ECM001

CC02/07

---

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

---

**E.ON UK plc**

**-and-**

**GEMA**

---

# APPLICANT'S STATEMENT OF CASE

---

**DEFINED TERMS USED IN THIS STATEMENT OF CASE**

| | |
|---|---|
| GEMA | The Gas and Electricity Markets Authority |
| Ofgem | The Office of the Gas and Electricity Markets Authority |
| E.ON | The Applicant, E.ON UK plc |
| NGG | National Grid Gas |
| NTS | Gas National Transmission System |
| GDN or DN | Regional Gas Distribution Network |
| IDN | Independent Distribution Network |
| RDN | Retained Distribution Network |
| DNO | Distribution Network Operator |
| TCC | Transmission Connected Customer |
| UNC | Uniform Network Code |
| CBA | Cost-benefit analysis |
| Mod | UNC Modification Proposal |
| FIA | Ofgem's Final Impact Assessment (7 February 2007) **[PB1, 6/64/2238-2296]** |
| Decision | GEMA's Decision Document (5 April 2007) **[PB1, 1/1/22]** |
| RIA | Regulatory Impact Assessment |
| Shuttleworth WS | Expert Report of Graham Shuttleworth (27 April 2007) submitted by E.ON |
| GS2 | Mr Shuttleworth's Report, December 2006 (for Gas Forum) |
| GS3 | Mr Shuttleworth's Report on the FIA, 5 March 2007 |
| Bolitho WS | Witness Statement of Peter Bolitho, 30 April 2007 (E.ON) |
| PB1 | Exhibit 1 to Mr Bolitho's WS |
| E.ON Submissions | E.ON's submissions to GEMA on the FIA, March 2007 **[PB1, 6/65/2374-2402]** |

Other terms are used as defined in the Glossary

## *(a) The applicant's grounds of appeal*

The Decision is wrong on all or any of the following grounds:

(i) GEMA failed properly to have regard to the matters mentioned in section 175(2) of the Energy Act 2004;

(ii) GEMA failed properly to have regard to the purposes for which the relevant condition has effect;

(iii) GEMA failed to give the appropriate weight to one or more of those matters or purposes;

(iv) the Decision was based, wholly or partly, on an error of fact; and/or

(v) the Decision was wrong in law.

### *(b) The applicant's reasons in support of its grounds of appeal*

The applicant's reasons in support of its appeal include the points set out below and the points contained in:

(i) the Expert Report of Graham Shuttleworth (Director, NERA) dated 27 April 2007 (Shuttleworth WS);

(ii) Mr Shuttleworth's Report dated 5 March 2007 submitted for the Gas Forum to the consultation on the FIA (Exhibit GS 3);

(iii) Mr Shuttleworth's Report dated 7 December 2006 (Exhibit GS2); and

(iv) Peter Bolitho's Witness Statement dated 30 April 2007;

(v) E.ON's Submissions to the FIA Consultation **[PB1, 6/65/2374-2402]**.

The applicant has not repeated in this document all the points contained in Mr Shuttleworth's Reports, Mr Bolitho's Witness Statement and the E.ON Submissions (so as to avoid unnecessary duplication) but those points are included as part of the applicant's reasons as though they were set out in this document.

## INTRODUCTION

1. This is an appeal from two decisions of GEMA, published on 5 April 2007, relating to the offtake arrangements in the UNC:

   (1) GEMA's decision to direct implementation of Mod 0116V;

   (2) GEMA's decision not to approve Mod 0116A.

2. Both decisions are contrary to majority recommendations of the UNC Panel, which is the representative industry body responsible for the UNC.[1]

3. Both decisions are opposed by the great majority of industry parties.[2] These appeals are supported by: EDF Energy, Centrica (British Gas Trading), the Chemical Industries Association (CIA), the Association of Electricity Producers, Electricity Supply Board (Rep. Ireland), the Society

---

[1] Nine of the ten UNC Panel members voted in favour of Mod 0116A, including the two NGG members. Seven ranked Mod 0116A as their preferred option against all other options. These included all five of the members representing shippers and two members representing transporters. Only Mod 0116A obtained a majority recommendation from the UNC Panel. Mod 0116V attracted only two votes: from the two NGG members, representing NGG NTS and NGG's Retained GDNs. No member representing either shippers or independent GDNs voted in favour of Mod 0116V. Bolitho WS, paragraph 166**.**

[2] In the UNC Consultation Process, 23 out of the 27 Consultation responses were in favour of Mod 0116A. These include the Major Energy Users Council, the Association of Electricity Producers, the Chemical Industries Association, the Gas Storage Operators Group, GdF, Statoil, RWE-NPower, Shell Gas Direct, British Gas Trading, Centrica Storage, Conoco-Philips, EDF Energy, EDF Trading, International Power, E.ON UK, SSE, Total E&P, Total Gas & Power, Wales and West Utilities, Bord Gais Networks (Ireland), Viridian Power & Energy (N.I.), the Northern Ireland Authority for Energy Regulation, and the Electricity Supply Board (Ireland). This is a wide cross-section of affected parties, including shippers, generators, large industrial consumers, and the Northern Ireland regulator. Apart from Energywatch, Mod 0116A was supported by every other respondent which had not been affected by the "best endeavours" Licence Condition. Energywatch (which expressed no preference for any one Mod) stated that Mod 0116V "*does not fit the requirements or a simple, predictable and transparent regime for gas offtake and may indeed increase costs to users and ultimately to consumers*". NGG NTS itself supported Mod 0116V only if the Ofgem Impact Assessment demonstrated that the costs of Mod 0116V did not outweigh the benefits. See: Bolitho WS at paragraph 163.

of British Gas Industries (SBGI) Storage Operators Group (save for National Grid Storage), the Major Energy Users Council (MEUC) and the Gas Forum.

4. All of these parties have authorised E.ON to inform the Competition Commission that they support the appeals, and to convey their own position on the issues. Their letters are at **PB1, 6/69**. E.ON will rely in these appeals on the contents of these letters and the consultation responses referred to in the letters.

5. Mod 0116V, although formally proposed by NGG, is in fact a package of proposals that has been driven from the start by Ofgem and GEMA.[3] They impose very substantial costs and increased complexity on the industry for no real benefit. GEMA directed implementation of Mod 0116V although GEMA's own quantitative assessment showed that the costs of this outweighed the benefits by some £27m PV. These costs and complex arrangements bear particularly hard on the industry parties which operate in the competitive part of the gas sector – the shippers, suppliers and large industrial consumers directly connected to the NTS. They strongly oppose Mod 0116V.

6. The history of Ofgem's role in driving these proposals is explained in the Witness Statement of Peter Bolitho. It includes inappropriately linking Ofgem's project to the GDN sales issue; imposing licence conditions on the transporters which required them to use best endeavours to introduce proposals as directed by GEMA, and so inappropriately tied their hands; and introducing "sunset clauses" into the UNC itself.

---

[3] NGG's original preferred solution to the offtake arrangements that should apply after NGG sold four of the eight DNOs involved relatively simple adjustments to the then current arrangements. This was satisfactory to other industry parties. But Ofgem made it a condition of its approval to NGG's sale of the GDNs in 2005 that NGG and the DNOs should accept licence conditions committing them to use best endeavours to introduce Ofgem's own preferred offtake arrangements.

7. These "sunset clauses" have the effect of automatically causing the offtake provisions in the UNC to self-destruct at appointed times, leaving a regulatory and operational void. This is a wholly inappropriate device, productive of regulatory uncertainty. Its effect (and purpose) is to undermine the industry self-governance structure of the UNC licence conditions. It was designed to make it necessary that further Modification Proposals would need to be brought forward, and so give Ofgem and GEMA further opportunities to implement their project.

8. GEMA's decisions in this case are not an adjudication of a dispute between industry parties. They are the implementation of Ofgem and GEMA's own project, against the wishes of the industry, and the recommendations of the UNC Panel.

9. We submit that the history and the Decision itself plainly show that Ofgem and GEMA prejudged these issues.

**MOD 0116A and MOD 0116V**

10. Mod 0116A simply "switches off" the sunset clauses in the current UNC. As a result, the present offtake arrangements will continue.[4]

11. Mod 0116V is the Ofgem / GEMA preferred set of arrangements. They are complex, and their introduction will add both complexity and transaction costs to the offtake arrangements. A full description is at **PB1, 5/50/1798-1826**. In very broad outline, Mod 0116V is a package with a number of separate items. Three of the most contentious are:

---

[4] Of course, any industry party could at a future time propose some amendment to the current of-take arrangements, large or small. If this occurred, the proposal would be properly considered under the UNC process. But the mood of the industry now seems very clear from the recent consultations. The industry wants the current offtake arrangements to continue. Industry parties certainly do not want Mod 0116V or any variant of it.

(1) lengthening the time period for which users must contractually commit for firm exit capacity to four years from the current one year;

(2) withdrawing the current right of users to opt for interruptible status rather than firm status; and

(3) replacing the current right of shippers and other NTS Users (other than the GDNs) to offtake gas at a variable rate of flow within their maximum hourly capacity limit, and replacing this with a new "flexibility exit capacity product" for which shippers and other Users will have to pay, and which will be allocated by some form of auction process. [5]

**THE TWO APPEALS**

12. The Decision itself, and the FIA, assessed Mod 0116V against Mod 0116A. They treat Mod 0116A as the status quo for comparative purposes. .

13. The Decision also asserts that Mod 0116A will not, as against the actual status quo (i.e. the UNC offtake arrangements with the 'sunset clauses' embedded in them) "better facilitate the achievement of the relevant objectives of the UNC". This is wrong. Removal of the sunset clauses will better facilitate the achievement of these objectives because this will reduce regulatory uncertainty, increase the efficiency of the operation of the NTS and increase the efficiency of NGG's discharge of its licence obligations. [6]

---

[5] Mod 0116CVV effectively detaches this item from the recent Ofgem/GEMA package.

[6] Similarly, the FIA appeared not to ascribe any benefits to Mod 0116A, as against the status quo. The benefit analysis in an Impact Assessment should take as its starting point the UNC Code as it stands at present. There can be no doubt that Mod 0116A, by removing the 'sunset clauses', and allowing the current offtake arrangements to continue

**COSTS & BENEFITS**

14. The Decision's analysis of the costs and benefits of introducing Mod 0116V is plainly defective. The Decision is not efficient or proportionate.

