

CODE MODIFICATION PROPOSAL No xxxx

<Title>
Version x.x

Date: 05/03/2009

Proposed Implementation Date:

Urgency: Non Urgent

1 The Modification Proposal

a) Nature and Purpose of this Proposal

Where capitalised words and phrases are used within this Modification Proposal, those words and phrases shall usually have the meaning given within the Uniform Network Code (unless they are otherwise defined in this Modification Proposal). Key UNC defined terms used in this Modification Proposal are highlighted by an asterisk () when first used.*

This Modification Proposal, as with all Modification Proposals, should be read in conjunction with the prevailing Uniform Network Code* (UNC).*

Background

Review Group 0221 “Review of Entry Capacity and the Appropriate Allocation of Financial Risk” was established in September 2008 to assess whether or not the current credit arrangements in place for securing long term NTS Entry Capacity were sufficiently robust and provide the correct balance of risk between various Shipper Users.

Following Review Group 221 discussions, National Grid NTS believes there are two key issues that have been identified:

1. The current UNC requirements, for Quarterly NTS Entry Capacity* (QSEC), are that a User puts in place credit arrangements to provide security for a rolling twelve month period. Thus, the obligation commences twelve months prior to the date on which the entry capacity bought in a QSEC auction becomes effective. If insufficient credit is put in place, all QSEC rights (across all ASEPs) “for the relevant quarters” lapse. Notwithstanding, National Grid NTS’s obligation to make capacity available for up to the next four quarters, a User at a single entry point would effectively be able to keep deferring capacity commitments up to twelve months prior to the event.
2. In addition to the above, the Review Group considers that there is currently an inappropriate length of time between a User committing to buy long term NTS Entry Capacity and the User financially underpinning this commitment. This could lead to a situation where, following User default or deferral of capacity commitment, the revenue associated with this User’s capacity commitment will be recovered through changes to general NTS Transportation Charges. NG NTS and Review Group attendees consider that the timing of the

capacity commitment and the associated financial underpinning should be more closely aligned in order to minimise the amount of associated revenues being recovered through general, i.e. non User specific, NTS Transportation Charges.

Modification Proposal

National Grid NTS has raised this Modification Proposal to address the above issues.

The following part of the Modification Proposal relates to addressing issue one:

Current security provisions set out in B2.2.15 of the UNC TPD mean that NG NTS looks at the sum of the User's current Relevant Code Indebtedness* and the following twelve months liability for capacity charges associated with Quarterly NTS Entry Capacity, as acquired in Quarterly System Entry Capacity (QSEC) auctions.

If this aggregated amount exceeds 85% of the User's Code Credit Limit, then National Grid NTS will notify the User. The User can either increase its Code Credit Limit by providing additional security or be in the position where the User's Registered Quarterly Firm NTS Entry Capacity for each of the relevant calendar quarters will lapse and the User will cease to be treated as holding the Registered Quarterly Firm NTS Entry Capacity.

These provisions define the requirement for NG NTS to be provided with security for near term entry capacity, i.e. the next 12 months capacity charges that form part of the transportation invoicing arrangements and it is proposed that this provision in UNC TPD Section B2.2.15 remain in place.

However, we propose to amend UNC TPD Section B 2.2.16 to:

- Remove the ability for a User to defer the provision of the security required under UNC TPD Section B2.2.15 and therefore, for this User's Registered Quarterly Firm NTS Entry Capacity to lapse;
- Clarify that the User will continue to be treated as holding the relevant Firm NTS Entry Capacity and will be subsequently invoiced for that capacity. Any failure to pay the above invoices will be treated in the same way as any other transportation debt; and
- In addition we also propose that National Grid NTS will reject any further QSEC capacity bids at any ASEP submitted by the User until the above security has been provided by the User.

It is anticipated that this change will enhance current incentives for Users to submit the required security as per UNC TPD Section B2.2.15.

The following part of the Modification Proposal relates to addressing issue two:

Within [28] days of the implementation of this proposal, it is proposed that Users will be required to put in place and subsequently keep in place sufficient security to underpin their existing Quarterly NTS Entry Capacity (QSEC) holding. The level of security will be the amount determined by the entry capacity risk assessment i.e., the User's User Security Value (USV). Full details of the entry capacity risk assessment and the USV are explained later in the proposal. The User shall provide this security via either a Deposit Deed* or Letter of Credit*.

