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

Tel: 02476 181421
richard.fairholme@eon-uk.com

Alena Fielding
Gas Transmission
Ofgem
9 Millbank
SW1P 3GE

March 27, 2015

Dear Alena

RE: Ofgem's Gas Transmission Charging Review: Part II - our assessment of potential impact

E.ON welcomes the opportunity to respond to Ofgem's Gas Transmission Charging Review (GTCR) proposals and its assessment of the potential impact. As you will be aware, we have participated extensively in Ofgem's GTCR process to date and we welcome the industry engagement that Ofgem has undertaken on this issue, prior to releasing its proposals.

Our central view remains that the current gas transmission charging arrangements are not fundamentally flawed and remain robust and fit for purpose. We are concerned that introducing the sweeping and commercially significant changes proposed here are highly likely to have major impacts in terms of redistributing costs between Shippers, particularly in the years immediately following the changes, which is unlikely to be in the best interests of consumers. In addition, we are unconvinced that these proposals would improve the efficiency of network planning and operation undertaken by National Grid Gas Transmission (NGGT) or improve either security of supply or cross-border trade. Overall, our assessment is that the costs of implementation far outweigh the small and uncertain benefits identified by Ofgem.

We are, nonetheless, pleased to see that Ofgem has recognised the value and importance of retaining some level of discount to capacity in the short-term; but in the absence of specific proposals as to what the level of discount should be we, we are unable to offer our full support at this time. We will, however, continue to engage in the industry debate to decide what the most appropriate level should be.

E.ON UK plc

Registered in
England and Wales
No 2366970

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

In terms of next steps for the GTCR project, we urge Ofgem to delay making any final decision until the Tariffs Network Code is finalised. We see no reason for Ofgem to take a quick decision following this consultation, particularly given the requirement in our view, for further analysis to better evidence the proposed benefits. In addition, we see a strong case for avoiding further market uncertainty by developing and introducing new charging arrangements in GB as a result of the GTCR, which may turn out to be incompatible with the final version of the Tariffs Network Code.

We offer the following comments in response to Ofgem's detailed questions.

CHAPTER 2: Explanation of our proposed changes to the charging regime
Question 1: What are your views on our proposed changes?

Discounts for Short-Term Capacity

We are pleased that Ofgem has recognised that "*the short-run marginal cost principle should continue to be recognised*"[1] and that discounts for short-term capacity should continue in some form.

Ofgem argues that reducing the level of discount would introduce more locational signals, which would provide benefits through more efficient use of the NTS by its users. However, we contend that it is the *level* of discount, not the introduction of a weak locational signal (achieved by reducing the discount on or near the day) which creates the opportunity for efficient use of the network, by allowing marginal sources of gas to flow.

In practice, many users simply will not have the option to divert gas flows in response to capacity-based locational signals on the day, particularly at Entry points, where, for example the flows are backed by an upstream supply contract for a specific gas field. In addition, the gas supply infrastructure for GB is now in place and cannot be relocated readily. In any case, even if switching entry points were to be possible, we doubt that the locational signal generated by these proposals would be strong enough to have a discernible impact on commercial decision making. Moreover, the addition of a "floating capacity charge", which is likely to be far greater than the (discounted) reserve price, would greatly erode potential locational signals. As a result, we believe these proposals are unlikely to materially alter use of the network and therefore it is difficult to see how more efficiency would be delivered.

[1] Ofgem, "Gas transmission charging review: Part II - our assessment of potential impact", page 19

We do welcome Ofgem's intention to allow the industry to discuss and debate as to what the level of discounts should be; however, we are concerned that any kind of consensus will be extremely challenging to achieve, given the wide range of legitimate business models operated by the 100+ Shippers active in the GB wholesale gas market. It is inevitable and perfectly understandable that Shippers will want to set the discount to the level which best suits their business model. With this in mind, we recommend that Ofgem develops its thinking on this matter and considers a further consultation with specific proposals, including the option of retaining the *status quo*. In our view, this would better guide industry debate.

Introduction of Floating Entry Capacity Charges

We strongly oppose Ofgem's proposals to introduce floating capacity charges, which in short, we consider to be a solution looking for a problem. We believe that the concept, as described by Ofgem, is also in need of significant development before it could be considered a viable alternative to the current arrangements.

