Review Group Report
Review Proposal Reference Number 0221
Review of Entry Capacity and the Appropriate Allocation of Financial Risk
Version 1.0

This Review Group Report is presented for the UNC Modification Panel's consideration. Whilst consensus has been reached by the Review Group that it would be reasonable, and consistent with user commitment, for Users to be required to provide financial security earlier than currently, consensus was not reached on the stage in the QSEC Auction process where that security should be required.

National Grid NTS' Proposal 0246 "Quarterly NTS Entry Capacity User Commitment" is a development of the 4th draft proposal it submitted to the Review Group. This Proposal, based on security provision within 28 days of implementation and 14 days prior to participation in the QSEC Auctions, is supported by some members of the Review Group. Other members support the principle of additional security being provided after, rather than in advance, of QSEC auctions, and an earlier draft proposal was based on this principle. Providing security after the QSEC auction could incorporate the principle of provisional allocation and hence a two stage approval process with National Grid NTS' allowed revenue based on the second stage approval. The first approval stage would provide sufficient confidence for the shipper to obtain security from a financial institution; the second stage would take place after this security was obtained and National Grid NTS' revenue allowance would reflect this second stage approval.

It was recognised that, for this two stage approval option to be implemented, an amendment might be required to the Gas Transporter Licence. Whilst such a change is outside the scope of this Review Group, some Members indicated that, whilst preferring two-stage allocation, their support would be conditional on adoption of any necessary licence change.

1 Review Proposal

National Grid NTS raised Review Proposal 0221, for which the Terms of Reference are in Appendix 1.

2 Review Process

In accordance with the Modification Rules, at its meeting on 21 August 2008, the Modification Panel determined that this Review Proposal should be referred to a Review Group for progression. This Review Group Report was subsequently compiled by the Joint Office and approved by Review Group attendees.

The Review Group has received one formal representation from Gazprom, which was discussed at its eleventh meeting on 26 February and placed on the Joint Office website. The draft Modification Proposal was revised to reflect, to some extent, this representation.

3 Areas Reviewed

a) Proposal Development

The first seven meetings of the Review Group concentrated on the various issues that were set out in the terms of reference. On the basis of these discussions National Grid NTS tabled a "strawman proposal", which set out a number of options for further debate. These options were refined in the strawman presented at the ninth meeting. For meetings ten, eleven and twelve, National Grid NTS submitted draft Modification Proposals. Between meetings eleven and twelve, National Grid NTS also developed two proposals based on the discussion that took place at the eleventh meeting, and these included the principle that security be provided after provisional allocation of capacity. However, in developing these National Grid NTS encountered a number of insurmountable issues. It therefore submitted a single draft proposal to the twelfth meeting that incorporated the principle of security provision prior to the auction accompanied with an explanation of the issues that it had encountered.

This draft Modification Proposal envisaged that:

1. Prior to participation in the QSEC Auctions, Users will be required to provide security of up to 10% of their successful bid values for years Y+2 to Y+16 inclusive.
2. Security requirements will be reduced by up to 70% for Users that have recognised Moody's Financial Services or Standard and Poor's credit ratings.
3. The current ability for a User to defer the provision of security for transportation invoicing will be removed.
4. In contrast to the current arrangements, where they can defer, Users will be treated as holding the relevant Firm NTS Entry Capacity and will be subsequently invoiced for that capacity.
5. Acceptable types of security are deposit deeds and letters of credit.

Whilst not developing an alternative draft proposal, a number of Review Group members, that accepted most of the above, favoured a requirement to provide security after allocation of capacity. If one or more of the Users did not provide the required security at that point, questions naturally arose on whether the auctions should be re-run in order to establish auction bids that reflected the remaining Users participation in the bid process. However, supporters of this option agreed that auctions should not be re-run and all NTS Entry Capacity allocated to bids submitted by the remaining Users should stand.

b) Shortcomings of Current UNC Provisions

The security provisions set out in B2.2.15 of the UNC mean that National Grid NTS looks at the sum of the User's current Relevant Code Indebtedness and the following 12 months liability for capacity charges associated with rights acquired in Quarterly System Entry Capacity auctions.

