

User Commitment for National Transmission System Quarterly Entry Capacity Initial Impact Assessment on modification proposals

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Overview:

This document sets out our analysis of the potential impact of a series of Uniform Network Code (UNC) modification proposals relating to credit arrangements for the booking of gas entry capacity on the National Transmission System (NTS) through the long-term auctions. It also discusses alternative ways of achieving similar end goals through potential changes to the Gas Transporter license.

Responses to this impact assessment will inform our final decision on the modification proposals, which is planned for December 2009, and also future policy on credit arrangements.

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Context

This document sets out Ofgem's initial Impact Assessment (IA) on Uniform Network Code (UNC) modification proposals relating to the securitization of gas entry capacity bookings on the National Transmission System (NTS). The IA includes a summary of the discussions that took place during the UNC review group 221, from which the UNC proposals emerged, in order to provide the reader with a background on the key credit issues identified by the group. It also discusses related aspects of entry gas credit which the group recognised as important, but which were outside the remit of the review group.

This IA and its responses will inform the Authority's assessment on whether to approve any of the proposed modifications.

Associated Documents

- "Arrangements for gas and electricity supply and gas shipping credit cover - Consultation document", Ofgem, 24/02
<http://www.ofgem.gov.uk/Licensing/Work/Revoc/Documents1/310-11march02.pdf>
- "Arrangements for gas and electricity network operator credit cover - Conclusions and proposals document", Ofgem, ref 06/03
<http://www.ofgem.gov.uk/Licensing/IndCodes/CreditCover/Documents1/2018-14feb03.pdf>
- "Recommendations for best practice guidelines for gas and electricity network operator credit cover - Consultation document", Ofgem, ref 226/04
<http://www.ofgem.gov.uk/Licensing/IndCodes/CreditCover/Documents1/8473-22604.pdf>
- "Best practice guidelines for gas and electricity network operator credit cover - Conclusions document", Ofgem, ref 58/05
<http://www.ofgem.gov.uk/Licensing/IndCodes/CreditCover/Documents1/9791-5805.pdf>
- Transco Price Control and SO incentives 2002-7 - Licence modifications and way forward
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/Transco/Documents1/Transco-letter27sep02.pdf>
- Proceedings of UNC Review Group 221 meetings, accessible at
<http://www.gasgovernance.com/Code/Reviews/Closed/Rev0221/>
- UNC246/246A/246B report, available at
<http://www.gasgovernance.com/NR/rdonlyres/D1C0E027-BA98-4084-AFE3-B566AEA1A06C/34407/02460246A0246BModificationReportv20.pdf>

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Summary

Background to the gas entry capacity credit arrangements

The allocation of long term entry capacity on the gas transmission system is based on financially backed user commitment. In order to secure capacity at existing entry points or signal to the system operator the need for new capacity, users have to bid in auctions against other shippers. Those shippers that are allocated capacity are then subject to the credit requirements set out in the Uniform Network Code (UNC).

The strength of user commitment is only as good as the robustness of the underlying credit arrangements. The current arrangements are such that if a shipper defaults on its financial commitments, the shortfall in expected revenues to National Grid Gas (NGG) are socialised; they are borne by the remaining shippers through capacity charges. A significant proportion of these charges will ultimately be passed through to consumers.

Recent events have called the robustness of the current credit arrangements into question and, following discussion of the issues in a UNC review group, have led to a number of UNC modifications. This impact assessment seeks to present the issues around these proposals (including the discussions of the review group) in a manner which will draw informed comment from interested parties, as an aid to the Authority's decision making process.

The modification proposals focus on how an obligation to put credit in place prior to bidding in a capacity auction might help to prevent industry (and ultimately, consumers) from the effects of default by "risky" projects. The review group was limited in its remit to discussing issues within the vires of the UNC, but some members considered that there were other aspects of the credit arrangements that should be examined by Ofgem, eg how much risk NGG's allowed revenues should be exposed to in the event of such a default. This IA attempts to gather views on these related issues, to inform Ofgem's future work in this area. We are conscious that a number of industry participants consider that the current arrangements expose NGG to little or no revenue risk, and that this is considered by some to represent an inappropriate balance of risk and reward.