Ofgem's proposals are unclear about the impact floating charges would have both on TO/SO charges and the arrangements overall. For instance, is it envisaged that the TO commodity charge is replaced in its entirety? Would SO commodity charges continue (and if so, how can this be objectively justified)? Furthermore, any change to the overall TO/SO arrangements would be a fundamental shift in regulatory policy, going beyond the charging methodology and into NGGT's price control settlement and presumably would also have very significant ramifications for both Capacity Neutrality and SO Incentive arrangements. Ofgem also makes reference to the introduction of a potential new commodity charge to cover 'other' flow-related costs, but does not state what costs this charge is expected to cover.

We also request clarification as to *when* the floating charge would be applied to short-term capacity, assuming some level of discount continues to apply. For instance, is it applied before or after the discount? The implications are significant because clearly the outturn price, if it is applied after the discount to the reserve price, is significantly higher than if it is applied before.

Our fundamental concern is that we fail to see how these proposals achieve anything other than transferring the current commodity charge into a capacity charge: effectively 'commoditising' NTS capacity charges. Ofgem argues that these proposals would better recover "*historical network costs*", but does not clarify what these costs are, or the quantity that are not currently being recovered. As a result, we have no feel for how large the floating charge might be, but our expectation is that it would not be dissimilar from the current TO commodity charge level.

In addition, we do not support the implication by Ofgem that the current gas transmission charging arrangements are 'unfair' and see no compelling evidence presented here that any particular ratio between TO entry capacity and commodity charges is more or less equitable (or efficient) than what we have in place at present.

Managing Daily Volume Risk

It is important for us to reiterate the point we have set out repeatedly on the issue of short term charging, which has been well discussed over the past 10 years: Many Shippers, particularly those managing a large customer supply portfolio and/or gas fired generation fleet are not waiting until the day for the sole reason of purchasing capacity for (near) zero cost. Rather, they are doing so to efficiently and cost-effectively manage volume risk associated with daily changes in weather, customer churn and electricity demand. For such Shippers, it is impossible even at the day-ahead stage to know precisely what their capacity requirements will be. The current arrangements provide Shippers with a means to profile their capacity requirements close to the point of delivery of gas into the system without being penalised financially for doing so. If the costs of managing this volume risk increase (which is the overall effect we expect Ofgem's proposals to have for such Shippers), the cost of supplying gas to end consumers will increase. We do not consider that this would be in the best interests of consumers. We expect that increased costs would materialise in two key ways, if Ofgem's proposals were to be implemented:

(i) An increase to the cost of 'optionality'.

The current arrangements (including a 100% on the day discount) provide Shippers with a valued option to flow; i.e. an ability to react to market conditions on a day, which promotes liquidity and market responsiveness. If capacity can only be affordably purchased (in volume terms) close to actual gas flows (which, in the short term are unlikely to be known with complete accuracy), we foresee Shippers reducing their aggregate bookings. The impact will be to reduce opportunities (compared to now) to flow gas and/or increase the cost of responding to market signals. We believe such costs are far more likely to filter through to consumer bills than the extremely remote chance of NGGT making poor (or inefficient) investment decisions based solely on short-term capacity bookings, as Ofgem contends.

(ii) An increase to the cost of obtaining capacity in the short term if flows are expected to be greater than forecast

To manage the risk of having inadequate capacity on the day and not being able to flow gas when required, it is reasonable to assume that Shippers may "over-buy"

capacity in the long-term as a means of insurance. Whilst this may generate more capacity-based revenue, and thereby help address NGGT's allowed revenue under-recovery situation, it also risks closing-out new entrants. This capacity purchasing strategy would also likely increase the cost of accessing the network for most Shippers, when compared to the current arrangements.

Impact on Gas Storage

We welcome Ofgem's assessment that the benefits of gas storage should be reflected in the transmission charges they pay. This is consistent with the most recent draft of the Tariffs Network Code and is also a well-established principle in GB gas transmission charging. We support Ofgem's proposals that existing storage arrangements are preserved, namely that:

i. Storage users would not pay the 'floating' element of capacity charges; and
ii. the existing arrangements, where storage users don't pay commodity charges is preserved.