Three possible defects in these arrangements were identified by the Review Group:

1. If insufficient credit is put in place, all that User's QSEC rights (across all ASEPs) "for the relevant quarters" are removed. However, any capacity holdings relating to subsequent periods are unaffected. This potentially gives Users an opportunity to effectively opt-out of previous commitments on a quarter by quarter basis.
2. 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.
3. QSEC outcomes may trigger an increase in the allowed revenue which National Grid NTS is entitled to collect, irrespective of whether or not National Grid NTS invests in response to the release of capacity rights. If a User(s) holding capacity at the ASEP where incremental revenue was triggered defaults, recalled capacity is offered for sale. If this amount is below the allowed revenue, the difference is paid by Users collectively.

c) Value to be Secured

Initially, a range of views was expressed on the level of security that might reasonably be required. These ranged from retention of the current arrangements to underwriting 100% of the auction bid values.

It was recognised that, for new Users seeking to deliver gas at a new ASEP, the level and phasing of security requirements may be a crucial element if a project is going to be progressed, and hence there was potential to create a barrier to entry through the credit arrangements. This lay behind the consistently expressed position, by some members, that a relatively modest level of security was sufficient to deter spurious auction bidding, which was considered by them to be the main risk.

The Review Group considered whether a proportion of project value or any incremental revenue allowance value associated with incremental capacity release should be secured, but concluded that, to be non-discriminatory, security should be based on the value of all allocated capacity and not solely on the value of incremental allocations.

After discussion, most Review Group members concluded that security should be lodged that was proportionate to the risk faced by Users as a whole. This should recognise, however, that a balance should be struck between mitigating Users' risks and the creation of an unreasonable barrier to entry. Accordingly, National Grid NTS provided illustrative figures based on five options for setting security requirements based on allocated capacity. These demonstrated the order of magnitude for the value of security which might be sought. Taking each option in turn:

1. Next full Gas Year (Y+1) + peak year in the 8 year NPV test period - £320m
2. 30% of all auction bids within a forward looking period Y+2 to Y+16 - £356m
3. 25% of all auction bids within a forward looking period Y+2 to Y+16 - £297m
4. 20% of all auction bids within a forward looking period Y+2 to Y+16 - £238m
5. All auction bids within a forward looking period Y+3 to Y+5 - £428m

The Review Group concluded that, were this approach to be adopted, Users should be required to provide security for 10% of all auction bids within a forward looking period Y+2 to Y+16. National Grid NTS' Proposal 0246 is based on this and includes an element for VAT. Whilst reaching a consensus on this element, the Review Group recommended that Ofgem include an analysis of all the options within any subsequent impact assessment.

c) Adjustment to Security Requirements to Reflect Risk

The Review Group considered that security requirements should be tuned to reflect the risk facing Users. The Proposer, therefore, developed adjustment calculations that reduced the security requirements by up to 70% for companies that have Moody's credit rating of Aa or better (or Standard and Poor's equivalent). The table setting out the User's credit rating and the associated credit risk is included within Modification Proposal 0246.

Discussion took place within the Review Group on strawman proposals that initially included adjustments for User credit rating, User project risk and User community risk. The project risk element recognised how far associated projects had advanced in terms of funding, approval and construction. Whilst there was some support for this principle, it was concluded that it would be unduly difficult to apply in practice, and therefore the idea was discarded. The Review Group also discarded the User community risk element and resolved that only User Credit Risk should be used.

d) Timing of Security Requirement

The Review Group discussed five options for the stage in the QSEC process where security would be required from Users. These were:

Option 1 Prior to the auctions

Option 2 After the auctions but prior to allocation – with National Grid NTS advising the User on the likely outcome of the allocation.

Option 3 Post allocation.