The modification proposals

The original proposal, UNC246, proposes measures to both prevent shippers from being able to defer the provision of credit without penalty and to require shippers to provide credit cover for 10% of the value of their long-term capacity holdings. This requirement would apply to both current and future holdings; shippers would have to provide appropriate credit cover in advance of the long-term auctions to ensure their bids would be deemed valid. The proposal limits the scope of the available credit tools over those currently available in the Uniform Network Code (UNC).

Alternative proposal UNC246A is largely the same as UNC246, but does not limit the availability of the current credit tools. The other alternative, UNC246B, is based on

UNC246A, such that it maintains the full range of credit tools for the provision of credit cover, but proposes that only future capacity bookings need to be securitized.

Issues arising

We have conducted a cost benefit analysis to assess whether these proposals offer value for money. The outcome is largely determined by the likelihood of default by shippers booking capacity going forward, and the degree to which a securitization requirement would prevent the most risky capacity bookings from occurring in the first place. We ask for views as to whether our approach captures the key features of the modifications and on whether the resulting risk calculations are an appropriate representation of the overall risk profile within the industry.

This IA also raises qualitative issues around the proposals; issues of competition, discrimination and security of supply. In particular, we are looking for views as to whether UNC246B might discriminate in favour of current market incumbents, since under that proposal existing capacity bookings would not have to be securitized. If UNC246B were to be implemented, shippers looking to acquire capacity at those same entry points would incur the extra costs of having to securitize their capacity and so may be at a competitive disadvantage.

Finally, we discuss license issues which were outside the remit of the UNC review group but which might facilitate the same end goal of protecting the consumer from the effects of credit default by a shipper. We are looking for views on these proposals, but are mindful of the fact that the implementation of any such proposals would require the consent of the licensee.

1. Introduction

Chapter Summary

This chapter provides background on how long-term entry capacity is allocated on the GB gas transmission system and the credit arrangements for securing entry capacity. It also provides information on related aspects of the gas transporter's licence.

Background on the GB gas transmission system

1.1. National Grid Gas (NGG) National Transmission System (NTS) is the owner and operator of the high-pressure gas pipeline system in Great Britain. The pipeline system transports gas from Aggregate System Entry Points (ASEPs), such as coastal terminals and storage facilities, to system exit points. Exit points are predominantly connections to Gas Distribution Networks (GDNs), but also include storage sites, and direct connections to large industrial consumers and other systems, such as interconnectors to other countries.

1.2. In order to obtain rights to flow gas into the NTS, Shippers must bid for system entry capacity at a number of entry capacity auctions. These auctions vary in the length they allocate rights to flow gas onto the NTS. The Quarterly System Entry Capacity (QSEC) offers long-term capacity rights to flow gas for between 2 and 16 years in advance at each ASEP. These rights are sold in quarterly blocks of system entry capacity entitling the holder to enter gas onto the NTS up to the allocated quantity for each day in the quarter.

1.3. At QSEC, Shippers can bid for two types of capacity: existing unsold baseline¹ capacity, and additional entry capacity which is in excess of baseline (called incremental obligated entry capacity). NGG use bids for incremental obligated entry capacity as the user signal to provide new entry capacity.

1.4. NGG provide a price schedule for each ASEP showing the price for each quantity of entry capacity. The baseline or reserve price (P_0) is derived using the Gas Transmission Transportation Charging Methodology. The incremental obligated entry capacity is usually offered in 20 price steps derived from the Incremental Entry Capacity Release (IECR) methodology statement. The auction invitation also lists the estimated cost of investing to deliver the incremental amounts of capacity.

1.5. During the auction, shippers bid for entry capacity at the different price levels in the schedule for each of the entry points and quarters in which they want entry capacity. NGG makes a final allocation of capacity 60 days after the close of bidding. The decision process for determining whether to release incremental obligated entry capacity is contained in the IECR methodology statement.

¹ Baselines define the levels of capacity that the transmission licensee is obligated to release. Baselines also determine the levels above which incremental capacity is defined.

1.6. When bids show that demand is greater than supply, NGG conducts a Net Present Value (NPV) test. If the NPV of the revenue from the bids for incremental entry capacity in eight consecutive years equals at least 50% of the estimated project value then NGG seeks approval from the Authority to treat additional entry capacity as incremental obligated entry capacity.

