CC02/07

An appeal under section 173 Energy Act 2004

E.ON UK plc

-and-

GEMA

E.ON'S WRITTEN SUBMISSIONS REGARDING THE TRANSMISSION ACCESS REGULATION

1. These submissions are served pursuant to points 3 and 6 of the Commission's letter dated 25 May 2007, which sought submissions on the "*relationship between the pricing of interruptible capacity and the Transmission Access Regulation, and in particular the way in which GEMA approached the obligations imposed by the Regulation in the Decision.*"

2. This issue arises out of GEMA's reply, which refers (at paragraphs 74 to 80) to Article 4.1(b) of Regulation (EC) NO 1775/2005 on conditions for access to the natural gas transmission networks ("**the Regulation**"). Article 4 concerns third party access services. Article 4.1(b) provides that:

> "*Transmission system operators shall:*
>
> ...
>
> *(b) provide both firm and interruptible third party access services. The price of interruptible capacity shall reflect the probability of interruption;*"

3. By Article 4.1(c), transmission system operators must "*offer to network users both long and short-term services*", i.e. services with a duration of one year or more; and services with a duration of less than one year (see Articles 2.1(14) and (15)).

4. By Article 1.1(1) of the Guidelines on Third Party access Services annexed to the Regulation, "*Transmission system operators shall offer firm and interruptible services down to a minimum period of one day.*"

5. It should be noted that the provisions of Article 4 are not the only provisions relating to the price of interruptible third party access services. In particular, Article 3 on "*Tariffs for access to networks*" contains a large number of principles applicable to tariffs or the methodologies used to calculate them. These include, for example, the principle in Article 3.1(1) that tariffs set by transmission system operators shall "*reflect actual costs incurred ...whilst including appropriate return on investments*".

No consultation on the Regulation before the Decision

6. GEMA did not refer in the consultation about Mod 0116V to any concern over compliance with the second sentence of Article 4.1(b). That provision is not cited in Ofgem's Final Impact Assessment dated 7 February 2007.

7. If GEMA had made its Decision on the basis of a finding that Mod 0116A did not comply with the Regulation, it would have done so without any proper prior consultation and without giving affected parties the opportunity to make representations on the point. In those circumstances, the Decision would plainly have been vitiated by an error of law.

GEMA reached no conclusion on the Regulation in the Decision

8. In fact, GEMA did not base its Decision on any conclusion that Mod 0116A was not compliant with Article 4.1(b) of the Regulation.

9. The relevant passages are the final two paragraphs on page 14 of the Decision and the second full paragraph on page 20. In the penultimate paragraph on page 14, GEMA stated that:

> "*The Authority has some concerns that the present interruptible arrangements and those proposed in 0116A may be inconsistent with the European Transmission Access Regulation. However, in assessing the proposals the Authority has not concluded on whether or not this is the case. Indeed, the Authority notes that the requirements in the Regulation that interruption is priced on the basis of probability are likely to reflect broader European objectives aimed at ensuring that customers on interruptible contracts genuinely receive a discount in return for accepting a lower level of service than is provided relative to a firm customer.*"

10. Despite this, GEMA stated that it considered that Mod 0116V represented an "*improvement on the current arrangements insofar as future discounts should genuinely reflect the probability of interruption and would not be provided to*

supply points that are unlikely to be required for interruption on the 1 in 20 peak day."

GEMA's new position in the Reply

11. On appeal, GEMA resiles from its position in the Decision. GEMA now asserts that "*E.ON as appellant must satisfy the Commission that 0116A is compliant*" with Article 4.1(b) (Reply, paragraph 76). But, in fact, GEMA is not submitting on this appeal that Mod 0116A is not compliant.

12. This is not a case where:

    (1) GEMA has decided that Mod 116A was not compliant; and

    (2) E.ON has appealed against that decision.

13. Neither of these conditions applies. There is no such decision and no such appeal. The question whether Mod 0116A – or Mod 0116V – complies with Article 4.1(b) simply does not arise. The point is as unnecessary for the Commission to decide as it was for GEMA.

14. Indeed, GEMA makes no relevant submission either of law or of fact on this issue. GEMA does not advance in its Reply any positive case as to the meaning of the second sentence of Article 4.1(b). Nor does GEMA contend that Mod 0116A does not comply with that provision on the facts.