Option 4 Hybrid of Options 1 and 2

Option 5 Hybrid of Options 2 and 3

(i) Hybrid Options

As part of the discussions on Options 4 and 5, the Review Group considered possible combinations, including securing an initial amount prior to the auctions and the remainder at a later stage. This initial amount could be a fixed amount, or "bid bond" such as is used for participation in other auctions known to members.

Some members of the Review Group had particular knowledge of arrangements within the electricity sector that seek to phase the security requirements associated with grid investment on the basis of a typical project S curve. In principle, this seeks to match the security provided with sums spent on the network at any particular date. The Review Group concluded that this approach was not valid for incremental entry capacity because Users as a whole take on the full liability for National Grid NTS' revenue allowance from the day that Ofgem approves an application for incremental capacity.

After discussion of the hybrid options, Review Group members did no express for any of these or Option 2 and therefore the analysis below centres on Options 1 and 3.

(ii) Option 1

The Review Group has identified the following advantages and disadvantages of implementation for Option 1 compared with Option 3

Advantages

- Provides greater protection to Users under the Transporter's allowed revenue mechanism from the consequences of a User not providing the required security.
- Provides greater assurance that auction prices will not be adversely influenced by a User not providing the required security.
- Reduces risk of uneconomic NTS investment as a User has to provide in advance the required security associated with any incremental capacity application.
- Retains current lead-times for provision of NTS Entry Capacity.

Disadvantages

- Requires User to estimate security required, which could lead to errors if bidding strategy is changed/flawed. However, this risk is to an extent mitigated by providing Users with the ability to top-up security prior to allocation.
- The above could lead to Users providing head-room/more security than required, increasing operating costs.
- Possible barrier to entry due to project sanctioning issues.

With respect to the barrier to entry issue, the Review Group discussed applications for capacity at new ASEPs and the challenges facing Users at these points, especially project financed developers. The view was expressed by some members of the Review Group that requiring security from independent developers was unrealistic ahead of an auction. They considered that banks were extremely unlikely to provide letters of credit since guaranteed capacity rights are a key condition precedent if project funding is to be released, and this guarantee is only available at the final step of the process, which is Ofgem accepting the release of capacity. Option 1 would, therefore, in their opinion, effectively remove small, independent developers from the market. Such an outcome would not better facilitate the achievement of the code relevant objective: *"the securing of effective competition between relevant shippers…"*. On the other hand, reducing the risk of Users paying for uneconomic investment on the NTS that are not involved in the auctions or have provided security would be consistent with the achievement of this objective.

(iii) Option 3

Review Group Members that supported this option acknowledged an issue in respect of Users' exposures where incremental entry capacity was allocated. When Ofgem approved the application, in the absence of substitution, National Grid NTS' allowed revenue would be increased. Under the current Licence arrangements, this revenue allowance would be funded by Users even if:

- The User(s) that triggered the additional revenue subsequently do not pay for the capacity concerned; and/or
- National Grid NTS does not invest in order to be able to accommodate incremental flows.

Some Members therefore supporting Option 3 considered that a two stage approval process would be required as follows:

1. On the basis of a compliant National Grid NTS application for incremental entry capacity, Ofgem gives approval to the application subject to security being provided by the relevant User(s).
2. The relevant Users have 30 days to provide the required security.
3. If the relevant Users provide the required security, final approval would be given by Ofgem and the revenue allowance would be increased. If this security is not provided, then no approval would be made and the revenue increase would not be triggered.

Where security is provided or where the User failing to provide security is the sole bidder at an ASEP, the situation is relatively straightforward and it is anticipated that this could be reflected by a simple change in the Licence or IECR, if required, to avoid incremental revenue being triggered.