1.7. If the request is approved by the Authority, NGG is obliged to release this incremental entry capacity within a default investment lead time of 42 months. NGG has an incentive to release this incremental obligated entry capacity on an accelerated timescale, but it has a limited number of opportunities to extend this default investment lead time. On releasing incremental entry capacity, in response to demand which is backed by financial commitment from users, NGG's allowed revenue automatically increases via the revenue driver mechanism (unless the capacity requirement is wholly met through entry capacity substitution).

1.8. NGG earns additional revenue as determined by the revenue driver amount for a fixed five year period. The allowed revenue is determined by the product of a unit revenue allowance and the incremental capacity released. Essentially, the revenue drivers fund the depreciation and return on a deemed amount of capex, with an allowance for opex. At the price control following the end of the five year period we review NGG's spend so that only efficiently incurred investment is allowed into the Regulated Asset Base (RAB).

Current entry capacity security arrangements

1.9. The current credit rules are contained in the Uniform Network Code (UNC). Section B paragraph 2.2.1.5 requires users who buy capacity at QSEC auctions to provide security 12 months prior to the capacity flow date. NGG is required to sum the cost of this newly bought capacity with the relevant code indebtedness of the user; that is, the aggregate amount of other energy balancing charges that a user is liable for, determined on the amount of capacity accrued, irrespective of whether amounts have been invoiced or due. If the relevant code indebtedness is greater than 85% NGG must inform the user within five business days after the first business day of the calendar month. The user then has 10 business days to provide additional security or the users' relevant registered QSEC capacity will lapse and they will no longer be considered as holding registered quarterly firm NTS entry capacity for that quarter across all of the ASEPs where they sought capacity.

1.10. If a user defaults on providing security for capacity obtained through the QSEC, NGG can offer any of that entry capacity for resale. However, any under-recovered income would continue to accrue to NGG. As a consequence, the SO or TO commodity charge² payable by all users increases to recover the short fall in allowed revenue. In effect, all shippers (and ultimately consumers) are exposed to the financial consequences of the mismatch between the credit underwriting timeframe (ie 12 months prior to capacity flow) and the timeframe over which investment costs accrue (from 42 months prior to capacity flow).

² Depending on whether the capacity the user defaulted on was incremental or baseline

Problems identified with the current arrangements

1.11. At the time the current arrangements were devised, the prospect of a defaulting user losing all of its capacity holdings for that quarter was considered to be a significant deterrent. For a shipper needing to deliver on a number of contracts through a number of different ASEPs, this penalty seemed to be a proportionate deterrent against the likelihood of credit default. However, this sanction only has genuine effect where a user has holdings at multiple ASEPs or where a user has multiple obligations at a single ASEP. In the instance where a shipper is delivering against a single obligation from a single ASEP, the cessation of that obligation would allow the shipper to default against the capacity obligation without fear of further penalty, to the detriment of all other users of NTS entry capacity.

1.12. Some review group members expressed the opinion that the changing nature of gas supply to the UK could increase the likelihood of credit default and therefore result in cost pass through to other shippers (and ultimately on to consumers). Specifically, some users were concerned that, 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 to develop import and storage facilities. It is expected that 'new' entrants to the GB gas market who may be single entry point users will develop a number of these new projects.

1.13. The prospect that an increasing proportion of the capacity holdings could be held by single ASEP shippers, and that the majority of new infrastructure developments could be instigated by new entrants with no other commitments to the transmission system has raised concerns as to the levels of exposure to which the shipper community (and ultimately consumers) are exposed.

1.14. The arrangements also provide the scope for shippers to book capacity at single ASEPs under individual licences, and default if the capacity doesn't hold sufficient value at the time by which credit is required. This might be regarded as providing a set of free options for such shippers.

Comparison with the Electricity regime

1.15. The credit arrangements underpinning the electricity regime are different but also of relevance. In that context, the analogue of gas shippers requesting entry capacity is a generator requesting Transmission Entry Capacity (TEC). Currently, there are two different means by which generators can securitize the investment underpinning a connection to the transmission system, these are: Final Sums Liabilities (FSL), and Interim Generic user Commitment (IGUC). What follows is a brief description of the features of these schemes; a more complete description is given as Appendix 2.

