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UNC Modification Proposal 0246, 0246A and 0246B –
"Quarterly NTS Entry Capacity User Commitment "

Dear John,

Thank you for your invitation seeking representation with respect to the above Modification Proposals. National Grid NTS, as proposer of modification 0246, continue to support implementation of its proposal for the reasons set out in the proposal.

National Grid NTS also provide qualified support for Modification Proposal 0246A on the basis that National Grid NTS don't consider it appropriate to extend the available credit tools to include all tools in UNC TPD Section V 3.4.5 but it does consider that this is outweighed by the remaining benefits of this proposal.

We believe that as Modification Proposal 0246B restricts security provision to future allocations of capacity the benefits of the proposal are reduced significantly and it also introduces a differential treatment between Users. Coupled with the expansion of the credit tools as in 0246A, this leaves National Grid NTS to be neutral in respect to 0246B.

The Modification Proposal 0246 was raised by National Grid NTS as a consequence of discussions within Review Group 0221 "Review of Entry Capacity and the Appropriate Allocation of Financial Risk". We would like to take the opportunity to thank all parties who participated and contributed in this Review Group.

Proposal 0246, if implemented, would remove what the Review Group agreed was an inappropriate length of time between a User bidding and subsequently being allocated capacity in the Quarterly NTS Capacity auction and committing financially to this long term NTS Entry Capacity. The proposal also enhances the current regime by removing the ability for Users to defer their Quarterly NTS Entry Capacity commitments. Together these proposed enhancements will:

- Serve to discourage speculative QSEC auction bidding;
- Reduce the risk to the Shipper Community of under recovery of allowed revenue associated with such speculative bidding or a Shipper default; and
- May serve to encourage the User to signal the desire to trade the capacity earlier to another party where a User no longer requires the QSEC capacity.

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We believe that all three proposals support the changes required to enhance the current regime to prevent Users deferring their Quarterly NTS Entry Capacity Obligations, therefore the rest of our response is specifically related to the long term user commitment aspects of the proposals and the credit tools to be made available.

Quarterly NTS Entry Capacity User Commitment: All holdings or Future Holdings Only

The National Grid NTS (0246) and EDF Energy (0246A) proposals require Users to securitise all existing and new QSEC holdings, whereas, BGT (0246B) is proposing that only future allocations of QSEC capacity should be securitised.

Review Group 0221 explored a number of different options in regard to what capacity holdings would be covered by any new security requirement and we believe that the consensus view established at that time was that the preferred option was to provide security for all bookings both present and future. We consider this to be non-discriminatory as it would provide a level playing field for all those holding QSEC entry capacity and wishing to hold QSEC in the future.

BGT feel that 0246 is excessive in terms of the potential costs faced by existing Users and highlights that had Users known about the proposed increase in costs they may not have purchased the capacity or may have amended how much they were prepared to pay for each unit of capacity. In response to these concerns 0246B proposes to just securitise future allocation of capacity. We believe this will mean the treatment of new capacity holdings will be different to that of existing capacity. We are mindful that this may be viewed as unduly discriminatory.

We also believe that the BGT proposal will not reduce the risk, identified at Review Group 0221, of inefficient system investment to the same degree as 0246 and 0246A, as there will still be an inappropriate length of time before some existing Users commit financially to the long term NTS Entry Capacity they have already acquired via previous QSEC auctions. The introduction of 0246B will mean that Users will not be required to put security in place to underpin any system investment associated with existing holdings until 12 months prior to the Gas Day.

National Grid NTS is also mindful of the Authority's decision to reject CUSC Amendment CAP131 on the 13th October 2008 which paid particular attention to the issue of undue discrimination between new and existing generators. Following discussion at Review Group 0221, specifically in relation to the CAP131, we now consider it highly likely that the same assessment completed by Ofgem with regards to the issue for generators could also be applied to BGT's proposal 0246B, in that it may be considered that "the proposer has failed to demonstrate that there are sound, objective reasons for the proposed differential treatment of new and existing users which … may give rise to undue discrimination".

At a meeting of the Review Group 0221 a potential implementation risk was identified, where Users may choose, at the point of implementation (of a retrospective proposal such as 0246 or 0246A), to not put in place the required security and therefore relinquish their existing Quarterly NTS Capacity across all ASEPs for Years 2 to 16 inclusive. In such a situation the User may then go on to acquire their capacity requirement again via other mechanisms (i.e. Daily Capacity auctions at a different (and potentially lower) price.

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National Grid NTS has assessed the potential size of this implementation risk and believe that, dependant on the scenarios applied, it could vary in a range between £30m to £400 million over the next 16 years but mainly concentrated in the earlier years. Whilst National Grid NTS believes that the likelihood of Users choosing to relinquish their current QSEC capacity holdings at the point of any implementation of Mod 0246 or 0246A is very limited (due to the potential for such relinquished capacity being unavailable to that User in subsequent auctions), we have also sought to mitigate this risk by seeking to apply appropriate sanctions should Users not provide the necessary security. However, we do recognise that despite the above some Users may still seek to relinquish and then repurchase capacity as a response to the implementation of either 0246 or 0246A.

