UNC Modification Reference Number 0221
Entry Capacity and the Appropriate Allocation of Financial Risk
- Strawman Modification Proposal

1. Introduction

Review Group 221 was established in September 2008 to assess whether or not the current credit arrangements in place for securing Entry Capacity are sufficiently robust and provide the correct balance of risk between various UNC Parties.

The Review Group developed several options as a means of resolving the issues identified with the current arrangements and agreed to progress the following option:

- All new and existing capacity holdings should be required to provide appropriate flat security based on a credit assessment of auction bid values.

This strawman seeks to define this option further and highlight the decisions required prior to a Modification Proposal being raised in January/February 2009.

2. Background

The current credit rules within the UNC require that a User puts in place credit arrangements to provide security (on stepped basis) for the 12 months immediately prior to the start date of the QSEC capacity previously bought in a QSEC auction, which includes the Incremental Capacity Release Obligations. This underwriting timeframe is misaligned with the trigger for the incremental revenue recovery requirement incurred in meeting the auction obligations.

As the patterns of gas delivery to the NTS change and the GB market becomes increasingly dependent on overseas gas supplies, significant investment is anticipated to be required in order to develop import and storage facilities. It is also anticipated that a number of these new projects will be developed by participants that are ‘new’ to the GB gas market and may also be single entry point Users.

In this context, one facet of the existing credit arrangements is that there is potentially an increased risk of User “default” i.e. walking away from previous auction commitments at or before the point at which a financial commitment is required, resulting in increased costs being incurred by other industry stakeholders. The entry capacity incentive arrangements from April 2007 enable National Grid Gas NTS to recover 5 years of incentive payments from the first month that incremental capacity is released based on the agreed revenue driver in the GT Licence. In the event that the relevant User “defaults”, the incremental obligated entry capacity can be offered for resale. However, any under-recovery of the agreed revenue driver income would continue to accrue. This would, in turn, lead to the SO commodity charge payable by all Users being increased to recover the short fall in allowed revenue. In effect the shipper community holds a risk associated with the current mismatch between the credit underwriting timeframe currently in the UNC and the timeframe over which incremental revenue accrues.

3. Security Required

3.1 Value measure to be secured

It is proposed that each user's entry capacity auction bid values be secured and the following auctions are within scope:

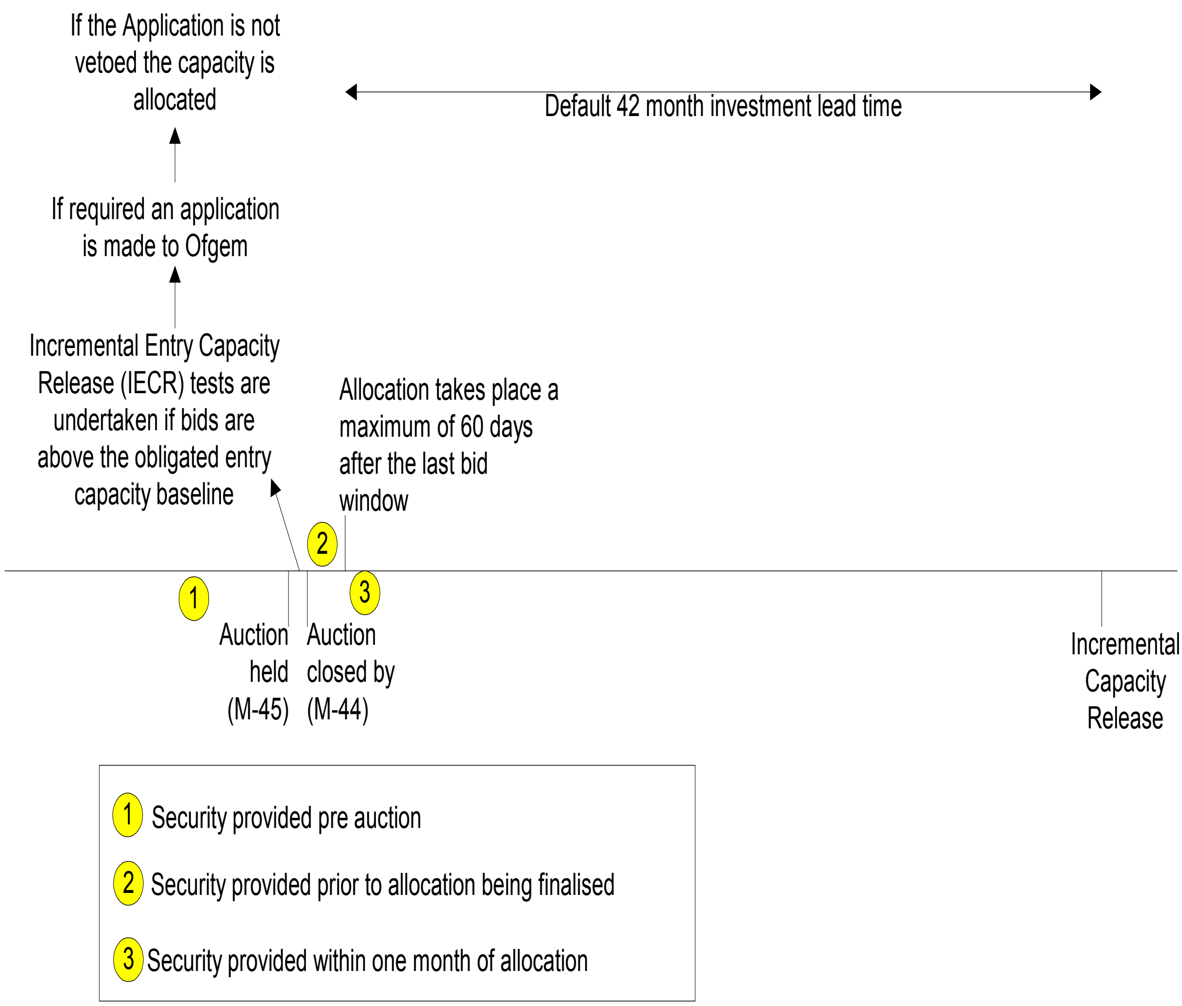
- QSEC Auction Bid Values (Baseline and Incremental).

