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Dear David,

RE: Gas Transmission Charging Review – Call for Evidence

E.ON believes that the primary objective of this Ofgem review should be to examine the implications of the Tariffs Framework Guidelines (FG) in GB and ensure the market arrangements are compliant. We do not believe it is practical at this stage to review all aspects of the GB charging regime, which would be very resource intensive and introduce unnecessary risk and uncertainty. The current GB charging arrangements have been established over a number of years and have generally worked well to date, helping to secure gas supplies for GB, facilitating significant new investments and supporting a liquid wholesale gas market. This is not to say that the charging arrangements are perfect, but we consider that any significant issues can be adequately handled though the existing Code governance process.

Inevitably, some Shippers will be dissatisfied with the current charging arrangements if these do not fully support their business model. Ofgem should ensure, however, that the charging arrangements are not tailored just to suit those that shout the loudest, but should continue to promote economic and efficient grid access for all parties. It is also important to acknowledge that uncertain outcomes are a feature of auctions and therefore a certain degree of volatility has to be expected when attempting to recover fixed revenue through this mechanism.

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Process points:

- We do not believe this review merits becoming a Significant Code Review (SCR). If it does, it would be likely that any charging proposal raised through the UNC governance process would be subsumed. Experience shows that an SCR is not a quick process and subsuming proposals in this way could prevent or restrict significant value issues from being addressed. It is important that the usual governance arrangements are not overridden by this review and that Shippers continue to have the opportunity to raise, discuss and develop issues that are important to the industry.

- A common consequence of change to the charging arrangements is to create 'winners' and 'losers' because of the variety of business strategies that Shippers will have developed over a number of years, based on the existing arrangements. As a result, it would be a reasonable expectation of Shippers that should Ofgem decide there is a need for change, that sufficient notice is provided to allow market participants to adapt.

Before responding to Ofgem's detailed questions, we would like to set out our views on the key issues raised by this review.

Applicability of FG Tariffs

E.ON does not believe that the GB gas market would currently benefit from the application of the FG on Tariffs at system points other than interconnectors. Whilst it is clearly not ideal to have different charging arrangements for points that are part of the same network, we believe that this is more practical than trying to change the arrangements for all system points, given the timeframe for GB to comply.

Once implemented, it will be important to allow the new arrangements to "bed in" for a period of time and then consider whether any improvements are required and whether it is appropriate to apply the arrangements on a wider basis. There is clearly significant commercial and physical risk attached to changing the charging arrangements for all points at the same time, particularly if the new arrangements lead to unintended consequences or drive perverse behaviour in the market.

Impact of Commodity Charges on Cross Border Flows

As highlighted in our response to Ofgem's recent open letter on cross-border gas flows, whilst high GB commodity charges may be an influencing factor, this is far from being the only reason for unexpected or "sub-optimal" flow patterns. Our view remains that the forthcoming European Network Codes, if implemented in full across Europe, will address the majority of concerns about apparently inefficient flows across interconnectors.

Consultation Questions

Question 1: What has given rise to the current balance between charges for access to the transmission network? How might this change in future?
and
Question 2: What issues are there with current charging arrangements? For example: Does the charging structure strike the right balance between incentives to use capacity efficiently and investment?

E.ON UK's views on grid access and charging have been extensively set out in our responses to previous consultations, including NTS GCD 08, NTS GCM 19, Ofgem's "Review of NTS Entry Charge Setting Arrangements - Impact Assessment", UNC Mods 284 & 285 and as part of the Competition Commission Appeal on Exit Reform[1] (UNC 116). We also note that our views are broadly consistent with those previously expressed by Ofgem, as confirmed by Ofgem's decision letter for NTS GCM 19. We agree that charges for short-term capacity should continue to be based on the short run marginal cost (SRMC) and long-term capacity charges to be based on the long run marginal cost (LRMC).

In addition, we provide a summary of our views as extracts from previous responses on gas transmission charging:

- *An appropriate balance needs to be struck between incentivising long-term bookings and providing short-term flexibility for both incumbents and new entrants. Efforts to maximise long-term entry capacity bookings by incumbents runs the risk of reducing opportunities for new entrants to enter the market if capacity is wrapped up in long-term contracts.*
- *It could also be argued that long-term entry capacity bookings do not necessarily improve security of supply since this may restrict the flexibility to flow gas, if short-term capacity isn't available in the quantity required when needed. Access to short-*

[1] See page 33, onwards.

