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Dear Paul

RE: NTS GCD 01: Introduction of NTS Exit (Flat) Capacity Charges under the Enduring Offtake Arrangements

E.ON UK supports a move towards a Transportation Model Base approach for the calculation of LRMCs, although this should not, in any way, be construed as implying that we offer any support towards the establishment of a so-called 'flat' exit capacity product. We believe a number of the suggested changes to the charging methodology would enhance the cost-reflectivity and predictability of NTS exit charges and therefore have their own merit irrespective of any 'linkage' to the reforms associated with the enduring offtake arrangements.

In short, we consider that many of the revisions to the charging methodology described in this discussion paper could be applied to the existing 'bundled' exit capacity product, although retention of the current interruptible arrangements would necessarily mean that these loads are excluded from the model.

Our detailed comments are as follows:

Q1. LRMCs are calculated from either a Transportation Model of the NTS or are calculated from Transcost

We note the Transportation Model approach is similar in nature to the approach taken for modeling the electricity system to derive transmission Use of System charges, effectively focusing on a Year +1 'snapshot' of the network to derive marginal costs using expansion 'constants' (or, more correctly, factors to calculate costs in terms of £/GWhkm).

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This approach works well in the electricity market and market participants are able to use the electricity model for scenario planning to help predict future transmission charges. This is important as such charges can have a profound affect on profitability, particularly as suppliers are unable to change customer tariffs overnight. In any new charging methodology, E.ON UK would be looking for predictability rather than necessarily stability – these characteristics should not be viewed as the same. Stability may not be appropriate if this was at the expense of cost-reflectivity. For instance, restricting changes from year-to-year so that charges fail to reflect underlying LRMCs could undermine location signals; an important consideration for those wishing to be connected or ceasing to be connected to the system.

It also appears that the Transportation Model approach will allow the charges to respond quicker to the significant changes in the pattern of supplies anticipated over the next few years. It might be argued that this increases price instability from year-to-year, but would be more cost-reflective if the distance over which gas is transported to supply particular users alters as a result of changes in patterns of supply.

Option 1: Transportation Model Based Approach

LRMC are calculated from a Transportation model of the NTS consequently excluding spare capacity and including backhaul benefit equal to the avoid cost of reinforcement

It is E.ON UK's belief that the transmission charging methodologies in both electricity and gas should be designed to calculate fair charges for the use of the system. This necessary means that spare capacity should not be included in the model. To include spare capacity would allow some users to "free ride" at the expense of other users.

Our views on this principle were articulated in our submissions to a series of similar consultations which considered the treatment of spare capacity in the methodology for calculating electricity transmission use of system charges in 2004 and 2005:

"...[T]he current charging methodology [i.e. the electricity transmission charging methodology] does not seek to look at how a new connection, or disconnection will be accommodated, but looks at the notional increase or decrease in usage of the network. Therefore, if an increase in capacity in reality requires a chunk of investment larger than a potential new connection then this is ignored by the model. The model assumes only a "fair share" allocation to meet the calculated change in flows. The expansion constant then calculates the average cost of accommodating flows per MWkm [similar to the expansion constant per GWhkm proposed for gas].

These chunks of investment create spare capacity for subsequent users. In a similar way to the model, ignoring whether actual chunks of capacity are needed to meet an increase in flows, the model also ignores whether spare capacity has been created, perhaps by a previous chunk which can meet a further increase in flows. This is correct as the model seeks only to measure the cost notional increases or decreases in flows."

It is our current understanding that these statements are equally applicable to the proposed new gas Transportation Model. In summary, we consider that accounting for spare capacity is fundamentally inconsistent with the shallow charging methodology approach of the Transportation Model to reflect notional increased or decreased flows on the network.

Q3. NTS Exit Flat Capacity Prices are determined for each gas year from analysis of a single year Supply and Demand forecast using the relevant Gas Year's base case data and network model for the capacity release.

This could apply equally as well to existing 'bundled' exit capacity charges. We are somewhat worried

by the statement in the consultation that National Grid may rely exclusively on user commitments to signal investment. We value the existing 10 Year Base Planning process and it is important that National Grid use such a process to inform its (efficient) investment decisions. In our view, undue reliance on user commitments is likely to result in sub-optimal investment and could potentially prejudice National Grid's ability to fulfill its 1 in 20 obligations which in turn would adversely impact continuity of supplies to some users.

