create a 'flexibility capacity' product and to ration access to this new product by auction.

[14] In discussing this, the June RIA at 1.63 refers to "achieving our high level policy objective". This is a rather revealing remark. It shows prior commitment to some 'high level policy objective' rather than a proper RIA assessment of all the relevant costs and benefits. What is the high level policy objective? How does it rank higher the Authority's principal objective under Section 4AA(1)?

fierce and margins are very slim. Some companies have already exited this market. The prospect of added complexity, and the need to manage the added risk associated with flat and flexibility capacity bookings persisting for longer than one year, may encourage other suppliers to follow.

Second, the longer term nature of the required commitments (and the importance to TCCs of securing the capacity that they need) will adversely affect competition in the shipper/supply markets. A TCC which is not also a shipper will have to rely on a shipper to purchase capacity on its behalf. The shipper in turn has to ensure the TCC underwrites these purchases. The transfer of capacity from one shipper to another will become an impediment for TCCs switching supplier. Longer term user commitments (which the shipper must enter into with NGG) create a barrier for I&C consumers to switch suppliers, while increasing the risk to suppliers if left holding exit capacity of no value. FIA 4.55 recognises that the proposed arrangements could increase the difficulty that customers face in switching shippers, and that this has negative consequences for competition in gas supply. Yet this has not been reflected in the FIA Summary.

Third, the increased level of the financial commitments required for new entry capacity, compared to the level of the ARCA commitments (as established by the Authority itself in the Marchwood and Langage determinations) increase barriers to entry, with negative competition impacts on the electricity wholesale market. The Authority's standing policy on NTS shallow connection charging policies, and the Authority's recent determinations on the appropriate level of the ARCA commitment, were both taken in order to reduce barriers to new entrants and so promote competition. The present proposals undermine that policy. The deterrent effect on market entry of inflexible and disproportionate user commitments is a very real risk. The experience in the electricity industry suggests that this is a very delicate balance, and that market entry will almost certainly be affected. This also has huge consequences for electricity security of supply.

Finally, the proposals carry the serious risk of even more fundamental adverse effects on competition, in both the gas and electricity wholesale markets, because of the inappropriate emphasis on attempting to tie NGG's investment planning to financial signals from users. We have discussed this above.[15] The consequences for the wholesale gas and electricity markets of unnecessarily constraining capacity on the NTS could very easily dwarf any supposed investment cost savings which Ofgem believe may result from their proposals. Disallowing investment may not be viewed as beneficial to consumers if this induces unduly risk-averse investment planning in the asset base.

The benefits of having "flexibility" in the transmission system should not be underestimated where this provides greater opportunities for more gas to be brought to and compete in the market place.

We urge the Authority to give great weight to the primary importance of the wholesale markets in both gas and electricity. These are flourishing competitive markets which directly impact on consumers, large and small. The Authority's most important policy

[15] In the section on Investment Signals.

objectives, which are to protect consumer interests by promoting competition in these markets, are at risk of being compromised by the practical effects of the present proposals, and for very little benefit. Ultimately, as the European Commission points out, the transportation infrastructure is important because it provides the necessary physical base for the competitive supply markets.

APPROPRIATE ALLOCATION OF RISK
(FIA 4.11 to 4.15)

We strongly disagree that the increased financial cost of user commitments in the proposed new arrangements can be described as an improved allocation of risk "between industry participants and consumers."

Risk should be allocated to the party that can most efficiently manage it. The risks associated with investment in the NTS can only be sensibly managed by NGG. Only NGG has the 'key to the black box' – only NGG can in reality assess the physical consequences for the system as a whole of off-take at particular exit points, and only NGG can plan the necessary investment. TCCs are unable to 'signal' what investment should take place within the NGG 'black-box' - it is NGG that is clearly best placed to manage this risk. This would remain the case if the proposed new off-take arrangements were introduced. This point seems to be another failure to understand that the exit-entry model does not provide NTS users with useful information. It does not represent the physical system.

