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Sonia Brown
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Dear Sonia

Overview

E.ON UK remains unconvinced that that this is the right time or route to be discussing fundamental reform of the interruptions regime. The reasons for change outlined in the RIA do not refer to those changes that are expedient and necessary to facilitate a sale and create the potential for double counting any perceived benefits of a DN sale with the assumed benefits of fundamental reform of the interruptions regime.

In previous discussions with regards to the interruptions regime, Ofgem's main driver for change and the introduction of a Universal Firm Capacity product was the issue of cross-subsidies between different types of customers. We are surprised, therefore, to see no mention of this in the RIA.

We are concerned with the apparent confusion of the value of interruption. It is our understanding that the value of interruption refers to the cost of interrupting customers versus the cost of investing in the system. Over stating the importance of creating value for interruption for customers may have significant and detrimental repercussions for security of supply.

When considering the allocation of exit capacity, we are not convinced that any supposed shortcomings with the current regime are significant enough to justify fundamental reform.

Of the various options put forward for interruption, E.ON favour option 1, using the base case to go forward with the DN sales. This option prevents any mis-allocation of perceived benefits of reforming the exit regime with the benefits of a DN sale. Where the option may score less on areas such as undue discrimination, for example cross-subsidies between interruptible

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customers, we believe this is far outweighed by the disproportional costs of fundamental reform of the regime.

Given this standpoint, we accept that some customers may desire more flexible options for contracting for interruption and that option 2A* addresses this at least cost to customers and Network Operators. We do not believe that the other options put forward benefit the industry to the extent suggested in the RIA and the cost and complexity associated with the other options outweighs any potential benefits.

We are also of the view that transitional arrangements must be put in place to avoid current interruptible customers, who are obliged to go firm, being hit by an unmanageable cost.

In addition, we have concerns relating to the draft European Union Gas Regulation. We do not feel that Ofgem has given the draft regulation due consideration. We understand that the proposed regulation is still in draft form, however, we are conscious that closer analysis is required of specific wording to avoid the situation where the industry expends time and resources on new arrangements, which are later found to compromise European legislation forcing the industry to return to square one.

Options for interruption

Option 1 Status quo

This is E.ON's preferred option. We accept Ofgem's argument that, to some extent, different interruptible customers receive the same discounts yet face discrepancies in the number of days for which they are interrupted. When interrupted for constraint reasons, we recognize this as an issue, however, we also recognise that it is impossible to eradicate all cross subsidisation within the interruptions regime but it is unclear whether these are significant enough to rationalise fundamental reform of the interruptions regime.

Moreover, the issue that some customers enjoy the discounts associated with being interruptible and yet are never interrupted, does not mean that Transco have over-contracted. In a severe winter, Transco have previously stated in workstreams that they would need to call on all interruptible customers for interruption, not necessarily for constraint purposes but also for supply/demand management. It is, therefore, a commercial decision of the customer to choose whether or not to accept this risk.

Recent mild winters have reduced the need for interruption but this cannot be relied upon to continue.

Option 2 Unconstrained allocation of the firm capacity product

As stated in our overview, we are not convinced that any supposed shortcomings with the current regime for the allocation of exit capacity are significant enough to justify fundamental reform.

Efficient investment signals already exist as the current NTS exit arrangements provide for the 'automatic' booking of exit capacity for LDZs based on aggregate shipper supply point offtake quantities (SOQs) for each

shipper in an LDZ. This arrangement was introduced under a network code modification in 1998 to relieve shippers from the onerous task of separately booking exit capacity, a process that invariably involved greater risk from potential overrun penalties than the benefits that could ever be obtained from the optimisation of exit capacity bookings.

We would prefer for the industry to continue to rely on the 'tried and tested' planning process between the NTS and DNs, rather than seek to distort the current 'automatic' capacity booking mechanism for shippers.

Option 2A Pure matrix

In addressing a number of customer concerns, this option goes someway to giving more flexibility to customers on a non-discriminatory basis. However, we feel that the matrices under this option are over complex and as a result, might deter customers from entering into interruptible contracts, presenting a risk to security of supply.

There is a danger under all of the options put forward that customers might be deterred from entering into interruptible contracts as they would not receive the same benefits, which they receive now with increased likelihood of being interrupted and would find it inefficient and uneconomic to enter into contracts for fewer discounts than they currently receive.