Although Ofgem appears to want to preserve the 'spirit' of the current arrangements, we are concerned about what this may mean in practice if the GTCR proposals are implemented as currently drafted. For example, the proposal to reduce the discount for gas storage short term capacity products could be considered to be contrary to Ofgem's stated principle of preserving the existing arrangements. In addition, as Ofgem will be aware, the Tariffs Code may result in the need for new charging arrangements for storage. For example, one possible outcome is that network access charges for storage could reduced to zero and that only the additional costs of connection (net of any system benefits) could apply. Ofgem will clearly need to ensure that the GTCR proposals properly reflect the new arrangements for storage resulting from the Tariffs Code. This also further strengthens the case for Ofgem delaying any decision on the GTCR until the Tariffs Network Code is finalised.

Ofgem states that "*storage users would not pay the 'floating' element of capacity charges, so this change would not have an impact on them*"[2]. We find it impossible to agree with this conclusion without knowing how significant the variable, flow related charge (that Ofgem suggests that gas storage would pay instead), will be and what it will comprise. We believe that further detail and analysis is required to ensure that gas storage is not materially disadvantaged by these proposals.

[2] Ofgem, "Gas transmission charging review: Part II - our assessment of potential impact", page 7

It is important that Ofgem recognises the challenging economic conditions that gas storage is facing and any additional costs, or risk of increased costs or uncertainty over future costs will only add to growing concerns about the continued viability of gas storage assets.

Impact on Shorthaul Tariff

We have significant concerns about the impact of Ofgem's proposals on the future viability of the shorthaul tariff. As we noted in our response[3] to the NTS GCD 08 charging proposal:

"…it could be argued that a predominantly capacity-based charging structure would unfairly penalise those sites on the short-haul tariff, which have taken efficient decisions to locate close to large entry terminals, thereby reducing the potential size of the network and ultimately saving money for consumers. Due to the benefits they provide, these sites justifiably do not pay TO Commodity charges and therefore remain unaffected by the variable charge levels seen recently. Ultimately, if the regime were to become predominantly capacity-based, the short-haul tariff would become increasingly less attractive, potentially resulting in more inefficient bypass of the NTS."

If Ofgem's proposals were to be implemented, our assumption is that the shorthaul tariff calculation will need to be revised to substitute the commodity charge for the floating capacity charge element, but this is far from clear in Ofgem's proposals. For the reasons set out directly above, it is important that users do not lose the important economic and efficiency benefits that shorthaul provides and the impact of Ofgem's proposals on shorthaul needs to be considered in more detail.

Question 2: Do you agree with our rationale for rejecting the alternatives? If not, please explain why.

No, we believe that the alternatives Ofgem has rejected are still worthy of further consideration and should not be discounted at this stage.

(i) Alternative Proposal to "*adjust the payable price on long-term capacity products to take account of inflation*"

We are somewhat surprised and disappointed to see that this option is not being pursued. One of the main concerns identified when this proposal was first raised was the practicality of applying the inflation adjustment retrospectively – i.e. to capacity already purchased in long-

[3] http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=9438

term auctions. We recognise that this would be very challenging from a legal perspective. However, we do see benefits from linking Entry capacity prices to inflation in future long-term auctions. Whilst we accept that this would not deliver immediate benefits, we believe it would over time help minimise the gap between revenue generated from capacity bookings and NGGT's maximum allowed revenue. It would also ensure Entry is more consistent with the current Exit capacity arrangements.

In addition, we note that a material influence on a growing TO Commodity charge identified previously by both Ofgem and NGGT, is that a significant amount of historical long-term capacity bookings were made based on prices generated by the old "Falcon" charging model (i.e. pre-Transportation Model). It is our understanding that capacity prices were set at a much lower level compared to today's prices and consequently for the duration of these existing capacity bookings, there will continue to be an adverse impact on revenue recovery. We are disappointed that the impact of this has not been quantified and we urge Ofgem to look into this issue further and to clarify its magnitude.

