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2 November 2006
Our Ref: AHT/Mod 0109 response

Dear Julian

Representation in response to Modification Proposal 0109: "Acceptable Security Tools available to Users for Transportation Credit Arrangements"

Thank you for the opportunity to respond to this Draft Modification Report (DMR).

National Grid NTS offers qualified support for this proposal and offers the following comments, in line with the section headings in the DMR.

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

National Grid NTS agrees that implementation of consistent credit processes should help ensure that there is no inappropriate discrimination and no inappropriate barrier to entry, thereby facilitating the securing of effective competition between relevant shippers.

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

National Grid NTS does not foresee any detrimental implications for security of supply or operation of the Total System. National Grid NTS believes that consistent credit arrangements could facilitate non-fragmentation of the industry.

4. The implications for Transporters and each Transporter of implementing the Modification Proposal, including

a) implications for operation of the System:

National Grid NTS does not foresee any implications for operation of the System.

b) development and capital cost and operating cost implications:

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National Grid NTS understands that this Modification Proposal is unlikely to require significant expenditure for development, capital or operating costs.

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

National Grid NTS considers that any such costs would fall into the category of TO operating costs and would therefore treat these costs in the same way as our existing TO operating costs.

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

National Grid NTS notes and takes comfort from the Proposer's reiteration of the assurances made in Ofgem's Best Practice Guidelines[1] regarding the potential for bad debt recovery, resulting from the implementation of the Guidelines.

5. 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

National Grid NTS does not agree with the Proposer's assumption that "all the security tools identified are currently acceptable to all Transporters". Furthermore, National Grid NTS believes that some of the proposed tools will have an impact on Transporters' level of contractual risk, as detailed below.

Of the six tools listed in the Modification Proposal, National Grid NTS agrees that the Letter of Credit, prepayment agreement and Deposit Deed Agreement options are acceptable to Transporters and do not represent any increase in the level of contractual risk of each Transporter.

National Grid NTS is pleased to note that the Proposer has not included the option of a bilateral credit insurance policy in the Modification Proposal on the grounds that "long term credit exposure is not effectively transferred through the insurance product". National Grid NTS shares the Proposer's concerns in this area.

National Grid NTS has a number of concerns over the usage of a Parent Company Guarantee (PCG) as a security tool. National Grid NTS' understanding of Ofgem's Best Practice Guidelines is that the function of a PCG is to allow a counterparty to be assigned an unsecured credit limit based on the credit strength of the parent company (paras 3.9-10). National Grid NTS notes that Ofgem does **not** include a PCG in its list of acceptable tools in its Best Practice Guidelines (para 3.36). Our concern centres on the potential for double counting of a PCG as a method of obtaining unsecured credit as the Modification Proposal is currently drafted.

For example, the UNC currently states that a User with an Approved Credit Rating of Ba3 with Moody's Investors Service could obtain an Unsecured Credit Limit of 15 percent of the Maximum Unsecured Credit Limit. Ofgem's guidelines envisage that the User could benefit from a PCG to increase its Unsecured Credit Limit, such that if the entity providing the guarantee has a Moody's rating of A, and meets the other conditions set out in the guidelines, the counterparty could benefit from an increased Unsecured Credit Limit of 40 percent (assuming that the PCG covers just one

[1] "Best practice guidelines for gas and electricity network operator credit cover, Conclusions document, February 2005, 58/05"

counterparty). The legal drafting provided with this Modification Proposal allows a User to supplement its Unsecured Credit Rating through the usage of a number of security tools, including a PCG. If a User has already extended its Unsecured Credit Limit through using a PCG and is then allowed to use the PCG as a security tool, the PCG is double counted.

Furthermore, the definitions used in the legal text only require the entity providing the Parent Company Guarantee to have a Moody's or equivalent long term debt rating of at least Ba3. This is not in line with the requirements elsewhere in the legal drafting which require a long term debt rating or a sovereign credit rating of at least A2 from Moody's Investors Service. It is also not specified as a requirement in Ofgem's Best Practice Guidelines. National Grid NTS considers that the requirement for a Parent Company should be a long term debt rating of A2 by Moody's Investors Service or the equivalent Standard and Poor's Corporation rating.

This would offer protection to the Transporters (and thereby the rest of the industry) against the potential for bad debt to arise should a Parent Company not be sufficiently robust to fulfil its financial obligations in the event that a subsidiary company became insolvent; it would also bring this obligation in line with those pertaining to the additional security tools, as described below.

