CODE MODIFICATION PROPOSAL No 0246B
Quarterly NTS Entry Capacity User Commitment
Version 1.0

Date: 23/04/2009

Proposed Implementation Date:

Urgency: Non Urgent

1 The Modification Proposal

a) Nature and Purpose of this Proposal

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.

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.

First change

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 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 remains 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 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 as a default in the same way as any other transportation debt; and

• such that National Grid NTS will reject any further 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.

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.

The User shall provide this security via any of the current suite of transportation credit tools set out in the UNC.

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 (i.e. each day) National Grid NTS will reject all capacity bids submitted by a User in that window where that User's revised USV reflecting 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 affect the reporting during the auction and are also disregarded prior to determining whether or not the auction has reached stability.

It is also proposed that a full Business Day is added between the closure of each QSEC bid window and the opening of the next in order 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 between the windows and that the current auction information is sent to Users by 20:00 on the 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.

Entry Capacity Risk Assessment

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

USV = ACV + VAT
Where:

VAT = Value Added Tax at the prevailing rate

ACV = that User's QSEC NTS Entry Capacity bids at all ASEPs for all 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 (maximum) value of its successful capacity bids across all auction periods and to add this to the value of any existing capacity holdings acquired following implementation of this proposal.

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.

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. any part of the User's supplied security has less than 30 days validity remaining; or

3. the credit rating of 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 entry 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, 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.

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.

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.

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

As an alternative to 0246, this modification proposal should follow the same

timescales as 0246.

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.

As an alternative to 0246, this modification proposal should proceed straight to consultation without development. However, it should be noted that the concepts described by this proposal have been extensively discussed at Review Group 0221, and subsequently at Transmission Workstreams and Transmission Charging Methodology Forums.

2 User Pays

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

National Grid NTS believes that any changes to the UKLINK system resulting from this proposal should be funded via a "User pays" approach. Whilst we are not entirely satisfied that Users should face any cost from attempts to rectify the perceived underlying defects in the User Commitment regime established between National Grid and Ofgem through the Gas Transporter's Licence, reluctantly we agree that under current arrangements, this is a 100% User Pays proposal.

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

100% Entry Capacity Users.
The benefits of this Modification Proposal will be felt by Shippers as:

- There is a risk that if a User "defaults" or defers their capacity commitment, the allowed revenue associated with this User's capacity commitment will be recovered through changes to general NTS Transportation Charges. This Proposal aims to mitigate the risk of this type of event. Therefore this proposal benefits all Users which 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 their Entry Capacity holdings.

- Gas Transporters are financially neutral to the risks and benefits highlighted in this proposal.

Please note that this assumes that NGG 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

Costs should 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 shall 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 this Modification Proposal would better facilitate the achievement (for the purposes of each Transporter's Licence) of the Relevant Objectives

BGT considers this Proposal would, if implemented, better facilitate 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 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 will give National Grid NTS and the shipper community greater (but by no means complete) 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. 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 this proposal provides an appropriate level of incentive on Users not to bid in such auctions in a speculative manner. By discouraging such speculative bidding this proposal also minimises 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).

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 entry Capacity holdings booked after implementation (referred to below as "defaulting"), without introducing a prohibitive cost to Users who may wish to take part in the Entry Capacity auctions. The proposer believes that this proposal ensures that costs and shipper default risks are allocated appropriately across Users.

As described in the A11 1 (c) section above, arrangements which maintain the ability for a User's QSEC capacity 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. The proposer considers that such arrangements are less optimal than those proposed in this proposal in relation to this relevant objective.

Arrangements which seek to reduce the current UNC timeframe during which a User can effectively decline to take up the capacity allocated (such as Option 3 discussed within Review Group 0221) would, in BGT's opinion, be better than the current regime in relation to the detrimental effects of speculative auction bidding. However the fact, that any such arrangements would continue to provide the opportunity for a User to decline to take up the capacity allocated, perpetuates the detrimental impacts of speculative bidding and subsequent unwinding of allocations. It also introduces complex questions in relation to the treatment of other Users' allocations at ASEPs where a User has subsequently "defaulted". BGT therefore considers that such arrangements would not facilitate this relevant objective to the same degree as this proposal. Indeed we consider that the detrimental effects described above also outweigh the potential barriers to entry introduced by the requirement to put in place the security proposed prior to the QSEC allocation process commencing.

