Modification proposal:	**Uniform Network Code (UNC) 350: Combining the NTS entry capacity and exit capacity credit checks (UNC 350)**		
Decision:	The Authority[1] directs that this proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	22 June 2011	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Entry capacity credit cover arrangements

The allocation of long-term firm capacity on the gas transmission system is based on the principle of financially backed user commitment. Users purchase long-term entry capacity rights on the National Transmission System (NTS) in Quarterly System Entry Capacity (QSEC) auctions. These offer firm entry capacity rights in three-monthly blocks to flow gas for between 2 and 16 years in advance at each Aggregate System Entry Point (ASEP). Users who buy this capacity are required to post credit 12 months before the date the capacity rights are due to be used. Failure to post credit results in users' entry capacity rights lapsing (i.e. being withdrawn). In the case of a new entrant at a single ASEP that defaults on its initial credit commitment, the specific capacity which lapses, under the UNC, is the first quarter of capacity rights.

It has become apparent that this penalty may not be as much of a deterrent as previously considered, as the defaulting user still retains the rights to its future quarters of capacity. For example, if a project associated with the capacity requirement is delayed, such that the first quarter of capacity has no value to the user, such a user can default on their credit commitment leading to the capacity lapsing. They can also continue to default on their financial commitment for each subsequent quarter without any real penalty. In effect, they have a free option on entry capacity. In the meantime, any shortfall of capacity revenues due to National Grid Gas (NGG) are socialised through the System Operator (SO) commodity charge.

Previous modifications to address this issue

UNC modifications 0246/246A/246B sought to address this problem. All three modifications would have resulted in users retaining liability for any deferred capacity. These were rejected by Ofgem as they had specific disadvantages which were seen as outweighing their benefits. In our decision letter[3] we noted the widespread support for removing the ability of shippers to defer their security commitments on booked capacity and we indicated that the introduction of such a change to the UNC would represent a significant improvement on the current arrangements. We also noted that we had already approved a similar proposal with regards to exit capacity (Modification 261[4]) and, without fettering our discretion, would welcome such a proposal with respect to entry capacity.

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] Quarterly NTS Entry Capacity User commitment (UNC 246) 3 June 2010: http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC246D.pdf
[4] Annual NTS Exit (Flat) Capacity Arrangements (UNC 261) 8 December 2009: http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC261D.pdf

UNC 332 (Removal of a Users ability to allow Quarterly NTS Entry Capacity to lapse) was raised by NGG in September 2010. This was subsequently referred by the September 2010 Modification Panel for development via the Transmission Workstream. During the October 2010 Transmission Workstream a consensus was reached that there was merit in combining the entry capacity and exit capacity checks and that any such proposal would meet the objectives of UNC332. UNC 332 was subsequently withdrawn and UNC350, raised by NGG, is the result of these considerations.

The modification proposal

UNC350 proposes to:

- eliminate the current NTS entry credit check[5] and replace it with a combined NTS entry and exit capacity check;
- remove the sections of the UNC that allow a user's registered quarterly NTS entry capacity to lapse[6]: and,
- clarify the legal text to:
    - identify where a breach of the UNC can lead to termination (under V3.3.3); and,
    - identify where the Transporter can reject: applications for system capacity or increased system capacity; a system capacity trade; a system capacity assignment[7].

This modification would prevent shippers from being able to defer their quarterly entry capacity holdings. Shippers who default on their associated credit payments would still be treated as if they were holding the capacity and will be billed accordingly. Failure to pay the invoices will leave the shipper subject to the normal transportation related debt processes, including termination.

Under the current arrangements, shippers can use the same credit as security for the separate entry and exit credit checks. A combined entry and exit credit check should reduce the risk of charges to shippers from a user default that has not lodged sufficient credit. It would also simplify the credit arrangements.

