

E.ON UK PLC

Appellant

- v -

GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

SUMMARY OF GEMA'S REPLY TO E.ON'S STATEMENT OF CASE

1. GEMA resists E.ON's appeal on the grounds set out in its Reply of 22 May 2007, as supported by the witness statements of David Gray and Professor George Yarrow (respectively executive and non-executive members of GEMA).

Fundamental flaws in E.ON's approach

2. The Appeal is characterised by a number of fundamental flaws:
 - a. E.ON misunderstands the proper role of a regulator such as GEMA, which is not limited to consulting and adjudicating upon the proposals of others but which involves the formulation of, consultation on and implementation of policy in performance of its statutory functions and its principal statutory objective of protecting consumers.
 - b. E.ON seeks to tempt the Commission beyond its appellate role, into a second-guessing of fine decisions made by the sectoral regulator on the basis of the anticipated behaviour of market participants.
 - c. E.ON exaggerates the significance of the final impact assessment consultation document, adopting the fallacy that the most important factors are those which can be quantified in monetary terms, and attributing excessive emphasis to a net cost figure which amounts, on an annualized basis, to no more than about £4m: a tiny proportion of turnover both in the gas industry and in downstream markets such as electricity generation.

- d. E.ON seeks to ignore or downplay, without any proper basis, the economic benefits that may be expected to follow from:
 - i. the introduction of a user commitment framework which redistributes risk towards large commercial users (such as E.ON) in such a way as to improve investment signals and reduce the risk of unnecessary or inefficient investment in the national transmission system;
 - ii. the introduction of auctions for flexibility capacity, which should reduce the potential for undue discrimination between GDNs and shippers, and provide important information regarding the market value of flexibility; and
 - iii. the reform of interruption arrangements, which should reduce potential for undue discrimination between firm and interruptible customers and promote competition between shippers in the offer of interruption terms to the NTS.
3. So far as the specific grounds of appeal are concerned, as they are set out in the summary of E.ON's case, GEMA responds as follows.

“Pre-judgement”

4. GEMA is an independent regulator charged with protecting the interests of consumers and not simply with following the views of industry participants. It is entitled to have preferred views (formed in this case over a period of almost 10 years in which offtake reform has been discussed). However it consulted meticulously on offtake reform, remained open-minded and listened and reacted to the responses that it received.

“Mod 116V has a substantially negative CBA”

5. While GEMA has, throughout the process leading up to the Decision, recognised the value of quantitative assessments in informing its deliberations, GEMA has also had in mind the inevitable limitations to which such analyses were, for a number of reasons, subject.
 - a. First, the reliability of any quantitative CBA of the proposed modifications was dependent upon the reliability of the data on costs (including the data which shippers had provided regarding their own costs), and there were good reasons for suspecting that this data was subject to a high margin of error.
 - b. Secondly, the true economic value of benefits was also incapable of precise quantification, consisting partly in a valuable reduction of risk, and partly in a prediction of the extent to which better information would lead to more efficient capital expenditure.
 - c. Thirdly and most significantly, the greatest potential benefits were likely to be those arising from the promotion of competition through fair and non-discriminatory arrangements; and the scale of those benefits, while potentially very significant, was too uncertain to be capable of meaningful quantification in NPV terms, and therefore had to be left out of account in the quantitative analyses, albeit that those benefits still needed to be taken into account in assessing the proposals.
6. Accordingly, GEMA's process could not be one of 'decision-making by numbers' under which the 'correct' decision could be identified simply by looking at the bottom line of the

quantitative CBA to see if it showed a positive or a negative number. Rather, GEMA had to make a judgement between the proposed modifications, taking all the information and experience available to it "in the round". The fact that its quantitative CBA calculation produced a negative figure was relevant in taking the decision, but could not in itself be decisive.

"The Decision understates the negative CBA"

7. **Costs:** From the time of the GDN Sales process, GEMA has consistently made clear its position that the costs to transporters arising as a result of those sales and the new interface which they created (including the upfront costs of introducing new enduring offtake arrangements) should be regarded as part of the costs of the GDN sales process which those transporters should make provision to bear. Against this background, it was reasonable for GEMA to exclude transporters' upfront costs from the quantitative CBA. It was also reasonable for GEMA to focus on costs and benefits within Great Britain, given that GEMA is charged by statute with responsibilities in connection with the meeting of reasonable demands for gas only within Great Britain, and is not responsible for the regulation of the gas industry elsewhere. In any event, the correctness of GEMA's Decision depended on taking account of all relevant factors looked at together, and the Decision does not stand or fall based on a forensic recalculation of the values which GEMA attributed to each and every costs item in the quantitative CBA.
8. **Benefits:** GEMA considers that the values which it attributed within the quantitative CBA to the provision to NGG NTS of better investment signals, and the reduction in the scope for discrimination by NGG in favour of its own GDNs, were not unreasonable, albeit that (as GEMA noted in its decision) those benefits could not be quantified precisely. In addition, GEMA rejects E.ON's assertion that the savings of the costs currently employed in negotiating bilateral ARCAs and resolving related disputes would be nil. The modification which GEMA has approved will remove the need for ARCAs to be negotiated between signatories to the UNC, and it is entirely reasonable to expect this to generate cost savings.

