Draft Modification Report
Quarterly NTS Entry Capacity User Commitment
Modification Reference Number 0246/0246A/0246B
Version 2.0

This Draft Modification Report is made pursuant to Rule 9.1 of the Modification Rules and follows the format required under Rule 9.4.

1 The Modification Proposal

Proposal 0246:

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.

Proposal 0246A:

Background

Review Group 0221 "Review of Entry Capacity and the Appropriate Allocation of Financial Risk" was raised in response to a very specific issue, namely that a Shipper could secure capacity at a single entry point through the QSEC auctions resulting in a significant increase in NGG's allowed revenue with no exposure if the project failed. National Grid NTS raised Modification Proposal 0246 "Quarterly NTS Entry Capacity User Commitment" which was their interpretation of the outcome of this Review Group.

EDF Energy believes that this has highlighted a failure in the price control and NGG's Licence that needs to be addressed. In particular as capacity has been allocated through the QSEC auction NGG's allowed revenue has been increased by £100m over 5 years even though no investment has been undertaken. This £100m will have to be funded by the industry and customers, and if no costs have been incurred by NGG then this will represent a significant increase in their bottom line. Whilst outside of the scope of this proposal we believe that this is a significant issue that needs to be addressed by Ofgem to protect the interests of consumers.

EDF Energy believes that the purpose of 0246 should be to discourage Shippers placing speculative bids with no exposure if the project fails to be delivered. If this objective is achieved then NGG should not have to undertake investment to support a project that is unlikely to be delivered. However for clarity we also do not believe that securing credit should provide NGG with a carte blanche for increasing allowed revenue.

It is important to note that the role of 221 was to attempt to protect the industry from the risk of project failure – the risk that that capacity will be allocated to support a project which fails to be delivered – with the risk that the associated capacity could not be utilised by another party as it was project specific therefore leading to stranded costs. This is materially different to company failure where it is likely that the capacity would be utilised by the party acquiring the assets of the distressed party, i.e. leading to no stranded costs, e.g. see TXU, Dynergy and Enron.

Review Group 0221 identified the following two issues:

Proposal 0246B:

This modification proposal has been raised as an alternative to 0246 "Quarterly NTS Entry Capacity User Commitment", raised by National Grid.

Background

Modification proposal 0246 broadly sets out two changes to the UNC. First, it seeks to close the existing "loophole" whereby a User at a single entry point, having committed to NTS entry capacity through a long term auction, can decline NG NTS requests for credit made 12 months in advance of capacity delivery and instead repeatedly defer the capacity delivery date at no additional cost to itself. In the absence of payment by the bidding User, the revenue owed by that User to NG NTS would continue to be paid by the balance of the shipping community through increased TO Commodity charges even in situations where NG NTS had incurred very minor or indeed zero costs as a result of the capacity purchase.

The second function of proposal 0246 is to remove the lag between auction bid and placing of credit by the bidding User by requiring the immediate securitising (upon implementation) of all existing QSEC holdings, and securitisation in advance of all new QSEC capacity bookings.

BGT agrees with the proposer of proposal 0246 that the current arrangements are untenable and need rectification. We believe that possibly the neatest way of resolving the deficiencies is through a combined UNC modification proposal(s) and an amendment to NG NTS' transportation licence to prevent NG NTS collecting auction bid revenues significantly in excess of its incurred costs in situations where the User's capacity requirement is deferred, or indeed the capacity is no longer required. However, we recognise that as a shipper we are unable directly to effect changes to the transporter licence. This UNC modification proposal, therefore, is an attempt to prevent the worst financial aspects of the current "loophole" from impacting the shipping community, and hence consumers.

Proposal 0246:

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

Proposals 0246 and 0246A:

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. National Grid 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.

Proposal 0246A:

However National Grid NTS' Modification Proposal goes further and proposes that the only acceptable credit tools are a Letter of Credit (LoC) or a Deposit Deed, provided that these were provided by a financial institution with an A grade rating from Moody's. In effect this would mean that a Parent Company Guarantee (PCG) from a company with a rating higher than A would be less credit worthy than a LoC from a bank with an A rating. In addition some Shippers are owned by banks and so a PCG would again not be acceptable but a LoC from the same institution would be. EDF Energy does not believe that this is appropriate.

