COMPETITION COMMISSION

An appeal under section 173 of the Energy Act 2004

E.ON UK Plc — **Appellant**
and
GEMA — **Respondent**
and
British Gas Trading Limited — **Intervener**

Decision and Order of the Competition Commission

10 July 2007 **CC02/07**

Website: www.competition-commission.org.uk

This appeal was heard by the following group of Competition Commission members:

Dame Barbara Mills QC *(Chairman of the Group)*

Robert Turgoose

Professor Catherine Waddams

E.ON UK Plc was represented by:

Alan Griffiths and Conall Patton instructed by Bevan Brittan

GEMA was represented by:

David Anderson QC, Daniel Beard and Alan Bates instructed by Herbert Smith

British Gas Trading Limited was represented by:

Ian Glick QC instructed by Ashurst

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1. Introduction

1.1 This is an appeal by E.ON UK Plc (**E.ON**) from a decision (**the Decision**) of the Gas and Electricity Markets Authority (**GEMA**) dated 5 April 2007 in relation to proposed changes to arrangements for the offtake of gas from the National Transmission System. The appeal is made pursuant to section 173 of the Energy Act 2004 (**EA04**).

1.2 The Decision concerned five proposals for modifications to the Uniform Network Code. In the Decision, GEMA directed that a proposal made by National Grid Gas NTS, proposal 116V, should be implemented. Of the four remaining proposals, proposal 116A was proposed by E.ON, and proposal 116CVV was proposed by British Gas Trading Limited (**BGT**) who intervened in the appeal. The other proposals were made by RWE Npower (proposal 116BV) and Scotia Gas Networks (proposal 116VD). Details of the various proposals are set out below.

1.3 By a notice of appeal served on 30 April 2007, E.ON appealed against two aspects of the Decision—GEMA's decision that proposal 116V should be implemented and its decision that proposal 116A (E.ON's own proposal) should not be implemented. The Competition Commission (**CC**) granted E.ON permission to appeal on 11 May 2007. On 1 June 2007, the CC granted BGT permission to intervene in the appeal.

1.4 This decision is structured as follows:

(a) Introduction

(b) Background

(c) GEMA's Decision

(d) Summary of the parties' positions

(e) The nature of the CC's jurisdiction

(f) Analysis of the issues:

(i) User commitment

(ii) Interruptibility

(iii) Flexibility

(iv) Cost benefit analysis

(v) E.ON's procedural case

(g) Conclusions on the Appeal

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2. Background

The gas industry

2.1 In the following paragraphs we summarize certain aspects of the gas industry in Great Britain. The description is not intended to be comprehensive, but is intended to ensure that our decision is intelligible to those who have not been directly involved in the appeal, and to explain the definitions and abbreviations used in this decision. Definitions and abbreviations used in the remainder of this decision are shown in bold.

2.2 The National Transmission System (**NTS)** is the national high-pressure gas transmission system in Great Britain. The NTS is connected to eight regional Gas Distribution Networks (**GDNs**) which operate at a lower pressure.

2.3 Most consumers of gas are connected to one of the eight GDNs. However, certain large customers are directly connected to the NTS, and those customers are referred to as Transmission Connected Customers (**TCCs**). TCCs include some industrial users and gas-fired power stations.

2.4 The NTS is also connected to Connected System Exit Points (**CSEPs**), where the NTS connects to other gas transportation systems. CSEPs include **interconnectors** with other national networks (such as the Irish network) and connections with independently owned gas pipelines. The NTS is also directly connected to storage facilities. In total, the NTS has 180 exit points, of which approximately two-thirds are NTS/GDN transfer points and the remainder are connections to TCCs, inter-connectors and others.

2.5 The NTS is owned and operated by National Grid Gas NTS (**NGG**). Four of the GDNs are also owned by NGG (the retained GDNs, or **RDNs**). The other four were previously owned by NGG, but were sold by NGG on 1 June 2005, and are now independently owned (the independent GDNs or **IDNs**). The sale of the IDNs forms part of the background to this appeal, as explained below.

2.6 All gas transporters (both the NTS and the GDNs) are required to hold a licence under section 7 of the Gas Act 1986 (**GA86**). Gas transporters are also subject to certain statutory obligations, in particular obligations under section 9 of GA86, which is set out below.

2.7 **Shippers** purchase gas on the wholesale market (for example, from producers or from other shippers) and arrange with gas transporters for the transportation of gas through the pipeline network. **Suppliers** sell gas and arrange supply to domestic and business customers at their premises. Both shippers and suppliers are licensed under section 7A of GA86.

2.8 Shippers offtake gas from the NTS and/or the GDNs at exit points where the gas is required by their customers. Shippers' customers include suppliers and TCCs, although a company may be licensed both as a shipper and as a supplier (as are both E.ON and BGT). Shippers, when acting on behalf of TCCs, are referred to as **TCC Shippers**.

2.9 The Uniform Network Code (**UNC**) is a legal document which sets out transportation arrangements in relation to the NTS and the GDNs (to the extent that they are in common), and which governs the relationship between transporters and shippers. All transporters are required to establish the UNC by Standard Special Condition (**SSC**) A11 of the transporters' licence. The sale of the IDNs brought about the need for

changes to the UNC's predecessor, the Network Code, and the UNC took effect from 1 May 2005. The UNC sets out the procedures by which it may be modified.

2.10 The role of GEMA, in so far as relevant to this appeal, is set out in the following section.

The role of GEMA

2.11 **GEMA** is the regulator of the gas and electricity industries in Great Britain. **Ofgem** is the Office of Gas and Electricity Markets, which supports GEMA. During the appeal, the parties referred to GEMA and Ofgem interchangeably. In this decision we refer throughout to GEMA, as GEMA is the formal respondent to this appeal, although some of the actions we describe were in fact taken by Ofgem.

2.12 GEMA has various statutory objectives and duties. There was a broad consensus between the parties as to what those obligations are, and we summarize the most relevant obligations below.

2.13 Under section 4AA(1) of GA86, GEMA's principal objective in carrying out its functions under Part I of GA86 is to:

> *protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas so conveyed.*

'*Consumers*' in this context includes industrial consumers such as TCCs, and is not limited to domestic customers.

2.14 Under section 4AA(2) of GA86, GEMA shall carry out its functions in the manner which it considers is best calculated to further the principal objective, having regard to:

> *(a) the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met …*

2.15 Under section 4AA(4) of GA86, GEMA may also in carrying out any function under Part I of GA86 have regard to the interests of consumers of certain other utility services which are affected by the carrying out of that function, including electricity conveyed by distribution systems.

2.16 Under section 4AA(5) of GA86, GEMA shall carry out its functions under Part I of GA86 in the manner which it considers is best calculated:

> *(a) to promote efficiency and economy on the part of persons authorised by licences or exemptions to carry on any activity, and the efficient use of gas conveyed through pipes;*
>
> *(b) to protect the public from dangers arising from the conveyance of gas through pipes or from the use of gas conveyed through pipes;*
>
> *(ba) ... ; and*
>
> *(c) to secure a diverse and viable long-term energy supply …*

2.17 Under section 4AA(5A) of GA86, GEMA must also have regard to *'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 best regulatory practice…'.*

2.18 Section 4A of GA86 requires GEMA to consult the Health and Safety Commission (**HSC**) about gas safety issues which may be relevant to the carrying out of its functions and to take into account any advice given by the HSC about any gas safety issue.

2.19 Section 4B(4) of GA86 provides that '*the duties imposed by sections 4AA to 4A do not affect the obligation of the Authority … to perform or comply with any other duty or requirement (whether arising under this Act or another enactment, by virtue of any Community obligation or otherwise)'.*

2.20 Under section 5A of the Utilities Act 2000 (**UA00**), where GEMA is proposing to do anything for the purposes of, or in connection with, the carrying out of any function under Part I of GA86, and it appears to GEMA that the proposal is important according to certain criteria, GEMA must either carry out and publish an impact assessment or publish a statement setting out its reasons for thinking that it is unnecessary to do so. Where GEMA publishes an impact assessment, it must provide an opportunity for interested persons to make representations in response to it. The requirement for an impact assessment does not apply where a matter is urgent.

2.21 GEMA also has a role in relation to modifications to the UNC. GEMA does not have the power to propose modifications itself. Rather, modifications are proposed by industry parties, and are considered in the first instance by an industry panel known as the UNC Modification Panel (**the Panel**). However, GEMA's consent to a proposed modification must be obtained before it can be implemented. Under paragraph 15(b) of SSC A11 of the transporters' licence, the test that GEMA must apply when deciding whether to direct that a proposed modification should be made is whether the modification:

> *in the opinion of the Authority, will, as compared to the existing provisions of the … uniform network code or any alternative proposal, better facilitate, consistent with the licensee's duties under section 9 of the Act, the achievement of the relevant objectives.*

2.22 GEMA must therefore consider whether the modification is consistent with the licensee's objectives under section 9 of GA86 and whether it will better facilitate the relevant objectives. The relevant objectives are those set out in paragraph 1 of SSC A11, which provides:

> *The licensee shall establish transportation arrangements … which are calculated, consistent with the licensee's duties under section 9 of the Act, to facilitate the achievement of the following objectives—*
>
> *a) the efficient and economic operation of the pipe-line system to which this licence relates;*
>
> *b) so far as is consistent with sub-paragraph (a), the co-ordinated, efficient and economic operation of (i) the combined pipe-line system, and/or (ii) the pipe-line system of one or more other relevant gas transporters;*

c) so far as is consistent with paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence;

d) so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition:

between relevant shippers;

between relevant suppliers; and/or

between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;

e) so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards … are satisfied as respects the availability of gas to their domestic customers; and

f) so far as is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;

hereinafter referred to as 'the relevant objectives'.

2.23 The licensee's duties under section 9 of GA86 (in so far as they are relevant) are:

(1)(a) … to develop and maintain an efficient and economical pipe-line system for the conveyance of gas; and

(b) subject to paragraph (a) above, to comply, so far as it is economical to do so, with any reasonable request for him—(i) to connect to that system, and convey gas by means of that system to, any premises or (ii) to connect to that system a pipe-line system operated by an authorised transporter …

(1A) … to facilitate competition in the supply of gas …

(2) … to avoid any undue preference or undue discrimination (a) in the connection of premises, or a pipe-line system operated by an authorised transporter, to any pipe-line system operated by him; or (b) in the terms on which he undertakes the conveyance of gas by means of such a system.

2.24 Initially, we were concerned that we should understand whether any hierarchy existed between these various obligations on GEMA. However, GEMA submitted that it would not be helpful, at least for the purposes of the present appeal, to attempt to set out its duties and objectives in a hierarchical way. GEMA submitted that it had to pursue all of its objectives and duties simultaneously, in so far as it was possible for it to so do, and that in relation to the present appeal, there was no conflict between any of GEMA's duties and objectives.

2.25 Having considered the matter, we accept GEMA's submission that it is not necessary for us on this appeal to consider its various obligations and duties in hierarchical terms. We note that there is significant overlap between GEMA's statutory objectives and duties and the relevant objectives of the UNC. Further, we received no

submissions from E.ON or BGT that GEMA had given the wrong priority to one or other of its objectives or duties.

2.26 As we set out below, discrimination is one of a number of important issues on this appeal. (The legal test for unlawful discrimination is addressed in paragraphs 6.58, 6.65 and 6.77 of this decision.) We therefore invited submissions from the parties as to the nature and source of any obligation on GEMA to ensure that unlawful discrimination does not take place.

2.27 GEMA submitted, and we accept, that in considering whether modifications meet the test under paragraph 15 of SSC A11, GEMA must ensure that any modification is consistent with NGG's obligation under section 9 of GA86 to avoid any undue preference or any undue discrimination. GEMA also submitted that NGG is under a directly applicable obligation under Article 4(1)(a) of the Transmission Access Regulation 1775/2005 (**the Regulation**) to offer the same service to different customers on equivalent terms and conditions. Again, GEMA submitted, and we accept, that GEMA must not direct the implementation of a modification which would put NGG in breach of the Regulation.

2.28 GEMA also submitted that it is under an obligation to take steps to eliminate unlawful discrimination for two other reasons. First, GEMA submitted that ensuring non-discriminatory access to monopoly infrastructure is essential to promote competition and efficiency, matters which clearly form part of its objectives and duties. GEMA said that this is the premise of European legislation, such as the Regulation, which has the objective of creating a single European market for natural gas, and which ensures equal access to infrastructure to that end. We accept that GEMA may in practice be under a positive duty to take steps to remove unlawful discrimination if that discrimination inhibits the achievement of other of GEMA's objectives, such as the protection of the interests of consumers (wherever appropriate by promoting effective competition) and the promotion of efficiency and economy.

2.29 Secondly, GEMA submitted that there was an 'equity' or 'fairness' aspect to non-discrimination, which formed part of its obligations as to 'better regulation'. However, given that the GA86 imposes a clear and detailed scheme of obligations on GEMA, it does not appear to us that GEMA is subject to an obligation to ensure non-discrimination on the basis of any general principle of equity or on the basis of its obligations as to 'better regulation'.

Gas offtake arrangements

2.30 In this section, we explain the subject matter of the proposed reforms under modification proposal 116V—reform to arrangements for the offtake of gas from the NTS.

2.31 Users of the NTS require the right to take certain quantities of gas off the system in order to meet the needs of their customers. The right to offtake a given quantity of gas each day is known as **exit capacity** (or offtake capacity). The right to put a given quantity of gas into the system is known as **entry capacity**. Entry and exit capacity are concerned with access to the network—ie the right to put in or take off gas—not with the purchase or sale of gas itself. Users of the NTS are charged separately for (1) access to the network, which is paid for by **capacity charges** and (2) the volume of gas in fact offtaken, which is paid for by **commodity charges**.

2.32 Exit capacity may be firm or interruptible. **Firm capacity** is the right to offtake a certain quantity of gas and which is not generally subject to exceptions or curtailment. **Interruptible capacity** is the right to take a quantity of gas off the NTS but

which is subject to restriction or complete curtailment in the event of network capacity constraints. At present, shippers using the NTS can nominate their supply points as interruptible. In return NTS shippers receive a 100 per cent discount on NTS exit capacity charges, but pay a commodity charge on any gas offtaken. NGG has the right to curtail interruptible flows, generally for up to 45 days a year, for constraint management purposes (where there is insufficient pipeline capacity), in an emergency and for testing purposes. Interruptible supply tends to be nominated by TCCs who have alternative 'standby' sources of supply of fuel available.

2.33 Prior to the changes in issue, capacity on the NTS was allocated to GDNs and TCCs on similar bases. TCCs were (and are) assigned capacity based on a maximum daily quantity known as the supply point capacity, which was based on a maximum hourly quantity multiplied by 24. TCCs are required to make their capacity requirements known on an annual basis, although it has been assumed that TCCs will roll their existing capacity over from one year to the next. TCCs can reduce capacity on one month's notice provided they have not used the relevant capacity during the previous 12 months.

2.34 Prior to the GDN sales, GDNs were also allocated capacity based on the estimated maximum daily quantity, although this was done on an administered basis within NGG. Capacity was allocated so as to ensure that the GDNs would satisfy their **1 in 20 obligation**—the obligation on gas transporters to develop their systems to meet the peak aggregate daily demand for gas to be conveyed to premises that is likely to exceeded (whether on one or more days) only in one year out of 20. The 'peak aggregate daily demand' for this purpose does not include interruptible loads.

2.35 Where a TCC or GDN required additional capacity over and above its existing capacity, and this in turn required additional investment in the NTS, NGG would enter into an Advanced Reservation of Capacity Agreement (**ARCA**) with the TCC or GDN. ARCAs generally require users to make a commitment for one year, although this is subject to a case by case assessment. The provision of additional capacity under an ARCA is generally subject to a lead time of about three years.

2.36 In general terms, gas flows into the NTS at a constant rate. However, the rate at which gas is offtaken is variable—for example, domestic use of gas is higher during the day than at night. This variation in demand is met thorough **diurnal storage**, where gas which flows into the NTS and the GDNs during periods of low demand is stored and used during periods of higher demand. An example of diurnal storage is **linepack**, which occurs where gas is packed into the NTS or the GDNs and offtaken when it is needed. The ability of users of the NTS and GDNs to vary their rate of offtake due to the existence of additional capacity in the system is referred to as **flexibility**. In order to meet their customers' needs for flexibility, GDNs have a choice as to whether to use their own linepack, or to use local storage sites, or to use NTS linepack.

2.37 Prior to the GDN sales, GDN offtake flexibility was managed through NGG's internal processes and procedures. TCCs could also request offtake flexibility of NGG, and although NGG was not obliged to accommodate all of the TCCs' requests, on the whole it could do so because of spare capacity on the NTS. NGG could nevertheless agree ancillary restrictions on the right of TCCs to vary their rate of offtake under Network Exit Agreements.

Events leading to modification proposal 116V

2.38 Modification proposal 116V is the culmination of a long and controversial process of reform in relation to arrangements for gas offtake. The reform has occurred in two

main phases. First, the period from 1998 to 2003, during which the proposed reforms were considered by GEMA and the industry as a matter of principle. Secondly, the period after 2003, when the sale by NGG of the IDNs created a particular opportunity (and GEMA would argue, a particular need) for the reforms to be carried into effect.

2.39 E.ON argued that the process by which GEMA sought to bring about offtake reform was flawed, and that GEMA prejudged the issue. We consider the merits of that argument in a later section of this decision. In this section, we set out what is intended to be an uncontroversial summary of the process of NTS offtake reform.

2.40 The process began in 1999, when GEMA published a series of documents which contemplated the need for entry and exit capacity reform. Initially, the emphasis was on entry capacity reform, as a result of shortages in entry capacity at St Fergus in 1998. Entry capacity reform took place between 1999 and 2003.

2.41 However, GEMA's view was that the arguments for reform to entry capacity also applied to exit capacity, and in March 2001, GEMA consulted separately on offtake reform. The consultation included arrangements for the purchase of capacity rights and interruption arrangements. Some of the objectives of the proposed reform were similar to those for entry capacity—improved investment signals and the provision of efficient incentives for investment—but the paper also considered additional issues, such as the prevention of discrimination between Transco's customers, and as between different types of interruptible customers. (Transco changed its name to NGG in October 2005.)

2.42 GEMA's preferred option for reform was an option described as 'universal firm', whereby Transco would only contract for interruption to the extent necessary to manage constraints on its system. In the 2002 Transmission Price Control Review (**TPCR**), Transco accepted an 'all reasonable endeavours' licence obligation to introduce universal firm from 1 April 2004.

2.43 However, in May 2003, Transco indicated that it was considering selling one or more of the GDNs. GEMA's view was that the creation of a new interface between the NTS and the GDNs made offtake reform yet more important, and indicated that it would take offtake reform forward as part of the GDN sales. Thus, GEMA described offtake reform as a '*gateway*' to the sale of the GDNs, and said that it would address the two issues '*in tandem*'. GEMA maintained this view notwithstanding calls from the industry to separate GDN sales from offtake reform.

2.44 A Regulatory Impact Assessment (**RIA**) on offtake arrangements, published by GEMA in June 2004, set out four options for reform, and indicated that Transco's proposed option 1, formalization of the existing arrangements, was unlikely to promote economic and efficient network development and operation. It appeared from the RIA that option 2, 'the direct booking model', under which exit capacity would be booked by GDNs and TCCs five years in advance, was the most likely model for reform, at least in the first instance. GEMA said that this model would remove the potential for undue discrimination by NGG in favour of the RDNs, and would introduce competition and remove the potential for undue discrimination between TCC Shippers and GDNs.