"Incorrect analysis of 'qualitative' benefits"

9. The qualitative benefits which arise both from mandating non-discriminatory access to infrastructure, and from promoting competition, cannot be dismissed as easily as E.ON suggests. As explained in the witness statement of Professor Yarrow, the dynamic relationship between competition and non-discriminatory access to infrastructure has the potential to generate significant benefits for consumers, as has been proved time and again by the UK's experience of liberalisation and regulation in utility markets. Having considered the likely effects of the proposed modifications on competition and non-discrimination, GEMA concluded that if fair and non-discriminatory arrangements were put in place in relation to (a) interruption; and (b) offtake capacity, competition would be promoted and consumer benefits would be likely to flow as a result.
10. GEMA recognised, however, that the introduction of new arrangements would impose costs on market participants, and undertook considerable work in order to provide itself with information regarding the likely extent of those costs. But it could not concentrate upon those costs to the exclusion of the less easily quantifiable – but potentially very significant – "qualitative" benefits arising from competition and non-discrimination. Having considered all the information before it, GEMA was justified in coming to a view that the (in comparison with the turnover of the gas industry, very modest) negative figure produced by the quantitative

CBA was, on balance, not a reason for failing to institute fair and non-discriminatory offtake arrangements.

“Non-discrimination”

11. GEMA denies that its ascription of quantitative and qualitative benefits to Mod 116V in connection with a reduction in undue discrimination was based on an error of law. In that regard, GEMA notes that the fact that two categories of persons are different in some respects cannot make it right to treat them differently in every respect. The question must always be whether the differences between them are sufficiently material to justify the particular difference in treatment.
12. ***Interruption:*** GEMA notes that, under the present (transitional) offtake arrangements, shippers of gas to Transmission Connected Customers (“TCCs”) are able to unilaterally nominate supply points as interruptible and thereby obtain a 100 per cent discount on NTS offtake capacity charges at those points. This is so even in respect of points at which the shipper (and its TCC) receives what is effectively a firm supply; indeed, at those points, the shipper, by self-nominating as interruptible, is currently able to obtain the same 100 per cent discount as would be available to shippers at a supply point where supply was interrupted with a regularity of up to 45 days a year. Shippers of gas to GDN supply points, in contrast, are unable to nominate their supply points as interruptible and are therefore unable to grant themselves access to free offtake capacity. In GEMA’s submission, it is inappropriate to discriminate between shippers supplying self-nominated interruptible users who in fact receive a firm supply, and other customers of the NTS who also receive a firm supply, with one set of users paying for offtake capacity, and the other set getting it for free. Both types of user receive essentially the same service from the NTS, and neither provides the NTS with an interruption service which has genuine value to it.
13. ***Flexibility:*** GEMA also submits that it was justified in taking the view that it was inappropriate that TCC shippers did not have to purchase separate rights to offtake flexibility whereas GDNs did. In that regard, GEMA notes that, while there are some respects in which those two categories of customer are different from one another, both categories are relevantly similar in respect of their presentations of offtake demand to the NTS: if a TCC shipper and a GDN both require the same flexibility capacity at a particular node, they will be putting exactly the same pressures on the availability of that capacity. Further, they are both capable of making commercial trade-offs between paying the market price for flexibility capacity (when scarce), and adopting alternative courses of action.

“Competition”

14. GEMA rejects the allegation that it did not properly consider competition issues in reaching its Decision. As set out in paragraphs 9 and 10 above, competition issues were, in fact, central to GEMA’s consideration of the various modification proposals and its ultimate decision to approve 116V. Carrying out a formal competition assessment and market definition analysis in accordance with the OFT Guidelines on Competition Assessment (which are intended to promote the analysis of competition considerations in contexts quite different from that of GEMA’s Decision) would have added nothing to GEMA’s decision-making process.

ON BEHALF OF THE GAS AND ELECTRICITY MARKETS AUTHORITY

22 May 2007