15. The Decision accepts that, on the quantitative cost benefit analysis, the quantified costs of introducing Mod 0116V exceed the quantified benefits by up to £28m PV: **Decision, p. 7**.

16. This negative CBA clearly indicates that Mod 0116V is not efficient, economic or proportionate.

17. However, the Decision discounts this quantified negative CBA, saying that this is outweighed by certain non-discrimination and competition "qualitative" benefits identified in the FIA.

18. The Decision is wrong on this central point because the supposed non-discrimination and competition "qualitative" benefits identified in the FIA and relied on in the Decision cannot reasonably be considered to be capable of outweighing the quantified negative CBA of up to £28m PV. GEMA has plainly given them wholly inappropriate weight. The Applicant relies on the facts and matters below, on the guidance in the Treasury Green Book and on **Shuttleworth WS esp. at paras. 2.4; 2.36-2.39; 3.15-3.16; 3.18 to 3.43; 5.16 to 5.19**.

19. Further, the Decision is wrong on this point because (as explained below):

    (1) On non-discrimination: There is a fundamental error of law in the approach to non-discrimination. The Decision expressly states that GEMA makes no actual finding of discrimination. GEMA does not properly consider the facts and matters which should be central to

---

as the enduring arrangements, reduces uncertainty and regulatory risk for market participants. This is a benefit.

any discrimination inquiry. No proper case has been made that the alleged non-discrimination 'benefits' are benefits at all.

(2) On competition: The competition issues are not properly analysed, either in the Decision or the FIA. The competition factors actually identified in the FIA are negative, not positive, for Mod 0116V.

(3) On the overall quantitative CBA: The negative CBA of £28m PV stated in the Decision is seriously understated because (a) relevant costs are still excluded; and (b) the values ascribed by Ofgem in the FIA (and adopted in the Decision) to the three identified "quantitative benefit" items in FIA Chapter 3 are speculative, and there is no good reason to conclude that these three items will produce any benefits, let alone benefits of the amounts ascribed to them.

***The FIA***

20. GEMA is required by Section 5A of the Utilities Act 2000 to carry out and publish "*an assessment of the likely impact of implementing the proposal*", and to consult on it. Ofgem published the FIA on the Modification Proposals on 7 February 2007, in response to this statutory duty.[7]

21. Section 5A(5) of the Utilities Act 2000 provides that GEMA "*must have regard to such general guidance relating to the carrying out of impact assessments as the Authority considers appropriate"*. GEMA has stated that it considers it appropriate to have regard under Section 5A(5) to the Treasury Green Book and to the OFT Guidelines on "Completing competition assessments in impact assessments".

---

[7] FIA 1.3

***"Quantitative" and "qualitative" assessments in the Decision and the FIA***

22. Chapter 3 of the FIA contains a "quantitative" assessment of "*the key benefits and costs*".[8] The three main benefits considered, and quantified, are said to arise from: (1) "*efficient investment signals*"; (2) reduction in "*the risk that NGG's retained GDNs are treated more favourably [by NGG] than independently owned GDN networks*"; and (3) reduced dispute costs from the reduced incidence of ARCAs. FIA Chapter 3 also contains an analysis of quantified costs. The "quantitative" assessment in the FIA concluded that Mod 0116V had a positive net benefit of £8.3m PV, but this excluded all the transporters' costs.[9] Chapter 4 of the FIA contains a "qualitative" assessment, of "*qualitative benefits and costs*", which are "*less measurable impacts*" which "*are difficult to quantify in practice*". [10]

23. The Decision accepts that it would be unreasonable to exclude the transporters' ongoing costs (but still excludes their upfront costs): **Decision, p. 7**.

24. The Decision concludes, on the quantitative cost benefit analysis: "*for the proposals other than 0116A and 0116CVV, there are net costs in the region of £20m to £28m*": **Decision, p. 7**.

25. The Decision does not break down this quantitative calculation of costs and benefits. It appears that the Decision's analysis of the quantitative costs and benefits, and the relevant figures, derive from those stated in the FIA, except that the Decision, unlike the FIA, includes the ongoing <u>operating</u> costs of the transporters (£35.5m) as relevant costs. (The Decision still excludes the transporters' upfront costs of £20.9m). This is supported by the statement that: "*The Authority considers that the Final IA and the subsequent revisions to this analysis (as set out above) identify a*

---

8 So described in FIA 4.1
9 FIA Table 3.1
10 FIA 3.5

*plausible estimate of the costs and benefits.*" **Decision, pp. 7-8, FIA Table 3.13.**

26. The central reason given in the Decision for directing implementation of Mod 0116V, despite the negative quantitative cost benefit assessment of Mod 0116V, is "*the potential benefits of non-discrimination and competition*", which it says are "*inherently diffuse and difficult to quantify*". The Decision further identifies, as the reason for over-riding the negative cost benefit analysis of Mod 0116V, "*the principles of non-discriminatory access and the promotion of competition (as identified in the qualitative impacts assessment)*". The Decision adds that "*the Authority considers it important to give weight to the principles of non-discrimination and competition as identified in the qualitative analysis, which in the Authority's view demonstrates potentially significant benefits arising from proposal 0116.*" **Decision, pp. 7-8**. In order to understand the non-discrimination and competition benefits on which the Decision here relies, we must therefore turn back to the discussion in the FIA of "qualitative" benefits (FIA Chapter 4).

***The "Qualitative" Discrimination and Competition Assessments in the FIA***

27. Two "qualitative" non-discrimination benefits are identified in the FIA, at FIA 4.30 to 4.38: (1) reduction in the "*potential for discrimination between firm and interruptible customers*"; and (2) reduction in the "*potential for discrimination*" between GDNs and shippers in access arrangements "*for NTS flexibility rights*". The competition "qualitative" assessment is a brief passage at FIA 4.8 to 4.10.

28. The two "qualitative" non-discrimination issues at FIA 4.30 to 4.38 and the competition "qualitative" analysis at FIA 4.8 to 4.10 are defective, as explained below, in the sections on Discrimination and Competition.

29. In any event, these issues cannot reasonably be considered to be capable of having sufficient weight to outweigh the quantified negative CBA of Mod 0116V, which the Decision accepts is up to £28m PV.

30. If GEMA has understated the negative CBA (as submitted below), the imbalance increases.

***The Quantitative CBA***

31. Analysis of the "quantitative" assessments in the FIA (FIA, Chapter 3) shows that:

(1) Mod 0116V on GEMA's own figures has a negative PV of £27m.[11]

(2) This includes costs to shippers, TCC users and storage operators. It also includes ongoing costs to transporters (which Ofgem had excluded in the FIA).

(3) But this still excludes all the transporters' upfront costs: £20.9m.[12]

(4) It also excludes upwards of £6.2m of costs to parties in Northern Ireland and the Republic of Ireland.[13]

(5) The first, and largest, quantitative benefit item is Ofgem's estimate of savings in NGG's investment in the NTS, as a result of "*efficient investment signals*". Ofgem quantifies this at £42.3m PV. Ofgem accepts that "*by its very nature, this figure is subjective*". [14]

(6) The second largest quantitative benefit item is a non-discrimination issue: Ofgem's claim that Mod 0116V will "*reduce the risk that*

---

[11] Adding the transporters' ongoing costs (£35.5m) from FIA Table 3.13 to FIA Table 3.17. Mod 0116V is therefore at the top end of the £20m - £28m negative PV range stated in the Decision, p. 7.

[12] FIA Table 3.13

[13] FIA 3.83 to 3.86

[14] FIA 3.14 to 3.25

*NGG's retained DNs are treated more favourably [by NGG as NTS operator] than independently owned GDN networks*". Ofgem claims that this risk could lead independent DNOs to over-invest in their own GDNs, and this could adversely affect comparative regulation during the GDN price control process. Ofgem's estimate of the quantitative benefit is approximately £20m PV. This is based again on a "*subjective*" assessment.[15]

(7) The third, and final, quantitative benefit item is an estimated saving of £10m PV in dispute costs associated with ARCAs.[16]

32. The Decision's conclusion, on the quantitative assessment, that the costs of Mod 0116V outweigh its benefits by £27m PV, is a serious understatement. This is because (among other reasons):

(1) The costs should include all of the transporters' costs, including upfront costs. This adds another £20.9m to the costs.

(2) The costs should include the Irish costs. This adds another £6.2m.

(3) The "efficient investment signals" argument is defective. It rests on a failure to appreciate that the NTS "exit – entry" model cannot deliver efficient investment signals because it does not represent the physical reality of the NTS. Far from increasing investment efficiency, there is a serious risk that Mod 0116V will lead to inefficiency in investment decisions. Ofgem's quantification of this supposed benefit at £42.3m is admitted by the Decision to be "*speculative*" and "*subjective*". It is at least as plausible that there would be costs associated with inefficient investment decisions as a result of Mod 0116V.

---

[15] FIA Summary, p. 4; FIA 3.26 to 3.36; FIA 4.42. The FIA Summary wrongly states that the £20m is an amount per annum: it is a PV amount.

[16] FIA 3.37 to 3.46.

(4) Ofgem's analysis leading to the conclusion (adopted in the Decision) that approximately £20m of benefits will result from reducing the "risk" that NGG will discriminate in favour of RDNs and against IDNs is seriously implausible. Again, the quantification of this supposed benefit is "*speculative*". No benefit should be quantified under this head.

(5) New arrangements as proposed under Mod 0116V will not reduce dispute costs by £10m (or any other figure). The costs of ARCA disputes will fall in any event because of the guidance given by GEMA's published determinations in the Langage and Marchwood cases. Mod 0116V will lead to additional risk of disputes on other issues. The costs of these have not been brought into account.

(6) The quantification of the supposed benefit items is "*speculative*". By contrast, the Decision accepts that "*the transaction and implementation costs are in principle more direct and measurable.*" Decision, pp. 7-8.

33. A more appropriate figure for the quantitative cost benefit analysis of Mod 0116V, taking into account these points, is a negative CBA of over £120m PV (see below).

