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Dear Robert,

RE: Transmission Price Control Review - Gas Entry Baseline Re-consultation - 234/07

E.ON UK welcomes the opportunity to comment on this, the first of Ofgem's re-consultation documents examining the setting of entry capacity baselines. We support re-consultation on this critical industry issue and welcomed the workshops arranged by NGG NTS to aid the consultation process.

Overall, we consider that the only satisfactory solution is to re-instate either the baselines from the previous price control (2002 – 2007) or to re-adopt the "theoretical maximum physical capacity approach" to calculating baselines. It is fundamental that the correct starting point for setting of baselines should be the physical capability of the NTS. The danger of failing to align the commercial with the physical through over-complication of the trading arrangements is that the true physical capability of the NTS under any scenario fails to be realised. We believe that the mechanism for deriving baselines for the 2007 – 2012 TPCR has been over-engineered and over-complicated with too many unforeseen side-effects. As a result, a 'back to basics' approach now should be adopted by Ofgem on this issue.

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CHAPTER 4: TPCR approach to baseline determination

Question 1: Do you agree with the objectives of the TPCR baseline review?

We fully agree that a key objective of the TPCR baseline review should be to ensure entry baselines reflect the physical capability of the NTS. We believe Ofgem made a fundamental mistake however, in first setting buy-back allowances and then setting baselines. This approach allows NGG NTS to set its own acceptable risk limits and then derive the baseline numbers to fit (perhaps comfortably) within these limits. We believe this is the wrong way around. The correct approach should be to first set the baseline levels, then design a risk and reward package (including the buyback arrangements) around this. This would encourage NGG NTS to adopt a more innovative approach to using the wide range of network management tools available to them, rather than perpetuating the current situation where NGG NTS often seems to act in a very risk-averse manner. The limited amount of capacity moved through the winter 2007/2008 trade and transfer process suggests that NGG NTS may not have the appropriate incentives in place to encourage it to respond to its customers needs. E.ON UK and other shippers have faced considerable frustration throughout 2007 when trying to develop a productive and transparent trade and transfer process only to be faced with what has sometimes felt like a “damage limitation” approach from NGG NTS. In short, we believe that under the current TPCR, the Transporter simply has too many incentives to sit on its hands in respect of regulatory change, rather than react to the dynamics of a changing gas market.

Question 2: Do you agree with the modelling approach we asked NGG NTS to carry out? If not, why not.

We understand that it may have been necessary for Ofgem to explore alternative methods for modelling baselines to ensure that the most appropriate process was being followed leading up to the current price control. We do not see evidence, however, that the considerable change to modelling methodologies was given the appropriate weighting when compared to the vast regulatory instability that deviation from the 2002-2007 approach could cause. The fact that three intensive, in-depth industry meetings were required, simply to illustrate how the baselines were derived should be evidence enough that the approach taken was too complicated

and much less transparent when compared to the previous TPCR baseline arrangements. The attempt to be more 'precise' in calculating baselines is undermined by the use of compounded averages and proxies, which rather introducing equity and balance, actually make the calculation far too complex and more importantly, fail to reflect physical capability of the NTS. In summary, we do not support a deviation from the "theoretical maximum physical capacity approach" of baseline modelling adopted by Ofgem for the 2002 – 2007 TPCR and now believe this approach should be re-instated following re-consultation.

Question 3: One of the main difficulties we faced in the run up to Final Proposals was to account for zonal constraints. Are there any better ways accounting for zonal constraints?

If zonal constraints are cited as a significant problem then Ofgem and NGG NTS need to examine why the constraint actually exists and whether the current TPCR package is delivering appropriately to incentivise NGG NTS to resolve such network problems. Accounting for zonal constraints as part of the baseline calculation appears to give NGG NTS little or no incentive to actually address and resolve them; and thereby benefit all Users of the system. Without doubt, it should be for NGG NTS to decide how to best deal with network constraints but equally the Transporter should be incentivised to develop practices and procedures to deal with constraints efficiently and economically. In this regard, we feel the current TPCR package may not be delivering appropriately. As a result, we do not believe it is appropriate to include, or account for, zonal constraints in the baseline calculation.

On a wider issue, it is of concern to us that the definition of "zones" seems to continually change, particularly in regard of the UK east coast and the Easington area. Throughout the development of the trade and transfer process, NGG NTS insisted on following strictly the 'NG 10YS zone' model. However, in subsequent baseline workstream meetings, frequent reference was made by NGG NTS to use of an "East Coast Super Zone" when modelling and deriving baselines. This inconsistency raises some confusion doubts about the true physical extent and nature of so-called "zonal constraints". We believe this may be an area worthy of further external, independent analysis of both the nature of the constraint and more importantly, why it has arisen.