Credit requirements, and costs, are by their very nature specific to each individual company. Significant work is undertaken by credit rating companies to ascertain the credit worthiness of a company and attribute a credit rating to it which will be dependent on issues such as:

- capital gearing
- payment history
- Quality of risk management
- General business management
- Geographical risk
- Jurisdictional risk
- Regulatory risk

This credit rating will then be used by the financial institutions when charging for a LoC. Therefore the requirement to lodge a LoC will favour institutions with a higher credit rating who can secure it at a lower cost (roughly 1%)

compared to a company with no credit rating who may have to lodge cash.

EDF Energy believes that this blanket approach to credit tools fails to take into account the company specific nature of credit and will merely create costs to consumers. We are therefore proposing that the changes to the acceptable credit tools contained within NGG's proposal are removed and the current credit tools detailed within UNC Section remain in place.

This is in line with the recommendation of the Review Group that a Users' credit requirements are decreased in line with their credit rating. This was removed by NGG from Modification Proposal 0246 at a late stage because they believed that it was undue discrimination. However EDF Energy believes that provided the credit requirements are applied in a transparent manner based on the company's credit rating then we do not believe that this would be undue discrimination. Conversely forcing a company with an A grade rating or higher to provide the same credit as a company with no credit rating could be viewed as undue discrimination as this fails to take into account the difference between the two companies. However given that NGG's original proposal relied solely on credit rating and failed to take into account over factors such as payment history we believe that the current credit tools should be retained as they are more sophisticated than NGG's proposal.

Proposal 0246B:

Summary of this proposal

As with 0246, this proposal seeks to make two main changes to the UNC. The first change sought by this proposal is largely the same as the first part of proposal 0246. Much of the wording below describing this first change is a direct lift from proposal 0246.

The second change to the UNC set out by this proposal is to require that, following implementation, all new baseline and incremental capacity bids to be made in any QSEC auction held in the relevant year must be securitised in advance of the auction. For the avoidance of doubt, this proposal differs from 0246 in that 0246 has a significant retrospective element i.e. it would require Users to securitise all existing QSEC capacity holdings as well as all new QSEC holdings. This proposal would apply only to QSEC bookings made after implementation.

Whilst BGT fully understands the reasoning behind proposal 0246 and its additional requirement to securitise all existing and new QSEC capacity holdings, we believe that that approach is inefficient and excessive, and that the credit cost to shippers of doing so will outweigh the benefits – particularly in the prevailing economic climate.

Existing capacity holdings were bought by Users on the basis of the rules, and associated costs, in place at the time of purchase. 0246 would change (possibly significantly) the costs faced by Users in respect of existing capacity holdings, without a corresponding increase in the value of that capacity. It is likely that in some cases, had Users known about the proposed increase in cost, this would have changed their decision about what capacity to purchase, and how much they were prepared to pay for it.

Implementation of 0246 would therefore gives rise to a possibility that where the cost/value dynamic of a User's existing capacity holdings changes significantly, that User may decide relieve themselves of that capacity by some means or other rather than face the additional cost of securitisation. We believe this could destabilise the capacity process.

We believe there is also a timing issue. If, as seems likely, there is a QSEC auction process in September 2009, then following a Regulatory Impact Assessment and final Ofgem decision, Users may have only a matter of a couple of weeks in order to put up what could be a significant amount of security. For any User who has not been close to this process, this could come as an unwelcome surprise and could cause real financial difficulties.

Instead, this proposal seeks to capture the risk to the shipping community from cost socialisation posed by all future QSEC bids.

Unlike proposal 0246, however, this proposal does not seek to restrict the suite of transportation credit tools available to shippers, instead allowing the full suite of UNC transportation credit tools to remain available as at present. This differs from 0246, which seeks to restrict available credit tools to Letter of Credit or Deposit Deed.