It is also proposed that [28] days prior to participating in any auction process for Quarterly NTS Entry Capacity (QSEC), that Users will be required to provide sufficient security to cover their revised holding.

Prior to the commencement of the auction allocation process NG NTS will determine whether a User's revised USV (reflecting their existing holding and any new capacity bids made) exceeds the actual security provided. If the User USV exceeds the security provided then NG NTS will reject all of that User's auction bids at all ASEPs and across all Years in that auction. The User can provide additional security at any point prior to the start of the allocation process.

The security provisions proposed in this proposal are in addition to those currently within UNC TPD Section V.

Entry Capacity Risk Assessment

All Users with QSEC NTS Entry Capacity holdings will be required to provide appropriate security to support their QSEC capacity holding. This security will be known as the User Security Value and will be based on a risk assessment of the Allocated Capacity Values (ACV). Each User's User Security Value (USV) required will be calculated as follows:

$$\text{USV} = \text{ACV multiplied by UCR} + \text{VAT}$$

Where:

VAT = Value Added Tax at the prevailing rate

ACV = that User's allocated QSEC NTS Entry Capacity bids at all ASEPs for all Years Y2 to Y16 inclusive multiplied by [0.1].

In order to ensure that their auction bid values are allocated the User will be required to derive the ACV, by estimating the (max) value of their successful capacity bids across all auction periods and adding this to the value of their existing capacity holding for Gas Years Y2 to Y16 (inclusive).

A number of options for selecting the QSEC NTS Entry Capacity bid years used to derive the ACV were investigated by the Review Group. Each

option was discussed in turn and dismissed as being capable of manipulation by auction parties. The Y2 to Y16 option was considered by the group as being the option which best balanced the conflicting aims of capturing the financial impacts of a User's commitments, whilst not unduly disincentivising long term investment signals.

The Review Group sought to achieve the balance referred to above by reducing the value to a proportion of Y2 to Y16, thus ensuring that the overall level of security required is relative to the problem and does not unnecessarily discourage User's from giving long term auction signals. It is the view of the attendees of the 0221 Review Group that this proportion/percentage be [10%].

UCR is the User Credit Risk. Where a User has an Approved Credit Rating from Standard and Poor's, or Moody's Investors Service, the User's UCR will be determined via the table below.

Where a User currently uses an Independent Assessment Score or Parent Company Guarantee (PCG) as security for their NG NTS Transportation Invoicing, then the associated rating/score will be used in determining a Users UCR via the table below.

Standard and Poor's	Moody's Investors Service	Independent Assessment Score	User Credit Risk (UCR)
AAA/AA	Aaa/Aa		30%
A	A		72%
BBB+	Baa1	10	86%
BBB	Baa2	9	86.7%
BBB-	Baa3	8	87.4%
BB+	Ba1	7	88.1%
BB	Ba2	6	88.8%
BB-	Ba3	5	89.5%
		4	90.7%
		3	93%
		2	95.3%
		1	97.7%
No credit rating	No credit rating	0	100%

Long Term Entry Capacity Default Process

It is also proposed that the following actions be classed as “events of User default” which will trigger the following “default process”:

1. the amount determined by the User’s USV exceeds the value of the security in place; or
2. the User’s supplied security tool (LoC or Deposit deed) has less than [30 days] validity remaining; or
3. The credit rating of the financial institution providing the LoC has gone below the minimum credit rating specified in UNC TPD Section V.

If an “event of default” occurs, a notice will be issued to the User by National Grid NTS informing the User of the event of default and requiring the User to provide the necessary security to cover at least the User’s USV within the next 10 Business Days.

In addition National Grid NTS will aim to lessen the impact of the event of default by rejecting any further applications for [QSEC and AMSEC] capacity by the User, until the necessary security is put in place.

In the event that the User has not met the conditions of the notice (after 10 business days), then the User’s QSEC capacity holding across all ASEPs in Years Y2 to Y16 will be cancelled and the User charged a cancellation fee equivalent to the User’s security held for the purposes of underwriting the User’s holding of QSEC. As an appropriate sanction, National Grid NTS will also reject any further applications made at the [next QSEC and AMSEC auction].

It is proposed that the provisions of UNC TPD Section B5.4 will continue to apply in relation to the cancelled capacity but it will be amended to reflect that they will be followed in the event of a long term entry capacity “default”.

Following application of Section B5.4 any remaining cancelled NTS Entry Capacity will be offered in subsequent capacity auctions and treated as unsold capacity.