***Shippers' costs***

34. The Decision states that GEMA "*also considered a case in which … shipper costs were based on the costs of the lowest four shippers*": **Decision, p. 7.** It does not appear that GEMA adopts this case as the basis of its Decision. This would be inappropriate.

35. The analysis of costs in FIA 3.51 to 3.89 is based on responses by industry parties to Ofgem's own cost survey. Ofgem provided a Guidance Document that stressed that cost estimates should represent the most likely outcome (i.e. base case / median estimates) and that the costs of

introducing new systems and processes should only be included where introduction of such measures is efficient and necessary. Ofgem followed up with clarificatory meetings with half of the parties who responded.

36. The costs emerging from this process are not a 'worst case scenario'. Attempts to reduce the costs by excluding higher costs estimates as 'outliers' which can be ignored have no statistical validity. The fact that Ofgem attempted in the FIA to massage down the costs, and the reference to this exercise in the Decision, is a further indication that much of the analysis in the FIA suffers from ex-post justification and that the Decision itself was prejudged.

***Transporters' costs***

37. Ofgem's decision to exclude the transporter costs from the assessment of the overall costs and benefits (FIA 3.77 to 3.80) is flatly contrary to the purpose of a Regulatory Impact Assessment. It undermines the utility of the RIA both as a measure of the economic efficiency of the introduction of the proposed new arrangements, and as a measure of the proportionality of introducing them. In the Decision, GEMA has admitted some of the costs, but not all. There is no justification for excluding any of the transporters' costs. They are all relevant to an assessment of whether the proposals are efficient and proportionate.

***Costs in Ireland and the Isle of Man***

38. Both the Decision and the FIA exclude costs of introducing Mod 0116V which are incurred in Northern Ireland and the Republic of Ireland: **FIA 3.83 to 3.86; Decision, pp. 21-22**. The argument given for this is that it would not be "appropriate" for GEMA "to take into account the downstream impacts and costs associated with implementation of Mod 0116 on customers in other jurisdictions" because its principal aim and

statutory duties under the Gas Act concern the gas industry and consumers in Great Britain.

39. This is wholly inappropriate as a matter of policy; and if (as it appears) it is based on a belief that GEMA is not entitled to take these costs into account, it is an error of law.

40. Under the *Marleasing* doctrine the provisions of the Gas Act 1986 should be construed consistently with all relevant EU obligations. The Authority's principal objective under Section 4AA(1) is to protect the interests of consumers in relation to gas conveyed through pipes. There is no territorial limitation which limits this to consumers in Great Britain and excludes consumers in Northern Ireland or in the Republic of Ireland. Such a limitation is inconsistent with the policy of EU law in this context, including the Directive, and with the development of the internal European gas market. The only express territorial limitation in Section 4AA is found in subsection (2)(a). Excluding these costs also has no economic rationale in terms of assessing the efficiency and proportionality of Mod 0116A.

41. GEMA's proposal that a "single party purchaser" should be established at Moffat (a) does not remove the cost implications for parties in Northern Ireland, the Isle of Man and the Republic of Ireland; and (b) is objectionable on competition grounds.

***Overall Outcome of the Quantitative Cost Benefits Analysis***

42. When all the transporters' costs and the Irish costs are added back to the calculation, the overall outcome of the quantitative benefits and costs analysis is, on the FIA's own figures, yet more negative for Mod 0116V. It is negative for all the Modification Proposals other than 0116A.

| NPV (£m, 05/06) (at 6.25%) | 0116V | 0116A | 0116BV | 0116CVV | 0116VD |
|---|---|---|---|---|---|
| Table 3.17, Benefits | 72.4 | 0 | 72.4 | 62.2 | 72.4 |
| Table 3.17 Costs (Shipper, TCC, Storage) | (64.1) | 0 | (59.6) | (15.0) | (58.1) |
| Transporter Costs (Table 3.13) | (56.4) | 0 | (56.9) | (49.9) | (56.7) |
| Irish costs (FIA 3.85) | (6.2) | 0 | (6.2) | (6.2) | (6.2) |
| | **(54.3)** | **0** | **(50.3)** | **(8.9)** | **(48.6)** |

43. The very substantial negative CBA of Mod 0116V plainly shows, even on the FIA's own figures, that it is not proportional or efficient to approve it. It is simply irrational.

44. The excess of costs over benefits becomes even plainer in the light of our analysis (below) of the purported benefits. In reality the supposed quantitative benefits are non-existent, while the costs are all too real. We submit that an appropriate assessment is that the negative PV of these Modification Proposals are over £120m for each of Mods 0116V, 0116BV and 0116VD, and over £70m for Mod 0116CVV.

45. It is not surprising that there is such deep and widespread opposition in the industry to the introduction of these proposed arrangements. Imposition of these offtake arrangements on the industry would be a serious waste of economic resources.

46. On the issues of costs and benefits, E.ON further relies on the analysis in Mr Shuttleworth's Expert WS and in the NERA Reports for the Gas Forum.

***Negative CBA of the "flexibility product" proposal***

47. Mod 0116V links together in one packaged modification a number of distinct issues, which are not necessarily interdependent. One of these distinct issues is the creation of the new "flexibility exit capacity" product. The distinct issues are not clearly separated out or costed in Ofgem's FIA or in the Decision.

48. But it is clear, from comparing the FIA's figures for Mods 0116CVV and 0116V, that the negative CBA for the new "flexibility exit capacity product", taken on its own, is very substantial indeed. Mod 0116CVV differs from Mod 0116V by excluding the new "flexibility exit capacity product".

    (1) The total costs of Mod 0116CVV are some £55m PV lower than for Mod 0116V. This includes a reduction of £32.4m PV in shipper costs[17] and of £16.7m PV in TCC and storage operator costs.[18]

    (2) But the FIA's assessment of quantified benefits as between the two options is only lower by £10.2m PV. This is because Ofgem reduces by 50% the value it attributed (for improved comparative regulation in setting the GDN price control) to reducing the "risk" that NGG will discriminate against IDNs as against RDNs. The FIA reduces the attributed value of this from £20.4m PV for Mod 0116V to £10.2m PV for Mod 0116CVV.[19]

---

[17] FIA Table 3.8

[18] FIA Table 3.11

[19] FIA 3.35 to 3.36, FIA 3.47 and FIA Table 3.6. The remaining saving of £6.5m appears to be in transporters costs: FIA Table 3.12.

(3) The quantitative CBA of the new flexibility product, taken as a distinct issue, is substantially negative – by about £45m PV. This clearly indicates that this change is not efficient or proportionate.

(4) The only quantitative benefit attributed to the new flexibility product is a supposed benefit for comparative regulation of the GDNs, for price control purposes. This does not justify or explain why it is necessary or proportionate for the shippers and storage users and TCCs to be subjected to the new flexibility product, and it does not justify imposing these very high costs on these parties.

49. The Decision states that there is currently no shortage of flexibility on the NTS: **Decision, p. 6**. This underlines the point that introducing the new flexibility product is not proportionate or efficient.

***Why impose unnecessary costs on shippers?***

50. The central concerns which Ofgem and GEMA express in relation to offtake arrangements after NGG sold the four Independent GDNs in reality only concern the relations between NGG and the IDNs / RDNs. For example, Ofgem is concerned about the way in which GDNs may rely on NTS linepack rather than their own networks. It is concerned that there is a risk of NGG discriminating in some way in favour of its retained RDNs and against IDNs, and that fear of this risk may lead the IDNs to over-invest in their own networks, and this in turn may compromise the comparative regulation gains which Ofgem wants to achieve during the GDN price control process. (This last very far-fetched point is the only quantified benefit from a non-discrimination issue in the FIA).

51. But neither of these points requires that shippers or TCCs are subjected to any change in their current offtake arrangements. Even if it were thought appropriate to change the NTS offtake arrangements affecting the GDNs to seek to achieve the alleged non-discrimination benefits, or to affect the

investment incentives as between the NTS and the GDNs, the proportional way to do this would be to apply any change only to the GDNs. This would avoid imposing unnecessary costs on the shippers and TCCs.

52. Why does not GEMA do this? The only explanation appears to be a mistake of law by GEMA - that even where there is a good reason for applying a different charging structure to two different groups of NTS user, it would be somehow improper discrimination to do this.

**DISCRIMINATION**

53. Throughout the history of these proposals, GEMA and Ofgem have advanced a number of "non-discrimination" arguments as one of the main reasons for altering the current offtake arrangements. Non-discrimination arguments are still cited in favour of introducing Mod 0116V.

54. The problem is that there is a fundamental (and mistaken) assumption that non-discrimination requires treating two groups the same even whether there is a good reason for treating them differently – or where a reason which applies to one group does not apply to another.

55. GEMA and Ofgem frequently assume that "non-discrimination" requires that all users of the NTS should have the same terms and conditions as all other users. For example, paragraph 2.21 of GEMA's Decision of February 2005 states: "*… to ensure equality in treatment of all users connected to the NTS these arrangements should also apply between NTS and directly connected customers. This will serve to ensure that access to the NTS is provided to all network users in a manner which is not unduly discriminatory*."

56. This assumption is an error of law as to the meaning and effect of non-discrimination obligations, both under English law and under EU law. The relevant legal and factual issues (a) have not been properly investigated, assessed or weighed, and (b) have not been properly identified for consultation. If these issues are not properly identified, consulted on and resolved, a decision may (i) wrongly conclude that there is a prohibited discrimination problem which needs to be addressed, when in fact there is none; and/or (ii) give a wrong weight to a 'potential' non-discrimination issue against (e.g.) cost and efficiency considerations.

57. The Decision itself states that GEMA makes no actual finding of undue discrimination: **Decision, p. 6**. But the Decision also states that it is appropriate to reduce the "risk" or "potential" for undue discrimination – by imposing the same offtake terms on all NTS users: **Decision, p. 6**. In the Decision and the FIA, GEMA and Ofgem repeatedly approach non-discrimination issues by assuming, and asserting, that applying the same terms to different classes of NTS user will "reduce the potential for undue discrimination" or "reduce the risk" of undue discrimination. This is not the right approach in law.

**Law on Discrimination**

58. Non-discrimination obligations are contained in Section 9(2) of the Gas Act 1986 ('***Section 9(2)***'); in EC Directive 2003/55/EC on common rules for the internal market in natural gas ('***the Directive***'); in Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks ('***the Regulation***'); and under the general principle of non-discrimination in European Community law.