2.45 The RIA also contained the first indication that GEMA regarded the right to vary the rate of offtake as a '*secondary capacity product*', whereby flexibility would be allocated on market principles to those that valued it most (**the flexibility product)**. In GEMA's view, the flexibility product would require all NTS users to signal the value that they placed on flexibility, and so would address a concern that GDNs would fail to invest in storage for their own needs, and would instead 'free ride' on additional

capacity in the NTS. It would also promote competition and remove potential for undue discrimination, although GEMA recognized that this would require incentives to be placed on GDNs to discourage them from over-purchasing NTS capacity.

2.46 Responses to the RIA indicated that there was industry opposition to the flexibility product. GEMA nevertheless maintained its position, but recommended further consultation on the flexibility product. GEMA also indicated that 'enduring' arrangements for gas offtake would not be introduced in time for the period 2005 to 2008, and so interim arrangements would be needed for that period.

2.47 In January 2005, GEMA consented to the sale of the IDNs. In doing so, GEMA required an undertaking from NGG that it would use best endeavours to ensure that steps were taken to implement enduring offtake arrangements by 1 September 2005. GEMA also required NGG to obtain similar undertakings from the purchasers of the GDNs. Thereafter, a new licence condition to the same effect, SSC A55, was inserted into all of the transporters' licences.

2.48 Following GEMA's consent to the sale of the IDNs, NGG continued to develop the UNC, which was implemented with effect from 1 May 2005. The UNC provided for interim offtake arrangements to apply until 30 September 2008 (**the interim arrangements**). After 30 September 2008, a sunset clause had the effect that the interim arrangements would expire.

2.49 For TCCs, the interim arrangements were essentially the same as those which applied prior to the sale of the IDNs. However, new and different arrangements applied to the GDNs, which became independently responsible for determining their offtake needs consistently with the 1 in 20 obligation. GDNs were required to register their requirements for capacity in terms of a flat capacity product (offtake at a constant rate of flow) and a flexibility capacity product (permitting offtake at a variable rate of flow). Under the interim arrangements, GDNs did not bid against each other for flexibility capacity, but were required to request capacity on an administrative basis in terms of flat and flexibility capacity. GDNs were subject to financial incentives to mitigate any tendency to overbook NTS capacity rather than invest in their own networks and storage.

2.50 The sale of the IDNs took place on 1 June 2005, and later that month, GEMA indicated that the deadline of 1 September 2005 for the implementation of enduring offtake arrangements would be postponed to September 2007. GEMA's view was that 'de-coupling' the GDN sales and offtake reform would allow additional consultation on the latter, in part through the TPCR for 2007–2012.

2.51 As a result, NGG proposed, and GEMA directed, that the sunset clauses should be extended until 30 September 2010, and that transitional arrangements should apply from 1 October 2008 until 30 September 2010 (**the transitional arrangements**). The key difference between the interim and transitional arrangements relates to the booking of additional capacity. Because the lead time for a capital project is around three years, users would not be able to book incremental capacity during the interim period if that additional capacity required investment. However, additional capacity could be booked ahead for the transitional period, subject to the conclusion of an ARCA.

2.52 Late in 2005, GEMA started consultation on NGG's new TPCR, and enduring offtake reform was considered in the first and subsequent consultation documents. In June 2006, in an appendix to its initial proposals on the TPCR, GEMA published a draft impact assessment on offtake reform. The June 2006 impact assessment found net benefits of offtake reform of £45.9 million present value. (All quantified cost or benefit

values stated in this decision are present values over 20 years unless otherwise stated).

2.53 In August 2006, NGG indicated its intention to bring forward a formal UNC modification proposal in relation to enduring offtake reform.

The modification proposals

2.54 On 13 September 2006, NGG proposed modification proposal 116. Under the UNC modification rules, proposals are considered in the first instance by the Panel, which comprises ten voting representatives from shippers and transporters. (Non-voting members, including representatives from Ofgem and the consumer body Energywatch, also attend Panel meetings.) Under the modification rules provided for in the UNC, the Panel will decide whether the proposal requires consultation, and will ultimately decide whether to recommend the implementation of the proposal. The decision as to whether a proposal should be implemented lies with GEMA, which will apply the test set out in paragraph 2.21 above.

2.55 As we explain below, proposal 116 eventually became proposal 116V. The main features of proposal 116V are as follows:

Flat capacity and flexibility capacity

(a) NTS offtake capacity would be sold as two separate products—flat capacity, which would confer the right to offtake gas at an even flow rate across the day, and flexibility capacity, which would allow NTS users to offtake gas at flow rates which deviate from the uniform flow rates conferred by the flat capacity product. These products would be available to TCC Shippers and GDNs on the same basis. Users who offtake gas in excess of their booked capacity would be subject to overrun charges.

Flat capacity

(b) Existing users of the NTS would retain their 'prevailing rights' to flat capacity. Should they wish to request additional capacity, they would be required to make a four-year commitment 40 months ahead, whether or not new investment is required to meet the request. Users would have to give 14 months' notice to reduce their prevailing rights (and could not give notice in respect of any new incremental capacity until after the four year commitment has elapsed).

(c) Any remaining capacity would be allocated on the basis of annual and day-ahead pay-as-bid auctions.

Flexibility capacity

(d) Flexibility capacity rights would be the subject of a national annual auction a year ahead for the following five years. Flexibility would also be released as a daily right on the basis of individual offtake profile notices or through a pay-as-bid auction a day ahead where a shortage of flexibility is likely. Otherwise, flexibility capacity would be granted to users for free. A reserve price would be set by NGG for auctions. The amount of flexibility capacity needed would be calculated according to a formula, whereby two-thirds of the user's total end-of-day allocated quantity would be subtracted from the cumulative allocated quantity offtaken between 6 am and 10 pm, including a tolerance of 1.5 per cent on measurements of the cumulative flow.

Interruptibility

(e) The current form of long-term arrangement for shipper-nominated interruptibility would be removed. Instead there would be long-term buy-back contracting by NGG (under Exit Capacity Management Agreements) for the interruption of firm rights if that is more efficient than investment in the NTS. In addition, a day-ahead interruptible product would be offered by NGG.

(f) Exit Capacity Management Agreements may comprise forward or option agreements pursuant to which users would surrender a certain amount of firm exit capacity. In addition, NGG may at any time issue a tender for the buy-back of exit capacity.

2.56 E.ON opposed proposal 116, and on 12 October 2006, it put forward proposal 116A which would preserve the transitional arrangements for the long term.

2.57 Also on 12 October 2006, RWE Npower put forward proposal 116B, which included changes to certain points of detail within the structure of NGG's proposal 116. On 17 October 2006, BGT made proposal 116C, which was essentially proposal 116 without the flexibility product. On 22 November 2006, Scotia Gas Networks made proposal 116D, which like RWE Npower's proposal, proposed changes to certain matters of detail within proposal 116.

2.58 On 15 November 2006, NGG made certain minor variations to proposal 116, which were presented under revised proposal 116V. These changes were also reflected in revised proposals 116BV, 116CV and 116DV.

2.59 The modification proposals were the subject of consultation. There was some debate before us as to how to read the outcome of that consultation. We believe it is uncontroversial to say that a clear majority of respondents supported proposal 116A, either unconditionally or on some conditional basis, and that 116V received qualified support from only a few consultees.

2.60 On 21 December 2006, the UNC voted on the proposals. Proposal 116V received 2 out of 10 votes (both from NGG), and so the Panel did not recommend its implementation. Proposal 116A received 9 out of 10 votes, and so was recommended by the Panel. No votes were cast in favour of proposals 116BV or VD. Proposal 116CV was modified and replaced by proposal 116CVV, which was the subject of a new consultation. NGG and National Grid Distribution subsequently supported 116CVV, with NGG describing it as a '*pragmatic compromise*'. However, the Panel's recommendation remained that proposal 116A should be implemented.

The FIA

2.61 On 7 February 2007, GEMA published a Final Impact Assessment (**FIA**) in relation to proposal 116V and the related proposals. The FIA summarized the proposals as providing for:

- *increased levels of financial commitment for all NTS users (both new and existing) seeking to obtain access to NTS exit flat capacity with existing holders being granted prevailing rights …*

- *the introduction of new network interruption arrangements with interruption being managed by NGG NTS through long term contracting and the sale of a day ahead interruptible product.*

- *the release of NTS flexibility capacity rights to GDNs and shippers through annual auctions up to five years in advance …*

2.62 These three issues—user commitment, interruptibility and flexibility—were subsequently identified in the Decision as the key benefits of reform, and by E.ON in its Statement of Case as the most controversial aspects of proposal 116V. The appeal before us has focused on those three issues, and the cost benefit analysis relating to the proposal as a whole.

2.63 The FIA indicated that it undertook both qualitative and quantitative cost benefit analysis. (In this decision we use the word 'qualitative' in the sense in which it was used in the FIA and the Decision.) It said that there were significant potential benefits to customers from the reform proposals, although there were uncertainties associated with measuring the benefits. The costs, on the other hand, were more directly measurable, and so GEMA suggested that undue weight should not be given to the quantitative analysis in the FIA. The benefits were identified as follows:

- Improved investment signals to inform NGG's investment process. This should bring about more efficient investment and reduce the risk of 'stranded assets'. The estimated benefit was £42 million.

- Reduced potential for discrimination between firm and interruptible customers (the interruptibility reforms) and as between GDNs and shippers (flexibility).

- Reduced risk of discrimination between RDNs and IDNs in allocation processes. GEMA's '*subjective*' but '*cautious*' estimate of this benefit was £20 million.

- The promotion of competition in the provision of interruptible services to NGG and between parties seeking access to flexibility.

- Reduced likely incidence of disputes over the terms of ARCAs—estimated benefit of £10 million.

2.64 The FIA also calculated the transaction and other costs of the reforms. The costs of proposal 116V included:

- Shipper initial and ongoing implementation costs. GEMA's '*cautious and pessimistic*' estimate was £40.9 million.

- TCC and storage operator costs—the '*worst case outcome*' was said to be £23.3 million.

2.65 Costs to GDNs and their agency of £56.4 million were excluded from the total costs, on the basis that these costs should have been reflected by the purchasers of the IDNs and by NGG in the IDN sales transactions (by reflecting the cost in the price), and so should be borne by shareholders rather than by consumers. GEMA said:

> *… we are of the view that, provided they are not manifestly disproportionate, it is appropriate for the Authority to give little weighting to these costs when assessing the overall cost impact to customers of these modifications.*

2.66 Costs to the industry and consumers in other jurisdictions, of the order of £6 million, were also excluded on the basis that they were incurred by respondents operating outside GEMA's jurisdiction.

2.67 For proposal 116V, the estimated cost was £64.1 million. The costs for proposals 116BV, VD and CVV were lower, with CVV the lowest at £15 million. Proposal 116A, which GEMA said '*represents a continuation of the existing offtake arrangements*', had a cost of zero.

2.68 The FIA therefore estimated that proposal 116V would result in net quantified benefits of £8.3 million. The net quantified benefits of 116A were zero and those of 116CVV were £47.2 million. The FIA also set out the net quantified benefits of the proposals using the lowest four costs submissions from shippers. On this approach, the net quantified benefits of 116V were some £20 million higher at £28.5 million.

2.69 The FIA also discussed the expected qualitative benefits of reform, which were as follows:

- efficient network development and system operation;
- promotion of competition;
- appropriate allocation of risk;
- simplicity and transparency;
- preservation of security of supply; and
- preventing undue discrimination.

2.70 Respondents criticized the FIA, both as to matters of quantification and as to the merits of proposal 116V. E.ON's particular criticisms of the FIA are discussed below.

3. GEMA's Decision

3.1 In the following summary of the Decision, we focus on aspects relating to proposals 116V and 116A, those being the proposals in issue on this appeal. In highlighting certain key aspects of the decision, we take them out of the order in which they were presented in the Decision, but we note that GEMA's discussion of the proposals in the Decision was structured by reference to the objectives of the UNC and its statutory duties.

3.2 GEMA identified the 'key benefits' of proposal 116V as relating to user commitment, flexibility and interruptibility. Of user commitment, GEMA explained the benefits as follows:

> *the introduction of a user commitment framework which should improve the investment signals received by NGG NTS to inform and improve its investment and planning process. The Authority considers that improved investment signals should bring about more efficient NTS investment and reduce the risk that customers will have to pay for investment by NGG NTS that proves to be unnecessary or inefficient.*

3.3 GEMA said that TCCs and shippers are best placed to manage the risks associated with whether investment should be triggered on the NTS, and that financially backed commitments from users are preferable to the use of forecasts and voluntary information. GEMA also said that efficient network investment would lead to increased security of supply.

3.4 Of interruptibility, GEMA said:

> *the reform of the NTS interruption arrangements such that the discounts provided to sites more closely reflect the services provided by NGG NTS and the probability of interruption. The Authority considers that reform of these arrangements should reduce potential for undue discrimination between firm and interruptible customers and should promote competition between shippers in offering interruption terms to the NTS;*

3.5 GEMA identified that the current arrangements create incentives for a 'flight from firm', whereby a customer which has triggered investment on the network may subsequently opt to be interruptible, leaving others to fund the investment. GEMA also said that the interruptibility reforms would assist NGG in comparing the costs of entering into network interruption contracts with the cost of physically investing in the NTS. GEMA expressed some concerns as to whether proposal 116A was consistent with the Regulation, but did not conclude on the point.

3.6 In relation to flexibility, GEMA said:

> *the introduction of auctions for flexibility capacity … should reduce the potential for undue discrimination between GDNs and shippers in the allocation of flexibility. It should also provide important information regarding the market value of flexibility;*

GEMA also said that the proposal would better facilitate competition between shippers and GDNs.

3.7 As regards discrimination, GEMA expressed the view that the existing differential treatment of GDNs and shippers as regards flexibility '*appears unduly discriminatory*'. However, it noted that there were uncertainties relating to '*the risk of constraints in*

the provision of flexibility in the future' and that the costs of establishing markets for flexibility were '*potentially significant*'. Accordingly, GEMA considered whether the discrimination is '*justifiable*', and whether reform was consistent with its better regulation duties.

3.8 In the event, GEMA expressly did not determine that the existing arrangements are discriminatory, but nevertheless concluded that they should be reformed, because although '*current evidence suggests that there is sufficient flexibility available to the market, this may not necessarily be the case in the future, particularly as GDNs may reduce their reliance on their own network's flexibility going forward*'.

3.9 GEMA rejected arguments that differential treatment between shippers and GDNs was justified because of differences between them. GEMA said that both classes of user impose costs on the system which do not vary according to the type of user that they are. Further, GDNs book capacity as agents for shippers, and are therefore in the same position as shippers acting for TCCs. GEMA also said that it was consulting on incentive mechanisms to encourage GDNs to make commercial trade-offs.

3.10 GEMA identified a number of other benefits of flexibility. It said: *'… flexibility would be auctioned and allocated to those that value it most. Auctions of flexibility would allow GDNs to compare the true cost of purchasing flexibility with the costs of investing in diurnal storage on their own networks and adopt the most efficient solution. Whilst GDNs make similar trade offs in the transitional offtake arrangements, the introduction of flexibility auctions should reveal a market value of flexibility and enhance these trade offs'*. In addition, the flexibility product would target the costs of offtake flow variations to GDNs and TCCs, and so would reduce the likelihood that NGG will be required to take gas balancing actions when flexibility is scarce. The reform would have security of supply benefits in the electricity sector (by ensuring non-discriminatory access to flexibility for TCC generators).

3.11 For reasons similar to those given in relation to the question of undue discrimination, GEMA was satisfied that the reform was proportionate, and consistent with its statutory 'better regulation' duties. It said:

> *… only a short period of time has passed since GDN sales in June 2005 and there is a risk that over time GDNs may start to become more reliant on NTS flexibility. For example, GDNs, in order to obtain costs savings might consider divestment of gas storage holders which currently provide a source of network flexibility.*
>
> *The Authority considers that it is difficult to make precise judgments regarding the risks of flexibility constraints occurring in the future. Indeed, there is significant uncertainty as to whether constraints will arise.*
>
> *However, to the extent that constraints do arise, NGG NTS may need to arbitrarily allocate flexibility on an administered basis which may in turn lead to costs to customers.*

3.12 GEMA went on to give the example of TCC generators potentially not receiving the capacity they need, leading to an increase in electricity prices and '*significant costs*' to customers. It concluded:

> *Whilst the Authority recognises that at present, there is no shortage of flexibility capacity, in view of the uncertainties and risks to customers identified above and the benefits of revealing a market value for flexibility the Authority considers that it would be proportionate to implement 116V.*

3.13 GEMA also revisited the cost-benefit analysis (**CBA**) in the FIA. GEMA accepted that ongoing operational costs to GDNs should not be excluded from the CBA, and that such costs should be subject to comparative analysis and benchmarking in future price controls. On this basis, proposal 116V had a net cost of £28 million. However, GEMA reiterated its view that 116V had various benefits, including the benefits of '*non-discrimination and competition*' which are '*inherently diffuse and difficult to quantify*'. GEMA expressed concern that the estimated costs were an over-estimate, particularly if major flexibility constraints do not occur in practice. GEMA therefore reiterated the view it expressed in the FIA that undue weight should not be given to the quantitative analysis when compared with the qualitative analysis, and said:

> *Given the uncertainties and the margins of error in assessing both the costs and the benefits in this case, the Authority considers that unless the quantitative analysis indicates that the net costs would be disproportionately high, then it should proceed on the basis that the principles of non-discriminatory access and the promotion of competition … should prevail … As such, the Authority does not consider that establishing a positive quantitative benefits case is a necessary a* [sic] *pre-requisite to accepting proposals 116V, 116BV or 116VD.*
>
> *The Authority considers that the Final IA and subsequent revisions to this analysis … identify a plausible estimate of the costs and benefits. However, the uncertainties in the assumptions underpinning the cost and benefits analysis are such that a plausible alternative range of outcomes could arise, including estimated net benefits outcomes and different net cost outcomes. Taking this into account, the Authority does not consider that the analysis demonstrates that the net costs would be disproportionately high or that there is an overwhelming case to justify rejection of proposal 116V … on the basis of the quantitative analysis. 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 116V.*

3.14 GEMA thus concluded that proposal 116V best met the relevant objectives under SSC A11 and its principal objective under the GA86, and directed that the modification should be made. It decided that the deadline for implementation of the enduring offtake arrangements should be extended to 1 April 2008, so that in the intervening period, arrangements for the Moffat interconnector with Ireland, Northern Ireland and the Isle of Man could be considered and so that the Health and Safety Executive could consider revised safety cases. GEMA has subsequently consented to a further modification extending the sunset clauses to 30 September 2011.

4. Summary of the parties' positions

4.1 On this appeal, we have received comprehensive and detailed submissions from all three parties, and witness and expert evidence in support. E.ON provided a statement of grounds of appeal which, even in point form, ran to 15 pages. It is not possible for us to address every argument which has been made to us on this appeal. Rather, we address what appear to us to be the central issues on which the appeal turns.

4.2 Accordingly, we set out below a summary of each party's position, by reference to brief summaries of their respective cases which they each provided to us. We set out the more detailed arguments made in relation to particular issues in later sections of this decision.

4.3 During the course of the appeal, we asked NGG for written answers to a number of specific questions. As NGG is not a party to the appeal, its answers are not set out in this section of our decision, but in later sections where they are relevant.

Summary of E.ON's appeal

4.4 E.ON submitted that the Decision amounts to the implementation of GEMA's own project, not the adjudication of a dispute between industry parties. E.ON submitted that the history and the Decision plainly show that GEMA prejudged the issues.