Q4. Entry and exit LRMCs be calculated from a “reference node” to each relevant offtake point and the cost from each entry point to the “reference node” and that the LRMCs is adjusted to give a 50:50 cost split between average positive values of these adjusted Entry and Exit costs

This is similar in approach to the model used to determine electricity transmission charges. We are happy for this to also be adopted in gas.

Splitting charges between entry and exit may be appropriate to help provide for greater overall charge stability in terms of separate ‘pools’ of cost for entry and exit respectively. Without such ring-fencing, the over or under-recoveries at exit could affect costs borne by shippers at entry, and vice versa. This, in turn, can impact contractual arrangements and market prices at the NBP.

One must, however, question whether the split is correct given the degree of new investment required to accommodate a diverse range of new entry terminals. This might suggest that a greater proportion of current NTS assets are used to support the supply side (i.e. the producer side) rather than the demand side of the market. National Grid may wish to consider whether the 50:50 split is still appropriate in seeking to target costs at the appropriate players in the market.

Option 2 – Transcost Base Approach

On balance we think National Grid should move away from this approach, although we are unclear as to whether the simplifications inherent in the Transportation Model may be too far removed from traditional engineering-based models, on which Transcost and its predecessor models are based. What we would like to know is whether such simplifications could be considered to materially weaken cost reflectivity? A quick overview of the level of charges, comparing the current Transcost approach with the Transportation Model, tend to suggest that demand that is close to large and increasing sources of supply would benefit – and from a locational signal point of view this would seem to be appropriate.

For detailed views on questions Q5, Q6 and Q7 please refer back to our comments for questions Q2, Q3, and Q4.

Common Proposal Features

Q8. Prices are set at a nodal level rather than an exit zone level for NTS exit points.

This only affects DNs and is arguably more cost reflective. The zones are largely a hang-over from the pre-DN sales world where this formed the basis of shipper exit capacity charges for non-transmission connected customers and the concept of booking capacity by DNs was an irrelevance. It was thus simply a vehicle for seeking to fairly allocate exit charges across the country.

Q9. Exit LRMCs are converted into prices using the annuitisation factor set out in National Grid’s NTS Transportation Licence

This seems reasonable and is consistent with the approach adopted for electricity transmission use of system charges.

Q10. No year-on-year capping of NTS Exit Capacity process is included in the methodology

Given the radical changes in the pattern of supplies on the NTS we would support this change because charges might otherwise become significantly out of step with the underlying LRMCS. This would not be particularly cost reflective.

Other issues

Prices should be adjusted to recover the fixed cost proportion of the allowed TO revenue. This could easily be implemented with respect to the current 'bundled' exit capacity product. However, if National Grid's Modification proposal 116V were to be implemented, problems with respect to over- or under-recovery would introduce inappropriate instability to overall TO exit charges. At worst one could see an inappropriate commoditisation of charges that makes the prediction of charges almost an impossible task. Such unpredictability inevitably increases risks faced by shippers; the cost of which will ultimately have to be borne by customers.

It is our understanding that the unadjusted LRMCS would only recover around 45% of the allowed TO revenue. This is not appropriate and we would rather have this set close to the "fixed cost level". Any over-recovery from flexibility could then be reflected in the exit commodity charge(s).

The reserve prices for Annual NTS Exit (Flat) Capacity, Daily Firm NTS Exit (Flat) Capacity should have reserve prices equivalent to the charge for Prevailing NTS (Flat) Capacity,

We support the 100% discount for existing interruptible capacity or any daily interruptible capacity, should this be implemented as part of Modification Proposal 116.

We assume that interruption payments would be included in the Charging Methodology if E.ON UK's Modification Proposal 116A is implemented and the transitional arrangements effectively become the "enduring" arrangements.

Under Table C2, we do not understand why the indicative charges using the Transportation Model are not identical for Deeside and Connah's Quay power stations. It was always our understanding that charges for all users connected to the Mickel Trafford to Deeside pipeline were determined at Mickel Trafford. This is because although this pipeline was originally paid for by National Power and Powergen, it was adopted by National Grid. Therefore, no capacity charges should be applied for use of this asset and the capital cost of it should not be included within National Grid's regulated assets base.

Please note that our statement of preferences above does *not* in any way imply support for the introduction of a flat capacity product and we would ask that National Grid make this clear in any summary of industry responses.

Please feel free to me a call on 02476 183384 if you wish to discuss any of the points made above.

Yours sincerely

Peter Bolitho
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