1.16. Under FSL, a generator does not have to provide an upfront payment when applying for network access. The generator has to provide security from the point of initiation of construction, and the liability rises directly in line with the Transmission Licensee's construction costs (typically an 'S-curve'). Once construction is

completed, the liability drops off to the level of one year's worth of Transmission Network Use of System (TNUoS) charges.

1.17. For IGUC, once a connection offer is accepted, the generator is liable for a charge of £1/kW in year one, rising by £1/kW per year up to a maximum of £3/kW. Following consents being granted, the security charges ramp up over a four year period to a total of 10 times the annual TNUoS charge. Once construction is completed, the liability drops off to the level of one year's worth of Transmission Network Use of System (TNUoS) charges.

1.18. Note that in contrast to the gas transmission arrangements, those users requiring electricity transmission capacity are required to provide security for essentially all of the cost of the incremental capacity during the construction phase, thereby completely eliminating the risk of default (depending on the strength of the lodged credit) prior to commissioning. However, on completion of the project, the security requirements drop off significantly and so the risk of asset stranding reverts to consumers.

1.19. The types of security that are allowed to be used in the electricity regime are stated in the Connection and Use of System Code (CUSC); these are:

- Performance Bond/letter of credit from a bank
- Performance Bond/letter of credit from a company
- Cash deposit in a bank account

1.20. The arrangements set out above have been subject to industry consideration, which gave rise to CUSC Amendment Proposal (CAP) 131. Ofgem issued a decision on CAP 131³ and its alternatives, which sought to amend the securities required by new and existing users. It sought to replace the FSL mechanism with a generic profile of securities based on TNUoS charges, reduce the total level of costs securitised by generators by 50 per cent and increase the level of user commitment by existing generators. Ofgem rejected the proposal because it would have required more security from new generators than existing ones, and we considered that this was unduly discriminatory as we did not consider new generators to necessarily pose greater risk than existing ones.

Ofgem credit guidelines

1.21. Ofgem has published a number of documents regarding gas network operator credit cover⁴, which led to the establishment of a number of "best practice"

³ CAP131-user Commitment for New and Existing Generators , Ofgem, 13 Oct 2008

⁴ "Arrangements for gas and electricity supply and gas shipping credit cover - Consultation document", Ofgem, 24/02

"Arrangements for gas and electricity network operator credit cover - Conclusions and proposals document", Ofgem, ref 06/03

"Recommendations for best practice guidelines for gas and electricity network operator credit cover - Consultation document", Ofgem, ref 226/04

principles. In addition, Ofgem published a paper in conjunction with the direction to implement the changes to the 2002 - 07 Transco price control and SO incentives; this paper also discusses the issue of credit arrangements. We comment on each of these in turn.

Ofgem's credit cover documents

1.22. Between March 2002 and February 2005, Ofgem held a series of consultations on gas and electricity network operator credit cover arrangements. In February 2003, it published a set of principles which we will have regard to when discharging its functions in relation to credit issues, and which also set down our preferred approach to management of credit risk going forward. These principles were:

- Incentives need to be placed upon the Network operators (NWOs) to manage debt efficiently;
- The credit arrangements must not be unduly discriminatory, or prevent the promotion of competition;
- The credit arrangements should provide a secure and stable business environment; and
- Ofgem should take measures to protect consumers from loss of supply, in the event of a supplier or shipper's failure to maintain adequate levels of credit cover or default on payments due.

1.23. The February 2005 document set out further details on the principles relating to the identification, assessment of, and protection from credit exposures; payment/billing/collection procedures; and remedies for payment default. Whereas much of the focus of this document was on short/medium term credit default risk, it did express views on issues of relevance to the proposals at hand, namely:

- **Credit tools:** it accepted the use of Parent Company Guarantees (PCGs) for use as security, provided that these were legally enforceable in Great Britain. It also stated that the party reliant on the PCG may be required to provide reasonable counsel's opinion of enforceability, particularly if the guarantors are not GB-based⁵;
- **Pass through:** NWOs must have implemented credit control, billing and collection procedures, in line with the best practice guidelines in order to be eligible for pass-through; and
- **Timing of recovery:** all sums to be recovered will be 'logged up' and dealt with at the subsequent price control review. However, where a delay in recovery would have a material adverse effect on the financial position of a NWO, Ofgem may consider earlier licence modifications.

