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 long term 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 be underpinned by appropriate flat security based on a credit assessment of auction bid values.

This strawman seeks to define this option further and consider how to appropriately allocate financial risk between:

- An Existing and New Aggregated System Entry Point (ASEP)
- A Single and Multiple User ASEP

It is intended that a Modification Proposal will be raised in February 2009.

2. Background

There is currently no security or credit required to be lodged at the time a User makes a financial commitment at a long term capacity auction (Annual Monthly System Entry Capacity (AMSEC) or Quarterly System Entry Capacity (QSEC)). Current UNC credit/default arrangements may be appropriate for larger portfolio players but they don't have the same impact on single entry point Users or small portfolio players.

The current credit rules within the UNC require that a User puts in place credit arrangements to provide security (on a stepped basis) for the 12 months immediately prior to the start date of the entry capacity previously bought in a QSEC auction, which includes any Incremental Capacity Release Obligations. If insufficient credit is in place within 12 months of the first gas day then all QSEC rights (across all ASEPs) "for the relevant quarters" is removed. However, National Grid would still be required to make capacity available for the next quarter. Therefore where a user is a single entry point User they are able to defer capacity commitments 12 months prior to the event and keep deferring each quarter.

Auction bids by new entrants may relate to a new ASEP but significant investment may also be required at an existing ASEP due to them purchasing incremental (and/or baseline) capacity. As well as deferring capacity, there is also a risk that their project does not go ahead, leaving the entry capacity with no value as it is unlikely to be purchased by anyone else.

When bids received for entry capacity trigger incremental capacity, they are tested against the Incremental Entry Capacity Release Methodology statement and if positive a proposal is submitted to Ofgem. If the proposal is not vetoed, build commences (or NG takes the buy back risk) and National Grid receives a revenue driver[1] for 5 years. If the shipper then terminates, the capacity is offered for sale but any under-recovery of the allowed revenue would need to be paid by all Users (the community) via SO commodity charges.

[1] The entry capacity incentive arrangements from April 2007 enable National Grid Gas NTS to recover 5 years of auction revenue from the first month for which incremental capacity is released based on the agreed revenue driver in the GT Licence.

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 continue to be required in order to further develop import and storage facilities. It is also anticipated that a number of new projects will be developed by participants that are 'new' to the GB gas market and may also be a single user entry point.

3. Security Required

[We currently see the proposal complementing the current entry capacity credit arrangements – any views?]

It is envisaged that the current credit arrangements remain in place to obtain appropriate security for the next 12 months capacity charges. This proposal aims to introduce long term Entry Capacity security arrangements that will run in parallel with those for transportation charges.

3.1 Value measure to be secured

It is proposed that each User's accepted entry capacity auction bid values be secured. The auction bid values within scope are those allocated as a result of the annual NTS Entry Capacity auctions:

- Allocated QSEC Auction Bid Values (Baseline and Incremental)
- Allocated AMSEC Auction Bid Values

3.2 When security is required

Security is required to be put in place pre auction. Security shall be put in place prior to the annual auction taking place and Users should provide sufficient headroom to cover their existing capacity holding (across all ASEPs) and an estimate of any new auction bids they wish to make. If sufficient security is not put in place by an existing capacity holder then their capacity would be released for inclusion in the next auction or in the case of new Users they would be unable to take part in the auction.

Implementation

As part of the implementation plan, security for any existing User holding shall be put in place prior to the next annual auction. Users will have their auction bid value assessed in line with the agreed methodology and be required to put their requirement in place within 2 months of the next annual auctions taking place.

It is proposed that the security covers 100% of the existing holding, i.e. the User cannot decide to relinquish any of its existing capacity through this process.

Enduring Arrangements

[Please note that auction timescales are likely to change in the near future - 0230 and 0230A: Amendment to the QSEC and AMSEC Auction Timetable]

QSEC

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. The auction transaction period is 15 years, starting 18 months from the date of the auction (i.e. a September 2009 auction would offer capacity release from April 2011).

Following an invitation to participate in the annual QSEC auction or a new ASEP QSEC auction, Users will be required to put in place sufficient security to cover their existing holding and any new capacity bids. This security needs to be in place prior to them taking place in the first auction bid window.

Security can be topped up by Users *[if within agreed tolerances?]*, during the auction bid windows (10 max). If the revised auction bid value exceeds the security provided then any new bids will be void.

[The practicalities and impacts (timescales, pricing information, etc.) of Users providing/topping up security are being investigated]

AMSEC

The AMSEC auction runs in February of each year for capacity release in the following April for a 2 year period e.g. February 2009 auction is run, capacity is allocated for the period 1st April 2009 to 31st March 2011.

Following an invitation to participate in the annual AMSEC auction, Users will be required to put in place sufficient security to cover their existing holding and any new capacity bids. This security needs to be in place prior to them taking place in the first auction bid window.

Security can be topped up by Users [if within agreed tolerances?], during the auction bid windows (4). If the revised auction bid value exceeds the security provided then any new bids will be void.

[The practicalities and impacts (timescales, pricing information, etc.) of Users providing/topping up security are being investigated]

3.3 Selection of auction bid values

The level of security (∑allocated 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 that cover differing proportions of the ∑allocated auction bid values:

(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 (year 4 to year 11 - inclusive) considered by the most recent QSEC Auction. Unlike the other options this assessment is conducted by ASEP but a Users auction bid value will be the aggregated amount.