[NG View: The AMSEC auction runs in February of each year for capacity release in the following April for a 2 year period e.g. February 2008 auction is run, capacity is allocated for the period 1st April 2008 to 31st March 2010. Therefore the capacity released in the AMSEC is very much in the near term and perhaps doesn't have the risk profile that is apparent with QSEC. However, the inclusion of the AMSEC auction has been suggested by one Review Group party and could be considered]

3.2 When security is required

The QSEC auction offers 90% of current (unsold) obligated baseline entry capacity and 100% of any incremental entry capacity available at particular ASEPs. This provides Shippers with an opportunity to signal additional incremental NTS entry capacity.

Security is required in advance of the Release Obligation and the following timeline diagram illustrates the options that are available.



Discussion points on the three options are as follows:

- **Option 1 Security put in place pre auction**. Security could be put in place prior to the auction taking place, based on an estimate of the required auction volume or for existing capacity holders based on their current capacity). The period would need to be defined but no later than one month before the QSEC auction window starts. If security is not put in place by an existing capacity holder then that capacity would be released for inclusion in the new auction or in the case of new Users they would be unable to take part in the auction.
  If on confirmation of a successful allocation of capacity the level of security could be reviewed and amended if necessary (provided within the allocation window). If additional security is required but not provided, then the capacity could be reduced and re-allocated. This option may also require some level of confidentiality between National Grid and the perspective bidders.
- **Option 2 security provided prior to allocation being finalised**. Security would need to be provided within the existing 60 day window after the auction closes to avoid adverse effects on any construction period. For baseline capacity this period of time should be sufficient to put the security in place but if a requirement for incremental capacity is triggered, then an application to Ofgem is sought reducing the timescales available. Consideration therefore may need to be given to increasing both the investment lead time and the allocation window.
- **Option 3 security is provided within one month (or a suitable time period) of the allocation process taking place**. This option has the benefit of the User knowing exactly what security is required and allows for sufficient time to be provided for the security to be put in place.
  However, it does not handle the risk of the User failing to provide the security within the agreed timescales, creating a mismatch between the revenue allowed and the security provided. A process would need to devised to explain what should be done with the associated capacity (baseline capacity may need to be re-allocated or rolled over to the next applicable auction or with regards to incremental capacity cancelled) and the impact on other auction participants (baseline and incremental bidders). As with option 2 some of these issues could also be lessened by increasing the investment lead time and allocation window.