Further, unlike 0246 this proposal does not use the term "cancellation fee", as we believe that that terminology legitimises the action of Users who renege on previous auction User Commitments. BGT is also aware of views that use of the term "cancellation fee" may restrict National Grid to recovering only the amount of security provided by a defaulting User, and may preclude National Grid from seeking to recover the full amount of outstanding revenues from a defaulting User. This proposal therefore seeks to avoid any such pitfall.

Proposals 0246 and 0246A:

Modification Proposal

Proposal 0246:

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

Proposals 0246 and 0246A:

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

Proposal 0246B:

First Change

All Proposals:

Current security provisions set out in B2.2.15 of the UNC TPD mean that National Grid 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 the auctions for Quarterly NTS Entry Capacity (QSEC) (referred to below as QSEC auctions). (Proposal 0246B: ~~auctions for Quarterly NTS Entry Capacity (QSEC) (referred to below as~~ 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 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 NTS Entry Capacity.

These provisions define the requirement for National Grid 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 predominantly 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 (Proposal 0234B: all of) this User's Registered Quarterly NTS Entry Capacity to lapse;
- to clarify that the User will continue to be treated as holding the relevant NTS Entry Capacity and will be subsequently invoiced for that capacity. Any failure to pay the above invoices will be treated (Proposal 0234B: as a default) in the same way as any other transportation debt; and
- such that National Grid NTS will reject any further QSEC (Proposal 0234B: ~~QSEC~~ entry) 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.

Proposals 0246 and 0246A:

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

Implementation

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 this proposal.

Proposal 0246:

The User shall provide this security via either a Deposit Deed* or Letter of Credit*. Deposit Deeds and Letter of Credits are a firm commitment to pay and cannot be amended or cancelled without agreement of all parties involved, fully covering against insolvency. Other security tools are not being considered as they do not offer the same protection in the event of insolvency.

Proposal 0246A:

For clarity it is proposed that the security tools detailed within TPD V 3.4.5 remain acceptable security tools.

Proposals 0246 and 0246A:

It is also proposed that 14 days prior to participating in any subsequent auction process for Quarterly NTS Entry Capacity (QSEC), Users will be required to provide sufficient security to cover their anticipated additional capacity holding resulting from their participation in the auction. Such security amount to be determined through the application of the entry capacity risk assessment referred to above to the User's anticipated additional capacity holdings.

Proposal 0246B:

Second Change

It is proposed that 14 days prior to participating in any future auction process for Quarterly NTS Entry Capacity (QSEC), Users will be required to provide sufficient security to cover their anticipated additional capacity holding resulting from their participation in the auction.

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 this proposal.

All Proposals:

National Grid currently invites Users to make applications for Quarterly NTS Entry Capacity for a period of ten consecutive Business Days (unless stability has been reached) during 01 September and 30 September in a Capacity Year. Users submit capacity bids between 08:00 and 17:00 hours on an invitation date and auction information is sent to Users by 20:00 each day.

It is proposed that following closure of each QSEC bid window (Proposal 0246B: (i.e. each day)) National Grid NTS will reject all capacity bids submitted by a User in that window where that User's revised User's Security Value (Proposal 0246B: ~~User's Security Value~~ USV) reflecting both their existing holding and (Proposal 0246B ~~both their existing holding and~~ their) "anticipated" capacity allocation that would have resulted had that bid window been the final bid window, exceeds the User's prevailing security. This will ensure that a "defaulting" User's bids do not effect (Proposal 0246B: ~~effect~~ affect) the reporting during the auction and are also disregarded prior to determining whether or not the auction has reached stability.