It is proposed that any revenues accumulating from the cancellation charge and any new Allocated Capacity Values from the resale or B5.4 process will be combined and compared to the expected revenue. It is anticipated that NG NTS will need to consult on the Charging Methodology to define the cancellation charge and consequential recalculation of the existing charges which will be considered as part of the actual revenue assessment.

- b) **Justification for Urgency and recommendation on the procedure and timetable to be followed (if applicable)**

- c) **Recommendation on whether this Proposal should proceed to the review procedures, the Development Phase, the Consultation Phase or be referred to a Workstream for discussion.**

2 Extent to which implementation of this Modification Proposal would better facilitate the achievement (for the purposes of each Transporter's Licence) of the Relevant Objectives

National Grid NTS considers this Proposal would, if implemented, better facilitates the following Relevant Objectives as set out in its Gas Transporters Licence:

- In respect of Standard Special Condition A11 1(a), the efficient and economic operation of the pipeline, this Proposal discourages speculative auction bidding, thus reducing the risk of inefficient system investment and provides an incentive for Users to honour entry capacity auction commitments. This in turn will give National Grid NTS and the shipper community greater assurance over the appropriateness of any associated system developments and or allowed revenue returns.

- In respect of Standard Condition A11.1(c) the efficient discharge of the licensee's obligations under this licence, by providing an incentive on Users to book Quarterly NTS Entry Capacity only when required is expected to reduce the potential for providing unnecessary physical NTS capacity. This would be consistent with the achievement of this relevant objective.

- In respect of Standard Special Condition A11 1(d), the securing of effective competition, this Proposal, whilst extending the credit arrangements, aims to reduce the Shipper community's exposure to a User failing to pay for their Entry Capacity holdings, without introducing a prohibitive cost to Users who may wish to take part in the Entry Capacity auctions. We believe that this proposal ensures that costs and shipper default risks are allocated appropriately across all Users.

3 The implications of implementing this Modification Proposal on security of supply, operation of the Total System and industry fragmentation

This proposal seeks to strike a balance between capturing an efficient level of User commitment and mitigating the shipper community's risk from User failure to pay capacity charges.

During the development of this proposal National Grid NTS has sought to reflect the views of the attendees of the 0221 Review Group. These views included the ability to mitigate the shipper community's risk to a single User's default, whilst at the same time not creating an undue barrier to entry or adversely impacting on the

amount of capacity purchased through long term auctions and the long term investment singles that these auctions seek to provide.

Using all years between Y2 and Y16 to calculate the ACV and reducing it to a proportion [(10%)] ensures the overall level of security required is relative to the problem and does not discourage User's from making long term auction signals.

This proposal seeks to mitigate the risk to the shipper community of a User failing to pay capacity charges, by removing the current ability for single ASEP User's to allow their capacity to lapse.

4 The implications for Transporters and each Transporter of implementing this Modification Proposal, including:

a) The implications for operation of the System:

This Proposal seeks to ensure that any investment in the NTS is efficient and economic by requesting an appropriate level of User Commitment, which we believe, should not unduly discourage Users from bidding for unsold baseline and triggering non-obligated or incremental capacity.

b) The development and capital cost and operating cost implications:

The levels of security to be provided by Users as a result of the introduction of this proposal is expected to be in the region of £65m (5.5% of all Allocated Capacity Values (ACV)), which would equate to an estimated Letter of Credit cost across all Users of around £1.6m to £3m per year. This estimate is based on a LoC cost range - 1% LoC face value for AAA User's rising to 7% for User's with no credit rating.

However, Users with poor credit ratings may choose to use a deposit deed as a cheaper option, as the amount deposited is currently subject to bi-annual interest payments equal to Bank of England base rate.

This Proposal seeks to provide an incentive for Users to honour existing and future capacity auction commitments and ensure that any investment in the NTS is efficient and economic. This would be reflected in the Transporter's development and capital costs.

c) Whether it is appropriate to recover all or any of the costs and, if so, a proposal for the most appropriate way for these costs to be recovered:

National Grid NTS believes that any changes to the UKLINK system resulting from this proposal should be funded via a "User pays" approach. [A ROM has been requested]. National Grid NTS proposes that development and implementation costs should be funded [100%] by Users in proportion to:

Total implementation and development costs * (User's ACV divided by the sum of all User's ACV)

The ACVs to be used in the above calculation shall be the ACVs applicable

on the date of the implementation of this proposal.

