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**An appeal under section 173 Energy Act 2004**

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**E.ON UK plc**

**-and-**

**GEMA**

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**Witness statement of Peter Bolitho**

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I, Peter Bolitho, of E.ON UK plc ("E.ON"), of Westwood Way, Westwood Business Park, Coventry, CV4 8LG, will say as follows:

1. I am the Trading Arrangements Manager for E.ON. I am duly authorized by E.ON to make this statement on its behalf. The facts and matters referred to in this statement are either within my own knowledge or are based on documents and the information acquired by me in my capacity as the individual at E.ON responsible for this appeal and are true to the best of my knowledge, information and belief.
2. Unless I expressly indicate otherwise, in this witness statement:
  - (1) technical terms have the meanings ascribed to them in the Glossary;
  - (2) documents referred to are contained in the six-volume exhibit marked PB1;

- (3) references to [x/y/z] are to volume x, divider y, page(s) z within that exhibit.
3. I have been working in the energy sector in various capacities for over 15 years. I joined British Gas in September 1991 and had responsibility for negotiating and developing third party access contracts to the newly liberalised gas market. In 1997, I left to join Powergen, where I initially managed the implementation of and changes to the gas Network Code. In 2001, I became Trading Arrangements Manager, with responsibility for representing the company's interests for wholesale market arrangements in both the gas and electricity sectors. Powergen became E.ON in 2004.
4. I serve as an elected member of the UNC Modification Panel ("**the UNC Panel**") representing shippers' interests. Consequently, I have had a close involvement in the events leading up to GEMA's decision of 5 April 2007 ("**the Decision**") directing that Modification Proposal 0116V ("**Mod 116V**") to the Uniform Network Code ("**UNC**") be implemented and directing that Modification Proposals 0116A ("**Mod 116A**"), 0116BV ("**Mod 116BV**"), 0116CVV ("**Mod 116CVV**") and 0116DV ("**Mod 116DV**") not be implemented [1/1/1-22].

#### Introduction

5. I make this witness statement in support of E.ON's application for permission to appeal (and in support of the appeal, if permission is granted) against two aspects of the Decision, namely:
- (1) GEMA's decision to direct implementation of Mod 116V; and
- (2) GEMA's decision not to direct implementation of Mod 116A.
6. The Decision concerns the arrangements for the offtake of gas from the National Transmission System ("**NTS**"). In broad terms, GEMA's decision to implement Mod 116V will create a new and complex system for the allocation of rights to offtake gas from the NTS and for the framework of charges in respect of those

rights. By contrast, Mod 116A, which was proposed by E.ON, would largely have preserved the previously existing arrangements.

7. The UNC Panel, of which I am a member, voted by a majority (9 against 1) to recommend the implementation of Mod 116A and (by 8 against 2) not to recommend implementation of Mod 116V. I am advised that, since the Decision overrides the recommendations of the UNC Panel, an appeal lies to the Competition Commission pursuant to s. 173 of the Energy Act 2004.
8. As set out in E.ON's Statement of Case, E.ON believes that the Decision is flawed and incorrect on a number of grounds. Some of these grounds are matters of economics and are set out in the expert report of Graham Shuttleworth, an independent expert instructed by E.ON for the purposes of the appeal. I do not propose to comment further on those aspects of the appeal.
9. In this witness statement, I seek to set out, from my experience of working in the industry, features of the British gas industry that are relevant to an understanding of the Decision. I also seek to outline the procedure by which GEMA arrived at the Decision and to explain why E.ON believes that this procedure was flawed and inappropriate.
10. In relation to the latter, my experience of the British gas industry is that, where a possible problem has been identified within the industry, the appropriate course of action for the regulator is to carry out a broad consultation with industry participants in order to determine whether that problem really exists.<sup>1</sup> Only if a problem is indeed found to exist is it appropriate for the regulator then to elicit the industry's views as to the range of possible solutions to it. The regulator may then proceed to canvass the industry's views about the best solution and, where there is a broad consensus in that regard, the regulator should normally give

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<sup>1</sup> In both the gas and electricity industries, there are industry codes governing (among other things) access, connection, customer registration, energy balancing and trading. Each of these codes contains modification procedures which allow industry participants to propose changes to address particular defects or problems in the existing arrangements. As explained below, the UNC Modification Rules allow for "Review Proposals" to be put forward where a problem has been identified by the industry. This process is designed to allow the industry participants to work up detailed proposals to address specific problems.

effect to the consensus unless there are overriding reasons of public policy not to do so.

11. I believe that this approach reflects what participants in the gas industry consider to be best practice on the part of the regulator. I also understand that it reflects Ofgem's statutory duty in section 4AA(5A) of the Gas Act 1986 to have regard to (among other things) the principle that regulatory activities should be targeted "only at cases in which action is needed." In a number of cases, this is precisely the approach which Ofgem (the office which supports GEMA's activities) has taken. I regret to say, however, that I do not believe that this is the approach that Ofgem has taken in the present case.
12. On the contrary, E.ON believes that, at the time when Ofgem raised the question of "reform" to the offtake arrangements, there was no concern on the part of any significant section of the industry regarding the existing arrangements. Although there is always some scope for incremental improvement, there was a broad consensus across the various sectors of the British gas industry that the existing arrangements were working well and should be continued. This remained the position even after the sale of four gas distribution networks ("GDNs"). It is E.ON's belief that the only impetus for fundamental change came from Ofgem itself. Furthermore, once Ofgem had taken the view (contrary to the industry consensus) that there was a problem which required fixing, it was Ofgem itself, not the industry, that formulated the supposed solutions. E.ON indicated its concerns about Ofgem's approach in its comments dated September 2006 on Ofgem's Five Year Strategy and Plan 2007-12 [1/2/23-26]. We urged [1/2/27] that wide-reaching market reforms should be driven by market participants rather than by Ofgem.
13. E.ON believes that Ofgem's decision to advance reform in the absence of industry concern or support was inappropriate: Ofgem's role is to adjudicate on the competing proposals put forward by industry participants. It is my belief that, by itself originating the proposals, Ofgem put it out of its power to consider the merits of those proposals with a genuinely open mind. Indeed, it is E.ON's belief

that Ofgem had effectively prejudged what modifications should be made to the offtake arrangements long before the first modification proposal was formally made in September 2006.

14. I believe that this emerges clearly when one scrutinises the sequence of events leading up to the Decision. As I have said, the modification proposals to which the Decision relates were not formally made until September 2006. However, I believe that the true genesis of the Decision can be traced back to as early as 2004. Accordingly, the structure of this witness statement is as follows:
- (1) In Section 1, I give a broad overview of the gas transportation network in Great Britain and I identify the various entities in the gas industry whose activities relate to that network.
  - (2) In Section 2, I describe the events from May 2003 onwards leading up to the sale of four GDNs in June 2005, with particular emphasis on how Ofgem linked the prospect of such a sale to the modification of the NTS offtake arrangements.
  - (3) In Section 3, I describe the sale itself and Ofgem's further deliberations in its aftermath regarding changes to the offtake arrangements.
  - (4) Finally, in Section 4, I set out the events from the inception of the formal modification proposals in September 2006 to the Decision.

### **Section 1: Overview of the gas transportation system**

#### Gas transporters, shippers and suppliers

15. The NTS is the national high pressure gas transmission system in Great Britain. According to information published by GEMA, the NTS consists of approximately

6,900 kilometres of pipeline that transport gas from the seven entry terminals to 180 offtake points.<sup>2</sup>

16. Gas is offtaken from the NTS by eight regional Gas Distribution Networks at NTS/GDN “transfer” or “exit” points. The GDNs operate at lower pressure compared with the NTS. Gas flows through the GDNs and may be offtaken by customers at exit points on the GDNs. Where I refer in this witness statement to the “whole system” or the “gas transportation network” in Great Britain generally, I am referring to the NTS and the GDNs collectively.
17. The companies responsible for operating the gas transportation network are designated as “gas transporters” by the Gas Act 1986. Gas transporters require a licence under s. 7 of the Act. The licence imposes a number of important responsibilities, including the obligation to develop the gas transportation system to meet the peak aggregate daily demand for gas to be conveyed to premises that is likely to be exceeded (whether on one or more days) only in one year out of 20. This is referred to as the “**1 in 20 obligation**”.
18. More generally, s. 9 of the Act imposes the following duties on gas transporters:
  - (1) to develop and maintain an efficient and economical pipe-line system for the conveyance of gas;
  - (2) subject to paragraph (1) above, to comply, so far as it is economical to do so, with any reasonable request for him
    - (1) to connect to that system, and convey gas by means of that system to, any premises; or
    - (2) to connect to that system a pipe-line system operated by an authorised transporter;
  - (3) to facilitate competition in the supply of gas;

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<sup>2</sup> The description of the network in this and the following paragraph is taken from an Ofgem Regulatory Impact Assessment dated June 2004 referred to below.

- (4) to avoid any undue preference or undue discrimination—
- (1) in the connection of premises, or a pipe-line system operated by an authorised transporter, to any pipe-line system operated by him; or
  - (2) in the terms on which he undertakes the conveyance of gas by means of such a system.
19. NGG is under an obligation to publish a Ten Year Statement each year setting out its assessment of the future demand and supply position for natural gas in the United Kingdom, and the consequences for investment in the gas transmission network. NGG's most recent Ten Year Statement (to which reference is made in a number of submissions leading up to the Decision) is dated December 2006 [1/3/27-148].
20. Gas transporters are to be distinguished from at least two other gas industry participants who must also be licensed under the Gas Act (specifically, s. 7A). Shippers are companies who purchase gas on the wholesale market and who arrange with the gas transporters for that gas to be conveyed through the transportation network. Suppliers are companies who supply gas to domestic and business premises. Although a company may be licensed as both a shipper and a supplier (as E.ON is – see below), gas transporters are not permitted to act as shippers or suppliers unless they receive an appropriate exemption from the Secretary of State.
21. The regulatory justification for this prohibition is obvious. Gas transporters form the monopoly infrastructure for the British gas industry. They are subject to price controls determined by Ofgem with a view to recouping the transporters' expenditure on investment and operational costs in addition to a reasonable return on their investment. By contrast, shippers and suppliers are competitive market players. They compete with another on price and quality of service in order to attract or retain customers. The gas transporters provide a common infrastructure to the competitive players. There would, therefore, be the plainest

risk of unfairness and distortion of competition if the gas transporters were also allowed to enter into the competitive part of the industry. There would be an obvious conflict of interest between the gas transporters' obligations to develop an appropriate network infrastructure for the benefit of consumers and of the industry as a whole, and their interests as competitors in the shipping and supply markets.<sup>3</sup> There would also be huge inequality of information regarding the workings of the network and its future development.

22. As explained above, the NTS is connected to the regional GDNs by transfer points at which the GDNs offtake gas from the NTS. Gas may then be offtaken from the GDNs by shippers who have customers connected to the GDNs, such as small to medium sized power stations and suppliers of gas to business and domestic premises. In this witness statement I refer to shippers who offtake gas from the GDNs as "**GDN Shippers**".
23. However, there are also "direct connect" offtake points on the NTS. Although this term is not always used consistently, I use the term "direct connect" offtake points to include all offtake points on the NTS save for the NTS/GDN transfer points. Direct connect offtake points permit gas to be offtaken from the NTS itself, i.e. without passing through the GDNs. There are a number of entities who offtake gas directly from the NTS in this way. First, there are end-customers who take their gas direct from the NTS. These customers are known as Transmission Connected Customers ("**TCCs**"). TCCs include gas-fired electricity generators and large industrial customers who require gas at high pressure. The gas is offtaken from the NTS by shippers acting on behalf of the TCCs. I refer to shippers who offtake gas directly from the NTS as "**NTS Shippers**". Second, there are storage facilities that are directly connected to the NTS. Third, there are Connected System Exit Points ("**CSEPs**"). CSEPs include interconnectors (which transport from the NTS to other transportation systems, such as the Irish transportation networks) and independently-owned gas pipelines. For clarity, I

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<sup>3</sup> As the Monopolies and Mergers Commission (CM 2315, 1993) found in the case of British Gas's old integrated structure in its report in 1993 – an "inherent conflict of interest" – see paragraph 1.6 of the Executive Summary [**1/4/155**].

should say that in some documents the term "TCC" is used more broadly than I have used it, to encompass all those who offtake gas directly from the NTS (i.e. not only end-customers but also interconnectors, storage sites etc). In this witness statement, I use the term TCC only in the narrower meaning indicated above, i.e. end-customers who use gas offtaken directly from the NTS by NTS Shippers.

24. NTS/GDN transfer points make up the majority of the 180 offtake points on the NTS. Approximately 64 of the points are direct connect offtake points used by shippers, interconnectors and/or TCCs.

#### E.ON

25. Before turning to the detail of the offtake arrangements, I should outline what E.ON's role is in relation to the gas transportation system. E.ON is one of the UK's largest integrated energy companies. Its relationship with the NTS arises in four different ways – as a gas supplier, as a shipper, as a user of gas storage facilities and as a consumer. I have a few observations to make about each of these roles.
26. First, E.ON is a major shipper of gas. E.ON ships gas on its own behalf and on behalf of a number of industrial and commercial customers. One of these customers is a TCC, the others are connected to the GDNs. E.ON is therefore both an NTS Shipper and a GDN Shipper.
27. Second, E.ON is also a supplier of gas. It supplies gas to industrial and commercial customers, as well as to small and medium businesses and to domestic gas consumers.
28. Third, E.ON is a user of storage facilities. Indeed, it is one of the largest users of the various storage facilities connected to the NTS, including the Rough and Hornsea facilities. Furthermore, E.ON is also developing a new "fast churn" storage facility at Holford which E.ON will own itself.