However, Review Group Members recognised that a Licence or IECR change would not be so straightforward if the User declining to provide security were one of several at that ASEP and baseline incremental and potentially substituted capacity were to be affected. If National Grid NTS' allowed revenue reflected the total incremental capacity allocated in the auction, with no adjustment for a User's failure to provide security, there would be a risk that other Users would be required to fund capacity that was not required and may or may not be provided physically by National Grid NTS. The current Licence provisions do allow for Users to make representations to Ofgem that occurrences such as these are Income Adjusting Events (IAE), and National Grid NTS can request that capacity be cancelled. However, there is no certainty whether an IAE will be accepted by Ofgem. The Review Group concluded that a more fundamental Licence amendment might be required to allow for this more complex scenario but that this might be a matter for the next Price Control Review discussions rather than being progressed immediately. It was agreed by all attendees at the 12th meeting of the Review Group that this issue was a significant obstacle to adopting Option 3 and one which is avoided by Option 1.

National Grid NTS indicated that the approach of a conditional approval which is made absolute when security is provided may not need a change to the Licence.

Assuming the above, the Review Group has identified the following advantages and disadvantages of implementation for Option 3 compared with Option 1

Advantages

- Provides certainty on the level of security required, so minimising the costs to Users of providing that security.
- Provides degree of certainty to developers with respect to NTS Entry Capacity provision, with which they can approach financial institutions for letters of credit.
- In so far as independent developers are better positioned to develop marginal projects, enhances security of supply.

Disadvantages

- Provides less protection to Users under the Transporter's allowed revenue mechanism from the consequences of a User not providing the required security.
- Increases risk to other capacity bidders of auction costs being raised by bids that are not subsequently backed-up by security provision.
- Increases risk of uneconomic NTS investment if a User had not provided the required security associated with any incremental capacity application.
- Increased lead-times for provision of NTS Entry Capacity due to additional time associated with the two stage approval process.

This risk identified in the first bullet above would be mitigated in any two stage Ofgem approval process but only if there was a new provision in the IECR and/or Gas Transporter Licence that prevented the allowed revenue from reflecting auction bids that were not subsequently backed-up by security provision. In the absence of a Licence change, if a User failed to provide security, National Grid NTS would still be entitled to any consequential allowed revenue. Such an outcome would not better facilitate the achievement of the code relevant objective: *"the efficient discharge of the licensee's obligations under this licence…".*

Where both baseline and incremental capacity were allocated at an ASEP, and a number of Users had made bids, some Review Group Members considered that there could be a number of undesirable impacts under Option 3, including potential delays to the provision of capacity, if one or more of these Users failed to provide security and all Users' allocations were consequently set aside since the release of incremental capacity may no longer be justified. For this reason, Members did not generally favour cancelling all allocations and re-running the auctions on an ad-hoc basis at that ASEP. Instead it was considered that Users who provided the necessary security should be entitled to the NTS Entry Capacity even if the revenue from these bids was insufficient to meet the economic test. This would potentially result in capacity release and consequential investment that might not otherwise have been justified or economic, and as a result, Users as a whole would be required to fund allowed revenue that was higher than it would have been if all Users had provided the required security. For these reasons, and for the likely lower costs, some Review Group Members maintained their support for Option 1 in preference to Option 3, even if the auctions were not rerun, considering that such outcomes would not better facilitate the achievement of the code relevant objectives: *"the efficient discharge of the licensee's obligations under this licence…" and "the securing of effective competition between relevant shippers…".*

After discussing the advantages and disadvantages of the three main options, the combinations of these and the more complex phasing arrangements in electricity, some members expressed support for either Option 1 or 3, whilst others were less inclined to support any change until there had been a full assessment of the amount at risk and the cost of the options, such that there was a better understanding of the case for making any change. From these responses, the preferences for Options 1 and 3 were derived

While preferences were sought and expressed at the twelfth meeting, where not all members were present, members indicated that the choice was finely balanced rather than being clear cut. Preferences were: Ritchard Hewitt (National Grid NTS) and Chris Wright (Centrica) for Option 1; Graeme Thorne and John Baldwin (Canatxx), Jeff Chandler (Scottish and Southern Energy), Nick Wye (WatersWye) and Roddy Monroe (Centrica Storage) for Option 3.

e) Acceptable Security Provisions

Modification Proposal 0246 reflects the views of the Review Group in respect of acceptable security provisions. This proposes that security should be provided by either a Deposit Deed or a Letter of Credit.