4.5 E.ON submitted that it is accepted in the Decision that the implementation of proposal 116V will have a negative CBA value of £28 million, and that the proposal is therefore by definition inefficient and disproportionate. Further, E.ON submitted that the negative CBA value was seriously understated. In particular, E.ON submitted (1) that gas transporters' upfront costs should not be excluded from the CBA, nor should (2) Irish, Northern Irish and Isle of Man costs and (3) that the values ascribed to the 'quantitative' benefits in the CBA are speculative, and that there is no good reason to conclude that the items will produce any benefits.

4.6 E.ON also submitted that the argument that 116V will deliver '*efficient investment signals*' is defective, and rests on a failure to appreciate that the entry exit model cannot deliver investment signals because it does not represent the physical reality of the NTS. E.ON submitted that there is a serious risk that proposal 116V will lead to inefficiency in investment decisions.

4.7 E.ON submitted that GEMA wrongly assumed in the Decision that the qualitative benefits outweigh the negative CBA value. E.ON said that the benefits do not stand up to scrutiny and have been given inappropriate weight.

4.8 E.ON submitted that GEMA had erred in law by assuming that non-discrimination requires equal treatment even where there is a good reason for treating parties differently. As a result, GEMA was said to have failed to consider the facts and the matters which should be central to any discrimination inquiry. In any event, GEMA expressly made no actual finding of discrimination, and so no proper case had been made that the non-discrimination benefits are benefits at all. E.ON also submitted that, although GEMA relies on the qualitative benefits of positive consequences for competition, the competition issues are not properly analysed in the Decision at all, and that the proposal will actually have negative consequences for competition.

4.9 E.ON argued that GEMA failed to acknowledge the clear qualitative advantage of regulatory certainty under its proposal, 116A.

4.10 We note at this point that E.ON's appeal is supported by a number of other industry parties, including EDF Energy, the Chemical Industries Association, the Association of Electricity Producers, the Electrical Supply Board (Republic of Ireland), the Society of British Gas Industries, the Storage Operators Group (save for National Grid Storage), the Major Energy Users Council, the Gas Forum, International Power Plc, Gaz de France, Phoenix Supply Limited (NI), Scottish Power and Bord Gáis Energy Supply.

Summary of GEMA's reply

4.11 GEMA submitted that E.ON has misunderstood the proper role of a regulator such as GEMA, which is not limited to consulting and adjudicating on the proposals of others, but which involves the formulation of, consultation on and implementation of policy in the performance of statutory duties and functions (in particular, protecting consumers). GEMA submitted that E.ON was seeking to tempt the CC beyond its appellate role into a second guessing of fine decisions by the sectoral regulator acting on the basis of anticipated market behaviour.

4.12 GEMA submitted that E.ON exaggerated the significance of the FIA, 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 which is tiny in real annual terms. In GEMA's submission, E.ON sought to downplay the economic benefits which may be expected to follow from the user commitment model, the flexibility product and reform of the interruption arrangements.

4.13 As to the allegation of prejudgement, GEMA submitted that it 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, in this case formed over almost ten years, but it consulted meticulously on offtake reform, remained open minded, and listened and reacted to responses.

4.14 GEMA submitted that it had recognized the value of quantitative assessments throughout the process, but had in mind the limitations of such analyses: in particular that there was good reason for suspecting that the CBA was based on data which was subject to a high margin of error, that the true economic value of benefits was incapable of precise quantification, and that the greatest potential benefits of the proposal—those arising from the promotion of competition through fair and non-discriminatory arrangements—did not form part of the quantitative analysis. GEMA's process could not therefore be decision-making by numbers, but it rather had to form a judgement 'in the round'. The negative quantitative figure was relevant but not decisive.

4.15 GEMA restated its view that it was right to omit upfront transporters' costs from the CBA for the reasons given in the FIA. It also submitted that it was reasonable to focus on costs and benefits in Great Britain, that being the area for which it is responsible. GEMA stood by the quantification of benefits in the CBA. In any event, GEMA submitted that the reasonableness of the decision depended on taking account of all relevant factors looked at together, and denied that the Decision stood or fell based on a forensic recalculation of each item in the CBA.

4.16 In relation to qualitative benefits, GEMA submitted that the UK experience of liberalization and regulation in utility markets demonstrated that competition and non-discriminatory access to infrastructure have the potential to generate significant benefits for consumers. GEMA had reached the conclusion that fair and non-discriminatory arrangements for interruptibility and flexibility would promote competition and consumer benefits would follow. GEMA was justified in coming to

the view that, given the potentially very significant (albeit non-quantifiable) benefits of the modification, the negative quantitative CBA value was not a reason for failing to institute fair and non-discriminatory arrangements.

4.17 In relation to discrimination, GEMA submitted that it is inappropriate to discriminate between shippers supplying self-nominated interruptible customers who in fact receive a firm supply, and other customers who receive a firm supply. Both use or receive essentially the same service from NGG, and neither provides an interruption service of any value. Further, in relation to flexibility, GEMA submitted that TCC Shippers and GDNs are relevantly similar in their presentations of offtake demand to the NTS—both put the same pressure on the availability of flexibility capacity, and both are capable of making commercial trade offs in the event of scarcity.

4.18 GEMA rejected the allegation that it did not properly consider competition issues in the Decision. Competition issues were in fact central to the Decision, and a formal competition assessment was unnecessary.

Summary of BGT's Statement of Intervention

4.19 BGT stated that it generally supported E.ON's Grounds of Appeal. However, BGT later clarified that its intervention related principally to the question of flexibility, and the CBA as it related to that issue.

4.20 BGT submitted that GEMA had failed to appreciate the abundance of within-day offtake flexibility in the NTS, which is a byproduct of NGG's investment to meet the 1 in 20 obligation. As a consequence, proposal 116V would not achieve the UNC objectives of efficient and economic operation of the pipeline systems and effective competition.

4.21 BGT remained unconvinced that the qualitative benefits relied on by GEMA will materialize, and submitted that GEMA's reasoning for attributing specific values to the benefits is not transparent or supported by industry assessments of the impact of 116V. BGT also criticized GEMA's quantification of costs and benefits, and the attribution of unsubstantiated and high values to uncertain benefits, and complained that insufficient reasoning makes it difficult to assess the adequacy of GEMA's case for 116V. BGT submitted that the benefits are speculative, whereas the costs are demonstrable, and that it is disproportionate to base fundamental changes to the gas industry on theoretical risks.

4.22 BGT submitted that NGG does not invest in the NTS to create flexibility, so that flexibility auctions will not provide useful investment signals to NGG. BGT also submitted that 116V will result in overpriced NTS flexibility, giving the wrong investment signals to GDNs, not improved signals.

4.23 As regards discrimination, BGT submitted that shippers and GDNs place different demands on the system, particularly with respect to their nature and the timing of their flexibility requirements. As a result, the two are not comparable. BGT also submitted that the non-coincidence of demand for flexibility from GDNs and shippers was relevant to the need to book flexibility, and submitted that 116V will generate artificial scarcity in flexibility as users opt to bank flexibility rather than risk running short.

4.24 BGT submitted that annual auctions of flexibility will introduce discrimination to the market, as GDNs are likely to have a greater ability to forecast their needs, and are able to pass through the additional costs to their consumers, so that there is limited incentive for them to restrain their bidding. BGT submitted that such discrimination

would have significant consequences for the efficiency of the power sector as gas-fired power stations fail to secure sufficient flexibility.

4.25 In relation to user commitment, BGT submitted that the proposed changes offer no advantage over the existing ARCA arrangements, and that ARCA disputes are rare. BGT also submitted that 116V is likely to require further costly UNC modifications.

5. The nature of the CC's jurisdiction

5.1 This is the first appeal under EA04, and we received detailed submissions from the parties as to the nature of our jurisdiction and our role as an appellate body.

5.2 Section 175(4) of EA04 provides for an appeal on the merits, and states as follows:

> *The Competition Commission may allow the appeal only if it is satisfied that the decision appealed against was wrong on one or more of the following grounds—*
>
> *(a) that GEMA failed properly to have regard to the matters mentioned in subsection (2);*
>
> *(b) that GEMA failed properly to have regard to the purposes for which the relevant condition has effect;*
>
> *(c) that GEMA failed to give the appropriate weight to one or more of those matters or purposes;*
>
> *(d) that the decision was based, wholly or partly, on an error of fact;*
>
> *(e) that the decision was wrong in law.*

5.3 Under section 175, our role is to decide whether a code modification decision is wrong on one or more of the specified grounds. Those grounds clearly differ from the judicial review grounds of illegality, irrationality or procedural impropriety. This is clear on the face of the legislation, and it is also consistent with the purpose of the section 173 jurisdiction, which is to subject GEMA to a greater level of accountability than would be the case in judicial review.

5.4 E.ON and GEMA agreed that, as an appellate body, our jurisdiction should be compared to that of a court of appeal under Part 52 of the Civil Procedure Rules 1998, where the threshold for allowing an appeal is whether a decision is 'wrong'. In our view, this is a useful comparison, and we observe that other aspects of the CC's jurisdiction, including the test to be applied on an application for permission to appeal, support that comparison. There was nevertheless some disagreement as to the level of scrutiny that we should apply to GEMA's decisions on an appeal under section 173.

5.5 E.ON submitted that under section 173, the relevant question is whether GEMA's decision is 'right or wrong'. E.ON submitted that EA04 does not confer any special status on GEMA's evaluation of the relevant matters or purposes. It pointed to section 175(4), and submitted that it is for the CC to determine the appropriate weight to be given to the relevant matters and purposes (section 175(4)(c)), and to determine the true position in fact (section 175(4)(d)). E.ON also relied on section 175(2), under which the CC '*must have regard to the same extent as is required of GEMA, to the matters to which GEMA must have regard*'. E.ON said that the matters which GEMA is required to decide when considering a UNC modification proposal are not matters of impression or discretion.

5.6 On this basis, E.ON submitted that the CC clearly must enter into the substance of GEMA's decision, and that as a specialist and expert body, the CC is amply equipped to decide the relevant questions of law and economics.

5.7 GEMA's position was that the possibility of a speedy appeal under EA04 provides a valuable cross check on whether its decisions are taken in line with its statutory duties and are not vitiated by errors of fact or law. However, GEMA submitted that the Decision was one for GEMA to take with the benefit of its expertise and experience in regulating energy markets. Decisions in relation to code modifications require GEMA to make a broad assessment of the likely future impact of the relevant proposal. This is necessarily an inexact exercise, as the future can only be predicted, and the relative weights to be attached to different factors, possibilities and risks is a matter of judgment which GEMA is well placed to exercise.

5.8 GEMA submitted that the correct approach is that taken by the Court of Appeal when hearing appeals against decisions in the exercise of discretion and drew our attention to the judgment of the Court of Appeal in *Tanfern v Cameron McDonald* [2000] 1 WLR 1311. At paragraph 32 of his judgment Brooke LJ cited with approval the following passage from the opinion of Lord Fraser of Tullybelton in *G v G* [1985] 1 WLR:

> *… the appellate court should only interfere when they consider that the judge of the first instance has not merely preferred an imperfect solution which is different from an alternative imperfect solution which the Court of Appeal might or would have adopted, but has exceeded the generous ambit within which a reasonable disagreement is possible.*

5.9 Given the '*generous ambit within which a reasonable disagreement is possible*', GEMA submitted that the CC should be slow to impugn decisions of fact made by an expert and experienced decision maker. Further, said GEMA, the CC should be even slower to impugn '*educated prophesies and predictions for the future*': see *R v Director General of Telecommunications ex parte Cellcom* [1999] COD 105 at paragraph 26.

5.10 We do not accept E.ON's submission that decisions taken by GEMA in relation to code modifications do not involve the exercise of any discretion by GEMA. In considering code modification proposals, GEMA must determine whether a particular proposal better facilitates the achievement of the relevant objectives than the status quo or any other proposal, and also whether the proposal is consistent with GEMA's statutory obligations. We agree with E.ON that the statutory and regulatory framework in which GEMA must take its decision is carefully defined. But we consider that GEMA's decision will require the exercise of judgment or discretion in applying that statutory and regulatory framework to what will often be complex facts.

5.11 As a specialist appellate body charged with considering whether a decision of GEMA is wrong, the function of the CC is to provide accountability in relation to the substance of code modification decisions. However, leaving to one side errors of law, it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator. We make that clear in our Guide to Appeals in Energy Code Modification Cases (CC11, July 2005) paragraph 2.2. The Energy Code Modification Rules (ECMR) also make clear that we will proceed by way of a review of the decision subject to appeal, not a rehearing. In our view, the approach adopted in our Guide, and reinforced by the ECMR, is consistent with the nature and complexity of the issues in code modification appeals, and the short period of time allowed for the appeal process.

5.12 Under section 175, our role is to determine whether GEMA's decision is wrong, because it has failed properly to have regard to, or failed to give the appropriate weight to, the matters to which GEMA must have regard, or because GEMA has erred in law or in fact. In our view, this test clearly admits of circumstances in which

we might reach a different view from GEMA but in which it cannot be said that GEMA's decision is wrong on one of the statutory grounds. For example, GEMA may have taken a view as to the weight to be attributed to a factor which differs from the view we take, but which we do not consider inappropriate in the circumstances

5.13 This is not to say that every aspect of a code modification decision will be a matter for GEMA's discretion. There may be issues in respect of which it can more easily be said that GEMA's decision is wrong—for example, if GEMA has made an error of principle. The CC will therefore consider on a case by case, and issue by issue, basis whether GEMA's decision is wrong on one or more of the statutory grounds.

5.14 For completeness, we note that we have considered an extract from Hansard (HL Debate 29 March 2004) 1145, drawn to our attention by E.ON, in which Lord Kingsland said that the clause in the Energy Bill which later became section 175(4)(c) '*clearly entitles the Competition Commission to reassess the factual basis on which weights were accorded, and then compared by Ofgem, and then to make its own independent assessment'*. We did not find it necessary to have recourse to Hansard in order properly to interpret section 175(4(c). However, we do not in any event consider that the extract to which E.ON referred points to the conclusion that the CC should, on an appeal under section 173, substitute its view for that of GEMA.

5.15 In relation to findings of fact, we accept the thrust of GEMA's submission that the CC will be slow to impugn findings of fact made by the specialist regulator. However, rather than rely on the observations of Lightman J in *ex parte Cellcom*, which were made in the rather different context of judicial review proceedings, we prefer to rely on the decision of the Court of Appeal in *Assicurazioni Generali Spa V Arab Insurance Group* [2003] 1 WLR 577, in which the Court of Appeal set out its approach to appeals on the basis of error of fact. Clarke LJ said at paragraphs 14 and following:

> *The approach of the court to any particular case will depend on the nature of the issues and the kind of case determined by the trial judge … In appeals against findings of primary fact, the approach of an appellate court will depend on the weight to be attached to the findings of the judge and that weight will depend on the extent to which, as the trial judge, the judge has an advantage over the appellate court; the greater that advantage, the more reluctant the appellate judge will be to interfere … Some conclusions of fact are not however conclusions of primary fact of the kind to which I have just referred. They involve an assessment of a number of different factors which have to be weighted against one another. This is sometimes called an evaluation of the facts and is often a matter of degree upon which different judges can legitimately differ. Such cases may be closely analogous to the exercise of a discretion, and in my opinion, appellate courts should approach them in a similar way.*

5.16 Applying these principles, our view is that GEMA, as the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. In some respects, the advantage may be less than that which the trial judge has over the Court of Appeal, because GEMA's decisions are not based on the evidence and cross examination of witnesses. GEMA nevertheless has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry, as it did in the present case. For these reasons, the CC will be slow to impugn GEMA's findings of fact. Nevertheless, the CC has a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact.

5.17 In considering whether GEMA's decision is wrong for an error of fact, the words '*based … on*' in section 175(4)(d) must be accorded their full weight. It is not enough to succeed under that section for an appellant to demonstrate that some error of fact, whether consequential or inconsequential, has been made by GEMA in its decision. Rather, an appellant will need to demonstrate that the error was material to the outcome of the decision. Only if the error was material in this way will we regard the decision as 'wrong' under section 175(4)(d).

5.18 As regards errors of law, E.ON submitted that section 175(4)(e) incorporated a jurisdiction to hear appeals on all of the public law grounds of judicial review: see *Begum v Tower Hamlets LBC* [2000] 1 WLR 306. GEMA accepted that 'error of law' would include the judicial review ground of breach of natural justice (also known as procedural unfairness). In our view, this is an important and helpful consensus. The clear parallels between our jurisdiction under EA04 and the jurisdiction of a court of appeal under CPR Part 52 have already been discussed. Under CPR rule 52.11(3), a court may allow an appeal on one of two grounds - (1) that the decision of the lower court is wrong and (2) that the decision of the lower court is unjust because of a serious procedural or other irregularity. Section 175 by contrast gives the CC no express power to allow an appeal on the basis of procedural or other irregularity. This is an important difference between the CC's jurisdiction on the face of section 175 and Part 52. However, there are obvious advantages in the CC having jurisdiction to allow an appeal on procedural grounds, in particular the avoidance of multiple actions.

5.19 Given that we have a clear jurisdiction to review the substance of decisions under sections 175(4)(a) to (d), we consider that public law grounds of review on substantive, as opposed to procedural, issues, are unlikely significantly to add to the scope of our jurisdiction under sections 175(4)(a) to (d).

6. Analysis of the issues

6.1 In this section, we consider in further detail the three issues we have already identified as the most controversial aspects of proposal 116V—user commitment, interruptibility and flexibility—before considering GEMA's overall cost-benefit analysis (including matters of quantification) and E.ON's argument that GEMA has directed the implementation of 116V on the basis of a flawed process.

6.2 Although we consider user commitment, interruptibility and flexibility separately, GEMA pointed out, and we accept, that it was not in a position to direct the implementation of part but not all of proposal 116V, and that it had to take a decision as to whether to consent to the proposal as a whole or to reject it. Nevertheless, in order to understand the arguments for and against the different aspects of proposal 116V, we have found it most useful to break the issues down in this way. The framework for considering the issues which we adopt in this section follows that which we adopted at our clarification and final hearings.

6.3 In this section of our decision, we set out and consider the arguments made by E.ON, GEMA and BGT in relation to each of the five areas identified above. We draw our conclusions on the appeal in the following section.

User commitment

6.4 E.ON contended that GEMA was wrong to conclude that proposal 116V was preferable to the existing ARCA mechanism for a number of reasons.

6.5 E.ON's case on this issue relied heavily on the expert evidence of Mr Graham Shuttleworth, who, prior to being instructed by E.ON, acted as expert adviser to the Gas Forum in relation to the proposals for offtake reform. In his report prepared for this appeal, Mr Shuttleworth restated his view (also expressed in earlier reports) that the entry-exit regime is not a good representation of the underlying network, so that signals derived from demands for entry and exit capacity indicate little about the need for investment in the network. Mr Shuttleworth explained that although all gas in the NTS is notionally treated as passing through a single point (known as the National Balancing Point), the NTS does not consist of a physical set of pipelines bringing gas to and from a central point. Rather, the NTS is a network of point-to-point routes through which NGG can move gas around Great Britain without any formal distinction between parts which are devoted to entry capacity and parts which are devoted to exit capacity.

6.6 For this reason, Mr Shuttleworth said that a demand for exit capacity does not correspond to any particular investment in pipelines, so that in practice only NGG can decide how to meet a demand for capacity and whether investment is required. In Mr Shuttleworth's opinion, one could not infer whether a user would be willing to pay for investment, or whether an investment was efficient, from his willingness or unwillingness to pay for exit capacity, because a real pipeline has more uses than exit capacity. Mr Shuttleworth described this as a 'mis-match' between the commercial regime for selling capacity and the real underlying investments.

