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Dear Andrew,

**RE: Informal Consultation on Entry Capacity Substitution**

This response by E.ON UK is on behalf of all E.ON group companies operating in the UK which hold a UNC Shipper licence.

Having been involved in the development of the concept of entry capacity substitution since the first industry meetings on the issue, we are well aware of the significant amount of industry time and effort devoted to the implementation of this National Grid licence obligation. We believe there are valuable governance lessons to be learnt by all parties in how to tackle such a market rule change in future. In particular, we would have liked to have seen:

- Such significant changes not being foisted upon the industry by rigid licence conditions without obvious consideration of the detailed implications for Shippers until later in the process.
- National Grid being more flexible earlier on in listening to alternative approaches to substitution, rather than rigidly sticking to their first methodology statement.
- Ofgem giving their detailed views at an earlier stage – i.e. suggesting consideration be given to an “Option” approach at the start, rather than towards the end of the process.

Notwithstanding our concerns about the process, E.ON UK has remained broadly supportive of the principle of capacity substitution, provided it can be demonstrated that the process offers genuine long-term system benefits rather than short-term fixes. However, our concern throughout the development process has been that the reality of implementing substitution presents so many difficulties and potential unintended consequences that it may struggle to deliver any tangible benefits – particularly for consumers.

Whilst it is not unreasonable to want to make better use of existing NTS assets, the risk under any of the three potential solutions for substitution is the loss, on a permanent basis, of sufficient flexibility in the system to permit the required diversity of gas supplies to come to the UK. It could be argued that the case for change is not particularly compelling and it is disappointing from a regulatory point of view, that a fourth option of “do nothing” is not at least being considered as part of this proposal. However, considering the pros/cons of the *status quo* may be something more suitable for Ofgem when conducting a Regulatory Impact Assessment on the final proposal.

Overall, we believe that this methodology statement represents an improvement over the previous version submitted to and rejected by Ofgem; primarily because it acknowledges to a greater extent the needs of National Grid’s customers – i.e. Shippers. For clarity, we view the “Two Stage Auction” to be the ‘least worst’ approach. We are not supportive of either the “Mechanical” or “Option” approaches. The reasoning behind our preference is set out below.

## Questions for Consultation

### Paragraph 28

***a. Are there any other factors that National Grid should include in the Base Methodology?***

***b. Are there any aspects of the Base Methodology that should be excluded or amended?***

We note that the Base Methodology refers to the licence condition of “no material increase in costs”. The issue of what this means in practice for National Grid NTS was thoroughly debated as part of the capacity ‘trade and transfer’ implementation process. It was noted by Shippers that moving capacity around on the system has the potential to both increase *and* decrease the risks facing National Grid.

For instance:

Scenario 1: NG substitutes capacity from ASEP A to ASEP B = material increase in risk.

Scenario 2: NG substitutes capacity from ASEP C to ASEP D = material reduction in risk.

In this example, the net effect if both scenarios are realised is no material increase in risk. However, if the licence wording is applied strictly, there would be no capacity substitution in scenario 1 - only in scenario 2. As a result, there would actually be a net material *decrease* in risk.

In reality, it may be possible for National Grid to net off the two scenarios and accept some increase in risk in return for a reduction in risk elsewhere on the network. However, as with the trade and transfer process, there is little detail on what “no material increase in risk” really means in practice, and the discretion as to whether to substitute rests entirely with National Grid and their ‘black box’ network risk analysis. How strictly this licence wording is interpreted by National Grid will directly affect how much capacity is substituted.

#### **Paragraph 52**

##### ***c. Should the substitution methodology use an exchange rate cap to limit the impact of substitution on donor ASEPs?***

We would favour an exchange rate cap of as close to 1:1 as possible to prevent the permanent “destruction” of entry capacity through substitution. Although the trade and transfer auctions do not always make use of a 1:1 exchange rate, any loss of capacity is temporary and then reverts (i.e. is not permanent), which is the key distinction to be made between the two processes.

We note with disappointment that exchange rates are not published in advance. Whilst we recognise National Grid’s claim that this would limit substitution opportunities, knowing exchange rates in advance is likely to lead to much more efficient decisions being made by Shippers participating in the QSEC auctions.