59. None of these non-discrimination obligations prohibit offering different terms to different classes of user for access to the NTS; nor do they require that identical capacity charging arrangements must be applied at all NTS exit points. The non-discrimination obligations do <u>not</u> preclude

offering different terms to different classes of user for access to the NTS. Different terms may be offered where there is a material difference between classes of user or a good reason for the difference in terms.

60. Proper application of the non-discrimination provisions requires answering two questions: (a) are the users or classes of user materially comparable; and (b) is there a valid reason, or objective justification, for any difference in treatment. Where there is a material difference between two cases, or a good reason for treating them differently, different treatment will not constitute prohibited discrimination. Proper application of the non-discrimination provisions may not only permit but actually require that material differences between classes of user be reflected in appropriately different treatment. Applying a non-discrimination provision to particular situations always requires considering the actual facts and circumstances. The assumption that non-discrimination requires that different types of user must be offered identical access terms is an error of law.

61. Section 9(2) requires NGG "*to avoid any undue preference or undue discrimination*". The English case law on similar provisions establishes that:

(1) The prohibition of undue discrimination or undue preference does not require identical treatment of different classes.

(2) Identical treatment of different classes may indeed itself constitute undue discrimination or undue preference: materially different classes should not be treated alike.

(3) The inquiry in each case as to whether a difference in treatment (or identical treatment) amounts to "undue discrimination" or "undue preference" as between two classes requires analysing the facts of

the particular case, and the reasons for the different (or identical) treatment.

(4) All relevant circumstances should be taken into account in deciding whether different (or identical) treatment amounts to undue discrimination or undue preference. [20]

62. In EU law, the general principle of equality and non-discrimination is one of the fundamental general principles. It requires that comparable situations must not be treated differently, and different situations must not be treated comparably, unless such treatment is objectively justified. The existence of a comparable situation is a question of fact, which must be proved, not alleged. The ECJ has consistently held that particular non-discrimination provisions in EU legislation are specific expressions of the general principle of equality. This applies to the non-discrimination obligations in both the Directive and the Regulation.

63. The Directive and the Regulation are designed to create an internal competitive gas market in the European Union. This is explained by the European Commission: [21]

"*The gas and electricity Directives were adopted by the European Parliament and by the Council in order to create competition. The key element is the introduction of non-discriminatory and transparent third party access to the networks with ex-ante supervision by regulators*."

---

[20] See e.g. *Pickering Phipps v LNWR* [1892] 2 QB 229 (CA), *South of Scotland Electricity Board v British Oxygen Co. Ltd* [1956] 1 WLR 1069 (HL); *South of Scotland Electricity Board v British Oxygen Co. Ltd* [1959] 1 WLR 587 (HL); *London Electricity Board v Springate* [1969] 1 WLR 524 (CA).

[21] See: the Executive Summary to the Technical Annex to the Commission's 2005 report to the European Parliament and Council on progress in creating the internal gas market.

64. There is a fundamental structural distinction between the monopoly infrastructure operators (including transmission and distribution system undertakings) and the competitive part of the market (including shippers and suppliers):

"*… networks are largely natural monopolies providing the basis and the fundament upon which competition among gas and electricity suppliers is to develop. This means that there is a non-competitive and a competitive part of the gas and electricity sectors. The former is made up of the necessary infrastructure and its operation, which should work to facilitate the market, while the latter is represented by suppliers and producers, often with traders and big customers contracting directly with the producers. These market participants should compete with each other for market shares in both the wholesale and retail market enjoying non-discriminatory use of the necessary infrastructure*." [22]

65. The objective of the internal market reforms is a market structure where the (largely monopoly) infrastructure providers (including the transmission and distribution system operators) facilitate competition between the competitive market participants (including shippers, suppliers, traders and large consumers):

"*operators of transmission and distribution grids would act as market facilitators allowing system users (suppliers, traders, large consumers etc) to exploit market opportunities to the extent possible*." [23].

66. The requirements in the Directive and Regulation for non-discriminatory access to the infrastructure system are designed to achieve this objective. Their central purpose is to secure the objective of a functioning competitive market for the competing market participants.

---

[22] Ibid, p. 9
[23] Ibid, p. 10

67. The Directive's recitals link non-discrimination to the Directive's competition objectives. The structure of the Directive makes a fundamental distinction between infrastructure (including transmission, distribution and LNG facilities) and the competitive parts of the market (including the shippers and suppliers). Undertakings in the infrastructure part of the market are not in comparable situations with undertakings in the competitive part of the market.

68. Regulation (EC) No 1775/2005 concerns conditions for access to the natural gas transmission networks. The fundamental objective of the Regulation is "*to tackle remaining barriers to the completion of the internal market in particular regarding the trade of gas*." The non-discrimination provisions of the Regulation, like those of the Directive, are intended to further the basic objective of developing the competitive market.

69. Since the fundamental object of these non-discrimination provisions is to facilitate competition among the competitive market participants (shippers, suppliers etc), in applying the provisions, the central focus should be on whether measures discriminate as between competitive market players. This applies both to the comparability and the objective justification issues.

**Application to the present case**

70. It is not appropriate to categorise GDNs and shippers/suppliers as competitors or to assume that they are comparable for the purposes of non-discrimination provisions. They occupy fundamentally different positions. GDNs are part of the largely monopoly infrastructure of the gas sector; while shippers and suppliers are part of the competitive part of the sector. Directly connected users, such as generators and large industrial plant, are consumers.

71. Since GDNs and shippers are in structurally different parts of the sector, this strongly indicates that they are not in a comparable position for the

purposes of non-discrimination provisions. It would be wrong simply to assume that they are comparable. This is also relevant in assessing whether there are good reasons for different treatment, and objective justification for such treatment.

72. Where the design of access conditions is based on reasons which relate to encouraging efficient infrastructure investment by DNOs, such reasons will not apply to shippers / suppliers or TCC users, since they have no infrastructure investment functions.

73. Similarly, reasons for designing access conditions to reduce the risk of discrimination as between Retained and Independent GDNs are not relevant to shippers / suppliers or to TCC users.

74. In both cases, non-discrimination obligations cannot justify applying these access conditions to shippers / suppliers or TCC users. This because (1) the two cases are not in fact comparable; and (2) the reasons for treating one class in a particular way do not apply to the other. There can be no assumption that non-discrimination provisions automatically require identical treatment of two classes. This is wrong in law. Everything depends on analysing the comparability of the two classes; and the reasons for differential treatment.

75. The basic division between the infrastructure and the competitive part of the gas sector also points to the need to consider the comparative position of competitive market players in relation to the infrastructure network as a whole: for example, some shippers offtake gas from the transmission system, and others from distribution networks. Non-discrimination rules do not mandate that TCCs connected to the transmission system must be treated in the same way as distribution networks connected to that system. In considering the offtake conditions for the shipping and supply to TCCs connected to the NTS, it is necessary to consider the corresponding situation for the shipping and supply to customers

connected to the GDNs. This is so even if it would support treating different classes of user of the transmission system (i.e. GDNs and directly connected customers) differently. The difference arises again because of their fundamentally different positions in the market structure: they are not in comparable positions; and the reasons which apply to one class do not apply to the other.

76. Comparability and justification issues also arise as between other classes of NTS User. In particular, interconnector access to the NTS raises such issues. The non-discrimination provisions do not justify an automatic assumption that interconnector access to the NTS must be on identical terms to access by GDNs. The relevant comparability and objective justification issues need to be investigated on the facts. Relevant matters would include the overall EU objective of establishing a single internal market in gas, and security of supply considerations: these affect the question whether interconnector undertakings are in a comparable position to DNOs and/or provide objective justification for different treatment.

**Discrimination Issues in the FIA**

77. As noted above, the Decision effectively adopts the FIA's analysis of both the quantitative assessment and the qualitative assessment of the costs and benefits of introducing Mod 0116V. The FIA considers discrimination issues under both heads.

78. The FIA Summary (p. 4) claims that the "*potential benefits*" of the new Mod 0116V offtake arrangements include the reduction of the "*potential for discrimination*" (sic) in three identified cases. The first two are treated as 'qualitative' benefits (in FIA Chapter 4), while the third is treated as a major quantitative benefit (in FIA Chapter 3):

(1) "*Reforms to the NTS interruption arrangements should reduce the potential for discrimination between firm and interruptible customers*." This is explained as a qualitative benefit at FIA 4.30 to 4.35.

(2) "*Modification Proposals 0116V, 0116BV and 0116VD should also reduce the potential for discrimination as between GDNs and shippers by establishing equivalent access arrangements for NTS flexibility rights*." This is explained as a qualitative benefit at FIA 4.36 to 4.38.

(3) "*Establishing transparent and non-discriminatory allocation processes should reduce the risk that NGG's retained GDNs are treated more favourably than independently owned GDN networks*." This is treated as a quantitative benefit at FIA 3.26 to 3.36; see also FIA 4.42. [24]

79. The quantitative benefit associated with non-discrimination is estimated in the FIA as approximately £20m for 0116V, 0116BV and 0116VD and £10m for 0116CVV: see FIA 3.26 to 3.36. (These are PV amounts, not amounts per annum, as wrongly stated in the FIA Summary, at p. 4). All of this in fact relates only to case (3) above (i.e. the alleged potential for discrimination by NGG NTS in favour of NGG's retained GDNs against the independent GDNs). It is based on a 'subjective assessment' of a 5% potential compromise to comparative regulation: see FIA 3.26 to 3.36. No quantitative benefit is estimated in the FIA for cases (1) and (2) above: these are simply discussed as 'qualitative benefits' at FIA 4.30 to 4.38.

[24] See also FIA 2.3 (third bullet); 2.17, 2.18 (second bullet); 2.32 and 3.4. FIA 4.39 to 4.41 discusses potential discrimination issues as between existing and new users, but neither the FIA nor the Decision advances this issue as a substantial benefit of Mod 0116V. Mod 0116V itself, by recognising prevailing rights, treats existing and new users differently.