The current ARCA arrangements provide a wholly satisfactory way of signaling serious commitment to a new user project. The financial level of the ARCA commitment has been set by the Authority itself at a level so as not to create a barrier to new entrants. There is not in fact any problem of new user TCCs disengaging from the NTS after their plant has been constructed. In the real world this simply does not happen. The capital investment in the plant is sunk.

Not only is there no problem, but the suggested solution is perverse. It involves introducing financial commitments which are higher than those the Authority considers appropriate for the current ARCA commitments. This will simply create inappropriate barriers to entry, with adverse consequences for competition.

We also simply cannot understand what this section of the FIA is trying to say. FIA 4.11 refers to improved allocation of risk as between "industry participants" and "customers". FIA 4.12 refers to allocating risk between "industry participants" and "consumers". FIA 4.13 refers to transferring risk "away from consumers to NTS users and shippers". What is all this supposed to mean? The generating stations and large I&C plant which are directly connected to the NTS are themselves consumers of gas. They (or their shippers) are also users of the NTS. We simply cannot understand what risk allocation the FIA is attempting to describe. The FIA at this point appears to suffer from the same failure to appreciate the structure of the industry which is apparent in the discrimination and competition sections of the document.

SIMPLICITY AND TRANSPARENCY
(FIA 4.16 to 4.22)

The FIA accepts that the proposed new off-take arrangements are more complex than the current arrangements, and that this complexity may be expected to increase costs to system users, and may disincentivise market entry: see FIA 4.16, 4.19.

This is quite plainly a negative consequence of the proposed alterations.

The rest of this section of the FIA is simply an exercise in damage limitation, bearing the hallmarks of ex-post justification. The proposals may be in some respects a little less complex than originally proposed. But they remain substantially more complex than the current arrangements, with all the negative effects which result from this.

On FIA 4.22: We consider that the new auction arrangements for flexibility capacity will introduce artificial restrictions on the amount of NTS flexibility that can be made available, will create false scarcity, and will ultimately result in TCCs being outbid by DNs (which may need to acquire NTS flexibility capacity to help meet their 1 in 20 obligation). Generators that have offers accepted in the electricity balancing mechanism will have to generate at short notice, and as a result may face significant flexibility overrun risk. Such a risk would have to be reflected in their offer prices. Overall these arrangements are likely to increase electricity wholesale prices when the gas system is under stress.

SECURITY OF SUPPLY
(FIA 4.23 to 4.27)

We disagree with the FIA's analysis of security of supply.

We agree with the Association of Electricity Producers that the proposed alterations are likely to have an adverse effect on security of supply.

The Authority may, and we submit should, consider security of supply both in the gas and in the electricity markets: see Section 4AA(4)(a) of the Gas Act 1986.

The claim in FIA 4.23 that the proposed new arrangements "might be expected to incentivise the provision of long term investment signals and in turn have a positive impact on security of supply" is in our view wrong. As we have explained above, the proposed new user commitments do not substantially add to the investment information already available to NGG NTS. Treating them as a necessary signal for NGG's allowable investment in the NTS (which appears to be Ofgem's approach) carries a strong risk of inappropriately chilling investment in the NTS. This has negative, not positive, consequences for security of supply (both in the gas market and in the electricity market).

The proposed new 'flexible capacity' product could adversely affect both gas and electricity security of supply, because generators are incentivised to operate their plant less flexibly. The flexible running of gas plant has in recent year allowed more gas to be released into the gas market providing vital peak gas supplies when needed. The scope to operate plant flexibly under the new regime may be much reduced. The artificial scarcity of flexibility capacity created by the proposed new regime will reduce the amount of flexibility that can be used to support gas fired generation. This will reduce the potential amount of generation capacity that can be made available. This has negative implications for security of supply in electricity.

