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Dear Paul

NGG Response to "User Commitment for National Transmission System Quarterly Entry Capacity: Initial Impact Assessment on modification proposal"

This response is on behalf of National Grid Gas's Transmission business (NGG). This response is structured in two parts: this letter summarises our views on the key issues for the consultation, and Appendix 1 provides our specific responses to the individual questions raised in the consultation document.

Ofgem has provided details of the issues considered by UNC Review Group 221 (Review of Entry Capacity and the Appropriate Allocation of Financial Risk) and the Modification Proposals raised to address these issues. We believe that this information highlights that the process followed was extensive and completed in consultation with the industry. We hope that the Impact Assessment (IA) will allow industry participants to provide further comments and in doing so support the Authority's decision making process.

After careful consideration of the information provided within the IA, NGG, as proposer of Modification Proposal 0246 (0246), continues to support implementation of its proposal for the reasons set out in the proposal. If implemented, 0246 would remove what the Review Group identified and agreed was an inappropriate length of time between a User bidding for, and subsequently being allocated, capacity in the Quarterly NTS Entry Capacity auctions and committing financially to this long term NTS Entry Capacity holding. The proposal also enhances the current regime by removing the ability for Users to defer their existing Quarterly NTS Entry Capacity (QSEC) commitments. The Review Group 0221 report stated that 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 their desire to trade the capacity earlier to another party where a User no longer requires the QSEC capacity.

NGG also sees merit in implementing Modification Proposal 0246A (0246A), as although it extends the available credit tools to include all tools in UNC TPD Section V 3.4.5, its benefits and costs are similar to those of 0246. Although Modification Proposal 0246B (0246B) is the lowest cost option, and incorporates the expanded credit as in 0246A, we believe that as it restricts security provision to future allocations of capacity the benefits of the proposal are reduced significantly. Since 0246B also introduces differential treatment between existing and future registered capacity holders, and, as such, is not so clearly non-discriminatory as 0246 or 0246A (albeit that it does treat all future allocations of capacity alike), NGG is less certain as to whether the proposal is discriminatory. However, we would note that arguments around discrimination between Users at different times could, if deployed in the wrong circumstances, inhibit beneficial changes to the commercial regime.

Key issues

Our position on the core issues covered within the consultation is as follows:

- **Cost and benefits** - all three Modification Proposals aim to reduce the Shipper community's exposure to a User failing to meet their QSEC commitments and reduce the impact of speculative auction bidding on other auction parties. We believe that the information provided by Ofgem does not fully illustrate the benefits of the proposals in terms of risk reduction. Although we appreciate it is difficult to quantify these benefits, we continue to believe that they outweigh the costs.
- **Effect on competition** – we acknowledge that there is a cost implication in extending the current security arrangements and that this may be more difficult for small players to fund. However, we believe that importation and storage projects will continue to be started by small developers and, where these are found to be financially viable, they will be able to attract the necessary funding to meet their security commitments and for this to be provided prior to the auction. We conclude that the competition benefits of reducing speculative auction bidding offset any potential adverse impact on competition from the risk of reduced numbers of auction players.
- **Discrimination** - NGG believes that both 0246 and 0246A are non-discriminatory and would not introduce differential treatment between existing and future registered capacity holders. This is not as clear cut for 0246B but we would acknowledge that with 0246B, all future capacity holders would be treated the same.
- **Alternate approaches -** the recent emergence of small "one-off" developers has highlighted the need to change UNC credit arrangements and we believe that these proposals are an appropriate outcome to the work of Review Group 0221. NGG's Transmission Licence obligations and allowed revenue arrangements do not fall under the auspices of the UNC and are, therefore, not relevant to resolving the key UNC issues that have been identified by the Review Group. Furthermore, it is appropriate to pursue UNC changes where we believe they will better facilitate the relevant objectives regardless of any possible future changes to Licence conditions. Although we see some merit in the alternate options suggested by Ofgem, it remains our view that matters relating to our allowed revenues and NGG's Licence obligations should be considered in the round at the time of the next price control review

Implementation date

For sometime, NGG has been aware that to implement Modification Proposal 0246 or one of the alternatives prior to the March 2010 QSEC auction, that an interim manual/offline solution would be required until a system solution was delivered. Although an interim solution has been found to be feasible there is now insufficient time to implement an offline solution before March 2010.