##### ***d. Would the intended benefits of an exchange rate cap be better achieved through implementation of any of the options (Mechanical Approach, Option Approach or Two-Stage Auction) discussed in Section 6?***

***If an exchange rate cap is used:***

***e. At what level should the exchange rate cap be set? Respondents may consider that a different value is appropriate depending upon other factors of the methodology, e.g. whether any of the options discussed in Section 6 is implemented.***

In the absence of detailed analysis by National Grid to demonstrate, for a range of scenarios, the outcomes under each option and then the outcomes after applying exchange rates, we are unable to offer a view on this point. It is clear, however, that this is something Ofgem must consider as a part of its own assessment of National Grid's proposal(s).

***f. Notwithstanding that National Grid is obliged to review the substitution methodology on an annual basis, should the exchange rate cap be set at a low level in the expectation of increasing in future years?***

This would seem to be a prudent approach to begin with and not necessarily dismissed on an enduring basis, either. Such an approach would seem to fit with the UK Better Regulation Commission's "Five Principles of Good Regulation", whose advice of "think small first" is particularly apt given the permanent ramifications of substitution.

***Paragraph 59***

***g. Do respondents consider that an economic test is appropriate or necessary for the substitution methodology?***

***h. Would an economic test add unnecessary complexity to the process?***

***i. What benefits, if any, would an economic test provide?***

***If an economic test was introduced***

***j. What parameters should be used for the donor and recipient ASEP values?***

***k. Are there any alternative tests that should be considered?***

Although it would add some complexity to the Base Methodology, we believe that an economic test would be useful to minimise uneconomic outcomes. As noted by National Grid at Paragraph 48 of the consultation document, an exchange rate cap *alone* does not reflect the difference in value of capacity between donor and recipient ASEPs even where a 1:1 cap exists. We believe the purpose of an economic test should be to seek to avoid a Shipper being able to buy entry capacity at a recipient ASEP at less than the effective value at the donor ASEP. For example, a Shipper may not be prepared to pay the 0.5p/th reserve price at ASEP A, and it then gets transferred to ASEP B on a 5:1 exchange rate and sold at 0.5p/th. The effective price at ASEP A is then 0.1p/th, which maybe a Shipper would have been prepared to pay.

**Paragraph 80**

***l. Do respondents prefer the Mechanical Approach over the Option Approach and/or Two- Stage Auction? Why / why not?***

***m. What features of the Mechanical Approach do respondents like / dislike; e.g. simplicity, lack of User commitment?***

As noted above, our preference is for the **Two Stage Auction** Approach. Although complicated, its greatest advantage compared to the alternative approaches is that it gives Shippers a genuine opportunity to minimise any perceived adverse outcomes. On the downside, in some circumstances it may force Shippers to commit earlier in order to avoid capacity being substituted away, but in effect that is the economically efficient outcome that Shippers will have to accept if this approach is implemented.

The **Mechanical** approach, on the other hand, leaves Shippers powerless to influence any future substitutions, with all the discretion in National Grid's hands. In addition, given that the methodology for calculating which ASEPs are "protected" is based on Shipper-submitted data, there is potential for parties to manipulate data, which could distort the whole TBE reporting process. We are concerned that too much emphasis will be placed on the accuracy of the TBE data, which fundamentally is an estimate for an unknown future based on National Grid's interpretation of available data – and, therefore, not necessarily the most accurate of possible measures.

Although the **Option** approach gives Shippers an opportunity to influence the outcomes of substitution, it also involves significant up-front costs for the Shippers that take out an Option, but actually confers very few rights. This is because the user paying the Option fee is in no advantageous position compared to other users at the ASEP when it then comes to actually booking the capacity. There is also the potential that Shippers take out Options which are subsequently found to be unnecessary, but cannot be refunded. By way of contrast, for the Two Stage Auction approach, user commitment is required if substitution is likely, whereas for the option you would need to anticipate (and probably speculate) before the auction whether there was a *chance* capacity could be substituted away and pay the option fee. Compared to the Two Stage Auction, this feels like a sub-optimal solution for both Shippers and National Grid in terms of economic and efficient outcomes.

***n. What criteria should National Grid use to determine the level of protected capacity at each category of ASEP (e.g. beach terminal, storage etc)?***

***o. Is the use of deliverability, or similar, such that substitution is limited to major beach terminals acceptable? Would this be undue discrimination?***

***p. Are there alternative sources of data to the TBE, deliverability that would be reliable, transparent and readily available?***

We believe that the risk of misreporting should place a serious question mark against the use of TBE data. In previous consultation responses on substitution, we have favoured the use of maximum historical flows as a means to “protect” appropriate levels of capacity and believe this is still a valid approach.