29. Fourth, E.ON is one of the two largest consumers of gas in the UK. It owns and/or operates five gas-fired electricity generation plants and two Combined Heat and Power (“CHP”) plants connected to the NTS, in addition to a further seven CHP plants that are connected to GDNs.
30. I should also mention that E.ON’s sister company, E.ON Ruhrgas, is a major user and stakeholder in both the Bacton to Zeebrugge and Bacton to Balzgang interconnectors.
31. As a result of these different capacities in which E.ON’s business interacts with the NTS, it is plain that any changes to offtake arrangements could have a significant impact on E.ON. I set out at paras. 184-194 below the specific effects which I believe the Decision may have on certain of E.ON’s activities.

Capacity, flexibility and interruption

32. The Decision is principally concerned with the allocation of exit offtake “capacity” and the framework for charging for such allocation. Capacity in this context means the right (but not the obligation) to offtake a particular quantity of gas from the NTS in a given period. It does not refer to the quantity of gas that is actually offtaken from the pipeline during that gas day. Accordingly, charges for offtake capacity merely secure the right for the paying party to offtake a quantity of gas on a particular day. If that party then chooses to exercise that right, he must pay additional charges (called commodity charges) referable to the quantity of gas actually offtaken.
33. Without straying into matters of economics, I believe that the commodity charge is intended to at least cover the avoidable variable costs of the gas transporter in transporting the quantity of gas actually offtaken out of the pipeline. In fact, I believe from discussions I have had within the industry that the commodity charge is set at a level which also provides a contribution to fixed costs (including the cost of investment in pipeline infrastructure).

34. Offtake capacity may be "firm" or it may be "interruptible". Firm capacity arrangements apply to supply points which need to be able to offtake gas at any time. Interruptible capacity arrangements apply to supply points which (provided they meet certain criteria) are willing to have their supply of gas restricted in certain circumstances. NGG may declare an interruption in the event of network capacity constraints, in an emergency for supply/demand balancing purposes, or for testing purposes. Having called an interruption, NGG uses an "equitability algorithm" to determine which sites are in fact interrupted.
35. I should mention here that in the Decision, GEMA appears to assume that there has been a "flight from firm" by NTS users, that is to say, that there has been a significant increase in firm customers changing to interruptible status. The Decision does not identify any evidence of such a change having occurred, and (as set out in E.ON's response to the Final Impact Assessment preceding the decision, referred to below), it is contrary to E.ON's understanding. I can say that, from my own knowledge of events in the industry, I am not aware that such a change has taken place.
36. Another concept which it may be helpful to explain at this stage is "linepack". The NTS is sometimes described as a 'bulk' transportation system, designed to be operated 'flat'. What I mean by this is that at any given point in time, input flows should broadly match output flows. In reality this is far from the truth because input and output flows are not uniform throughout the day nor do they match each other hour by hour or minute by minute. Consumers offtake gas at a rate of flow that varies over the course of the gas day. A profile for domestic consumers, for example, is that gas consumption will be high during the day and very little overnight. Similarly, flexible gas-fired electricity generation necessarily requires the offtake of gas to vary through the day in response to changes in the electricity market.
37. The ability of gas transporters to provide gas at varying rates of flow depends on the existence of "diurnal storage": instead of the gas flowing out of the pipeline at a uniform rate, gas is stored when the rate of offtake is lower and then released

when the rate of offtake increases. Linepack is one form of diurnal storage. The capability of the NTS to offer linepack (diurnal storage in the NTS<sup>4</sup>) can be viewed in one sense as spare capacity in transmission pipes.

38. Key elements in determining linepack availability in the NTS are the physical size of the pipes that make up the NTS and how gas flows both within it and in and out of it. The latter is ultimately determined by shipper input flows and also by how NGG NTS chooses to 'push' gas around its system using compressors and 'direct' gas around its system by adjusting the settings of flow control valves.
39. The greatest need for diurnal storage is in the GDNs, so that GDN Shippers can in turn offtake gas to their customers at a variable rate of flow. GDNs meet this need through the use of some NTS linepack (by choosing to vary flows at GDN exit points) but mainly through the use of storage facilities (high pressure storage bullets and low pressure gas holders) and linepack within the GDN itself.
40. Under the current daily gas balancing regime it is not possible to allocate quantities of linepack or indeed other forms of diurnal storage to shippers. Linepack therefore remains essentially a tool for the transporters to efficiently manage the flows of gas across the whole system.
41. The word "flexibility" can be used in a number of senses. First, it can refer to the linepack or diurnal storage capacity itself. Second, it can refer to the ability (of a network user) to vary his rate of offtake over the course of the gas day (by reason of diurnal storage). In its various consultation documents, Ofgem usually defines "flexibility" to have this second meaning. Third, the Decision introduces a new product called a "Flexible Capacity" product.
42. It is important to avoid confusion in the use of the term "flexibility". For example, the ability to vary one's profile of offtake does not correlate directly with the availability of linepack in the pipeline. Similarly, it is E.ON's belief that the "Flexibility Capacity" product does not correlate directly with either (1) the ability

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<sup>4</sup> There is usually some difference in the total level of linepack held in the NTS from one day to another.

to vary one's offtake profile or (2) linepack. For clarity, where I use the word "flexibility" in lower case in this witness statement, I am using it simply to mean the ability of a user to vary his rate of offtake of gas over the course of the day. Where I am referring to the new "Flexibility Capacity" product which this Decision will introduce, I will use the upper case. Where I am referring simply to linepack or diurnal storage, I will use those terms instead of "flexibility".

## **Section 2: possible sale of the GDNs and the link with offtake "reform"**

### The administered offtake arrangements prior to the GDN sale

43. Following privatisation of the gas industry in 1986, the entire gas transportation network (i.e. the NTS together with the 8 GDNs) fell under the ownership of British Gas which was then the UK's monopoly gas transporter, shipper and supplier. Subsequently, in 1997 the shipping/supply arm was divested from the transportation business. The former, which found itself in competition with other shipping and supply companies, retained the British Gas name, whilst the transportation business adopted the name Transco. After the National Grid Company (the owner and operator of the electricity transmission system in England and Wales) acquired Transco in 2002 it became known as National Grid Transco ("**Transco**"). The name changed again in October 2005 to National Grid Gas ("**NGG**").
44. It is right that I should explain at the outset the arrangements that applied to the allocation of rights to offtake gas from the NTS, while the NTS and all eight GDNs were under NGG's ownership. These arrangements were "administered" arrangements, in the sense that they were implemented by NGG as the common owner of the monopoly infrastructure.
45. First, it is necessary to explain how capacity on the NTS was allocated to (1) GDNs and (2) TCCs. As regards the GDNs, capacity was allocated based on the maximum daily quantity ("**MDQ**") which the GDN estimated it would require. As the term suggests, the MDQ was the maximum quantity of gas which the GDN would need to offtake in the course of a day. This was determined by NGG's

internal processes and was designed to ensure that the GDN would be able to satisfy the 1 in 20 obligation.

46. As regards the TCCs, the position was broadly similar to that applicable to the GDNs. TCCs were also assigned capacity based on a maximum daily quantity known as the Supply Point Capacity. This was calculated by multiplying the maximum instantaneous hourly rate of offtake required by the TCC by 24. TCCs were required to make known their capacity requirements to NGG on an annual basis and to pay the appropriate fee. However, it was assumed that TCCs retained their existing level of NTS exit capacity provided they renewed it each year at the renewal date. Where a TCC needed additional capacity over and above its existing capacity, it could request this through a process defined in NGG's Network Code and, where appropriate, through entering into Advanced Reservation of Capacity Agreements ("**ARCAs**") (which I explain below).
47. Second, there is the issue of how (1) GDNs and (2) TCCs were charged for that capacity. The charges were applied as follows:
  - (1) The capacity allocated to the GDNs was not charged to the GDNs themselves. It is to be remembered that the GDNs were at this stage in common ownership with NGG. Instead, charges in respect of offtake capacity allocated to the GDNs were made direct to the GDN Shippers. NTS/GDN transfer/exit points were grouped into 33 exit "zones" for charging purposes.
  - (2) The capacity allocated to TCCs was charged to the TCC's NTS Shipper. Direct connect points on the NTS were considered as individual exit points and specific charges were set for those points.
48. As regards calculation of the charges, these were set by NGG on an administered basis using a methodology which sought to reflect the estimated long run marginal cost of developing the system to meet a sustained increase in the use of the system.

49. Where requests for increases in exit capacity by GDNs or TCCs were considered by NGG to require additional investment to be made to the NTS, NGG would enter into an ARCA with the relevant GDN or TCC (or, on occasion, with the TCC's shipper). The purpose of an ARCA was to protect NGG from the risk that the investment was undertaken which turned out to be unnecessary. It sought to do so by binding the requesting party to pay for the capacity, whether or not it ultimately needed it. The terms of the ARCA were primarily a matter for negotiation between NGG and the requesting party, but in the event of dispute could be referred to Ofgem. Ofgem has indicated that ARCA should not normally require a commitment longer than one year, and Ofgem has generally adhered to this position where disputes over ARCA terms have been referred to it. This was consistent with the "shallow connection policy" i.e. the idea that one should err on the side of encouraging new competitors to enter the market rather than imposing lengthy user commitments or connection costs which might discourage such entries. This policy was confirmed in Ofgem's determination in the Laggage Energy Park dispute [1/5/158-200] (see particularly para. 2.6).
50. Third, there is the question of how variation in the flow of gas at exit points should be managed. Again, a distinction is to be drawn between (1) the GDNs and (2) TCCs:
- (1) The within-day variation of gas flow at GDN exit points has an impact on both NTS linepack and linepack within each GDN and the allocation of this NTS offtake flow to GDNs was managed through NGG's internal processes and procedures. GDNs that required further "offtake flexibility" from the NTS were governed by internal NGG operating Rules which were agreed as part of the annual planning cycle. Any further utilisation of NTS linepack would be used to supplement the GDN's own diurnal storage and linepack.
  - (2) NGG was not obliged to accommodate all the TCCs request for offtake flexibility although on the whole NGG was able to accommodate these requirements by virtue of some spare capacity on the NTS. NGG could,

however, limit the rights of large customers to vary their rate of offtake by imposing "rate change notice periods" and "ramp rates" specified in Network Exit Agreements ("NExAs") which were ancillary documents to NGG's Network Code. Subject to such restrictions, flexibility was not itself regarded as a capacity product for which charges were levied; TCCs were entitled to vary their rate of offtake provided they did not, at any given point, exceed their maximum hourly quantity or (save with NGG's prior permission) their rate of change notice period.

51. Fourth, there is the issue of interruptible capacity arrangements. In broad terms, shippers could request that certain NTS supply points be designated interruptible sites. Provided that the sites were of requisite size and were capable of ceasing to offtake gas within the five hour notice period following a declaration of interruption, NGG was obliged to agree to those requests. Shippers supplying interruptible sites did not have to pay NTS exit capacity charges, although they would of course pay commodity charges in respect of gas actually offtaken from those sites.

#### Proposed sale of GDNs and the link with offtake reform

52. On 21 May 2003, NGG announced as part of its Preliminary Results Statement that it would consider the sale of one or more of the GDNs if to do so would maximise value for NGG's shareholders. Any such sale required the consent of GEMA, the Health and Safety Executive and the Secretary of State.
53. Shortly after this announcement, on 27 May 2003, Ofgem wrote an open letter to industry participants headed "*Universal firm registration of NTS exit capacity: further developments*" [1/6/201-203]. This letter referred to the Exit Reform Advisory Group ("ERAG"), a body established by Ofgem principally to consider possible changes to the interruption arrangements – or rather, the possible abolition of interruption arrangements, which was favoured by Ofgem. The letter states that at an ERAG meeting on 14 May 2003, Ofgem identified six objectives to be addressed in any reform of the exit capacity arrangements, namely:

- (1) cost reflective pricing, non-discrimination and removal of cross-subsidies;
  - (2) NGG, rather than customers, should determine whether services are deemed interruptible;
  - (3) increased customer choice;
  - (4) a reformed exit regime "*should provide Transco with efficient signals of the value of interruption*";
  - (5) maintenance of a safe and secure pipeline system; and
  - (6) reforms should be robust to any separation or sale of GDNs.
54. The letter noted NGG's announcement in the meantime that it would consider selling one or more GDNs. Ofgem said that this sale could have "*significant implications for the reform of the exit capacity regime*" and, accordingly, that Ofgem now intended to take "*exit capacity reform forward*" as part of the GDN disposals project. Consequently, the proposal consultation on the GDN sales would incorporate a discussion of the exit arrangements and "*options for reform going forward*".

#### The Consultation Document

55. On 31 July 2003, Ofgem issued a consultation document regarding the potential sale entitled "*National Grid Transco – Potential sale of network distribution businesses*" ("**the Consultation Document**") [1/7/204-359]. The Consultation Document introduced the "*gateway concept*", referring to "*changes that must be delivered before a sale can occur*", in other words, preconditions to the sale (paras. 2.5-2.7 at [1/7/217]).
56. Among the issues which Ofgem regarded as "*gateway*" issues were the contractual arrangements for interruption at the NTS/GDN interface and the pricing of exit capacity and interruption (para. 5.2 at [1/7/239]). At paras. 5.20-5.29, Ofgem sets out the same "*objectives of reform*" as the six objectives listed in the 27 May 2003 letter (see above). Although it is fair to say that the emphasis

at this stage is on interruption arrangements, it was clear to me from the repeated references to “*exit capacity arrangements*” that the scope of Ofgem’s proposed “*reforms*” went beyond interruption alone. One of the issues on which Ofgem invited comments was what it called the “*weaknesses of the current exit capacity arrangements*” and the issues raised by the sale of GDNs other than those referred to in chapter 5 of the Consultation Document.