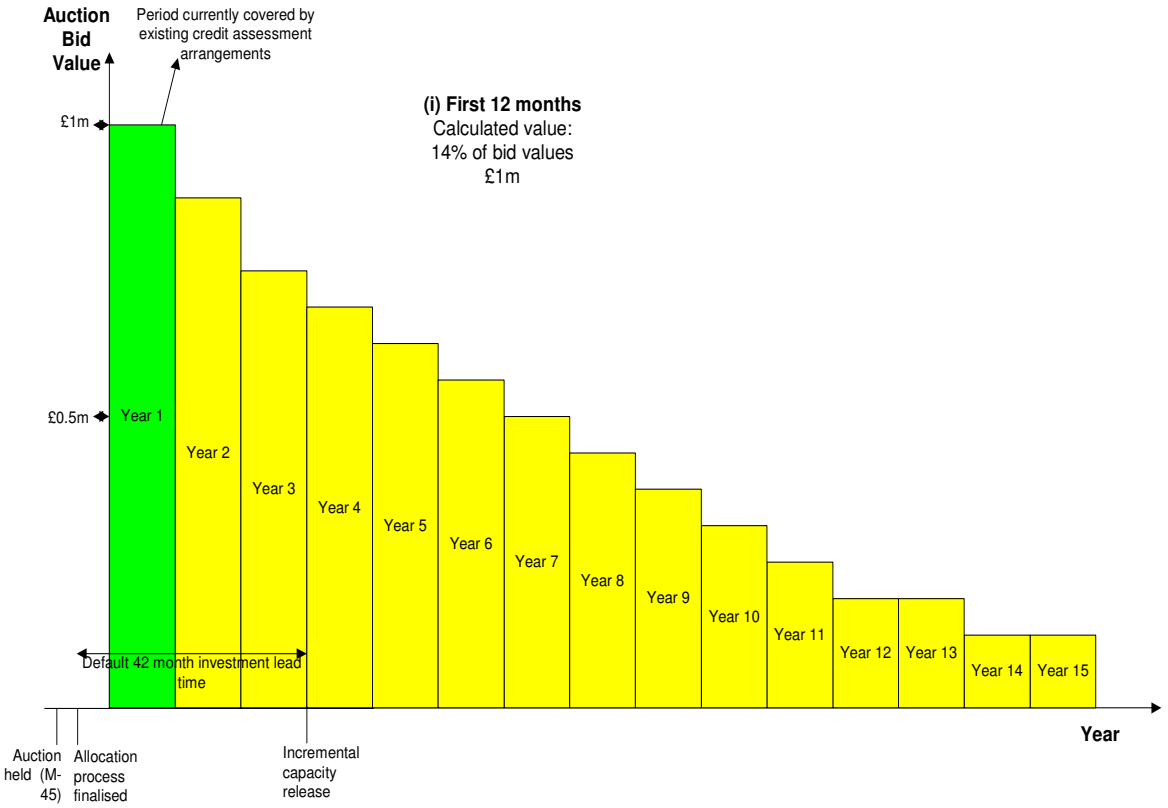
[No option has been agreed yet – do we have a preferred option?

The figures below are the actual QSEC auction bid values by option

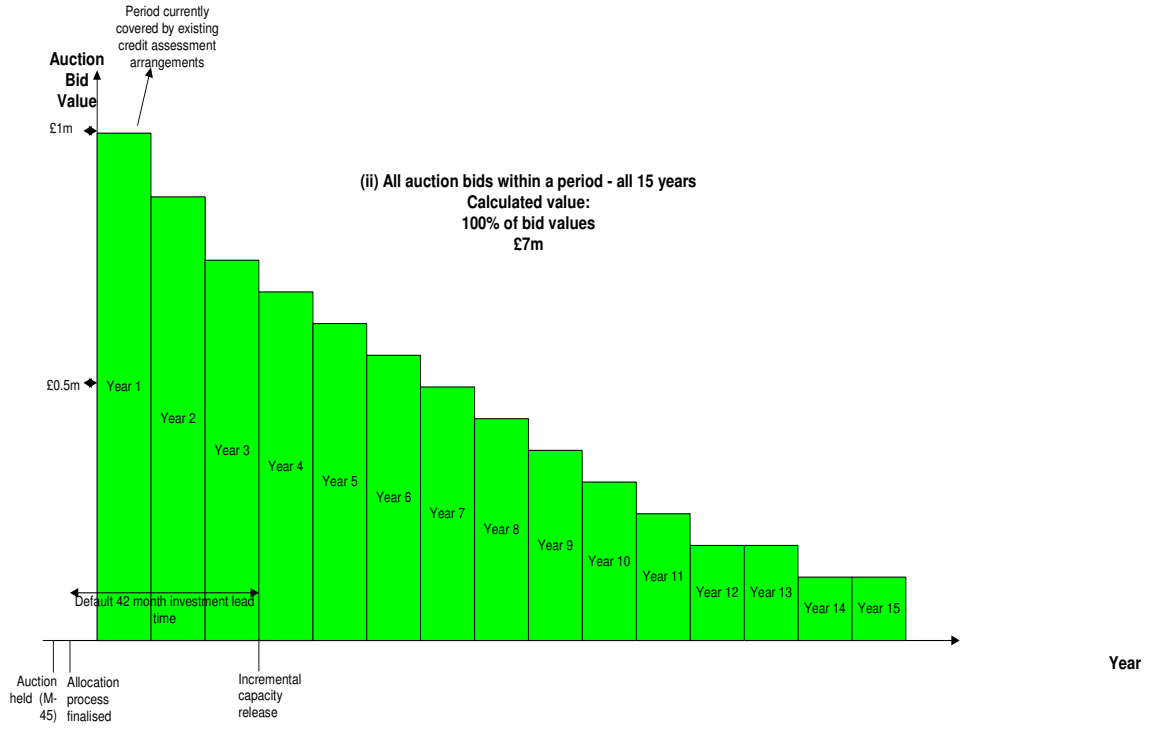
***(i)** Next full Gas Year– **130,837,551** 6.88%*
***(ii)** All bids. **1,902,795,545** 100.00%*
***(iii)** Next 4 full Gas Years. **587,844,703** 30.89%*
***(iv)** Next full Gas Year + Y+4 auction year. **274,972,739** 14.45%*
***(v)** Next full Gas Year + peak year. **274,972,739** 14.45%].*

The diagrams below aim to illustrate the options for calculating the accepted auction bid values. Example capacity profiles at an individual ASEP (all profiles and values are for illustration only) are used. For simplicity the examples show total auction bid values (AMSEC & QSEC and Incremental & baseline) and do not consider the number of Users at the ASEP.