2A* Simplified Pure matrix

It is worth reiterating that out of all of the options, we believe the base case is the most appropriate way forward to ensure that there are no cross benefits and/or costs counted from a DN sale and fundamental reform of the interruptions regime. However, we accept that the current arrangements lack flexibility in the interruptible product offered to the customer. If Ofgem consider it prudent to consider changes for this winter to tackle such concerns, then we believe that this is the most appropriate way of providing a least cost solution. Having said this, this is not the option put forward by shippers. The shipper version of the matrix did not assume universal firm capacity and therefore has the added benefit of less cost and reduced complexity.

We do not consider there to be any significant issues with the way in which exit capacity is currently booked and experience from the entry capacity auctions shows us that shippers are generally unwilling to book capacity far in advance and so the Network Operator would not receive the investment signals that Ofgem have assumed. It is worth, therefore exploring in more detail option 2A* where Universal Firm Capacity is not assumed.

Option 2B Tenders for interruption

On the basis of the disproportionate cost and complexity alone, we would strongly oppose this option. For many customers, energy is not their key business and so they would be unwilling to enter into any such arrangements. A risk to security of supply would result as there could be an unwillingness to enter into enough contracts to cover a 1-in-20.

Option 2C Tenders plus matrix

Combining the cost and complexities associated with the matrix and tenders approach would serve only to increase those costs and complexities to an unmanageable degree, far outweighing any potential benefits.

Option 3 Constrained allocation of the firm capacity product

E.ON is strongly opposed to this option. Constrained allocation of a firm capacity product would have significant detrimental affects on transportation charges, bringing unpredictability and lack of transparency to the exit regime.

Allocating firm exit capacity under a constrained approach would distort investment signals as shippers would more likely be risk averse and over contract for capacity, resulting in a gold plated system where the Network Operator is lead to over invest in the system. We do not believe that UIOLI provisions will fully address this. There is also associated risk to security of supply as it is unclear which entities are driving investment in NTS exit capacity or whether this conflicts with the 1 in 20 obligation placed on transporters. Furthermore, the complexity of such arrangements would require more regulatory management and oversight.

Security of supply would be severely compromised as shippers would have reduced certainty in their ability to secure supply to their customers.

For customers whose primary business is not energy, the option would also result in a reluctance to enter into complex and costly processes for purchasing capacity, potentially inhibiting participation in interruption arrangements altogether.

We do not agree that this option would reduce the potential for stranded assets for the same reasons we have argued earlier that shippers will naturally be risk averse and therefore book more capacity than required, distorting the investment signals to the Network Operator. Furthermore, the majority of capacity booking would be shorter term as shippers and customers cannot know what they will require with any accuracy in the longer term.

Over-reliance on a regime, which seems to focus more on interruptions rather than investment on the system, could reduce longer term security of supply as a failure to interrupt becomes more common place.

We would also like to draw attention to the HSE's response to Ofgem's RIA on Offtake Arrangements, where the HSE states the inherent risks to security of supply under a shipper led process for the booking of exit capacity.

We might also learn from the European market where tendering for exit capacity has lead to reports of uncompetitive behaviour, risk to security of supply and high prices.

Transitional arrangements

Transitional arrangements are needed to ensure current interruptible customers are not unfairly hit with unmanageable costs if forced to go firm under the proposed changes to the interruptible arrangements.

Assessments of costs and benefits of interruption options

Please see Appendix one for an E.ON UK assessment of the costs and benefits associated with the different options detailed in the RIA. It is our view that, compared to the base case, Option 2A* achieves the highest Net Present Value. We accept that there are some benefits to be gained through offering different services for interruption, nevertheless, the disproportional cost of many of the proposed options far outweighs any of the benefits.

Conclusion

We accept that certain incremental changes to the interruptions and to the exit regime are necessary to facilitate a DN sale and we should be more than happy to discuss the various options available to achieve this. Of particular concern is the substantial cost attached to fundamental reform of the regime, consequently increasing the risk to shippers, which would be mitigated through an increase in charges to customers.

The proposed sale of a number of gas distribution networks (DNs) by National Grid Transco may yield efficiencies both though new management of the divested businesses and comparative competition between the newly independent businesses and Transco's retained distribution networks (RDNs). It is important to ensure that these benefits remain clear and are not clouded by the introduction of changes, which do not facilitate a sale.

I hope you have found these comments useful. Please do not hesitate to contact me if you wish to discuss any of my points made.

Yours sincerely

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