15. Without prejudice to this basic point, E.ON makes the following submissions regarding the relationship between the Regulation and pricing of interruptible capacity.

Cost-reflectivity

16. GEMA's Reply focuses on the second sentence of Article 4.1(b) (which is considered below) but ignores all the other relevant provisions of the Regulation. The primary provision as to tariffs in the Regulation is Article 3 which, as set out above, establishes the general principle that tariffs levied by transmission system operators must be cost-reflective.

17. Mod 0116A complies with the requirement of cost-reflectivity. As set out in the witness statement of Graham Shuttleworth, paragraphs 2.20-2.22, interruptible capacity does not impose any marginal cost of investment on the NTS.

Consequently, interruptible customers pay the commodity charge for gas actually offtaken from the NTS, but do not need to pay any capacity "booking" charge. Far from being subsidised by firm customers, it is likely that interruptible users currently pay somewhat more through the commodity charge than the costs they impose on the system in any one year (Shuttleworth, paragraph 2.22).

18. It is wholly unclear, however, whether the day-ahead release of "interruptible" capacity envisaged under Mod 0116V will be charged for in a cost-reflective way.

The Regulation and long-term interruptible service

19. A second requirement in the Regulation is that, under Article 4.1(b), a transmission system operator must provide both firm and interruptible service. Under Article 4.1(c), these services must be provided both on a long-term and a short-term basis.

20. Again, Mod 0116A plainly complies with these requirements. Long-term interruptible service would be made available to NTS users, as it is under the existing arrangements.

21. It is, however, difficult to see how Mod 0116V can be said to comply with these requirements. Mod 0116V essentially abolishes the interruptible service and seeks to establish "universal firm" arrangements. Although NGG NTS would apparently be permitted to enter into long-term bilateral contracts for the provision of an interruptible service, there is no requirement on it to do so.

"The price ... shall reflect the probability of interruption"

22. Also of potential relevance is the second sentence of Article 4(b). In the Decision, GEMA rightly acknowledged that this was an obscure provision which had to be construed purposively.

23. By contrast, the Reply focuses on the literal "*wording*" of Article 4(b). It appears to be assumed that, on a literalist approach, Article 4(b) requires interruptible capacity to be priced as a percentage of the price of firm capacity, the percentage being the probability of an interruptible customer being interrupted.

24. Even on a literalist approach, this is an inherently implausible construction. The word "*reflects*" is not confined to reflecting "*like a mirror*". For example, the requirement of cost-reflective pricing in Article 3(1) of the Regulation is not applied by regulators, including GEMA, so as to require charges to be confined to the recovery of historic cost plus return. NGG, for example, is permitted to charge shippers based on a long run marginal cost formula.

25. Thus, the word "*reflects*" is given a much broader meaning. A better reading of the words, therefore, would be that the pricing of interruptible capacity should take account of ("*reflect*") the fact that such capacity may be interrupted ("*the probability of interruption*"). This is, in effect, the meaning given to the provision by GEMA in the Decision: there must be at least some discount over the firm service price to reflect the lower quality of service.

26. A second objection to this literalist approach is that Article 4(b) must be construed in the light of the Regulation as a whole, including Article 3(1) itself. Yet the construction now apparently advanced in the Reply would forbid cost-reflective pricing of interruptible capacity, since pricing would instead have to be calculated based on the probability of interruption. A construction which leads to a flat contradiction between two adjacent provisions of the Regulation is plainly wrong.

27. A third, fundamental objection is that, as a matter of EU law, the Regulation must be construed purposively, not literally. As Lord Denning recognised early on:

> *"... what are the English courts to do when they are faced with a problem of interpretation? They must follow the European pattern. No longer must they examine the words in meticulous detail. No longer must they argue about the precise grammatical sense. They must look to the purpose or intent. ... They must divine the spirit of the Treaty and gain inspiration from it. ..."*[1]

28. An economic analysis of the purpose of the Regulation is carried out by Graham Shuttleworth at paragraphs 2.23 to 2.29 of his witness statement. Mr Shuttleworth concludes that construing the Regulation to require a direct proportionality between charges and the probability of interruption would lead to inefficiency, since it would not reflect the underlying cost structure of interruptible service and would cause inefficient use of capacity (paragraph

[1] HP Bulmer Ltd v J Bollinger SA [1974] 1 Ch 401.

