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Dear Paul,

**RE: User Commitment for National Transmission System Quarterly Entry Capacity Initial Impact Assessment on modification proposals**

E.ON UK welcomes this Impact Assessment (IA) as an important step in assessing the impact that any of the UNC Modification Proposals on entry capacity credit would have, if implemented. Throughout the governance process E.ON UK has, in line with other Shippers, called for Ofgem to consider not only the UNC Modification Proposals put to them, but also National Grid NTS' (NG) licence. As a member of Review Group 0221 – *'Review of Entry Capacity and the Appropriate Allocation of Financial Risk'*, we are conscious that the Group felt somewhat constrained by only being able to consider changes to the UNC, and generally felt that progress could only really be made through appropriate licence changes – not by just tweaking UNC credit rules. We are, therefore, pleased to see that Ofgem is going further than strictly required in assessing the Modification Proposals before them and is considering the wider (NG licence) issues.

In respect of the specific Modification Proposals, our previously expressed preference for Modification Proposal 246B appears to be further substantiated by the findings of this IA; i.e. it is, as we expected, the least costly and most proportionate response to the perceived problems. However, we note that this proposal still does not deliver a favourable outcome when subjected to cost-benefit analysis.

As a result, and given that this IA explores the options of making NG licence changes, we believe that licence change would be more preferable (and proportionate) than a UNC change. As regards the possible Licence changes discussed, our preference is *firstly* for a

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widening of the range of events by which an IAE could be triggered (including the ability for Shippers to raise an IAE), *secondly* for a review of the structure of revenue drivers and *thirdly* for a review of the use of termination as a means of dealing with credit default. Furthermore, we note that these options should not be thought of as mutually exclusive – all three could, in theory, be implemented and all merit further consideration.

Our response to the questions posed in the Impact Assessment is detailed below:

## **CHAPTER Two**

### **Question 1: Do you have any additional views on the merits/disadvantages of the options for securitization of capacity to add to those of the review group?**

The debate throughout the Review Group was extensive but was ultimately constrained by the nature of the UNC Review Group process which does not allow for changes to National Grid's licence to be formally proposed. As a result, the Modification Proposals were developed and raised in anticipation of no future changes to the licence. Had the Review Group been able to consider potential NTS licence changes, then we consider that a different outcome may have been achieved. For instance, the possibility of ramping up securitisation of capacity as a project progresses could be an improvement on the current arrangements, but was deemed incompatible with the nature of the revenue driver in NG's licence, and therefore could not be pursued further within the Review Group.

### **Question 2: Do you have views on the ability for NGG to cover the potential of shipper default through commercial insurance instruments?**

The Review Group noted that there appeared to be currently little, if any, market for such insurance products. Regardless, this 'product' seems to be ignoring the root cause of the problem we are dealing with; instead concentrating on ways of *managing* the undesirable outcome of User default and termination, rather than seeking to *prevent or reduce* the incidence of it – which surely is the more appropriate objective.

## **CHAPTER: Three**

### **Question 1: Do you agree with the analysis of the risks involved? Are there any quantifiable risks that have been omitted?**

The IA correctly identifies that the real risk lies with Shippers under a single obligation at a single ASEP. In our view, the current UNC arrangements provide sufficient incentive for a Shipper operating at a number of ASEPs to not default on their capacity holdings at one particular ASEP, since they risk losing their entire capacity holdings across all ASEPs if they do so. As a result, the group of Users posing a genuine risk of default (Shippers under a

single obligation at a single ASEP) is relatively small. Hence, we believe it is important that a sense of proportion is maintained when looking at potential solutions which might better manage the risk.

**Question 2: Is the level of securitization being proposed appropriate? If not, why?**

As outlined in our formal representation for the UNC Modification Proposals, we do not believe it is appropriate to revisit past bookings and ask for a stronger user-commitment, which could have undesirable retrospective implications. With this in mind and ignoring the potential licence changes for the purpose of this question, Modification Proposal 246B represents the most “fair” and most proportionate response.

**Question 3: Do you agree with the benefits as presented here? Are there any other ways in which the quantitative benefits could be presented?**

In our view, it is clear that based on the quantitative analysis presented in the impact assessment, none of the Modification Proposals have sufficient benefits to outweigh the likely cost to industry of implementation.

**Question 4: How do the risk ranges presented for each of the proposals rank against your perceived risk of default for future capacity bookings?**

The numbers in the quantitative analysis show that in order for a positive cost-benefit analysis result to be achieved, the risk of default must be higher than is currently expected. Based on historic events, it is clear that trying to determine the likely incidence of a Shipper failure (and termination under the UNC) is not easy, and therefore we feel unable to comment on the appropriateness of the 1-2% risk of default identified by Ofgem.

**Question 5: Do you have any preference amongst the proposals on the basis of the quantitative analysis?**

Our previously stated order of preference is unchanged.

