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Dear Jenny

**Code Governance Review: Governance of charging methodologies: Initial proposals**

E.ON UK whether as a generator, supplier or gas shipper has consistently called for network users to have a more direct say over market rules and charging arrangements that directly or indirectly affect its day to day operations and the quality of service it provides to its customers. In recent years fragmentation of market arrangements and the hiving-off[1] of key terms and conditions into non code documents over which user have no formal rights to propose changes has become a particular cause for concern.

Thus we see Ofgem's proposals to extend the rights to users to allow them to formally propose changes to charging methodologies as a positive a step in the right direction. Nevertheless we think that a degree of caution is required so as to get the best out of these new rights. Robust procedural safeguards governing development, assessment and decision making for such user originated proposals are required, otherwise over the longer term, charging methodologies could become muddled and incoherent.

In our view relevant network operators are best placed to oversee and maintain charging methodologies that are cost reflective and avoid inappropriate cross subsidies favouring particular classes of user. These regulated businesses should be able to resist inappropriate political

[1] As a generator, shipper and supplier E.ON UK is as 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 Balancing Services Adjustment Data Methodology and the System Management Actions Flagging methodology statement (both can have a profound effect on electricity cash-out prices) and the Entry Capacity Release Methodology Statement , the Incremental Exit Capacity Release Methodology Statement, the Entry Capacity Transfer and Trade Methodology Statement, the Entry Capacity Substitution Methodology Statement and the Exit Capacity Release Statement (each of which of which have a material impact on access rights in gas). One of the key purpose of establishing codes was to ensure common terms for access to grids but unfortunately many of these fundamental terms have since been progressive 'hived-off' into non code by agreement between Ofgem the relevant network operator. If Ofgem truly believes in extending rights for users to propose changes to charging methodologies this should also logically extend to these to other fundamental terms and conditions affecting users use, access, trading and settlement on/to those grids .

interference and pleas for special treatment, but only if they continue to have the right to decide which user proposals merit development.

That is why under options for change we previously advocated, 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. In our view this approach would offer real benefits in allowing users to propose changes whilst at the same time allowing the relevant network owner(s) scope to decline to pursue changes that undermined the integrity and coherance of the relevant charging methodology. We also find the current code modification decision making process to be much less efficient than the comparable process for charging methodologies.

Moving to a regime requiring 'positive' approval by the regulator (Options 2, 3 and 4) rather than 'not vetoing' a network operator proposal by a given date would be a fundamental change in approach. The key advantage being that 'veto/not veto' decisions on charging amendments must be made within a prescribed period of time. A weakness of the more 'open-ended' decision making processes typical of most industry codes is that, sometimes, important decisions seem to be unnecessarily slow[2].

We also think there is a high risk that certain parties will seek to use any new right to propose changes (with those proposals rejected or approved by Ofgem) as a means of continually re-opening 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. In this regard we are somewhat puzzled as to why Ofgem feels it necessary to highlight the views from Scottish interests and the Scottish Renewables Association in paragraph 2.12 of the consultation over renewables and conventional generation elsewhere in GB.

Overall we think our proposed variation of Option 2 offers the best way forward in terms of balancing costs and benefits - costs would be low because this proposal simply seeks to formalise how users put forward their ideas as part the ongoing review of charging methodologies, and avoids the costly administration of full 'code style administration' (Options 3 or 4). Benefits may be slightly lower, but the detrimental impact we think is more likely with Options 3 and 4, namely a tendency towards less coherence in charging methodologies and piecemeal changes is less likely. The Brattle Group analysis commissioned by Ofgem concluded that there was potential for increased administration costs and the risks from uncertainty and volatility in network charges arising from 'code style' user origination of charging proposals.

E.ON UK primary consideration in assessing Ofgem's latest proposals for governance reform of both industry codes and charging methodologies is regarding the quality and timeliness of decisions. We do not want change for changes sake, nor do we want a regime that is constantly being reviewed. Ultimately we would like a regime that provides a more stable investment environment, where regulatory interventions are proportionate and targeted.