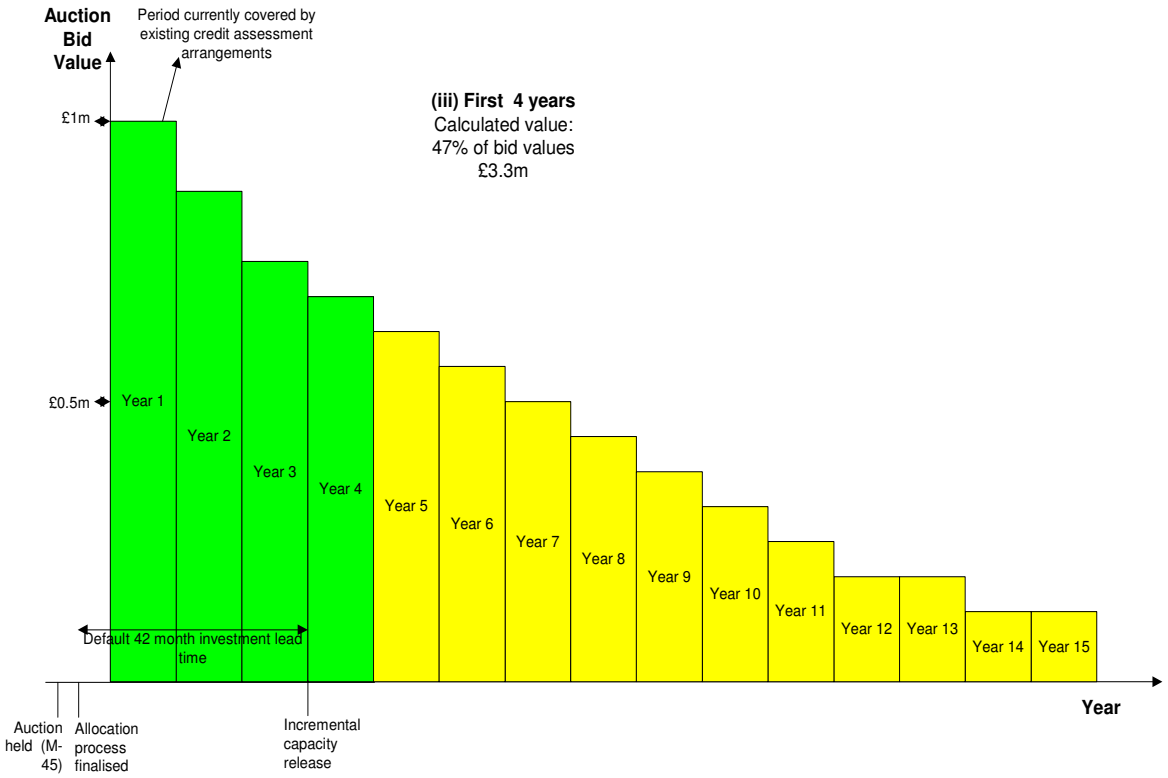
Option (i) Next Full gas year – example



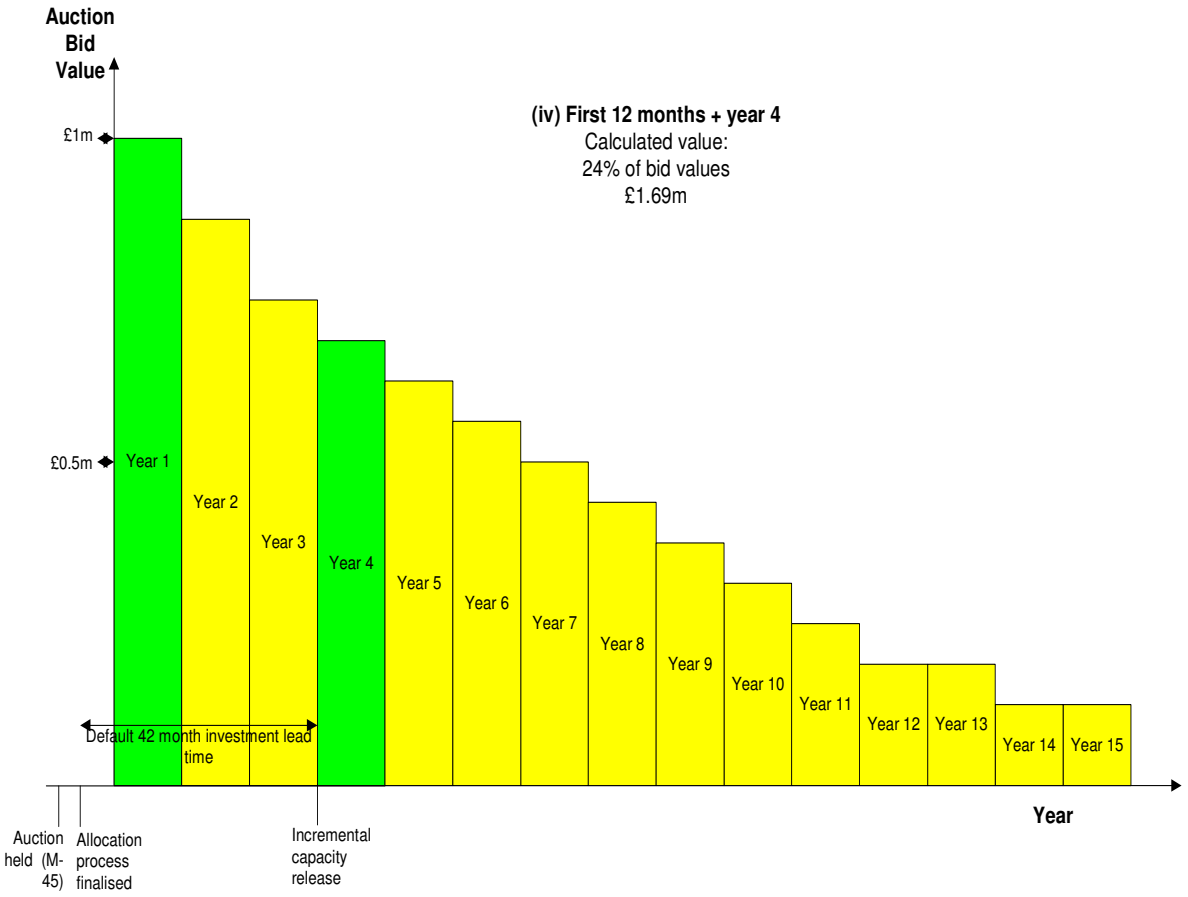
Option (ii) All auction bids within a forward looking period - all bids yet to reach Gas Flow Day) - Example.