- *term products is also critical for those Shippers who have a large or variable supply portfolio and who will be subject to within-day fluctuations in the size of their portfolio. This may be due to customer churn, electricity demand, weather, maintenance, etc. As a result, it is impossible even at the day-ahead stage for Shippers to know exactly what their capacity requirements will be. Moreover, pushing Shippers into procuring capacity purely on a long-term basis would force them to over-state their requirement (in order to manage risks), buying more than they need and sending an erroneous signal to National Grid of high demand, leading in turn to a network which is over-built and under-utilised.*
- *We believe it is appropriate for the industry to consider ways in which an increasingly volatile TO Commodity charge level can be reduced (or better managed), although ultimately it should be recognised that fluctuating commodity charge levels are an inevitable outcome when auctions are used to collect fixed allowed revenue.*

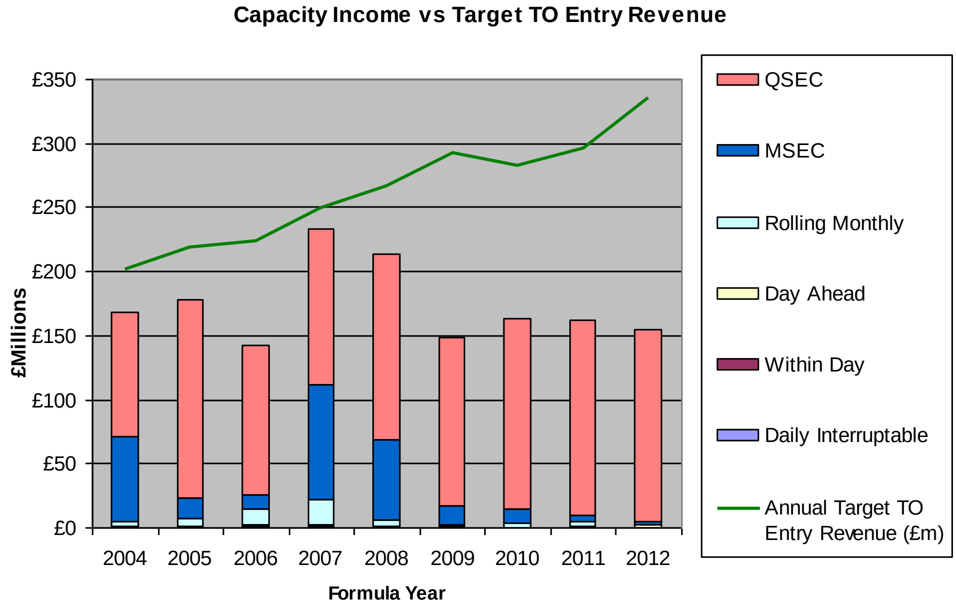
QSEC Bookings & Under-Recovery

In this Call for Evidence, Ofgem notes that:

- *Total sales (over the 15 year allocation period) of QSEC capacity is falling year-on-year*
- *QSEC capacity is being bought by a declining number of shippers year-on-year*
- *In 2012 and 2013 all capacity was sold at the reserve price*

We do not see these outcomes as a failure of the existing charging arrangements. Lower QSEC bookings may be explained by a number of factors, such as an unconstrained NTS with high baselines in excess of physical system capability and less large scale investments on the NTS due to the general economic downturn. In addition, Shippers are mothballing existing assets and likely surrendering associated capacity, which only adds to the spare capacity on the system. It should, therefore, not automatically be assumed that the charging arrangements are to blame.

We also note from National Grid's data, as presented at Ofgem's opening seminar for this review, that QSEC bookings as a percentage of overall bookings, haven't changed much since 2008; i.e. they account for 50% of the volume, giving ~95% of NGG's income from capacity bookings. However, critically, allowed revenue for NGG has increased by ~30% during the same period. See below:



Source: National Grid presentation, 8th July 2013.

It would appear that NGG's significantly increased allowed revenue against mostly static long-term capacity bookings is a major contributing factor to overall under-recovery; and therefore higher commodity charges. On this basis, we find it hard to see how any potential review of the whole charging arrangements could be conducted without also considering the direct impact of allowed revenue. Whilst we do not dispute the appropriateness of the overall level of NGG's allowed revenue, Ofgem may need to consider further how the increased cost is passed through to Shippers, and ultimately consumers – and whether this could be better managed.