We do appreciate that, as Modification Proposal 0246B is only looking to secure future baseline and incremental capacity bids made in the QSEC auction, it does not have the same implementation risk associated with 0246 and 0246A.

As part of discussions with the Review Group 0221 we note that Ofgem have confirmed that this implementation risk will form part of any Regulatory Impact Assessment to be performed by Ofgem. At this stage we feel that National Grid's Modification Proposal, which is seeking to provide security for all existing and future QSEC holdings is the most appropriate taking into account all of the above factors.

Security Tools

National Grid NTS proposes that the credit tools to be utilised to underpin the security requirement introduced by 0246 should be either a Letter of Credit (LoC) or a Deposit Deed. Both of the alternative proposals expand on these tools to include all the current credit tools listed within UNC TPD Section V 3.4.5. National Grid NTS are of the opinion that the benefits attributable to restricting Users to the use of LoC's and Deposit Deeds outweigh the reduced costs that some parties could obtain from using other credit tools such as an Investment Grade Rating (IGR) or a Parent Company Guarantee (PCG). A LoC or a Deposit Deed is a firm commitment to pay and cannot be amended or cancelled without the agreement of all parties involved. This therefore provides valuable cover against insolvency.

Other tools e.g. Parent Company Guarantees may not offer the same protection in the event of insolvency of the Guarantor, as there is a risk that the Guarantor (particularly if the guarantor is part of the same group of companies as the defaulting User) will not be able to fulfil its obligation in the event that the relevant User does not meet its obligations. In the past, banking and energy companies were in distinct and separate sectors of the economy, and therefore it is unlikely that difficulties or failure of an energy company will be simultaneous with that of the bank providing the LoC. This is in contrast to the situation with PCGs, where it is more likely that the parent and subsidiary will be in the same or closely related industries and therefore may face financial difficulties at the same time.

It should also be recognised that the Review Group noted in November 2008, that the current credit guidelines should be seen as related to usage not commitment. With this in mind National Grid NTS believes that the consensus of Review Group 0221 was that the guidelines had not been written in relation to long term products or commitment and that a different approach should not be ruled out.

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Costs Vs Benefits

National Grid NTS recognises that there is a cost implication in extending the current security arrangements. Discussions at Review Group 0221 were extremely useful in exploring whether the costs of such a change would outweigh the benefits accrued from limiting speculative auction bids and reducing the risk of a User's failure to meet its auction commitments. In particular the review group debated at length what proportion of the User's QSEC entry capacity should be used to derive the required security, whether it was proportionate to the risk identified and whether it would discourage Users from making long term auction signals. In the development of its Modification Proposal National Grid NTS has sought to reflect the views provided and has therefore proposed that the security level should be set at 10% of all QSEC capacity holding in years Y+2 to Y+16.

National Grid NTS has assessed the aggregate level of security to be provided by Users as a result of the introduction of proposal 0246. This is expected to be in the region of £119.5m. It is estimated that the cost of using a Letter of Credit across all Users to cover this amount of security would be in the region of £4m per year. This estimate is based on a LoC cost range of 1% face value for Users with AAA credit ratings, rising to 7% for Users with no credit rating. If Users with a lower credit rating chose to use a deposit deed then our estimate of the costs would be reduced to around £2.2m per year. In producing this further estimate we have acknowledged that providing a deposit deed will prevent Users from using these funds for other purposes and a cost of 3% has been assumed to reflect this.

National Grid NTS has also analysed the estimated costs of proposals 0246A & 0246B, where Users with (or their parent have) a credit rating may choose to use an IGR/PCG which for this exercise have been given an associated operating cost of zero. Initial analysis indicates that the security costs would be reduced to approx £3.3 m per year (a reduction of around £0.7m against 0246).

National Grid NTS are of the opinion that the certainty relating to LoC's and deposit deeds justifies the additional cost associated with their use. We also believe that the level of User Commitment being requested within 0246 is an appropriate response to the risk currently being faced by the Shipper Community of a project failure and or a Shipper default. Whilst events of past default are extremely rare and analysis of future risk is difficult to quantify, experience available in relation to historic failures such as that befalling Enron and recent planning permission failures, leads National Grid NTS to estimate potential costs related to the risk of an event of default to be in the region of £20m per year.

Default Rules

Both 0246 and 0246A state that a cancellation fee equivalent to the User's security provided to cover its QSEC capacity holding will be charged if an event of default has not been rectified by the User. This mechanism allows National Grid NTS to count this recovered security towards payment of the QSEC cancellation amount and subsequently be used as part of any expected revenue assessment.

