E.ON UK plc
Westwood Way
Westwood Business Park
Coventry
West Midlands
CV4 8LG
eon-uk.com

Richard Fairholme
T 02476 181421
richard.fairholme@eon-uk.com

Anjli Mehta
Ofgem
9 Millbank
London
SW1P 3GE

17 September 2013

Dear Anjli,

RE: Gas Security of Supply Significant Code Review – Demand-Side Response Tender Consultation

E.ON has advocated the introduction of a Demand Side Response (DSR) tender since the beginning of the gas Significant Code Review (SCR) process and we are pleased to see that this proposal is now being considered in more detail as part of Ofgem's final proposals. In designing a market-based DSR tender, we believe the following principles should be adhered to:

A DSR Tender:

- Should not undermine or restrict market participants efforts (either individually or collectively) to resolve any potential or actual emergency situation.
- Should recognise that the gas wholesale market is not 'broken' and is a liquid, competitive market which does not require fundamental reform (as recently reaffirmed by DECC)
- Should not distort the gas market or artificially inflate prices for Shippers, and ultimately, consumers.

We now turn to addressing Ofgem's detailed questions.

E.ON UK plc

Registered in
England and Wales
No 2366970

Registered Office:
Westwood Way
Westwood Business Park
Coventry CV4 8LG

CHAPTER Two

Question 1: What are your views on a SO-run DSR tender? Do you think it is an appropriate addition to the Gas SCR?

And

Question 2: What do you think the purpose of the tender should be?

We agree that NGG is best placed, as System Operator (SO), to co-ordinate a DSR tender. We do not believe it is necessary, however, for exercised DSR bids accepted through this tender to be priced into cashout, in the same way that the current Operating Margins (OM) arrangements do not also set daily imbalance prices for the whole market, where accepted bids are exercised.

Allowing parties to freely state their price of interruption is acceptable in principle, where it is a bilateral agreement which can be accepted, rejected or negotiated, but where the implications flow beyond the bilateral relationship and into the wider market (as proposed here - into daily imbalance prices) there needs to be rigorous rules in place to prevent exaggerated or excessive bids distorting market prices. However, this is likely to result in arbitrary acceptance criteria, which may (legitimately) exclude many bids. We consider that a more pragmatic solution is to simply not to link accepted and exercised DSR bids with cashout, which avoids the potential for distortions to market prices. Even in the absence of exercised DSR bids being priced into cashout, the revised rules already provide for a potentially highly penal cashout regime and therefore one of the main aims of this gas SCR has been achieved. It is our view that increasing the size of the "stick" further, is unlikely to elicit any more useful, "desirable" behaviour from Shippers.

Question 3: What benefits do you see a DSR tender providing?

As acknowledged by Ofgem, the main benefit is in discovering individual customer VoLL, which is preferable to an arbitrary, administered VoLL price. A DSR tender, if appropriately structured, can also provide certainty of response for the SO, which has the potential to enhance security of supply.

Question 4: What costs do you see arising from a DSR tender?

As we have stated in previous responses, we do not believe this tender will be a success unless option fees are allowed. This does not mean that they should be compulsory, but that participants should have the freedom to structure their own bids. This should lead to the most

efficient and cost-reflective bids being placed. Allowing option fees inevitably means that an on-going cost is incurred by the market, but optionality does not come for free and this needs to be recognised in the tender arrangements; as it is for the Operating Margins tender. It must also be recognised that an increased level of security of supply above that which the market is already efficiently providing, will come at a cost.

Question 5: Do you think a DSR tender should have a role subsidising investment in back-up facilities? If so, why?

We do not believe that the link between a DSR tender bid and investment in back-up has to be so explicit. If we accept that parties have the freedom to structure their bids, then there should not be an additional layer of scrutiny of what parties then do with the income, if their bids are accepted. This would only serve to discourage potential bidders. Ultimately, the risk of not providing the DSR service will sit with the accepted bidder and it should be up to them to decide how best to meet their contractual obligations.

CHAPTER: Three

Question 1: What do you see as the key design issues for the high level design of a DSR tender? Are there any we have not included here?

As mentioned above, the freedom for parties to set their own bid structure is key and is absent from the Ofgem proposals. This will restrict participation unless included. Overall, we believe that the most efficient solution for a DSR tender would be to simply extend the Operating Margins requirements into a larger and/or more targeted volume requirement. This would likely mean including the supply side (such as gas storage), which is also omitted from Ofgem's preferred solution.

In addition, we note that Ofgem's proposals only allow for a single year product. We believe that allowing bidders to set duration is key and that a fixed, single year product is unlikely to be attractive.

Question 2: What are your views on having variable option fees in the tender? Do you have any concerns about the costs that these could impose irrespective of a GDE actually occurring? How should these be funded?

We consider that option fees are necessary, for the reasons outlined above. If the current

OM arrangements are extended, the natural place for the cost to be recovered would be through SO incentives and commodity charges, as it is currently. However, alternative cost recovery mechanisms should also be debated to ensure the actual cost of increased security of supply is appropriately borne by the beneficiaries.

Question 3: What are your views on the eligibility of gas-fired power stations? How should the interactions with the electricity market be managed?

