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Dear Andrew,

Consultation on the NTS Exit Capacity Release Methodology Statement (ExCR) in respect of the Transitional and Enduring Exit Periods: Appendix 2: Supplementary Consultation

Thank you for the opportunity to comment on the Supplementary Consultation concerning User Commitment duration, as set out in Appendix 2 of the document.

A fundamental principle underpinning the reformed exit regime is that user commitment to capacity is expressed in financial terms, based on the indicative price applicable when the commitment is made. Thus, if actual prices payable are twice the indicative level, the nominal four year commitment duration is halved, ensuring that the original financial user commitment level is maintained. This principle is intended to ensure that shippers are clear as to the financial commitment they are making when committing to incremental capacity, which in turn is intended to provide robust investment signals to National Grid.

However, under the current arrangements, this principle is undermined by the capacity reduction rules which in effect set a duration-based (rather than financially-based) minimum commitment of 12 months, irrespective of actual price levels. The effect is to discriminate against shippers holding capacity for which actual prices turn out to be more than four times the indicative prices – their user commitment in financial terms can increase many-fold – whilst shippers holding capacity subject to lesser price movements are unaffected, and retain their original financial user commitment. We do not believe these somewhat random and arbitrary impacts, driven entirely by the degree of price volatility at a given exit point, were an intentional design feature of the reformed exit regime.

In our view the matter can be remedied through a simple revision to the rules that would enable shippers in each application window to notify capacity reductions in respect of holdings for which the financial user commitment expires in the forthcoming October-September period.

For consistency we would also recommend that the financial user commitment principle be extended to embrace all capacity holdings, not just those where applications for incremental capacity have been made. This would address those capacity holdings that can be reduced on 14 months notice under the current rules. Shippers who elect to retain (rather than reduce) such holdings in effect make a one year user commitment to that capacity. To ensure a common approach, this form of user commitment also needs to be dealt in accordance with the financial user commitment principles outlined above.

The overall approach advocated would provide universal alignment across all capacity holdings and shippers, irrespective of price movements or user commitment durations, in accordance with one simple principle; that the financial user commitment to any capacity should be no greater than that implied by the indicative price for the capacity at the time the commitment is made. This would eliminate the inconsistent and discriminatory aspects of the existing arrangements.

We believe such an approach would improve capacity planning processes – National Grid will receive more robust signals of future exit capacity requirements where shippers make capacity commitments in the certain knowledge that the associated financial commitment is capped at a transparent level, and that the exposure to uncertain and potentially volatile movement in indicative and actual prices is removed.

We explain our thinking on this in more detail in the attachment to this letter. If you would like to discuss any aspect further, please do not hesitate to make contact.

Yours sincerely,

Mark Sutton

Attachment

Exposure to enhanced user commitment

The Moffat example in Appendix 2 sets out the issue very clearly – we do not believe that it was the intent at the time the exit reform rules were established that a shipper could be exposed to a financial user commitment of some £56,210 per GWh/d when that based on the indicative price was only £1,460 per GWh/d (a 38.5 fold increase). In fact, under the current rules, the exposure could be even greater as it is driven entirely by the difference between the indicative and actual prices.

Inequality of treatment

Furthermore, the rules appear to operate inconsistently in that modest price increases (less than four-fold) result in the financial user commitment remaining the same, as the commitment duration can be reduced. Where higher price increases arise this principle is undermined by the mandatory 14 month notice period for capacity reduction. This clearly discriminates against shippers holding incremental capacity at exit points where prices are volatile – one might expect the rules to afford some protection against price volatility, rather than penalising the shippers concerned. At the very least one would expect equality of treatment, irrespective of price volatility.

Refinement of pricing methodology

Whilst we appreciate the work National Grid is undertaking to refine the pricing methodology under Modification 356, this will not guarantee that large price movements will not occur in future, and is not therefore a solution to this problem.

Addressing the problem

At the heart of the problem is the minimum 14 month notice period for capacity reduction, which effectively fixes the minimum user commitment period at 12 months, irrespective of price movements. We see no reason why the minimum user commitment period should not be subject to adjustment to account for indicative and actual price movements in exactly the same way as the remainder of the notional 4 year user commitment period.