These sums will be invoiced over the remainder of the Gas Year following implementation of this Proposal.

d) The consequence (if any) on the level of contractual risk of each Transporter under the Uniform Network Code of the Individual Network Codes proposed to be modified by this Modification Proposal

No such consequences have been identified.

5 The extent to which the implementation is required to enable each Transporter to facilitate compliance with a safety notice from the Health and Safety Executive pursuant to Standard Condition A11 (14) (Transporters Only)

Not applicable.

6 The development implications and other implications for the UK Link System of the Transporter, related computer systems of each Transporter and related computer systems of Users

[A full assessment has not yet been conducted] National Grid NTS believes there will be system impacts as a result of having to carry out the entry capacity default process.

7 The implications for Users of implementing the Modification Proposal, including:

a) The administrative and operational implications (including impact upon manual processes and procedures)

For those Users participating in the QSEC auctions, the User will probably need to adjust their administrative arrangements to reflect the User Commitment arrangements so that they are able to assess their credit requirements and ensure a Deposit Deed or Letter of Credit is in place to match their capacity holdings.

This proposal has implications for single ASEP Users as they will need to provide security and pay for capacity that they have committed to in the QSEC auctions. The requirement to pay will be regardless of whether or not they are in a position to utilise the capacity they have booked.

b) The development and capital cost and operating cost implications

National Grid NTS appreciates that there will be cost implications in extending the security arrangements. As a result of the 0221 Review Group discussions we consider that the costs incurred from implementing this proposal are offset by the benefits accrued from mitigating the risk of a User's failure to pay Entry capacity charges.

We also believe the operating costs associated with this proposal (£1.6m to £3m) are reasonable when compared to the Shipper community bearing the

full cost of a project or major User failure (circa £20m per year).

c) The consequence (if any) on the level of contractual risk of Users under the Uniform Network Code of the Individual Network Codes proposed to be modified by this Modification Proposal

By reinforcing the obligations on Users to pay capacity charges, the current risk to other Users would be reduced.

8 The implications of the implementation for other relevant persons (including, but without limitation, Users, Connected System Operators, Consumers, Terminal Operators, Storage Operators, Suppliers and producers and, to the extent not so otherwise addressed, any Non-Code Party)

No such consequences have been identified.

9 Consequences on the legislative and regulatory obligations and contractual relationships of the Transporters

No such consequences have been identified.

10 Analysis of any advantages or disadvantages of implementation of the Modification Proposal not otherwise identified in paragraphs 2 to 9 above

Advantages

National Grid NTS believes that by introducing appropriate User Commitment for long term entry capacity:

- Shippers will continue to signal sufficiently far in advance to allow National Grid NTS to make appropriate investment decisions.
- The proposal lessens the risk of, and shipper community exposure to, an event of a Shipper failing to pay its entry capacity charges
- Discourages speculative auction bidding, thus reducing the risk of inefficient system investment
- Provide an incentive for Users to honour existing and future entry capacity auction commitments.

Disadvantages

National Grid NTS recognises that there are some disadvantages in relation to this proposal, namely that

- Users may feel that their capital is tied up in the provision of the additional User Commitment which prevents other use of these funds. The provision of Letters of Credit or Deposit Deed will also come at a cost to the User. NG NTS would welcome views from respondents to this proposal as to the extent of annual costs in this area.
- Implementation risk: Projects could be delayed or cancelled as a result of the new User Commitment required

- User may use the opportunity provided by the implementation of this proposal to withdraw from their current capacity commitments.
- Single ASEP Users would no longer have the benefit of, Registered Quarterly NTS Entry Capacity lapsing and will have to provide security and pay for such capacity that they may not be in a position to use.

11 Summary of representations received as a result of consultation by the Proposer (to the extent that the import of those representations are not reflected elsewhere in this Proposal)

None received

12 Detail of all other representations received and considered by the Proposer

None received

13 Any other matter the Proposer considers needs to be addressed

None

14 Recommendations on the time scale for the implementation of the whole or any part of this Modification Proposal

15 Comments on Suggested Text

16 Suggested Text

Code Concerned, sections and paragraphs

Uniform Network Code

Transportation Principal Document

Section(s)

Proposer's Representative

Name (Organisation) Ritchard Hewitt (National Grid NTS)

Proposer

Name (Organisation) National Grid NTS