## THE 'QUALITATIVE ASSESSMENT' NON-DISCRIMINATION ISSUES

### *Alleged "potential" for undue discrimination (1) between 'firm' and 'interruptible' customers and (2) between GDNs and shippers in access arrangements for "NTS flexibility rights"*

80. These two arguments are the 'qualitative' assessment non-discrimination arguments which are identified in the Decision as being so important as to outweigh (with the qualitative competition arguments) the negative quantified CBA of Mod 0116V. These two arguments are also the only arguments which directly affect shippers. The third non-discrimination argument directly affects only the GDNs.

81. The two arguments are entirely unconvincing, and cannot properly be given the weight necessary to over-ride the negative quantitative CBA of Mod 0116V (which on Ofgem's own figures is £27m PV, and, as submitted above, in reality markedly higher).

82. No industry party has in fact made any formal complaint that these issues constitute undue discrimination against its position.

83. The discrimination obligations on NGG (including Section 9(2) and NGG's licence obligations) in themselves provide satisfactory mechanisms for controlling any undue discrimination. If any industry party did consider that there was a case of undue discrimination, any such complaint (if and when made) should be properly considered on its merits, with all relevant legal and factual points properly addressed.

84. No quantitative benefit has been – or could be – ascribed to these two discrimination arguments. The points are fanciful. They do not amount to any "qualitative benefit". There is no sensible basis for asserting that any benefits will accrue to consumers from these points.

***Alleged discrimination between 'firm' and 'interruptible' customers***

85. The contentions in FIA 4.30 to 4.35, largely repeated in the Decision, are not well-founded for the following reasons:

(1) There is no proper discrimination issue here. There is an objective distinction between 'firm' and 'interruptible' customers. They are not comparable, and there is an objective reason for different treatment. NGG is not required to invest to meet interruptible demand as this is not covered by the 1 in 20 obligation. So interruptible customers pay the commodity charge (which is already set at a considerably higher level than is appropriate to recover the relevant costs), but do not pay the capacity charges, which are intended to recover the infrastructure costs.

(2) There is also no discrimination within the present interruption arrangements. There is no discrimination between different classes of interruptible users under the current arrangements.

(3) The proposed new arrangements are likely themselves to create non-discrimination issues in relation to interruptibility as between generators (and other industrial / commercial users) connected to the NTS and those connected to GDNs.

(4) There is no evidence that the alleged risk of a flight from firm to interruptible status is a real issue in practice.

(5) If the probability of interruption is low, this may mean that consideration could be given to the level of the exemption from capacity charges (although there are economic efficiency arguments against this), but it does not dictate that the radical

changes of Mod 0116V are necessary or proportionate. Nor does it support any discrimination complaint. [25]

(6) Interruptible capacity should not be priced in accordance with the probability of interruption, because this does not reflect the cost of providing the service. Where the system has a large amount of capacity (due to the 1 in 20 obligation) the cost of providing interruptible capacity is close to zero. The European regulations do not require GEMA or NGG to ignore cost-reflectivity in charging.

(7) The Mod 0116V proposals on interruptibility could lead to inefficient under-use of the NTS.

(8) They also have an important practical effect on generators who are currently interruptible users for back-up supplies. Under Mod 0116V, current interruptible users must either purchase long term firm capacity or they must risk relying on bidding for day ahead interruptible capacity. If they choose the former they may have the opportunity to enter into bilateral interruption contracts with NGG, and they may receive some compensation in terms of option and exercise fees. But this will not be available to those that use the NTS for back-up supplies – because, unless NGG has the prospect of interrupting gas, no such contract will be agreed. This is a particular concern for E.ON UK and a number of other generators. There is no good reason, either of investment planning or of non-discrimination, which justifies this result.

(9) There is no available information on the form or content of the proposed bilateral interruptible contracts under Mod 0116V, or how they will operate in practice. The change is a leap in the dark. This

[25] The probability of interruption has not been tested under prolonged cold winter conditions. Since the Network Code was introduced in 1996, weather conditions have not been severe enough to test the 1 in 20 peak demand license obligation.

is not consistent with GEMA's regulatory duties under Section 4AA(5A).

***Alleged "potential discrimination" between GDNs and shippers in "access to flexibility"***

86. The alleged "potential discrimination" between GDNs and shippers in respect of "flexibility" (FIA 4.36 to 4.38) is a wholly bad point for the following reasons:

(1) NGG has no incentive to discriminate in favour of shippers, as against GDNs, as it has no affiliated shipper business. There is therefore no real risk of impermissible discrimination.

(2) TCCs and GDNs are simply not comparable for discrimination analysis (see above). There is no warrant for regarding different treatment of these as prohibited by a non-discrimination obligation.

(3) GDNs, by their nature as part of the pipeline infrastructure, have an inherent flexibility capacity within their own networks. TCCs do not have such flexible capacity and their flexibility requirements depend upon access to the flexibility capacity of the NTS. There is a material reason for treating these two classes of user differently.

(4) In respect of access to NTS flexibility capacity, the proposed new arrangements are in fact likely in practice seriously to disadvantage TCCs and their shippers as against GDNs. GDNs are monopoly price controlled regulated businesses with firm 1 in 20 licence obligations. TCCs / shippers will be at a serious disadvantage if required to bid against GDNs for access to flexibility capacity.

(5) The original issue here concerned the interface between NTS and the GDNs, and the investment decisions of GDNs in relation to the NTS. This has nothing to do with shippers, who have no

transportation infrastructure. Charging methods (or administrative methods) which may be thought necessary or appropriate for GDNs because of the NTS/DN interface between two parts of the transportation network should not be applied to shippers / TCCs where the reasons are not applicable.

(6) It is wrong in law to assume that shippers and GDNs, which are materially different, must be treated in the same way in this respect.

(7) The proposed new arrangements are likely themselves to create non-discrimination issues in relation to access to flexibility as between generators (and other industrial / commercial users) connected to the NTS and those connected to GDNs. This is not considered by Ofgem.

(8) The new "flexibility exit capacity product" is simply an invention of Ofgem's. It does not relate to any real product.

(9) There is, as Ofgem recognises, in fact no scarcity of flexibility at present.

(10) NGG does not invest to create "flexibility" but to satisfy its 1 in 20 obligation. So there are no investment costs to be recovered by this new capacity charge.

(11) The charges which will result under Mod 0116V will not be cost-reflective. There are no costs to reflect. Also, the suggested auction allocation systems cannot by their nature deliver properly cost-reflective charges.

(12) There is an extremely large negative CBA of introducing the new "flexibility product": on Ofgem's own figures this cost is £45m PV (see above). It is ironic that Ofgem cites non-discrimination in the

allocation of this invented 'flexibility' product as one of the three reasons which trumps the overall negative CBA of Mod 116V. [26]

(13) These costs are targeted on the competitive market players – shippers, suppliers, TCCs etc.

(14) These costs will inevitably filter back to customers – including domestic consumers – as Energywatch warned.

(15) The 'flexibility product' proposals themselves cannot be justified on the basis of GEMA's statutory duties. There are no useful benefits (qualitative or quantitative) derived from "reducing the potential for undue discrimination" in the allocation of this product. There is simply an additional error of law.

## THE 'QUALITATIVE ASSESSMENT' COMPETITION ISSUES

87. As noted above, the Decision justifies the adoption of Mod 0116V (despite its negative quantitative cost benefit assessment) because of the supposed "qualitative" benefits arising (a) from the two non-discrimination points we have just considered, and (b) from the competition points identified in the FIA qualitative assessment.

88. The FIA qualitative assessment of the competition effects of Mod 0116V is contained in three short paragraphs at FIA 4.8 to 4.10. On analysis, the competition consequences of Mod 0116V are negative not positive. FIA 4.10 itself expressly identifies a competition <u>cost</u> of Mod 0116V not a benefit.

---

[26] Once again this is in fact a good illustration of the 'ex post' justification nature of the reasoning both in the FIA and in the Decision.

89. FIA 4.8 and 4.9 contain the only discussion of allegedly positive consequences on competition. The claims are that "*the proposals might be expected to promote competition between NTS users in that all participants will be able to secure access to the same defined products in the long and short term*" (FIA 4.8) and that there will be competition for long run interruption services, or for flexibility capacity (FIA 4.9) and that this may avoid the risk that flexibility capacity may be allocated in an arbitrary manner so distorting competition (FIA 4.9).

90. These paragraphs are wholly defective as a proper competition assessment: see the OFT Guidelines on Competition Assessments in Impact Assessments. The analysis is not a proper competition analysis for the purpose of GEMA's statutory duties. It does not give effect to the competition objectives of the relevant statutory duties; it fails to appreciate what these duties actually mean; and it is not an orthodox economic competition analysis.

91. In conducting the competition assessment, GEMA and Ofgem should have, and have not, defined the relevant market and identified the competing suppliers. GDNs and TCC/shippers are not competing suppliers in any relevant market. The GDNs are part of the largely monopoly transportation infrastructure, the shippers and suppliers are part of the competitive section of the market; the consumers are the purchasers in the competitive sector of the market. There appears to be a complete failure to understand and/or to apply the relevant competition provisions in FIA 4.8 and 4.9.

92. The points made in FIA 4.8 and 4.9 actually appear to be nothing to do with competition.

93. The points are also very odd in another way. There is not in fact a shortage of flexibility capacity on the NTS and there is not in fact any need to create a 'flexibility capacity' product and to ration access to this new

product by auction. Nor is there any real practical risk at present that "flexibility capacity" might be allocated so as to distort competition - since there is no shortage of NTS flexibility. Again, it is ironic that the qualitative benefit that GEMA identifies as justifying over-riding the negative CBA of Mod 0116V is competition in accessing the very "flexibility product" which itself, if introduced, would carry a negative CBA of some £45m PV.

94. FIA 4.10 acknowledges a much more serious issue – that the increased complexity and transactional costs of the Mod 0116V proposals may adversely impact on competition in the gas shipping sector by increasing barriers to entry. This is a competition cost, not a benefit, of Mod 0116V.

95. The inadequate analysis of the (adverse) competition effects of Mod 0116V in the FIA is a serious defect in the decision-taking process, and in the Decision itself.