CHAPTER 5: Sensitivity Analysis

Question 1: Would you consider any of the alternative approaches for allocating the free increment as discussed in this chapter more or less appropriate than the approach adopted for the TPCR Final Proposals baselines, please given reasons why.

We do not support the use of so-called “free increments”, which have become a real problem only because of the change to the baseline calculation methodology. Therefore, we advocate a return to the 2002 – 2007 TPCR approach.

Question 2: We allocated the Caythorpe and Blyborough (Welton) free increments to Hornsea and Theddlethorpe respectively, do you agree with this approach or should these free increments have been allocated in a different way and if so, how and why?

See response to Chapter 5, Question 1, above.

Question 3: NGG NTS presented three principles in order to allocate baseline capacity, namely to (i) allocate in line with physical capability; (ii) constrain not to exceed previous obligated levels; and (iii) broadly commensurate with buyback target. Do you agree with these principles? Please explain why or why not.

- (i) As stated previously, we fully agree that baselines should be in-line with physical capability of the NTS.
- (ii) It does not make sense to constrain baselines not to exceed previous levels. We do not see how, in principle, this is any different from constraining baselines not be lower than previous obligated levels, which is something that has occurred at many ASEPs for the current price control. The most pragmatic approach to dealing with this difficult problem would be to restore baselines to 2002 – 2007 TPCR levels.
- (iii) Please see our response to Chapter 4, Question 1, which deals with our concerns around buyback. In addition, we would question why, as a result of NGG’s concerns over high baselines levels, the buy-back incentives were changed to reflect the additional risk, but then the baselines were also

reduced, which further addressed this perceived risk? On the face of it, NGG seems to have made two significant gains in terms of reducing their risk profile, rather than a potential gain offset by the remaining 'risk' of maintaining the 2002 – 2007 baseline levels.

Question 4: NGG NTS presented slightly different ways of reallocating entry capacity to different entry points, would you find these approaches more or less appropriate? Please give reasons why.

As above, we advocate a return to the 2002 – 2007 TPCR baseline approach.

CHAPTER 6: Way forward

Reallocating TPCR Final Proposals aggregate baseline capacity

Question 1: Is our approach for allocating the free increment, taking zonal constraints into account appropriate given the premise that baselines need to reflect the physical capability of the system?

As above, we advocate a return to the 2002 – 2007 TPCR approach, which in Ofgem's own words "is the simplest, relatively mechanistic and more objective method compared with other methods". We believe all of these benefits outweigh the regulatory uncertainty and inconsistency introduced by changing the baseline calculation for the current price control.

Question 2: Are there any other factors that we have not considered which should be assessed in considering an appropriate adjustment to baselines?

It has been discussed in the baseline workstream meetings that the 2007 QSEC results could be used to help calculate baselines for the current price control. We have a long-held view that it is dangerous for NGG NTS to rely solely on auction signals. Applying the results of the 2007 QSEC to the baseline calculation could be highly misleading as there is simply no guarantee whatsoever that the bids are a definitive view of a Shipper's future plans at specific ASEPs. As the UNC rules currently stand, there is absolutely no requirement that Shippers must book capacity to prevent the reduction or substitution away of capacity at a specific terminal. Therefore,

QSEC bookings cannot be read as such and must not be used solely as evidence to support an increase or reduction in baseline capacity; either in aggregate or at specific ASEPs.

Question 3: What are your views on the different options outlined for allocating capacity in a different way, whilst maintaining aggregate baselines at the current TPCR Final Proposals level of 7629 GWh/d?

We advocate a return to the 2002 – 2007 TPCR approach.

Question 4: What are the advantages and disadvantages of keeping baselines unchanged at their current TPCR Final Proposals level?

We believe that the correct starting point should be, as a minimum, the previous baselines from the price control 2002 – 2007. One of the major advantages of adopting this approach is regulatory certainty and stability. We believe that it is important that any revised baselines take into account the degree of change from previous baseline levels that applied from 2002-2007. It is undesirable to have sudden changes in conditions where users have to adapt to unexpected alterations to the commercial arrangements.

In regard of the TPCR 02 – 07, NGG NTS states in its 'Summary Report on Entry Capacity Baseline Workshops'¹:

"In setting aggregate baselines of 9755 GWh/d, it was recognised that this was in excess of the physical capability of the system."