Q. Is capacity available when needed?

Generally yes, although we have observed instances of National Grid withholding capacity from auctions due to physical system constraints. It should also be understood that whilst capacity (particularly on, or close to, the day), can currently be obtained relatively easily, there is no guarantee that this will be the case tomorrow or at any time in the future. Shippers are accepting this risk by following such a strategy and the price paid for capacity, accordingly, reflects this risk.

Q. Do charging arrangements help NGG to plan network investment?

In a narrow sense, this is a question that only National Grid and Ofgem are in a position to answer, since Shippers do not have full visibility of how NGG plans network investment or manages risks.

In more general terms, a charging policy which encourages long-term capacity bookings at the expense of the short term is likely to lead to an oversized and underutilised transmission system. Moreover, a charging policy which increases charges to certain users who place a low value on interruptible services is likely to lead to a reduction in overall network usage.

Q. How do our current charging arrangements interact with those in neighbouring markets? What is the impact of these interactions? How do current arrangements give rise to these issues?

As noted in our response to the Ofgem open letter on cross border flows:

In terms of the wider European regulatory framework, access to day-ahead and within-day capacity at market-based prices is key to enhancing cross-border trade. For instance, the provisions of the EU Network Code on CAM will provide for such short-term access. They will not, however, provide for market-based pricing if short-term auctions begin at a regulated reserve price which is up to 175% of the respective price of a yearly capacity product, for instance. Prohibitive capacity and commodity charges are without doubt the biggest barrier to further integration of NW European gas markets.

and

Whilst it is clearly important to give due consideration to issues which may be hampering cross-border gas flows, our view is that given the significant amount of recent market rules changes (particularly in Belgium and the Netherlands), sufficient time must be allowed for these arrangements to properly 'bed in' before considering further interventions. We also expect to see the forthcoming European Network Codes improve the efficient utilization of cross-border infrastructure in future.

Question 4: In the event that there were to be minimal implementation of the Framework Guidelines/network codes as currently drafted, e.g. no subsequent changes at domestic points, what would be the impact?

Adopting brand new arrangements across all domestic points and abandoning the well-developed, functioning GB charging arrangements could have serious and damaging implications for system users, if the new arrangements fail to function properly. As noted already, whilst it is clearly not ideal to have different charging arrangements on the same transmission network, we do not see this as insurmountable if a collaborative approach is adopted by industry and regulator. In the longer term it is worth keeping the situation under review and considering whether there is a robust case for extending the new arrangements beyond interconnection points.

In addition, there may be a strong case for having different charging arrangements for different types of points on the system, which should not automatically be viewed as discriminatory. For instance, the primary focus of the European Network Codes is to facilitate cross-border trade. Therefore, provided the interconnection points are compliant, it could be argued that this aim has been achieved.

Question 5: Are our goals for the review appropriate?

Broadly, yes, although we would suggest that a further objective (or aspiration) should be to minimise on-going uncertainty for current and future users of the system, whilst the review is undertaken. We believe this would be best achieved by keeping the scope of the review narrow and focused on interconnection points only.

Question 6: How could charging arrangements better meet the objectives set out in NGG's special standard condition A57 which sets out the objectives for NGG's charging methodology?

We do not believe there is a case for fundamental change beyond interconnection points and that discrete issues can still be dealt with effectively through the usual governance channels.

Question 7: Do the objectives set out in NGG's special standard condition A5 remain fit for purpose? If not, how should they be changed?

We consider that the current NGG licence objectives have supported efficient changes to the charging methodologies and arrangements in the past and we have no reason to believe they will not do so in future.

Question 8: What other suggestions do you have for the objectives of our review?

None.

Question 9: What is your view on the timescale for our review?

Ofgem has not actually set out its views on this matter in this Call for Evidence, so it is not possible for us to comment. We would, however, welcome Ofgem's views on the expected timescale for this review as soon as possible, in order to minimise on-going uncertainty.

Question 10: Bearing in mind the issues and objectives you have identified, what options should be explored to address these?
And
Question 11: What are the pros and cons of your suggested option?

We propose focusing only on interconnection points for the reasons outlined above. The industry will clearly need to develop and debate the most efficient solution for implementing the Tariffs FG at interconnection points in GB. We look forward to participating in these discussions and exploring the pros and cons of the various means to achieve implementation.

We hope you find our comments helpful in developing your position on the best way forward for this review. If you have any comments or questions in relation to this response, please do not hesitate to contact me on T: 02476 181421.

Yours sincerely,

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