With this in mind we propose that on approval of one of the modification proposals that NGG would work with xoserve to determine the implementation date for a full Gemini system solution, which at this stage is anticipated to be between September 2010 and March 2011.

If you need further clarification on any of the points raised in this response, please do not hesitate to contact Chris Shanley on 01926 656251.

Yours sincerely

Mark Ripley
Regulatory Frameworks Manager

Appendix 1 - Response to specific questions

CHAPTER: Two

Question 1: Do you have any additional views on the merits/disadvantages of the options for securitization of capacity to add to those of the review group?

NGG has no additional views on the merits/disadvantages of the timing options for providing the security provision. Modification Proposals 0246/A/B all require Users to underwrite their anticipated allocation of capacity prior to a QSEC auction and this provides an appropriate level of incentive on Users not to bid in such auctions in a speculative manner.

Any option that provides an opportunity for the User to decline to take up the capacity allocated after the closing of the auction to bidders (by, for example, not subsequently providing the required security to underwrite that allocated capacity), increases the potential for speculative bidding. Such a situation also 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.

NGG consider that such arrangements are less optimal than those proposed in any of the 0246 proposals. It also introduces complex questions in relation to the treatment of other Users' allocations at ASEPs where a User has subsequently "defaulted". Therefore, NGG considers that these detrimental effects outweigh the potential barriers to entry introduced by the requirement to put in place the security proposed prior to the QSEC allocation process commencing.

We also believe that small developers should be encouraged to ensure certain aspects of their project, such as planning permission, are in place prior to them participating in the auction, as we believe this is good practice for all projects. As part of Review Group 0221 we highlighted that where developers are not able to do so, they should consider whether to sign a Preliminary Works Agreement (PWA) with NGG, prior to a Shipper signalling their entry capacity requirements in the auction process. The PWA will indicate that the capacity will be made available to purchase in the next auction in the timeframe agreed. Once the auction bid has been received and entry capacity has been allocated to the Shipper, the PWA is terminated and costs previously paid by the Developer are refunded.

We would like to take this opportunity to clarify that the original draft of 0246 included a security requirement adjustment, which reflected the risk posed by a User (based on their Moody's or Standard and Poor's credit rating) but that this mechanism was removed prior to the modification proposal being formally raised by NGG.

Although Review Group 0221 considered that security requirements should be further reduced depending on the Users credit rating, NGG considered 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. As such, NGG declined to include this element within the final Modification Proposal.

Question 2: Do you have views on the ability for NGG to cover the potential of shipper default through commercial insurance instruments?

NGG considered and conducted initial enquiries as to the feasibility of such an option during the Review Group 0221 discussions. These initial enquiries revealed that, as far as we were able to determine, credit insurance covers actual debt rather than potential debt and is unsuitable for the requirements considered by Review Group 0221.

We have also noted that Review Group 0252: Review of Network Operator Credit Arrangements, has questioned whether bilateral insurance should continue to be included as one of the allowed security tools under the UNC, as it not currently used and review group members were unclear as to how such an instrument would work.

CHAPTER: Three
Question 1: Do you agree with the analysis of the risks involved? Are there any quantifiable risks that have been omitted?

We believe that Ofgem has undertaken some informative cost and risk analysis within the IA. The operational costs figures are in-line with those provided by NGG within 0246 and/or our representation for the three proposals. We have provided some comments below on the benefits analysis.

Question 2: Is the level of securitization being proposed appropriate? If not, why?

As previously stated, NGG recognises that there is a cost implication in extending the current security arrangements. This point was debated at length within Review Group 0221 and whether the security being requested as proposed within 0246 was proportionate to the risk identified and would not discourage Users from making long term auction signals.

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. During the development of this proposal, NGG has sought to reflect the views of the attendees of the Review Group 0221. Using all years between Y+2 and Y+16 to calculate the Allocated Capacity Value (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 User's from making long term auction signals.