In this context we believe our suggested variation of Option 2 offers the most robust framework to achieve such aspirations with respect to charging methodologies. We therefore urge Ofgem to

[2] CUSC Amendment CAP148 - Deemed Access Rights to the GB Transmission System for Renewable Generators has been with Ofgem for a decision since 14 December 2007, and BSC Modification Proposal P203 – Introduction of a seasonal zonal transmission losses scheme was lost because of difficulties in making a decision by a (reasonable) 'decision-by 'date set by the BSC Panel.

consider this as the most optimal way forward. Our second best preference would be Option 3 code style governance with full merit based appeal rights to the Competition Commission - this will provide procedural checks and balances that may mitigate against a tendency to approve piecemeal changes. In our view Option 2 as defined in the consultation would be the worst of all options as this would provide an unhindered opportunity for users to put forward proposals for consideration by Ofgem without the corresponding checks and balances that come with Options 3 and 4, including assessment by peers as well the relevant network operator(s), panel recommendations and a potential Competition Commission[3] appeal process.

Our detailed responses to individual consultation questions are set out below:

**CHAPTER: Three**

**Question1: Do you agree with the output from the assumptions made within the quantitative analysis undertaken?**

We acknowledge that it is extremely difficult to quantify both the cost and benefits of the various options. On the cost side which is slightly easier to quantify we consider Ofgem's assessments of costs to be broadly reasonable, and given the imprecise nature of these cost assessments we have not sought to carry out a line by line review of Ofgem's cost projections. Nevertheless, the the comment in paragraph 1.59 that *"No large generators or shippers provided costs estimates un their response"* is not strictly true as E.ON UK did provide estimates as a network user across both gas and electricity (i.e. as a shipper, supplier and generator) although we may not have made this absolutely clear in our response at the time. The cost estimates from the *"second supplier"* (paragraph 1.56) should therefore cover cost for all our wholesale and retail market represention work. Ofgem's low, central and high cost estimates may therefore be slightly too high if Ofgem has considered that these related only to our supply activities.

In our response to the November 2008 consultation we suggested a variation of Option 2 that we considered could bring much of the benefits Ofgem was seeking without the costs and risks associated with full code style governance. We see that Ofgem has noted this suggestion in its latest consultation but has not included it in its analysis. Table 1 below therefore includes a qualitative assessment of the benefits and dis-benefits of this suggestion together with Options 2, 3 and 4.

The majority of the suggested cost savings seem to arise from CAPEX efficiency savings - it is hard to say what a realistic efficiency saving might be but the figures suggested do seem rather

[3] National Grid have in our view rightly declined to take forward GBECM-17 Transmission Charging – a new proposal, put forward by Scottish Power, Scottish and Southern , Scottish Renewables Forum and the Scottish Government. This proposal sought to socialise transmission charges for generators across GB whilst at the same time retain locational transmission charges for demand, thus benefiting both generators and customer located in Scotland. In our view this proposal is incompatible with the long established locational charging principle which is a central feature of the cost reflective ICRP charging regime. These principles were ratified after extensive consultation at the time of BETTA and unsuccessfully challenged at a Judicial Review. Thus we think this a matter where there is a settled view and as such it is entirely appropriate, and also procedurally efficient for National Grid to not take this forward. Under Option 2 (not the E.ON variation of Option 2) Ofgem would be required to opine on such a proposal. It is conceivable that Ofgem might approve such a proposal if subjected to intense political pressure. The prospect of Competition Commission appeals process under Option 3 may at least allow affected parties an opportunity to challenge such a decision. In this particular case the Competition Commission could be seen as a potential safeguard for Ofgem against (inappropriate) political interference, as they may reasonably anticipate others intervening in support of a rejection should their decision be challenged.

ambitious. We do however agree with the statement that , *"Everything else being equal, more cost reflective charges would encourage users to locate where they impose lower costs on the network, thereby reducing the need for capital expenditure on the network."* This is particularly important with respect to investment in the GB electricity transmission systems.

In our opinion ensuring cost reflectivity of charges for the use of the system not only has an important impact on the need for grid investment but also has a profound effect on helping to promote competition. We think Ofgem could also have emphasised this as a key benefit in its impact assessment (please also refer to our response to Chapter 3, Question 2 below for a more detailed explanation of the benefits of cost reflectivity).

We think Ofgem is mistaken in believing that opening up the charging methodologies for users and affected parties to raise changes will necessarily benefit competition, in terms of simplicity, tariff predictability and frequency of changes. Overall we think there will be detrimental impacts in each of these areas but that competition benefits can arise from reducing the scope for discrimination between different classes of users and their customers and reduction in cross subsidies could outweigh these dis-benefits. However, we believe this is only possible if the right procedural safeguards and checks and balances are established. This is where the choice of the right option is critical.