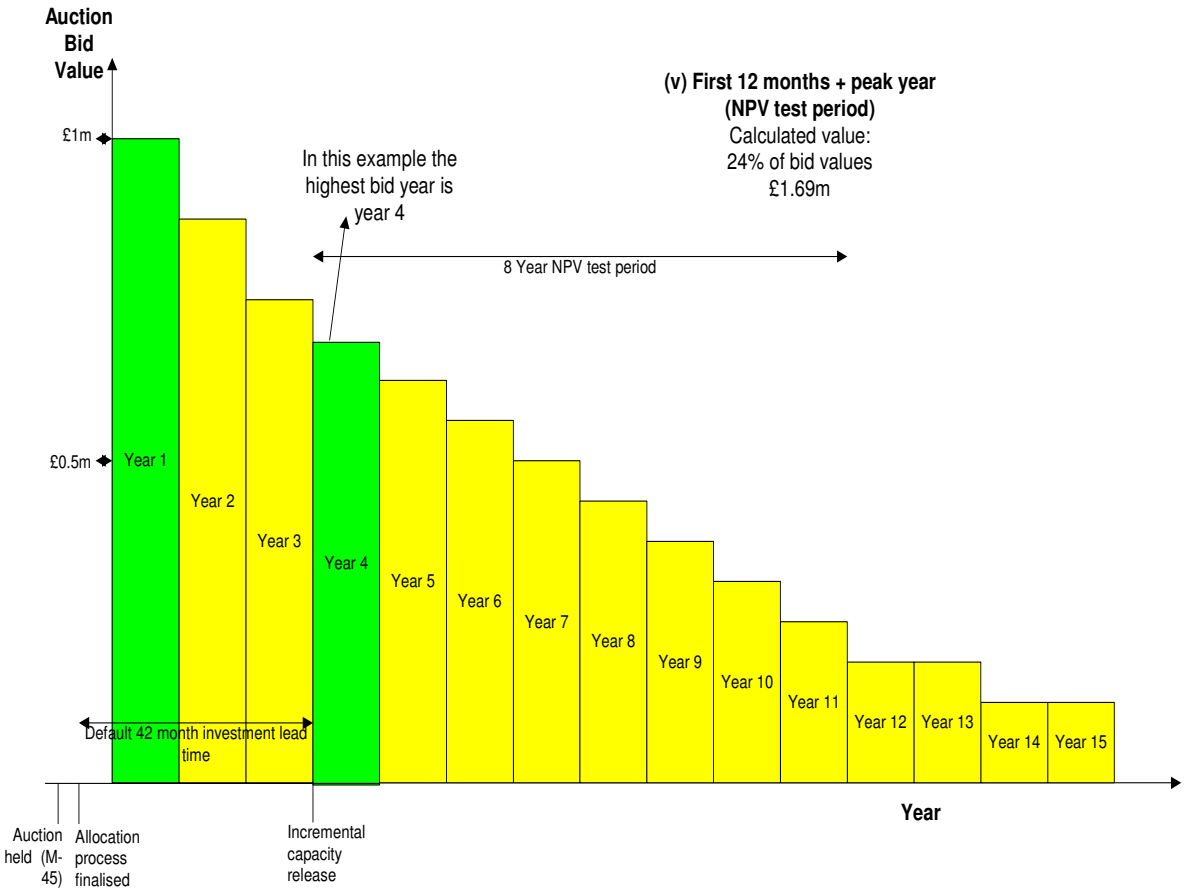
Option (iii) All auction bids within a forward looking period - Next 4 Full gas years - Example