***q. How could a soft-landing be applied to the Mechanical Approach?***

Applying a strict 1:1 exchange rate could be a means to achieve this. Although this could result in very little substitution, this does not necessarily mean that it is not the most economically efficient outcome at that point in time.

***Paragraph 94***

***r. Do respondents prefer the Option Approach over the Mechanical Approach and/or Two- Stage Auction? Why / why not?***

***s. What features of the Option Approach do respondents like / dislike?***

See our response to question (l), above.

***t. Bearing in mind the substitution objectives do respondents believe that it is appropriate that capacity can be protected from substitution with only a relatively small commitment from the User?***

We believe that the full User-commitment (as required under the Two Stage Auction proposal) is the most appropriate approach. We note that introducing a watered down User-commitment would be contrary to recent Ofgem decisions, for instance on Exit Reform, where the trend has been to increase, rather than decrease the User-commitments required by Shipper Users.

***u. Should the Option Approach be made available to non-Users? If so how should it be applied?***

By non-User, we assume this means parties who are not signatories to the Uniform Network Code (UNC). We believe this may present regulatory difficulties as it would allow parties who are not signatories to the UNC to potentially subjugate the rights of Users who are contractually bound by its terms. We are not aware that the barrier to becoming a Shipper under the UNC is excessively onerous, and therefore if a party wished to take out an Option, it would seem most appropriate that they accede to the Code before doing so.

***v. Is the option fee set correctly?***

***i. Is it correct to have the same fee for all ASEPs?***

***ii. Are the minimum reserve price and 8 year period appropriate parameters for setting the option fee; i.e. is a fee set at approximately £300,000 for 10 mcm/d correct?***

***iii. Are refunds in the circumstances described appropriate?***

Since we are not supportive of the Option approach on a fundamental level, we have no view on the most suitable fee level, other than to note that the level seems high given the limited rights it confers on the User.

***w. Should the option fees and refunds be dealt with through TO charges? If not, how should they be accounted for?***

This is an issue for National Grid NTS to deal with under the terms of its current price control and to bring forward any appropriate charging methodology changes, as and when appropriate.

***Paragraph 106***

***x. Do respondents prefer the Two-Stage Auction over the Mechanical and Option Approaches? Why / why not?***

***y. What features of the Two-Stage Auction do respondents like / dislike?***

***z. Bearing in mind the substitution objectives, do respondents believe that it is appropriate that capacity can only be protected from substitution if the Shipper makes a commitment to buy the capacity?***

See our response to (l) & (t), above.

***aa. Do respondents consider the timeline to be an issue, e.g. would five (or less) stage 1 auction bid windows create a problem?***

We believe very strongly that five or less stages would present a serious problem for Shippers participating in the QSEC auctions. Because the QSEC is a clearing auction, it can take some time for the bids to settle down and therefore any reduction in bid windows could undermine the effectiveness of the auction.

In addition, it is not clear how the substitution proposals fit with UNC Modification Proposal 0246 for QSEC credit security, which requires one working day between each round: The timeline in para 103 of the consultation paper does not allow for one clear day between each round. Furthermore, the comment in para 105 about possibly having to reduce the number of stage 1 windows further is worrying and something we would object to strongly.

***bb. Bearing in mind the level of commitment required, do respondents think that this proposal would encourage Shippers to obtain capacity for a discontinuous quarter (see section 7.1)? If so, is this a problem?***

***Paragraph 117***

***cc. Do respondents believe that single quarter bookings present a problem that requires specific rules to prevent them?***

***dd. Would single quarter bookings only be a problem with a specific substitution methodology, if so which?***

***ee. What is the preferred action, if any, to prevent single quarter bookings?***

***Paragraph 124***

In the absence of analysis to demonstrate this is a genuine problem which is frustrating the purpose of substitution, we do not believe action is required at this stage. Whether or not this is a problem will only be known once substitution is implemented and the results analysed. Pre-emptive action at this stage may be detrimental to the efficiency of the market.