For the avoidance of doubt we are not advocating that the 14 month notice period should be removed entirely – merely that at each application window a shipper holding capacity having a financial user commitment which expires (based on actual prices to be paid) in the forthcoming October-September period should be able to elect to reduce its holding from such expiry. This is similar to Option 2 set out in the Appendix – the "defined circumstance" when this would apply is the "mid-year" expiry of the financial user commitment, i.e. expiry within the forthcoming October-September period.

Impact on capacity planning and release processes

We believe such an approach would improve capacity planning processes – National Grid will receive more robust signals of future exit capacity requirements where shippers make capacity commitments in the certain knowledge that the associated financial commitment is capped at a transparent level, and that the exposure to uncertain and potentially volatile movement in indicative and actual prices is removed.

We do not believe that any "mid-year" capacity reductions arising pursuant to this approach would adversely affect the planning process because at this stage we are working in timescales where the physical availability of capacity cannot be affected by capacity holdings. From a capacity planning perspective it is immaterial whether capacity holdings in the forthcoming year are reduced at year-end or mid-year.

Nor do we believe that the potential for mid-year reductions would adversely affect capacity release processes. Should a shipper elect in an application window to reduce capacity mid-year on user commitment expiry, National Grid would simply make that capacity available through the daily release processes from the date of expiry and reduction. National Grid will have ample time to effect the release process as the election is made in the July application window, sufficiently in advance of any mid-year reduction.

Financial user commitment principle and "retained capacity"

We believe there is an artificial distinction in the current rules between capacity which is subject to a user commitment (as currently defined in the ExCR) and that which is not.

Take the case of a shipper whose capacity is not, under the current rules, subject to user commitment. If the shipper elects in an application window in year Y not to reduce holdings for Y+2 (i.e. following the minimum 14 month notice period) he is, in effect, making a user commitment to the "retained capacity" in Y+2.

We believe that the same financial user commitment principle as proposed above for incremental capacity should also apply to such retained capacity. Thus, where the actual price applicable to year Y+2 is greater than the indicative price (as notified at the time the commitment is made in the year Y application window) the shipper should have a further opportunity to elect in the Y+1 application window to reduce its holding from expiry of the "effective" financial user commitment, based on the actual prices to be paid.

For example, a shipper electing in the 2011 application window to retain 2012/13 capacity based on an indicative price of £5,000 per GWh/d would, where the actual price rose to say £10,000 per GWh/d, have a further opportunity in the 2012 application window to elect that the capacity is reduced after the first six months of 2012/13, i.e. from expiry of the "effective" financial user commitment, based on actual prices to be paid.

Universal application of the financial user commitment principle

We believe that a simple adjustment of the user commitment rules can achieve universal alignment across all capacity holdings and shippers, irrespective of price movements or user commitment durations, in accordance with one simple principle, viz; that the financial user commitment to any capacity should be no greater than that implied by the indicative price for the capacity at the time the commitment is made.

This does not undermine the user commitment principle; it simply adjusts the one and four year commitment periods to account for price movement, and ensures an appropriate conversion from duration to financial commitment.

Giving effect to the principle

This principle can be given effect through one simple additional rule:

- During any application window, a shipper may give notice of a reduction in its capacity holdings from a specified date within the forthcoming October-September period where the financial user commitment to such capacity (based on actual prices to be paid) expires on or prior to the specified date.

The financial user commitment definition would need to be expanded to include what we have termed in this note the "effective" financial user commitment made to "retained capacity", which would be based on the indicative price notified for the application window in which the commitment to retain the capacity was made.

Further refinement of the rules

The requirement under the current rules that reductions occur from the first of a month can also result in inappropriately enhanced financial user commitment. This is amply demonstrated in Appendix 2 through the Option 1 worked examples, which show that the outturn financial user commitment can be several times the appropriate level, even where "mid-year" reductions in capacity are allowed. This could be addressed by removing the "first of the month" requirement, allowing reductions from the date of expiry of the financial user commitment, as suggested above. Alternatively, if it is important to retain the "first of the month" rule, reductions could take place from the first of the month in which the financial user commitment expires, rather than the first of the following month.