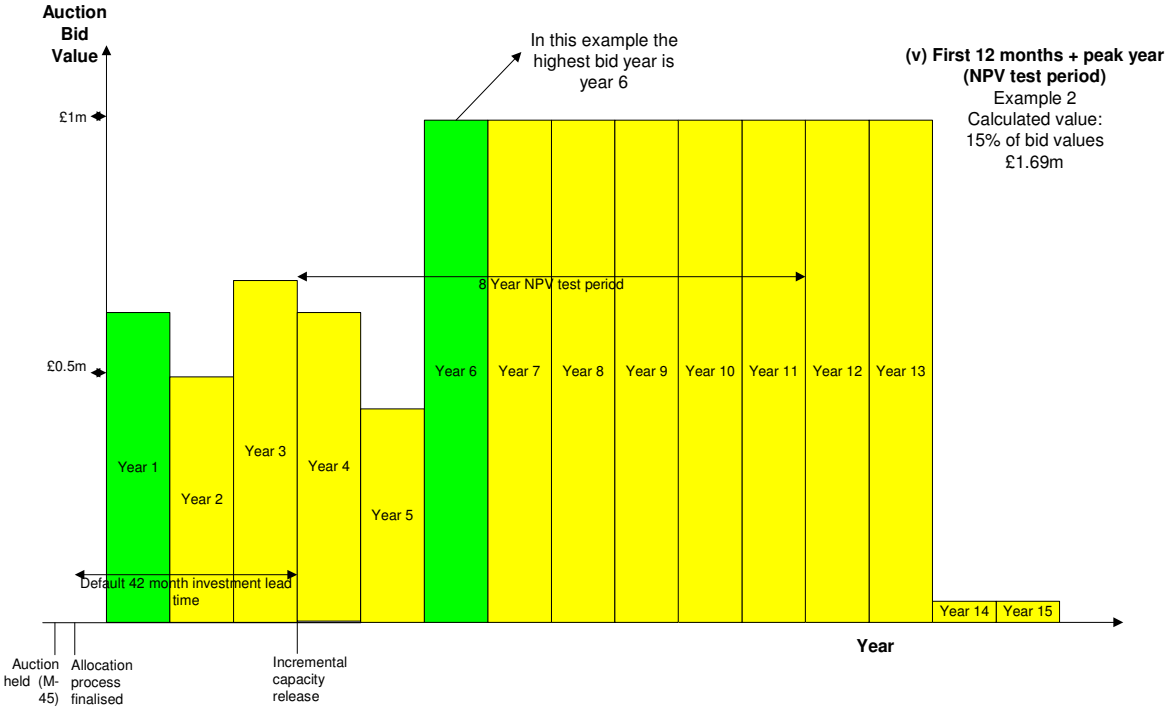
Option (iv) Next full Gas Year + Y+4 auction year - Example



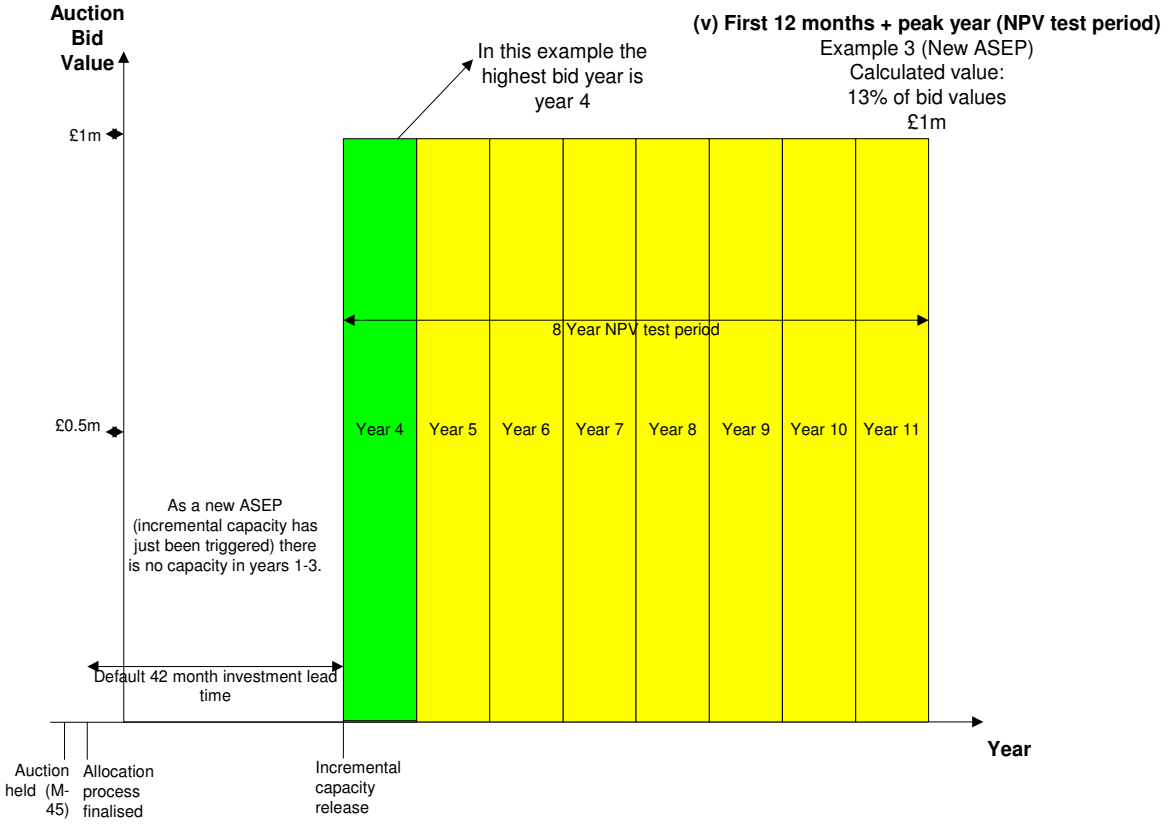
Option (v) Next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction – Example 1



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)