96. The competition consequences of the Modification Proposals should be a central factor in GEMA's decision. GEMA's principal objective, under Section 4AA of the Gas Act 1986, is to protect the interests of consumers in relation to gas conveyed through pipes, "*wherever appropriate by promoting effective competition between persons engaged in … the shipping, transportation or supply of gas so conveyed*". Section 9(1A) of the Act provides that NGG NTS (and indeed the GDNs) are under a duty to facilitate competition in the supply of gas. Competition effects in the electricity markets may also be considered, and we submit that it is right that they should be considered: see Section 4AA(4)(a) of the Gas Act 1986.

97. The competition analysis should have formed a central part of the FIA's assessment of the Modification Proposals: see both the Report of the Regulatory Policy Institute on RIAs, and Ofgem's own Guidance on Impact Assessments. As Ofgem's Guidance states (section 5.9)*: "IAs will assess whether there are significant positive or negative impacts on competition*

*in relevant markets. If any of the options are likely to have a significant effect on competition (either positive or negative), this impact will be included in the summary section on costs and benefits.*" The competition analysis should have followed the guidance published by the OFT. [27]

98. The first step is to identify the relevant markets where competition occurs, and to consider what effects the proposals would have on the operation of competition in those markets. We have described above the basic structural distinction between the largely monopoly infrastructure of the gas industry (including NTS and the GDNs) and the competitive parts of the market (shippers, suppliers and consumers).[28] The key question for a competition assessment is whether the proposals will promote competition between shippers / suppliers, or will hinder it. Competition in shipping and in supply is identified in Section 4AA of the Act, and competition in supply is identified in Section 9(1A). This question has not been systematically or seriously addressed in the FIA.

99. The competition analysis in the FIA is wholly inadequate. The FIA Summary states that the proposed alterations in NTS offtake arrangements "should promote competition" (FIA p. 4). This is wrong and misleading. So is the reference to the "potential benefits" of competition in FIA 3.4. The true position is that the proposals clearly have <u>negative</u> consequences for competition – in both the gas and electricity markets. The FIA itself acknowledges that the proposals have negative competition effects. The failure to highlight the negative competition effects in the FIA Summary, or give them proper weight in the overall FIA assessment and the Decision, is a serious defect.

---

[27] Ofgem recognizes that it should have regard to the guidance in the OFT Guidelines: see Ofgem Guidance on Impact Assessments (229b/04) section 5.2 and Appendix 1. See also Section 5A of the Utilities Act 2000.

[28] See the section on Discrimination above, and in particular the European Commission's analysis of the structure of the industry.

100. The real effects on competition of the proposed alteration to the offtake arrangements are negative.

101. First, the additional complexities and transaction costs of the proposed new arrangements increase barriers to entry, with negative effects on competition in the shipping / supply of gas. This is recognised in the June RIA at 1.64 and in the FIA at 4.10 and 4.55. Yet it was not reflected in the FIA Summary. [29]

102. These additional complexities and transaction costs may also accelerate exit from the market, which also has negative effects on competition in shipping / supply. Competition in gas supply to large I&C customers, some of which are TCCs, is very fierce and margins are very slim. Some companies have already exited this market. The prospect of added complexity, and the need to manage the added risk associated with flat and flexibility capacity bookings persisting for longer than one year, may encourage other suppliers to follow.

103. Second, the longer term nature of the required commitments (and the importance to TCCs of securing the capacity that they need) will adversely affect competition in the shipper/supply markets. A TCC which is not also a shipper will have to rely on a shipper to purchase capacity on its behalf. The shipper in turn has to ensure the TCC underwrites these purchases. The transfer of capacity from one shipper to another will become an impediment for TCCs switching supplier. Longer term user commitments (which the shipper must enter into with NGG) create a barrier for I&C consumers to switch suppliers, while increasing the risk to suppliers if left holding exit capacity of no value. FIA 4.55 recognises that the proposed

---

[29] In discussing this, the June RIA at 1.63 refers to "achieving our high level policy objective". This is a rather revealing remark. It shows prior commitment to some 'high level policy objective' rather than a proper RIA assessment of all the relevant costs and benefits. What is the high level policy objective? How does it rank higher the Authority's principal objective under Section 4AA(1)?

arrangements could increase the difficulty that customers face in switching shippers, and that this has negative consequences for competition in gas supply. Yet this again was not reflected in the FIA Summary.

104. Third, the increased level of the financial commitments required for new entry capacity, compared to the level of the ARCA commitments (as established by the Authority itself in the Marchwood and Langage determinations) increases barriers to entry, with negative competition impacts on the electricity wholesale market. The Authority's standing policy on NTS shallow connection charging policies, and the Authority's recent determinations on the appropriate level of the ARCA commitment, both reduce barriers to new entrants and so promote competition. The present proposals undermine that policy. The deterrent effect on market entry of inflexible and disproportionate user commitments is a very real risk. The experience in the electricity industry suggests that this is a very delicate balance, and that market entry will almost certainly be affected. This also has serious consequences for electricity security of supply.

105. Finally, the proposals carry the serious risk of even more fundamental adverse effects on competition, in both the gas and electricity wholesale markets, because of the inappropriate emphasis on attempting to tie NGG's investment planning to financial signals from users. We discuss this below.[30] The consequences for the wholesale gas and electricity markets of unnecessarily constraining capacity on the NTS could very easily dwarf any supposed investment cost savings which Ofgem believes may result from their proposals. Disallowing investment may not be viewed as beneficial to consumers if this induces unduly risk-averse investment planning in the asset base. GEMA should have given far greater weight to the primary importance of the wholesale markets in both gas and electricity. These are flourishing competitive markets which

[30] In the section on Investment Signals.

directly impact on consumers, large and small. Ultimately the transportation infrastructure is important because it provides the necessary physical base for the competitive supply markets.

106. The competition points at FIA 4.8 to 4.10 are wholly inadequate to establish any net competition benefits from Mod 0116V, let alone one which could properly be given sufficient weight to override the negative quantitative cost benefit. The real competition effects of Mod 0116V are negative, as explained above.

**The "Qualitative Assessment" Discrimination and Competition points cannot justify the Decision**

107. The purported discrimination and competition "qualitative benefit" issues analysed above are not reasonably capable of over-riding the negative quantified assessment of the costs and benefits of Mod 0116V. For the reasons given above (a) GEMA's analysis of the purported discrimination and competition "qualitative benefits" issues was seriously defective and/or (b) GEMA gave these issues wholly excessive weight in deciding that they over-rode the negative CBA (on Ofgem's own figures) of £27m, and accordingly GEMA (1) failed properly to have regard to the matters mentioned in section 175(2) of the Energy Act 2004; (2) failed properly to have regard to the purposes for which the relevant condition has effect; (3) failed to give the appropriate weight to one or more of those matters or purposes; and/or (4) the Decision was based, wholly or partly, on an error of fact; and/or (5) the Decision was wrong in law.

**THE QUANTIFIED BENEFITS**

108. We now turn to the three main "quantified benefits" identified by GEMA and Ofgem: (1) investment signals; (2) non-discrimination as between IDNs and RDNs; and (3) reduction in disputes costs of ARCAs. On

analysis the claimed benefits are speculative or non-existent and the values attributed to them are subjective and overstated.

**FIRST "QUANTITATIVE BENEFIT" – INVESTMENT SIGNALS**

109. The largest single quantified benefit shown in the FIA (£42.3m NPV) is the estimated gain from potential efficiency savings which are claimed to result from better investment signals from requiring increased financial commitments from NTS users (FIA 3.11 to 3.25).

110. The argument is that requiring users to make a significant financial commitment to guarantee ongoing access to the NTS "*may increase the efficiency of NTS investments and reduce the risk of stranded assets*" (FIA 3.11) because NGG "*will receive more robust information to inform its planning process*" (FIA 3.15).

111. The Decision on this point is fundamentally flawed by errors of fact and by wholly implausible assumptions. (See the critique in Shuttleworth WS and in the NERA Reports for the Gas Forum: GS2, GS3).

112. Also, the point cannot, in any event, justify all the elements in the Mod 0116V package – in particular, it is irrelevant to the items which concern (a) the new "flexible capacity exit product"; and (b) interruptible status.

113. The NTS entry-exit model was adopted to simplify charging for third party access and to facilitate energy trading at the National Balancing Point (a notional point). It does not model physical gas flows through the system. It was not designed to facilitate investment decisions, and nor can it be effectively used for planning investment decisions. The physical flow consequences of particular levels of offtake at particular nodes on the NTS depend upon the configuration of the system as a whole, and on interactions with other offtake points and indeed with input points. In reality

the entry-exit model is a 'black box'. Only NGG has the 'key to the box' – the knowledge, understanding and expertise to model actual physical flows. Investment decisions in the NTS must continue to be planned by NGG so as to meet the objectives placed on NGG, and in particular the 1 in 20 peak day obligation. NGG must continue to use all its system knowledge and expertise and all relevant information in carrying out its investment planning so as to meet its set objectives.

114. There are also serious risks with the approach apparently taken by GEMA to NGG's investment planning functions. The FIA gives a wholly inappropriate weight to what it describes as "financially backed user commitments". In reality, the information which may be obtained about exit capacity requirements at particular exit points do not improve to any real degree on the information already available to NGG for its investment planning. Such information goes nowhere near identifying the required physical investment in the NTS.

115. E.ON has very serious concerns about the indications (e.g. FIA 3.16) that GEMA and Ofgem apparently consider that this not very useful information should be inappropriately elevated to serve as the basis for regulatory decisions striking down and disallowing investment actually considered to be necessary by NGG itself to meet its required objectives.

116. This is likely to have a chilling effect on NGG's investment decisions, with potentially serious adverse consequences both for competition and for security of supply.

117. Regulatory pressure from GEMA / Ofgem on NGG NTS to support its investment decisions with such 'user signals' (reinforced with the sanction of disallowing NGG investment) is likely to have <u>negative</u> effects on

system investment and operation. NGG NTS will be incentivised to adopt an overly cautious, risk-averse investment strategy.

118. The NTS is the crucial transportation link for Britain's energy. It is central to gas and to electricity supply and to the competitive wholesale markets for the supply both of gas and of electricity. Attempts to fine-tune or second-guess or over-ride NGG's informed investment planning decisions, on the basis of this wholly inadequate type of information, would be detrimental both to the need to protect the interests of consumers by the promotion of competition in wholesale gas and electricity markets, and to the interests of consumers in secure supply both of gas and electricity.

