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Dear John,

RE: Modification Proposals 0246, 246A & 246B – “Quarterly NTS Entry Capacity User Commitment”

This response by E.ON UK is on behalf of all E.ON group companies operating in the UK that hold a UNC Shipper licence.

E.ON UK **supports** implementation of Modification Proposals 246A & 246B.

E.ON UK **does not support** implementation of Modification Proposal 246. We consider that the proposal unnecessarily restricts the use of transportation credit tools, without sufficient justification and is likely to push up the costs of implementation.

Our preference for implementation (listed in terms of the most support first) is as follows:

1. Modification Proposal 246B
2. Modification Proposal 246A

It should be noted that E.ON would be impacted in a number of ways by all three of these proposals, if implemented. As a major holder of entry capacity in the UK, we could be providing significant amounts of security. However, equally, given our entry capacity holdings, we risk facing a significant proportion of the industry liability in the event of another User's default. We consider, therefore, that we come to this issue from a balanced perspective.

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We recognise that the current UNC rules (in combination with National Grid's licence) could be considered deficient in respect of the treatment of entry capacity purchased by single entry point Users. As highlighted in the proposals, this class of Users enjoys the "free option" of choosing not to put suitable credit in place twelve months before the capacity is due to be released by National Grid and thereby defer their holdings for at least a further twelve months. Users at multiple entry points, however, face the much higher barrier to exit of the market, of losing all their entry capacity holdings at all other entry points at which they hold capacity, if they default on holdings at one particular entry point. For the vast majority of such Users, this is a risk that will prevent them from defaulting at a single ASEP. As a result, where this capacity could not be re-sold, it would be reasonable to assume the cost of the capacity would be met by the User, which would be forced to absorb the cost at its own expense.

This contrasts significantly with single entry point Users, which under the current UNC rules, can choose to renege on their user-commitment, face none of the associated costs and by choosing this course of action, oblige all other Users to pay for any loss. This is because under its licence, National Grid is entitled (in the absence of an Ofgem veto) to recover the cost of providing the capacity, even if it is deferred (or relinquished) and regardless of whether any money has actually been spent by National Grid in providing it. Where the costs cannot be recovered from the owner of the capacity, NG is currently entitled to recover the cost from all other Users, by increasing the commodity charges. We do not believe that this arrangement, which permits National Grid to charge Users even where no costs have been incurred, is tenable and cannot possibly be considered in the best interests of customers.

We agree with the proposers of Modification Proposals 246A and 246B that a UNC change is required *in addition to* a re-consideration of the current licence provisions. We do not believe that a UNC proposal alone can resolve all the known issues identified through Review Group 221.

Modification Proposal 246

As a participant in UNC Review Group 221 – "Review of Entry Capacity and the Appropriate Allocation of Financial Risk", we are conscious of the significant amount of work which has gone into developing set of credit rules applicable to long-term entry capacity auctions. We also note that this is also not the first time that the industry has examined these issues. For instance, in 2002, credit arrangements were considered as part of the development work for

Network Code Modification Proposal 0500¹, which implemented long-term entry capacity auctions. It was noted in Ofgem's decision letter for this proposal, that:

“A number of respondents were concerned that the proposed credit arrangements are not strong enough and expose Users to too much risk of bearing the losses caused by a defaulting User. Respondents also commented that Transco should undertake a review of a User's credit provisions more frequently than the current annual evaluation, with one noting that the proposed arrangements would result in low barriers to entry but a high risk of exposing Users to default costs. Another added that it was unclear whether the credit arrangements would be sufficient when a User rapidly lost its credit rating. One respondent stated that Transco should face incentives to manage the credit arrangements, by facing a proportion of the costs of any User default.”

And

“Transco states that it has tried to strike a balance between credit arrangements that would create prohibitive cost for some who may otherwise wish to take part in the long-term auctions and weak arrangements that enable any costs of failure to be passed on to other users. Transco believes that a twelve-month capacity credit requirement is the maximum term of credit guarantee that can be obtained without recourse to bespoke (therefore expensive) products.”

The challenge in the Review Group 221 process (and previously, as noted above) has been to find a level of securitisation proportionate to the risk(s), without Users having to over-collateralise their position in the market. Securitising ten per cent of all past and future QSEC capacity allocations does, in our view, provide an adequate level of security to protect existing Users (as per Mods 246 & 246A). Requiring credit pre-auction also requires a commitment from Users at an early stage in the process, which should have the desired effect of discouraging highly speculative bids.