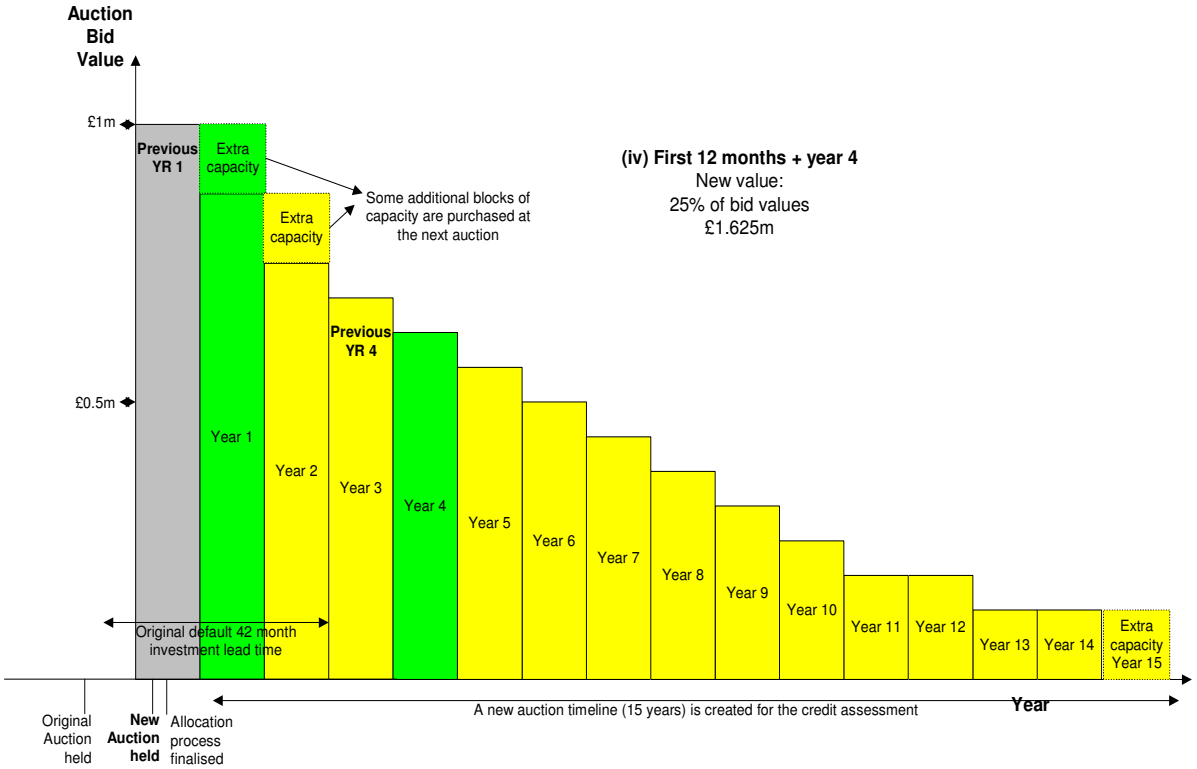


Option (v) Next full Gas Year + peak year in the 8 year NPV test period considered by the most recent QSEC Auction – Example 3 – New ASEP



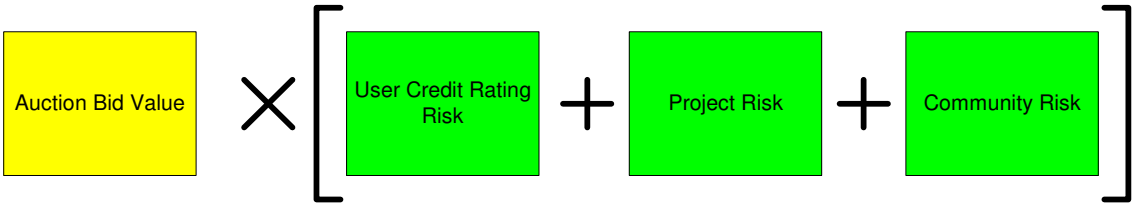
Following Year Assessment

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. Security required

[This section has been amended from the previous version of the strawman. The calculated *auction bid value is reduced using a scaling factor, which comprises of 3 key risk elements and differing weightings can be applied to each. Risk elements of the scaling factor could be removed if a less complex process is preferred].*



Once an auction bid value has been derived the following process needs to be used to determine the exact amount to be secured for each specific User. A scaling factor will allow the Auction Bid Value to be reduced to an appropriate level (percentage of overall auction bid value).

The scaling factor will comprise of 3 risk elements:

- Users credit rating risk
- Project risk
- Community impact risk

4.1 Users credit rating risk

[We have attempted to be consistent with section V but a different process could be developed to assess a Users credit rating risk – avoid confusion with the current arrangements?]

The first stage of the Entry Capacity Credit assessment process is to derive the Users Credit Rating risk by utilising the Users % of Maximum Unsecured Credit Limit (in accordance with section V3 – see PFD below).