This Proposal also identifies three circumstances where a User would be held as being in default:

1. Taken in aggregate across all QSEC Auctions, the User had put less security in place than is required in b) and c) above.
2. The security tools in place or notified to replace them at the expiry of the current tools had less than 30 day's validity remaining.
3. The financial institution providing security was downgraded to below that set-out in Section V of the UNC Transportation Principal Document (ie Moody's A).

In all of these circumstances, any new QSEC auction bids from the User would not be accepted. If the User did not remedy the default within ten Business Days of being notified by National Grid NTS, all of that User's existing QSEC capacity for years Y+2 to Y+16 would be recalled and offered in subsequent auctions. A cancellation charge would be raised for the amount of security held by that User and used to offset the impact on other Users resulting from the default.

This security provision would be in addition to the current provisions that concentrate on QSEC and AMSEC bookings for year Y0 and Y1.

f) Gas Transporter Licence Implications

Whilst recognising that the Review Group Terms of Reference necessarily focus on the UNC, the Shipper Members of the Review Group concluded that much of the difficulty in reaching consensus was due to the current Licence provisions.

In particular, where an application for incremental NTS Entry Capacity is approved by Ofgem this is reflected immediately in National Grid NTS' allowed revenue.

Shipper members of the Review Group, therefore, recommended that Ofgem considers whether a change to the National Grid NTS Licence should be proposed in order to ameliorate the risks identified, with respect to revenue allowances, when the amount paid for capacity is less than the amount bid.

Whilst Ritchard Hewitt and Chris Shanley (National Grid NTS) recognised some of the matters raised, they declined to support any approach to Ofgem that requested a Licence amendment, which would effectively reopen the Price Control outcome. They also pointed out to the Review Group that this issue was only associated with Option 3 and that the difficulty would not arise if Option 1 were implemented.

g) User Pays Implications

The Review Group acknowledged that if Proposal 0246 or an alternative were implemented the systems costs could be subject to User Pays provisions.

4. Recommendation

The Modification Panel is invited to accept this Report, which identifies both the areas where consensus was reached and the areas where consensus was not reached.

The Review Group also recommends that Ofgem carries out an impact assessment on all the options both for the stage at which security should be provided and its amount as discussed by this Review Group and summarised in this report.

Shipper members of the Review Group recommend that Ofgem considers whether a change to the National Grid NTS Licence should be proposed in order to ameliorate the risks identified, with respect to revenue allowances, when the amount paid for capacity is less than the amount bid.

Terms of Reference – Version 1.0
UNC Modification Reference Number 0221
Review of Entry Capacity and the Appropriate Allocation of Financial Risk

Purpose

This Review Proposal seeks to establish 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. Where issues are identified this Review Group will seek remedies to resolve them.

Background

The current credit rules within the UNC require that a User puts in place credit arrangements to provide security 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 can be misaligned with that of the costs or revenue recovery requirement incurred in meeting the auction obligations. Therefore there is currently a period of time where either of the above could be incurred prior to any commitment underwriting being in place.

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 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 capacity is released based on the 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-recovered 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 investment costs accrue.

National Grid Gas NTS therefore consider it to be prudent for the industry to review the current credit arrangements that underpin User commitments that are made during the entry capacity auctions.

It is therefore proposed that this Review Group be established to:

- review the existing credit security arrangements
- consider the issues which impact upon the relevant objectives including:
  - efficient and effective operation
  - development of competition
  - delivery of licence including no undue discrimination
- develop potential solutions to resolve any issues identified where appropriate
- develop any UNC contractual changes as necessary.

Scope and Deliverables

The Review Group is to consider the following:

- 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, type of capacity covered by any new arrangements.
- Consider whether the current arrangements unduly impact existing Users to a greater extent than they do for new Users.
- Identify any necessary changes to current credit default or User termination rules.
- Identify solutions to any issues derived from the deliberations of the above key points.
- Develop, by consensus, relevant UNC Modification Proposals to deliver any proposed changes to the current arrangements.
- Identify the impact on processes and procedures associated with the implementation of any identified solutions.
- Identify whether any revision to Security arrangements should be made retrospective and what any definition of retrospective should be in this context.