As noted in Ofgem's decision letter on Modification Proposal 0111 – “Management of Users Approaching and Exceeding Upper Limits of Credit Limit”, the UNC transportation credit rules must create “an environment whereby the User is able to trade with a monopoly provider and provide the Transporter with a reasonable level of risk to mitigate against.” It could be argued that under the current arrangements for long-term entry capacity, National Grid faces a very small (perhaps unreasonably small?) risk to mitigate against. This is due to the certainty that National Grid will receive a guaranteed revenue stream through its revenue

¹ Ofgem Decision Letter 0500, "Long Term Capacity Allocation" (30th September 2002).

driver, regardless of whether it actually incurs real costs on the ground. Ultimately, it will be a question for Ofgem to address through its Regulatory Impact Assessment in terms of impact on competition, as to whether the amount being requested by National Grid (ten per cent) is proportionate to the risks and does not limit any User's ability to trade with the monopoly provider.

The proposal to reduce the number of QSEC auction bid windows from ten to eight (which is a feature of all three proposals) is unfortunate and we would have preferred to retain the ten windows. Our understanding is the reduction stems from the resource intensive nature of analysing bids between windows. However, as IT systematisation is implemented we would expect the ten windows to be restored as soon as possible.

Modification Proposal 246A

We believe that this Proposal is superior to Modification Proposal 246 to the extent that it does not unduly restrict the range of credit tools available. In the absence of analysis to suggest that a Parent Company Guarantee (PCG) is not a sufficiently robust tool for transportation credit purposes, we support its continued use.

It is worth noting that for Energy Balancing Purposes, a PCG is *not* an acceptable credit tool and a letter of credit or a deposit deed must, instead, be provided. The rationale is that a PCG does not provide protection against large debts accruing quickly. As Ofgem noted in its decision on Modification proposal 0572 - 'The Provision of Letters of Credit for Energy Balancing Credit Cover':

"In situations where there is a combination of exposure to risk being managed on behalf of others, a potentially volatile debt, and where the scale of the potential debt is directly linked to the creditworthiness of the counter party (with a failing company, energy balancing performance is likely to deteriorate), there are strong arguments for cash or equivalent security. As the debt is managed on behalf of Users through the neutrality arrangements, the event of a User failure would smear the costs of any bad debt proportionately across the whole community, regardless of the good practice or otherwise of others in that community. As a result additional security is called for, over and above normal commercial arrangements for debt management.

In the absence of updated advice from Ofgem, we believe there is a valid distinction that can be made between credit tools suitable for energy balancing purposes and those applicable for transportation credit. Whilst a PCG might not in itself provide protection against bad debt accruing, in the case of transportation charges, the debt is not 'volatile', can be measured,

and to a certain extent limited, reduced or extinguished before it crystallises. This is because auction bids will relate to future capacity; i.e. capacity at least Y+2 from the date of the auction. In practice, this provides a significant lead-time before the capacity (be it either baseline or incremental) is delivered and therefore time in which National Grid can take remedial action if a User defaults; such as seeking to re-sell the capacity or to raise an Income Adjusting Event in order to prevent these cost being passed through to consumers.

In addition, it is worth noting that permitting the use of a PCG (as per Mods 246A & 246B) will reduce the costs of implementation compared to Modification Proposal 246 which only permits use a Letter of Credit or Deposit Deed.

Although it is not explicit in Mods 246A or 246B, it is our assumption that for the purpose of both proposals, the parent company providing the guarantee would be subject to a minimum credit rating, as per current UNC transportation credit arrangements. However, as neither proposal seems to incorporate the use of approved credit ratings to adjust the amount of credit required, we are somewhat unclear how the value of a PCG would be gauged; i.e. should a PCG from a BB-rated parent company be treated the same as one from a AAA-rated company? We believe not. We are not clear if the intention of both proposals is to have a minimum rating level for parent companies or to make use of the table in UNC Transportation Principle Document, Section G, 3.1.3 (a):

Approved Credit Rating		User's % of Maximum Unsecured Credit Limit
Standard and Poor's	Moody's Investors Service	
AAA/AA	Aaa/Aa	100
A	A	40
BBB+	Baa1	20
BBB	Baa2	19
BBB-	Baa3	18
BB+	Ba1	17
BB	Ba2	16
BB-	Ba3	15

It is not clear from 246A & 246B whether they intend to make use of the matrix in this table – i.e. reduce the amount of credit posted, based on credit rating. If this is so, then it would be

inconsistent with the approach for Letters of Credit or Deposit Deeds. Either way, we believe this point requires clarification from the proposer(s).