### The Next Steps Paper

57. The correctness of this belief was confirmed when, on 17 December 2003, Ofgem published a Next Steps paper regarding the potential sale GDNs (“**the Next Steps Paper**”) [1/8/360-431]. One of the issues discussed (chapter 5) was “*reform*” of the mechanism by which exit capacity from the NTS is allocated.
58. Ofgem acknowledges the views expressed in this regard not only by E.ON but by other industry parties in the Next Steps Paper about the inappropriateness of examining such an important and complex issue merely as an incident to the sale of the GDNs. Ofgem notes at paragraph 5.7 [1/8/392] that “*Several respondents expressed the opinion that exit reform should be pursued separately from the potential sale of DNs ...*”. Despite this, Ofgem took the view that the potential sale of the GDNs raised issues which “*impact directly upon the reform of the exit regime*” and that Ofgem would therefore consider the two questions in tandem: see paragraph 5.16 [1/8/394].
59. It is worth noting that Ofgem uses the word “*reform*” in the paragraph to which I have just referred. At the time of the Next Steps Paper, neither NGG nor anyone else was proposing that the offtake arrangements should be reformed at all. Rather, NGG’s position was that sale of the GDNs “*do not require any change to the existing exit regime and it would be possible to simply reflect the existing arrangements in the offtake arrangements*”: see paragraph 5.11 of the Next Steps Paper [1/8/393].
60. In view of E.ON’s concern about the use of the GDN sales process as a means of introducing unnecessary reform, I sought to narrow the scope of Ofgem’s

activities. I was a member of the Development and Implementation Steering Group (“DISG”), the committee established by Ofgem to assist it in determining whether the sale of GDNs should proceed. At the inaugural DISG meeting on 20 January 2004, I argued that its terms of reference should be confined to what was “*expedient and necessary*” to facilitate the sale. My objective was to focus Ofgem’s energies on those matters which were directly concerned with the sale, rather than collateral matters. As recorded in the minutes of the meeting, the other stakeholders represented at the meeting agreed with my proposal [1/9/432-438]. Regrettably, however, this did not appear to inhibit Ofgem from continuing to consider the issue of the offtake arrangements as part of the GDN sales process.

#### Inappropriateness of the link with offtake reform

61. I should make clear at this point that E.ON was disappointed that Ofgem should seek to link the sale of the GDNs to the issue of offtake capacity arrangements. So far as I was aware, there was no concern in the industry at that time about the way in which the offtake arrangements worked provided the NTS and GDNs continued to be operated as a “whole system” in the interests of efficient gas transportation to our customers. Yet by its repeated use of the word “*reform*”, Ofgem made clear to industry participants that Ofgem was eager for change in this area.
62. It was our view that examining the offtake arrangements in the context of the GDN sale carried at least two significant risks. First, there was a risk that the offtake arrangements would not receive the careful thought and attention which a central issue of this kind deserved. The central focus would be on issues directly arising from the GDN sales and these would drive the timetable for the programme as a whole. There would therefore be an obvious temptation to rush through ill-considered proposals on the offtake arrangements, simply to ensure that this did not delay sale of the GDNs (assuming that approval for their sale would be forthcoming).

63. Second, there was the risk that tying changes to the offtake arrangements to the issue of the sale might affect the stance taken by NGG regarding offtake arrangements. The proposal to sell some of the GDNs had come from NGG, which had taken the view that a sale would maximise value for its shareholders. NGG was therefore concerned, on behalf of its shareholders, to ensure that all necessary consents to such a sale were obtained, including that of Ofgem. If consent to the sale was dependent on the finalisation of new offtake arrangements, NGG would have to consider very carefully whether its interests would be served by advancing offtake proposals that did not coincide with Ofgem's way of thinking.
64. E.ON's views were shared by other shippers and industry participants. The Gas Forum is a body that was established in 1994. It now comprises virtually every significant gas shipper and supplier in Great Britain. On 8 April 2004, Angela Love, the Chairman of the Gas Forum, wrote to GEMA on behalf of the Forum and with the support of the Major Energy Users' Council to draw GEMA's attention to the "*potentially damaging linkage between potential Distribution Network (DN) sales and reform of the exit capacity regime*" [1/10/439]. The letter noted that this linkage unnecessarily stretched industry resources and squeezed development timescales. The letter expressed particular concern that this would jeopardise the ability properly to evaluate the available options and the appropriate way forward on exit reform. Accordingly, the Forum recommended that exit capacity should not continue to be regarded as a "*gateway issue*".
65. It is right to record that, as matters have turned out, the views expressed by E.ON and the Gas Forum have subsequently received support from independent bodies. The National Audit Office published a report dated 10 February 2006 regarding the sell-off of the GDNs [2/11/440-492]. The report noted (at para. 2.17) that the gas industry, particularly shippers, were "*deeply concerned*" about the way Ofgem had handled the reform of gas exit arrangements in parallel with the sale of the GDNs. According to the report, the NAO was told that this "*added significantly to the complexity of the sales and that it took up considerable resources within Ofgem and gas companies*" [2/11/459[19]].

66. Similarly, the Public Accounts Committee of the House of Commons issued a report dated 27 November 2006 entitled, "*Gas distribution networks: Ofgem's role in their sale, restructuring and future regulation*" [2/12/493-533]. As set out in the Summary [2/12/496], the Committee took the view that Ofgem made the project of selling the GDNs "*unnecessarily complex and placed a large burden of consultation on the industry.*" The Conclusions and Recommendations section of the report states (at para. 2) that "*As part of its sales approval process, Ofgem introduced unnecessary additional changes to the way gas networks operate. Ofgem subsequently decided to defer these reforms, known as gas exit reforms, until at least September 2007.*" [2/12/497]

#### The Offtake RIA

67. Returning to the chronology, in June 2004, Ofgem published a Regulatory Impact Assessment dated June 2004 ("**the Offtake RIA**"). Although made in the context of the proposal sale of the GDNs, the Offtake RIA was exclusively concerned with changes to exit offtake arrangements [2/13/534-650]. The Offtake RIA sets out four options for the allocation of NTS exit capacity following divestment of GDNs. These options are described in detail at paragraphs 5.10 to 5.46 of the Offtake RIA [2/13/585-597] and may be summarised as follows:

- (1) Option 1 is described as "*Transco's initial proposal*". As set out above, NGG was not initially in favour of changes being made to the offtake arrangements in the event of GDNs being sold off. Accordingly, this proposal consisted largely of a formalisation of Transco's existing internal procedures. Each GDN would submit a request for MDQs for each offtake from the NTS, consistent with the GDN's estimate of the level of MDQ it would need to meet its 1 in 20 obligation. Entities directly connected to the NTS would submit the equivalent Supply Offtake Quantities ("**SOQs**") to the NTS, indicating their maximum daily consumption for a particular supply point. It would then be for NTS to allocate capacity to GDNs and direct connect customers based on the requests received. It was proposed that the charging structure would also

remain broadly similar to that under the existing regime. This would have included retention of the "automated" calculation of exit capacity charges for GDN shippers based on aggregated customer SOQs.

- (2) Option 2 is described in the Offtake RIA as the "*NTS connects booking model*". Under this option, GDNs and NTS direct connect shippers would each estimate the level of exit capacity they required at NTS offtake points. They would then submit requests for capacity to NTS "*consistent with investment planning timescales (i.e. indicative five years ahead, and firm for three years ahead)*". The Offtake RIA comments that under Option 2, "*DNs and NTS direct connects would receive equal treatment of capacity allocation*".

As regards charging arrangements under Option 2, there were two further options. Under Option 2A, the GDN would pay for NTS exit capacity allocated to it as agent for the GDN Shippers. On this approach, the GDN would pay in the same way as an NTS Shipper, and would then recover those charges from its GDN Shippers in a way that reflected the GDN capacity requested by those shippers. By contrast, under Option 2B, the GDN shippers would themselves pay the NTS direct.

- (3) Options 3 and 4 emphasise the role of the shipper in the capacity allocation process. Of the two, Option 4 is the more extreme, in that GDNs would be released from their 1 in 20 obligation and would have no role in requesting capacity from the NTS. Instead it would be for shippers to request exit capacity provision from the NTS adequate for their needs. Option 4 anticipated that such requests would have to be made three years ahead of time "*in timescales consistent with investment planning*" (paragraph 5.38) [2/13/594].

68. Although Option 1 is clearly attributed in the Offtake RIA to NGG, I believe (since no contrary indication is given) that Ofgem itself was the originator of Options 2, 3 and 4. It is important to note that at this time detailed proposals to split direct connect exit capacity rights into flat and flexibility had not been discussed with

the industry. These proposals were to emerge at a DISG meeting later in the year.

69. In chapter 4 of the Offtake RIA, Ofgem sets out what it describes as the key issues to be addressed in determining the appropriate form and content for the offtake arrangements. The first of these key issues is "*preventing undue discrimination*", which is explained at paragraphs 4.4 to 4.16 [2/13/575-578]. In particular, Ofgem expresses concern about the potential for discrimination by NGG between IDNs and RDNs, and of discrimination between GDNs and other direct users of the NTS. The second key issue is economic and efficient network development. This is discussed at paragraphs 4.17 to 4.18 [2/13/578]. In this regard, Ofgem states that the offtake arrangements should give "*clear investment signals*": they should provide incentives for both GDNs and network users to reveal their true requests for NTS offtake capacity "*in timescales appropriate for the planning of necessary investment.*" Other issues raised in chapter 4 are security of supply, effect on competition and accountability and regulatory development, although it is fair to say these issues are dealt with quite briefly: see paragraphs 4.19 to 4.27 [2/13/579-580].
70. In chapter 6 of the Offtake RIA, Ofgem set out its initial analysis of the costs and benefits of the four options. However, Ofgem indicates that it has not carried out any quantitative evaluation of Option 1 on the grounds that Option 1 is "*the closest alternative to status quo*" and it is therefore adopted as the base case (para. 6.12) [2/13/609]. As regards qualitative assessment of Option 1, Ofgem states that "*this option performs poorly*" when measured against the key issues identified by Ofgem, including avoiding undue discrimination, economic and efficient network development, security of supply, effect on competition and accountability and regulatory involvement (para. 6.13) [2/13/609]. Indeed, Ofgem expresses the view that Option 1 would furnish NTS with a "*significant opportunity to behave in an unduly discriminatory manner*" towards the Independent GDNs as compared with Retained GDNs. Ofgem also states that Option 1 would require "*an unacceptably onerous level of ongoing regulatory input*", presumably by Ofgem itself.

71. It was therefore plain to me and to any informed reader of the Offtake RIA in June 2004 that Ofgem had no sympathy with formalisation of the existing administered offtake arrangements following a sale of GDNs. This was disappointing for E.ON and other industry participants, since we believed that formalisation of the administered arrangements was likely to be the cheapest and simplest solution, as well as one which had proven successful in the past and with which the industry was fully content.
72. As appears from the Summary to the Offtake RIA, Ofgem's own preference was for the implementation of Option 4 [2/13/537]. However, Ofgem noted that it might be impractical to move directly to Option 4 and that it might therefore be preferable to adopt Option 2 initially, whilst leaving the implementation of Option 4 for the longer term.
73. The Offtake RIA also discusses the issue of diurnal storage: see paras. 5.47 to 5.54 [2/13/597-599]. It is apparent that Ofgem feared that GDNs would fail to invest properly in creating adequate storage for their own needs, and would instead seek to free ride on NTS's diurnal storage. Ofgem's preferred solution to this was, as set out in the Summary [2/13/539], called Option B.
74. Option B is described at paras. 5.53-5.54 of the Offtake RIA [2/13/599]. Although described in broad terms, it is clear that Ofgem was attracted to allocating rights to flow above or below defined operational flow rates "*according to market-based principles*". Both GDNs and other NTS users would "*signal the value they place on both diurnal storage rights, and the right to deviate from predefined operational parameters.*" Ofgem said that this would enable those parties who valued "flexibility" the most to acquire it, leading to a more efficient allocation of "scarce" NTS flexibility. As indicated above, there is some confusion here between "flexibility" in the sense of the ability to vary the rate of offtake, and "flexibility" in the sense of "diurnal storage" or linepack: although linepack facilitates the ability of gas transporters to cater for variations in the rate of offtake, the two concepts are distinct.

75. At paragraph 5.47 of the Offtake RIA, Ofgem indicates that it regarded variation in the rate of offtake from the NTS as a “*secondary’ capacity product*” [2/13/597]. This was in itself a new suggestion, since neither the ability to vary the rate of gas offtake nor linepack had been regarded hitherto as a product in its own right. Rather, linepack had been regarded merely as a by-product of NGG’s obligation to create a pipeline that would satisfy the 1 in 20 obligation: the pipeline was sized in such a way that there was spare capacity that could be used for storage. This storage in turn enables gas transporters to cater for variations in users’ rate of offtake.
76. A number of industry parties submitted responses to Ofgem regarding the proposals contained in the Offtake RIA. E.ON submitted its response on 9 July 2004, expressing our scepticism that much could be gained from focusing effort and time on fundamental changes to the offtake regime [2/14/652-658]. Instead, we proposed that a relatively simple administered offtake regime be implemented. Regarding diurnal storage, we expressed the view that an administered regime could be used to ensure that the cost of investment in diurnal storage by the different parts of the transportation network was fairly distributed. We concluded that “*the more radical proposals suggested by Ofgem risk seriously undermining the current trading arrangements in pursuit of theoretical gains that are unlikely to be realised.*” We even provided Ofgem with our quantification of the negative net benefits of options 2, 3 and 4. We essentially wanted retention of the existing exit charging arrangements in the short term (to minimize fragmentation risk), but were open minded about GDNs paying exit charges and recharging GDN shippers in future. We also suggested that if there was a risk that GDNs might place additional costs on the NGG NTS by varying exit flows to a greater degree than they had done in the past, a simple administered cost reflective charge could be applied between these regulated transportation businesses.
77. On 19 July 2004, the Gas Forum wrote to Ofgem in similar terms [2/15/659-660]. The Forum stated that the approach taken by Ofgem in the Offtake RIA did not reflect discussions held in workgroups with industry participants. The Forum

expressed the view that the existing licence obligations on network owners, perhaps coupled with an express obligation to co-operate with other network owners, should suffice to ensure that an efficient amount of investment was undertaken by both the NTS and GDN owners and that appropriate levels of NTS exit capacity was allocated to each GDN. The Forum noted, in addition, that the regulatory price control process would provide owners with the commercial incentives to invest in an appropriate way: in the unlikely event that a network owner disagreed with an investment request by another network owner, Ofgem would be in a position to resolve the dispute.