National Grid NTS also proposes that following each QSEC bid window closure (Proposal 0246B: ~~National Grid NTS also proposes that following each QSEC bid window closure~~ It is also proposed) that a full business day (Proposal 0246B: ~~business day~~ Business Day) is added between the closure of this window and the opening of the next to carry out the aforementioned validation of the auction bids. It is therefore proposed that the ten consecutive Business Days is changed to eight bid windows each punctuated with one business day (Proposal 0246B: ~~business day~~ Business Day) between the windows and that the current auction information is sent to Users by 20:00 on the business day (Proposal 0246B: ~~business day~~ Business Day) after the bid window; to which the information relates: closes. Previous QSEC auctions have been analysed and National Grid NTS has found that stability has always been reached by the seventh consecutive day if not before. Therefore reducing the number of bid windows to eight would not have changed any previous auction and is therefore unlikely to have a material effect going forward.

To be clear, this proposal does not preclude a User providing additional security during the annual invitation period.

Proposals 0246 and 0246A:

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

All Proposals:

Entry Capacity Risk Assessment

As detailed above, all Users with (Proposal 0246B: ~~with~~ wishing to buy) QSEC NTS Entry Capacity holdings will be required to provide appropriate security to support their QSEC capacity holding (Proposal 0246B: ~~holding~~ bids). This security will be known as the User Security Value (Proposal 0246B: ~~User's Security Value~~ USV) and will be based on a risk assessment of the Allocated Capacity Values (ACV). Each User's required User Security Value (USV) (Proposal 0246B: ~~User's Security Value (USV)~~ USV) will be calculated as follows:

USV = ACV + VAT

Where:

VAT = Value Added Tax at the prevailing rate

ACV = that User's allocated (Proposal 0246B: ~~allocated~~) QSEC NTS Entry Capacity bids at all ASEPs for all Years (Proposal 0246B: ~~Years~~ years) Y+2 to Y+16 inclusive multiplied by 0.1.

In order to ensure that its QSEC auction bids are allocated the User will be required, prior to the auction, to derive its post auction ACV, by estimating the (max) (Proposal 0246B: ~~max~~ maximum) value of its successful capacity bids across all auction periods and to add this to the value of its (Proposal 0246B: ~~its~~ any) existing capacity holding for Gas Years Y+2 to Y+16 (inclusive) (Proposal 0246B:~~holding for Gas Years Y+2 to Y+16 (inclusive)~~ holdings acquired following implementation of this proposal).

Proposals 0246 and 0246A:

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 all but the one proposed in this proposal were (Proposal 0246A: ~~were~~ was) dismissed as being capable of manipulation by auction parties. The Y+2 to Y+16 option put forward in this proposal 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 further achieve the balance referred to above by reducing the value of the aggregate ACV to a proportion of Y+2 to Y+16, thus ensuring that the overall level of security required is proportionate to the problem and does not unnecessarily discourage Users from giving long term auction signals. It was the view of the attendees of Review Group 0221, which expressed a preference, that this proportion/percentage be 10%.

Proposal 0246:

The Review Group also considered that security requirements should be further reduced depending on the Users credit rating. National Grid NTS put forward adjustment calculations that reduced the security requirements based on their Moody's credit rating or Standard and Poor's equivalent. This approach was initially incorporated within Modification Proposal 0246. However, National Grid NTS considers that any proposal which seeks to charge similar Users a different cancellation fee when recalling the same value of capacity is likely to be viewed as unduly discriminatory and therefore at odds with our licence obligations. National Grid NTS has therefore not included this element within this revised Modification Proposal.

Proposal 0246B:

Available Security Tools

Review Group 0221 spent some considerable time discussing appropriate security tools, including the use of reductions based on a User's Credit Rating. That approach was originally included in proposal 0246, however this element has subsequently been withdrawn by National Grid. The reason given is that National Grid NTS considers that any proposal which seeks to charge similar Users a different fee when recalling the same value of capacity is likely to be viewed as unduly discriminatory and therefore at odds with its licence obligations. National Grid NTS has therefore not included this element within 0246.

However, BGT understands that using a range of credit tools in order to match the security requirement to the risk posed by the debtor is a robust and extremely well established principle, not only within the UNC but also across the broader business community in much of the commercial world. We therefore propose that the security requirements set out in the above mentioned USV can be met by individual Users based upon the existing transportation capacity credit tools set out in the UNC.