Question 3: Do you agree with the benefits as presented here? Are there any other ways in which the quantitative benefits could be presented?

As pointed out by Ofgem, there is no history of any default of entry capacity holdings and as a result it is difficult to quantify the benefits of the proposals.

As part of the benefits analysis, Ofgem has used "break-even" analysis that derives values for change in risk that they suggest provides a "yardstick to consider whether the costs outweigh the risks". This analysis looks wholly at the potential benefit of the proposals preventing a default with regards to future bookings. The average risk reduction required to break-even for the different proposals is as follows:

- 0246: 2.6% to 8.2%
- 0246A: 1.5% to 5.5%
- 0246B: 0.5% to 2.4%

We have some concerns with this analysis and some of the assumptions made by Ofgem. It is our view that the benefits of the proposals are greater than the above yardstick suggests and, in particular, there are benefits from the implementation of 0246 and 0246A in relation to current capacity holdings that have not been included.

We disagree with the comment made by Ofgem that "none of the proposed modifications, if implemented, would have any affect in the case of capacity, which has already been booked". We believe that this comment can only be associated with 0246B as it restricts security provision to future allocations of capacity.

We agree with Ofgem that there is a risk that Users will default on implementation of proposals 0246 or 0246A and acknowledge that this risk has been captured as a cost by Ofgem. The default risk cost calculated by Ofgem is different across the three modification proposals:

- 0246 - £7.25m to £14.5m
- 0246A - £3.1m to £7.25m
- 0246B - £2m to £5m

We suggest that Ofgem's own figures indicate that only a proportion of Users may choose to default and "crystallise the potential deficit" on implementation. This would suggest that a number of Users, who potentially may default in the future, will on implementation provide the required security, giving greater assurance that they will honour their future entry capacity commitments.

It should also be recognised that all the proposals introduce changes to enhance the current regime to prevent Users deferring their QSEC obligations, and without such a change being introduced potential User defaults may take some time to fully materialise. We believe there is a further benefit from this change (current and future capacity holdings) in that, should a User's project be delayed, they will have to pay for the capacity even if it cannot be utilised. We do not believe that these benefits have been recognised in the break-even analysis.

Ofgem also indicates that it would expect that "a significant proportion of capacity going forward to be booked by very low risk incumbents" and that as a result their analysis may have underestimated (by 50%) the average risk reduction required to break-even. We believe that the analysis conducted over simplifies the risks inherent in the current regime and that this may materialise in the future. NGG has spent sometime trying to analyse the benefits of 0246 and details of the analysis included in the proposal are set out below:

> *Given events since the introduction of Network Code, NGG 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.*
>
> *Following discussion at the April Transmission Workstream as to whether this proposal is an appropriate balance between the introduction of costs and the mitigation of User "default" risk, we have updated the proposal to include the analysis below, which we believe helps clarify the potential risk to the Shipper Community.*
>
> *Review Group 221 considered 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.*
>
> *Currently 12 Users have a QSEC capacity holding but do not provide any 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) and hold allocated capacity to the value of £343m (29% of the value of all the QSEC capacity allocated in years Y2 to Y16).*
>
> *This risk is further illustrated by the fact that:*
> - *around 50% of the baseline capacity (Y2 to Y16) at Bacton is held by 7 of these Users (circa £56m auction bid value).*
> - *2 of the Users are single ASEP Users (Barrow & Fleetwood) that have an entry capacity holding (£190m combined auction bid value) and have storage projects related to the utilisation of the capacity.*

We believe that this analysis highlights some areas that may influence the average risk of default:

- 12 Users have a QSEC capacity holding of £343m (29% of the QSEC capacity allocated in years Y2 to Y16 – both baseline and incremental capacity) and have no credit rating. As a result we believe that the risk associated to this capacity is above average in terms of default risk
- Two of these Users are Single ASEP Users with projects that are under development and they hold £190m of the aforementioned capacity. As part of the discussions held within Review Group 0221 this category of User was generally seen as high risk.

