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Dear Bogdan,

RE: Gas Entry Capacity Substitution Methodology Initial Impact Assessment

This response by E.ON UK is on behalf of all E.ON group companies operating in the UK which hold a UNC Shipper licence. E.ON UK welcomes this Impact Assessment as an important governance step in assessing the impact of a proposed entry capacity substitution methodology on the UK gas market. In brief, we find the Impact Assessment unconvincing in its conclusion that this Substitution Methodology will provide net benefits to the UK gas market and, ultimately, consumers.

Analysis of Benefits

We broadly agree with the three main advantages identified by Ofgem; i.e.:

"(1) lower costs to customers as a result of the avoided capex, (2) environmental benefits associated with avoidance of constructing cross-country pipelines, and (3) avoiding potential delays and costs associated with the planning process linked to investment projects which can impact the timing of the delivery of new infrastructure."

However, it is important that these are quantified and balanced against the potential costs of implementing substitution. It is the in-depth analysis of costs to all market participants, which we believe is lacking in this Impact Assessment.

Analysis of Costs

Too much of this Impact Assessment is focused on the costs (and savings) to the Transporter (impact on IT systems, avoiding potential investment in the system, etc.) and provides very brief analysis of the impact on Shippers, who are clearly fundamental to the success (or failure) of this proposed regime change.

E.ON's position on entry capacity substitution throughout the lengthy industry development process has remained that, in principle, substitution seems a logical idea (to the extent that it is a method of making better use of existing assets), but that it must be implemented in a way which delivers genuine, long-lasting benefits for the whole market – not just cost-savings for National Grid NTS.

With this in mind, we disagree with Ofgem's statement that *"the proposed methodology will not place an undue burden on shippers as it builds on existing processes associated with the long-term entry capacity auctions."* Rather, we believe that this methodology will place an on undue burden on Shippers and if anything, will actually undermine the existing processes.

For instance, little consideration is given to the fact that Shippers will have to do much more "guesswork" pre-QSEC, taking in most cases a speculative view as to whether an option/retainer needs to be taken out, increasing risk and costs. This will result in costs being incurred where they are not necessary and which are never refunded. In short, the option/retainer approach involves significant up-front costs for the Shippers that take out an option/retainer, but actually confers very few rights. Over the duration of the 'retainer' commercial priorities might change and a Shipper may legitimately choose not to subsequently purchase the capacity covered by a 'retainer' in a future auction. As a result, an opportunity to substitute and hence to prevent unnecessary investment will have been lost, potentially leading to additional risks and/or costs facing consumers.

We also struggle to see how the option/retainer approach fits with the user commitment model. In taking out an option/retainer, the Shipper is not providing any robust information on which the Transporter can rely on to plan its system, since the product expires after one year. As a result, it is actually a very 'watered-down' user commitment, which from a policy perspective seems to be moving away from the recent regulatory trend of increasing, rather than decreasing the size of user commitments (e.g. exit reform). In our view, a two-stage auction-based methodology would be much more consistent with the established user-commitment model, as it forces Users to commit in full.

Contrary to repeated requests from a number of Shippers, no analysis has been included in this impact assessment of the impact of substitution on the wholesale gas price - which is disappointing. As we noted in a previous response: *"as regards the impact of substitution on* *wholesale gas markets, we note that if a Shipper is short of capacity at a specific ASEP, taking out a 'retainer' is effectively flagging to the market that this Shipper is a distressed buyer, potentially resulting in price spikes".*

We note that Ofgem states that no evidence on the effect on wholesale gas prices has been provided to them. We would like to point out that no request (formal or informal) has ever been made by Ofgem, so Shippers will have been unaware that Ofgem was apparently seeking any particular pieces of information on this subject.

We also find it surprising that no qualitative costs could be identified by Ofgem. We highlight the following:

- Potential for unintended consequences due to significant additional complexity in the entry capacity regime, particularly for new entrants.

- The loss, on a permanent basis, of sufficient flexibility in the system to permit the required diversity of gas supplies to come to the UK.

- Encourages those with the funds available to protect capacity from substitution, regardless of whether or not they want to subsequently buy it; ultimately frustrating the very purpose of substitution.

In summary, we do not agree that the methodology should be approved and believe that there are much better solutions already developed - namely the two stage auction. Its greatest advantage compared to the alternative approaches is that is gives Shippers a genuine opportunity to minimise any perceived adverse outcomes. It is also the only approach that affords shippers a genuine opportunity to influence the outcome of substitution by using existing, familiar tools – i.e. QSEC auction bids.

I hope that the above comments prove useful. Should you wish to discuss our response in any further detail, please do not hesitate to contact me on T: 02476 181421.

Yours sincerely,

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