3.3 Financial level of security required

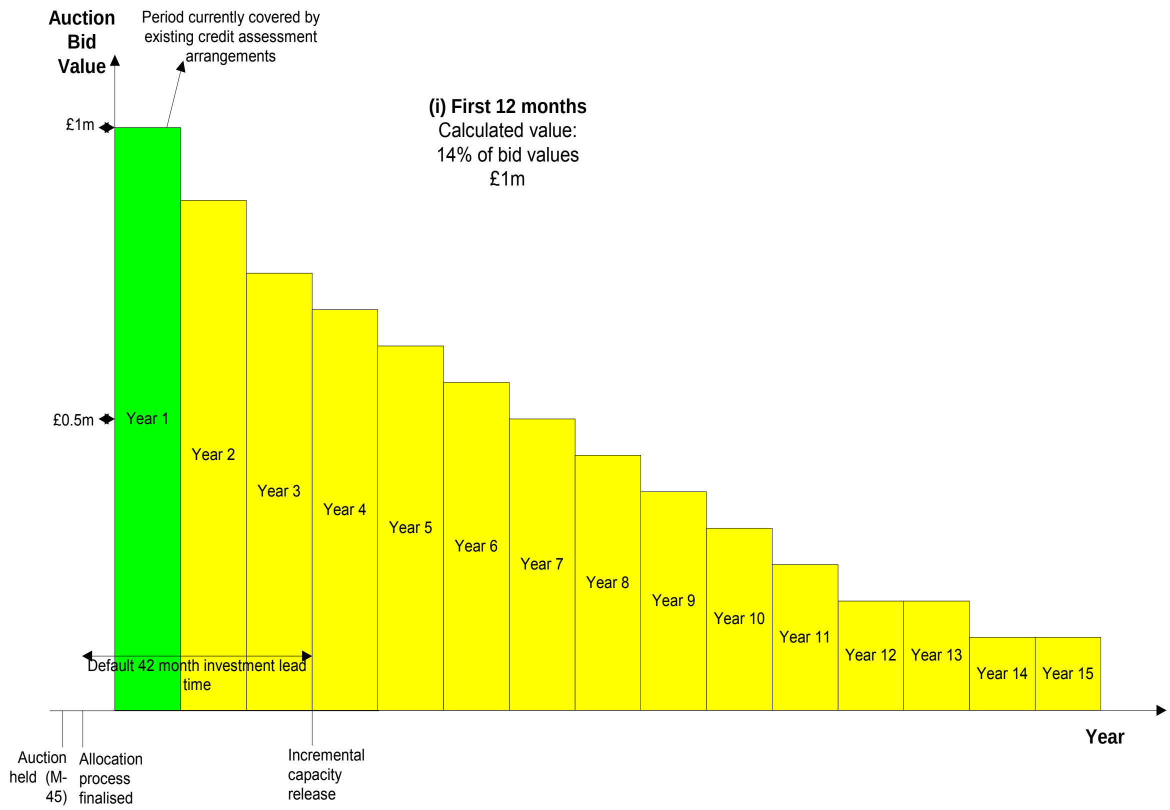
<u>Selection of auction bid values</u>

The level of security (∑auction bid values) that is required can be determined in a number of ways based on the number and actual years selected. The following options illustrate potential calculations:

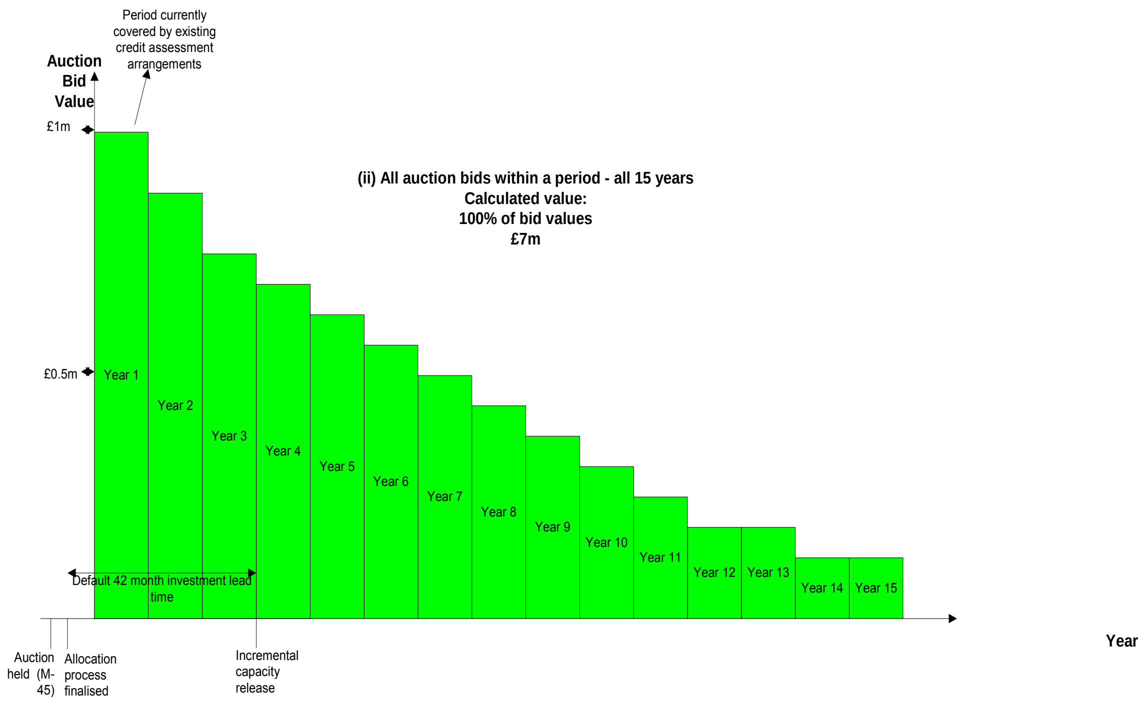
(i) Next full Gas Year– period selected is the same as at present but the associated security may be required earlier and may or may not be staggered as at present.
(ii) All auction bids within a forward looking period - all bids yet to reach Gas Flow Day.
(iii) All auction bids within a forward looking period - Next 4 full Gas Years
(iv) Next full Gas Year + Y+4 auction year
(v) Next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction.

The diagrams below illustrate the options and give an indication of the auction bid values for example capacity profiles (all profiles, values are illustration only).