We think there is a greater chance of more 'special pleading' type modifications being approved under Option 2 , where user proposals can be brought forward without being subject to the broader, more rigorous assessment provided by the more inclusive 'code style' modification process. If the network operator is required to take all proposals forward to Ofgem for a decision they will be less able to resist such lobbying or undue political pressure. With more such proposals being approved, there is a danger of more complex and muddled charging methodologies emerging over time, whereas currently it is usually possible to understand most charging methodologies by relating them to underlying core economic principles. This is why we have suggested a variation to Option 2 where the network operator would decide which user's proposals would go forward under the current relevant 'veto/not veto' licence procedures.

Ofgem also seem to imply that more options and choice will somehow necessarily lead to better outputs. Innovative user proposal are certainly to be welcomed, but all need to be rigorously assessed. Users will naturally tend to put forward proposals that offer them competitive advantage (and this 'competition' in modifications is to be commended), but it does mean such proposals should be thoroughly tested against the relevant /applicable objectives during the assessment process. In terms of challenge from users and other affected parties Option 2 offers the least safeguards, because the administration of charging methodologies will still be run by the relevant network operator and managed primarily in its own interests.

On the matter of costs of the Competition Commission appeals process Ofgem has considered the costs but not reflected on the benefits that arise from the improved accountability and transparency of the industry codes modification decision making. We consider that these sizeable benefits must form part of its assessment. There are a number of useful DTI and BERR[4]

[4] DTI's April 2003 document *Gas and Electricity Codes: Strengthening the transparency and accountability of the gas and electricity industry code modification process* available at: www.dti.gov.uk/energy/consultations/elec_mod.pdf (LINK NOW BROKEN).
Appeals against Ofgem code modification decisions – response to draft order – June 2005 http://www.berr.gov.uk/files/file28686.pdf

documents that considered the likely benefits of the code modification appeals process including the recent extension of this appeals process to the IGT Uniform Network Code and the Distribution Connection and Use of System Code. Costs associated with the appeal of UNC116 modifications were about £1m but it should be remembered that that case was the first of its kind and the parties involved had to do much work to provide the Group considering the case with an understanding of the scope of their powers and indeed GEMAs powers. Much of this work is unlikely to be required next time around as all parties will now know what to expect. A total cost of around £0.5m for each Competition Commission case (excluding the costs of interveners) may be a more reasonable estimate.

**Question 2: Are there any factors that you believe should have been considered in this analysis?**

There are a number of factors we believe should be considered as part of the regulatory impact assessment. These include those benefits arising from reducing discrimination and cross-subsidies mentioned above as well as a fuller assessment of the accountability and transparency of the process including inclusivity and accessibility for users and their customers, regulatory certainty and the quality of decisions making.

We have sought to summarise our views on these factors together in table 1 below.

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Impact assessment – July 2005, http://www.berr.gov.uk/files/file33240.pdf.
Extension of right of appeal with respect to certain CEGA decisions: Section 173 Energy Act 2004 – August 2007, www.berr.gov.uk/files/file40898.pdf.
Summary and conclusions – July 2008, http://www.berr.gov.uk/files/file46966.pdf.