Without the introduction of one of the proposals there will continue to be what Review Group 0221 agreed was an inappropriate length of time between a User committing to buy long term entry capacity and the User financially underpinning this commitment. This analysis would suggest that as well as future capacity being booked by low risk parties, it may also continue to be booked by higher risk speculative parties with no credit rating, with single ASEP status and project risk.

Ofgem highlights that there is a valuable secondary benefit "that if, post implementation a shipper defaults on existing capacity holdings, then 10% of the value of the capacity holding is covered through the security being held by NGG NTS". We believe that this useful benefit has also not been captured in the break-even analysis. We also feel that the benefit should be clarified in terms of the three proposals:

- 0246 - restricts Users to the use of Letters of Credit and Deposit Deeds, which are a firm commitment to pay and cannot be amended or cancelled without the agreement of all parties involved. Therefore, NGG will always hold the full value (10%) in the event of insolvency.
- 0246A and 0246B – also allow other credit tools such as an Investment Grade Rating (IGR) or a Parent Company Guarantee (PCG). These other tools may not offer the same protection, as there is a risk that the Guarantor (particularly if the guarantor is part of the same group of companies as the defaulting User and also become insolvent) will not be able to fulfil its obligation in the event that the relevant User does not meet its obligations. Historic examples of such an event being Enron and Lehman Brothers.
- 0246B - is only looking to secure future baseline and incremental capacity bids and therefore this benefit would not apply to any existing capacity holdings.

Question 4: How do the risk ranges presented for each of the proposals rank against your perceived risk of default for future capacity bookings?

As discussed above we believe that the analysis performed to date by Ofgem does not fully illustrate the benefits of the proposals in terms of risk reduction.

We believe that 0246B will not reduce the risk 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 existing 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.

We believe that the approach and current risk analysis performed by Ofgem is unlikely to help industry participants correctly assess whether the benefits are sufficient to justify the costs (IT, Credit and Default risk) and rank the proposals. The costs highlighted in the IA are as follows:

- 0246 (all capacity holdings and only LoC/Deposit deed) – costs £19.5m to £36.7m
- 0246A (all capacity holdings and all credit tools are allowed) – costs of £10.65m to £24.75m
- 0246B (future capacity only and all credit tools are allowed) – costs of £3.59m to £10.6m

It is also our view that commercial acumen will drive the industry to seek to utilise the lowest cost security tool available and where the cost of a Letter of Credit is prohibitive the User will choose to use a deposit deed. We believe that this will lead to the costs incurred to be towards the lower end of the ranges provided by Ofgem.

Question 5: Do you have any preference amongst the proposals on the basis of the quantitative analysis?

The quantitative analysis performed by Ofgem has not changed our view, which remains that 0246 would better reduce the exposure of the shipper community to the risk of a default and that this benefit would outweigh the costs. Although NGG does not consider it appropriate to extend the available credit tools to include all tools in UNC TPD Section V 3.4.5, we also support 0246A as we can recognise that in comparison to 0246, this proposal could be delivered at lower cost and realise similar benefits.

CHAPTER: Four

Question 1: Do you think that the implementation of any of these proposals would have an adverse effect on competition? Please give reasons for your answer.

As previously noted, NGG recognises that there is a cost implication in extending the current security arrangements and that this may be more difficult for small players to fund. That said, it is always the case that any security arrangements are easier for larger players to manage. Currently there are numerous importation and storage projects either under construction or proposed, of these a number are being progressed by “small” developers. These projects are of different sizes and involve different levels of complexity/new technology. It is anticipated that only a proportion of all the proposed projects will actually be implemented.

Ofgem highlights that some projects started by small developers have since been acquired by larger industry players. We believe that many of the other projects currently being progressed by small developers could follow a similar route. We also believe that further projects will be started by small developers and that many of these will be able to attract the necessary funding to meet their security commitments.

The aim of the Modification Proposals was 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. NGG explored with Review Group 0221 attendees the level of security required and the provision of security for all QSEC capacity holding, present and future, taking account of barriers to entry and competition. NGG believes that all three of the "0246 proposals" better facilitate the securing of effective competition.

Question 2: Do you think any of these proposals are unduly discriminatory?