6.7 On the basis of Mr Shuttleworth's evidence, E.ON described the entry exit model as a 'black box', to which only NGG has the key—that is, the knowledge, understanding and expertise to model actual physical investment flows. The effect, E.ON submitted, is that NGG will retain a role as the central planner of the NTS regardless of any reform to the user commitment model. E.ON relied on statements in NGG's ten-year statements that market signals will not override its own planning criteria, and on Mr Shuttleworth's view that market-based signals will be an incomplete and

unreliable guide to investment needs. As a result, E.ON argued that NGG, rather than users, should continue to bear the risk of investment decisions.

6.8 At our clarification hearing, E.ON advanced a different position on this issue. E.ON said that the release of additional user commitment information under proposal 116V might afford a marginal advantage over the current position, but argued that any such benefit was outweighed, indeed dwarfed, by another disadvantage of the proposal—namely, the risk that the proposed reform would chill investment by NGG in the NTS. E.ON drew attention to a statement by GEMA in the FIA that the user commitment information released by 116V could be used to disallow investment by NGG in the NTS if the investment was not supported by user commitment information. Attempts by GEMA to fine tune or second guess NGG on investment decisions would incentivize NGG to adopt an overly cautious and risk-averse investment strategy, and so might result in underinvestment and undercapacity in the NTS.

6.9 E.ON further argued that the reform would increase barriers to entry into the electricity wholesale market by increasing investment costs, and that the user commitment model under 116V would have an adverse effect on competition in shipper and supplier markets, because shippers would require TCCs to make longer-term commitments if they in turn were required to make longer-term commitments to NGG.

6.10 E.ON also submitted that the quantified benefits attributed by GEMA to this aspect of the reform were implausible. (We address the question of quantification in our discussion of the CBA below.)

6.11 E.ON submitted that the proposed alterations to the current exit arrangements were wholly unnecessary to avoid the risk of stranded assets because the current ARCA commitments are sufficient to provide reliable information about prospective increases in offtake demand. E.ON submitted that ARCAs are more flexible than the proposed arrangements under proposal 116V because they are bilaterally contracted on a case-by-case basis. E.ON said that ARCAs are a more proportionate way of obtaining reliable user information given that they typically require only a one-year financial commitment.

6.12 In response GEMA submitted that the reform would provide improved investment signals, in the form of more reliable user information, which would improve NGG's investment and planning process and reduce the risk that customers would pay for unnecessary investment in the network.

6.13 In response to Mr Shuttleworth's opinion, GEMA relied on the evidence of Professor George Yarrow, who is a non-executive director of GEMA. Professor Yarrow, although possessing significant expertise in relation to the issues which are the subject of this appeal, participated in GEMA's decision to approve proposal 116V. Professor Yarrow is not therefore an independent expert witness, and we bear this in mind in considering the weight which should be attached to his evidence.

6.14 Based on Professor Yarrow's evidence, GEMA submitted that the physical reality of the NTS and in particular the value of incremental capacity expenditure at different points in the network is adequately represented by the entry-exit charging system. GEMA submitted that proposal 116V, by providing locational demand information, would facilitate investment planning. It would be for NGG to interpret that information, subject to regulatory oversight by GEMA. GEMA submitted that it is difficult to see how additional offtake demand information could be expected to have other than positive value for NGG.

6.15 Relying on the witness evidence of Mr David Gray, an executive member of GEMA and Managing Director of the Networks Division within Ofgem, GEMA explained that, apart from ARCAs, NGG also currently receives forecast usage data, but that information is provided in response to surveys. GEMA submitted that, if demand forecasts are backed by financial commitments, that will improve the incentives on users to ensure that the information they provide is accurate.

6.16 In relation to ARCAs, GEMA submitted that an increase in the length of the commitment given by users from one year to four years would reallocate some of the risk currently borne by customers generally to those that make the capacity requests, and that this reallocation of risk was appropriate.

6.17 GEMA also drew attention to the fact that, under proposal 116V, users will be required to give 14 months' notice of a reduction in capacity requirements, rather than one month's notice. GEMA submitted that this would allow NGG to take account of the amount of capacity being released up to 14 months ahead when deciding whether additional investment would be required to meet the incremental requirements of other users.

6.18 GEMA disputed that 116V would have a chilling effect on NGG's investment decisions. GEMA said that NGG would only be penalized if it made incompetent decisions. GEMA also submitted that it could already disallow investment by NGG if it saw fit. GEMA said that a change whereby it is better able to scrutinize NGG's investment decisions is to be welcomed as in the interests of consumers generally.

6.19 In response to the argument that the reform would have an adverse impact on competition in the shipper and supplier markets, GEMA submitted that TCCs could address this possibility by agreeing appropriate commercial terms with shippers.

6.20 Finally, GEMA disputed that the reform would chill new investment by TCCs, or raise barriers to entry for generators. GEMA said that it was reasonable to make users commit for four years when the network asset might have an actual life of up to 100 years and a depreciation life of 45 years. The commitment required was sufficient to indicate seriousness, but represented a modest contribution to the investment cost. GEMA said that it was fanciful to suggest that this reform would increase barriers to entry given the cost of the commitment compared with the costs of entry. GEMA also submitted that a longer commitment was needed given that the lead time for investment projects was often three to four years, whereas the lead time construction of a power station was shorter, and a user might therefore trigger investment before it became apparent that the power station would not proceed.

6.21 Our questions to NGG included questions in relation to user commitment. We asked NGG about the investment signals it would obtain from the proposed modification. It replied as follows:

> *… the NTS Exit (Flat) Capacity product is anticipated to provide NGG with financially backed, clear locational signals for where, when and how much transportation capability may be required by Users to support anticipated demand …*
>
> *NGG recognise that there is inherent uncertainty within supply, demand and flexibility forecasts. The advantages of the User Commitment model, in NGG's view, is in providing appropriate incentives, via financially backed commitments, to Users to ensure forecasts are as accurate as possible. This, in turn, reduces the risk of a non-optimal level of NTS investment. Mod 0116V also allows Users to request the reduction of*

their capacity holdings with a 14 month reduction notice period (as long as they have not requested incremental NTS Exit (Flat) Capacity with the associated commitment period) and this will provide NGG with the ability to be able to stop/defer/revise planned investments should capacity requirements be reduced for existing loads in an area where load growth requiring investment had been envisaged.

6.22 Our view is that, although an incremental unit of exit capacity can be offered in different physical forms, information which indicates that there will be a demand for gas at a particular location is important for network planning. Further, our view is that if users are required to make a commitment for four years rather than for a maximum of one year, and are required to make financially backed commitments rather than provide forecasts which are not financially backed, NGG is likely to receive more robust information to assist its investment decisions.

6.23 The fact that NGG will retain overall control of the investment planning process does not seem to us to point to the contrary conclusion. Even if NGG alone has 'the key to the black box', it will be better placed to make investment decisions under 116V than it is at present.

6.24 We also see no grounds for criticism of the Decision in relation to the question of allocation of risk. It does not seem to us to be inappropriate for NTS users who trigger investment in the network, rather than consumers generally, to bear a higher proportion of the risk associated with any new investment which they trigger than they do at present.

6.25 We were not persuaded by E.ON's submission that the proposal will have a chilling effect on investment in the NTS, for two reasons. First, NGG has a statutory duty to develop and maintain an efficient and economical pipeline system for the conveyance of gas. Thus it appears to us that a cautious approach to investment in the NTS is desirable, and consistent with NGG's statutory duties, to the extent that it reduces the probability of investments resulting in stranded assets. Secondly, the concern expressed by E.ON appears to flow not from the proposed reform itself, but from the way in which the additional information released by the proposal may be used by GEMA to regulate NGG. E.ON itself recognized that the availability of the information to NGG, and the use of that information by GEMA, are separate issues.

6.26 We have no reason to believe that GEMA, in regulating NGG, will not make appropriate use of any additional information which becomes available as a result of 116V. NGG does not appear to share the concern expressed by E.ON. In any event, the fact that GEMA might err in the use of the information in due course is not, in our view, a compelling reason why the proposed changes to user commitment should not be implemented given the advantages of the reform, described above.

6.27 In response to the submission that the proposed reform will increase barriers to entry for electricity generators, our view was that any increase in barriers would be small and would not be material in the context of such projects. Likewise, we were not persuaded that there would be any material impact on competition in shipper or supplier markets, nor that this point ought to have caused GEMA to take a different view in relation to user commitment.

6.28 Overall, we were not persuaded that GEMA's Decision in relation to the user commitment aspect of proposal 116V can be criticized for the reasons given by E.ON.

Interruptibility

The Transmission Access Regulation

6.29 As set out above, in the Decision, the question of interruptibility reform was considered principally from the point of view of the objectives of the UNC and GEMA's statutory duties. The question of whether any or all of the proposals complied with the Regulation was referred to only in passing.

6.30 On this appeal, whether proposals 116V and 116A complied with the Regulation became an important issue. First, in its Reply, GEMA argued that, on reflection, it considered that E.ON's proposal 116A was not compatible with the Regulation. In response, E.ON argued that proposal 116V was not compatible with the Regulation. E.ON sought permission to amend its grounds of appeal to that effect at our final hearing.

6.31 We find it unsatisfactory that we are being called upon to determine important questions of law which do not appear to have been properly addressed by either side in the context of the Decision, and which developed unevenly before us. In our view, the question of the compatibility of 116V with the Regulation ought to have been addressed in the Decision and, to the extent that E.ON wished to raise that issue before us, it should have done so from the outset of its appeal.

6.32 Given that we cannot determine whether the Decision was 'wrong' within the meaning of section 175 of EA04 without considering E.ON's arguments based on the Regulation, we address those arguments below. Nevertheless, we would suggest that if parties in future appeals wish to raise important legal questions of this sort, the relevant arguments should be raised squarely on the face of their statement of case.

6.33 E.ON argued that proposal 116V is incompatible with the Regulation on two related grounds—that the proposal is contrary to (1) a requirement in Article 4 of the Regulation that NGG should offer a long-term interruptible service and/or (2) a requirement that it should offer interruptible services down to a minimum period of one day.

6.34 Article 4(1) of the Regulation provides as follows:

> *Transmission system operators shall:*
>
> *(a) ensure that they offer services on a non-discriminatory basis to all network users. In particular, where a transmission system operator offers the same service to different customers, it shall do so under equivalent contractual terms and conditions, either using harmonised transportation contracts or a common network code approved by the competent authority in accordance with the procedure laid down in Article 25 of Directive 2003/55/EC;*
>
> *(b) provide both firm and interruptible third party access services. The price of interruptible capacity shall reflect the probability of interruption;*
>
> *(c) offer to network users both long and short-term services.*

6.35 E.ON drew attention to a number of defined terms under Article 2 of the Regulation, as follows:

'interruptible services' means services offered by the transmission system operator in relation to interruptible capacity;

'interruptible capacity' means gas transmission capacity that can be interrupted by the transmission system operator according to the conditions stipulated in the transportation contract;

'long-term services' means services offered by the transmission system operator with a duration of one year or more;

'short-term services' means services offered by the transmission system operator with a duration of less than one year;

6.36 We note that '*transportation contract*' is defined as:

a contract which the transmission system operator has concluded with a network user with a view to carrying out transmission;

6.37 Further, E.ON drew our attention to Guidelines set out in the Annexe to the Regulation which state:

Transmission system operators shall offer firm and interruptible services down to a minimum period of one day.

6.38 E.ON argued that subparagraphs (b) and (c) of Article 4(1), read together, impose an obligation on NGG to provide long-term interruptible services. It argued that, on GEMA's own description of 116V, it is intended to withdraw long-term interruptible service and to move to a system of 'universal firm'. E.ON argued that under 116V, NGG is neither required nor permitted to offer long-term interruptible services. It argued that, under SSC A7, NGG cannot offer services outside the UNC or it would breach the conditions of its licence.

6.39 E.ON also argued that 116V is contrary to the Regulation because NGG will not be 'offering' interruptible services to users, in the form of a 'standing offer'—rather, NGG *may* buy back firm capacity at its own discretion. Likewise, under the proposed buy-back arrangements, a user's service would not be interruptible by NGG, as the user's service would be firm, subject to the user selling that firm capacity back to NGG. E.ON submitted that user nomination is required by the Regulation. Further, E.ON said that under the proposed buy-back arrangements, the service would not be interruptible on conditions specified in the transportation contract, but rather on the basis of a separate buy-back contract. E.ON also argued that the buy-back arrangements would not comply with the obligation on NGG to offer services on transparent and non-discriminatory conditions, in particular because they would be priced through bilateral negotiations not through administered pricing. E.ON described the proposals for long-term arrangements as a 'leap in the dark'.

6.40 E.ON made a further submission that GEMA had failed to consult on the legal arguments being advanced on this appeal.

6.41 In response, GEMA said that under 116V, there will be two types of interruptible arrangement—a day-ahead interruptible product and long-term buy-back contracting for the interruption of firm offtake rights. GEMA said that the obligation in Article 4(1)(a) is an obligation on NGG, and unless 116V precludes NGG from offering long-term interruptible services (which GEMA submitted it does not), then the modification is compatible. GEMA also said that Article 4(1)(a) does not require long-term interruptible services to be offered, only long-term services, which are available.

6.42 GEMA said that buy-back contracts would operate on a transparent and non-discriminatory basis. GEMA said that the legal text of the modification provided for the publication of information in relation to buy-back contracting. GEMA also drew our attention to NGG's procurement guidelines, under which NGG will procure services by a competition wherever possible, and will only negotiate on a bilateral basis where there is insufficient competition or where it is more economic or efficient to do so. Under bilateral contracts, NGG would negotiate by reference to the cost of new investment. GEMA also submitted that the guidelines provided for certain information to be provided to potential tenderers, and for procurement to be carried out on a non-discriminatory basis. GEMA said that the same principles would apply to long-term buy-back contracting under 116V.

6.43 Overall, GEMA submitted that it was both a practical and a legal nonsense to suggest that NGG should be obliged to contract for interruptibility where there is no probability of interruption.

6.44 We accept E.ON's submission that the UNC defines the terms on which transportation arrangements may be provided by NGG. The question for us is therefore whether the UNC contains machinery under which NGG can provide the services which it is required to provide under the Regulation. If it does, it is then incumbent on NGG to offer those services in accordance with the Regulation.

6.45 Overall, we have in mind that the Regulation is intended to establish a framework of minimum standards which are designed to ensure non-discriminatory access to the network in each member state of the EU. Thus recital 10 of the Regulation provides:

> *References to harmonised transportation contracts in the context of non-discriminatory access to the network of transmission system operators do not mean that the terms and conditions of the transportation contracts of a particular system operator in a Member State must be the same as those of another transmission system operator in that Member State or in another Member State, unless minimum requirements are set which must be met by all transportation contracts.*

6.46 The purpose of the Regulation is not therefore the harmonization of transportation arrangements, and it seems to us unlikely that the Regulation was intended to prescribe the detailed machinery by which services should be provided. We interpret and apply the Regulation in that spirit.

6.47 We do not accept E.ON's submission that Article 4(1)(c) clearly places an obligation on NGG to provide long-term interruptible services, although we do accept that that is one reading of the provision. The provision refers only to 'long and short-term services'. E.ON submitted that if Article 4(1)(c) had intended to refer only to 'firm' services, it would have said so. However, we do not suggest that the provision is concerned only with firm services. Rather, it seems to us that the provision can be read as dealing with the need for services of different durations, without specifying the nature of the services. If the clear intention was that both firm and interruptible services should be provided on both a short-term and a long-term basis, that could have been put beyond doubt in subparagraph (c) of Article 4(1).

6.48 We note that the Guidelines set out in the Annexe establish a minimum period for both firm and interruptible services. That period is one day. Recital 18 says of the Guidelines:

In the Guidelines annexed to this Regulation, specific detailed implementing rules are defined on the basis of the second Guidelines for Good Practice ...

The Guidelines do not provide that long-term interruptible services must be provided for any particular period in excess of one day. In our view, there is no incompatibility between 116V and the provision of the Annexe to the Regulation relied on by E.ON.

6.49 It is not easy to apply the definitions of interruptible services and interruptible capacity under the Regulation to the proposed buy-back contracts. However, when the definitions of interruptible services and interruptible capacity are read together, their effect is to require NGG to provide capacity which can be interrupted by NGG according to conditions stipulated in '*the transportation contract*'.

6.50 Paragraph 3.10.3 of the legal text of modification 116V provides that Exit Management Constraint Agreements may take two forms—Exit Forward Agreements, under which a user will surrender a particular amount of NTS exit capacity in relation to a period of one or more days, and Exit Option Agreements, pursuant to which NGG may require a user to surrender a particular amount (or up to that amount) of NTS Exit Capacity in relation to any day in a period of one or more days.

6.51 In our view, the practical effect of the buy-back mechanism is that firm capacity provided by NGG is rendered interruptible by NGG. Therefore, where NGG buys back firm capacity, it can be said to provide capacity which can be '*interrupted by the transmission system operator*' within the meaning of the Regulation. We also note that '*transportation contract*' is defined in the Regulation as *'a contract which the transmission system operator has concluded with a network user with a view to carrying out transmission'*. This is a broad definition, and in our view, a contract under which firm capacity is surrendered, or which gives NGG an option to interrupt, can be regarded as a contract concluded '*with a view to carrying out transmission*'. Accordingly, the conditions of interruption are stipulated in a '*transportation contract*' as defined, so that the definition of '*interruptible services*' is satisfied.

6.52 E.ON argued that the Regulation requires NGG to provide a 'standing offer' of long-term interruptible services, capable of acceptance at the user's behest. However, even if the Regulation does require NGG to offer long-term interruptible services, we were not persuaded that the offer should necessarily be a standing offer which users could simply accept at any time. E.ON's point seems to us to go to the terms on which the service must be offered, rather than the initial obligation to provide the service, and that is not a matter which is addressed in the Regulation.

6.53 Having heard GEMA's explanation of the way in which NGG will contract for the buying back of firm capacity, we were not persuaded that the mechanism provided for in 116V is inherently unfair and discriminatory. We also do not accept that GEMA is under an obligation to consult on questions of the proper interpretation of legislation.

6.54 Having regard to the various points we have made above, and what we consider to be the right approach to the interpretation and application of the Regulation, we were not persuaded that 116V is incompatible with the Regulation.

6.55 As we have indicated above, GEMA's position before us was that proposal 116A is incompatible with the Regulation. GEMA argued that this was so because Article 4(1)(b) of the Regulation provides that '*The price of interruptible capacity shall reflect the probability of interruption'.* GEMA said that user-nominated interruptibility which

gives rise to a price of £0 for offtake capacity does not reflect the probability of interruption. It said that although the Regulation must allow some latitude in the precise pricing mechanism to be applied in relation to interruptibility arrangements, a blanket 100 per cent discount could not be treated as falling within that margin of discretion. GEMA said that, although it had been able to 'duck' this question in the Decision (because it had decided to direct the implementation of proposal 116V in any event), we would have to address the question before making any direction that proposal 116A should be implemented.

6.56 The question raised by GEMA on the proper interpretation of Article 4(1)(b) is a point of some general importance in relation to which we heard limited argument. We have found it difficult to understand the way in which, on GEMA's argument, price must be related to the probability of interruption so as to satisfy the Regulation. However, for reasons set out elsewhere in this decision, we have not found it necessary to reach a conclusion as to whether proposal 116A is compatible with the Regulation, and that being the case, we do not express any view on the proper interpretation of Article 4(1)(b).

Other issues

6.57 In relation to the substance of the interruptibility proposals under 116V, E.ON's central objection was the withdrawal of long-term interruptibility. E.ON said that this feature of 116V was not a proportionate solution to any concerns which had been identified.

6.58 E.ON said that the discrimination argument relied on in the Decision was wrong in law. Discrimination consists in treating materially comparable cases differently without objective justification. E.ON submitted that interruptible services and firm services are different services. E.ON said that the Decision would in fact create discrimination between industrial and commercial users connected to NTS and those connected to GDNs.