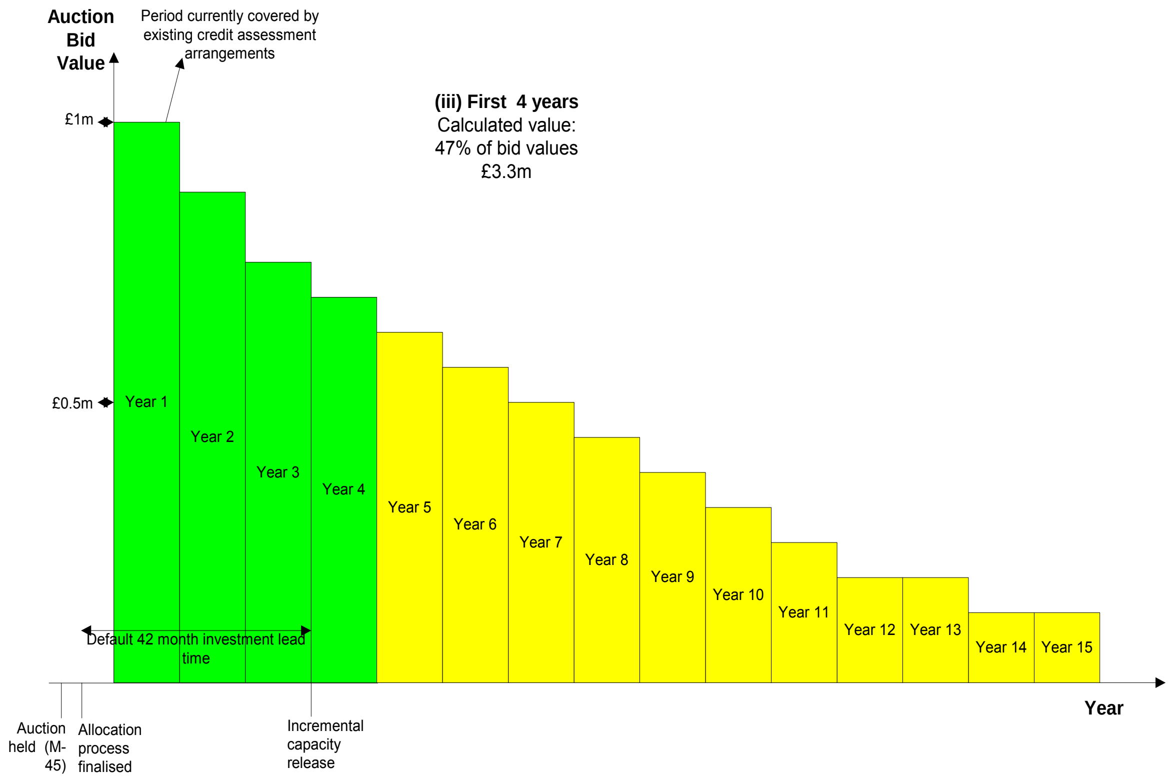
Option (i) Next Full gas year - example



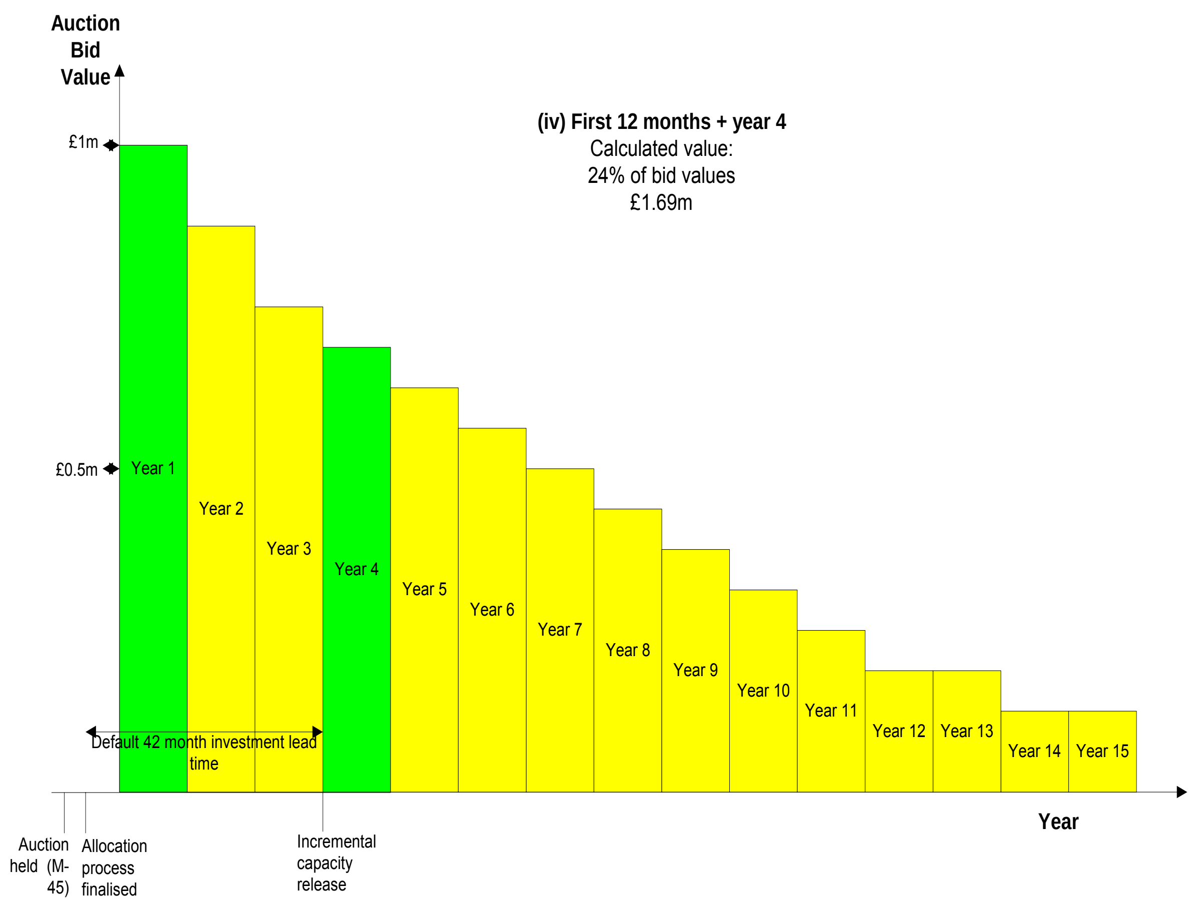
Option (ii) All auction bids within a forward looking period - all bids yet to reach Gas Flow Day) - Example.