**Table 1 – Qualitative assessment of proposed changes to charging methodologies**

| Factor | Option 2 – Refining existing arrangements (E.ON variant) | Option 2 – Refining existing arrangements | Option 3 – Industry Codes Governance | Option 4 – New Charging Methodology Code |
|---|---|---|---|---|
| **Promoting competition** | | | | |
| • Simplicity | ✗ | ✗✗✗ | ✗ | ✗ |
| • Tariff predictability | - | ✗ | ✗ | ✗ |
| • Frequency of changes | ✗✗ | ✗✗✗ | ✗✗ | ✗✗ |
| • Reduce scope of discrimination | ✓✓ | ✓ | ✓✓✓ | ✓✓✓ |
| • Reduce cross-subsidies | ✓✓ | ✓ | ✓✓✓ | ✓✓✓ |
| **Cost reflectivity** | ✓✓✓ | ✓✓ | ✓✓✓✓ | ✓✓✓✓ |
| **Industry costs** | | | | |
| • Non Network Operator | ✗ | ✗✗ | ✗✗ | ✗✗ |
| • Network Operator | ✗ | ✗✗ | ✗✗ | ✗✗ |
| • Code Administrator activities | n/a | n/a | ✗✗✗ | ✗✗✗✗ |
| **Accountability & transparency** | | | | |
| • Inclusivity and accessibility | ✓✓ | ✓✓✓ | ✓✓✓✓ | ✓✓✓✓ |
| • Regulatory certainty | - | ✗✗✗[5] | ✗✗[5] | ✗✗[5] |
| • Quality of decision making | ✓ | ✗✗✗ | ✓✓ | ✓✓ |
| **Summary** | 5✗ 10✓ | 17✗ 7✓ | 13✗ 16✓ | 14✗ 16✓ |
| **Conclusion** – benefit : dis-benefit ratio | "Clear Winner" | "Not a viable proposal" | "Second choice" | "Third choice" |

We agree that allowing users to formally put forward changes to charging methodologies could be beneficial but only if procedural checks and balances are in place. We think that under Option 2 there is a greater chance that the process could be skewed to favour particular special interest groups or be procedurally vulnerable to particular users achieving their own objectives by stealth. For example one might expect regular submissions of proposals similar to *GBECM-17 Transmission Charging – a new proposal* with particular users seeking to revisit previously 'settled positions' on the locational nature of transmission charges.

Clearly these procedural checks and balances inherent in Options 3 and 4 have a higher price tag but, the overall effectiveness of the process would be significantly improved in terms of the accountability and transparency of Ofgem decisions.

We think all the options offer benefits in terms of improving inclusivity and transparency compared to the current tightly controlled network operator run change processes. Clearly there will be higher costs to produce the argumentation and analysis to support decisions under Options 3 and 4 but this is perhaps a cost that is worth paying to offset the risk of inappropriate proposals being approved.

Greater regulatory uncertainty would arise from a move to the 'open-ended decisions making in which Ofgem makes a 'positive' approval/rejection decision rather than a decision to veto/not veto

[5]Assuming the decision making process was to change to an 'open-ended' positive decision to approve or reject a charging methodology proposal rather than the current 'time-bound' decision to 'veto or not veto' a proposal.

within a prescribed time window. The latter ensures decisions on charging methodologies are made promptly and this is one aspect of the current licensing regime that should be retained. Under the existing code modification decision making process delays to decisions can been excessive and indeed viable modifications have been lost or simply 'withered and died' because of such changes. Again we think Option 2 is weakest in this regard but under Option 3 and 4, the relevant Panels are able to chase Ofgem for a decision or in the case of the BSC exert pressure to make timely decisions where there a risk of a change being "timed-out".

Without Panel oversight (a feature of Options 3 and 4) or retention of the network operator's right to choose which charging proposals go forward (as per E.ON variant of Option 2), Option 2 is in our view susceptible to undue political influence or special pleading. Ofgem might for example be less willing to refuse a proposal that effectively cross-subsidises particular classes of user in a particular region of GB if that proposal had for political reasons been given an 'easy ride' by the relevant network operator under Option 2, whereas the network operator might otherwise have been inclined not to bring forward such a proposal because of a lack of cost-reflectivity under the E.ON variant of Option 2. Alternatively under Options 3 or 4 the Panel may have recommended rejection of the proposal on similar grounds, which would add weight to a possible Ofgem decision to reject or in the case of a decision to approve open up the opportunity to appeal to the Competition Commission.

**CHAPTER: Four**
**Question 1: Which governance Option do you consider is the most appropriate for charging methodologies?**

On the basis of our comments thus far, summarised in table 1 we believe the E.ON variant of Option 2 offers the best way forward. For quite modest reforms it offers very real benefits without incurring the regulatory risks or excessive complexity in the regime that the other options are likely to encourage. **In our view Option 2 offers the worst of all worlds.** It offers the greatest chance driving inappropriate change which would in our view lead to the emergence of muddled and incoherent charging methodologies. Costs for implementation would be quite high and the lack of credible user/customer challenge in a network owner run process and the absence of a merits based Competition Commission appeals process would most likely lead to poorer regulatory decision making.