DISCRIMINATION
(FIA 4.28 to 4,42)

This issue has been considered above. There is no basis to the alleged discrimination benefits suggested in this section. The whole analysis rests on serious errors of law. The legally relevant issues have not been analysed.

FIA 4.40 states that the current proposals "provide for holders of existing capacity and purchasers of new capacity to be treated differently". So they do. This is an example of the general point we have made above. Non-discrimination obligations do not prevent different treatment where (a) the situation of users is not in fact comparable or (b) there is an objective reason for the difference in treatment. FIA 4.40 states that the Authority "will need to carefully consider the potential discrimination issues associated with the different treatment of customers". This concedes that different treatment of users does not of itself amount to impermissible discrimination. It undermines the contrary presumption which runs throughout the FIA's consideration of the discrimination issues.

ELECTRICITY MARKET CONSEQUENCES

The Authority is entitled to consider the consequences for consumer interests in relation to electricity, including competition and security of supply in the electricity markets. (Section 4AA(4)(a) Gas Act 1986).

We submit that the Authority should do so.

The electricity consequences are not addressed in the FIA.

The proposed alterations to the NTS off-take regime have negative consequences both for competition and for security of supply in the electricity markets (see above). Implementation of the proposed new arrangements will adversely affect investment for both generation and storage projects. This could have significant implications for security of supply in both gas and electricity in terms of tightness of supply at the peak.

PARTICULAR EXAMPLES OF ADVERSE EFFECTS ON E.ON UK OF THE PROPOSED ALTERATIONS IN NTS OFF-TAKE ARRANGENMENTS

Below we give examples of the adverse effects of the proposed new off-take arrangements on our own position, which we consider is likely to be mirrored for other market participants.

Impact on current TCC power stations

We face the prospect of having to pay higher charges because the practical effect of the new arrangements may require exit capacity to be booked on a 'firm' basis for a number of our power stations. The NTS supplies to two of these stations are back-up or alternative supply routes. NGG not contract for "interruptible services" for these stations. These higher charges are not cost reflective for parties that are willing to have an interruptible service. They unfairly disadvantage such generators and their ability to compete in the electricity wholesale market.

Impact on investment decisions for new power stations

Planned new generating stations would be subject to the new more onerous and inflexible user commitments compared to the current ARCA arrangements. Under the ARCA arrangements a typical 500MW power station may be required to underwrite a proportion of upstream reinforcement to the value of £1m to £3m; but under the new arrangements commitments would be required just over 3 years in advance for a 3 year strip (July 2007 for the period 1/10/2010 to 30/9/2014) i.e. £3m to £9m commitment.

The current ARCA arrangements are bilateral contracts which allow the start day to be amended, but under the new arrangements shippers are 'on the hook for' a fixed date.

ARCAs are agreed with the project developer (unless they are also a shipper) whilst the new arrangements would be with the shipper.

The effect is to create a less conducive investment climate, which at the very least is likely to delay investment decisions.

This is not in consumer interests, given that electricity margins in the medium term are likely to get tighter (due to retirement of older coal plant) and new gas generating stations are the main foreseeable replacement option. There are potential adverse effects on the security of electricity supply.

Impact on storage facilities and on investment decisions relating to storage facilities

Storage facilities connected to the NTS do not currently pay any charges for off-taking gas (exit capacity or commodity charges) and are deemed to have interruptible status. Storage is assumed to operate counter to other flows on the system: gas is typically injected into store when there is low demand, and withdrawn when there is a shortage.

Currently this is a seasonal cycle for long-range storage, or cycled up to 2 or 3 times for mid-range storage, but for newer fast-churn facilities the cycling is expected to be much more frequent. Under the proposed new arrangements, it may be necessary for firm incremental flat exit capacity to be purchased to accommodate these dynamic characteristics. Under the current arrangements no charges for off-take are levied. The application of charges where no such charge existed before is likely to have serious implications for the viability of such projects.