2.27). It is inherently implausible that the EU intended to legislate to bring about this inefficient outcome.

29. Assuming, therefore, that the Regulation was intended to promote rather than impair efficiency, the purpose of Article 4(b) may have been to ensure that lower tariffs for interruptible service should be provided only if the user can truly be interrupted, and not for instance as a way to cross-subsidise favoured users whose service is de facto firm.

30. An alternative purposive interpretation is that preferred by GEMA in the Decision, namely that interruptible users should receive a real discount over the price of the firm service. E.ON agrees that this is a possible interpretation.

31. Further guidance on the purpose of the legislation can be derived from the legislative history:

    (1) In the Commission's original proposal for the Regulation, what is now Article 4(b) provided that, "*The price of interruptible capacity shall reflect the probability of interruption, if not otherwise laid down by the relevant regulatory authorities.*"

    (2) The underlined words were deleted by the European Parliament on the grounds that, "*The setting of prices for interruptible capacity is done on the basis of commercial considerations. This cannot be the job of the authorities ...*".

32. The rationale for deleting the underlined words – that prices are set on the "*basis of commercial considerations*" – is wholly inconsistent with the suggestion that Article 4(b) was intended to require – by force of law – a strict relationship between pricing and the probability of interruption.

33. On any view, therefore, the Commission could not decide with "*complete confidence*" that the Regulation required direct proportionality between pricing and interruption. Consequently, and given in particular the position taken by other Member States, if the Commission were minded so to hold, it would have to consider making a preliminary reference to the European Court of Justice under Article 234 of the EC Treaty.[2]

[2] R v International Stock Exchange, ex p Else [1993] QB 534.

34. However since, as set out further below, the Regulation would not affect the outcome of the appeal, E.ON submits that it is unnecessary to decide the point at all.

Mod 0116V is not the solution

35. Even if (contrary to the foregoing) it were thought that the Regulation required direct proportionality between pricing and the probability of interruption, it does not follow that Mod 0116A should be rejected or Mod 0116V approved.

36. Professor Yarrow concedes in his witness statement (paragraph 65) that Mod 0116V itself "*does not require direct proportionality between charges and the probability of interruption.*" Consequently if (which is denied), the Regulation requires such proportionality, on GEMA's own case, Mod 0116V fails to achieve it. GEMA's new case on the Regulation is, therefore, self-defeating.

37. On the other hand, if (as GEMA appears to contend) the supposed requirement of proportionality in the Regulation does not impede the implementation of Mod 0116V, it equally cannot impede the implementation of Mod 0116A. GEMA's belated suggestion that the implementation of Mod 0116A is "*unavailable*" to the Commission as a remedy on this appeal is misconceived (Reply, page 23, fn. 31).

38. As noted above, Mod 0116V was not proposed in response to concerns over compliance with the second sentence of Article 4.1(b), nor was it adopted by GEMA on that basis. If this were a genuine concern, there should be a proper consultation on the issue. There may be a range of possible solutions. It would be necessary to consider which among them was the most proportionate. Mod 0116V is not the answer to any such problem.

39. There is no finding (not even by GEMA) that the existing arrangements are unlawful. GEMA is not contending in this appeal that they are unlawful. The appropriate course is to maintain the status quo. That is precisely what Mod 0116A achieves. It simply deletes the "sunset" clauses on the existing arrangements.

Conclusions

40. In summary:

(1) GEMA made no decision that Mod 0116A did not comply with the Regulation and there is no issue between the parties on that point;

(2) even now, GEMA advances no positive case either on the law or the facts that the current arrangements relating to interruptible capacity are contrary to the second sentence of Article 4.1(b);

(3) in any event, the Regulation requires the price of interruptible capacity to be cost-reflective, and does not require direct proportionality between charges and the probability of interruption;

(4) Mod 0116A complies with the requirements of Articles 3(1) and 4(b) and (c) of the Regulation, as properly construed; and

(5) on GEMA's own case, Mod 0116V does not bring about direct proportionality between charges for interruptible capacity and the probability of interruption.

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