The proposer believes the proposal will better facilitate the following UNC relevant objectives[8]:

- The efficient discharge of the licensee's obligations under this licence
- Securing of effective competition between relevant users
- Promotion of efficiency in the implementation and administration of the code.

UNC Panel[9] recommendation

The Joint Office received 7 responses to its consultation on modification 350. Of these responses 6 supported the modification and 1 was neutral. The UNC Panel voted on the modification on 21 April 2011. There was unanimous support for the proposal with all 10

[5] UNC TPD Section B 2.2.15
[6] UNC TPD Section B 2.2.16
[7] As described in UNC TPD Section V 3.3.2
[8] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/index.php?pk=folder590301
[9] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

potential votes cast in the favour of the modification. Therefore the UNC Panel recommended implementing UNC350.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 27 May 2011. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[10]. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[11].

Reasons for the Authority's decision.

We consider that UNC350 will impose greater discipline on users when booking entry capacity such that they are more likely to book the level of capacity actually required. This should reduce the risk of users defaulting on their capacity commitments and limit the risk of the associated costs being socialised and collected from the shipper community.

We consider that UNC350 will better facilitate achievement of the UNC relevant objectives (c), (d) and (f) as set out below:

Standard Special Condition A11.1 (c): the efficient discharge of the licensee's obligations under this licence;

The proposer indicates that the proposal may discourage speculative auction bidding as the bidder would be aware of the tighter credit arrangements and sanctions that could be applied, thus reducing the risk of inefficient system investment and providing a greater incentive for users to honour their NTS entry capacity auction commitments. This was a benefit supported in all responses to consultation. We agree with this analysis and believe that this is a significant benefit of the modification.

Further, the removal of the ability for shippers to use the same lodged credit to securitise different types of capacity reduces the inherent risk to other shippers, making the credit arrangements more robust.

Standard Special Condition A11.1 (d): the securing of effective competition

The proposer indicates four potential benefits to competition and we agree with three of these. We accept that the reduction in speculative bids would reduce the level of Entry Capacity Commodity charges, which can impact shippers disproportionately depending on their portfolio. We also agree that if termination occurs it would be possible for another user to purchase and use the available long-term capacity, facilitating development at that entry point in the interests of competition. We also accept that the cost allocation between shippers is improved thereby facilitating competition. However, the proposer

[10] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[11] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

also argues that reducing uncertainty about commodity charges can facilitate competition by not deterring entry. This benefit was disputed by one respondent and given the other sources of variability in charges, we do not see this as a significant factor in terms of weight.

We also note that the current credit arrangements could be interpreted as being discriminatory. The fact that capacity can lapse and user commitment be deferred allows specific types of users (new single entry users) to keep capacity rights for which there is no firm financial user commitment. In contrast, existing users with multiple obligations cannot maintain capacity rights without user commitment. The ability to defer financial commitment also undermines the Net Present Value (NPV) test which is used to trigger the release of incremental capacity and may be distortive of competition in relation to incremental entry capacity.

Standard Special Condition A11.1 (f): the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code.

We agree that there will be some minor administrative benefit for both shippers and NGG, in that two credit checking processes will be combined.

Other considerations

We consider the proposal is consistent with our principal objective and wider statutory duties. No security of supply impacts were identified by the proposer.

Under the current system, the separation of entry and exit credit requirements mean that the same credit tool can be used against both entry and exit commitments. In the new system the aggregation of exit and entry commitments will mean that some shippers will be required to post additional credit cover. The additional credit cover required has been estimated as £14.75million in aggregate. The annual costs to post credit for affected shippers will depend on their particular circumstances, but have been estimated by NGG as between £0m and £1m per year, in total. The higher estimate being based on the costs of providing the required security via Letters of Credit.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority hereby directs that modification proposal UNC 350: 'Combining the NTS entry capacity and exit capacity credit checks' be made.

Hannah Nixon, Partner, Transmission

Signed on behalf of the Authority and authorised for that purpose.