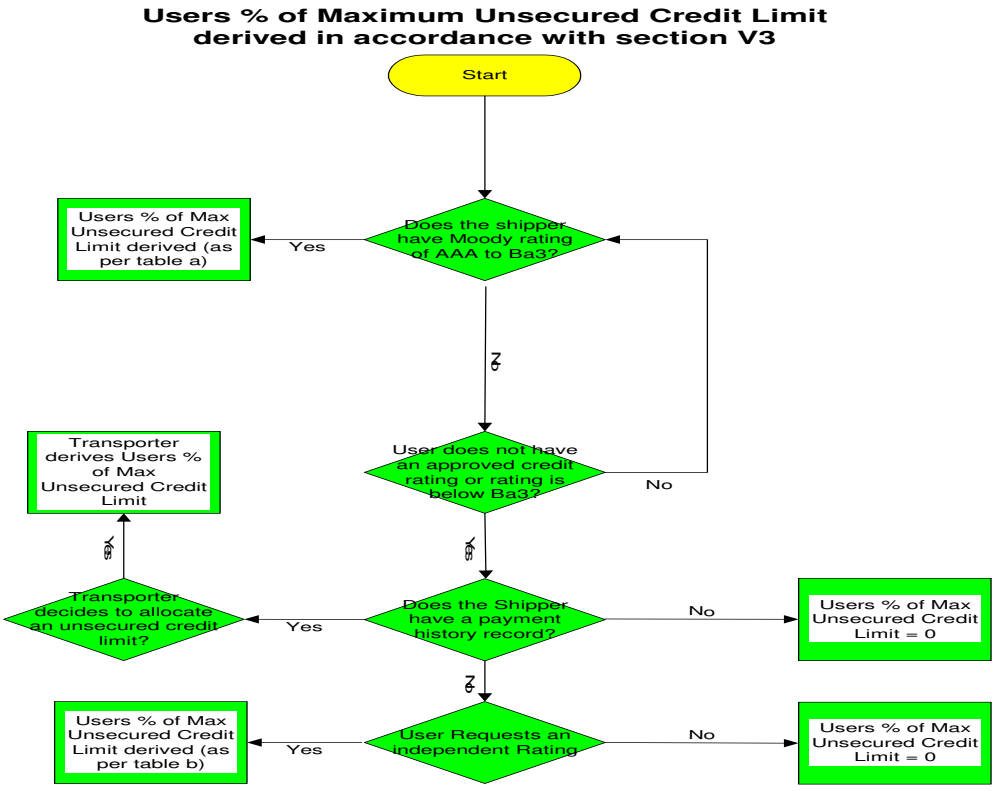


Table a

Approved Credit rating		**Users % of Maximum Unsecured Credit Limit**
Standard and Poor's	**Moody's Investors Service**	
AAA/AA	Aaa/Aa	100
A	A	40
BBB+	Baa1	20
BBB	Baa2	19
BBB-	Baa3	18
BB+	Ba1	17
BB	Ba2	16
BB-	Ba3	15

Table b

Independent Assessment Score	**Users % of Maximum Unsecured Credit Limit**
10	20
9	19
8	18
7	17
6	16
5	15
4	13.5
3	10
2	6.66
1	3.33
0	0

The Users credit rating risk is calculated by the following formula:

Users credit rating risk = (25 (X) + (25 (Y) * (100 - Maximum Unsecured Credit Limit)%)%

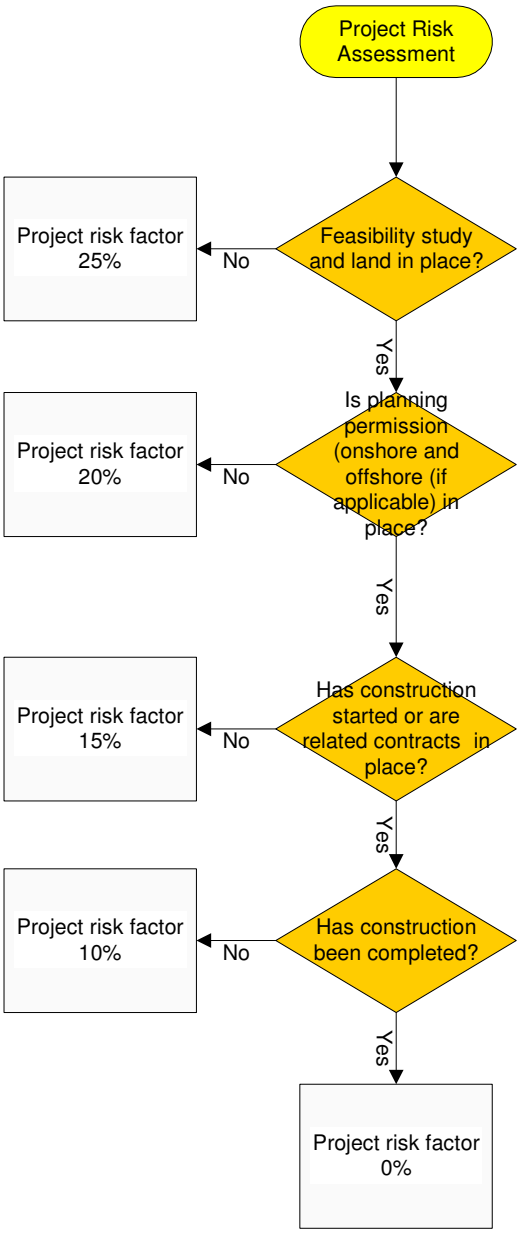
[The above percentages need to be agreed]. Element X [25%] sets the minimum percentage of the Auction Bid Value to be captured and a further percentage is added to this (Y – 25% max), which takes into account the Users Credit Limit. See worked example below.

Worked Example

Example: a User with a Moody's rating of A entitles them to a Maximum Unsecured Credit Limit of 40%. Their credit rating risk is 40% (25 + (25*(100-40)%)).

4.2 Project Risk

If the utilisation of the Users entry capacity is dependent on significant investment to develop an import or storage facility, then a project risk assessment will be undertaken. *[The project risk assessment will only be applicable at a new ASEP or ASEPs where incremental capacity has been triggered].*



[The above project assessment steps and risk factor percentages need to be agreed].

4.3 Community Impact

Current UNC credit/default arrangements may be appropriate for larger portfolio players but they don't have the same impact on single entry point Users or small portfolio players. If a project does not proceed, any under-recovery of the allowed revenue would need to be paid by all Users (the community) via SO commodity charges.

This risk to the community can be measured by the proportion of the revised auction bid value against the existing User holding *[reset every year or two?]*. This measure could be derived in terms of auction volume or bid value. This measure may also encourage Users to sell any capacity they no longer require.