Retroactive Effects

We have some concerns about the retroactive nature of this proposal and Modification Proposal 246, which may have implications for competition between Users. Re-visiting past user-commitments and effectively demanding a stronger signal, places a financial burden on Users which could not have been reasonably foreseen when bidding for entry capacity in the past. We believe it is only reasonable that Users continue to be treated in-line with assumptions made under the regulatory context of the time and that, in general, there should be no retrospective application of later, more exacting standards. It was noted through the Review Group 221 process that small players and new developers may struggle to satisfy the new credit requirements. For instance, there is a risk under Mods 246 & 246A that Users (particularly those at a single entry point) may choose to surrender their existing capacity rather than put in place the new security, with the result that the industry could then be exposed to paying for that capacity. It is reasonable to assume that, if implemented, these new credit rules will be a good test of the robustness of the current user commitment model.

Modification Proposal 246B

We consider this proposal to be the most proportionate response to the problems identified through Review Group 221. Of the three proposals, we believe this Modification Proposal fits best with the UK Better Regulation Commission's (BRC) "Five Principles of Good Regulation". By applying the proposed new credit rules only to future auctions, we believe the proposal maintains a fair playing field for all Users by allowing time ahead of the next QSEC auction for Users to prepare for and implement the new rules. The beneficial effect of discouraging future speculative bids, which is a feature of all three proposals, is retained.

Compared to Modification Proposals 246 and 246A, it is clear that this proposal provides less protection for existing Users against the risk of a User defaulting on their existing capacity holdings. This is because Users would not have to provide security against previously allocated bids. Based on historical trends, User default on capacity tends to be a low-probability event. Hence, we consider that the BRC's guidance advice of "think small first" is particularly apt. There is a risk under 246 and 246A that the amounts of credit requested would not be proportionate to the risks facing the User community. On the other hand, by implementing 246B, there would be a larger financial exposure (compared to 246 & 246A) in the event that a User defaults on their previously-allocated capacity holdings. However, on

balance, we believe that given such events are rare and do not have an immediate financial impact, the most proportionate response is probably through an Income Adjusting Event applied to National Grid's licence, rather than seeking retroactive changes to user commitments.

Assessment of the Proposals against the Relevant Objectives

Standard Special Condition A11.1 (a): the efficient and economic operation of the pipeline system to which this licence relates.

Applicable to 246, 246A & 246B:

We agree with the proposer of 246 that “[i]mplementation would discourage speculative auction bidding, thus reducing the risk of inefficient system investment and provides an incentive for Users to honour entry capacity auction commitments”. Reducing the incidence of spurious or speculative bids should ensure that inefficient investment decisions by National Grid are made less frequently.

Standard Special Condition A11.1 (c): so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence;

Applicable to 246, 246A & 246B

Compared to the *status quo*, these proposals place a greater financial burden on auction participants. However, this reflects the fact that under the current licence arrangements, allocated auction bids can have a direct impact on National Grid's allowed revenue, which must ultimately be recovered from Users in one form or another, and therefore may be considered appropriate.

We believe all of these Proposals go a long way towards removing the “free option” currently enjoyed by certain Users of the system, which can choose not to provide security and as a result forego their capacity holdings, irrespective of whether or not National Grid has invested to accommodate the capacity.

Standard Special Condition A11.1 (d)...the securing of effective competition between relevant shippers



By restricting the range of credit tools currently available for transportation credit purposes, we consider that Modification Proposal 246 may have an adverse impact on competition between shippers, when compared to Modification Proposals 246A & 246B. This is because, by not allowing the use of PCGs, the cost to Shippers of providing suitable levels of credit is likely to be significantly higher than if their use was permitted. As stated above, it is for this reason that we are unable to lend our support to Modification Proposal 246.

I hope you find these comments useful. If you wish to discuss any aspect of this response in further detail, please do not hesitate to contact me on the number above.

Yours sincerely

Richard Fairholme (by email)

Trading Arrangements

E.ON UK