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Dear Thomas / Anjali,

RE: Gas Security of Supply Significant Code Review - Proposed Final Decision

E.ON welcomes the opportunity to respond to the Ofgem proposed final policy decision. We wish to make it clear that we do not support Ofgem's proposals, consistent with our previous responses on this matter. The GB wholesale gas market is working, it is well-supplied and as acknowledged by DECC¹, resilient to all but the most unlikely combination of supply shocks.

We consider that Ofgem's proposals are highly unlikely to deliver additional levels of gas security of supply in GB. Rather than strengthening incentives on market participants as Ofgem intends, these proposals (through the introduction of administered VoLL) introduce potentially unmanageable risks into the market, which may ultimately force participants out of business. Furthermore, we must be clear that Ofgem's proposals will do nothing to incentivise the build of new infrastructure which could benefit security of supply, such as gas storage.

Our response is structured around what we now see as the key issues for the remainder of this SCR. Since the proposed final decision was issued by Ofgem in July 2012, there have been a number of significant new developments; most notably the emergence of a Shipper and customer-backed alternative approach to the Ofgem SCR proposals, but also the formation of a UNC issues group to look at balancing credit implications. We consider these two developments to be of such materiality that Ofgem must now take these matters into account and re-consider its position under this SCR.

¹ Source: DECC (November 2011), "Risk assessment for the purpose of EU Regulation 994/2010 on security of gas supply"

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Given Ofgem's statement that implementation of any potential solution may not be until Winter 2013/14, we believe that an important window of opportunity has now opened to properly develop an industry-backed workable solution, which will satisfy Ofgem's objectives for this SCR, namely to:

- *Minimise the likelihood of a GDE occurring by encouraging gas shippers and suppliers to undertake sufficient investment to enhance security of supply.*
- *Minimise the severity and duration of a GDE, if one ever occurred, by sharpening incentives to attract gas into GB; and*
- *Ensure that firm consumers are paid for any involuntary DSR services that they provide in an emergency.*

Whilst we remain of the view that fundamental market intervention in respect of GB gas security of supply is not required, we acknowledge that there is room for incremental and proportionate improvements to be made in this area. The introduction of a Demand (and Supply) Side Reduction auction / tender is one such possible improvement which E.ON has supported throughout this SCR process.

A market-based auction / tender, with National Grid NTS contracting for demand reduction (e.g. from CCGTs / large I&C customers) and supply increases (e.g. from gas storage) pre-emergency, is a much less interventionist approach than Ofgem's proposals and should help address any concerns about physical security of supply. If structured appropriately, it may also help incentivise new build of infrastructure or support existing assets, to further strengthen the security of GB's gas supplies.

Governance Process

We strongly disagree with Ofgem's stated intention to exercise its new powers under the Energy Act to implement these proposals directly into the UNC. We do not believe that bypassing the UNC governance process is appropriate and would, in fact, add more uncertainty, since there is a real risk of Ofgem rushing in an under-developed solution. A more proportionate and less divisive approach would be to allow UNC proposals to be raised and alternatives to be fully developed through the usual governance channels. This is E.ON's firm preference. Overall, this should result in a more efficient outcome as it gives industry participants the formal right to suggest improvements and the relative merits to be properly and transparently assessed. Moreover, we find it somewhat surprising that Ofgem is choosing to bypass a governance model which it has devised and obliged Code signatories to follow for all other Code changes.

Consideration of Alternatives

As outlined above, we believe that Ofgem must now give full and due consideration to alternative approaches to implementation of the SCR proposed final decision, including the industry-backed Gas Forum proposal and the recently raised UNC Modification Proposal 0435 – “*Arrangements to better secure firm gas supplies for GB*”.

We welcome Ofgem’s recent willingness to consider alternatives which could enable Ofgem to better meet its stated objectives for the SCR. We consider that UNC Modification Proposal 0435, as a starting point for development, is far more consistent with a market-based approach than Ofgem’s ‘administered-VoLL’ based proposals. Furthermore, such an auction / tender would allow large customers to express their own ‘VoLL’ through auction / tender bids and if accepted, be compensated accordingly for their services. We acknowledge that work is needed to develop this (or any other formal alternative) but we are committed to this process, as we have been throughout the whole SCR.

Role for Demand and Supply Side

In our view, the currently proposed Demand Side Reduction auction / tender could be enhanced by including the supply side. Gas storage and other supply side sources have a key role to play in preventing or minimising the duration of a Gas Deficit Emergency; particularly where the demand-side response has been exhausted. In our view, a credible alternative to UNC Modification Proposal 0435 would be to introduce a Demand *and* Supply Side auction / tender, which would be more closely aligned with the existing (Ofgem approved) model for gas Operating Margins.

Credit Implications

Energy balancing credit implications have failed to be properly taken into account by Ofgem in its proposed final decision. Key aspects of the credit rules are entrenched in the UNC and any change is unlikely to be a self-governance Code change, due to the potential impacts. Therefore, Ofgem should not “brush off” this issue as a matter for shippers to sort out between themselves and needs to very carefully consider the impact of its proposals in this area. Given the potential adverse implications for both competition and for NBP liquidity of increasing the credit hurdle for shippers in the wholesale gas market, we consider Ofgem’s dismissive approach on credit to be very unhelpful.



Conclusion

In light of recent developments and discussions in the Ofgem SCR workgroup meetings, we believe Ofgem's focus must now be on giving full and due consideration to alternatives. The fact that formal alternative proposals have now been brought forward should be sufficient evidence that the industry remains fully engaged on this issue and is keen to see the implementation of a constructive and credible solution. Equally, the significant lack of support from industry (including customer representatives) for Ofgem's proposals should signal a need for Ofgem to step back and reconsider its proposed course of action under this SCR.

We urge Ofgem to work with the industry to fully develop the Demand Side Response auction / tender model and not to take a final decision on the SCR until all genuine alternative solutions have been properly assessed. We firmly believe this course of action is in the best interests of GB gas security of supply.

Yours sincerely,

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