All Proposals:

Long Term Entry Capacity Default Process

It is also proposed that the following actions be classed as "events of User default":

1. the amount determined by the User's USV exceeds the value of the security in place; or
2. (Proposal 0246B: any part of)the User's supplied security tool (LoC or Deposit deed) (Proposal 0246B: ~~LoC or Deposit deed)~~) has less than 30 days validity remaining; or
3. the credit rating of the financial institution providing the LoC (Proposal 0246B:~~the financial institution providing the LoC~~ any organisation backing any part of a User's supplied security) has gone below the minimum credit rating specified in UNC TPD Section V.

If an "event of User default" occurs, a "default process" will be triggered whereby 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 (Proposal 0246B:~~QSEC~~ entry) capacity by the User, until the necessary security is put in place.

Proposals 0246 and 0246A:

In the event that the User has not met the conditions of the notice after 10 Business Days, or in the event that the User has been terminated under UNC TPD Section V, then the User's QSEC capacity holding across all ASEPs in Years Y+2 to Y+16 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 NTS Entry Capacity for Years Y+2 to Y+16 inclusive as proposed in this proposal. As a further appropriate sanction, National Grid NTS will also reject any further applications made to acquire System Capacity under Section B or via a System Capacity Trade in which the User is a Transferee User until the following Day after the bids are allocated by National Grid in the next QSEC auction.

Proposal 0246B:

In the event that the User has not met the conditions of the notice after 10 Business Days, or in the event that the User has been terminated under UNC TPD Section V, then the User's QSEC capacity holding across all ASEPs in Years Y+2 to Y+16 will be cancelled and the full amount of the User's provided security will be drawn down by National Grid for the purposes of underwriting the User's holding of NTS Entry Capacity for Years Y+2 to Y+16 inclusive. This action shall not preclude National Grid utilising all existing powers available to it to pursue the User for the full amount of all outstanding auction revenues.

As a further appropriate sanction, National Grid NTS will also reject any further applications made to acquire System Capacity under Section B or via a System Capacity Trade in which the User is a Transferee User until the following Day after the bids are allocated by National Grid in the next QSEC auction.

All Proposals:

Where a User fails to provide or maintain the security required by this proposal the User's prevailing QSEC capacity holding across all ASEPs in Years Y+2 to Y+16 that has been previously subject to Transfer will be treated as though the User had been terminated under UNC TPD Section B5.4. i.e. the Transferee User may elect to be registered as holding the Capacity and subsequently liable for Capacity Charges in respect of the transferred capacity.

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

Proposals 0246 and 0246A:

It is proposed that any revenues accumulating from the cancellation fee 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 National Grid NTS will need to consult on the Charging Methodology to define the cancellation fee and consequential recalculation of the existing charges which will be considered as part of the actual revenue assessment.

Proposal 0246B:

It is proposed that any revenues accumulated followed National Grid's drawing down of the defaulting User's security, and any new Allocated Capacity Values from the resale or B5.4 process will be combined and compared to the expected revenue. At the time of writing, National Grid NTS is consulting on its Charging Methodology to define the "cancellation fee" (as referred to in 0246) and consequential recalculation of the existing charges which will be considered as part of the actual revenue assessment. Further changes to the Charging Methodology may be required if this modification proposal (which does not use the term "cancellation fee") is implemented.

2 User Pays

a) Classification of the Proposal as User Pays or not and justification for classification

All Proposals:

It is considered that any changes to UK Link resulting from implementation would be funded via a "User pays" approach.

b) Identification of Users, proposed split of the recovery between Gas Transporters and Users for User Pays costs and justification

All Proposals

!00% Entry Capacity Users

Users would benefit from implementation as:

- There is a risk that if a User "defaults" or defers its capacity commitment, the allowed revenue associated with that User's capacity commitment would be recovered through changes to general NTS Transportation Charges. These Proposals aim to mitigate the risk of this type of event. Therefore implementation would benefits all Users that are liable to pay the above charges as it aims to discourage speculative bidding and reduce the Shipper community's exposure to a User failing to pay for its Entry Capacity holdings.
- Gas Transporters are financially neutral to the risks and benefits highlighted in this proposal.