78. Consequently, the Forum said that it was “*extremely concerned*” at the approach suggested by Ofgem in the Offtake RIA, an approach which was “*clearly at odds with accepted regulatory practice*” and which the Forum did not believe would result in meaningful investment signals or allow network operators to develop their networks in an economic or efficient manner. Accordingly, the Forum urged Ofgem to reconsider the approach set out in the Offtake RIA.

#### The Conclusions Document

79. Following this, in August 2004, Ofgem published a Conclusions Document on Framework regarding the offtake arrangements (“**the Conclusions Document**”) [2/16/661-726]. The Conclusions Document indicated that, in the light of responses received, Ofgem had decided that the Option 2 approach should be adopted in the event the sale of the GDNs went ahead. Ofgem conceded, however, that if the costs of introducing these reforms were prohibitively high relative to the benefits, then it would not be in customers’ interests to pursue these issues further. Accordingly, Ofgem recommended that these issues be kept under review following any disposal of one or more GDNs.
80. The Conclusions Document also recommended that “flexibility” should be defined as a product to be allocated between the NTS and its direct customers. Ofgem said that it recognised that this recommendation had not been consulted upon and indicated that it would therefore carry out further consultation [2/16/670]. As foreshadowed above, this could not sensibly mean that “diurnal storage” such as

linepack was itself to be sold as a product, since linepack by its very nature cannot be allocated to a specific customer: the existence of linepack at a given time depends, as I have said above, on a number of factors, including the input flows in the pipeline. Nor, as matters turned out, did the product simply provide users with the right to vary the offtake flow up to a maximum hourly quantity. Rather, as explained in greater detail below, it was to be an entirely new product with no direct link to user's normal methods of determining their offtake requirements.

81. Ofgem first set out its ideas for a Flexibility Capacity product in a PowerPoint presentation to the 17<sup>th</sup> DISG meeting on 24 August 2004 shortly after the publication of the Conclusions Document [2/17/727-748]. The presentation is headed, "*Diurnal storage: definition of product*" which, for the reasons I have given, is rather confusing. The presentation takes care to point out [2/17/731] that "*the proposals ... have been developed jointly with Transco*".
82. At the next DISG meeting on 7 September 2004, Transco gave a presentation regarding the proposed "*flexibility product*" (Transco did not make the mistake of characterising the product as "*diurnal storage*") [2/18/749-763]. Interestingly, the Transco presentation directly refers to Ofgem's previous presentation [2/18/753] and appears to take Ofgem's own proposals as the starting point.
83. On 24 September 2004, the Gas Forum wrote to the Chairman of GEMA [2/19/764-765]. In its letter, the Forum emphasised the importance of the GDN sell-off being successfully implemented, and noted the "*significant risk that the rush to implement certain areas of reform, such as offtake, interruption and flexibility, could severely compromise the efficient operation of the industry and the benefits to be delivered to customers.*" The letter noted the Forum's view that the proposed reform of exit and interruption arrangements was a "*genuine impediment to effective implementation*" of the GDN sale.

The Sale FIA

84. On 18 November 2004, Ofgem issued a Final Impact Assessment on the potential GDN sale ("the Sale FIA") [2/20/766-927]. As emerges from the Summary [2/20/770-771], Ofgem concluded that sale of one or more GDNs would create an "external interface" between the newly independent GDNs and NGG which had previously been internalised within NGG, and it was therefore necessary to develop a set of arrangements to "manage" that interface. What Ofgem describes as the "proposed new arrangements" are summarised as follows:
- (1) GDNs and NTS shippers would purchase NTS offtake capacity "on the same basis" thereby ensuring "equal access" to the NTS;
  - (2) this means that for short-term access to the NTS (which would be constrained by the NTS's current capabilities), GDNs and NTS Shippers "will need to compete to gain access" to the NTS;
  - (3) for long-term capacity rights, NTS users would be guaranteed the volume of NTS capacity they required "so long as users are willing to pay for transmission capacity in the timescales that allow the NTS owner time to invest to satisfy that demand ...";
  - (4) a level playing field for access to the NTS's offtake flexibility for GDNs (whether the newly independent GDNs or those retained under NGG ownership) and other NTS users "on a commercial basis" would be established; and
  - (5) NTS users would be able to purchase interruptible capacity on a day-ahead basis, although Transco might also contract to buy back capacity from users holding exit capacity if it believed it economic to do so.
85. In the body of the Sale FIA, Ofgem analyses the two possible options regarding the grant of permission for the sale of the GDNs: either permission is refused (the "no sale option") or permission is granted (the "sale option") (see para. 5.1)

[2/20/817]. Significantly, Ofgem's consideration of the sale option is expressly predicated on the assumption that "*the regulatory, commercial and operational framework accompanying the sale of one or more DNs would be consistent with the conclusions reached within the four conclusions documents issued.*" I understood this to mean that, as of November 2004, Ofgem could conceive of a sale of GDNs proceeding only on the basis that, for example, the Option 2 approach favoured by Ofgem in the Consultations Document would apply to exit capacity arrangements. In other words, if the sale of the GDNs went ahead, it would not be on the basis that the industry would then have a choice as to what changes, if any, it considered appropriate to offtake arrangements. On the contrary, if Ofgem consented to a sale, it would do so on the assumption that the question of what to do about offtake arrangements had already been resolved.

86. One sees this clearly from paras. 5.43 to 5.118 of the Sale FIA, which describe in some detail the proposed offtake arrangements under the sale option [2/20/828-854]. Ofgem again reiterated its "*conclusion that Option 2 was the most appropriate form for the proposed NTS exit capacity offtake arrangements*": see para. 5.56 [2/20/833]. Ofgem asserted that this option had been favoured by the most respondents relative to the other options outline in the Offtake RIA,<sup>5</sup> that it would produce more reliable information for assessing investments in the price control process and that the Offtake RIA had given a favourable cost-benefit analysis for this option (though Ofgem noted that a number of shippers "*had concerns over the accuracy*" of that analysis). This may have been a reference to the Gas Forum's letter of 24 September 2004, to which I have referred above.
87. As regards payment arrangements, Ofgem preferred the Option 2A approach referred to in the Offtake RIA, under which GDNs would pay the NTS "*effectively acting as an intermediary*" for the GDN Shippers (para. 5.59) [2/20/834].
88. On the issue of diurnal storage, Ofgem confirmed the proposal first mooted in the Conclusions Document (a proposal made without prior consultation, as the

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<sup>5</sup> Of course, at the time of the consultation, respondents could not have known that Option 2 would necessarily involve separate Flat and Flexibility Capacity products.

Conclusions Document itself acknowledged) that there should be a distinct Flexibility Capacity product sold by the NTS to both GDNs and NTS Shippers: see paras. 5.69 to 5.75 [2/20/837-838]. I would note that Ofgem reached this conclusion without the benefit of formal consultation on a properly defined Flexibility Capacity product.

89. As regards interruption arrangements, Ofgem proposed that NTS would no longer be obliged to offer interruptible terms to NTS customers on demand. Instead, the NTS would “*contract for demand management contracts (and organise ‘buy backs’ of firm capacity) on market based terms*”. It would also offer an interruptible product for sale on a day-ahead basis: see paras. 5.87 to 5.88 [2/20/842-843].
90. In relation to the timing of these proposals, Ofgem noted that NGG intended to carry out the long term allocation of NTS offtake rights in the summer of 2005. In order to ensure that sufficient “*investment lead times*” were given to NGG, this auction would sell offtake rights for the gas year 2008/09 and onwards; rights would be sold for three years up to fifteen years ahead: see paras. 5.89 to 5.92 [2/20/843-4].
91. For this reason, what Ofgem called the “*enduring*” arrangements would not apply to the allocation of capacity rights in respect of the period from 2005 to 2008. In the meantime, short-term or “*interim*” arrangements were required. In this regard, Ofgem said that NGG had proposed that TCCs seeking offtake rights during this period should be permitted to request them at a regulated price (subject to oversight by Ofgem to ensure that NGG did not unduly discriminate and complied with its statutory and licence obligations) and that the current interruption arrangements would be maintained largely in their current form.

Legal framework for the new offtake arrangements is developed

92. In the light of this direction from Ofgem, NGG, no doubt anxious in the interests of its shareholders to ensure that the sale should proceed, set about developing

the legal framework for the post-GDN sale network, including the changes to the offtake arrangements required by Ofgem.

93. As matters stood before the sale, Transco maintained a Network Code containing the terms on which it provided transportation services. Licensed shippers would enter into Framework Agreements (or Accession Agreements) with Transco to accede to the terms and conditions of the Network Code.
94. Following the GDN sale, the Network Code was to be replaced by the Uniform Network Code (“UNC”). The background to the creation of the UNC is a distinct and involved story in its own right. It has generated a great deal of paper and spawned numerous committees. It suffices for present purposes to mention the key documents and committees which are of relevance to the Decision.
95. As regards committees, in around September 2004, NGG established the UNC Development Forum outside the Network Code Modification procedures to assist with drafting the UNC. Furthermore, on 29 October 2004, Peter Bingham of Transco wrote by email to a large number of industry parties noting that it “*will be necessary for NGT to implement Offtake, Exit and Interruption reforms in order to facilitate the sale*” of four GDNs [3/21/928-930]. Accordingly, Transco proposed to launch an Exit Reform Development Forum (subsequently known as the Exit Regime Forum, “ERF”) commencing on 11 November 2004 in order to “*present and work through*” the proposed reforms with the industry. One of the purposes of the meetings was to “*bring stakeholders ‘up to speed’ on the proposed offtake arrangements and exit/interruptible reforms*”, which plainly meant the reforms published by Ofgem. I did not myself attend the ERF’s meetings, although a member of my team did, together with representatives of shippers, customers and prospective purchasers of GDNs.
96. This led to the publication by Transco of a consultation document dated December 2004 entitled, “*Towards a new industry framework*” (“TANIF”) [3/22/931-1001]. Its purpose was to invite views on proposals for reforms to the commercial framework for gas transportation in Great Britain. As set out at section 2.3 of TANIF [3/22/940], Transco’s preferred model was that the UNC

should be a single set of substantive commercial terms for gas transportation services applicable to the NTS and to the GDNs. The NTS and each GDN would have their own "short-form" network code, which would incorporate by reference the relevant provisions of the UNC. Shippers would then enter into accession arrangements with the NTS or the relevant GDN (as desired) and would thereby become bound by the terms and conditions of the relevant NTS or GDN network code.

97. TANIF explains at section 2.4 [3/22/941] the process by which the UNC was to be drafted. According to TANIF, modifications to Transco's existing Network Code had to be made via the modification process specified in the Network Code itself. Transco followed this process insofar as the drafting of the UNC involved a modification to the Network Code (one leading to the demise of the Network Code itself). However, the UNC also involved the creation of new sets of relationships – that between the GDNs and NTS, and that between the newly independent GDNs and shippers. This was said to be outside the scope of the Network Code modification process and accordingly Transco had established the UNC Development Forum and the Exit Reform Forum to obtain industry views.
98. Chapter 3 of TANIF sets out "*Transco's proposals*" for the exit offtake regime [3/22/964-992]. In broad terms, these proposals adopt Ofgem's Option 2 from the Offtake RIA and Option B regarding "flexibility". Indeed, there is a striking similarity between Transco's proposals as described in the TANIF and Ofgem's views as described in the Sale FIA. Both documents were published at around the same time, in November 2004.
99. Furthermore, TANIF mirrors the Sale FIA in proposing, at para. 3.1.5 [3/22/965], that "*interim*" arrangements should apply during the period 2005 to 2008, whereby new and existing users would continue to purchase capacity rights at administered prices. This is explained in greater detail in section 3.7 [3/22/958]. It appears that Transco anticipated at this stage that the offtake reforms would be introduced into the UNC at its inception, albeit subject to the interim arrangements until September 2008.