(ii) Alternative Proposal: "*TAR NC implementation at IPs only"*

As set out in our initial response to the GTCR, our view remains that Ofgem should make only the minimum changes required at Interconnectors for GB to comply with the European Network Codes and this includes the Tariffs Code. We believe that this review would have been better aimed at achieving this objective and then, once the changes are in place, carefully consider based on experience, whether these new arrangements could be usefully applied to other points on the system. The extrapolation of Tariffs Network Code concepts to all Entry points is, in our view, disproportionate to the perceived problems and the case for change is weak.

CHAPTER 3: Impact assessment of these proposals
Question 1: Do you think we have identified the relevant quantitative impacts?
And
Question 2: Do you think we have modelled the impacts appropriately?

Whilst we welcome Ofgem's efforts to model some of the potential impacts of its proposed policy position, we are concerned by Ofgem's over-reliance on the CEPA/TPA model developed during the GTCR. Whilst the model can provide useful insights in to the possible effects of a certain policy change, it cannot hope to replicate the commercial decision making process of individual Shippers and, as the Gas Forum report/critique identified, relies on too many assumptions to provide incontrovertible evidence of the benefits or dis-benefits of a specific policy change.

Our most fundamental concern in relation to this impact assessment is Ofgem's finding that "t*he overall effect of introducing fully-floating capacity charges would be to reduce the average entry charge, because it would spread the historical costs more widely than at present*"[4]. As far as we understand, the key assumption used here by Ofgem is that capacity bookings will stay the same, regardless of any future policy change. We do not consider this to be a credible assumption. All Shippers are incentivised to minimise their costs and these proposals will have the effect of making it less appealing to hold on to capacity against which a Shipper has no intention to flow gas. This point is clearly acknowledged in Ofgem's proposals. If individual users find that based on their current capacity holdings or strategy, their costs would increase, it would be reasonable and rational to expect these parties to look at reducing their bookings before (and after) the proposed change is implemented. As a result, it does not follow that costs could be spread more widely, as the capacity bookings against which the floating capacity charge would be levied, would be less than at present. As a result, it is entirely possible that the introduction of a floating element may actually result in higher, not lower, charges for Shippers compared to the current arrangements.

Overall, our assessment of Ofgem's proposals is that they will impose unnecessary costs on industry participants and deliver highly uncertain benefits.

Question 3: Do you think we have identified the relevant qualitative impacts?

Ofgem states that: "*the benefits for consumers that we expect from our changes would be dynamic: potentially avoiding future bill increases by promoting the efficiency of NGGT's network operation; and ensuring that GB security of supply, including cross-border trade in gas, is not hindered by network charges.*"[5] We disagree with these findings for the following reasons:

Efficiency of Network Operation

We do not agree with Ofgem's assertion that NGGT uses short-term capacity bookings to plan the network or make any fundamental operational decisions on a day-to-day basis. Ofgem suggests that its proposals would help deliver more accurate capacity bookings by users, which in turn would deliver better information to NGGT about intended use of its network, thereby allowing more efficient decisions to be made by the Grid operator.

[4] Ofgem, "Gas transmission charging review: Part II - our assessment of potential impact", page 7
[5] Ofgem, "Gas transmission charging review: Part II - our assessment of potential impact", page 7

It is our understanding that capacity bookings data is only useful to NGGT for the purposes of planning the network if it is provided weeks – not days – in advance of the gas flow day. Moreover, it is Shipper nominations which are, and will continue to be, the fundamental driver for short-term network planning and operation. Furthermore, even if these proposals did generate more 'useful' information in relation to Shipper intentions to flow gas, we would question whether it is even important in an unconstrained network.

Above all, it is critical that Ofgem does not focus unduly on extracting every efficiency possible in terms of network operation, to the detriment of those wanting to use the NTS in a flexible and efficient manner. In our view, the benefits of a flexible gas network are far more significant in terms of improving consumer welfare. An efficient market is one which allows for all users, including customers, generators and storage providers (who do not know when their customers want to take from, or put gas onto the system) to respond effectively to the market signals. In our view, the introduction of additional short term costs, which will serve to inhibit market responsiveness, can only introduce inefficiencies into the market.