This assumes that National Grid NTS is allowed to recover all of the revenue resulting from incremental entry capacity release even if the User defaults and no investment is incurred.

c) Proposed charge(s) for application of Users Pays charges to Shippers

All Proposals:

Costs would be funded by Users in proportion to:

User Pays costs * (User's ACV divided by the sum of all User's ACV)

The ACVs to be used in the above calculation would be the ACVs applicable on the date of the implementation of this Proposal.

d) Proposed charge for inclusion in ACS – to be completed upon receipt of cost estimate from xoserve

3 Extent to which implementation of the proposed modification would better facilitate the relevant objectives

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

All Proposals:

Implementation would discourage speculative QSEC 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 would give National Grid NTS and Users greater (but by no means complete) assurance over the appropriateness of any associated system developments and/or allowed revenue returns.

Standard Special Condition A11.1 (b): so far as is consistent with sub-paragraph (a), the coordinated, 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;

All Proposals:

Implementation would not be expected to better facilitate this Relevant Objective.

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;

All Proposals

Implementation would provide an incentive on Users to book Quarterly NTS Entry Capacity only when required. This is expected to reduce the potential for providing unnecessary physical NTS capacity.

By requiring Users to underwrite their anticipated allocation of capacity prior to a QSEC auction, and subsequently maintain this underwriting, implementation would provide an appropriate level of incentive on Users not to bid in such auctions in a speculative manner. By discouraging such speculative bidding implementation would also minimise the risk of speculative bidding influencing the outcome of the auction process thus reducing the potential for inefficient outcomes.

Any arrangement, such as the current position with the UNC, which maintains the ability for a User's QSEC auction bids to be considered during the auction allocation process and then subsequently provide an opportunity for the User to decline to take up the capacity allocated (by, for example, not subsequently providing the required security to underwrite that allocated capacity), increases the potential for speculative bidding and the associated adverse effects on the efficiency of the auction signals given. Such arrangements are therefore less optimal in terms of both this Relevant Objective and A11 1 (d).

Standard Special Condition A11.1 (d): so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition:

(i) between relevant shippers;

(ii) between relevant suppliers; and/or

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

All Proposals:

Implementation, whilst extending the credit arrangements, would potentially reduce the exposure on Users as a whole to one or more Users failing to pay for their Entry Capacity holdings (referred to below as "defaulting"), without introducing a prohibitive cost to Users who may wish to take part in the Entry Capacity auctions. Implementation would ensure that costs and shipper default risks were allocated appropriately across all Users.

As described in the A11 1 (c) section above, arrangements which maintain the ability for a User's QSEC auction bids to be considered during the auction allocation process and then subsequently provide an opportunity for the User to decline to take up the capacity allocated (by, for example, not subsequently providing the required security to underwrite that allocated capacity), increases the potential for speculative bidding. Such a situation increases the potential for a, subsequently "defaulting", User to unduly influence the bidding arrangements of other Users in the QSEC auction and the subsequent capacity allocations. Such arrangements are less optimal than those proposed in this proposal in relation to this Relevant Objective.

It should be noted that there could be an implementation risk that could impact on competition between Users, where projects could be delayed or cancelled as a result of the new User Commitment required.

Standard Special Condition A11.1 (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;

All Proposals:

Implementation would not be expected to better facilitate this Relevant

Objective.

Standard Special Condition A11.1 (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;

All Proposals:

Implementation would not be expected to better facilitate this relevant objective.

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

All Proposals:

Insofar as security of supply may be enhanced by onshore and offshore developments financed by small Users, which would not be considered by larger Users, implementation might affect security of supply. This assumes that certain small Users would be inhibited from developing projects due to difficulties in obtaining security from financial institutions prior to obtaining guarantees of NTS Entry Capacity..