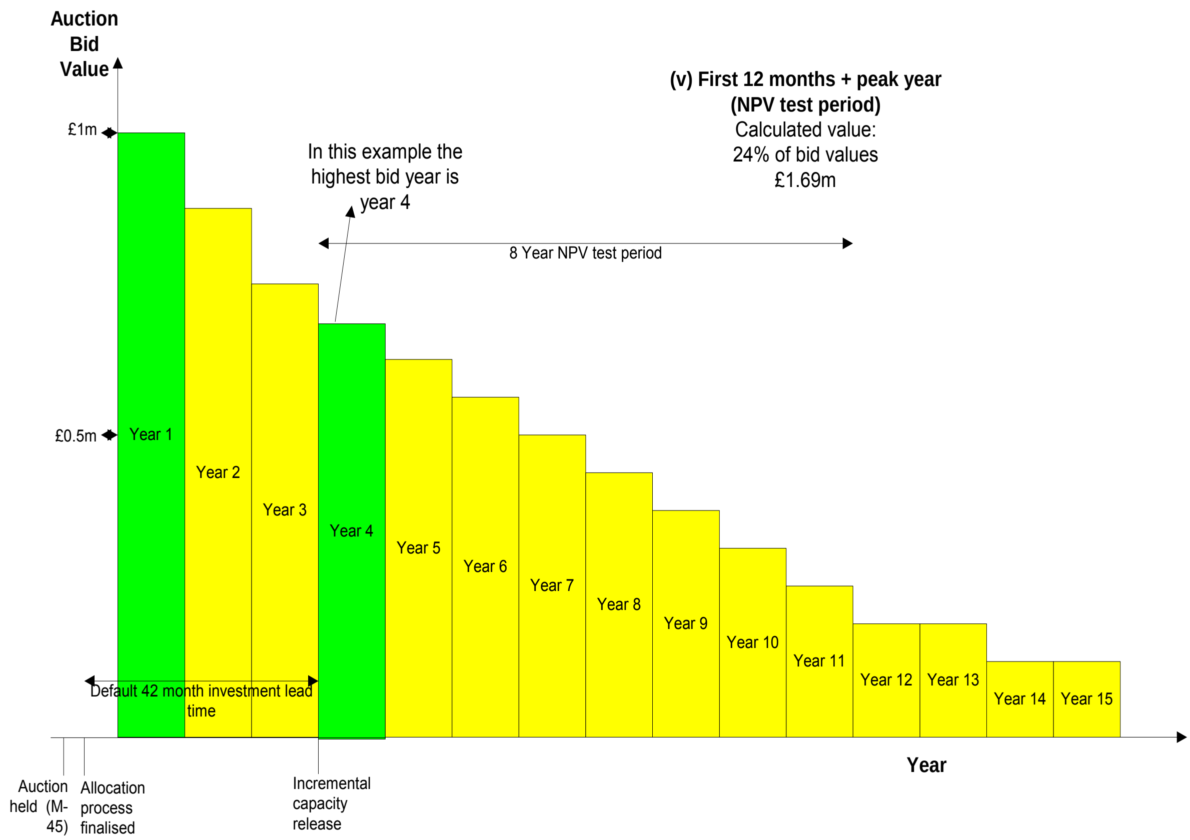
Option (iii) All auction bids within a forward looking period - Next 4 Full gas years - Example