Security of Supply

Whilst reducing transmission charges in absolute terms might be expected to bring more gas to the GB market, we struggle to see how this would be achieved under these proposals. Given that the arrangements are intended to apply at all Entry terminals on the NTS, that NGGT's allowed revenue will not decrease and that the number of Shippers between which the charges are shared will stay broadly the same, the only conceivable affect these charges will have is to re-distribute the same costs in a different way. As most Shippers have a broad range of supply / import options available to them when bringing gas to GB (Interconnector, LNG, Norwegian gas, gas in store, etc.) we simply do not see how a redistribution of charges against these supply sources could materially increase security of supply.

Furthermore, we believe that these proposals could risk actually *worsening* security of supply, by increasing the cost of obtaining a mix of both long and short-term capacity, which could serve to reduce optionality and increase the transactional cost of bringing marginal sources of gas to GB when it is most needed.

Cross-Border Flows

Ofgem argues that "*the existing [charging] arrangements…affect cross-border trade in gas*… [with]…*potential adverse implications for GB security of supply, and GB consumers"*.

Whilst we acknowledge that high TO/SO commodity charges can, in some cases, influence cross-border trade, we do not consider these to be a major influence; particularly given the

effect of the shorthaul tariff. In our view, the more significant barriers to cross-border flows exist because of fundamental differences in market structure and capacity availability at borders. In our view, the biggest change required to materially improve cross-border trade is the full implementation of the EU Network Codes across Europe.

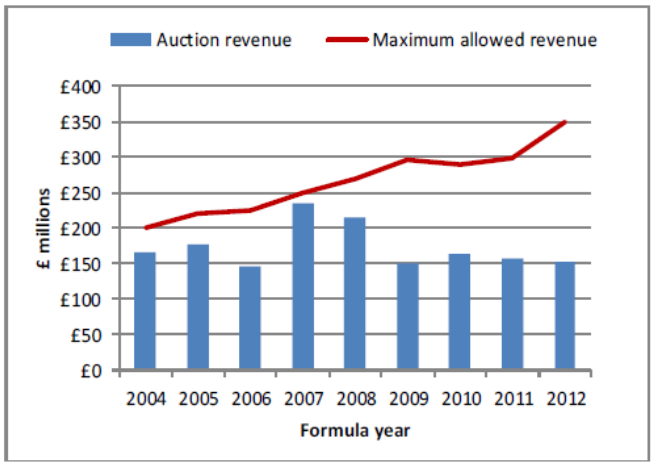
We also disagree that the current interconnector charging arrangements could have adverse implications for GB security of supply. The technical capacity of GB interconnectors is not changed by these proposals and it is our expectation that market price signals would ensure gas is delivered to the highest priced market at times of severe system constraints.

Question 4: Do you have any further evidence of the potential impacts of our proposed changes not covered by our analysis?

Impact of NGGT's RIIO price control settlement

Although Ofgem has explicitly excluded it from the scope of the GTCR, we do not believe that NGGT's price control should be immune from consideration when looking at the main causes of revenue under-recovery. As Ofgem illustrates in its document (page 11 and included for ease of reference, below), whilst the revenue generated from capacity auctions has stayed broadly the same between 2004 and 2012, the Maximum Allowed Revenue for NGGT has nearly doubled.

Figure 3: Capacity auction revenue and Maximum Allowed Revenue



Source: NGGT data

It is well understood that use of the NTS is not increasing, which is consistent with a forecast year-on-year reduction in gas demand for the foreseeable future. Meanwhile, allowed revenue, as set under the RIIO price control, continues to increase, inevitably creating a funding gap, which is presently addressed by the TO Commodity charge. Assuming capacity auction revenue continues to stay broadly the same (or even reduces) and allowed revenue continues to rise for the remainder of the RIIO price control, we do not see how Ofgem's proposals will fully address the perceived problem of an increasing 'top up' charge for users. Rather, these proposals will simply transfer the current under-recovery risk from the TO Commodity charge into the proposed 'floating' charge; which logically will continue to increase year on year, throughout the remainder of the price control.