119. The central challenge facing NGG as operator of the NTS is to ensure that the NTS has the capacity to meet these demands. This should also be the central concern of GEMA as regulator. The analysis in the FIA is more concerned with (unrealistic and misplaced) fears about the risk of stranded assets rather than with the efficient development of the NTS network as a whole and the over-riding importance of the competition and security of supply objectives. The absence of any serious analysis in the Decision or the FIA of these questions is remarkable.

120. Investment in the NTS supports more competitive gas and electricity wholesale markets by ensuring the right assets are in the right place at the right time (with sufficient flexibility) to ensure gas from a diverse range of locations can be brought to market when needed.

121. With an annual UK gas demand of around 4 btherm/annum, a 0.25p/therm increase in gas prices would cost £10m. Under-investment, investment in the wrong place or investment delays will all restrict the supply of gas that can be brought to market and supplied to customers. This could cost customers dear.

122. The alleged benefits Ofgem ascribe to the reforms could easily be offset by even the smallest increase in wholesale gas prices arising from constraining access to available gas supplies.

123. NGG's 10 year statement shows that NGG itself would not undertake its investment planning on a nodal basis. Paragraph 5.3.9 shows that investment sensitivity analyses, which are conducted in the light of the 1 in 20 peak day criteria, would be analysed on a zonal not a nodal basis. This is because "*the interconnected nature of the NTS means that it is appropriate to consider entry point capability in terms of zones … Within the zones, the maximum and minimum capabilities can be used to flex gas inputs …*"

124. Paragraph 5.3.9 of NGG's 10 year statement also states that "*National Grid is unable to take long term auctions as the definitive signal from shippers as to their intentions to flow gas on any particular day.*"

125. Even in respect of new connections, the proposed alterations to the current exit arrangements are wholly unnecessary to avoid the supposed risk of stranded assets.

(1) The risk of such stranded assets is itself wholly exaggerated – no exit-related examples have in fact been identified.

(2) The current ARCA commitments are sufficient to provide a financial commitment on the part of the user requiring a prospective new connection to the NTS. The current ARCA commitments are a more proportionate way of addressing this issue, and a way which is more consistent with the promotion of competition.

(3) The ARCA commitments are capable of bilateral negotiation between NGG and the prospective connecting party, so that NGG does not incur investment or impose costs in advance of the user's actual development timetable. They enable a flexible and efficient alignment of the planning timetables of NGG and the user.

(4) The proposed new arrangements on the contrary, would be date-fixed, without the ability to adjust start times.

(5) The new commitments would also be substantially larger in amount than the current ARCA commitments. The effect would be to deter or delay some investment decisions, and to create an unnecessary barrier to new entrants. [31]

126. NGG's investment decisions are driven by the 1 in 20 obligation. The alterations which Mod 0116V would make (a) to interruptible status; and (b) by introducing the new "flexibility exit capacity product" have little or no practical impact on NGG's investment decisions. The "investment signals" point cannot have any practical relevance to these two features of Mod 0116V. As we have noted above, the "flexibility product" has, on its own, a very seriously negative PV. The "investment signals" argument cannot assist it.

127. This is a good example of how Ofgem's approach to the offtake arrangements (a) is wrong and (b) leads inevitably to giving the wrong weight to issues, or deploying them in contexts where they are not applicable. The bundling together by GEMA and Ofgem of the separate

[31] FIA 3.63 at p. 31 contains an account of a significant cost relating to the risk of CCGT delay brought about by the inflexibility of the timing issues resulting from the proposed new arrangements. This is clear case of a cost of Mod 0116V. Ofgem's disagreement, recorded in FIA 3.63, shows that GEMA/Ofgem have not in fact appreciated the point that such costs result from the loss of timing flexibility.

items which are included in the Mod 09116V package, and the failure to disaggregate the relevant CBA analyses, makes it impossible (i) for consultees to comment properly on the various items of the Mod 0116V package, or (ii) for GEMA to take a rational decision.

128. Mod 0116V has no merit from an efficient investment perspective. It would have an unnecessarily chilling effect on new investment in generation and storage. Mod 0116V would also adversely affect efficient use of the flexibility that does exist in the NTS system.

129. These proposals are in sharp conflict with the Authority's standing policy in favour of a 'shallow connection' regime, and generally limiting the current ARCA commitments to a one year commitment (see the recent Langage and Marchwood determinations). These decisions were taken to promote competition and to minimise barriers to new entry. The current proposals are inconsistent with the policy behind these decisions, and represent an incoherent and inconsistent regulatory approach.

## SECOND "QUANTITATIVE" BENEFIT – RISK OF DISCRIMINATION BETWEEN RDNs AND IDNs

### Alleged "risk" of undue discrimination by NGG in favour of NGG's retained DNs as against the independently owned DN networks (FIA 3.26 to 3.36)

130. This is the only discrimination argument for which the FIA estimates a quantified benefit: it accounts for some £21m PV of the quantified benefits identified in the FIA.

131. The alleged potential for undermining the potential benefits of comparative regulation during the DN price control process is based on a wholly unrealistic assessment of the likelihood of NGG breaching its licence

conditions, and an equally unrealistic assessment of the behaviour of the Independent GDNs.

132. The argument is bad and/or cannot properly be assigned the weight assigned to it in the FIA and Decision, because:

(1) The potential risk of undue discrimination by NGG NTS in favour of its retained GDNs is very seriously overstated in the FIA. Licence conditions are already in place to protect against preferential treatment of the retained GDNs, with recourse to the regulator in the event of dispute or breach. NGG would be in serious breach of its licence were it unduly to discriminate in favour of its Retained DNs. It is highly unlikely that NGG would discriminate in this way, given the serious consequences of this being discovered.

(2) The likelihood of the Independent GDNs engaging in over-investment in their own networks because they feared such licence breaches by NGG (which they could not remedy by regulatory complaint) is very low. The hypothetical example given in FIA 3.31 is entirely theoretical, not real.

(3) GEMA and Ofgem have not, in the FIA or the Decision, adequately deal with the point made in the NERA Reports that, even under the Mod 0116V arrangements, NGG's pricing of capacity products could equally bring about the possibility of discrimination.

(4) The estimated value placed on the 'incremental reduction in the scope for undue discrimination' is speculative and highly exaggerated: the FIA itself describes it as "a subjective assessment" (FIA 3.33) and recognises that "there are uncertainties regarding the degree of benefits provided by non-discrimination" (FIA 3.36).

(5) The estimated value of a PV of £21m has no serious basis.

133. Additionally, the alleged issue does not require, or justify, altering the access arrangements for shippers / TCCs.

(1) The issue does not concern any allegation of potential for discrimination in favour of shippers / TCCs.

(2) The alteration in shipper / TCC access arrangements in Mod 0116V is not a necessary or a proportionate response to this alleged issue.

(3) Even if certain offtake arrangements were to be considered appropriate for the DNs, because they reduce the alleged risk of undue discrimination by NG between RDNs and IDNs, and so secure comparative regulation benefits in a price control of the DNs, there is no proper explanation in the Decision or the FIA as to why this requires applying the same arrangements to TCCs or shippers or storage or interconnector users. GEMA's conclusion that this is necessary is based on an error of law as to the true meaning of the non-discrimination obligations (see above).

**THIRD "QUANTITATIVE" BENEFIT – REDUCED DISPUTE COSTS (ARCAs)**

134. The third "quantitative benefit" claimed for Mod 0116V is a supposed reduction in dispute costs, arising from fewer ARCA disputes. This is quantified at £10m PV (FIA 3.37 to 3.46),

135. There is no real basis for the claim that the proposed new arrangements are likely to result in reduced dispute costs, still less that there is any substantial basis for ascribing a PV of £10m (or any other figure) to this supposed benefit.

136. Far from improving the transparency of the arrangements, the fragmentation of the rules across the UNC and the ExCR statement will make life more difficult and uncertain for shippers The ExCR is not

subject to UNC governance and shippers will be unable to propose changes to many key terms and conditions. This will increase the likelihood of disputes if National Grid unilaterally seeks to implement change. The new regime will be more complex and less transparent than the ARCA regime. This is also likely to lead to greater not less potential for disputes.

137. The FIA also exaggerates the likelihood of ARCA disputes under the present arrangements. Precedents have been set in the Marchwood and Langage directions which are very likely to reduce the likelihood of further contentious disputes. Some of the existing ARCA disputes also appear to have been caused by NGG receiving conflicting messages from Ofgem with respect for the need for and the extent of user commitments.

138. There is no reason to ascribe any positive PV to this supposed benefit. It could equally easily be a detriment.

**THE COST BENEFIT ASSESSMENT REVISITED**

139. We have now considered all the quantitative cost and benefit issues identified in the FIA and all the qualitative cost and benefit issues relied on in the Decision to over-turn the negative CBA of Mod 0116V.

(1) GEMA's own Decision shows a negative CBA or Mod 0116V of some £27m.

(2) The analysis above indicates (a) that the quantitative costs should be assessed at a higher figure (including all the transporter and Irish costs); and (b) that the three supposed quantitative benefits (investment signals, better comparative regulation by reducing the risk of RDN/IDN discrimination; and reduction in ARCA dispute

costs) are non-existent or highly speculative, and the values ascribed to them are subjective and overstated.

(3) We have also considered the "qualitative" non-discrimination and competition arguments which allegedly justify directing implementation of Mod 0116V despite the negative "quantitative" CBA.

(4) The identified "qualitative" non-discrimination arguments (a) are wrong in law and/or (b) cannot properly be given sufficient weight to over-turn the quantified assessment that the costs of Mod 0116V outweigh its benefits.

(5) The "qualitative" competition effects of Mod 0116V considerations are, on analysis, costs not benefits.

(6) Considering all these points, there is no proper justification for Mod 0116V.

140. We now comment on a number of further issues. Some are additional reasons why Mod 0116V has costs and should not be implemented: some of these are recorded in Chapter 4 of the FIA, but are not apparently given any weight in GEMA's Decision. Some are remaining 'qualitative' items from FIA Chapter 4, which Ofgem identified a 'benefits', but which the Decision does not rely on as trumping the negative quantitative CBA of Mod 0116.