Ofgem consents to the sale, conditional on support for its reforms

100. On 21 January 2005, Ofgem issued a press release announcing its decision to approve the sale of the four GDNs to third party purchasers, subject to a number of conditions [3/23/1002-1003].
101. Ofgem set out its detailed reasons for the decision to give conditional consent in a further publication dated February 2005 (“**the Sale Decision**”) [3/24/1004-1103]. The Sale Decision also gave details of the conditions which Ofgem required to be met before its consent would become unconditional final.
102. As set out in the Summary [3/24/1005-1011], Ofgem indicated in the Sale Decision that it endorsed its own previous decisions regarding arrangements necessary to protect consumers’ interests once the GDNs were no longer all owned by the same entity. These decisions included “*the continued development of the enduring offtake arrangements for the allocation of [NTS] exit capacity and NTS offtake flexibility through the DN sales process.*” Ofgem stated that it had concluded that “*all of the proposed enduring offtake arrangements*” were reasonable and proportionate and protected the interests of customers.
103. As regards timing, the Sale Decision noted that respondents to Ofgem’s Final Impact Assessment on the GDN sale had expressed concern about the timetable for the introduction of the proposed enduring offtake arrangements. In response to these concerns, Ofgem had decided that it was not necessary to implement the enduring offtake arrangements prior to the completion of the GDN sales transaction. Ofgem stated, however, that it did not believe their implementation should be delayed beyond September 2005.
104. Ofgem’s views regarding the enduring offtake arrangements were reflected in the conditions that Ofgem imposed on its consent to the proposed sale. First, Ofgem required an undertaking from NGG that it would use its best endeavours to ensure steps were taken to ensure the implementation of the enduring offtake arrangements by 1 September 2005. Ofgem also required NGG to procure equivalent undertakings from the third party purchasers of the GDNs.

105. In addition, Ofgem said that it intended to introduce the same “best endeavours” obligation into the gas transporter licences of NGG and each of the GDNs. Ofgem’s consent to the sale was conditional upon NGG and the GDNs agreeing to the inclusion of this obligation in their licences.
106. In the event, NGG and the GDNs did agree to this course of action and in due course standard special condition A55 (“**Condition A55**”) was inserted into the gas transporters’ licences [3/25/1104]. Condition A55 provided as follows:
- “1. The licensee shall use its best endeavours to implement, on or before 1 September 2005, the enduring offtake arrangements in a form approved in writing by the Authority.
  2. The licensee shall within 5 days of this licence condition becoming effective ... procure from each company or other person which is an ultimate controller of the licensee an undertaking (in a form specified by the Authority) in favour of the Authority that that ultimate controller will:
    - (i) use its best endeavours; and
    - (ii) procure that the licensee will use its best endeavours,to introduce on or before 1 September 2005 the enduring offtake arrangements in a form approved in writing by the Authority.
  3. The licensee shall deliver each such undertaking to the Authority as soon as practicable.
  4. For the purposes of this condition “enduring offtake arrangements” means those enduring offtake arrangements as described in the Authority’s Final Impact Assessment in connection with Transco plc’s proposed sale of distribution networks published in November 2004 and entitled “National Grid Transco – Potential sale of gas distribution network businesses. Final Impact Assessment. November 2004 255/04a” together with such variations as may be directed in writing by the Authority.”
107. I understood that the effect of Condition A55 was to oblige NGG and the GDNs to do their best to ensure that Ofgem’s proposed changes to the modification arrangements as set out in the Sale FIA were implemented or, in the event that Ofgem directed that those proposals should varied, to ensure that the proposals as varied were implemented.

108. So far as E.ON was concerned, the imposition of this licence condition meant that NGG and the GDNs were no longer in a position to express their own genuine views regarding changes to the offtake arrangements. The licence obligation extracted by Ofgem as a condition of its consent to the sale meant that the gas transporters were effectively bound to support Ofgem's own proposals. I was conscious at this time that the UNC had not yet been designated under secondary legislation as a document in respect of which decisions of Ofgem could be appealed under section 173 of the Energy Act 2004 (I am advised that this did not occur until 14 July 2005). I am advised that if, as a result of this licence condition, the enduring offtake arrangements had been implemented as Ofgem wished, E.ON would not have had any right of appeal on the merits against that decision.

#### The Freedom of Information Request

109. These were matters of concern not only for E.ON but for gas shippers in general. On 1 March 2005, the Gas Forum made a number of requests under the Freedom of Information Act 2000. I refer to the letter dated 28 February 2005 from Angela Love, Chairman of the Gas Forum, to Ofgem setting out the requests [3/26/1105]. The fourth request related to the "enduring exit arrangements" which Ofgem wanted to be implemented in September 2005 as a condition of its approval for the proposed GDN sale. The Gas Forum requested copies of any information at any time provided to any member of GEMA which explained, analysed or recommended the provisions of those arrangements.
110. Ofgem responded to the request on 14 April 2005, indicating that disclosure of certain documents was being withheld by references to exemptions in the 2000 Act [3/27/1106-1111]. A number of the documents disclosed were also redacted. Overall, the documents disclosed did not shed very much light on how Ofgem had reached its preference for the enduring offtake arrangements. I would, however, refer to an internal Ofgem memo dated 25 March 2004 [3/28/1112-1117]. This concerned a licence obligation which Ofgem had previously imposed on Transco to use reasonable endeavours to develop "universal firm

arrangements” for exit capacity on the NTS, i.e. to bring an end to interruptible offtake arrangements. The memo discusses whether that obligation should be maintained following a GDN sale. I note that the memo cites the following as an advantage of retaining the obligation:

“Given the level of industry opposition to exit reform and the possibility that DN sales may not go ahead, it is important to retain a mechanism by which exit reform can be partially introduced.”

111. It is apparent, therefore, that Ofgem regarded the imposition of such licences as a mechanism for introducing reforms in the face of industry opposition. In the event, as set out above, Ofgem introduced a new licence obligation on gas transporters concerning the enduring offtake arrangements.

#### The UNC and the “interim” offtake arrangements

112. At around the same time, changes were made to the contractual arrangements relating to the transportation of gas in the NTS and GDN pipelines systems.
113. Following publication of TANIF, Transco began to draft the detailed legal text of the new UNC. Then, on 23 February 2005, Transco raised Modification Proposal 0745 (“**Mod 0745**”) to the Network Code, which would have the effect of removing virtually all of the operative text of the Network Code and replacing it with text incorporating the provisions of the new UNC by reference. Transco requested that the proposal follow urgent procedures, in view of the imminent sale of the GDNs. This would have the effect of curtailing the usual consultation process, thereby significantly reducing the opportunity for industry participants to make representations. On 25 February 2005, Ofgem granted urgent status to this proposal.
114. On 3 March 2005, the Gas Forum wrote to Ofgem putting formally on the record the views of members of the Gas Forum [3/29/1118-1120]. It noted that several of the proposed amendments to the gas transporters’ licences stipulated requirements which Transco and the GDN owners would be obliged to reflect in the UNC. In so doing, Ofgem could be said to be bypassing open discussion and

presenting Gas Forum members with a *fait accompli*: the licence amendment process was not formally open to shippers, so there could be no meaningful consultation at that stage, and “*any modification proposals to introduce these terms into UNC raised by [gas transporters] will be approved regardless of the results of consultation.*” This was a particularly prescient observation, as matters turned out.

115. Specifically in connection with offtake arrangements, the Forum noted that Ofgem had failed to make a compelling case for continuing to link them with the GDN sales. The Forum expressed the view that the arrangements now planned for the enduring regime represented an important change from those envisaged in the original Impact Assessment and that a further regulatory impact assessment should be undertaken looking at exit reform in its own right. The Forum also expressed concern that the proposed arrangements would have the undesirable effect of stifling competition. The Forum ended by saying that it anticipated that “*should a regulatory impact assessment on exit reform show that costs outweigh benefits then the current plans will be suitably amended.*”
116. On 4 March 2005, Ofgem issued an open letter initiating the first stage of consultation on the proposed UNC [3/30/1121-1132].
117. In their responses to the draft UNC, many industry participants sharply criticised the limited time made available for consultation. A number of shippers also take particular issue with the provisions regarding offtake arrangements. For example, Shell Gas Direct noted in its comments sent under cover of a letter dated 18 March 2005 that paras. 3.8 and 3.9 of TPD Section B “*appears to presume the implementation or the enduring exit arrangements ... These changes appear to presume acceptance by Ofgem of other changes currently out for consultation and/or not yet consulted upon*” [3/31/1136]. Shell’s covering letter further stated that, “*Developments since February have only reinforced our view that Ofgem’s proposed changes to the exit regime should not be implemented but we can not see why the Authority considers a rushed process to be either necessary or efficient.*” [3/31/1134]

118. Similarly, BP noted in its letter dated 18 March 2005 that Ofgem was proposing “*fundamental exit reform without being able to convince the majority of customers or participants of the need for such change*” [3/32/1141-1143].
119. Meantime, on 17 March 2005 Ofgem replied to the Gas Forum’s letter of 3 March 2005 [3/33/1144-1149]. Ofgem rejected the suggestion that Gas Forum members were faced with a *fait accompli* in relation to the licence consultation process. However, Ofgem did not address the Gas Forum’s point that any modification proposals made by a gas transporter in fulfilment of a licence obligation would inevitably be approved, irrespective of the results of consultation. With regard to offtake arrangements, Ofgem reiterated its view that its proposed changes to the offtake arrangements were necessary. Ofgem also said that it did not agree that this would stifle competition, but indicated that it was considering the need for a further impact assessment.
120. On 29 March 2005 Ofgem issued a further letter initiating the second stage of consultation [3/34/1150-1157]. It is worth noting that Ofgem comments as follows in the 29 March 2005 letter:
- “Finally, it was suggested in responses that some aspects of the changes set out in Transco’s draft UNC, specifically changes relating to the UNC modification process and the offtake arrangements, went beyond the changes required to give effect to DN sales. Ofgem does not intend to make any comment on the detailed drafting prepared by Transco as part of this process. However, as previously explained, Ofgem considers that changes to the modification process and the offtake arrangements are required to protect the interests of customers under a divested industry structure. This view is shared by the Authority which, as part of its conditional decision, endorsed the need for these changes. It is now a matter for Transco to propose the arrangements which it considers, having regard to its statutory and licence obligations, better facilitate the relevant objectives in a divested industry structure.”
121. It was plain to E.ON from this letter that Ofgem/GEMA was out of sympathy with shippers’ and relevant customers’ views, and was determined that its proposed changes to offtake arrangements should proceed.

122. On 12 April 2005, E.ON submitted its comments at the second stage of consultation on the draft UNC document. We noted that a number of clauses in Section B of the draft Transport Principal Document (“TPD”) “*appear to pre-judge the form of any enduring exit arrangements ...*” [3/35/1158-1165].
123. Nonetheless, on 25 April 2005, GEMA issued a decision directing that Mod 0745 be implemented from 1 May 2005 or such later date as GEMA might direct [3/36/1166-1177]. The new UNC had thus been approved within fewer than 2 months after its proposal by Transco. It was my view and that of other industry participants that it was inappropriate to rush through such an important document without proper consultation on the modification proposal as ultimately formulated.
124. As foreshadowed in our response to the consultation, the provisions of the UNC which GEMA’s decision brought into force governing offtake arrangements did pre-judge the question of what changes, if any, should be made to those arrangements. In particular, the offtake provisions were governed by “sunset” clauses expiring on 30 September 2008. Thus, for example, Section B of the Transport Principal Document of the UNC [4/37/1178-1317] provided, by para. 3.9.1, that NTS users could apply for capacity only in respect of the period “*ending not later than 30 September 2008*” [4/37/1230]. As regards capacity in respect of the period after 30 September 2008, the UNC was entirely silent. In other words, no legal mechanism was provided in the UNC for the allocation of capacity in respect of the period after 30 September 2008.
125. It is unclear who had introduced these “sunset” provisions into the UNC text. A time restriction of this kind was clearly in accord with Ofgem’s repeatedly-expressed view that new “*enduring*” offtake arrangements should be introduced at the earliest possible opportunity. Given the very limited opportunity given to shippers to study the formal UNC draft and to analyse its provisions, it is perhaps unsurprising that industry participants did not object to this provision quite as strongly as they might have done after fuller consideration.
126. As regards TCCs, these “*interim*” offtake arrangements applicable until 30 September 2008 remained substantially unchanged from the arrangements that

existed prior to the sale of the GDNs. Capacity was to be allocated to shippers at supply points on an administered basis and specified in terms of a maximum daily offtake quantity, being the supply offtake quantity of the site in question. NTS exit capacity charges were determined by reference to the "exit zone" to which the offtake point was assigned. Sites with interruptible status continued to receive relief from exit capacity charges.

127. The "*interim*" offtake arrangements permitted TCCs to "roll-over" their existing NTS exit capacity entitlements on an annual basis, paid monthly in arrears. In the event that the TCC required additional exit capacity, this could be requested through a process set out in the UNC. Where additional capacity requests triggered further investments, the TCC would have to enter into an ARCA with NGG, as before.
128. The "*interim*" arrangements for the allocation of exit capacity to GDNs were also broadly similar in practice to the existing arrangements, although there were significant differences in form. Instead of NGG determining the capacity requirements for the GDNs (as their owner), the GDNs themselves became responsible for determining their offtake capacity needs consistent with the 1 in 20 obligation. For the first time, GDNs were required to register their requirements for capacity in terms of a Flat Capacity concept (i.e. offtake at a constant rate of flow) and a Flexibility Capacity concept (broadly speaking, permitting offtake at a variable rate of flow). These concepts were broadly similar to the Flat and Flexibility Capacity products ultimately approved in the Decision, as explained below. It is important to emphasise, however, that the GDNs did not bid against each other for their allocations of Flat or Flexibility Capacity. The administered regime continued to apply, and it was GDN Shippers, not the GDNs themselves, who were charged for the GDNs' NTS capacity. It was simply that there was an application process in which GDNs would make known to NGG NTS their capacity needs in terms of these new concepts, rather than in terms of their MDQ as previously.