The NGG (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 should be covered by any new security requirement(s) 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 (proposer of 0246B) 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 proposed to just securitise future allocation of capacity which we acknowledge treats all future capacity bookings the same, even though it does not apply the security requirements to all bookings. NGG 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, although we would point out that arguments around discrimination between Users at different times could, if deployed in the wrong circumstances, inhibit beneficial changes to the commercial regime.

Question 3: Do you think the proposals are sufficiently simple and transparent?

We consider that modification proposal 0246 is simple and transparent and draft legal text has been provided. As draft legal text has not been provided for 0246A and 0246B we are not completely clear as to how:

- both the alternative proposals will expand the credit tools to include all the current credit tools listed within UNC TPD Section V 3.4.5
- the default rules will work for 0246B, as it specifically excludes a reference to a "Cancellation Fee"

The above points are now only likely to be addressed through a request for legal text.

Ofgem highlights that Users are required to estimate their capacity requirements in advance of the QSEC auction and any failure to do so may result in capacity bids being rejected. We would like to make the following comments in this regard:

- All of the Proposals require Users to have in place (14 days prior to the QSEC auction) sufficient security to cover their existing (not 0246B) QSEC capacity bookings and their anticipated additional holdings resulting from their participation in the auction.
- As part of all the proposals during an auction if a User were to have insufficient security then their bids are disregarded prior to determining whether or not the auction has reached stability.

This provides greater assurance that auction outcomes will not be adversely influenced by a User who subsequently does not provide the required security.

- To avoid having bids rejected we anticipate that most Users will provide security that will include an element of "headroom" to cover all eventualities/changes to their bidding strategy. Users will be able to remove any surplus security/headroom after the auction if they so wished.
- The Modification Proposals also allow Users in some instances to "top-up" their security but this depends on the type of security tool they have utilised. A full business day is to be added between the closure of one auction bid window and the opening of the next to carry out the aforementioned validation. Following each QSEC bid window closure; if stability has not been reached the Users will have the flexibility to increase their security via adding to a deposit deed. If this security is put in place before 5pm on the Business Day preceding an annual invitation date, NGG will endeavour to take account of this security.

Question 4: What is your preference on the basis of the qualitative issues?

NGG continues to support implementation of 0246. We recognise that 0246A also requires Users to securitise all existing and new QSEC holdings and, therefore, this proposal is also not viewed as being unduly discriminatory.

CHAPTER: Five

The implementation of Network Code Modification Proposal 0500 introduced industry credit rules that ensured all market participants were aware of the risks in the market and their responsibilities. It has until recently been accepted that these credit arrangements were appropriate to underpin a robust User commitment model/long term entry capacity auctions.

However, changes in industry environment and the emergence of small "one-off" developers have highlighted the need to change the UNC credit arrangements. Review Group 0221 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 Review Group 0221 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*".

NGG's 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.

Although we see merit in some of the alternate options suggested by Ofgem, 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.

The Ofgem representative at the Review Group 0221 meetings expressed the view 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. We concurred with this view at the time and see no reason to believe that this IA process is a more appropriate vehicle. The next Transmission Price Control negotiations are due to start in 2010 and we would be more than willing to discuss our views on revenue drivers and some of the other issues raised as part of this established process. With this in mind we have restricted our comments to the alternate approaches that fall within the auspices of the UNC and are of relevance to the three Modification Proposals.

Question 1: Do you think that shipper termination is a tool that should be more widely used to deal with credit default issues?

Under the current arrangements a User can legitimately allow their capacity to lapse (indefinitely) without penalty/being terminated. The “0246 proposals” aim to prevent a User deferring their capacity and termination action could be taken if they did not pay for charges that become due. This aspect of the proposals is keenly supported by the industry. However, if a User’s project is just delayed we would expect them to pay the charges due, even if the capacity is not utilised.

It has been our Legal view that terminating a User before they have used the product (12 months in advance) is not inline with the termination events prescribed in UNC TPD Section V4.3 and could be open to challenge, i.e. without actual invoiced debt what are the grounds for termination? We believe that the 0246 approach is more appropriate than exploring the potential of terminating a Shipper as a result of credit default (12 months in advance), especially as their project may have been legitimately delayed.