6.59 Turning to the competition benefits relied on by GEMA, E.ON submitted that the Decision was not based on any proper competition assessment (for example, by reference to the relevant markets), and did not include a competition impact assessment consistent within OFT Guidelines. E.ON contended that the promotion of competition, and indeed the diminution of discrimination, are abstractions. It said that the assertion that an abstract principle will be advanced is not the same as identifying a real specific benefit that can be set off against a real quantified cost. E.ON said that in order properly to explain a benefit, it is necessary to explain the mechanism of cause and effect by which it will manifest itself in the real world—for example, in which sector, for the benefit of whom, how behaviour would be modified as a result and why the change in behaviour would be beneficial.

6.60 E.ON submitted that 116V was inefficient and could lead to underuse of the NTS. In support, E.ON relied on the expert evidence of Mr Shuttleworth, who stated in his report:

> *Interruptible service allows users to gain access to capacity even if they place a relatively low value on the capacity and would not be willing to pay much more than the operating costs of using it. A tariff policy that removed this possibility would discourage low value users (…). These users would be prepared to pay for operating costs and make a small contribution towards the fixed costs of investment, but may not be prepared to pay the full costs of capacity. Discouraging such users from*

using the network would lead to reductions in network utilisation and consumer welfare.

6.61 E.ON argued that interruptible users impose no capacity cost on the system. This is because NGG is not required to invest to meet interruptible demand, which is not included in the 1 in 20 obligation. E.ON submitted accordingly that interruptible users should pay the commodity charge but be exempt from the capacity charge which is intended to recover the infrastructure costs. Indeed, E.ON initially submitted that interruptible users are already 'cross-subsidizing' firm customers through commodity charges.

6.62 E.ON submitted that the reform will lead to overinvestment in the NTS, because additional apparent demand for firm capacity will provide erroneous investment signals.

6.63 E.ON submitted that any concerns about whether the level of capacity charges payable by interruptible customers reflected the probability of interruption could be addressed in a proportionate manner by adjusting the amount of those charges. Similarly, E.ON submitted that, in so far as the existing number of days on which a user may be interrupted is thought to be too short, that could have been addressed by a proportionate modification addressing that issue. However, neither issue required the withdrawal of the long-term interruptibility product.

6.64 E.ON contested the 'flight from firm' argument set out in the Decision. E.ON said that there was no evidence of flight from firm, which was no more than a hypothesis.

6.65 In response, GEMA submitted, based on the decision of the House of Lords in *R (Carson) v Secretary of State for Work and Pensions* [2006] 1 AC 173, that the test for discrimination is whether there is enough of a relevant difference between X and Y to justify different treatment. GEMA submitted the majority of sites which have nominated themselves as interruptible under the present arrangements could currently be provided with their maximum demand on a firm basis on high demand days. As a result, firm and interruptible users face very different charges for levels of service which are in effect identical. GEMA submitted that this amounts to discrimination.

6.66 GEMA also put its case in terms of fairness. It said that in circumstances where there is an excess of capacity in the system so that most interruptible users are receiving a firm service (ie with no real likelihood of interruption), it is fair that interruptible customers should bear part of the cost of the excess capacity, rather than for firm customers to bear the entire cost of capacity. GEMA said that this unfairness is compounded because some firm users do not qualify for interruptibility, and nomination for interruptibility under the current arrangements is at the option of the user.

6.67 GEMA submitted that the reform had clear competition benefits. It said that promoting competition to further the interests of consumers has been the watchword of the liberalization of the energy markets in the UK and the approach adopted by GEMA. The benefits of competition may be expected to arise where market structures are put in place to facilitate competition, and one of the fundamental principles of such markets is non-discriminatory access to monopoly infrastructure. Non-discrimination and competition benefits are intimately linked, and consumers can expect to see the benefits of such structures feed through to them. In support of this submission, GEMA relied on the evidence of Professor Yarrow, whose witness statement made the same points.

6.68 GEMA therefore accepted that it relied on principles in making its decision, and that the principles brought with them assumptions about benefits. The introduction of long-term buy-back contracting for interruptible capacity, and day-ahead auctions, would create competition for interruptible capacity. A separate competition impact assessment, carried out on the basis of OFT Guidelines, would have added nothing to the process, as the OFT Guidelines were not intended for specialist regulators charged with promoting competition.

6.69 GEMA submitted that the proposed changes to interruptibility would improve investment signals to NGG. It said that NGG had been subjected to incentives which encouraged it to make efficient trade-offs between investment in new capacity and contracting for interruption. NGG would need to decide whether it is cheaper to invest to provide capacity or to enter into interruption contracts with users. GEMA said that it was right to price interruptibility in this way, rather than by simply adjusting the level of the discount as E.ON suggested. GEMA said that that proposal represented an obvious improvement on the existing arrangements which are 'one size fits all'— users are interruptible for up to 45 days and given a 100 per cent discount on exit capacity charges.

6.70 GEMA argued that user nomination was an undesirable feature of the current arrangements, citing the 'flight from firm', which GEMA submitted could be expected of rational industry parties.

6.71 GEMA disputed Mr Shuttleworth's argument that interruptible customers impose no capacity cost. Relying on Professor Yarrow's evidence, GEMA submitted that it is not necessarily correct to say that interruptible users do not impose capacity costs on the NTS. Interruption of these users can only be for up to 45 days a year. In the remaining 320 days of the year NGG has to provide firm service to all interruptible users. GEMA submitted that whether or not this has costs will depend on the particular demand profile of other customers in nearby NTS offtake points.

6.72 Finally, GEMA disputed E.ON's 'cross-subsidy' argument, although it said that under current arrangements, commodity charges paid by interruptible users do make a contribution to fixed costs. It was not clear to us whether, having received a note from GEMA addressing this issue, E.ON maintained its cross-subsidy argument. In any event, we were not persuaded that interruptible users cross-subsidize firm users under current arrangements.

6.73 NGG replied to questions which we provided to it in the following terms:

> *Changes to interruptibility arrangements for existing customers connected directly to the NTS are not expected to have an impact on the investment across the NTS. The exception is in the South West Peninsula area and across parts of Southern England. Here NGG would expect to seek to enter into contractual arrangements where interruptibility continues to be required. Where contracts cannot be agreed or uneconomic offers are made by customers then NGG would need to initiate investment …*
>
> *NGG would consider long term interruptibility contracts under the following circumstances:*
>
> - *NGG perceive that capacity requirements exceed infrastructure capability.*

- *NGG evaluations identify that it is cheaper to contract for long term interruptible contracts rather than building infrastructure or to mitigate the perceived risks associated with relying on within day prompt system management costs.*

NGG is likely to facilitate long term interruption via issuing tenders for options and forwards and/or entering into bi-lateral contracts with Users at specific points on the system. The specific details of such tenders and the acceptance of any offers placed will be dependant upon a number of factors but these would include; the number of days in a period that NGG has identified a risk, the volume required, the lead time and the prices offered. Such contracts will be assessed on a case by case basis.

6.74 In the Decision, GEMA said that the proposed interruptibility reforms should '*reduce potential for undue discrimination between firm and interruptible suppliers*'. However, the discussion of this discrimination issue in the Decision was limited, and as a result, it is not clear to us to what extent the GEMA's views on interruptibility depended on the discrimination argument.

6.75 GEMA was more explicit in the FIA, where it said:

> *Ofgem considers that the discount provided to interruptible network users is largely unrelated to the probability or frequency of interruption. On this basis, we remain of the view that under the transitional offtake arrangements interruptible users may be receiving different levels of service for the same discount to NTS capacity charges.*

6.76 On this appeal, the discrimination issue has been put on the latter, wider basis, and we address that argument below.

6.77 The parties agreed that the legal test for unlawful discrimination is whether relevantly similar parties are being treated differently, or whether relevantly different parties are being treated in the same way. As we have indicated above, E.ON submitted that there is a further question as to whether any discrimination may be objectively justified, whereas GEMA submitted that any question of justification is no more than an aspect of 'relevant similarity or difference'. We do not think that for present purposes anything turns on this difference.

6.78 In our view, whether firm and interruptible customers are relevantly similar or relevantly different depends on whether the provision of the two types of service imposes the same or different costs on NGG. On the face of it, firm services and interruptible services are different services, and one would expect NGG to incur different capacity costs in providing those different services.

6.79 However, this straightforward analysis may not apply to the NTS at the current time. One reason is that there is currently an excess of capacity in the NTS, so that it cannot simply be said that firm users and interruptible users impose different costs on NGG. Rather, at points on the NTS where there is currently an excess of capacity, it may be said that NGG currently incurs no capacity cost in providing firm capacity and makes no savings of capacity cost if a user is interruptible.

6.80 However, this is not what GEMA submitted to us on this appeal. In response to E.ON's submission that interruptible users impose no capacity cost on the system, GEMA submitted that interruption is only for up to 45 days a year, and that the provision of firm capacity for the remaining 320 days may impose costs on NGG, depending on the demand profile of other fully firm customers in the vicinity of the

interruptible customers. GEMA said of interruptible customers '*their demands do impose a cost on NGG which has to be recovered from somewhere'.*

6.81 In the Decision, GEMA did not explicitly consider the discrimination issues relating to interruptibility by reference to the costs which firm and interruptible users impose on the system. GEMA did, however, say that at present, and under 116A, '*the discount payable in respect of supply points is largely unrelated to the probability of interruption*'. The probability of interruption, to which GEMA is required to have regard under Article 4(1)(b) of the Regulation, may be related to the costs which interruptible users impose on the system. However, it is not clear to us, based on the Decision and the submissions we received, that, because certain interruptible users face the same risk of interruption as firm users, the two types of user necessarily impose the same capacity cost on the system. GEMA's argument that interruptible users *may* impose capacity costs on the system, but will not *necessarily* do so, tends to suggest that the two types of user may impose different costs on the system.

6.82 In our view, the evidence contained in the Decision, and relied on by the parties on this appeal is inconclusive as to whether firm and interruptible customers necessarily impose the same or different capacity costs on NGG. On that basis, we are not able to reach a concluded view that the existing arrangements are not in fact discriminatory, as E.ON submitted we should. We are also not persuaded that GEMA erred in law in its approach to the question of discrimination. Nevertheless, by the same token, we find that the material contained in the Decision, and the submissions made to us on this appeal, do not adequately support GEMA's conclusion that the existing arrangements are in fact discriminatory, or potentially discriminatory.

6.83 Turning to the other arguments identified by GEMA in relation to interruptibility, our view is that GEMA cannot be criticized for having had regard to the 'flight from firm' argument. User nomination under the existing arrangements may adversely affect the efficient operation of the NTS if users who require a firm supply are able to nominate themselves as interruptible only because there is no risk of interruption. This is possible under the current arrangements, and may be expected of a rational user. In our view, it would have been helpful if GEMA had also considered the practical experience in relation to this issue. However, we accept GEMA's argument that it is appropriate to have regard to the possibility of the 'flight from firm' in considering the merits of 116V against the status quo and proposal 116A.

6.84 Whether or not E.ON is right to say that a change to the level of the charges for interruptible capacity would have been a more proportionate reform, GEMA was obliged to consider the proposals before it. Those proposals contained two options as regards interruptibility: that contained in 116V and that contained in 116A. E.ON's point therefore has no bearing on the decision which GEMA was required to make.

6.85 We accept in principle GEMA's argument that 116V can be expected to deliver efficiency gains through competition for interruptible services and through more efficient investment decisions by NGG as a result. However, the overall efficiency of the interruptibility arrangements under 116V will also depend, at least in part, on the considerations identified by Mr Shuttleworth—namely, that interruptible services allow network usage to be increased in days where there is spare capacity. Given that proposal 116V withdraws the current long-term interruptible product, it may increase charges to certain users who place a low value on interruptible capacity, and so may lead to a reduction in network usage.

6.86 Under 116V, it is apparently envisaged that this issue will be addressed by short-term auctions of interruptible capacity. However, there is an important ambiguity in

GEMA's explanation as to whether short-term auctions will have this effect. GEMA said (in paragraphs 68 and 71 of its Reply):

> *NGG has indicated that the majority of interruptible sites could be provided with their System Offtake Quantity on a firm basis on high demand days. In other words there is no need for them to be interruptible at all …*
>
> *Where interruption is needed due to real capacity constraints on the NTS, NGG will enter into interruption contracts with users. …*

6.87 However, in paragraph 72 of its Reply GEMA said '*those who wish to access the network only at times when this would not cause a cost to be incurred by NGG can continue to do so by purchasing day-ahead interruptible capacity. This is released by NGG (under its incentive scheme) at the day-ahead stage*.'

6.88 It is not therefore entirely clear from the Decision or from the submissions made to us on this appeal whether NGG will be *incentivized* to enter into interruption contracts with users where it has no need to do so. It is also not clear to what extent GEMA had regard to the possible costs to users of using short-term auctions, as opposed to long-term arrangements, to release excess capacity.

6.89 In our view, the Decision ought more clearly to have discussed and explained the factors we have set out in paragraphs 6.85 to 6.88 above. Nevertheless, our view is that the proposed changes to interruptibility under 116V are capable of delivering competition and efficiency benefits relative to the status quo and proposal 116A. To achieve those benefits, GEMA must ensure that appropriate incentives are applied to NGG in relation to the release of interruptible capacity. We have no reason to believe that those incentives will not be applied, although the point is important and warrants emphasis. On that basis, we are not persuaded that GEMA erred in its view that proposal 116V can be expected to deliver competition and efficiency benefits.

Flexibility

6.90 E.ON argued that the decision in relation to flexibility had proceeded on a '*fundamental and mistaken assumption*' that non-discrimination requires all users of the NTS to be afforded the same terms as one another. In fact, applying the test for discrimination set out above, E.ON submitted that shippers and GDNs are not relevantly similar, and that treating relevantly different users in the same way without reason itself amounts to discrimination. E.ON drew attention to a number of differences between shippers and GDNs, as follows:

(a) GDNs must invest in their networks to comply with the 1 in 20 obligation.

(b) GDNs are price-regulated monopoly businesses which can recover the costs they incur through the price review process, including the costs they incur to meet their 1 in 20 obligation.

(c) GDNs will be subjected to incentives in relation to the booking of offtake flexibility capacity in the NTS, which shippers will not. We expand on this point below.

(d) GDNs have their own source of flexibility in GDN diurnal storage.

(e) GDNs and shippers offtake gas from the NTS at different pressures and so receive a different service.

6.91 BGT made further points in a similar vein. BGT said that GDNs and shippers tend to need offtake flexibility at different times—GDNs require high levels of seasonal flexibility whereas gas power stations require high levels of daily flexibility. BGT also said that GDNs can aggregate their flexibility requirements across all customers, whereas TCCs cannot.

6.92 E.ON submitted that GDNs, as regulated businesses, will have a tendency to overbook NTS offtake capacity, and to rely on NTS linepack rather than to invest in their own network. In order to address that tendency, GDNs are subjected to regulatory incentives. However, E.ON submitted that that issue remained notwithstanding 116V—GDNs would be subject to the same incentives under 116V as under the current arrangements. BGT submitted that this illustrated that GDNs and shippers are not relevantly similar, and that GEMA will have to take active steps to try to make them relevantly similar, otherwise they would not be.

6.93 E.ON submitted that in considering what 'relevantly similar' means in this context, it is right to have regard to European law. Under Directive 2003/55 EC (**the Directive**) and the Regulation, non-discriminatory access to monopoly infrastructure is required as a means of creating a competitive internal market for natural gas. The Directive and the Regulation recognize the structural distinction between the competitive parts of the market and the monopoly parts. Accordingly, E.ON submitted that the purpose of non-discrimination obligations in this context is to avoid discrimination between 'competitive market players'. That objective did not support measures designed to eliminate differences in treatment between shippers and GDNs.

6.94 In response to the suggestion that 'relevant similarity' might depend on the costs which a user imposes on the network, E.ON submitted that there was no such similarity in this case because the provision of flexibility does not impose any cost—NGG builds to its 1 in 20 obligation, and the provision of flexibility is a by-product of that.

6.95 E.ON also emphasized that GEMA had made no *finding* of discrimination. E.ON submitted that there is no real risk of discrimination by NGG against GDNs in favour of shippers, or against IDNs in favour of RDNs. Any discrimination of either sort would breach NGG's statutory and licence obligations. Further, E.ON submitted that any risk of discrimination against IDNs in favour of RDNs, if there is any such risk, does not in any event justify changes to the arrangements for shippers.

6.96 E.ON further submitted that 116V creates the risk of discrimination in at least two ways. First, it creates the risk of discrimination between generators connected to the NTS and those connected to the GDNs. Secondly, it creates the risk of discrimination in the allocation of flexibility to geographic zones.

6.97 E.ON and BGT placed significant weight on the fact, accepted by GEMA, that there is no current shortage of flexibility. BGT submitted that any potential for discrimination would only become a reality if flexibility capacity ever became scarce, whereas flexibility is currently abundant.

6.98 BGT submitted that there is neither a current shortage of flexibility, nor any evidence of a likelihood of a shortage in the future. The highest GEMA can put its case is that things may unexpectedly change, but that does not justify the words 'real risk', 'significant uncertainties' or the implication that a problem is likely to arise in the foreseeable future. Relying on the same reasons, E.ON submitted that GEMA had failed to demonstrate that action now was proportionate, and being taken 'only where it was necessary', consistently with GEMA's statutory duties as to better regulation.

6.99 BGT submitted that the flexibility product would in fact create an artificial scarcity of flexibility. Users would not be able to forecast the amount of flexibility required four years ahead. As a result, users would seek to 'bank' flexibility capacity without certainty that the capacity would be needed. This would be the result of an artificial situation rather than genuine scarcity.

6.100 E.ON also submitted that the discrimination aspect of the Decision on flexibility was evidently based on two errors of fact. First, the misconception that, as matters stand, GDNs purchase NTS flexibility, rather than simply book it. E.ON said that this mistake became apparent from GEMA's Reply and Mr Gray's witness statement, and subsequently from 'briefing documents' disclosed by GEMA during the course of this appeal on the basis of which GEMA reached the Decision. E.ON also pointed out that similar language was used at one point in the Decision. Secondly, TCCs are subject to no restrictions in their ability to vary the rate of NTS offtake flow, which error was said to have been evident from GEMA's Reply.

6.101 Turning to the competition benefits relied on by GEMA, E.ON's submissions were similar to those made in relation to interruptibility (paragraph 6.59 above). E.ON said that there is no shortage of flexibility at present, and so no need to ration access by auction. E.ON also submitted that auctions will not be not useful because there is only one user at many points, and so the price will depend on the reserve price.

6.102 E.ON submitted that the Decision in fact recognized that the flexibility product would have *adverse* effects on competition because of an increase in complexity, so raising barriers to entry. However, E.ON said that this point had been given no weight by GEMA as a qualitative cost of the Decision.

6.103 As to investment signals, E.ON submitted that NGG will obtain no useful investment signals from the reform because it builds to its 1 in 20 obligation—it does not build for flexibility. BGT submitted that this was confirmed by NGG's response to questions from the CC (set out below). BGT further submitted that the flexibility product will have no value, and so will provide no useful investment signals, until there is scarcity, which at present there is not.

6.104 Finally, E.ON submitted that flexibility was not in fact a real product, because it was not related to any real assets or their characteristics. We had some difficulty in understanding this argument. In principle, we regard the right to vary offtake capacity as capable of forming the basis of a commercial product. We do not therefore consider this argument further.