129. It is my belief that the intention behind the inclusion of the sunset clauses was twofold: first, to emphasise the interim nature of the arrangements and that Ofgem did not intend to permit them to continue indefinitely; and second, to put pressure on gas industry players to agree new offtake arrangements that would meet with Ofgem's approval at the earliest opportunity.
130. Given the presence of this "time bomb" in the UNC provisions regarding offtake arrangements, it was inevitable that the UNC would have to be modified to provide for capacity allocations in respect of the period after 30 September 2008. In this regard, the UNC contained Modification Rules to facilitate the process of making changes to it. Modification proposals were to be channelled through the UNC Modification Panel ("the UNC Panel").
131. The UNC Panel consists of ten members – five representing shippers and five representing transporters. Shipper members are elected by the shipping constituency in annual elections and each of the transporter representatives are appointed by their respective companies. NGG has two representatives, one to represent NGG NTS and one to represent its retained GDNs. As I have already indicated, I am one of the shipper representatives on the UNC Panel. Non-voting members are also entitled to attend UNC Panel meetings, including Ofgem and Energywatch representatives, terminal operators, suppliers and independent (i.e. non-UNC) transporters. The secretary of the UNC Panel (a position which does not carry the right to vote) is an employee of NGG but is required to act in an independent capacity.
132. Once a modification proposal has been made, it is for the UNC Panel to determine whether the proposal should proceed straight to consultation or whether it required further development. Once the UNC Panel has decided that consultation should begin, NGG must prepare a Draft Modification Report, on which all interested parties will be invited to make representations. Following receipt of the representations, the Joint Office of Gas Transporters (the office supporting administration of the UNC) will produce a Final Modification Report. At this stage, the UNC Panel may make a recommendation as to whether the

Proposal should be implemented. On occasions the Panel has chosen not to make a recommendation on urgent modification proposals if they believe the short timescale prescribed by the urgent procedures prevent a properly informed recommendation being made. This is in part so as to not to potentially preclude parties having the right of appeal to the Competition Commission.

133. The decision whether to implement the proposal is, of course, taken by GEMA. The test applied by GEMA in assessing a UNC modification proposal is whether the proposal will better facilitate the achievement of the relevant objectives of the UNC. These objectives are set out in paragraph 1 of Standard Special Condition A11 of NGG's NTS licence and are as follows:

- (1) The efficient and economic operation of the pipeline system to which the NGG NTS licence relates;
- (2) So far as is consistent with sub-paragraph (a), the coordinated, efficient and economic operation of (i) the combined pipe-line system, and/or (ii) the pipe-line system of one of more other relevant gas transporters;
- (3) So far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under the licence;
- (4) So far as is consistent with sub-paragraphs (a) to (c), the securing of effective competition:
  - (1) Between relevant shippers;
  - (2) Between relevant suppliers; and/or
  - (3) Between DN operators (who have entered into transportation arrangements with other relevant transporters) and relevant shippers).

134. As this description shows, the rationale for the UNC Panel is that the gas industry should be largely self-governing, subject to ultimate oversight by Ofgem.

### Section 3: Ofgem continues to seek “reform” following the GDN sale

135. On 25 May 2005 Ofgem published an open letter stating that it had granted its unconditional approval to the sale [4/38/1318-1336]. As a result, on 1 June 2005 NGG sold four of the GDNs to third parties: two to Scotia Gas Networks,<sup>6</sup> and one each to Northern Gas Networks and Wales & West Utilities.<sup>7</sup> NGG retains ownership of the other four.<sup>8</sup>

#### Extension of the “interim” arrangements

136. On 24 June 2005 Ofgem published an open letter stating that it had decided to delay the introduction of “enduring” offtake arrangements beyond the existing deadline of 1 September 2005 until September 2007 to allow for further consultation [4/39/1337-1339]. The new arrangements to be introduced in September 2007 would govern the allocation of offtake rights for the period beginning from October 2010 onwards. As noted in the letter, this meant that it was necessary to consider what mechanism should determine the allocation of exit capacity for the period from 1 October 2008 to 30 September 2010. Ofgem said that it was important to work towards introducing “*suitable transitional arrangements*” later in the year. Ofgem also said that, in view of this postponement of the introduction of new arrangements, it did not intend to enforce standard special condition A55 in the gas transporters’ licence, although it would give thought to amending the condition to reflect the new deadline of September 2007.

137. It is worth interjecting at this point that on 28 June 2005, NERA Economic Consulting published a report (“**the First NERA Report**”) which the Gas Forum had commissioned regarding the true cost of the proposed enduring offtake arrangements [4/40/1340-1454]. The Gas Forum was seeking to apply pressure on Ofgem to rethink the need for enduring offtake arrangements.

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<sup>6</sup> Scotland and South of England.

<sup>7</sup> Wales & West and North of England respectively.

<sup>8</sup> North West, London, West Midlands and East of England GDNs.

138. On 19 August 2005, Transco made Modification Proposal 046 [4/41/1455-1464]. This would have the effect of extending the sunset clauses on the interim offtake arrangements from 30 September 2008 to 30 September 2010.
139. On 12 September 2005 I submitted E.ON's submissions in response to the draft Modification Report for Modification Proposal 046 ("Mod 46") [4/42/1465-1466]. E.ON's position was that the continued inclusion of a sunset clause in the Uniform Network Code was wrong in principle. I said that we would offer our full support for the proposal if it did not impose a 30 September 2010 guillotine and instead suggested a permanent modification to the UNC until a code signatory thought it appropriate to propose further changes. I pointed out that the continued application of a 'drop-dead' date (the sunset clause element of the proposal) meant that parties did not have any certainty as to what arrangements might be in place after 30 September 2010. Indeed, I expressed E.ON's view that the whole process would be brought into disrepute if parties were forced to bring forward proposals simply because an arbitrary end-date had been included in the code.
140. On 20 January 2006 Ofgem announced that it had decided to implement Mod 46 [4/43/1467-1474], thereby extending the sunset clause in the interim offtake arrangements until 30 September 2010. The decision to extend the sunset clauses rather than to delete them altogether underlined once again for industry participants that Ofgem regarded the existing, "administered" arrangements for allocation of exit offtake capacity as no more than temporary.

Ofgem links offtake reform with the regulated price review

141. In the meantime, in December 2005 Ofgem had issued its Second Consultation in connection with the Transmission Price Control Review ("TPCR") [4/44/1475-1642]. The purpose of the TPCR is for Ofgem to establishing price control levels for NGG. However, the Second Consultation included a section (paragraphs 7.51 to 7.70) regarding arrangements of NTS exit offtake [4/44/1546-1552]. Ofgem discussed the advantages and disadvantages of either maintaining the existing "transitional" arrangements or instead introducing "*long term user*

*commitment models*". It is notable that the document is long on the disadvantages of the transitional arrangements and long on the advantages of long term user models.

142. E.ON was dismayed at Ofgem's decision to bring the proposals for offtake arrangements into the context of the TPCR. E.ON's view was that this would give NGG further incentives to align itself with Ofgem's wishes. The TPCR is very important for NGG as it establishes the prices that NGG may charge over a five year period. It would not have been advantageous for NGG to go against Ofgem's wishes at such a sensitive juncture.

#### The EOWG

143. On 16 December 2005, Ofgem announced its decision to establish an Enduring Offtake Working Group ("**EOWG**") [5/45/1643-1649]. It was unclear to E.ON what Ofgem's purpose was in establishing this new entity. The UNC Panel was the established body for considering modification proposals to the UNC. Its 50/50 split between shippers and transporter well reflected the different industry parties with an interest in offtake arrangements from the NTS. There were at least two established routes for considering prospective changes. First, an issue could be tabled at the relevant Transmission Workstream, a regular monthly meeting chaired by the Joint Office to consider actual or potential modification proposals. Alternatively, a Review Proposal could be formally raised for consideration by the UNC Panel, which could choose to establish a specific Review Group. A Review Group allows code signatories to develop solutions to identified problems and, if appropriate, a formal modification proposal may then be put to the UNC Panel. By contrast, the EOWG was not part of the formal modification process.
144. It is fair to say that E.ON was sceptical about Ofgem's motives for introducing this forum. We considered that there was a risk that its purpose was to manufacture support for Ofgem's preferred outcome. We were also wary of the additional burden on industry participants which a new talking shop would create.

Nevertheless, we felt that it was prudent to take part. Our aim was simply to mitigate the worst effects of the EOWG.

145. Ofgem's Third TPCR Consultation issued on 30 March 2006 [5/46/1650-1734] confirmed Ofgem's firm preference for long term user commitment models as the basis for reform of the offtake arrangements: see chapter 5 of the Third Consultation [5/46/1680-1687].
146. On 26 June 2006 Ofgem published, as an appendix to its Initial Proposals for the Transmission Price Control Review, a draft Impact Assessment on "enduring" offtake arrangements ("the Draft IA") [5/47/1735-1782]. Ofgem stated in the Draft IA that, absent enduring reform, it was to be assumed that the "transitional" arrangements would continue to apply beyond 1 October 2010. On this basis, Ofgem considered it appropriate to measure the potential costs and benefits of enduring offtake reform "*relative to the continuation of the transitional arrangements*": see para. 1.7 of the Draft IA [5/47/1740].
147. Ofgem estimated that, on this approach, enduring offtake reform would bring total net benefits to customers with a present value ("PV") of between £19.5 million to £66.5 million, assuming a discount rate of 6.5 per cent: see Table 17.16 of the Draft IA [5/47/1750].
148. On 18 August 2006 E.ON had a senior level meeting with Ofgem to present its concerns about "user commitments". The meeting was attended on the part of Ofgem by David Gray Managing Director, Networks and Colin Sausman, Associate Director Transmission and, on the part of E.ON, by Kenton Bradbury, Director of Risk Management and Strategy and me. Our presentation [5/71/2180-2193] focused on the enduring offtake arrangements and the fact that the TPCR proposal inappropriately transferred risk from NGG to users. We also mentioned how the industry had managed to agree more flexible user commitments for new power stations in electricity. The objective of the meeting was essentially to encourage Ofgem to rethink their position on the enduring offtake arrangements. I do not believe, however, that we succeeded in achieving this. Ofgem held an opposite view to E.ON in that they considered that

shippers were better able to manage the risk that would be transferred to them under the new regime.

149. The last meeting of the EOWG took place on 23 August 2006. I was not myself present at this meeting but I have seen a copy of the minutes [5/48/1783-1791]. NGG NTS gave a presentation on the enduring offtake arrangements "*in order to aid understanding of relevant issues*". The content of the presentation was virtually indistinguishable from the arrangements repeatedly put forward by Ofgem in the documents referred to above, albeit with a greater level of detail provided. NGG indicated that it intended shortly to submit a formal modification proposal to the UNC Panel. At the end of the meeting, the Chairman (Mark Feather of Ofgem) indicated that EOWG could continue on an ad hoc basis in order to discuss the drafting of relevant licence conditions, but that discussions concerning the modification process would now occur through the UNC processes [5/48/1791].

#### **Section 4: the UNC modification process**

150. As the above should make clear, the formal modification and consultation process did not begin until very late in the story. Ofgem made known its desire for offtake reform as early as 2004. Yet it was not until late 2006 that any modification proposal to implement Ofgem's reforms was tabled, as described below.

#### **NGG proposes Mod 116**

151. On 13 September 2006, NGG formally proposed Modification Proposal 0116 ("**Mod 116**") to the UNC Panel. In broad summary, the main features of Mod 116 were as follows:
- (1) NTS exit offtake capacity would be sold as two separate products: a Flat Capacity product, conferring the right to offtake gas at an even flow rate across the gas day; and a Flexibility Capacity product, which would allow

NTS users to offtake gas at flow rates which deviate from the uniform flow rate conferred through holding the Flat Capacity product. There would be a complex calculation for determining how much Flexibility Capacity was required, namely *“by subtracting 2/3 of [the user’s] total end of day allocated quantity from the cumulative allocated quantity it has offtaken between 06:00 and 22:00, including a tolerance of 1.5% on measurements of the cumulative flow.”*

- (2) As far as Flat Capacity is concerned:
- (1) Users (i.e. GDNs, TCC shippers and other direct connect NTS users) would be allocated an initial amount of “Prevailing” Flat Capacity based on their existing capacity entitlement.
  - (2) Users would be able to apply for an increase in their Prevailing Flat Capacity during an annual application window in gas year Y for use from gas year Y+4, Y+5 or Y+6 onwards. Users would have to commit to the increase requested for a minimum four-year period. So, for example, e.g. a user could bid in July 2008 for additional Prevailing Flat Capacity from July 2012 onwards and would be bound to retain and pay for such capacity until July 2016. Users would have to give a minimum of 14 months’ notice in order to reduce their prevailing rights (such notice would not be effective in respect of any requested increase in Prevailing Flat Capacity until the four-year commitment period had elapsed).
  - (3) Annual pay-as-bid auctions would be held in August of each gas year Y to provide GDNs and other NTS users with the opportunity to procure annual Flat Capacity rights for gas years Y+1, Y+2 and Y+3.
  - (4) Daily Flat Capacity might also be made available in pay-as-bid auctions held a day ahead of the gas day and during the gas day itself.

- (3) As regards Flexibility Capacity:
- (1) Annual pay-as-bid auctions would be held in July of each gas year Y to provide GDNs and TCC shippers to bid against one another for the opportunity to purchase annual Flexibility Capacity rights for gas years Y+1 to Y+5 inclusive.
  - (2) NTS users would also be able to apply on a day-ahead basis for daily Flexibility Capacity for a particular NTS exit zone by submitting an appropriate notice, unless NGG declares that flexibility constraints are in place.
  - (4) Users who offtook more gas than their Flat or Flexibility Capacity permitted would be subject to overrun charges if the aggregate end of day flow of all users at a particular NTS exit point exceeded the aggregate end of day Flat and/or Flexible Capacity held by all users at that point.
  - (5) The above Capacity products would be for firm capacity. Interruptible capacity would be made available in day-ahead auctions. NGG NTS would have the right to buy back interruptible capacity during the gas to manage any exit capacity constraints. NGG NTS would also have the power to enter into Exit Capacity Management Agreements, such as forward agreements or options, giving NGG NTS the right to buy-back Flat or Flexibility Capacity rights from users.
152. It was striking to E.ON that Mod 116 bore no resemblance to NGG's initial preference for an administered system for the allocation of exit capacity to NTS users (as described by Ofgem in the Next Steps Paper dated December 2003 and then presented as Option 1 in the Offtake RIA in June 2004).
153. On the contrary, as I have indicated above, Mod 116 has much in common with Option 2 in the Offtake RIA – the proposal ultimately recommended by Ofgem in its Conclusions Document of August 2004 – in that it treats both GDNs and shippers as being in the same position, both being required to book exit offtake

capacity a number of years in advance. Mod 116 also creates a separate Flexibility Capacity product for which both GDNs and shippers directly connected to the NTS would bid. Again, this echoed Ofgem's thinking in the Conclusions Document on variation in offtake flows being a product in its own right.