Notwithstanding Ofgem's previously stated position that the RIIO price control is out of scope of the GTCR, we would welcome further analysis from Ofgem to clearly articulate the reason behind the increase in allowed revenue and how its GTCR proposals would be expected to better allocate these costs proportionally back against the underlying causes, when compared to the current arrangements.

Inconsistency with the Tariffs Network Code

As Ofgem will be aware, the Tariffs Code is still being refined and it is too early to pre-empt the outcome of the current development process. Moreover, it is our view that Ofgem's GTCR proposals bear more resemblance to earlier and now succeeded versions of the Tariffs Network Code and therefore risk being incompatible with the final version. Furthermore, we are aware of efforts to "de-scope" the Tariffs Network Code, which could have significant impacts for the level of minimum changes required to the GB charging regime, if successful.

Given the ongoing development process and an implementation date of October 2017, we urge Ofgem to delay making any final decision on the GTCR until the final version of the Tariffs Network Code is completed; primarily to ensure industry time and money is not wasted in moving towards one set of arrangements, only to have to unpick them shortly afterwards. For example, the most recent draft of the Tariffs Code makes provision in relation to short-term capacity, that the discount is applied *after* the application of the floating capacity charge element. This potentially conflicts with Ofgem's proposals, which could be interpreted as applying the discount *before* the floating element is added. As noted in our response, above, the impact of this is significant.

CHAPTER 4: Assessment against our objectives

Question 1: Do you agree with our assessment of how our changes would align with our principal objective and statutory duties?
And
Question 2: Can you provide any evidence that supports or would contradict our assessment against one or more of them?
And
Question 3: Do you think there are other duties or aims that we should assess these changes against? If so, what are your views on how our changes might affect them?

Our assessment, in relation to Ofgem's principal objective under the Gas Act 1986 "*to protect the interests of existing and future gas consumers*", is that these proposals risk increasing the costs of supplying wholesale gas in the GB market. For the reasons noted above, we do not believe these proposals will improve security of supply and we consider that the inevitable redistribution of the same costs (i.e. allowed revenue) amongst Shippers, which is a certain outcome of any charging review, is unlikely to promote competition. As already discussed, we also disagree strongly that these proposals will lead to more efficient NGGT operational and investment decisions and would welcome NGGT's confirmation that our understanding on this matter is correct.

We disagree with Ofgem's assessment that "*the move to fully-floating capacity charges would bring GB closer to the prevailing network charging approach in the rest of the EU*"[6]. Adjacent markets to GB; namely Belgium and Netherlands currently employ a transmission charging system based upon completely fixed network access charges. There is no equivalent to the TO/SO commodity charge; but equally there is also no equivalent to Ofgem's proposed "floating" charge, either. Moreover, there is no concept of discounted on the day capacity, so it cannot follow that Ofgem's proposed arrangements are moving GB's closer to those of Continental Europe. In addition, it is our understanding that "fully floating" capacity charges are unlikely to be a mandatory feature of the Tariffs Network Code and therefore unlikely to be a mandatory minimum change to GB's charging arrangements, even at interconnectors.

Implementation

Whilst it is useful for Ofgem to set out its options for implementation, we have strong reservations about Ofgem placing specific and detailed obligations on NGGT to raise Modification Proposals, which may turn out to be impossible or incredibly complex, time

[6] Ofgem, "Gas transmission charging review: Part II - our assessment of potential impact", page 53

consuming and costly to implement. We believe that time must be taken first to digest the responses to this consultation and gauge the level of industry support for the proposals before considering implementation options (if appropriate). As outlined above, it is our strong belief that Ofgem should delay making any decision on the GTCR until the Tariffs Network Code is finalised, to avoid the potential for future inconsistencies and minimise further industry disruption. If Ofgem ultimately decides to pursue implementation of these (or any other) charging reforms, in our view, *at least* 12 months would be a reasonable notice period to allow Shippers sufficient time to adjust to the new arrangements. For clarity, we do not support implementation of any major changes to the charging arrangements earlier than 1 October 2017.

If you have any further questions or queries in relation to our response, please do not hesitate to contact me on 02476 181421.

Yours sincerely,

Richard Fairholme
Upstream Market Development
E.ON