5 The implications for Transporters and each Transporter of implementing the Modification Proposal, including:

a) Implications for operation of the System:

All Proposals:

No implications have been identified.

b) Development and capital cost and operating cost implications:

All Proposals:

These Proposals seek to provide some further reassurance that any investment National Grid NTS chooses to undertake in the NTS is efficient and economic by requesting an appropriate level of User Commitment, which should not unduly discourage Users from bidding for unsold baseline and triggering non-obligated or incremental capacity.

These Proposals also seek to provide an incentive for Users to honour future capacity auction commitments and provide some assurance that any investment in the NTS is efficient and economic. This would be reflected in the Transporter's development and capital costs.

Proposals 0246 and 0246A:

Implementation would provide this same incentive in respect of honouring existing capacity auction commitments.

c) Extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:

All Proposals:

A Rough Order of Magnitude (ROM) analysis for UK Link changes was provided by xoserve in February 2009. This indicated that the development and implementation costs related to a full system solution would be in the region of £250k-£500k. The proposed cost apportionment is set out in Section 2 above.

Proposals 0246A and 0246B:

Whilst this ROM was prepared for Proposal 0246, it is considered that the costs for 0246A and 0246B would be similar or less.

d) Analysis of the consequences (if any) this proposal would have on price regulation:

All Proposals:

No such consequences have been identified.

6 The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal

All Proposals:

A reduction in risk for National Grid NTS would occur due to a reduction in the likelihood of actions that attempt to strip National Grid NTS of perceived excessive unearned income or "windfall gains". This would occur, for example, where the requirement for that capacity had been deferred or was no longer required, and limited or no physical work had been undertaken by National Grid NTS, in order to deliver that capacity.

7 The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users

All Proposals:

An initial estimate of the costs related to a full system solution is in the region of £250k-£500k. A full Detailed Cost Assessment (DCA) has not yet been conducted by National Grid NTS and xoserve.

It is estimated that a full system solution could take of the order of two years to develop, test and implement, and therefore there would be a period of time during which National Grid NTS and xoserve would use manual procedures to provide the functionality described in this Proposal; the costs of which are estimated at circa £10k per annum.

Proposals 0246A and 0246B:

Whilst this ROM was prepared for Proposal 0246, it is considered that the costs for 0246A and 0246B would be similar or less. This also applies to any manual procedures whilst the full system solution was being prepared.

8 The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk

Administrative and operational implications (including impact upon manual processes and procedures)

All Proposals:

Users participating in the QSEC auctions would need to adjust their administrative arrangements to reflect the User commitment arrangements proposed so that they are able to assess their credit requirements and ensure Security was in place at all times to match their capacity holdings.

Implementation would have implications for single ASEP Users as they would need to provide security and pay for capacity to which they had committed, in the QSEC auctions. The requirement to pay would be regardless of whether or not they were in a position to utilise the capacity they had booked.

Proposal 0246:

Users participating in the QSEC Auctions would need to provide this Security through a Letter of Credit or Deposit Deed.

Proposals 0246 and 0246A:

Security and payment for NTS Entry Capacity would apply to such capacity purchased in previous QSEC Auctions.

Development and capital cost and operating cost implications

All Proposals:

The aggregate level of Security to be provided by Users as a result of the introduction of this proposal is expected to be in the region of £119.5m (10% of all Allocated Capacity Values (ACV)), which would equate to an estimated Letter of Credit cost across all Users of around £4m 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 might 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.

Proposal 0246B

Users may also choose to use other forms of Security already included in the UNC.

All Proposals:

Given events since the introduction of Transco's Network Code, National Grid NTS has estimated the costs of project or User default to be in the region of £20m per year. This is based on events such as the failure of Enron and the recent refusal of planning permission for the Fleetwood storage project.

The analysis below clarifies the potential risk to the Shipper Community:

Currently 12 Users have a QSEC Capacity holding but do not provide any financial commitment (not required to submit the required security as per UNC TPD Section B2.2.15). These Users do not have a Standard and Poor's credit rating (4 of these Users may have a parent that is Investment Grade Rated). In aggregate these Users hold allocated NTS Entry Capacity to the value of £343m (this equates to 29% of the value of all the QSEC Capacity allocated in years Y+2 to Y+16).