***ff. Do respondents believe that the substitution methodology should only allow substitution to proceed where an incremental signal can be met fully from substitution?***

***gg. Should partial substitution be allowed for specific options outlined in Section 6?***

***hh. Should partial substitution be considered as an element of a soft-landing to be introduced at a later date?***



We believe there may be merit in considering incorporating “partial substitution” into the methodology – for instance allowing a combination of substitution and physical construction to meet an incremental signal for demand. Whilst this may not be the most convenient approach to fit with the Transporter’s current Licence structure, it may be the most pragmatic approach in terms of minimising unintended consequences. Although partial substitution could be a means by which to achieve a “soft landing” at the beginning, it should also be considered as an approach which represents the most economic and efficient solution, on an enduring basis.

**Paragraph 129**

***ii. Do respondents believe that the use of entry zones in the substitution methodology is appropriate? or***

***jj. Should the methodology be applied purely on nearest donor ASEP?***

***kk. Do respondents favour pro-rating within zone?***

Our position when developing entry capacity trade and transfer auctions was to favour capacity zones. National Grid NTS has since argued that the use of zones led to sub-optimal results in the auction because it limited their options for “efficient” transfers. We are, therefore, somewhat surprised to see National Grid NTS now reversing this previously held viewpoint for the purposes of substitution; but nonetheless we support it! The use of zones has benefits for Shippers, particularly for the Two Stage Auction approach, since it allows Shippers to better understand which ASEPs could be potential donors, and therefore would inform more efficient decision making at Stage 2.

**Paragraph 139**

***ll. Whether respondents favour a soft-landing?***

***mm. If so, what parameter(s) should be used?***

***nn. Over what period should a soft-landing apply?***

***oo. Are there any other ways that a soft-landing could be introduced?***

Given the permanent effects of substitution, a soft-landing may be beneficial in terms of avoiding unintended consequences. The nature of the soft-landing clearly depends on which of the three approaches is ultimately implemented, but a measure such as 1:1 exchange rates may help achieve the objective. The ongoing suitability of a so-called “soft-landing” would be best considered as part of the annual review of the applicable methodology statement.

**pp. Should a transitional rule be included to ensure that substitution is introduced first to a regular QSEC auction?**

This could be a sensible way to ensure that all Shippers are sufficiently aware of, and geared up for, the new arrangements. The alternative – i.e. applying the rules to a one-off QSEC for a new entry point, would force Shippers into decisions based on no previous experience of the processes, which may lead to inefficient outcomes.

**Paragraph 143**

**qq. Notwithstanding the current position, National Grid would welcome views on whether proposals should be put forward to amend the Licence to facilitate a pricing structure which incentivises long term entry capacity bookings.**

If, by this, question National Grid is asking whether the discount for booking short-term capacity should be removed, then we would have serious concerns about such a proposal. As outlined previously in our response to NTS Discussion Paper GCD 04 – “Revisions to NTS Entry Capacity Reserve Price Discounts”:

*“We do not agree that discounted reserve prices are encouraging Shippers to avoid procuring entry capacity in the long-term auctions. It is our view Shippers are likely to be purchasing capacity on the day or day-ahead not because they are deliberately trying to pick up capacity at zero or near-zero cost, but because of the need to manage daily volume risk. As such, the availability of capacity in the short-term is a very important portfolio tool and increasing the current costs of procurement could lead to larger risk premiums being passed through to consumers.*”

*For the benefit of better competition in the gas wholesale market it is also important not to reduce the amount of, or access to, short term capacity: Primarily for the benefit of potential new entrants. If all capacity is tied up in long-term contracts, it could be argued that this leads to foreclosure of the wholesale market. Therefore, there ought to be a certain amount of capacity made available in the short-term. We already have concerns that the amount of short-term capacity held back by NG will diminish from 20% to 10% under the current Transmission Price Control (2007 onwards) and if the scarcity is then compounded by less attractive discounts, then this could lead to a significant barrier to market for new entrants.”*

There may already be evidence to suggest that Shippers are moving increasingly towards long-term entry capacity booking – for instance, the recent under-recovery by National Grid NTS in the 2009 AMSEC auction may be a sign of more emphasis by Shippers on long-term user commitments under the current pricing structure. However, if National Grid, with the support of the industry, does wish to undertake such a fundamental change to the market rules, then it is important that as much notice as possible is provided to Shippers.

**Paragraph 163**

***rr. Do respondents have any concerns or comments regarding aspects of the Base Methodology not discussed above?***

No.

I hope you find our comments in response to this informal consultation useful. If you would like to discuss any aspect of this response in further detail, please do not hesitate to contact me on the number above.

Yours sincerely

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