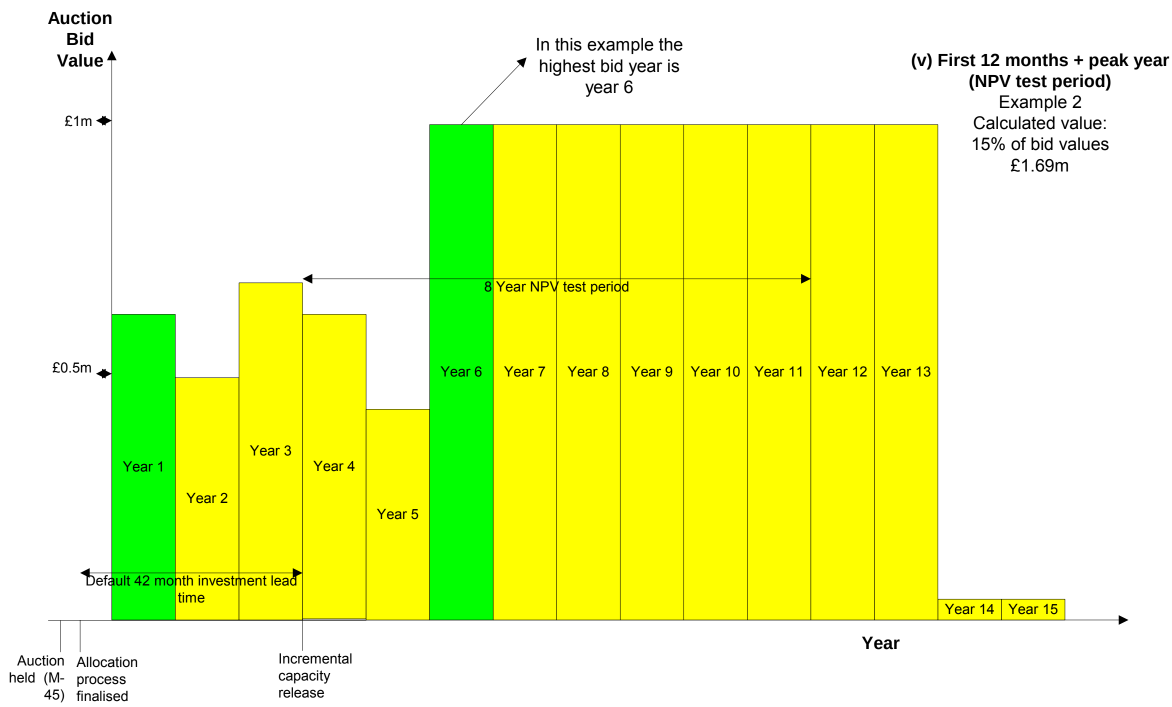
Option (iv) Next full Gas Year + Y+4 auction year - Example



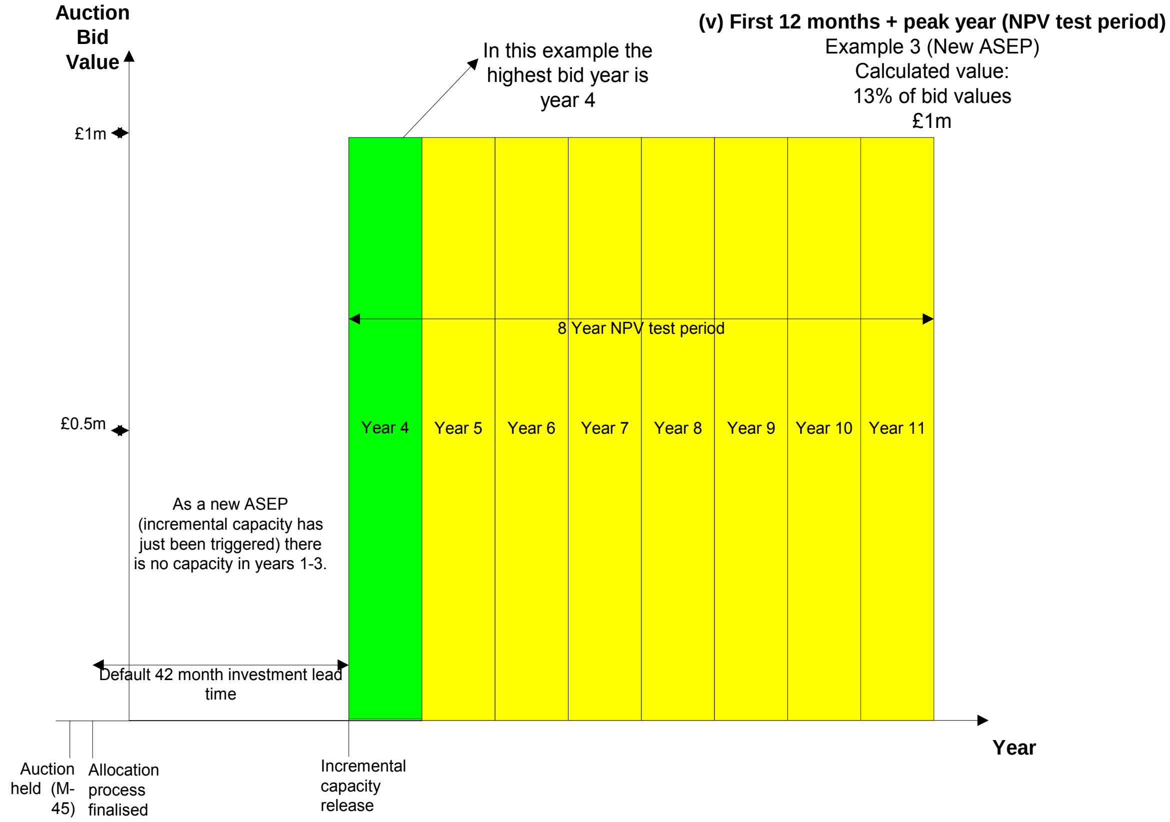
Option (v) Next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction – Example 1