Our view is that this tender should be open to the same participants as are eligible to participate in the current OM tender (i.e. including CCGTs), but it will also clearly need to include large industrial customers.

Question 4: Could participation of gas-fired power stations have a negative impact on the tender, or on the gas market as whole? If so, can you suggest any steps that could be taken, or an alternative mechanism that could be created, that would help mitigate these concerns?

If the purpose of the tender is to contract for as much genuinely useful and easily accessible demand reduction as possible (within agreed limits), then CCGTs clearly have an important role to play. However, given the potential for conflicting obligations or signals between gas and electricity markets (e.g. Capacity Mechanism penalties), CCGTs will need to carefully consider the increased risks which participating in a DSR tender may bring. It does not, therefore, follow that CCGTs will necessarily price other participants out of the market, since they may not be willing to accept the risk at all of contracting ahead of time in one market, over and above another. In developing this DSR tender, we urge Ofgem to carefully consider the interactions between gas and electricity markets.

An alternative approach to structuring the DSR tender would be to follow the current OM model and tender for different ‘categories’ of response, with associated limits on each type. This would ensure representation from the different types of demand and supply response; provided sufficient competition within each category exists (e.g. there isn’t one high bid taking all the volume).

Question 5: Do you have any views on what consumers whose bids were unsuccessful should be paid if they are firm-load shed?

It may be appropriate to provide a minimal level of recompense to cover the cost of preparing the bid. On the other hand, we see an equally compelling case for paying unsuccessful bidders nothing, as is the case under the current OM arrangements.

Question 6: What are your views on the response type the tender should contract for?

Potential bidders should be free to set their own bid structure, but clearly will need to meet SO-defined minimum standards, e.g. for deliverability, duration, volume, etc. It should also be recognised that potential bidders can offer different, useful services which are not mutually exclusive – i.e. partial as well as full interruption.

Question 7: What are your views on a minimum volume threshold? Do you have any ideas on how this could be set? Should there be a limit on the number or size of tranches that consumers can bid?

As above, following the current OM model would seem sensible.

Question 8: What is your preferred length of time and/or frequency with which NGG may exercise a DSR contract? Do you have a preferred minimum response time if a DSR contract were to include one?

As National Grid is managing the transmission system and this tender, we would welcome their proposals on minimum requirements, which can then be debated further with industry.

Question 9: Do you have any views on any other tender design issues?

We refer to two key points made in our previous response to Ofgem's gas SCR initial consultation, both of which remain valid and important design considerations:

- *An obligation on NGG to contract with customers could also include National Grid recording and maintaining customer contact details. This would also replicate some existing electricity processes for standing reserve.*

- *To avoid undermining the market's efforts to manage the situation, it would also be important to introduce a trigger mechanism to prevent NGG from exercising such contracts prematurely or for other, non-emergency reasons. One possible trigger could be a GBA (or a re-defined version of it – e.g. "GBA Demand"). An equivalent in electricity would be the existing "NISM" and "Demand Control" warning processes.*

CHAPTER: Four

Question 1: What are your views on the three straw men?

None of them are fully consistent with our preferred model, as outlined above.

Question 2: Do you think a price cap is necessary to limit shipper liabilities?

The potential for extreme (and potentially unjustifiable) liabilities would be removed if the tender did not link directly into cashout. Our understanding is that OM is capped by both budget and volume, which generally seems to result in efficient bids, where sufficient competition exists.

Question 3: Do you have any suggestions for how the volume cap in straw man 2 or 3 should be set?

This is for National Grid as SO to determine. However, the process for determining the required volume must be based on publicly available information and it should be possible for other parties to replicate the calculation, to ensure transparency and predictability.

Question 4: Do you think the volume cap in straw man 2 or 3 is sufficient to prevent inefficiently high DSR bids from being accepted?

Provided there is sufficient competition between bidders, we do not see why not. As with OM, however, it may be necessary to "disallow" certain bids if sufficient competition does not exist; a piece of analysis Ofgem already carries out for the OM process and which ultimately prevents "excessive" bids feeding into the process.

Question 5: Do you have any views on whether or not straw man 2 should be paid-as-bid?

Pay-as-bid is our preferred approach for this DSR tender.

Question 6: Do you have any ideas for how a fixed budget for straw man 3 could be set?

See existing OM model.

Question 7: Should any volume cap or fixed budget be known to the market ex ante?

In both cases, publishing this information in advance is only likely to be a problem where there is insufficient competition between parties to generate market-based prices.

Question 8: What do you think of the rationale for having fixed option fees in straw man 3? Why might they be necessary to ensure sufficient participation and competitive bidding?

As noted above, optionality does not come for free, and in our view an option fee is necessary to account for this. We foresee limited participation in the tender if parties are not allowed to set an option fee, since it will simply not be worth participants investing time and resources into developing competitive bids.

Question 9: How could the fixed option fees could be determined?

Participants should be free to structure their own bids in order to best reflect the costs incurred in providing a DSR service.

Question 10: Do you have an alternative design package that you think better meets the aims of the DSR tender than the three set out here?

Yes, see existing OM model, which could be extended and is well developed and widely understood.

I hope that you find this response useful in formulating the way for forward for the DSR tender process. 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,

Richard Fairholme
Trading Arrangements, E.ON UK