This risk is further illustrated by the fact that:

- Approximately 50% of the baseline Capacity (Y+2 to Y+16) at Bacton is held by 7 of these Users (circa £56m auction bid value).
- 2 of the Users are single ASEP Users (Barrow and Fleetwood) that have an entry capacity holding (£190m combined auction bid value) and have storage projects related to the utilisation of the capacity. The single ASEP User is considered to be a higher risk since current UNC "default" rules rely on the incentive that a User's capacity holdings at all ASEPs is removed for a period. A single entry point User has no other capacity holding and therefore this incentive property is ineffective.

Whilst the value of the capacity that is at risk has been calculated, the likelihood of company failure has not. The above figures may therefore overstate the default risk that the industry is exposed to. However without detailed information on the companies holding this capacity, a full risk analysis cannot be conducted.

Consequence for the level of contractual risk of Users

All Proposals:

These Proposals seek to strike an appropriate balance between capturing an efficient level of User commitment and mitigating the risk on Users as a whole from one or more Users failing to pay NTS Entry Capacity charges.

Implementation would mitigate Users' risks due to a single User's default, whilst at the same time not creating an undue barrier to entry or adversely impacting the amount of capacity purchased through long term auctions and this long term investment signals that these auctions seek to provide.

Using all years between Y+2 and Y+16 to calculated the ACV, and reducing it to a proportion of 10%, ensures the overall level of security required is proportionate to the problem and does not discourage Users from providing long term auction signals.

These Proposals seek to mitigate the risk to Users as a whole of one or more Users failing to pay NTS Entry Capacity charges by removing the current ability for Users at an ASEP to allow their capacity to lapse.

9 The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party

All Proposals:

No such implications have been identified.

10 Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

All Proposals:

No such consequences have been identified.

11 Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages

All Proposals:

- Users will continue to signal sufficiently far in advance to allow National Grid NTS to make appropriate investment decisions.
- Reduces the exposure of all Users in the event that one or more Users failed to pay its NTS Entry Capacity charges
- Discourages speculative auction bidding, thus reducing the risk of inefficient system investment and minimising any adverse impact on other Users bidding for capacity at the same ASEP in the same QSEC auction
- Provides an incentive for Users to honour future QSEC auction commitments.

Proposals 0246A and 0246B:

- Ensures credit requirements and tools are based on the credit rating of the company so reflecting the risk of failure.

Disadvantages

All Proposals:

- 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 Security provisions may also be additional costs to the User.
- Projects could be delayed or cancelled as a result of the new User commitment required.
- Users may use the opportunity provided by the implementation of this proposal to withdraw from their current capacity commitments.
- Users would no longer have the benefit of Registered Quarterly NTS Entry Capacity lapsing in the event that security is not put in place.

Proposal 0246:

- Additional Security costs associated with Letters of Credit or Deposit Deeds may be incurred.

12 Summary of representations received (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Written Representations are now sought in respect of this Draft Report.

13 The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation

All Proposals:

Implementation is not required to enable each Transporter to facilitate compliance with safety or other legislation.

14 The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence

All Proposals:

Implementation is not required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence.

15 Programme for works required as a consequence of implementing the Modification Proposal

All Proposals:

No programme for works would be required as a consequence of implementing these Modification Proposals.

16 Proposed implementation timetable (including timetable for any necessary information systems changes and detailing any potentially retrospective impacts)

17 Implications of implementing this Modification Proposal upon existing Code Standards of Service

All Proposals:

No implications of implementing this Modification Proposal upon existing Code Standards of Service have been identified.

18 Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel

19 Transporter's Proposal

This Modification Report contains the Transporter's proposal to modify the Code and the Transporter now seeks direction from the Gas and Electricity Markets Authority in accordance with this report.

20 Text

All Proposals:

None provided

Representations are now sought in respect of this Draft Report and prior to the Transporters finalising the Report.

For and on behalf of the Relevant Gas Transporters:

Tim Davis
Chief Executive, Joint Office of Gas Transporters