6.105 GEMA said that the flexibility product had been introduced for GDNs on the sale of the IDNs because of a concern that there was not sufficient flexibility capacity in the NTS to allow GDNs an unrestricted right to vary offtake throughout the day. However, the current arrangements, whereby GDNs and shippers are subject to different arrangements, were recognized to be imperfect, and further measures had always been considered necessary.

6.106 On the question of discrimination, GEMA submitted that GDNs and shippers are 'relevantly similar' for present purposes, because they make identical demands on the NTS for offtake capacity, and both make varying demands across the gas day. GEMA said, adopting the language of Article 4(1)(a) of the Regulation, that what matters is whether the users are receiving the '*same service*'. The fact that other differences exist between shippers and GDNs does not affect the discrimination analysis.

6.107 GEMA said that this is apparent because the GDNs effectively act as shippers in relation to the gas transported through their networks. GEMA said that GDNs obtain offtake capacity which is actually used by shippers using their networks. GDNs aggregate together the total demands of users of their networks and obtain the necessary amount of NTS offtake capacity. This 'shipper' role is apparent from the fact that GDNs are granted an exemption from the need to obtain a shipper's licence to carry it out. Likewise, GEMA said that GDNs are in materially the same position as a TCC shipper in their relation to commercial users and power stations connected to their networks.

6.108 GEMA rejected the factors relied on by E.ON as demonstrating relevant differences between shippers and GDNs, and said that the mechanism by which costs are recovered is not material. In fact, although GDNs are price regulated, they are subject to incentives and trade-offs similar to those faced in a market. GDNs cannot therefore pay whatever they like and pass on the costs to customers. GEMA also disputed that any difference arose because GDNs have their own flexibility. GEMA made the point that a TCC may also have alternative sources of fuel available, and so may be able to vary its offtake demand accordingly.

6.109 GEMA said that it recognized in the Decision that there is currently no shortage of offtake flexibility. However, GEMA submitted that a regulator has to look forwards as well as backwards. GEMA said that 116V will be in place for several years, and so it is appropriate for it to be 'future proofed' against a very realistic possibility of future scarcity.

6.110 GEMA said that as the Decision recognized, there is significant uncertainty relating to the risk of future constraints, in particular following the GDN sales. It said that it is not in a position definitively to say what might drive changes in demand for flexibility. However, it rejected any suggestion that it is fanciful to believe that constraints on flexibility will arise in the future. It described the issue as a 'time bomb', and highlighted a number of factors which it said were material to the risk of scarcity of flexibility.

6.111 First, GEMA drew attention (as it did in the Decision) to the high commercial value of city-centre sites on which gas holders are built. GEMA said that GDNs might seek to sell those sites, and so rely to a greater extent on NTS linepack for flexibility. It said that the volume of diurnal storage available to GDNs is very large, and a shift away from the use of such holders could have a significant impact on the demand for of NTS flexibility.

6.112 In his evidence, Mr Gray drew attention to a number of other factors which GEMA said represented the sorts of factors which GEMA took into account. In his evidence, Mr Gray said:

> *The Authority's concerns about the risk of flexibility constraints arising need to be understood in the context of historical difficulties with predicting constraints in the gas and electricity market in a period of changing supply and demand patterns. The constraints on gas entry at St Fergus through 1998 and 1999 had not been foreseen by Transco. In the electricity market there is currently a substantial queue for connection to the GB electricity transmission system which had not been foreseen before the introduction of the Renewable Obligation Order. There is therefore no guarantee that there would be sufficient warning that flexibility constraints would arise to allow market mechanisms to be introduced in advance in order to allocate efficiently the scarce capacity. Indeed, if anything the level of uncertainty appears set to increase given*

the large potential changes to flows across the NTS over the coming years as North Sea gas supplies deplete and GB becomes more dependent on imports of gas via interconnectors and LNG shipments.

6.113 In its submissions at our final hearing, GEMA also drew attention to two further such factors. The first was changes in electricity generation mix. GEMA said that some nuclear power stations will probably be retired over the next decade, and that there is a reasonable prospect of a reduction in coal=fired generation as a result of environmental legislation. Further, intermittent generation from renewable sources is likely to become more prevalent. When these factors are combined with an increase in demand for electricity, GEMA said that any supply-demand deficit is likely to be made up primarily from gas-fired plant, which will be required to operate more flexibly to meet peaks and troughs in demand and the peaks and troughs in production from renewables.

6.114 Secondly, in its submissions to us, GEMA pointed out that GDNs are currently subject to incentives which deter them from booking flexibility above certain targets set by GEMA. Without these constraining incentives, it is unclear what the extent of GDN demand for flexibility would be, but it could be expected that the overall price of flexibility would be positive.

6.115 GEMA argued that it was appropriate for it to direct the implementation of a modification proposal which would pre-empt and prevent any discrimination by NGG, rather than to rely on its power to take enforcement action after the event should NGG breach its licence and statutory obligations.

6.116 GEMA said that 116V would create competition for offtake flexibility capacity, so that it would be allocated to the party that values it most. GEMA submitted that the efficient allocation of flexibility should benefit consumers by ensuring the most efficient use of network and storage resources. The identification of these competition benefits did not depend on a separate competition impact assessment. GEMA nevertheless accepted that it was right to see the competition benefit as closely associated with that of non-discrimination.

6.117 GEMA reiterated its view, expressed in the Decision, that auctions would release information as to the value of flexibility. A GDN would therefore know, for example, whether it is more efficient to sell a gas-holder site and to rely on NTS flexibility, or to invest in its own system. TCCs would also know whether it is more efficient to use NTS flexibility or to rely on the available alternatives. However, GEMA said that it was only by holding the auctions four years in advance that the information released could affect investment decisions for the future. GEMA did not rely to the same extent on investment signals in relation to the NTS, but recognized the possibility that auctions for flexibility may reveal capacity constraints to NGG.

6.118 GEMA rejected the argument that auctions for flexibility will not identify market value for flexibility because of the constraints on GDNs. GEMA said that it is up to GDNs to decide how much flexibility capacity they need and how they should obtain it. GEMA said that GDNs will presumably pay for flexibility up to the point when it becomes cheaper to purchase or invest in other forms of diurnal storage. GEMA submitted that it is appropriate for an economic commodity in short supply to be priced according to demand, whether or not there is a specific cost of providing it.

6.119 In relation to the two alleged errors of fact, GEMA said that the first error had not been made, and represented no more than the loose use of language. GEMA said that it was evident from the Decision that GEMA understood that GDNs book, not purchase, flexibility capacity. GEMA also said that the incentive system applied to

GDNs meant that GDNs did in fact pay for bookings over target. Likewise, the second error had not been made, and was no more than a matter of drafting.

6.120 Finally, GEMA denied that the reform will create an artificial scarcity for three reasons: first, because NGG will be incentivized to release the maximum flexibility; secondly, because the arrangements provide for the trading of flexibility; and thirdly, because NGG has proposed that flexibility should be offered at zero reserve price.

6.121 In response to our questions on this subject, NGG said that it incurs operational costs of approximately £9 million a year in providing flexibility. We also asked NGG whether the flexibility product would affect the likelihood that it would have to undertake gas balancing actions to manage within day flow variations, one of the factors relied on by GEMA in the Decision. NGG said:

> *Gas Balancing actions are primarily dictated by User behaviour based on their supplies to and demands from the NTS. Currently almost all of NGG's balancing actions are driven by end of day supply/demand considerations and not by within day flow variations. Any change to this situation will depend on the extent to which system user behaviour changes, post 2011, with regard to the pattern of offtake and the extent to which future changes occur to the pattern/reliability and market responsiveness of inputs as the UK becomes more import dependent. Therefore whilst Mod 0116V might be a contributory factor to any changed behaviour post 2011, it may not be the only factor or even the most significant factor.*

6.122 We also asked NGG whether the flexibility product would affect investment decisions in relation to the NTS and/or the GDNs. It said:

> *National Grid Gas is not funded through its price control for incremental flexibility capacity. The probability that not all capacity will be utilised at the same time contributes to the existence of a latent flexibility capability. It is this latent flexibility capability that has been identified and will be offered in the proposed auctions (actual national quantity to be offered is 22 mcmd). The auction process is designed to efficiently allocate the finite quantity of flexibility capacity. The auction output will inform NGG of how much, and where, the available 22 mcmd of flexibility capacity is required. However, the flexibility capacity auction is not intended to provide NGG with investment signals or to provide funding for consideration of this type of system expansion.*
>
> *The auction process will provide GDNs with an indication of the price and availability of flexibility capacity from NGG. Over time they can compare this information with the costs of providing alternative (flexibility) investments from within their own networks so that efficient solutions are arrived at. The alternatives that can be sourced from within a GDN network include building diurnal storage pipelines and other storage facilities.*

6.123 As a starting point, we understood GEMA to accept that any benefits of the flexibility product in eliminating potential discrimination between IDNs and RDNs could not, in principle, justify the application of the flexibility product to shippers. The point is only relevant for our purposes to the extent that it formed part of the benefits relied on by GEMA in the CBA, and we discuss the point in that context.

6.124 We accept GEMA's submission that, in principle, shippers and GDNs are relevantly similar for the purposes of offtake capacity, because their needs for offtake capacity place the same demands on—ie impose the same costs on—the system. In our view, E.ON's argument that GEMA made an '*assumption'* that all users should be treated in the same way does not properly reflect the terms of the Decision. It is evident from the Decision that GEMA had regard, in our view rightly, to the costs which each user imposed on the system (see paragraph 3.9 above).

6.125 We do not accept the submission made by BGT that the parties are not in fact relevantly similar because the proposed reform relies on the existence of regulatory incentives on GDNs. However, the need for such incentives is relevant to the extent of the benefits which may be derived from the proposed reform, as we discuss below.

6.126 We recognize that, as E.ON submitted, European legislation has used the principle of non-discrimination as a means of creating a competitive market for natural gas. However, it does not follow that non-discrimination is only to be ensured (whether under European law, or more generally) as between parties which compete head to head in the same market. For example, competition in downstream markets may be adversely affected by discrimination between shippers and GDNs. As GEMA submitted, Article 4(1)(a) of the Regulation requires parties to be offered equivalent terms and conditions for the '*same service*'.

6.127 In relation to the first alleged error of fact identified by E.ON, it is regrettable that an error was made both in Mr Gray's statement, and in briefing documents provided to members of the Authority. However, we were not satisfied that this mistake did in fact demonstrate any significant misunderstanding on the part of Ofgem or GEMA, given, for example, that the Decision also uses the language of booking. We also were not persuaded that any error was material to the Decision in any way, in the sense that GEMA would have reached a different view on any of the issues it decided had it not made the error. As to the second alleged error of fact, in relation to the current restrictions on TCC offtake flexibility, it seemed to us more obvious that this error was not material to the Decision.

6.128 We accept GEMA's submission that it may be appropriate for a regulator to take pre-emptive action to address a perceived potential problem, rather than to wait for the problem to materialize in practice. Therefore, we do not regard the question of whether GEMA made an actual finding of existing discrimination in the Decision as crucial.

6.129 However, the non-discrimination benefit of the flexibility product was described in the Decision as a reduction '*in the* potential *for undue discrimination*' (our emphasis). In making oral submissions at our clarification hearing, GEMA said that this language, and the reference to uncertainties relating principally to the risk of constraints, indicate that '*if and when*' the moment comes when the constraints lock in, there will be discrimination, although that was not the case at the time of the Decision. We agree with this reading of the Decision. The benefits of non-discrimination in the allocation of flexibility will not accrue to consumers unless and until there is a scarcity of flexibility.

6.130 Likewise, the other key benefits of the flexibility product relied upon by GEMA, namely competition and the provision of investment signals, will only deliver benefits to consumers if flexibility becomes scarce (or where the auction is being conducted in advance, if flexibility is expected to become scarce over the relevant period). Until a scarcity of flexibility occurs or is expected, a market for the flexibility product will not reveal the value of flexibility capacity, and so will not deliver efficiency savings to

customers. For the same reason, auctions of flexibility will not provide GDNs with information which may influence their investment decisions until there is a scarcity.

6.131 In the Decision, GEMA identified a '*risk*' or a '*potential risk*' of future scarcity. That risk was said to be subject to '*considerable uncertainties*' and, in a different passage, '*significant uncertainty*'. GEMA said that although there is currently sufficient flexibility, that '*may not necessarily be the case in the future*'. Having regard to these various passages, GEMA clearly regarded the risk as worth acting upon. However, beyond that, the extent of the risk of future scarcity was not assessed or quantified by GEMA.

6.132 At the clarification hearing GEMA characterized the risk of future scarcity as a *'time bomb'*. However, as GEMA acknowledged elsewhere in its submissions, there is no guarantee that scarcity will in fact occur in the future. It is therefore possible, as GEMA recognized, that the industry will incur the transaction costs associated with the flexibility product but that the benefits identified in the decision will not in fact accrue to consumers.

6.133 We do not think it is possible to say that GEMA was wrong as a matter of fact to identify a risk of future scarcity of flexibility. However, although it is surely right that a regulator may in an appropriate case take prophylactic action to address a potential problem of discrimination, whether it should do so, and whether the reform can be said to benefit consumers, will inevitably depend on the extent of the apprehended risk. By extent of the risk, we mean the likelihood of the risk materializing, the timescale within which it might materialize and the magnitude of the consequences should it materialize.

6.134 In our view, the points made by GEMA in the Decision, and the additional points it made on this appeal, do not adequately explain why GEMA regards the risk of future scarcity, and therefore the risk of future discrimination, as sufficient to support the conclusion that there are benefits to consumers from action now, given the current excess of flexibility capacity. In so far as the proposed modification is intended to address a potential problem, rather than an existing problem, GEMA ought to have included within the Decision a clearer description of the extent of the risk, and the factors affecting supply and demand for flexibility capacity that are relevant to GEMA's assessment of that risk. The risk need not necessarily have been quantified, but it should have been described and supported, where possible, by reference to evidence and examples.

6.135 We were not persuaded by the additional factors highlighted by GEMA on this appeal (and which were not referred to in the Decision) that the risk is sufficiently real to support the conclusion that there are benefits to consumers from action now. Whether those factors are or are not likely to lead to an increase in demand for flexibility, and if so to what extent, remains unclear to us. Indeed, GEMA accepted that one of those factors, changes to gas flows across the NTS, could in principle lead to an *increase* in flexibility capacity. On the appeal, GEMA also accepted that flexibility capacity could be increased above current levels because NGG will be subjected to incentives to make the maximum flexibility capacity available. In any event, the absence of any discussion of, or reference to, these additional factors in the Decision supports our view that the Decision was not based on a sufficiently clear analysis of the extent of the risk of future scarcity.

6.136 If scarcity of flexibility does occur in future, there is a further question as to what benefits will in fact accrue to consumers from 116V. We accept in principle GEMA's argument that non-discriminatory access to monopoly infrastructure may be expected to lead to effective competition, and so to deliver efficiency savings and benefits to

consumers. However, the nature and extent of the benefits which may be expected as a result of further reform based on this model will, in our view, depend on the particular context in which the reform is implemented.

6.137 We do not consider it necessary for GEMA to carry out a formal competition impact assessment as some government departments, less expert in matters of competition, may need to. Nevertheless, the Decision contains limited explanation of the nature or extent of the consumer benefits which competition may deliver. For example, the Decision does not discuss how the proposal might impact upon downstream markets, other than one example described in paragraph 3.12 above, nor does it consider the extent of the benefits by reference to the potential value of the market.

6.138 This point is particularly important in the present case because competition for flexibility under 116V will occur between one price-regulated party which is subject to incentives and one party which competes in an unregulated market. In our view, this factor can be expected to affect the nature and, possibly, the extent of the competition benefits of reform. This makes it particularly important that GEMA should explain the nature of the competition benefits, rather than rely predominantly on the relevant principles.

6.139 Given that we reached these views in relation to flexibility, we did not find it necessary to reach a conclusion in relation to BGT's argument that the reform would generate an artificial scarcity.

6.140 We stress that our conclusions in this decision are concerned with the justification and explanation provided by GEMA in the Decision and elaborated upon in this appeal. Our view is that those reasons do not adequately support the conclusion that the product will, or is sufficiently likely to, deliver benefits to consumers if adopted now. We do not conclude here or elsewhere in this decision that GEMA could not properly reach that conclusion at the present time, for example on the basis of further evidence and analysis.

Cost-benefit analysis

6.141 E.ON submitted that, as the cost-benefit analysis in the Decision was negative, 116V was inefficient. E.ON further submitted that GEMA had (1) wrongly omitted transporters' upfront costs from the quantified costs and (2) wrongly omitted 'the Irish costs'. In relation to the former, E.ON relied on the Treasury Green Book. In relation to the latter, E.ON submitted that GEMA had erred in law if it believed it was not entitled to take the costs into account. Under principles of European law, GA86 should be construed consistently with all relevant EU obligations. Having regard to the EU single gas market, GEMA's duty to consumers should not be limited to consumers in Great Britain, and the costs should also be included as a matter of economics.

6.142 E.ON submitted that the quantified benefits were speculative and not benefits at all. Thus, E.ON submitted that efficient investment signals could not be expected to deliver a benefit, and that the figure of £42.3 million is speculative and implausible. E.ON made similar submissions in relation to the elimination of discrimination between IDNs and RDNs. In relation to the costs of ARCA disputes, E.ON said that such disputes were rare, and that recent cases had provided guidance to parties, making future disputes less likely. No saving of these costs could be expected.

6.143 On the overall question of quantification, E.ON submitted that the net cost of £28 million of 116V identified by GEMA in the Decision should in fact be treated as a net cost of £120 million, because relevant costs had been omitted or understated and

benefits had been wrongly included or overstated. It criticized GEMA for seeking to massage the costs figures down in the Decision—for example, in relation to shippers' costs.

6.144 E.ON also submitted that the qualitative benefits cannot reasonably be considered to be capable of outweighing the quantified negative CBA value of up to £28 million. It relied on its submissions in relation to the discrimination and competition issues, set out above.

6.145 E.ON criticized the CBA for 'double counting'. It said that the approach taken to the CBA made an 'audit' of the Decision difficult. However, GEMA was said to have double counted the overlapping benefits of competition and non-discrimination. E.ON said that in the Decision, GEMA had only taken account of these two benefits as against the quantified costs. However, to the extent that GEMA relied on the additional qualitative benefits identified in the FIA, there was double counting as between those qualitative benefits and certain quantitative benefits—for example, efficient network development and system operation and security of supply both overlapped with the investment signals benefit.

6.146 Both E.ON and BGT drew attention to the fact that proposal 116CVV had a positive quantified CBA. It was possible to derive, from a comparison between CVV and V, the conclusion that on GEMA's own analysis, the flexibility product alone had a negative quantified CBA of some £45 million.

6.147 E.ON also drew attention to matters which had not been considered in the CBA—such as the costs of changes in behaviour following the introduction of flexibility and the benefit of regulatory certainty associated with 116A.

6.148 E.ON contended that it was appropriate, given the relevant provisions of EA04, for the CC to review GEMA's treatment of economic information and concepts, and to review the evidence relied on by GEMA. In this regard, E.ON drew on the approach of the ECJ to the review of European Commission merger decisions under the principles established in *Commission v Tetra Laval*, Case C-12/03 P.

6.149 BGT submitted that the purpose of a CBA was, in short, to identify if money spent would be wasted. It submitted that in the absence of a real prospect of scarcity of flexibility, the net costs of the flexibility product (£45 million or more) would be wasted, and that would not be efficient.

6.150 GEMA's position in relation to the CBA was broadly as summarized in paragraphs 4.14 to 4.16 above. It accepted that the creation of markets has transaction costs, but it had decided that the transaction costs in the present case were not on a scale to suggest that it should not follow principles which could be expected, based on long experience, to deliver benefits. It said that a CBA is only one of the tools the regulator uses to make its decision, and emphasized the importance of judgement and experience in the taking of a decision 'in the round'.