"Best practice guidelines for gas and electricity network operator credit cover - Conclusions document", Ofgem, ref 58/05

⁵ Ofgem doc 58/05, pages 34-35

1.24. We will have due regard to these principles when considering the merits of the modification proposals.

Transco Price Control and SO incentives 2002 -7

1.25. In directing the licence modifications for the 2002 - 7 Transco Price Control, Ofgem published an accompanying paper⁶ which summarised responses received on a number of topics and set out Ofgem's final position. Page 11 of this letter notes that following termination⁷ of a shipper, Transco would be obliged to sell off any entry capacity that it had an obligation to supply to the terminated shipper and then could apply to Ofgem for an Income Adjusting Event (IAE)⁸ to recover any deficit. It goes on to note:

"... Ofgem does not believe that it would be appropriate to allow monopolies, such as Transco, mechanically to recover any bad debts through raising other transportation charges. Instead Ofgem considers that it is appropriate to expose Transco to some of this risk with respect to entry capacity. In this respect, in determining whether any request for an IAE was justified, Ofgem would have regard to the credit arrangements put in place by Transco and the extent to which these had been effectively managed. In particular, Ofgem would need to consider whether the credit arrangements were reasonable and commercial in nature having regard to other credit arrangements adopted with respect to, for example, long term supply contracts in the gas and electricity sectors. Until this was demonstrated, it would therefore be Transco, and not its customers, that carries the risk of shipper default with respect to entry capacity."

1.26. Therefore, there is a clear expectation that the burden of proof lies with the gas transporter before any rebate might be allowed by Ofgem. However, NGG have commented that the text refers to procedures relating to shipper termination, and question its applicability to the gas entry capacity regime where a party might default on credit arrangements without resulting in a shipper termination.

⁶ Available at <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/Transco/Documents1/Transco-letter27sep02.pdf>

⁷ See Chapter 5 for a description of shipper termination

⁸ See Chapter 5 for a description of the Income Adjusting Event process

2. Overview of the Modification Proposals

Chapter Summary

This chapter provides the details of the issues considered by UNC review group 221 and the consequent modification proposals being considered. It also provides a summary of the legal framework relating to the assessment of these modification proposals.

Question box

Question 1: Do you have any additional views on the merits/disadvantages of the options for securitization of capacity to add to those of the review group?

Question 2: Do you have views on the ability for NGG to cover the potential of shipper default through commercial insurance instruments?

UNC Review Group 221

2.1. UNC modification review group 0221 was established to examine if the current entry capacity credit arrangements are sufficiently robust and provide the correct balance of risk between various UNC parties. Specifically, the review group was asked to consider the following:

- Consider whether the current credit and security arrangements are sufficiently robust to underpin user commitments;
- 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; and
- Identify whether any revision to Security arrangements should be made retrospective and what any definition of retrospective should be in this context.

2.2. The review group were required to focus on changes to the UNC and relevant ancillary or associated documents relating to the credit arrangements underpinning user commitments made during Entry Capacity auctions. It was noted that any changes identified by the review group would need to be proportionate and cost effective. The group focussed on the long-term capacity allocated through the QSEC, as it was considered that this constituted the majority of the bookings (both by volume and value) and hence the majority of the risk involved.

2.3. The review group completed its work during March 2009. They identified the following three problems with the current arrangements:

- If a user puts in place insufficient credit, all of 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 opt-out of previous commitments to purchase entry capacity on a quarter by quarter basis;
- There is an inappropriate length of time between a user committing to buy long term NTS Entry Capacity and the user financially underpinning this commitment; and
- QSEC outcomes may trigger an increase in the allowed revenue which NGG NTS is entitled to collect. In the event of a default, recalled capacity is offered for sale. If the amount for which this is sold is below the allowed revenue, users pay the difference collectively.