**CHAPTER: Four**

**Question 1: Do you think that the implementation of any of these proposals would have an adverse effect on competition? Please give reasons for your answer.**

We believe that retrospective rule changes, as envisaged by Modification Proposals 246 & 246A could have potentially damaging effects on competition between Users, caused by National Grid NTS re-visiting user-commitments already made and requesting a stronger financial signal. We do not believe that this is appropriate. As we noted in our response to the UNC proposals:

*“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.”*

**Question 2: Do you think any of these proposals are unduly discriminatory?**

We note that determining what is “due and “undue” discrimination is often a difficult issue, which probably requires a formal legal opinion to be sought.

As regards Ofgem’s comments on discrimination that “shippers looking to acquire capacity at those same entry points would incur the extra costs of having to securitize their capacity and so may be at a competitive disadvantage”, whilst there may be a difference in securitisation requirements between incumbents and new entrants on a portfolio basis, the argument does not hold if both are competing for future capacity at the same ASEP, as both will be subject to the same securitisation requirements. Mod 246B effectively draws a line in the sand and treats capacity allocated prior to implementation according to the rules that were in place at the time, and any capacity bought after implementation would be subject to different rules; but rules which apply equally to all market participants. We believe this is a reasonable approach to take for this issue. Furthermore, we consider the poor regulatory practice of applying rules retrospectively would be much more damaging to competition than any potential discrimination which may arise in this case.

**Question 3: Do you think the proposals are sufficiently simple and transparent?**

The proposals inevitably add complexity to the existing regime, but this is more a reflection of the complexity of the issue at hand (and the need to work around NG’s licence), rather than a deficiency in the Modification Proposals.

**Question 4: What is your preference on the basis of the qualitative issues?**

Our previously stated order of preference is unchanged.

#### **CHAPTER: Five**

##### **Question 1: Do you think that shipper termination is a tool that should be more widely used to deal with credit default issues?**

Shipper termination caused by credit default may remove the 'free option' which exists for some Shippers currently, but ultimately this approach does nothing to mitigate the financial exposure of the Shipper community to a Shipper default. Whilst this procedure may stop the same "risky" Shipper from purchasing capacity again, it does not stop the potential problem of a Shipper being terminated then re-appearing under a different name - and just as "risky" as the one it replaced.

##### **Question 2: Do you agree that the Income Adjusting Event clause in the gas transporter licence should be reviewed? If so, what manner of changes would you recommend?**

We would welcome a widening of the range of events following which an Incoming Adjusting Event (IAE) could be triggered, as it is clear that the current licence provisions are unduly restrictive and fundamentally limit the risk faced by National Grid NTS. Furthermore, we believe it is important that Shippers have the ability to raise an IAE and that the mechanism and grounds for doing so should be set out clearly.

##### **Question 3: Do you agree that the revenue driver mechanism for gas entry capacity could be improved? If so, how?**

A phased release of revenue linked to the passing of specific project milestones would, in our view, be an improvement on the current regime. The fact that the revenue driver cannot be adjusted to reflect physical activity on the ground (or actual expenditure by NG NTS) is a serious downfall in the current regime and inevitably leads to windfall gains. Nonetheless, we recognise that the current structure of the revenue driver is a key part of National Grid's current price control arrangements and making changes here would be a considerable re-opening of the price control. The appropriateness of such a change is an issue for Ofgem to consider further.

**Question 4: Do you have a view as to whether the Authority's role in the approval of NGG NTS proposals to release incremental capacity is no longer required?**

We are concerned that the absence of regulatory scrutiny may expose consumers to the risk (and cost) of unnecessary investment by National Grid NTS. The current regime allows for a sense check to be applied to National Grid's proposals, to ensure they are in the best interests of consumers. This approach should be retained.

**Question 5: Are there any other options, outside of the UNC, that could be considered for making the entry capacity credit arrangements more robust?**

The UNC is the contract and framework that Shippers operate under. Therefore, any changes to the entry capacity regime should remain within Code and key terms (including credit requirements) should not be hived off into non-Code documents. As a result, all key terms relating to credit should be in the UNC and subject to the established governance process.

**Conclusion**

In summary, we feel that this Impact Assessment has been useful in illustrating both the complexity of the issue at hand and the impact of making changes to attempt to resolve it. The IA correctly identifies that the real risk of default under the current regime lies with Shippers operating under a single obligation at a single ASEP. Given that the likelihood of default (and therefore risk) is small, we are not convinced that any of the Modification Proposals really provide the optimal solution, given the costs of implementation across the whole industry. With the news that licence changes are now a possibility, we would like to make it absolutely clear that our preference is *firstly* licence change(s) and *secondly*, a UNC Modification Proposal (in accordance with our order of preference stated above).

I hope that the above comments prove useful. Should you wish to discuss this response in any further detail, please do not hesitate to contact me on T: 02476 181421.

Yours sincerely,

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