154. E.ON found it difficult to resist the conclusion that NGG had felt obliged to put forward a proposal regarding offtake arrangements that was closely aligned with Ofgem's own thinking.

#### E.ON proposes Mod 116A

155. E.ON was strongly opposed to Mod 116. As I have already set out above, E.ON's preference throughout has been that the existing "interim" arrangements should simply be made permanent by the simple expedient of removing the sunset clauses. Consistently with this, on 12 October 2006, E.ON put forward Modification Proposal 0116A ("**Mod 116A**"), which would achieve precisely this result, to the UNC Panel secretary. I refer to the text of Mod 116A [5/49/1792-1797].

#### Other modification proposals

156. Also on 12 October 2006, RWE Trading put forward Modification Proposal 0116B ("**Mod 116B**"). This was closely based on Mod 116, but with minor modifications including the following:

- (1) the tolerance for use of the Flexible Capacity product would be increased from 1.5% to 3%, so that users would be allowed to use more NTS Flexibility Capacity before incurring overrun charges;
- (2) overrun charges in respect of flexibility rights would be charged only on days when the demand for flexibility exceeded the volume available;
- (3) users could signal the need for additional Prevailing Flat Capacity outside the July booking window contemplated by Mod 0116; and

- (4) the cut-off date for Prevailing Flat Capacity would be extended from 1 July 2007 to 1 October 2010.
157. A further proposal, Modification Proposal 0116C ("**Mod 116C**"), was made by British Gas Trading on 17 October 2006. Although this was also based on Mod 116, there was a significant distinction, namely that Mod 116C did not provide for NGG to sell exit Flexibility Capacity's a product.
158. I should mention at this point that E.ON had a further meeting with Ofgem on 21 November 2006. Those present were Robert Hull, Director Transmission and Mark Feather, Associate Director Transmission at Ofgem and Paul Jones and myself from E.ON The meeting primarily dealt with TPCR matters but did provide another opportunity for us to outline our concerns about the enduring offtake arrangements. Our aim was to encourage a rethink from Ofgem although we believed that the chances of bringing about a change of heart were now even less likely. I used the same presentation as made at the 18 August 2006 meeting referred to above.
159. On 22 November 2006, Scotia Gas Networks made Modification Proposal 0116D ("**Mod 116D**"). This sought to modify Mod 116 on a number of points of detail that were of concern to GDNs.
160. I should say that it is E.ON's understanding that Mods 116B, 116C and 116D were attempts to mitigate the worst aspects of Mod 116. I do not believe that these proposals would have been put forward independently of Mod 116.
161. As set out in the Chronology, NGG made some minor variations to its own proposal, Mod 116, on 15 November 2006. Under the formal rules governing the UNC modification process, this meant that Mod 116 had to be formally withdrawn and replaced by a new proposal designated as Mod 116V. I refer to the text of Mod 116V [5/50/1798-1826]. The changes in Mod 116V were also carried through to the other proposals that had been based on Mod 116. Accordingly, the other proposals were replaced with Mods 116BV, 116CV and 116DV. Since

Mod 116A was not based on Mod 116 at all, there was no need to replace it or to change its designation.

Industry parties comment on the modification proposals

162. On 24 November 2006, a draft modification report was produced setting out the various proposals in a single comparative document [5/51/1827-1882]. Industry parties were then given an opportunity to make representations regarding each of the modification proposals by 6 December 2006. The dates on which representations were received are set out in the Chronology.
163. I have reviewed the representations submitted to the UNC Panel secretary regarding each of the modification proposals. In total, 27 interested parties made representations. Of these:
- (1) 16 interested parties said that they supported Mod 116A and that they did not support any of the other proposals. These parties were Scottish & Southern Energy [5/52/1883-1899], International Power plc [5/52/1895-1899], E.ON itself [5/52/1900-1912], The Chemical Industries Association [5/52/1913], The Association of Electricity Producers [5/52/1914-1924], SBGI Gas Storage Operators Group [5/52/1925-1942], EDF Trading [5/52/1943-1947], ConocoPhillips (UK) Ltd [5/52/1948-1951], Centrica Storage Ltd [5/52/1952-1960], Electricity Supply Board (Rep. Ireland) [5/52/1961-1965], The Northern Ireland Authority for Energy Regulation [5/52/1966-1967], Viridian Power & Energy Limited [5/52/1968-1975], Shell Gas Direct Limited [5/52/1976-1977], Statoil (UK) Limited [5/52/1978-1983], Gaz de France [5/52/1984-1986] and Bord Gáis Networks [5/52/1987-1995].
  - (2) In addition, the Major Energy Users Council (MEUC) simply stated that it supported Mod 116A, without commenting on any of the other proposals [5/53/1996].

- (3) Four companies stated that they supported Mod 116A, gave qualified or unqualified support to Mod 116CV and did not support the implementation of Modification Proposals 0116V, 0116BV or 0116VD. These companies were Total Gas & Power Limited [5/54/1997-2005], Total E&P UK plc [5/54/2006-2015], British Gas Trading [5/54/2016-2025] and EDF Energy [5/54/2026-2034].
- (4) RWE Npower expressed support for Mod 116A, qualified support for both Mods 116BV (its own proposal) and 116CV but stated that it did not support the implementation of Mods 116V or 116DV [5/55/2035-2044].
- (5) Wales & West Utilities expressed “*qualified support*” for Mod 116VD but said that “*in the absence of a unanimous decision supporting the implementation of 0116V, 0116BV, 0116CV, or 0116VD, Mod 0116A should be implemented as this would provide continuity to the current regime whilst other options are reconsidered.*” [6/56/2057-2062]
- (6) In total, therefore, Mod 116A had support from 23 out of 27 respondents.
- (7) Scotia Gas Networks plc expressed support for its own proposal, Mod 116VD and said that it did not support any of the other proposals [6/56/2045-2051]. Northern Gas Networks [6/56/2052-2056] expressed “qualified support” for Mod 116VD. NGG (UK Distribution) offered support for Mod 116VD, qualified support for Mod 116V and did not support the other proposals [6/56/2063-2069].
- (8) NGG NTS said that it did not support the implementation of Modification Proposals 0116CV, 0116BV or 0116VD [6/57/2070-2080]. NGG NTS said that it supported the implementation of Mod 116V if the Ofgem Impact Assessment demonstrated that the benefits of such reforms outweighed the costs. It said that it supported the implementation of Mod 116A if the Ofgem Impact Assessment demonstrated that the benefits of 0116V did not outweigh the costs and if NGG NTS’s concerns in respect of the deficiencies of Mod 116CV were not overcome.

- (9) Energywatch did not express a preference for any of the proposals [6/58/2081-2084]. However, it said that *"it seems that UNC 116V alone does not fit the requirements for a simple, predictable and transparent regime for gas offtake and may indeed increase costs to users and ultimately to consumers."*
- (10) Consequently, none of the 27 respondents offered unqualified support for Mod 116V.
164. I confirm that the facts stated in E.ON's submission are true to the best of my knowledge and belief.
165. On 7 December 2006 NERA Economic Consulting produced a report for the Gas Forum entitled, "Reform of NTS Gas Offtake Arrangements" on Modification Proposal 0116V and associated proposals ("**the Second NERA Report**") [6/59/2085-2175]. A copy of the Second NERA Report was provided to Ofgem and was subsequently discussed with Ofgem at a meeting to which I refer below.
166. On 21 December 2006, I attended a meeting of the UNC Panel to vote on the modification proposals. I refer to the minutes for that meeting [6/60/2176-2185]. Of the ten members with voting rights on the UNC Panel, only two (both representatives of National Grid) voted in favour of implementation of Mod 116V, and accordingly the UNC Panel did not recommend that Mod 116V should be implemented. By contrast, nine members of the UNC Panel (including the two National Grid representatives) voted in favour of Mod 116A, which the UNC Panel then duly recommended. No votes were cast in favour of Mod 116BV and three votes were cast in favour of Mod 116VD. Accordingly, the UNC Panel did not recommend implementation of those proposals. It was agreed that Mod 116CV should be further amended and replaced by Mod 116CVV, which would then be subject to further consultation. I refer to the text of Mod 116CVV [6/61/2186-2213].

Mod 116CVV

167. On the dates set out in the Chronology between 27 December 2006 and 3 January 2007, British Gas Trading [6/62/2214], RWE Npower [6/62/2215-2224], Wales & West Utilities [6/62/2225], Scottish & Southern Energy [6/62/2226], E.ON [6/62/2227], the Association of Electricity Producers [6/62/2228], Scotia Gas Networks [6/62/2229], NGG NTS [6/62/2230], Energywatch [6/62/2231], National Grid Distribution [6/62/2232-2235] and EDF Energy [6/62/2236] submitted representations to the UNC Panel secretary regarding Mod 166CVV.
168. Only two of those parties changed their views as a result of the amendment, namely NGG and National Grid Distribution. In its letter dated 3 January 2007, NGG said that it now supported the implementation of Mod 116CVV as a “*pragmatic compromise*” in the event the Ofgem Impact Assessment demonstrated that the costs of implementing Mod 116V outweighed the benefits [6/62/2232]. In its letter, also dated 3 January 2007, National Grid Distribution noted the conclusion in the Second NERA Report that the introduction of a Flexibility Capacity product would entail significant costs, with the result that Mods 116V, 116BV and 116DV were at risk of failing to show a net benefit [6/62/2234]. As a result, National Grid Distribution “*expressed qualified*” support for Mod 116CVV.
169. I should mention at this point that two further letters were written in January 2007 which are relevant to the various modification proposals. First, (as appears from the Decision) the Health and Safety Executive wrote to GEMA stating that it had not received from the relevant duty holders an assessment of the safety implications of the proposed changes. As a result, the HSE said that it would not be able to advise GEMA on the safety risks of the proposals before GEMA made its decision. Second, on 3 January 2007, Peter Boreham, the Network Emergency Coordinator (NEC) at NGG, wrote to the UNC Panel secretary expressing concern that the safety implications of Mod 0116 and its impact on the NEC and Transporter safety cases had not been properly considered [6/63/2237].

170. On 9 January 2007, I attended a meeting with Ofgem in my capacity as a representative of the Gas Forum. Also present at that meeting were David Gray, Robert Hull and Jason Mann of Ofgem, Graham Shuttleworth and Richard Druce of NERA. The purpose of the meeting was for NERA to explain and present the Second NERA Report to Ofgem. At that meeting I suggested to David Gray (that in the light of the evidence presented by NERA, GEMA might wish to reconsider its position.

#### The FIA

171. On 7 February 2007, Ofgem published a Final Impact Assessment (“the FIA”) regarding the offtake proposals [6/64/2238-2296].
172. It suffices to note that the FIA estimated that Mod 116V would result in net benefits of £8.3 million relative to the status quo (£28.5 million if only the four lowest costs submissions from shippers are included).
173. On the dates set out in the Chronology, between 2 March 2007 and 8 March 2007, responses to the FIA were submitted by International Power [6/65/2297-2299], Northern Gas Networks [6/65/2300-2302], the Gas Forum (“the Third NERA Report”) [6/65/2303-2330], the Association of Electricity Producers [6/65/2331-2335], Bord Gais Networks [6/65/2336-2339], British Gas [6/65/2340-2343], Chemical Industries Association [6/65/2345], EDF Energy [6/65/2346-2351], Energywatch [6/65/2352-2354], NGG NTS [6/65/2355-2357], NGG Distribution [6/65/2358-2359], RWE Npower [6/65/2360-2364], Scottish and Southern Energy [6/65/2365-2370], Wales & West Utilities [6/65/2371-2373] and E.ON [6/65/2374-2402].
174. Many of the submissions made criticisms of the FIA or aspects of it. Thus:
- (1) International Power criticised among other things the FIA’s failure to assess the likelihood of difference scenarios, whilst giving full benefits to improvements that might or might not happen [6/65/2297]. It also noted

that changes to NGG's licence conditions would be a sufficient protection against NGG discriminating against RDNs [6/65/2298].

- (2) NGN expressed concern at the level of complexity associated with elements of some proposals, particularly the Flexibility Capacity product which it considered "*unnecessarily complicated*", leading NGN to favour Mod 116CVV over Mod 116V [6/65/2302].
- (3) The Third NERA Report was particularly critical of the FIA's approach to discrimination, which NERA said failed to acknowledge that discrimination would be possible both before and after the proposed modifications. NERA also noted Ofgem's proposal to exclude the costs of gas transporters from its cost-benefit analysis and said that there were "*no economic grounds for omitting such costs.*" [6/65/2327]
- (4) The Association of Electricity Producers noted that the rationale for the proposed firm user commitment model was to avoid stranded assets, yet Ofgem had failed to identify when stranded assets have been created in the past [6/65/2331].
- (5) Bord Gáis Energy Supply said that since Ofgem itself had acknowledged in the FIA the considerable uncertainties associated with measuring the benefits of the proposals, it followed that those benefits "*cannot be trusted and irrespective of the result are only fictional and can never materialise.*" [6/65/2336]
- (6) Bord Gáis Networks said that it was "*not persuaded by the analysis and arguments*" advanced in the FIA [6/65/2338].
- (7) British Gas Trading (Centrica) challenged a number of assumptions in the FIA, including the "*assertion that competition would be promoted*" by Mod 116V, noting that there was no scope for competition for the Flat Capacity Product on a nodal level [6/65/2341].