2.4. The review group presented a report⁹ to the UNC modification panel and reached consensus that it would be reasonable and consistent with user commitment to provide financial security earlier than the current requirement (ie 12 months in advance of capacity flow). The group was not able to reach a consensus on what stage in the QSEC auction procedure the security should be required. For that reason, the chapter provides an overview of the discussions the review group had and the areas they reviewed. Discussions within the group focussed on the following areas:

- Value of capacity to be secured
- Adjustments to the security requirement to reflect user risk
- Timing of the security requirement
- Acceptable security provisions
- Components of a risk assessment mechanism

Each of these elements is discussed in turn below.

Value of capacity to be secured

2.5. The review group considered a range of views on the level of security that might reasonably be required. These ranged from retention of the current arrangements to underwriting 100% of all QSEC auction bid values.

2.6. The group recognised that for new users seeking to deliver gas at a new ASEP, the level and phasing of security requirements may be a crucial determinant of whether a project is going to be progressed. Therefore, the value of credit could be a potential barrier to entry if set too high.

2.7. The review group also considered in order for security to be non-discriminatory, it should be based on the value of all allocated capacity, ie baseline and incremental capacity allocations, rather than just incremental allocations.

⁹ "Review Group Report: Review Proposal Reference Number 0221", 10 June 2009, available at www.gasgovernance.com

2.8. A majority of the review group concluded that security should be proportionate to the risk faced by users as a whole. In doing so, the group considered that a balance must be struck between mitigating users' risks and the creation of an unreasonable barrier to entry.

2.9. NGG NTS provided illustrative figures to the review group for various options, based on the value of outstanding bids for allocated capacity being £1.33bn, while taking into account the possibilities for gaming of auction bids. These figures were intended to demonstrate the order of magnitude for the value of security which might be sought.

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

2.10. The review group concluded that 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 based proposal UNC246 on this.

Adjustment to Security Requirements to Reflect User Risk

2.11. The review group considered that security requirements should reflect the risk posed by users. NGG NTS put forward 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). This approach has been incorporated within Modification Proposal 246, which includes a table setting out the user's credit rating and the associated reduction in the level of required security.

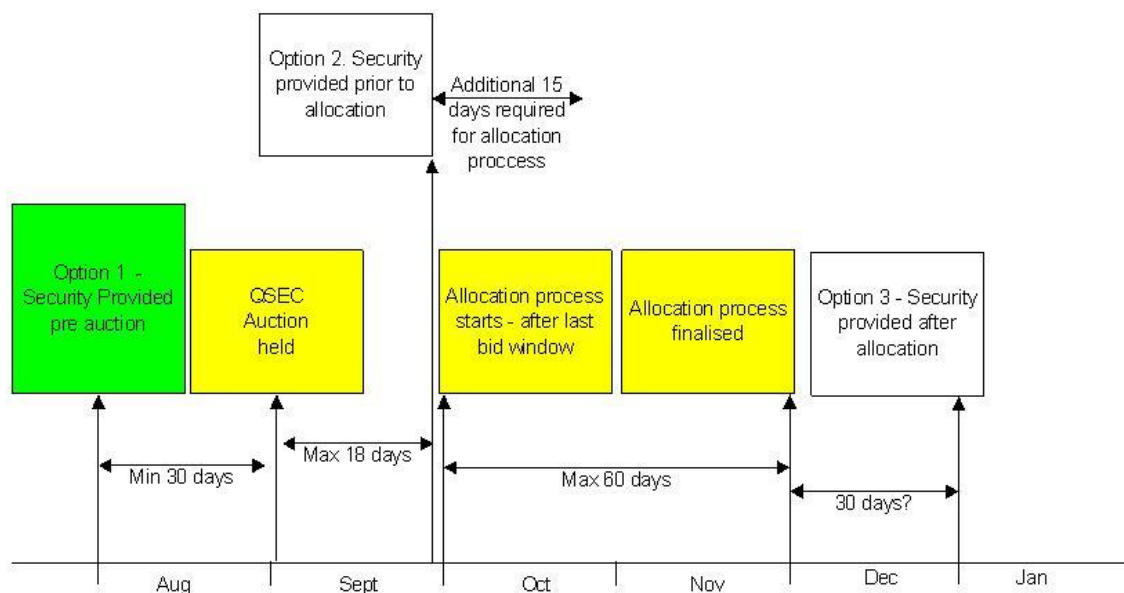
Timing of Security Requirement

2.12. The review group discussed five options for the stage in the QSEC process where security would be required from users. These were:

1. Prior to the QSEC auctions
2. After the auctions but prior to allocation – with NGG NTS advising the user on the likely outcome of allocation
3. Post allocation
4. A hybrid of Options 1 and 2
5. A hybrid of Options 1 and 3

Figure 2.1 shows where each of these options would fit into the current QSEC auction process¹⁰.