Option (v) Next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction – Example 2 – Incremental capacity triggered (existing ASEP)

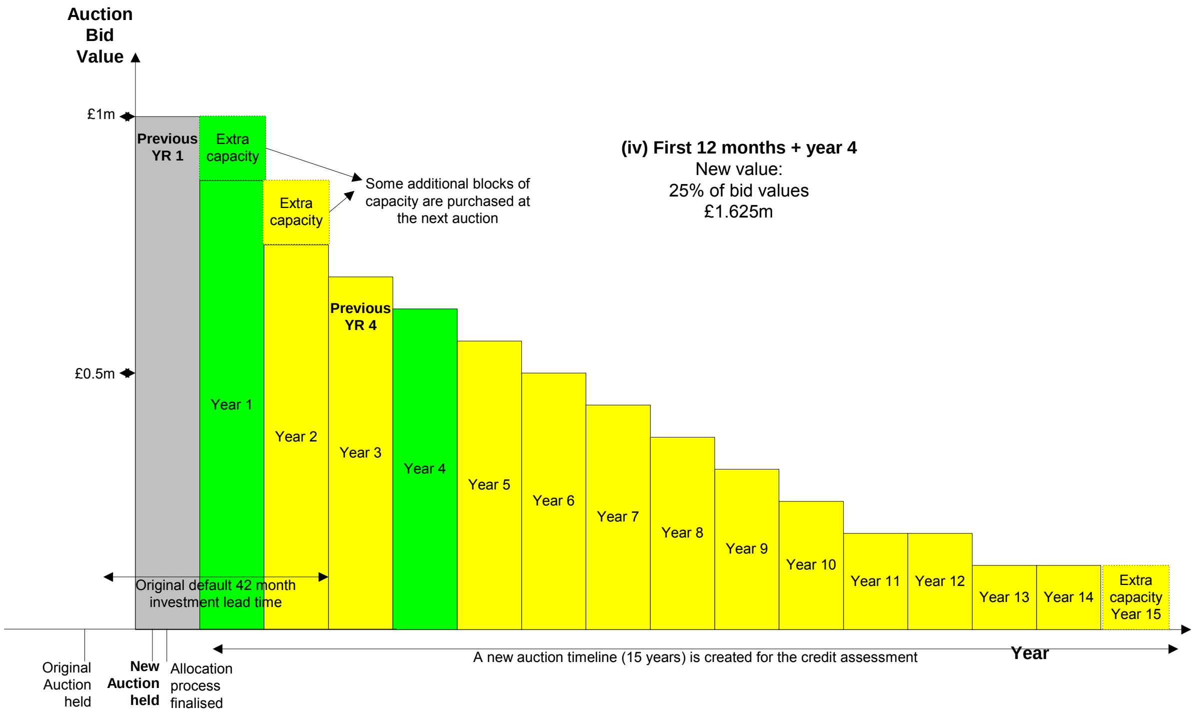


Option (v) Next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction – Example 3 – New ASEP