- (8) The Chemical Industries Association expressed concern at the proposal to treat industrial offtake points in the same way as GDN operators: “*GDNOs are subject to price control regulation, and shippers who represent industrial sites are not in a position to be able to fairly compete with DNs for access rights.*” **[6/65/2344]**
- (9) EDF Energy said that it continued to believe that NTS Offtake Reform was “*not warranted at the level Ofgem is proposing*” and that the current arrangements operated efficiently. It also noted that the FIA had not followed all of the recommendations in the National Audit Office’s report or that of the House of Commons Public Accounts Committee (both referred to above) **[6/65/2346]**.
- (10) Energywatch, whilst agreeing that market-based arrangements would prevent NGG from favouring IDNS over others, noted that market participants did have “*genuine concerns about the implementation of more complex arrangements*” **[6/65/2353]**.
- (11) NGG’s Regulatory Frameworks Manager expressed surprise that the costs of gas transporters had been fully excluded from the overall cost-benefit analysis, and also noted that it was “*difficult to understand*” from the FIA why the estimates of costs varied so much between the different proposals **[6/65/2356]**.
- (12) RWE nPower said, among other things, that it was “*sceptical*” whether the introduction of the proposed reforms would have a positive impact on competition, and said that it believed they were at least as likely to have the opposite effect **[6/65/2362]**.
- (13) Scottish and Southern Energy said that it did not believe that the FIA “*accurately reflects the costs*” associated with introducing NTS exit reform **[6/65/2365]**.

- (14) Wales & West Utilities expressed concern principally about the suggestion in the FIA that GDN shareholders should bear the GDNs' costs of introducing offtake reform [6/65/2371].
- (15) E.ON's submissions [6/65/2374-2402] contained a wide-ranging analysis of the FIA, challenging a great deal of the assumptions in it, and also noting that Ofgem appeared to have prejudged the issues. I confirm that the facts stated in E.ON's submissions dated 8 March 2007 remain true to the best of my knowledge and belief, and that the opinions expressed accurately reflect E.ON's views regarding the modification proposals. I should say that in E.ON's covering letter to Ofgem, I expressly requested that our submission should be provided to GEMA at its meeting on 22 March 2007 in advance of its decision. I was subsequently contacted by Mark Feather, Ofgem's Associate Director, Transmission, who assured me that all responses to the FIA would be provided to GEMA. However, as set out below, it is far from obvious from the Decision itself whether GEMA members actually did have an opportunity to review the submissions.

175. In short, none of the responses to the FIA indicated any real support in the industry for Mod 116V. Even NGG now supported Mod 116CVV in preference to Mod 116V, ostensibly its own proposal.

#### The Decision

176. As foreshadowed above, on 5 April 2007, GEMA publishes the Decision. The Decision directed that Mod 116V be implemented but that its implementation be delayed until 1 April 2008. The Decision also directed that none of the other proposals, including Mod 116A, be implemented at any time.
177. It is interesting to note that in the Decision, GEMA acknowledged for the first time that it was "*unreasonable*" to exclude the costs incurred by gas transporters from its cost/benefit analysis of the proposals. The result of this concession was that very substantial further costs had to be included which GEMA had omitted in the

FIA. As a result, in contrast to its findings hitherto that the implementation of Mod 116V would lead to net benefits, GEMA now indicated that it would lead to net costs of between £20 million to £28 million (or net costs of £1 million to £7 million if only the four lowest costs submissions from shippers are included). Despite this, GEMA nevertheless decided to direct the implementation of Mod 116V.

178. E.ON had resigned itself to the expectation that GEMA would reject Mod 116A despite its strong industry support. The reasons for this expectation should be obvious from the narrative set out above. The substance of Mod 116V can be traced back to Ofgem's RIA in June 2004. That is where, so far as I am aware, proposals of this kind (i.e. requiring TCC shippers to compete with GDNs for capacity rights, separating out flat and flexible capacity etc) were first made. It appears from that document that the proposal was originated by Ofgem rather than any industry participant. At that time, NGG was in favour of maintaining the administered arrangements.
179. It appears to me that Ofgem's position has only hardened with time. Ofgem's decision to impose a legal obligation on NGG and the GDNs to use their best endeavours to bring about the implementation of Ofgem's proposals makes this clear. Ofgem must have made up its mind by that stage, at the latest, that its preferred enduring offtake arrangements were going to be introduced. Otherwise, it would hardly have required the gas transporters to bring about implementation of those arrangements.
180. There has been no change in Ofgem's stance in the meantime. Although Ofgem has generated a vast amount of paperwork in connection with the proposed changes to the offtake arrangements, Mod 116V is in substance the same as the initial proposal made by Ofgem itself in June 2004. This is the case despite the numerous representations made by affected parties, particularly shippers, expressing concern about the complexity and cost of the proposed new arrangements.

181. Against this background, I regret to say that I do not believe that GEMA approached its decision whether to approve Mod 116V, Mod 116A or one of the other modification proposals with a genuinely open mind. On the contrary, it is my belief and that of E.ON that the outcome of the decision was essentially a foregone conclusion, given the stance which Ofgem has consistently taken since June 2004. In effect, Mod 116V gave Ofgem the opportunity to endorse a proposal which Ofgem itself had formulated and which it had required the gas transporters, as a condition of Ofgem's consent to the GDN sales, to bring forward.

#### Mod 142

182. The Decision delays the implementation of the "enduring" offtake arrangements until 1 April 2008. As a result, the sunset clauses in the UNC once again mean that there is a "black hole", in that the UNC does not now provide any mechanism for booking capacity arrangements during the gas year 1 October 2010 to 30 September 2011.

183. On 17 April 2007, NGG NTS raised Modification Proposal 0142 ("**Mod 142**"), which would extend the sunset clauses once again to 30 September 2011 [6/66/2403-2411]. On 18 April 2007, Ofgem agreed to grant urgent status to Mod 142 [6/67/2412-2413].

#### Implications of the Decision

184. As set out in E.ON's written submissions in response to the FIA, the implementation of the Decision will cause E.ON real detriment [6/65/2377-2378]. Mod 116V creates considerable complexity in the allocation of offtake capacity. There are real uncertainties, for example, about how the Flexible Capacity product will work in practice. The way in which that product is currently defined does not equate to any of the measures which shippers currently use to calculate their offtake needs. Consequently, shippers will have to establish new mechanisms in order to estimate what their requirements for this new product will be.

185. This additional complexity and uncertainty will directly lead to increased operational costs for E.ON in its capacity as an NTS Shipper. E.ON will also incur increased costs for the use of interconnections and storage.
186. As also foreshadowed in our submissions on the FIA, E.ON has identified specific examples of adverse effects which the Decision will cause [6/65/2401-2402].
187. First, there is the impact on E.ON's existing directly connected power stations. A likely practical consequence of the Decision is that E.ON will have to book exit capacity for a number of its power stations on a "firm" basis. This is so even though two of E.ON's power stations offtake gas from the NTS only as an alternative supply route to the main supply route or as a back-up supply. Currently, E.ON is able to designate the NTS supply to these power stations as having interruptible status, thereby achieving a discount on exit capacity charges. If the Decision is implemented, E.ON will no longer be able to plan in the long term for the provision of capacity on an interruptible basis. Furthermore, E.ON is unlikely to be willing to take the risk that it will be able to obtain interruptible capacity in the day-ahead auctions proposed in the Decision. Consequently, E.ON may have no choice but to purchase firm capacity for these power stations, notwithstanding that it is unlikely such capacity will actually be needed in some cases.
188. Furthermore, under the Decision, E.ON and other shippers will be bidding for the allocation of the Flexibility Capacity product against GDNs. GDNs will require that product in order to ensure that they can meet their 1 in 20 obligation, and it is likely that shippers will therefore be outbid. As a result, we would not be able to generate electricity when we would like to, since we would lack the right to vary our rate of gas offtake without incurring penalty charges.
189. Second, the Decision will have a serious deleterious impact on E.ON's investment decisions regarding new power stations. The long term commitments required from NTS users under the Decision will be significantly more onerous and less flexible than the existing arrangements. As matters stand, if the

construction of a new power station required additional investment to the NTS, E.ON would enter into an ARCA with NGG. In the Marchwood decision in October 2006, Ofgem ruled that such ARCAs should not normally impose a commitment to pay capacity charges irrespective of actual capacity needs for more than the first year [6/68/2114-2158]. For a typical 500MW power station, this equates to a commitment in the region of £1 million to £3 million. By contrast, under the arrangements proposed in the Decision, commitments would be required just over three years in advance and in respect of a four-year period. For example, capacity requested in July 2009 would be for the period from 1 October 2012 to 30 September 2016. This equates in financial terms to a commitment of between £4 million and £12 million.

190. I should also point out that the current ARCA arrangements are bilateral contracts between the project developer and NGG. The start day can be amended by agreement. By contrast, the new arrangements would be between the shipper and NGG, and the shipper would be "on the hook" for a fixed date, irrespective of what occurred in the meantime.
191. I believe that these differences between the current ARCA regime and the proposed new regime are likely to have a chilling effect on investment. Such long-term and inflexible commitments create a climate that is less conducive to investment. On any view, it is likely that these changes will delay investment decisions.
192. A further advantage of the ARCA regime was that the Langage and Marchwood decisions had confirmed the "shallow connection" policy to which I have referred above. On the basis of these decisions, industry participants had a clear idea of the parameters within which GEMA would make decisions in the event of disputes between developers/shippers and NGG NTS over the duration of an ARCA. I believe that this clear guidance would have led to fewer disputes over the terms of ARCAs in the future. E.ON, as a shipper and/or developer could reasonably approach its negotiations with NGG in the expectation that GEMA would follow the principles its previous decisions. NGG could also do the same.

Accordingly, I believe that the likelihood of either party choosing to trigger a dispute and require intervention by GEMA would have been significantly reduced.

193. Third, the Decision will have a significant adverse impact on storage facilities and on investment decisions relating to storage facilities. Storage facilities connected to the NTS do not currently pay any charges for off-taking gas (exit capacity or commodity charges) and are deemed to have interruptible status. Storage is assumed to operate counter to other flows on the system: gas is typically injected into store when there is low demand, and withdrawn when there is higher demand. Currently this is a seasonal cycle for long-range storage, or stored gas is cycled up to 2 or 3 times for mid-range storage, but for newer fast-churn facilities the cycling is expected to be much more frequent. Under the proposed new arrangements, it may be necessary for additional firm flat exit capacity to be purchased to accommodate these dynamic characteristics. Under the current arrangements no charges for off-take are levied. The application of charges where no such charge existed before is likely to have serious implications for the viability of such projects.

194. Fourth, I believe that the Decision will lead to greater volatility in the level of transportation charges we pay for off-taking gas from the NTS. There is no guarantee that the proposed auction mechanism will recover the appropriate level of NTS's allowed revenue. In that event, NTS will have to make adjustments to other charges (such as commodity charges). This inevitably creates uncertainty, and we will find it difficult to plan appropriately. There is a risk that we will have to pass on the costs of this increased uncertainty to our customers.

### **Letters of Support**

195. E.ON's position on this appeal is supported by a large number of other industry participants. I refer to the letters of support which E.ON has received from:

- (1) EDF Energy [6/69/2159-2163];

- (2) Centrica (British Gas Trading) [6/69/2164];
  - (3) the Chemical Industries Association (CIA) [6/69/2165-2167];
  - (4) the Association of Electricity Producers [6/69/2168];
  - (5) Electricity Supply Board (Rep. Ireland) [6/69/2169-2170];
  - (6) Society of British Gas Industries (SBGI) Storage Operators Group (although National Grid Storage withheld its support) [6/69/2171-2172];
  - (7) Major Energy Users Council (MEUC) [6/69/2173-2174]; and
  - (8) the Gas Forum [6/69/2175-2177]
196. On 26 April 2007, Robert McDonald, Scottish and Southern Energy (SSE), whose joint venture subsidiary Scotia Gas Networks (SGN) is a GDN operator, wrote by email to my colleague, Sara Vaughan, saying that although SSE shared many of E.ON's concerns about the reforms, "*since Ofgem has made their position clear and, in the case of SGN, there are licence obligations to deliver reform, we do not feel able to join your appeal.*" [6/69/2178-2179] I subsequently contacted Mr McDonald and he agreed that I could refer to his email in my evidence to the Commission.

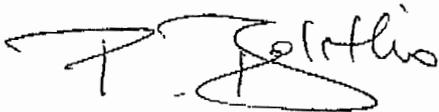
## Conclusion

197. For the above reasons and those set out in E.ON's Statement of Case, E.ON invites the Tribunal to quash GEMA's decision directing the implementation of Mod 116V and to remit the issue to GEMA with a direction that Mod 116A should be implemented.

ECM011

E.ON UK plc  
P Bolitho  
First  
Exhibit PB1  
30 April 2007

I believe the facts stated in this witness statement are true.

  
.....

Peter Bolitho

30/4/2007  
.....

Date

CC02/07

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**An appeal under section 173 Energy Act 2004**

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**E.ON UK plc**

**-and-**

**GEMA**

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**Witness statement of Peter Bolitho**

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**WITNESS STATEMENT OF  
PETER BOLITHO**

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