In addition, the Review Group agreed that this consideration of these items be structured around a number of questions to be addressed. These questions are included as an appendix to this document.

The Review Group will provide a written report to the UNC Panel and the final target deliverable shall be to submit any UNC Modification Proposal(s) that has received consensus approval within the Review Group to the UNC Panel by 19 March 2009.

Limits

The Review Group shall focus on changes to the UNC and relevant ancillary/associated documents pertaining to the credit arrangements underpinning User commitments made during Entry Capacity auctions. Where there are other industry arrangements having potential interactions with the outputs from this Review Group, the Review Group may consider the effects that those arrangements may have on this Group's deliberations. For example, the Review Group may wish to consider the outputs from the Transmission Access Review of the electricity transmission regime or developments in the National Grid Gas NTS Offtake Arrangements.

The Review Group will focus on developing UNC Modification Proposals that efficiently address any issues identified in a proportionate and cost effective manner. The Review Group will consider changes required to procedures and processes but will not investigate or develop changes required by IS systems.

Composition

Since the potential impacts of changes to the credit arrangements could be wide-ranging and are as yet uncertain it is essential that the composition of the Review Group covers as many interested parties as possible. Therefore it is desirable that the group is comprised of representatives from National Grid Gas NTS, other Transporters, UNC Users, the Regulator, Storage operators, Interconnector Users, Developers and End Users (and their representative bodies).

The Review Group will comprise the following representation:

Name	**Organisation**
John Bradley (Chair)	Joint Office of Gas Transporters
Lorna Dupont (Secretary)	Joint Office of Gas Transporters
Ritchard Hewitt (Proposer)	National Grid Gas NTS
Alex Barnes	BG Group
Andrew Fox	National Grid NTS

Benjamin Clair	South Hook Gas
Charles Ruffell	RWE npower
Chris Wright	Centrica
David Linden	BP Gas
Graeme Thorne	Mulberry Capital (for Canatxx)
Jeff Chandler	SSE
Paul O'Donovan	Ofgem
Rekha Patel	Waters Wye Associates
Richard Fairholme	E.ON UK
Robert Cameron-Higgs	Northern Gas Networks
Roddy Monroe	Centrica Storage Ltd
Tim Bradley	National Grid NTS

Information Sources

- Uniform Network Code (TPD Sections B, S and V)
- Gas Transporter, Shipper and Supplier Licences
- The Gas Act
- Various industry legislation as appropriate.

Timetable

It is proposed that a total period of 6 months be allowed to conclude this review.

Although the frequency of meetings will be subject to review and potential change by the Review Group it is suggested that the initial frequency of the meetings be every two weeks.

Meetings will be administered by the Joint Office of Gas Transporters and conducted in accordance with the Chairman's Guidelines.

It is anticipated that the timescales over which the review will run will enable any consequential UNC Modification Proposals to be raised and implemented prior to the autumn of 2009.

Questions to be Addressed by the Review Group

1 Do the current Default/Termination rules operate effectively and equitably and incentivise appropriate behaviour at the company group level?

2 In the context of the regulatory and licensing regime, under Default/Termination conditions is the balance of the risk shared between the transporter, new and existing Users, large and small portfolio players and the wider Community appropriate?

3 What should we be securing against?

- eg overall project value, revenue driver value or capacity auction bid value.

4 How far in advance of the capacity release obligation should security be required?

- What level of security should be provided during this period and, for example, should it be flat or stepped across period?

5 What level of security is needed post capacity release obligation?

- Flat, tapered etc?

6 Which Security tools are acceptable and should the same tools be available to all Users (New/Existing)?

- If not, who should be arbiter of what tools are available to each party?

7 Should any revision to Security arrangements be made retrospective and what should the definition of retrospective be in this context?

8 What relevant arrangements are or are proposed in related industries eg CUSC CAP131 in electricity, that might be of assistance?