***Simplicity and transparency***

141. Ofgem and GEMA accept that the proposed new offtake arrangements under Mod 0116V are more complex than the current arrangements, and

that this complexity may be expected to increase costs to system users, and may disincentivise market entry: see FIA 4.16, 4.19. This is quite plainly a negative consequence of Mod 0116V.

***Security of Supply***

142. GEMA was entitled to consider security of supply both in the gas and in the electricity markets: see Section 4AA(4)(a) of the Gas Act 1986.

143. The claim in FIA 4.23 that the Mod 0116V new offtake arrangements "might be expected to incentivise the provision of long term investment signals and in turn have a positive impact on security of supply" is wrong. As above, the proposed new or increased user commitments do not substantially add to the investment information already available to NGG. Treating them as a necessary signal for NGG's allowable investment in the NTS (which appears to be Ofgem's approach) carries a strong risk of inappropriately chilling investment in the NTS. This has negative, not positive, consequences for security of supply (both in the gas market and in the electricity market).

144. The proposed new 'flexible capacity' product could adversely affect both gas and electricity security of supply, because generators are incentivised to operate their plant less flexibly. The flexible running of gas plant has in recent years allowed more gas to be released into the gas market providing vital peak gas supplies when needed. The scope to operate plant flexibly under the new regime may be much reduced. The artificial scarcity of flexibility capacity created by the proposed new regime will reduce the amount of flexibility that can be used to support gas fired generation. This will potentially reduce the amount of generation capacity that can be made available. This has negative implications for security of supply in electricity.

***Electricity market effects***

145. GEMA was entitled to consider the consequences for consumer interests in relation to electricity, including competition and security of supply in the electricity markets (Section 4AA(4)(a) Gas Act 1986).

146. The proposed alterations to the NTS offtake regime have negative consequences both for competition and for security of supply in the electricity markets (see above). Implementation of the proposed new arrangements will adversely affect investment for both generation and storage projects. This could have significant implications for security of supply in both gas and electricity in terms of tightness of supply at the peak.

***Allocation of risk***

147. The Decision and the FIA (at 4.11-4.13) describes the Mod 0116V proposals as an improved allocation of risk "between industry participants and consumers." This is (a) meaningless and (b) wrong.

148. It is difficult to understand what is meant by this. FIA 4.11 refers to improved allocation of risk as between "industry participants" and "customers". FIA 4.12 refers to allocating risk between "industry participants" and "consumers". FIA 4.13 refers to transferring risk "away from consumers to NTS users and shippers". What is this all supposed to mean? The generating stations and large industrial and chemical plant which are directly connected to the NTS are themselves consumers of gas. They (or their shippers) are also users of the NTS. It is impossible to understand what risk allocation Ofgem is attempting to describe.

149. In any event, the point is wrong. Risk should be allocated to the party that can most efficiently manage it. The risks associated with investment in the NTS can only be sensibly managed by NGG. Only NGG has the 'key to the black box' – only NGG can in reality assess the physical consequences for the system as a whole of offtake at particular exit points, and only NGG can plan the necessary investment. TCCs are unable to 'signal' what investment should take place within the NGG 'black-box' - it is NGG that is clearly best placed to manage this risk. This would remain the case if the Mod 0116V offtake arrangements were introduced.

## FURTHER EXAMPLES OF THE ADVERSE EFFECTS OF MOD 0116V

### *Impact on current TCC power stations*

150. TCC power stations face the prospect of higher charges because the practical effect of Mod 0116V may require exit capacity to be booked on a 'firm' basis for power stations where the NTS supplies are back-up or alternative supply routes. Under Mod 0116V, NGG may not contract for "interruptible services" for these stations, as it does at present. The higher charges are not cost reflective for parties that are willing to have an interruptible service, and unfairly disadvantage such generators and their ability to compete in the electricity wholesale market.

### *Impact on investment decisions for new power stations*

151. Planned new generating stations would be subject to more onerous and inflexible user commitments in Mod 0116V compared to the current ARCA arrangements.

(1) Under the ARCA arrangements a typical 500MW power station may be required to underwrite a proportion of upstream reinforcement to the value of £1m to £3m; but under the new arrangements commitments would be required just over 3 years in advance for a

3 year strip (July 2007 for the period 1/10/2010 to 30/9/2014) i.e. £4m to £12m commitment.

(2) The current ARCA arrangements are bilateral contracts which allow the start day to be amended, but under the new arrangements shippers are 'on the hook for' a fixed date.

(3) ARCAs are agreed with the project developer (unless they are also a shipper) whilst the new arrangements would be with the shipper.

152. The effect is to create a less conducive investment climate, which at the very least is likely to delay investment decisions. This is not in consumer interests, given that electricity margins in the medium term are likely to get tighter (due to retirement of older coal plant) and new gas generating stations are the main foreseeable replacement option. There are potential adverse effects on the security of electricity supply.

***Impact on storage facilities and on investment decisions relating to storage facilities***

153. Storage facilities connected to the NTS do not currently pay any charges for offtaking 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 a shortage. Currently this is a seasonal cycle for long-range storage, or 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 Mod 0116V, it may be necessary for firm incremental flat exit capacity to be purchased to accommodate these dynamic characteristics. Under the current arrangements no charges for offtake are levied. The application of charges where no such charge existed before is likely to have serious implications for the viability of such projects.

## SAFETY

154. GEMA's statutory duties include safety duties under Section 4AA(5) of the Gas Act 1986, and a duty to consult the Health and Safety Commission, and take account of its advice, under Section 4A of the Act.

155. The Decision notes (pages 17 to 18) that respondents to the Consultation had raised concerns that the altered interruption arrangements in Mod 0116V could undermine both safety and security of supply, by leading to an earlier requirement for firm load shedding under Stage 3 of the Emergency Procedures.

156. 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 0116V and its impact on the NEC and Transporter safety cases had not been properly considered.

157. The Health and Safety Executive informed GEMA that the proposed alterations to the offtake arrangements would require material changes to both the NGG NTS and the GDN safety cases, and that the HSE would have to approve before they could be made.

158. The Health and Safety Executive wrote to GEMA in January 2007 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 the date on which GEMA proposed to make its decision.

159. Despite this, GEMA pressed ahead to take the decision to direct implementation of Mod 0116V at its March meeting, deferring implementation for one year "*to provide more time for HSE consideration of revised safety cases.*"

160. This is another illustration of GEMA's prejudgment of the proposals. GEMA took the Decision to direct implementation of Mod 0116V without properly informing itself as to the safety implications, or their costs, and without taking the HSE's advice.

**REGULATORY DUTIES UNDER SECTION 4AA(5A)**

161. Under Section 4AA(5A) of the Gas Act 1986, GEMA must, in carrying out its functions under Act,

"*have regard to (a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and (b) any other principles appearing to … it to represent the best regulatory practice.*"

162. In breach of these duties:

(1) GEMA's decision to direct implementation of Mod 0116V is (1) not proportionate and/or (2) not targeted at a case in which action is needed.

(2) The process leading up to and including the FIA and the Decision has not been transparent or accountable.

(3) The imposition of increased barriers to entry as a result of Mod 0116V is not consistent with GEMA's general policy of reducing barriers to entry.

(4) The inclusion of "sunset clauses" in the UNC, and their continued temporary extension undermines the industry self-governance framework for the UNC and is (i) not proportionate; (ii) not targeted at a case where regulatory action is needed; (iii) not accountable; and (iv) does not represent best regulatory practice, in that it undermines the industry self-governance framework for the UNC.

(5) GEMA's decision not to approve Mod 0116A undermines the industry self-governance framework for the UNC and is (i) not proportionate; (ii) not targeted at a case where regulatory action is needed; (iii) not accountable; and (iv) does not represent best regulatory practice, in that it undermines the industry self-governance framework for the UNC.

**PREJUDGMENT & BREACH OF GEMA'S DUTIES TO CARRY OUT AN IMPACT ASSESSMENT AND TO CONSULT FAIRLY**

163. GEMA was required in this case to carry out and publish an Impact Assessment, to consult on it, and to consider representations made, in accordance with Section 5A of the Utilities Act 2000. GEMA was also required to have regard to the guidance on impact assessments in the Treasury Green Book and the OFT Guidelines on Competition Assessments in Impact Assessments, under Section 5A(5).

164. GEMA was required to consult fairly on the proposals, and not to prejudge the proposals, both by reason of Section 5A(7) of the Utilities Act and under public law principles.

165. In breach of these duties GEMA:

(1) failed to carry out and/or publish the Impact Assessment in accordance with the guidance in the Treasury Green Book and/or the OFT Guidelines;

(2) failed properly to consult on the Impact Assessment and/or on the proposals to implement Mod 0116V, by (a) not providing consultees with proper and adequate information to enable them to make informed responses; (b) failing to keep an open mind and failing to consider responses fairly; and/or (c) wrongly prejudging the Decision.

The applicant relies on the facts and matters set out in the Witness Statement of Peter Bolitho and on the documents exhibited to it. Prejudgment is apparent from (a) the tying of the offtake proposals to the DN sales issue; (b) the 'best endeavours' licence conditions; (c) the "sunset clauses" in the UNC; (d) the failure to await the HSE's safety advice; (e) the failure to conduct a proper Impact Assessment; and (f) the reasoning in the FIA and the Decision, and its "ex post" justification nature.

166. Accordingly the Decision is wrong in law.[32]

**CONCLUSION**

167. For all of the reasons set out above, together with those in the expert reports of Mr Shuttleworth, the witness statement of Mr Bolitho and in E.ON's Submissions on the FIA, E.ON submits that:

(1) GEMA failed properly to have regard to the matters mentioned in section 175(2) of the Energy Act 2004;

(2) GEMA failed properly to have regard to the purposes for which the relevant condition has effect;

(3) GEMA failed to give the appropriate weight to one or more of those matters or purposes;

(4) the Decision was based, wholly or partly, on an error of fact; and/or

(5) the Decision was wrong in law.

[32] Jurisdiction to hear an appeal on a point of law includes procedural error and questions of vires, including irrationality and (in)adequacy of reasons: *Nipa Begum v Tower Hamlets LBC* [2000] 1 WLR 306 (CA).

CC02/07

---

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

---

**E.ON UK plc**

**-and-**

**GEMA**

---

# APPLICANT'S STATEMENT OF CASE

---