Whilst 0246B specifically excludes a reference to a "Cancellation Fee" after discussion with the proposer of 0246B, we have clarified that although different terminology will be used, the default rules will work in the same way as both 0246 and 0246A i.e. in the event of default a fee will be charged to the User which is equivalent to the security amount.

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Interactions with National Grid NTS Licence

EDF Energy highlight in their proposal (Mod 0246A) that:

- Review Group 0221 "Review of Entry Capacity and the Appropriate Allocation of Financial Risk" was raised in response to a "very specific issue", where a Shipper could secure QSEC capacity at a single entry point "resulting in a significant increase in NGG's allowed revenue with no exposure if the project failed".
- The above highlights "a failure in the price control and NGG's Licence that needs to be addressed".

We would like to take this opportunity to clarify the above:

Review Group 0221 was not established in response to one specific issue but rather it sought a wide ranging review of whether or not the current credit arrangements in place for securing long term entry capacity User commitments, deliver an appropriate balance between the risk of the individual User and that of the rest of the Shipper community. The following extract from the Terms of Reference for this Review Group aims to expand on this point: the Review Group shall "*consider whether the current credit and security arrangements are sufficiently robust to underpin User commitments effectively. For example; lead time, duration, level of credit cover, types of credit mechanisms, types of capacity covered by any new arrangements*". The same issues were, and continue to be, debated in relation to the development of the electricity transmission access regime as a robust user commitment model must be underpinned by appropriate credit security arrangements.

National Grid Gas' (NGG) Transmission Licence obligations and allowed revenue arrangements do not fall under the auspices of the UNC and are not relevant to resolving the key UNC issues that have been identified by the Review Group, which are:

- Users, particularly at a single entry point, can defer their capacity commitments
- There is currently an inappropriate length of time between a User committing to buy long term entry capacity and the User financially underpinning this commitment.

We believe that it is appropriate to pursue UNC changes where we believe they will better facilitate the relevant objectives regardless of potential future changes to Gas Act derived Licence conditions. We also concur with the views expressed by the Ofgem representative at the 0221 Review Group meetings that matters relating to NGG's allowed revenues and NTS Licence obligations should be considered in the round at the time of the next price control review.

Extent to which implementation of Modification Proposal 0246 would better facilitate the achievement (for the purposes of each Transporter's Licence) of the relevant objectives

- In respect of Standard Special Condition A11. 1(a), the efficient and economic operation of the pipeline, 0246, 0246A & 0246B all discourage speculative auction bidding but National Grid NTS believes that 0246 better facilitates this objective by limiting the security tools to Letter of Credit and a Deposit Deed. These credit tools are a firm commitment to pay and cannot be amended or cancelled without agreement of all parties involved, thereby fully covering against insolvency. Proposals 0246A & 0246B are less effective to this relevant objective since, by allowing the use of other security tools such as PCGs (which are not a firm

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commitment to pay), they will not be as effective in discouraging speculative auction bidding.

- In respect of Standard condition A11 1(d), the securing of effective competition. Whilst extending the credit arrangements, all 3 Modification Proposals aim to reduce the Shipper community's exposure to a User failing to meet their QSEC capacity commitments and reduce the impact of speculative auction bidding on other auction parties. However, National Grid NTS believes that 0246 and 0246A better facilitate this objective as they are non-discriminatory and would not introduce differential treatment between existing and future capacity holders. As discussed earlier, Review Group 0221 explored a number of different options for selecting the capacity holdings within scope and the preferred option was to provide security for all QSEC years +2 to +16 capacity holdings present and future. 0246B proposes just to securitise new capacity holdings and this could potentially mean that operating costs for new entrants would be different to those of Users with existing capacity holdings.

Section 7

As detailed in 0246, it is estimated that a full system solution could take up to two years to develop, test and implement, and that an interim solution may be required during this period. We have received further details from xoserve regarding the feasibility/costs of an interim solution and National Grid NTS recommend that a full Detailed Cost Assessment for the interim/full solution be progressed at the earliest opportunity.

Summary

The table below highlights the two main differences between the 3 QSEC Entry Capacity User Commitment Proposals:

	0246 National Grid NTS	**0246A EDF Energy**	**0246B British Gas Trading Ltd.**
QSEC Security: to cover all existing and new QSEC holdings for Years Y+2 to Y+16	✓	✓	**X** (prospective only)
Security tools limited to Letter of Credit and Deposit Deeds	✓	**X** (all tools - UNC TPD V3.4.5)	**X** (all tools - UNC TPD V3.4.5)

After fully considering these 2 key differences, National Grid NTS believe that National Grid's modification proposal, which is seeking to provide security for all existing and future QSEC holdings in the form of LoC or deposit deed, is the most appropriate.

Please let me know if you require any further information to enable preparation of the Final Modification Report.

Yours sincerely,

Chris Shanley
Senior Commercial Analyst