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Dear Mark

Code Governance Review: Charging Methodology Governance Options

In our previous response to Ofgem's November 2007 industry code governance review document we stated our wish to see minimal change to the governance of network charging methodologies.

We agreed with the analysis from the Brattle Group that concluded that these benefits could be outweighed by the potential for increased administration costs and the risks from uncertainty and volatility in network charges. There are however, some reforms to charging methodology governance that do appear to offer worthwhile improvements in accountability, accessibility and transparency for all stakeholders.

Although we are content that current arrangements allow our views, as a user, to be heard at the various charging methodology fora, we acknowledge that there may be merit in more formalised processes for consideration of user proposals. We think however, that there is a risk that the establishment of a full 'code style' right for users to propose changes and have those changes considered by Ofgem could well lead to the emergence of muddled and incoherent charging methodologies over the longer-term.

In our view individual (and where relevant collectively) network operators are best placed to oversee and maintain charging methodologies that are cost reflective and avoid hidden cross subsidies in charges for particular classes of user. These regulated businesses should be able to resist inappropriate political interference and pleas for special treatment, but only if they continue to have the right to decide which user proposals merit development.

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We also think there is a high risk that certain parties will seek to use any new right to propose changes as a means to continually re-open matters over which the regulator has a settled view, such as the principle of 'locational' rather than 'postage stamp' charges for generators under the GB Transmission Charge Methodology in electricity.

As a generator, shipper and supplier E.ON UK is more interested in achieving better governance of the numerous other, non code documents over which we have no direct right to propose changes such as the BSAD Methodology (this can have a profound effect on electricity cash-out prices) and the Entry Capacity Release Methodology Statement (which has a material impact on access rights in gas). Unfortunately, there has been a tendency over time for Ofgem and network business to agree to place many new market rules in non code documents – it is the lack of formal governance of these key documents that is of greater concern to E.ON UK than giving us a formal right to propose changes to charging methodologies.

Overall we consider a proposal based on Option 2, "modify the current licence regime" offers the benefits of greater accountability, accessibility and transparency whilst avoiding the risks and cost that may arise from a 'free-for-all' in user charging methodology proposals under Options 3 and 4.

Options for Change

From the different governance options presented we favour Option 2 "modification to the current licence regime", but with the relevant network operator(s) deciding which user proposals go forward to Ofgem for a decision.

This option builds upon the status quo and could therefore be introduced relatively quickly and would follow the established processes for change management. The timescales for administering and deciding upon a change are understood and have proved successful.

Transferring charging methodologies into existing code governance arrangements would require significant industry effort. Moving to a regime requiring positive approval by the regulator rather than 'not vetoing' a network operator proposal by a given date would be a fundamental change in approach. In fact the advantage that 'veto/not veto' decisions on charging amendments must be made within a prescribed period would be lost. A key weakness of the more 'open-ended' decision making processes of many industry codes is that, at times, important decisions seem to be unnecessarily slow. We do not wish to replicate this for charging methodology governance.

In addition the timescales for change development and the administration costs for the existing industry codes would need to be amended to ensure that they were suitable. Nevertheless we do acknowledge that industry code style governance would allow the change process for network charging methodologies to evolve over time and be more transparent and accountable to all parties.

The creation of a "new charging methodology change management code" (Option 4) would incur the greatest implementation effort and experience the highest ongoing administrative costs. We are therefore not in favour of this option.

Mitigating Potential Costs and Risks

With any change to the governance of network charging methodologies it is crucial that risks of significant numbers of amendments, targeted by individual organisations simply for short term cost reallocation rather than enduring cost reflectively improvement, are avoided and that costs incurred in administering the prospective changes are minimised.

We are however, not in favour of the options of creating change proposal windows or limiting the number of prospective changes that can be raised in a year. Such options seem unduly restrictive and may create difficulties in managing peaks of activity. They would encourage the development of a backlog of change proposals that may slow the implementation of beneficial changes.

Nevertheless each network operator may have in mind one or two dates each year when it would typically be appropriate to make changes to charges (e.g. 1 April and/or 1 October) each year. There is no reason why each network operator could not establish a typical timeline for consideration of user proposals e.g. if users propose a change before date X it could typically be implemented by date Y. Under such an arrangement the network operator would determine the implementation date if it was decided to take a user proposal forward.

A method whereby the network operators could assess a minimum threshold of support for a change amongst network users seems a positive suggestion. It should reduce the number of changes raised by parties hoping to capitalise from a short term reallocation of network charges.

Deciding upon the different classes of user that would vote upon changes and the relevant percentages needed to progress would be challenging and should not be underestimated however.