In our view the overall benefits of Options 3 and 4 are only just likely to exceed the costs. Options 3 and 4 are clearly preferable to Option 2. Overall we would urge Ofgem to reconsider E.ON's variant of Option 2 as this proposal can be implemented relatively easily, provides many benefits but without weakening the accountability and transparency of the overall charging methodology process.

**Question 2: Do you agree that we should initially focus on gas and electricity transmission charges, with gas distribution potentially to follow as a second phase?**

No. In our response to the November 2008 consultation we expressed the view that the priority should be set based on the relative financial impact of particular charges on customers. Thus we expressed the view that that the following order of priority a) gas distribution b) electricity distribution, c) electricity transmission d) gas transmission should prevail. We believe that there

is need to give top priority to gas distribution charges and in particular the structure of charges for independent gas transporter networks which act as an impediment to efficient gas supply competition for over one million customers.

We are concerned that Ofgem appear to be placing a disproportionate emphasis on transmission issues and indeed the recent Ofgem reorganisation seems to support such an emphasis, with transmission and the governance now becoming the responsibility of one senior partner. We think transmission charging issues are important - gas transmission charges being closely linked to auction, trade, transfer and substitution proposals and electricity the transmission access review (TAR) - but one would hope that over the next year Ofgem and the industry can reach a settled view on many of these reform proposals thereby establishing a sense of stability[6] in the regime. Such regulatory stability is a key consideration for gas producers, potential storage operators and generators as they make crucial investment decisions going forward.

**Question 3: Do you agree that annual/biannual change and implementation windows are the most appropriate mitigation measures to progress going forward for all the options?**

As a major gas and electricity supplier predictability of use of system charges is of utmost importance, so that we can accurately reflect these charges in our tariffs to customers. In this regard we would only like to see annual changes to tariffs and the new arrangements should ideally aspire to this. We do not however, think it is necessary to establish annual/biannual windows for changes as we think this will be unduly restrictive for both the network operators and their users.

In our response to the November 2008 consultation we stressed that we were ,*"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."*

We did however stress that we thought it was within the gift of network operators to establish processes to manage charging methodology change proposals efficiently, *"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."*

We think this is a more effective way of managing the flow of charging proposals and limit the number of dates when changes can take place.

**Question 4: Do you consider a 3 or 4 month window to be sufficient time to consider modification proposals? Please indicate your preference for either 3 or 4 months.**

[6] In this context we mean avoidance of 'change for changes sake', sticking to established charging principles e.g. location charges derived from load flow models and long run marginal costs, but facilitating necessary proportionate and targeted change to support offshore and onshore renewable generation, distributed generation, smart metering and smart grids.

For the reasons expressed above we consider such windows to be unduly restrictive. Please refer to the alternative approach set out in our response to Chapter 4 Question 3 above.

**Question 5: Do you agree with our approach to defining "affected parties" who would be entitled to raise modification proposals?**

No. In the main we believe that necessary changes can be progressed by the parties to the code, for example suppliers will naturally wish to progress changes to charging methodologies that allow them to offer new and better services to their customers or indeed address discrimination and fairness concerns. Thus there should ideally be no need for third parties to propose changes to the codes. The 'competition' in modification proposals amongst users should achieve this.

We have already expressed our concerns that allowing users to propose changes without appropriate checks and balances could lead to more opportunities for disproportionate influence by special interest or vocal lobby groups (perhaps representing certain classes of users within particular regions of GB). We think it should be sufficient to limit the right to raise modifications to the relevant network operators and their users.

In summary we would urge Ofgem to discard Option 2 and instead consider E.ON's variant of Option 2, given it offers a proportionate and targeted response to deficiencies identified in the current regime. Should Ofgem however, decide to proceed on the basis of Option 3 we consider that should be on the basis that charging methodologies are subject to the relevant code governance arrangements (e.g. electricity transmission charges covered by CUSC amendment procedures) and this shall include extension of full rights of appeal of charging methodology modification decisions to the Competition Commission.

In finalising and further assessing its proposals we think Ofgem should focus particularly on issues of avoiding of complexity, undue discrimination, and cross subsidies as well as ensuring maximum accountability and transparency (including procedural safeguards) to provide adequate levels regulatory of certainty and the quality of decision making. If you have any questions with regard to our response then please do not hesitate to contact me.

Yours sincerely

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