John Bradley

Chair of Review Group 221

20 February 2009

Dear Mr Bradley,

Gazprom Marketing and Trading Limited ("Gazprom") welcomes the opportunity to comment upon the principle of Shipper's securitising against their long term capacity holdings and in particular National Grid Gas' (NGGs) draft proposal.

Gazprom would like to note that it is not adverse to developing proposals that improve the existing entry capacity security arrangements and therefore supports the formation of Review Group 221. However, Gazprom were disappointed with the lack of explanation contained in the draft proposal considering it originates through a Review Group.

The draft proposal suggests that there has merely been a focus upon establishing a proposal that bolsters security levels rather than work being undertaken to properly assess the need for additional security. While in the current environment it is easy to make demands for additional security, such demands must also recognise the cost and impacts of any potential change upon Shippers, particularly at a time when the available supply of credit support may also be materially impaired.

Gazprom therefore cannot support the proposal in its current format, and would like to suggest that the Review Group goes back to first principles and quantifies the risk before developing proposals.

In particular, the current draft proposal raises these key questions:

- What sense check has been undertaken to ensure that the User Security Value (USV) calculation within the draft proposal achieves the correct balance between the additional costs incurred by Users and the industry's exposure through the smearing of costs?
- Is it not more appropriate to provide security against future actual costs of investment (as they will be incurred) rather than provide security for all historic bookings?
- Could the proposals prove to be a significant additional dis-incentive to Shippers in the future booking of long-term entry capacity, and how will this impact upon NGG's investment decisions, and the efficiency of such decisions?

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- How has the current level of secuitisation proposed been derived? For example, why is Years Y2 [Y1 if include AMSEC] to Y16 multiplied by [0.2] appropriate? How has this calculation been determined as the most appropriate level to securitise?

We believe these are fundamental questions that require answering, before an improved entry capacity user commitment proposal can be raised.

Gazprom believes any new credit arrangements proposed for securitising against long term entry capacity holdings must complement the existing entry capacity regime. For example, in the event of a party experiencing financial difficulties and then that party becoming unable to meet its cash call obligations associated with its incremental obligated capacity holdings, any such capacity would then be made available for re-use (UIOLI), re-auction and/or substitution. In Gazprom's experience, once constructed, pipelines which link suppliers and customers are always liable to be utilised (and future gas volumes likely to flow) in nearly all scenarios, albeit with facilities being owned and operated by new Shippers. Exceptions to this occur only where facilities being linked to the gas grid are either not built, or are abandoned (in the latter case having already paid NGG substantial revenues for their connection).

It would seem much more appropriate to provide securitisation against incremental new investment, rather than across the whole grid. In a worst case scenario, it could be considered that entry capacity be tied up in the medium term for up to 42 months. However, in this case, the community's exposure (and therefore cost) would be substantially reduced if it were considered to be more appropriate to capture a User's long-term entry capacity holdings for just Years Y2 to Y4.

Besides ensuring the correct numbers of Gas Years are captured to calculate the appropriate level of security, the proportion assigned is also a vital factor. The draft proposal suggests the Allowed Capacity Value (ACV) represents 20% of all bids, at all ASEP's for Years Y2 to Y16. Taking into consideration that historically industry has not experienced a huge smear back of costs through spurious projects, arrangements exists for capacity taken away from Shippers being offered for sale to others and taking into account the current financial climate, we believe 20% is far too onerous. An appropriate level could be considered to be 5% (or less) considering that some Users could incur a 7% cost for a Letter of Credit (LoC), per year. This is significantly higher than the 2.5% cost assumed by NGG within its analysis.

It is Gazprom's view that inevitably, any such additional securitisation costs incurred by Shippers will eventually have to be paid for by consumers. It is essential for any credit proposal raised that the additional costs incurred are proportionate to the risk faced by the industry through the smearing of costs. With regards to the draft proposal there doesn't appear to be any evidence that this is the case.

Gazprom's view is that the industry is at risk of being over-securitised through the potential implementation of this draft proposal. Over-securitisation has a whole new set of challenges for the industry to contend with. NGG analysis of the implementation of the USV contained in the draft proposal causes an existing User to be exposed to a credit requirement of £34 million. The implication of the individual User having to secure 34% of the full liability is abandoning the project that was previously viable, prior to introduction of over-securitisation.

Gazprom believe forcing a party into liquidation due to the introduction of security arrangements that attempt to capture the perceived risks rather than actual investment costs incurred is a worse situation for the community than the status quo.

Over-securitisation also leads to other areas of the regime being affected. A perverse incentive arising is Shippers' taking into consideration the credit requirement of their potential bids which influences their bidding strategy. Whilst the types of entry capacity being held by Shippers' may also fundamentally change. Shippers' are more likely to own short-term capacity, whilst avoiding the burdensome long-term exit holdings which includes security liabilities. As a result of this change NGG no longer receives the much valued long term signals provided by Shippers.

Gazprom believes additional action could also be taken in the form of licence changes to reduce the industry's exposure. In the event of a shipper defaulting, an automatic trigger of the reopening of the licence parameters could be implemented, if no investments were undertaken. This key licence change minimises the industry's ongoing liability, permitting a reduction in the amount securitised by individual Shippers.

To conclude, we believe further work is required to ensure the correct balance is achieved between Users' security requirements and the industry's potential risk. The draft proposal, unfortunately has not managed this equilibrium.

Gazprom therefore cannot support the current proposal, but would support the introduction of a less onerous USV that manages to preserve and encourage the appropriate behaviour, unlike the perverse effects of over-securitisation. We also believe it is extremely important to purse the suggested licence change to complement the credit regime, even under the existing regime.

Yours sincerely,

Keith Martin

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Director of Front Office