We believe that this should more correctly state that NGG NTS recognised this 'problem'. We certainly do not agree that any industry consensus was (or has yet been) reached on this point. We would also question why this aggregate figure remained unchallenged by NGG NTS throughout the previous price control. The reduction in aggregate baselines requested by NGG NTS seems to have been based on concerns that buy-backs could be excessive, as opposed to relying on evidence that this had become a real problem under the previous price control. The pattern of buy-backs historically is sporadic and infrequent (albeit large when they do occur) and address temporary locational constraints. This is as we would expect and

¹ 'Summary Report on Entry Capacity Baseline Workshops - Report by National Grid NTS', 28th September 2007.

does not, it could be reasonably argued, represent an emerging pattern to back-up the concerns expressed by NGG NTS; i.e. that the 9755 GWh/d figure considerably overstates the physical capability of the NTS, such that a significant reduction in aggregate levels was required. Indeed, since June/July 2006 to date, there have been no buy-backs at all.

Increasing Aggregate Baseline Capacity

Question 5: If we were to increase the aggregate baselines how could we quantify possible increases in buyback costs and/or capex allowance also given the timescales involved?

In terms of capex allowances, this is an area where Shippers have comparatively limited information and expertise to determine how capex should be dealt with. This is the role of the Regulator. If, however, Ofgem believes that a capex adjustment would be the right thing to do, then before allowing National Grid additional capex revenue, it should ensure that in the previous TPCR period NGG NTS invested the incremental revenue allowed to them from selling incremental capacity (e.g. Garton) to increase properly the capacity of the system. Otherwise, consumers may ultimately end up paying twice for the same capacity on the NTS.

In terms of buyback, it is clear that this area needs to be re-examined (and perhaps consulted on separately) if the aggregate baselines are restored to 2002–2007 levels or the “theoretical maximum physical capacity approach” is re-adopted, as we are advocating.

Question 6: If we were to increase the aggregate baselines how should we allocate the additional capacity? Which mechanism, if any, should we use?

It is clear that where a new mechanism is used, which deviates from the 2002 – 2007 approach, there are inevitably going to be winners and losers on a nodal level, since the process requires rationing of a finite amount of capacity between ASEPs. The easiest and most practical way to resolve these difficulties is to revert to the approach adopted in 2002 – 2007. This would bring much needed certainty to the market and ensure regulatory and commercial continuity and predictability for the remainder of the current price control.

Additional Consultation Comments by E.ON UK

We are concerned that the very nature of the ‘capacity’ product is being fundamentally changed from the original founding principles of the entry regime through the combination of lower baselines, substitution and trade and transfer of capacity. Originally, the ‘capacity’ product was designed as a right to flow gas up to a certain level. Now, the approach adopted by Ofgem in the current TPCR seems to be that the term ‘capacity’ is being used to represent almost an expectation that gas will be flowed at a certain level. In reality, a Shipper can and will decide to flow gas at any level up to the booked capacity level. Ofgem’s vision for the NTS seems to be one where all excess “fat” is trimmed from the system so that consumers only pay for the infrastructure that it is actually used to transport the gas. However, to achieve this would require Shippers to be booking capacity only where they intend to flow gas to the exact same level. By attempting to encourage streamlining of Shipper capacity bookings to an ‘optimal’ level restricts the flexibility of a Shipper to react to changing market conditions or prices. In effect, this imposes “thin” (and therefore inflexible and passive) commercial arrangements onto what can reasonably be considered a “fat” (and therefore flexible and reactive) physical NTS. Indeed the increasingly inflexible commercial arrangements may actually result in harm to the interests of consumers, as Shippers become unable to respond efficiently and economically to dynamic market conditions and are forced to pass through the associated costs. Furthermore, the presumption by Ofgem that consumers are paying for spare, “unused” capacity is, we believe, incorrect. Consumers are not paying for empty pipes and unused compressors, but are accepting the true cost of a flexible system that can cope safely and securely with swings and peaks in supply and demand.

Irrespective of any changes that may arise from this review process, we would be firmly against any move to further reduce the amount of capacity held-back from the long-term auctions, which is mentioned within this consultation paper. We have long advocated the need for at least 20% to be held back for the short-term and believe that Ofgem’s proposition that the next TPCR may remove entirely any capacity held back from long-term auctions is completely unwanted by any market participant.

Finally, we consider it wholly unacceptable that entry capacity substitution is anticipated to be implemented without the need for a UNC Modification Proposal. We believe that the only way such a fundamental process can be properly implemented is through use of a UNC Code Modification Proposal.



We do not believe it is at all appropriate to use the TPCR licence as a mechanism of introducing very substantial changes to the gas trading arrangements without resort to standard UNC governance procedures, which provide for full industry consultation and the opportunity for Code parties to raise alternative proposals or for robust development through workstreams.

I hope that you find these comments useful in informing the best way forward in respect of the entry baseline re-consultation.

Yours sincerely

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