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.

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

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

This proposal aims 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 signals that these auctions seek to provide.

BGT believes that the proposed ACV requirement ensures the overall level of security is proportionate 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 NTS Entry Capacity charges, by removing the current ability for ASEP User's to allow their capacity to lapse.

5 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 provide some further reassurance that any investment which National Grid chooses to undertake 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 QSEC capacity.

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

The implementation of this proposal will clearly result in higher credit costs, compared to current UNC arrangements, for a proportion of Users seeking to bid for new QSEC entry capacity. BGT has sought to minimise these costs to a large extent by restricting the security requirement to cover only new capacity bids, and by allowing a range of existing proven security tools to be used.

This Proposal seeks to provide an incentive for Users to honour future capacity auction commitments and to provide some further reassurance 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. Whilst we are not entirely satisfied that Users should face any cost from attempts to rectify the perceived underlying defects in the User Commitment regime established between National Grid and Ofgem through the Gas Transporter's Licence, reluctantly we agree that under current arrangements, this is a 100% User Pays proposal.

A Rough Order of Magnitude (ROM) analysis was provided by xoserve in February 2009 which indicated that the development and implementation costs related to a full system solution for modification proposal 0246 would be in the region of £250K- £500K. BGT believes that this alternative is certainly no more complex (and therefore costly) to implement than 0246, and therefore that the original ROM should remain valid as a cost guideline.

Costs should 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 shall be the ACVs applicable on the date of the 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

BGT believes that, if implemented, this proposal will reduce National Grid's level of risk. This reduction in risk will occur from a reduction in the likelihood of action to attempt to strip National Grid of perceived excessive unearned income or "windfall gains", e.g. where the requirement for that capacity is deferred or indeed no longer required, and limited or no physical work has been undertaken by National Grid in order to deliver that capacity.

6 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.

7 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

An initial estimate of the costs related to a full system solution for 0246 is in the region of £250K-£500K. At the time that 0246 was raised, a full Detailed Cost Assessment (DCA) for that proposal had not been conducted by National Grid NTS and xoserve. Whilst somewhat different, BGT believes that this proposal is simpler, and therefore the initial estimate of up to £500K should remain valid.

For 0246 it was estimated that a full system solution could take of the order of two years to develop, test and implement, and therefore, if that proposal was implemented, there will be a period of time during which National Grid and xoserve would use manual procedures to provide the functionality described in that proposal, the costs of which were estimated at circa £10k per annum.

BGT believes that, again, that figure of £10k per annum should cover the interim operational costs of this proposal.

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

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

Any User seeking to acquire capacity in future QSEC auctions will need to adjust its administrative arrangements to reflect the User Commitment arrangements proposed in this proposal so that it is able to assess its credit requirements and ensure that appropriate security is in place prior to commencement of the auction.

b) The development and capital cost and operating cost implications

There will be cost implications in extending the security arrangements. As a

result of the Review Group 0221 discussions it is considered 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 NTS Entry Capacity charges.

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.

9 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.

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

No such consequences have been identified.

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

Advantages

The proposer believes that by introducing appropriate User Commitment for long term entry capacity:
• Users 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 User failing 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 capacity auction commitments
• Users would no longer be able to benefit from Registered Quarterly NTS Entry Capacity lapsing in the event that security is not put in place.

It is also anticipated that this proposal will have a minimal impact on the current QSEC auction processes.

Disadvantages

The proposer 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 such

security may also come at a cost 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

12 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

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

None received

14 Any other matter the Proposer considers needs to be addressed

None

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

16 Comments on Suggested Text

17 Suggested Text

Code Concerned, sections and paragraphs

Uniform Network Code

Transportation Principal Document

Section(s)

Proposer's Representative

Chris Wright

Proposer

Chris Wright (British Gas Trading Limited)