The Community Impact risk is calculated by the following formula:

Community Impact risk = 25% (Z) * (1- revised auction bid value / existing User holding)

Element Z [25%] sets the maximum percentage of the Auction Bid Value to be captured by the Community Impact risk. *[The above percentage needs to be agreed].*

Example 1 – existing User:

$$\frac{\text{Existing holding (£0.9m)}}{\text{Revised Auction Bid Value (£1m)}} = 0.9$$

Community Impact risk = 25% * (1 - 0.9) = 2.5%

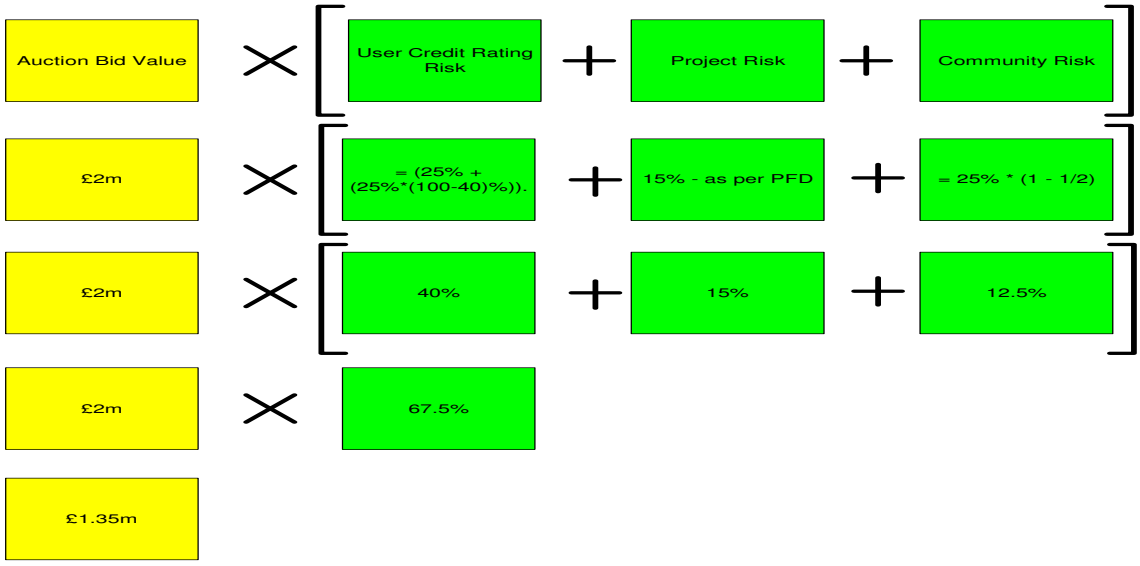
Example 2 – new Entrant:

$$\frac{\text{Existing holding (£100K)}}{\text{Revised Auction Bid Value (£1m)}} = 0.1$$

Community Impact risk = 25% * (1 - 0.1) = 22.5%

4.4 Entry Capacity Credit Assessment - Worked Example

Existing holding = £1m
Revised Auction Bid Values = £2m
Credit Rating = A
New project with planning permission but construction hasn't started



5. Acceptable types of security

Section V3.4.5 defines the types of security applicable under the Code. For the purposes of long term Entry Capacity, only the following types of security shall apply:

- **"Deposit Deed"** - deposit of cash as security or advance payments made by a User;
- **"Letter of Credit"** - letter of credit from a bank (approved by Transporter) with a long term debt rating of not less than A provided by Moody's Investors Services or such equivalent rating by Standard and Poor's Corporation.

It is therefore proposed that the following shall not apply:

- **"Bi-lateral Insurance"** - policy of insurance provided by a Qualifying Company and in such form as is acceptable to the Transporter *[currently not used];*
- **"Guarantee"** - guarantee or performance bond provided by a Qualifying Company or a Parent Company
- **"Prepayment Agreement"** - User makes payments of amounts calculated on a monthly basis by the Transporter.

6. Business 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 our approach and initial thoughts].

- Work is being undertaken to 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).

- The rules will reside in *[3 options are currently being considered but It is currently envisaged that the impact on the UNC is low to medium and that the required changes may be accommodated within Sections B and V]*:
    i. Amend UNC Sections B and V
    ii. fixed in a new section in the UNC
    iii. placed in section V12 (covers all Users) – governed by the UNC Committee and easier to amend as it would not require a Modification Proposal.

  [Supplementary guidance documents could also be produced]

- The rules will also specify what will happen in the event of a User default and ongoing security monitoring:
    - National Grid will call on the security in the case of a "default" or User termination.
    - Any User holding will be sold at subsequent auctions – *[need to consider terminated capacity licence/code obligations]*
    - The security and any revenue will be offset against allowed revenue
    - Any excess will be returned to the affected User or smeared to the community *[Any views?]*

7. Timeframe for implementation

TBC – once the above has been clarified.

8. Recommendation

[NG view: after analysing the information contained within the strawman, we suggest the following (outline of the proposal) is the recommendation of the group].

As a means of resolving the issues identified with the current entry capacity security arrangements, the Review Group recommends the following:

- All new and existing capacity holdings should be required to provide appropriate flat security based on a credit assessment of accepted auction bid values.
- The following auction bid values are within scope:
    - Allocated QSEC Auction Bid Values (Baseline and Incremental).
    - Allocated AMSEC Auction Bid Values
- The auction bid value should be:
    - Next full Gas Year + peak year in the 8 year NPV test period (year 4 to year 11 - inclusive)
- Security shall be put in place pre auction
    - As part of the implementation plan, existing Users will be required to put their requirement in place within 2 months of the next auctions taking place
    - New Users, will be required to put security in place prior to them taking place in the first auction.
    - Security can be topped up by new and existing Users during the auction bid windows. If security is not topped up, then any new bids will be void.
- The auction bid value derived must follow the specified credit assessment process and rules to determine the exact amount to be secured. A scaling factor will allow the Auction Bid Value to be reduced to an appropriate level (percentage of overall auction bid value). The scaling factor will comprise of 3 risk elements:
    - Users credit rating
    - Project Risk
    - Community Impact
- Section V3.4.5 defines the types of security applicable under the Code. For the purposes of entry capacity, only the following types of security shall apply:
        - "Deposit Deed"
        - "Letter of Credit"
- The rules will also specify what will happen in the event of a User default:
    - National Grid will call on the security in the case of a "default" or User termination.
    - Any User holding will be sold at the subsequent auctions
    - The above will be offset against allowed revenue
    - Any excess will be returned to the affected User
- The rules will reside in *[3 options are currently being considered]*:
        - Amend UNC Sections B and V
        - fixed in a new section in the UNC
        - placed in section V12