With regard to the remaining proposed security tools: performance bond provided by an insurance company and independent security; National Grid NTS has some concerns that these tools may represent an increase in contractual risk to Transporters, due to the unknown quality of the products and/or the providers of those products. However, National Grid NTS takes some comfort from the proposed legal text that requires providers of performance bonds or independent security to have a minimum long term debt rating of A2 by Moody's Investors Service (or equivalent Standard and Poor's Corporation rating) and requires the security tool to be legally enforceable.

6. 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

National Grid NTS notes that no UK Link system implications have been identified.

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

National Grid NTS agrees with the Proposer that the Modification Proposal should not impact on Users in terms of the administrative and operational costs they face.

In terms of the level of contractual risk faced by Users, National Grid NTS believes that the Modification Proposal has the potential to impact on the level currently faced by some Users. Currently, these Users are protected, to a certain extent, from others becoming insolvent and leaving bad debt by the requirement to use security tools which are, in the majority, proven to cover debts in the event of insolvency. However, the introduction of new security tools which may not provide guaranteed security to Transporters in the event that the relevant User becomes insolvent, could increase the level of risk to other Users.

If a User becomes insolvent, leaving debts to the Transporter and the Transporter is able to demonstrate that it has implemented the requisite processes in line with Ofgem's Best Practice

Guidelines, the Transporter should be able to recover the bad debt incurred. However, this would be to the detriment of the rest of the User community who in such a situation would have to fund the debt recovery through an increase in their Transportation Charges in subsequent years.

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

National Grid NTS agrees with the Proposer that Suppliers and subsequently Consumers could be impacted by an increase in costs as a result of bad debt pass through, dependent upon the commercial arrangements in place between the respective parties with regard to Transportation Charges.

9. 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

National Grid agrees with the Proposer's interpretation of Ofgem's Best Practice Guidelines.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages

National Grid agrees that alignment with Ofgem's Best Practice Guidelines could assist with the prevention of industry fragmentation and that greater clarity of current credit practices should be beneficial to all industry parties.

Disadvantages

While recognising the stated advantage to Users above, National Grid NTS believes that the Modification Proposal could potentially increase the risk of bad debt occurring. National Grid NTS takes comfort from the reassurances provided by Ofgem in its Best Practice Guidelines document which states:

"4.3 Companies demonstrating compliance with or able to satisfactorily to explain departure from the guidelines will be able to recover all bad debt losses arising in respect of charges not due for payment at the date of the relevant counterparty's insolvency, net of any dividends or recoveries;

4.4 Such companies will also be able to recover a proportion of bad debt losses arising in respect of charges overdue for payment at the date of the relevant counterparty's insolvency, net of any dividends or recoveries (which would be offset proportionately against all outstanding balances), depending on the age of the outstanding receivable. Ofgem has noted comments from a number of respondents regarding the opportunity to recover 100 per cent of bad debt whilst employing reasonable procedures. Ofgem has concluded that the amount recoverable would be equal to the value of outstanding balances subject to bona fide dispute (plus or minus the value of any reconciliation adjustments subsequently made) together with a proportion of the value of all undisputed balances (up to a maximum of 100 per cent) that varies inversely with the age of the balance, as set out below. The overall recoverable amount would be reduced for any other recoveries.

However, as stated in point 7 above, National Grid NTS recognises that this represents a potential disadvantage to Users who could have to face the cost of bad debt recovery through an increase in Transportation Charges.

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

National Grid NTS understands that there would be very little impact on operational processes and procedures in the event that this Modification were implemented.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

Given the limited impact outlined in section 14, National Grid NTS considers that this proposal could be implemented with immediate effect from the Authority's direction being given.

19. Legal Text

In line with our comments under point 5 above, National Grid NTS believes that a Parent Company Guarantee should have a long term debt rating of at least A2 by Moody's Investors Service in order to bring it in line with the requirements for the sovereign credit rating and the long term debt rating of the bank that provides a Letter of Credit. We would therefore recommend that the legal text be reworded such that the definition of Parent Company would read as follows:

"Parent Company" *shall mean a public or private company within the meaning of section 1(3) of the Companies Act 1985 with a long term debt rating of at least* ***A2*** *provided by Moody's Investor~~'~~s Service~~s~~ or equivalent rating by Standard and Poor's Corporation that is a shareholder of the User or any holding company of such shareholder (the expression holding company having the meaning assigned thereto by section 736, Companies Act 1985 as supplemented by Section 144(3) Companies Act 1989).*

Yours sincerely

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