6.151 In relation to upfront transporters' costs, GEMA submitted that there had been an acceptance by those involved in the GDN sales that those costs would not be passed on to consumers, and they had therefore been reflected in the price paid for the shares. The reforms were intended to deliver benefits to consumers, consistently with GEMA's principal objective. Accordingly, GEMA had given little *weight* to the costs in the FIA, adopting a consumer-oriented approach, and that was a matter within its discretion.

6.152 In relation to double counting, GEMA submitted that it was not possible to separate out with surgical accuracy the quantified benefits from the qualitative benefits. GEMA also submitted that there was no evidence that GEMA had been misled into its decision by overlaps between quantified and qualitative benefits. In any apparent area of overlap between the two in the discussion of qualitative benefits in the FIA, GEMA was simply picking out benefits which had not been captured within the quantitative analysis.

6.153 GEMA said that, consistently with the objectives of the UNC and its various statutory objectives, it would only direct the implementation of a proposal if it was satisfied that it had net benefits. Given that proposal 116CVV was the same as 116V but for flexibility, GEMA accepted that the qualitative benefits of flexibility had effectively been treated as exceeding £45 million. GEMA said that the decision between proposals 116V and 116CVV had been a fairly close call, but that GEMA had been clear in its preference for proposal 116V.

6.154 Before setting out our conclusions on the detail of these submissions, we wish to make three general points in relation to E.ON's appeal on the cost-benefit analysis, which may have some application to subsequent appeals on the type of issues we consider under this heading.

6.155 First, on an appeal under EA04, the CC will of course consider whether the reform can be expected to deliver the benefits which have been identified. However, in so far as costs and benefits turn on findings of fact, the observations in paragraphs 5.15 to 5.17 above apply. An example in the context of this appeal is that of ARCA dispute costs. We see that E.ON takes a different view from GEMA on this question. But in our view, the points made by E.ON fell far short of demonstrating that GEMA made a mistaken finding of fact that such costs may be avoided.

6.156 Secondly, we accept GEMA's submission that a code modification appeal should not be regarded as an opportunity for rival parties to debate exactly what value should be ascribed to particular items within a quantitative assessment of the costs and benefits of a proposal. Cost-benefit analysis involves a degree of judgement and discretion. Unless the regulator has erred in logic or principle in quantifying a benefit, the CC will be slow to overturn the regulator's quantification of that cost or benefit.

6.157 Thirdly, we accept GEMA's submission that benefits need not be quantified in order for them to be reflected in a CBA, and that non-quantified benefits may be as important, or more important, than quantified benefits. However, if a CBA is to be transparent, benefits should be quantified where possible. For the same reason, qualitative benefits should be explained clearly and in detail, so that it can fairly be seen whether there is any potential overlap between the qualitative and quantitative benefits.

6.158 Turning to the remaining points made by E.ON, for the reasons set out above, we are not persuaded that proposal 116V will not deliver improved investment signals, both in relation to user commitment and interruptibility. E.ON fell short of persuading us to re-evaluate the value put upon that benefit by GEMA.

6.159 In relation to Irish costs, we reject E.ON's submission that GEMA erred in law in relation to these costs. GEMA took, as we see it, a pragmatic and reasonable decision to focus on Great Britain, which is the main object of its responsibilities. We do not accept that European law requires GEMA to approach the matter in the way suggested by E.ON. E.ON made no persuasive case that the existence of a single market for natural gas under EU law has a direct bearing on the meaning of 'consumer' in GA86. Whilst there may be economic arguments in favour of a different

approach to this question, we consider that GEMA acted within its discretion in taking the approach that it did.

6.160 On a related issue, E.ON (rightly in our view) did not pursue the question of whether a single purchaser at Moffat would infringe competition law, on which we heard no substantive argument.

6.161 We have found the question of upfront transporters' costs more problematic. On the face of it, the upfront transporters' costs are costs of reform which ought to have been reflected in the CBA. It may in certain circumstances be open to a regulator to weight costs and benefits when carrying out a cost-benefit analysis, and we understand that GEMA, given its role and its duties, may wish to weight costs and benefits according to whether they affect consumers. However, we are concerned that GEMA's approach was not *consistent* across all of the costs it considered. In our view, if costs are to be weighted in a CBA, that should be made clear upfront and applied generally, rather than addressed only in relation to one specific item. Further, we do not understand why, in the FIA, the costs would only be given little weight as long as they were not '*manifestly disproportionate*'. It seems to us that if costs are for principled reasons to be given little weight, the magnitude of the costs should not affect the weight which they are given. For these reasons, our view is that GEMA erred in its approach to the transporters' costs because it failed to set out a principled and consistent basis for excluding those costs from the CBA.

6.162 We also have some difficulty with the approach which GEMA took to the issue of discrimination between IDNs and RDNs. We accept, as in relation to flexibility, that it may be acceptable for a regulator to take steps in advance of actual discrimination taking place, and to have regard to the consequent benefits in a CBA. However, as in relation to flexibility, there is no discussion of the extent of the risk of discrimination under this head. Further, in the Decision, this item is identified as an *incremental* benefit over the current booking and incentive arrangements (see paragraph 3.10 above). In our view, it is implicit in this that the existing arrangements go some way to ensure that there is no discrimination between RDNs and IDNs. In submissions made at our final hearing, GEMA submitted that 116V offers benefits by rendering the treatment of IDNs and RDNs more transparent. However, it is far from clear that, as a matter of principle, the benefit has been quantified in a way that reflects the nature and extent of the benefit. Nevertheless, given our findings below, we have not found it necessary to reach a conclusion as to whether GEMA erred on this point.

6.163 In relation to interruptibility, we have set out our view that the material contained in the Decision, and the submissions made to us on this appeal, do not adequately support a conclusion that the existing arrangements are in fact discriminatory, or potentially discriminatory. It follows that, in our view, GEMA ought not to have attached significant weight in the Decision to the benefits of non-discrimination in relation to interruptibility. It is not clear from the Decision whether this qualitative benefit was given significant weight in GEMA's overall analysis of proposal 116V, and we discuss this point further below.

6.164 In our view, the most significant flaw in GEMA's cost-benefit analysis follows from the points we have already made in relation to the flexibility product. In our view, the Decision contained insufficient material to support the conclusion that the flexibility product will, or is sufficiently likely to, deliver benefits to consumers, and insufficient explanation of the nature and extent of the benefits to be expected. This of itself means that the net benefit conclusion reached by GEMA in relation to 116V is, in our view, not adequately supported by the material set out in the Decision, or by the arguments advanced by GEMA on this appeal.

6.165 In our view, this conclusion is reinforced by the way in which GEMA treated qualitative benefits in the Decision more generally. The following key passage is worth repeating:

> *… the Authority considers that unless the quantitative analysis indicates that the net costs would be disproportionately high, then it should proceed on the basis that the* ***principles*** *of non-discriminatory access and the promotion of competition … should prevail …*

6.166 In our view it is unsatisfactory to refer to non-discrimination and competition as '*principles*' which should '*prevail*' in the context of a CBA. We accept of course that non-discrimination and competition are principles of regulation, and that they are principles to which GEMA must have regard in considering proposals for code reform, given its statutory obligations and the relevant objectives. However, the balancing of qualitative benefits against quantified costs is a conceptually difficult process. In order to explain why the regulator has reached the conclusion that there are, on balance, net benefits, any qualitative benefits which are claimed from the principles should be explained and substantiated as fully as possible. The regulator should set out a clear and cogent explanation from the relevant principle to the benefit identified. If different weights are attached to different qualitative benefits, that too should be explained. In our view, GEMA did not approach the qualitative benefits of 116V with proper regard to these considerations, particularly in relation to the proposed flexibility product.

6.167 There are three further particular aspects of the CBA which we feel merit comment, although we do not base our decision upon them.

6.168 First, the relationship between the 'principles' of non-discrimination and competition was an issue which was explored in some detail on this appeal. We are not satisfied that GEMA did, in its own thinking, 'double count' as between these benefits. However, we consider that the language of the Decision, in presenting the two as separate principles, further contributed to the lack of clarity and adequate explanation which we have identified above.

6.169 Secondly, GEMA explained at our final hearing that when it used the words '*disproportionately high*' in the passage set out above, it simply meant '*unless the costs exceed the benefits*'. However, that is not what the Decision says and GEMA itself accepted at our final hearing that *'disproportionately high'* is not the right test. In our view, it is important that a CBA should express the correct criterion for the relationship between cost and benefit.

6.170 Thirdly, in the Decision, GEMA reached an estimate of the quantified costs of reform, albeit an estimate which it regarded as uncertain and in some respects pessimistic. However, in resolving the question of whether the net costs were *'disproportionately high'* GEMA stated that while its estimate was *'plausible'* there were other *'plausible'* outcomes, including outcomes in which 116V had net benefits. GEMA took these other outcomes into account in concluding that the costs of reform were not disproportionately high. However, GEMA told us on this appeal that it did accept that 116V had net quantified costs.

6.171 We do of course recognize that quantified estimates of costs and benefits are subject to a margin of error, and that at times that margin will be significant. However, different uncertainties can be reflected in a CBA in many ways. Our view is that the identification and application of any margin of error should be principled and should be clearly explained. The approach taken by GEMA, as described in the previous paragraph, did not in our view meet these standards.

E.ON's procedural case

6.172 In addition to the substantive issues set out above, E.ON argued strongly that the Decision should be quashed on procedural grounds. It advanced three main arguments, relying in particular on the evidence of Mr Peter Bolitho, the Trading Arrangements Manager for E.ON.

6.173 First, E.ON alleged a failure to consult, in breach of section 5A of UA00, and contrary to guidance on impact assessments in the Treasury Green Book and OFT Guidelines. E.ON alleged that GEMA had failed to provide consultees with proper and adequate information to enable them to make informed responses. In particular, E.ON alleged that the FIA had not considered the different aspects of the proposed reform separately, but had rather bundled them together.

6.174 Secondly, E.ON argued that, in breach of sections 4AA(5) and 4A of GA86, GEMA took the Decision without having consulted the HSC or received advice from the HSC in relation to the safety risks of the proposals, and without necessary changes to the safety cases having been made. E.ON submitted that this point was a further illustration of the next point (prejudgement).

6.175 Thirdly, E.ON submitted that the entire history of 116V demonstrates that GEMA had prejudged the modification, in breach of public law and in breach of its consultation duties. GEMA was said not to have kept an open mind in relation to the proposals. E.ON relied in particular on (1) the fact that offtake reform had been tied to GDN sales, and the use of 'best endeavours' licence obligations to prevent industry parties from putting forward their own views and (2) the use of sunset clauses to force industry parties to bring forward proposals.

6.176 E.ON said that the process adopted by GEMA was plainly unorthodox, given that GEMA expressly does not have the power to bring forward modification proposals itself. E.ON directed us to a number of authorities, including *R v Teeside Development Corp ex parte Morrisons Supermarkets* (16 May 1997 Sedley J), for authority that a decision-maker must make a balanced appraisal, and not weight a decision towards justifying one side's case.

6.177 E.ON also argued that the approach taken by GEMA, and in particular the use of sunset clauses, was not best regulatory practice, as it undermined the industry self-governance framework for the UNC. E.ON drew our attention to comments made by Professor Yarrow in evidence to the House of Commons Select Committee on Regulation in which he set out a number of common criticisms of regulatory impact assessments, and which E.ON said applied squarely to 116V.

6.178 E.ON submitted that GEMA was under an obligation to provide a reasoned decision, and that it could not therefore rely on reasons which were outside the decision, relying on *R v Westminster City Council ex parte Ermakov* [1996] All ER 302.

6.179 GEMA's submissions in relation to its role as regulator are summarized in paragraph 4.11 above. It submitted that the mechanism for modifying the UNC represents 'co-regulation' by GEMA and the industry, rather than 'industry self-governance' as submitted by E.ON.

6.180 GEMA did not accept that it had to 'sit on its hands' until a concern was raised by the industry. Rather GEMA said that it has a principal objective of protecting the interests of consumers wherever appropriate by *promoting* competition, and also a duty to carry out its functions in such a way as to *promote* efficiency and economy. GEMA is not simply an adjudicator, but has an agenda placed upon it by Parliament. It cannot

but develop opinions on how best to deliver its statutory obligations, and those opinions will affect its consideration of modification proposals as they come forward.

6.181 GEMA said that its position was supported by the decision of the Court of Appeal in *Windsor v Bloom* [2002] 1 WLR 3002 where Lord Woolf CJ said at paragraph 31:

> *To my mind, the fact that the Rail Regulator in determining an application has to take into account section 4 considerations which may be of little or no concern to the parties is wholly inconsistent with his role being likened to that of a judge or arbitrator.*

6.182 GEMA submitted that its objectivity is ensured by the statute and independence of its members, by the elaborate statutory framework in which it operates, and by the mechanism of an appeal to the CC. It submitted that the 'co-regulation' structure under SSC A11 is tested to its limits if GEMA is perceived as the effective progenitor of a modification, but the limits had not been exceeded in the present case. The high watermark of E.ON's case, the best endeavours obligation placed on the transporters, was used as a highly exceptional course because offtake reform was a necessary condition for the DN sales. But GEMA did not dictate the terms of the proposal, and in any event withdrew the obligation before it became effective. Further, the final modification did not reflect GEMA's initial preferences, and changes were made to accommodate the preferences of industry parties.

6.183 GEMA said that the allegation of prejudgement could not be sustained given that GEMA's own documents demonstrated that the Executive's recommendation to members had been finely balanced, and reflected a division of opinion. GEMA also said that there had been almost endless consultation on the proposals, and submitted that in any event, the CC should not find that the consultation was flawed unless there was something '*clearly and radically wrong*' with the process: see *R (Greenpeace) v Secretary of State for Trade and Industry* 2007 EWHC 311 at paragraph 63.

6.184 In relation to reasons, GEMA submitted that the question was whether all of the material before the court supported the decision, not just the material in the decision document: see *OFT v IBA Health Ltd* [2004] 4 All ER 1103.

6.185 On this last question of the duty to give reasons, we have not found it necessary to determine whether E.ON's submission or GEMA's submission is to be preferred, given our substantive findings set out above.

6.186 We do not accept that GEMA failed properly to consult in relation to 116V. We were not assisted by the case of *Berkeley v Secretary of State for the Environment* [2001] 2 AC 603 HL, to which E.ON referred us, which was a case in which no impact assessment at all had been carried out. It is clear that E.ON took exception to the way in which the proposals were discussed and analysed by GEMA in the FIA. However, we heard nothing to suggest that E.ON was prejudiced in its efforts to comment on and respond to the FIA by the format or content of that document.

6.187 We agree with E.ON that the FIA, and the Decision, would both have been clearer had they set out the costs and benefits associated with different aspects of proposal 116V, as well as the overall CBA. That would have made clear, for example, which elements of the proposal had quantified net costs and which elements had quantified net benefits. However, E.ON did not explain how the alleged failure by GEMA to break the different aspects of the proposal down was said to have inhibited its ability to respond. On the contrary, E.ON continued to rely on this appeal on arguments

which it made to GEMA in response to the FIA. In our view, GEMA fully complied with its duty under section 5A UA00.

6.188 In our view, industry parties have been given exhaustive opportunity to comment on the issues of offtake reform over the period since 1999, and particularly since 2005. The fact that industry parties may object to the content and presentation of a consultation paper does not mean that a proper consultation has not taken place. We have already set out our view that GEMA was not under an obligation to publish a separate competition impact assessment. Further, as we understand it, E.ON's arguments in relation to the Treasury Green Book did not add to the arguments we have already considered in the context of the CBA above.

6.189 We also do not accept that GEMA's approach to the question of health and safety can be criticized. It is clear from the Decision itself that, although the relevant health and safety issues have not yet been addressed, GEMA has every intention of ensuring that they are addressed before the modification is implemented. In our view, the relevant health and safety issues can sensibly be separated from the issues which GEMA addressed in the Decision. In the event that health and safety issues present an obstacle to reform, we have no doubt that GEMA would respond appropriately at that time.

6.190 As to the allegation of prejudgement, we accept GEMA's submission that it has an 'agenda' based on its statutory obligations, and that it will necessarily carry that agenda, and certain long-held opinions, into the process of deciding upon code modifications. The observations of Lord Woolf in *Windsor v Bloom* appear to us to be directly in point.

6.191 Our main concern in relation to this aspect of the case is that under the UNC, GEMA has no power to make code modification proposals. On that basis, the need for GEMA's consent to a modification proposal is both necessary and appropriate, given its role as the guardian of consumer interest.

6.192 However, it is less clear that the system of checks and balances established in the code modification procedures works if GEMA is, to use GEMA's words, the 'effective progenitor' of a proposal (or at least if it is perceived as such). The existing system envisages that GEMA will express a firm view as to what (if any) reform ought to take place at the conclusion of the process, rather than at the start of the process. If GEMA is the effective progenitor of a proposal, there may be a perception that it cannot fulfil its intended role under the UNC modification procedures without having prejudged, or at least appeared to prejudge, the matter.

6.193 Given that EA04 now provides for the right of appeal to the CC, the problem we perceive is less acute than it once was. Further, E.ON did not argue that GEMA should never seek to influence the content of code modification proposals. Given GEMA's various statutory duties, we consider that an argument in those absolute terms would face some difficulty.

6.194 Overall, we are not persuaded that GEMA prejudged proposal 116V. It rather seems to us that GEMA's Decision was based on strongly-held views which GEMA maintained having listened to (rather than shut its ears to) contrary industry opinion. This is reflected in the fact that opinion within the Executive was 'finely balanced' in the lead-up to the Decision, in the fact that changes were made to the CBA following consultation on the FIA and in the fact that proposal 116V differed from GEMA's initial views on the subject. The use of sunset clauses, at GEMA's suggestion, does indicate that GEMA, as it admitted, considered reform to be necessary. However, it

does not follow that GEMA prejudged the decision, in the sense that it did not take into account the arguments made to it in reaching the Decision.

6.195 Likewise, we are not persuaded that GEMA could not properly link offtake reform to GDN sales, given that there was a clear relationship between at least some of the issues addressed in 116V and the sale of the IDNs. We note the observations of the National Audit Office and the Public Accounts Committee of the House of Commons, to which E.ON drew our attention, that the linking of the two issues was not necessary and introduced additional complexity into the process. However, that does not mean that the Decision was 'wrong' in the sense which is relevant for our purposes.

6.196 Nevertheless, our view is that where GEMA is giving or refusing its consent to proposals of which it, to use its own expression, is the effective progenitor, GEMA's better regulation duties of transparency and accountability apply with particular rigour. GEMA must take particular care to ensure that its decision is expressed as clearly as possible, and must ensure that the arguments for and against its preferred course of action are dealt with clearly and comprehensively in the relevant consultation and decision documents. For reasons already given, our view is that the Decision itself did not meet those standards, particularly in terms of the need for transparency. We would also suggest that GEMA's consultation process should be carried out with these considerations in mind, although as we have indicated, we find no grounds for criticism of the consultation process in this case.

6.197 Although we regard it as important to make these observations, we do not accept that the Decision was procedurally flawed for the three main reasons given by E.ON, as set out above. However, we note that E.ON's procedural case also alleged a lack of transparency in the '*process leading up to and including the FIA and the Decision*'. For reasons set out in earlier sections of in this decision, we do find a lack of transparency in certain aspects of the Decision document itself.

7. Conclusions on the appeal

7.1 As we have indicated above, E.ON's grounds of appeal ran to 15 pages. We will not address each of those grounds. Rather we summarize our conclusions on what are, in our view, the key issues.