¹⁰ Following the Authority's approval of UNC230AV, QSEC auctions will be held in March each year from 2010 onwards

Figure 2.1: Options for timing of security provision**Variations**

Option 4 - (hybrid of option 1 + 2) - minimum level of security or bid bond provided pre auction and security topped up prior to allocation

Option 5 - (hybrid of 1 + 3) minimum level of security or bid bond provided pre auction and security topped up after allocation has been finalised

2.13. The review group identified the possible advantages and disadvantages of each option. These are outlined below.

Option 1 – security provided prior to auctions

2.14. The review group considered that requiring security from independent developers especially at a new ASEP was unrealistic ahead of an auction and could form a barrier to entry.

2.15. They also considered that banks were unlikely to provide letters of credit to users ahead of the auction as guaranteed capacity rights are a key condition for the release of project funding. This guarantee is only available at the final step of the process, which is either NGG allocating baseline capacity or Ofgem accepting the release of incremental capacity.

2.16. The review group considered option 1 would remove small, independent developers from the market. This would not improve the code objective to secure effective competition between relevant shippers. However, it was the lowest risk option with regards the securitization of QSEC bids, and so of the available options, provides consumers with the greatest level of protection against default.

2.17. The review group summarised the advantages and disadvantages of implementation for Option 1 as follows.

Advantages

- Provides greater protection to users from the consequences of a user not providing the required security
- Provides greater assurance that auction outcomes will not be adversely influenced by a user not providing the required security
- Retains current lead-times for provision of NTS Entry Capacity

Disadvantages

- Requires user to estimate security required ahead of bidding in a QSEC auction, which could lead to errors if bidding strategy is changed. This risk could be mitigated by allowing users to top-up security prior to allocation
- Prior estimation of credit requirements could lead to users providing head-room or more security than required, thereby increasing operating costs
- Possible barrier to entry due to project sanctioning issues

Option 2 – security provided after auctions but before capacity allocation

2.18. The review group identified several problems with users providing security after the auctions are complete but before final allocations. In common with option 1, they consider that banks are unlikely to provide letters of credit to users ahead of final capacity allocation as guaranteed capacity rights are a key condition for the release of project funding.

2.19. The group also considered that option 2 could lead to gaming opportunities. users could bid for capacity but default on providing security which would affect the prices paid for capacity by other users at the same entry point – these allocations would not be reopened for fresh bidding.

Advantages

- Allows user to provide security to match his allocated capacity holding, ensuring efficient operating costs
- Ensures security is in place for all capacity holdings protecting community from the full impact of a user default
- No need to re-run auction

Disadvantages

- Requires extension of allocation window
- Potential minor impact on the timing of other capacity auctions/processes
- Open to gaming; significant distortion of outcomes if user defaults

Option 3 – security provided after capacity allocation

2.20. The review group considered that the generality of users could face increased financial exposure with option 3 if incremental entry capacity is allocated. Specifically, when Ofgem approves an application for incremental capacity, in the

absence of substitution, NGG NTS's allowed revenue increases. Under the current Licence arrangements, users fund this revenue allowance even if:

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

2.21. Some members supporting Option 3 considered that a two stage approval process would solve this problem. The two stage process would operate as follows:

- On the basis of a compliant NGG NTS application for incremental entry capacity, Ofgem gives approval to the application subject to security being provided by the relevant user(s)
- The relevant users have 30 days to provide the required security
- 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.

2.22. The two stage process would require a licence change. Review group members recognised that a Licence or IECR change would not be straightforward if the user declining to provide security were one of several at that ASEP and baseline incremental and potentially substituted capacity were affected.