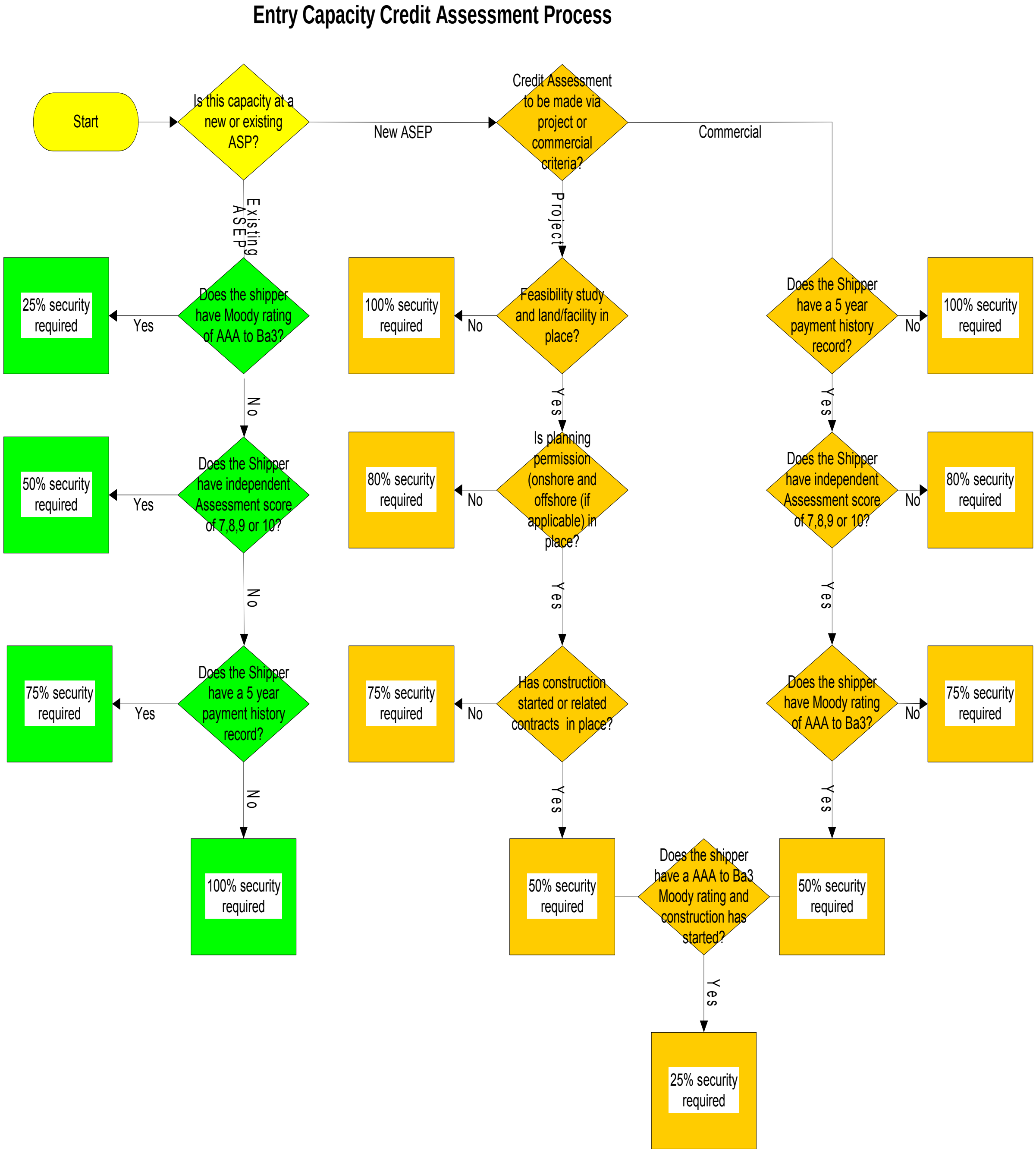
Following Year Assessment

The following diagram aims to illustrate how the auction bid values will be captured the following auction year. For this example option (iv) (twelve months + 4th auction year) is used.



4. Type of security required

Once an auction bid value has been derived the following process needs to be used to determine the type of security tool required and the exact amount to be secured. The credit assessment made depends on whether the capacity is at a new or existing ASEP. The timing of this process was covered earlier (see section 3.2).



[Note: This process does not intend to match/follow the network operator best practice guidelines but has used elements of it. All numbers (percentages) and scores (Moody ratings & independent credit scores) are estimates/for illustration and aim to illustrate the different levels of risk. This process will need to be reviewed by appropriate credit experts].

5. Credit Rules, including shipper default

[Once the variants of the strawman (discussed earlier) have been agreed, we will be in a position to define the appropriate credit mechanism and associated business rules. The following outlines the key steps that will need to be considered. Is there anything else that needs to be taken into consideration?].

- Identify any necessary changes to current credit default or User termination rules and any wider changes (Uniform Network Code (TPD Sections B, S and V), Gas Transporter, Shipper and Supplier Licences and The Gas Act).

- Based on the agreed option and above assessment, select the most appropriate vehicle for the credit rules to reside in:
    i. fixed in UNC (new section?) – Specified text in the UNC is the preferred option of the review group?
    ii. placed in section V12 (covers all Users) – governed by the UNC Committee and easier to amend as it would not require a Modification Proposal?
    iii. placed in an UNC ancillary document (bilateral arrangement)?
    iv. included in a document similar to the EBCC (Energy Balancing Credit Rules) and governed by a Committee – Not preferred by shippers at the review group?

- Consider how the credit rules explain when/if National Grid could call on security in the case of a "default" or User termination. If security is to be called on then the credit rules need to:
    - Explain how much security to be taken
    - Explain how we would treat the existing capacity and if it is sold explain how to recompense affected (defaulting) shipper if National Grid manages to resell some of the capacity
    - Cover ongoing monitoring of security provision and credit position

6. Timeframe for implementation

TBC – once the above has been clarified.

7. Recommendation

[NG view: after analysing the variants/information contained within the strawman, we suggest the following is the recommendation of the group].

The Review Group recommends that as a means of resolving the issues identified with the current entry capacity security arrangements the following:

- All new and existing capacity holdings should be required to provide appropriate flat security based on a credit assessment of auction bid values.
    - Security should be provided prior to the entry capacity (QSEC) auction allocation process being finalised
    - The auction bid value should be the next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction.
    - The auction bid value derived must follow the specified credit assessment process and rules to determine the exact amount to be secured. The rules will also specify what will happen in the event of a User default. [T*his area is still under development].*