7.2 In drawing our conclusions, we have in mind that GEMA could not pick and choose different elements from the proposals before it. Consequently, GEMA did not (and could not) separate out each element of proposal 116V and make separate decisions in relation to each one. It is therefore necessary for us to express our conclusions in relation to proposal 116V as a whole. Nevertheless, we also recognize that certain of E.ON's grounds of appeal relate only to one or other aspects of proposal 116V. We therefore summarize our findings in relation to each of the five substantive areas discussed above, before setting out our overall conclusions on the appeal.

7.3 We are not persuaded that GEMA erred in its analysis of the proposed reforms to user commitment.

7.4 As we explain further below, we find a lack of transparency in relation to certain aspects of the Decision document itself. Otherwise, we are not satisfied that the Decision was procedurally flawed for any of the reasons advanced by E.ON.

7.5 We make two key findings in relation to interruptibility. First, the material contained in the Decision, and the submissions made to us on this appeal, do not adequately support a conclusion that the existing arrangements are in fact discriminatory, or potentially discriminatory. It follows that, in our view, GEMA could not properly attach weight to the qualitative benefit of non-discrimination in relation to this aspect of 116V. Secondly, however, we are not persuaded that GEMA was wrong to conclude that the proposed reforms can be expected to deliver competition and efficiency benefits.

7.6 In our view, GEMA erred in its approach to the flexibility product in a number of related respects. GEMA concluded that there were benefits to consumers from action now, notwithstanding that the proposed reform would deliver benefits to consumers only in the event of a scarcity of flexibility. It did so without properly assessing or demonstrating the likelihood that such a scarcity will occur. It also did so without properly identifying the nature and extent of the benefits which would accrue to consumers in that event.

7.7 GEMA also made a number of errors in its cost-benefit analysis. The most significant error follows from the point made in the previous paragraph—GEMA erred in giving significant weight to benefits to be obtained from the flexibility product. GEMA also erred in its approach to the issue of upfront transporters' costs, by failing to adopt a consistent and principled approach to the weighting of those costs. More generally, in balancing quantified costs against qualitative benefits, GEMA failed sufficiently to explain the nature of the benefits relied on (particularly in relation to the flexibility product), and the way in which the benefits had been balanced and weighed against the costs.

7.8 With these findings in mind, we turn to consider whether E.ON's appeal should be allowed, and if so, on what grounds.

7.9 E.ON's appeal included certain grounds relating specifically to the proposed reforms to interruptibility. We do not allow the appeal on any of those grounds. Although we have identified a number of criticisms of the Decision in relation to interruptibility, we

are not satisfied that those criticisms are by themselves sufficient to render the Decision 'wrong' on any of the grounds alleged by E.ON.

7.10 Turning to the question of flexibility, as we have indicated, we will not on an appeal under EA04 substitute our view for that of the regulator. However, we are satisfied that GEMA should not have approached the benefits of the flexibility product as it did. That error by GEMA, and its error in relation to upfront transporters' costs, inevitably means that GEMA's conclusion that 116V can be expected to provide net benefits to consumers is not adequately supported. Further, we are persuaded that the Decision, and in particular the explanation of qualitative benefits and the balancing of those benefits against quantified costs, was not expressed in terms which satisfied GEMA's obligation of transparency under its 'better regulation' duties.

7.11 We are therefore satisfied that the Decision is 'wrong' within the meaning of EA04, and that the appeal should be allowed. (We explain what we mean by '*the appeal should be allowed*' in the following section.) In our view, the errors we have identified mean that the appeal should be allowed on several of the grounds relied on by E.ON. Those grounds all fall under subparagraphs (a) and (b) of section 175(4) and are summarized below.

7.12 We are satisfied that GEMA failed properly to have regard to its principal objective under section 4AA(1) of GA86 (protection of the interests of consumers), and its duty under section 4AA(5) of GA86 (promotion of efficiency and economy on the part of licensed persons), and relevant objectives (a) and (b) of the UNC (efficient and economic operation of pipeline system(s)) because the Decision did not present an adequate basis for the conclusion that the costs of reform to industry parties and to consumers will be outweighed by benefits to consumers (see points 3.1, 3.3, 4.2, 4.4 to 4.6 and 12.2 of E.ON's grounds of appeal).

7.13 We also allow the appeal on two grounds which relate to particular aspects of GEMA's cost benefit analysis in the Decision. First, GEMA did not approach the weighting of transporters' costs in a consistent and principled way, and so erred in quantifying the costs of proposal 116V. Secondly, GEMA failed, in quantifying the benefits of 116V in the Decision, properly to have regard to the current absence of any scarcity of flexibility capacity in the NTS. We are satisfied that GEMA failed properly to have regard to its duty under section 4AA(5) of GA86 (promotion of efficiency and economy on the part of licensed persons) on these two additional grounds (see points 4.7 and 4.16 of E.ON's grounds of appeal).

7.14 We are also satisfied that GEMA failed properly to have regard to the principle under which regulatory activities should be transparent under section 4AA(5A) of GA86, in that the Decision was not expressed in sufficiently clear and transparent terms, particularly in relation to the explanation of the qualitative benefits of reform, and in relation to the balancing of qualitative benefits against quantified costs (see point 6.2 of E.ON's grounds of appeal).

7.15 As will be apparent, we have not been persuaded to allow the appeal on any of the grounds alleged under section 175(4)(c) to (e). We were not satisfied that GEMA erred in fact or in law in any of the respects alleged under subparagraphs (d) and (e). In particular, the errors we have identified in GEMA's cost-benefit analysis do not, in our view, amount to errors of fact.

7.16 In relation to section 175(4)(c), it is important to note the precise language of that section. Section 175(4)(c) provides that a decision may be wrong on the grounds that GEMA failed to give the appropriate weight to one or more of the matters or purposes referred to in subparagraphs (a) and (b). Subparagraph (c) is therefore concerned

with the weight given by GEMA to the relevant matters and purposes. In the present case, we do not think that GEMA can be criticized on the basis of the weight it gave to the relevant matters or purposes. It is apparent that in making the Decision, GEMA sought to ensure that *all* the relevant matters and purposes were addressed. Although we have concluded that GEMA erred in its approach to certain of those matters and purposes, we are not satisfied that the errors which we have identified fall within section 175(4)(c).

8. Remedies

8.1 We asked the parties two questions in relation to the extent of our remedial powers. Those questions were:

(a) How should the CC use its powers under section 175(6) of EA04 should it find that it is unable to endorse either 116V or 116A, and in particular are there any directions that are appropriate or necessary having regard to the sunset clauses in present offtake arrangements?

(b) What directions is the CC empowered to make, and what directions should it make, should it find that the appeal should be allowed for reasons which relate only to certain aspects of Mod 116V?

8.2 E.ON submitted a short written response on these matters ('E.ON's remedies note') and the CC heard argument on these points from E.ON, GEMA and BGT at the final hearing.

8.3 The first question relates to the sunset clauses. As we have discussed above in paragraphs 2.48 to 2.51 and 3.14, the current offtake arrangements last only until 30 September 2008 when they will be superseded by transitional offtake arrangements that expire on 30 September 2011. We asked the parties to consider whether, should we allow the appeal, problems might arise because of the short-term nature of the offtake arrangements, and whether any direction from the CC could be of assistance in managing the situation.

8.4 In E.ON's remedies note, it argued that, in the event that the CC considered that the decision to approve 116V was wrong, the only question for the CC was whether to approve 116A or not. E.ON submitted that this involved only one consideration—whether the sunset clauses should be removed. In E.ON's submission, there could be no justification for retaining the sunset clause because the presence of the clauses *'wrongly prejudices the question of whether any changes to the existing arrangements are necessary and, if so, what the timescale for making such changes should be'*. Additionally, E.ON said that the use of sunset clauses creates regulatory uncertainty. In support of these observations, E.ON relied on matters raised in the *Final Report of the Mandelkern Group on Better Regulation* of 13 November 2001. In E.ON's submission, the continued inclusion of sunset clauses contravened section 4AA(5A) of GA86 as well as impairing efficiency contrary to code objective (f) of the relevant objectives.

8.5 In submissions made at the final hearing, GEMA told us that the sunset clauses create no need for special directions. If the appeal were to be allowed and the matter were to be remitted, GEMA told us that it would reconsider the matter with all reasonable speed. This, we were told, would mean that reconsideration would take place within the next year.

8.6 For reasons we set out below, we do not consider that our finding that GEMA was wrong to direct implementation of proposal 116V inevitably leads to the conclusion that proposal 116A must be given effect. There is, however, a separate question as to whether *practical* considerations require us to make directions for the removal of the sunset clauses.

8.7 Although there is some uncertainty as to how long GEMA may take to reconsider the Decision if that is necessary, we are satisfied that the duration of the existing transitional arrangements, and the speed with which GEMA has said it would reconsider the matter, will ensure that no difficulties arise in this respect. We agree

with GEMA that if for some unforeseen reason the offtake arrangements are likely to expire without a permanent modification having been put in place, the industry is capable of bringing forward a modification to address the immediate consequences. Consequently, it is not necessary for us to make a specific direction on account of the sunset clauses.

8.8 At the final hearing, argument about remedies focused on the scope of the CC's powers in relation to proposals 116V and 116A, and the consequences of the exercise by the CC of its power under section 175(6) of the Act to quash the decision appealed against. Section 175(6) provides:

> *Where it [the CC] allows the appeal, it must do one or more of the following:*
>
> *(a) quash the decision appealed against;*
>
> *(b) remit the matter to GEMA for reconsideration and determination in accordance with directions given by the Competition Commission;*
>
> *(c) where it quashes the refusal of a consent, give direction to GEMA, and to such other persons as it considers appropriate, for securing that the relevant condition has effect as if the consent had been given.'*

8.9 In E.ON's remedies note it argued that there are two decisions under appeal. First, there is GEMA's decision to direct the implementation of proposal 116V. Secondly, there is GEMA's decision to refuse consent to the implementation of proposal 116A. E.ON argued that the starting point for the CC in considering remedies is whether the CC is satisfied that the decision to give effect to proposal 116V was wrong. If it is, the CC should quash the decision *'to approve Mod 116V'*. E.ON then relied on the argument referred to above—namely, that the only additional choice for the CC is whether or not to remove the sunset clauses from the present offtake arrangements by directing the implementation of proposal 116A.

8.10 In answering the question set out in paragraph 8.1(b) above, E.ON made an important and far reaching submission, as follows:

> *In the circumstances referred to …, the CC would also have the* power *under s.175(6)(b), to remit the matter to GEMA for reconsideration and determination in accordance with the directions given by the CC.*
>
> *However, there would be no point in exercising this power in circumstances where the CC considered GEMA's decision to approve Mod 0116V to be wrong, since:*
>
> (i) *GEMA would not be able to approve Mod 0116V afresh, since the CC would already have held that to do so was wrong.*
>
> (ii) *GEMA would have no power, upon a remission, to approve Mod 0116CVV, Mod 0116BV or Mod 0116VD, as no appeal has been brought against GEMA's decision not to direct the implementation of those proposals.*
>
> (iii) *[…]*

(iv) *Thus, GEMA's only choice would be between approving Mod 0116A and not approving it …*

8.11 We found this submission ('E.ON's remedies submission') surprising. Its consequence is that, in the event that the CC quashes the decision to give effect to 116V, GEMA can only choose between two modifications rather than the original five, even if the CC's decision is that GEMA would have been wrong to adopt either of those two modifications. This is at first sight an undesirable outcome. As GEMA put the point in argument: if E.ON's remedies submission is correct, '… *when the thing is remitted, the moderate options fall out of the equation*'.

8.12 However, GEMA did not tell us that E.ON's remedies submission was wrong. Rather, GEMA said no more than that it was not sure that it was right. Significantly, there was agreement between GEMA and E.ON on one important point: that there are two decisions under appeal. GEMA told us that this is the consequence of sections 173(1) and 173(2)(c) of EA04 which define the circumstances in which an appeal shall lie to the CC. Under section 173(2) an appeal lies to the CC against a decision by GEMA which *'consists in the giving or refusal of a consent'*. The consent in question is for present purposes a direction that a modification should be made to the UNC.

8.13 In support of E.ON's remedies submission, it said that the structure of the process by which GEMA approves modification proposals, and the structure of the appeal process where GEMA's decision is contrary to the majority recommendation of the Panel, is predicated on taking one modification proposal at a time. E.ON said that the Decision was in fact five separate decisions, because there were five separate modification proposals. E.ON also said that GEMA's decision not to approve proposal 116CVV could not be appealed because of the effect of Articles 4 and 10 of the Electricity and Gas Appeals (Designation and Exclusion) Order 2005 (**the Order**). Thus, E.ON said that GEMA's decision in relation to proposal 116CVV is a final decision. If that modification could not be appealed to the CC, it could not be 'on the table' on a remission.

8.14 E.ON's remedies submission is therefore as follows: because the Decision is not in fact one but five decisions, and because only two of those five decisions have been appealed, then, should the CC quash one of those decisions, it is only that single decision that is remitted. Because GEMA's Decision was a final decision in relation to some (but not all) of the five modification proposals put forward, those final decisions cannot be reopened as a result of this appeal.

8.15 E.ON's remedies submission raises a point of real significance. If it is right, it means that, if the CC were to find that the correct remedy is to quash the Decision and to remit the matter to GEMA for a reconsideration of all the modifications proposed, it could not do so. GEMA would have to choose between two modifications, even if the CC found that neither of those modifications should be adopted.

8.16 In paragraphs 8.17 to 8.23 below we record our observations on two important issues that arise in connection with E.ON's remedies submission. We draw attention to these issues because they will be relevant to future appeals concerning decisions where there have been multiple modification proposals. Parties to appeals may well have to address E.ON's remedies submission at the permission stage of future code modification appeals.

8.17 Our first observation concerns Article 4 of the Order. Article 4 provides, in so far as it is relevant:

4–(1) No appeal shall lie to the Competition CC under section 173 of the Act from a decision made by GEMA … which consists in the giving or refusal of a consent … if the relevant condition is satisfied in respect of that decision.

(2) For the purpose of paragraph (1) the relevant condition is—

[…]

(f) in the case of a decision in relation to the Uniform Network Code, the condition in article 10(1).

8.18 Article 10(1) of the Order provides that the condition is *'that the decision consists in the giving of a consent to a majority recommendation made by the Modification Panel in the Modification Report'*. We suggest that parties to future appeals should pay particular attention to the precise and apparently limited scope of this exclusion, which applies only where GEMA has given its consent to a majority recommendation made by the Panel.

8.19 Our second observation relates to the proper interpretation of section 173(2)(c). Section 173(1) of the Energy Act provides that *'An appeal shall lie to the Competition Commission from a decision by GEMA to which this section applies.'* Subsection (2) provides that section 173 applies where:

(a) it is a decision relating to a document by reference to which provision is made by a condition of a gas or electricity licence;

(b) that document is designated for the purposes of this section by an order made by the Secretary of State;

(c) the decision consists in the giving or refusal of a consent by virtue of which the document has effect, or would have had effect, for the purposes of the licence with modifications or as reissued; and

(d) the decision is not of a description of decisions for the time being excluded from the right of appeal under this section by an order made by the Secretary of State.

8.20 Under section 173(2)(c), the decision is therefore the '*giving* or *refusal of a consent*'. The nature of GEMA's decision in the present case is further defined in paragraph 15 of SSC A11, the relevant provisions of which are:

Where a proposal is made in accordance with the network code modification procedures to modify … the uniform network code the licensee shall:

(a) as soon as is reasonably practicable, give notice to the Authority:

(i) *giving particulars of the proposal;*

(ii) *where an alternative proposal is made in respect of the same matter as the original proposal, giving particulars of that alternative proposal;*

[…]

(b) comply with any direction of the Authority to make a modification to … the uniform network code in accordance with a proposal described in a notice given to the Authority under paragraph 15(a) which, in the opinion of the Authority, will, as compared to the existing provisions of … the uniform network code or any alternative proposal, better facilitate, consistent with the licensee's duties under section 9 of the Act, the achievement of the relevant objectives.

8.21 The task with which GEMA is concerned in paragraph 15 is comparative. GEMA has to consider the modification or modifications before it and decide which of these can *'better facilitate'* the relevant objectives. It is only where there is a modification that *'better facilitates'* the relevant objectives that GEMA takes any action, and that action is to direct that a modification be made. GEMA has to take a decision 'to prefer'. Having regard to pages 4 and 5 of the Decision, we note that this is exactly what GEMA did in the present case. On page 5 it *'directs that modification proposal 0116V be implemented'*. Although the consequence of that direction is that other proposals will not be implemented, it does not seem to us to follow that the Decision is in fact five decisions. There appears to us to be just one decision directing one implementation which has the consequence that other modifications are not made. In form, and in substance, the Decision is best characterized as one decision to direct the implementation of proposal 116V.

8.22 Returning to the language of section 173(2)(c), we have to consider whether the Decision is properly characterized as 'consisting in the giving of consent' or 'consisting in the refusal of consent'. But for the agreement between E.ON and GEMA that there are two decisions under appeal, we would have concluded that the Decision consists in GEMA giving consent to a modification. A decision consisting in the refusal of consent would be a decision in which no modification is directed to be made.

8.23 It follows from our conclusions that, in our view, the decision to direct the implementation of proposal 116V should be quashed. The agreement between E.ON and GEMA that there are two decisions under appeal does not affect our view that the appeal should be allowed in relation to 116V, and the Decision quashed in so far as it is a decision to direct the implementation of proposal 116V.

8.24 However, because GEMA and E.ON have agreed that there are two decisions under appeal, we think it appropriate to give our views on the appeal in respect of proposal 116A. If GEMA made a separate decision not to direct the implementation of proposal 116A (in other words, to refuse its consent to proposal 116A), that decision was a direct consequence of its preference for proposal 116V. It follows that, having quashed the decision in relation to proposal 116V, we are also able to allow the appeal and to quash the decision in respect of proposal 116A on the same grounds. We wish GEMA to have the full range of options available to it when it comes to reconsider whether to direct the implementation of an offtake modification proposal. Therefore, assuming that there are two decisions under appeal, we exercise our power to allow the appeal against GEMA's decision not to direct the implementation of proposal 116A.

8.25 However, it does not follow that we direct the implementation of proposal 116A. E.ON told us that in giving effect to proposal 116A, the CC would be doing no more than stabilizing the present position, and that the CC would not thereby 'endorse' any particular part of the present offtake arrangements. E.ON also told us that we should give effect to proposal 116A even if in our view some of the reforms in proposal 116V were meritorious.

8.26 We do not accept E.ON's submission. We have accepted GEMA's argument that there are benefits in the user commitment model and in the reform of interruption under 116V. We cannot be confident that, should proposal 116A be implemented, further proposals for reform would be brought forward that would, for example, lead to the implementation of the user commitment reforms, or that would reform interruption arrangements, either within the next year or at all. Nor, for reasons mentioned above, do we see any need to make provision through 116A in respect of the sunset clauses. We do not therefore make an order for the implementation of proposal 116A.

8.27 Therefore, in so far as there is a separate decision in relation to 116A, we allow the appeal and quash the Decision to the extent that a decision has been made not to direct the implementation of proposal 116A. We make no order for the implementation of proposal 116A.

8.28 The Decision having been quashed on the terms set out above, it will fall to be taken again by GEMA. As we do not issue any directions to GEMA, we do not need to exercise our power under section 175(6)(b) of EA04 to remit the Decision for reconsideration and determination in accordance with directions given by the CC.

Order of the Competition Commission

That the appeal be allowed in part and that:

1. GEMA's decision to direct the implementation of modification proposal 116V is quashed; and

2. in so far as GEMA has made a separate decision not to direct the implementation of modification proposal 116A, that decision is also quashed.