Answers to Consultation Questions

Question 1: Are there other key issues that should be considered? If so what impact would these issues have on NWOs and network users?

We believe that Ofgem have captured the key issues within this consultation.

Question 2: Are there any aspects of the key issues that we have not addressed?

We were pleased to see that our concerns raised in our response to the previous consultation on this issue were taken into account. We believe that this consultation addresses the key issues. In all options, other than maintaining the status quo, there will be a need to further refine the preferred governance option.

Question 3: Should Ofgem consider governance arrangements for all charging methodologies on a common timetable, or seek to prioritise? If the latter, which methodologies do you consider should take priority and what would the benefits of this approach be?

It may be pragmatic to progress changes to the governance of network charging methodologies in an orderly sequence to mitigate the risk of excessive administration costs and resourcing constraints for both industry participants and Ofgem.

This may provide the benefit of developing a standard approach to changing the governance that would allow the subsequent arrangements to be changed relatively quickly.

Deciding upon the sequence of change to the network governance arrangements may be determined by a number of factors. These could include associated programs of activity (e.g. price controls), the numbers of potential changes that stakeholders feel are required, or the difficulty in implementing change (e.g. potential constraints from the existing licence arrangements).

Our preference would be to prioritise based upon the relative financial impact of the network charging costs on customers. Based upon the latest breakdown of domestic customer bills by Ofgem this would suggest the following order:

1. Gas Distribution
2. Electricity Distribution
3. Electricity Transmission
4. Gas Transmission

Question 4: Are there alternative governance arrangements that could be considered appropriate for charging methodologies?

Our support for Option 2, ″modify the current licence regime″ is conditional on the relevant network operator(s) deciding which user proposal should go forward to Ofgem to make a 'veto/not veto' decision. This might be viewed as a variation to Option 2.

As stated above we do not wish to see the more 'open-ended' decision making process of industry codes adopted as the incentives on Ofgem to make timely decisions may be reduced as a result. The process whereby a failure to veto a decision on a proposal within a given time results in its implementation also results in greater regulatory certainty than the typical industry code decision making process.

Question 5: Do you agree with our assessment of the options against the principles of the Review. Are there other impacts that we have not mentioned?

We agree with the use of Ofgem's principles of good governance to evaluate the various options. The additional regulatory burden that may arise from no ″decision-by″ dates and the prospect of all or most user proposals being put to Ofgem for a decision should be considered under the **poor cost effectiveness**, and in**efficient change management** criteria.

Question 6: What are your views on the cost and risk mitigation measures set out in this chapter? Are there other mitigation measures that could be introduced?

The option requiring a minimum threshold for network users to support a change is preferable compared to the other suggested measures. It should reduce the number of changes raised by parties hoping to capitalise from a short term reallocation of network charges.

The other measures suggested would potentially lead to additional costs for parties in managing change and may lead to beneficial changes being unnecessarily delayed.

Question 7: If you had the ability to raise modifications to charging methodologies how many would you have proposed within the last year?

Due to the existing nature of the governance of network charging methodologies our business structure (as a generator, shipper or supplier) is designed to be more reactive towards change. Our attention thus primarily focused on anticipating changes to the levels of charges and the associated methodologies. We are therefore do not feel in a position to comment on the number of potential changes that we may have raised within the past year.

Question 8: In light of your answer to Question 7, please give an indication (as far as possible) of the costs associated with each of the governance options as set out in Chapter 3 in terms (where appropriate) of:

- **Developing the proposal(s)**
- **Attending meetings and participating in the change process**
- **The impact on your business in terms of charging price certainty, regulatory uncertainty and business investment**

Further to our previous answer we have not considered the resource required in developing potential proposals.

We are currently active within the existing governance regime for charging methodologies attending all relevant industry forums. We are also active in all industry code governance arrangements. As a <u>user</u> the direct cost of participating in the new governance arrangements are not likely to be significant, but could amount to a few more staff – say 1 full-time equivalent regulatory analyst for Option 2 (where the relevant network operator(s) decide which user proposals go forward for decision), to say 2 full time equivalents for Option 2 (as described in the consultation document) or Option 3 and say 3 full time equivalents for Option 4.

The potential impact of numerous changes to network charging methodologies could if charges become volatile and unpredictable be significant. This would add to investment uncertainty for new generation and storage and the added uncertainty would have to be reflected in charges to customers. This can be mitigated to a reasonable extent by ensuring changes are only implemented after a sufficiently long lead time and that stakeholders are involved in debate from the outset.

If you have any questions with regard to our response then please do not hesitate to contact me.

Yours sincerely

Peter Bolitho
Trading Arrangements Manager