2.23. Taking the above into account, 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 a greater degree of certainty to developers with respect to NTS entry capacity provision, which will help them to approach financial institutions for letters of credit
- As independent developers are better positioned to develop marginal projects, it may enhance security of supply

Disadvantages

- Provides less protection to the user community from the consequences of a particular user not providing the required security
- Increases the risk to other capacity bidders at a given ASEP 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 does not provide the required security associated with any incremental capacity application
- Increased lead-times for provision of NTS Entry Capacity due to the additional time associated with the two stage approval process

2.24. This risk 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, NGG NTS would still be entitled to any consequential allowed revenue.

2.25. Some review group Members considered that there could be a number of undesirable impacts under Option 3 on occasions when both baseline and incremental capacity were allocated at an ASEP, and a number of users had made bids. These impacts could include 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.

Hybrid Options

2.26. The review group considered possible combinations of the above options 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". However, review group members did not express particular support for either of these hybrid options.

Acceptable Security Provisions

2.27. In the review group discussions, NGG proposed that security should be provided by either a Deposit Deed or a Letter of Credit (LoC). The underlying logic was that security should be instantly realisable in the event of default, and that instruments such as Parent Company Guarantees (PCGs) might not be, especially in the event that the parent company finds itself in financial difficulty. The recent demise of Lehmann Brothers was quoted as an example of relevance. A further issue regarding the use of PCGs was noted in relation to their enforceability if the parent company does not fall under the remit of GB statute.

2.28. While the restriction of the current forms of credit to Deposit Deeds or LoCs was debated during the review group meetings, members of the group accepted the basis for NGG's proposal, without necessarily agreeing with it.

Components of a risk assessment mechanism

2.29. It was originally proposed that the levels of credit to which a party would be required to commit would be assessed by means of a "composite", which initially comprised three elements:

- A credit rating element, whereby the better a party's rating is, the greater the relief it would be given from the requirement to post credit (as per the table in UNC Section TPD V 3.1.3). This constituted 50% of the composite credit requirement;

- A project risk element, whereby the closer a project is to completion (based on documented evidence given to NGG), the less credit a project would have to post. This constituted 40% of the composite requirement; and
- An incremental risk element, whereby users would have to post credit in line with the ratio of the value of their newly acquired capacity to their holdings prior to the QSEC. This was intended to reflect the increased risk in instances where a shipper acquires significant quantities of capacity relative to their existing holdings. This constituted the remaining 10% of the credit requirement.

2.30. The review group considered the impacts of the various components above by applying them to the differing profiles of shippers who currently hold capacity. It became evident that the same shippers were being similarly affected by each component, ie those who scored well on the credit rating also tended to be those who had little or no project risk and introduced little incremental risk, and conversely, those who scored poorly on one element generally scored poorly on all elements. On that basis, the review group discarded both the incremental risk element and the project risk element of the composite credit requirement, to arrive at a simple but effective means for assessing shipper risk.

UNC Modification Proposals

2.31. Following the work of the review group, NGG raised UNC modification proposal 246. This attracted two subsequent alternatives. The key components of each of these proposals are described in the following sections.

UNC modification proposal 246

2.32. UNC modification proposal 246 intends to address two key issues identified by the review group. First, that due to inconsistencies in credit arrangements obligations, users at a single ASEP can defer security commitments up to 12 months before capacity is available. Second, that there is an inappropriate amount of time between a user committing to buy QSEC capacity and financially underpinning the commitment.

2.33. NGG NTS propose to amend UNC TPD Section B 2.2.16 so that users can no longer defer the provision of security which would allow the QSEC provision to lapse. The changes will also clarify that the user will continue to be treated as holding the relevant NTS Entry Capacity and will be subsequently invoiced for that capacity. Any failure to pay these invoices will be treated in the same way as any other transportation debt; accordingly, National Grid NTS will reject any further QSEC capacity bids at any ASEP submitted by the user until the above security has been provided by the user.

2.34. Users will provide security by either a Deposit Deed or LoC (provided by a financial institution with an A rating from Moody's, or Standard and Poor's equivalent rating) which cannot be amended or cancelled without agreement of all parties involved.

2.35. NGG NTS propose that 14 days prior to participating in any subsequent QSEC auction, users will be required to provide sufficient security to cover both their existing and any anticipated additional capacity holding resulting from their participation in the auction.

2.36. This means that prior to a QSEC, users will be required to estimate their post-auction capacity holdings for the years Y+2 to Y+16, and post credit to cover 10% of the total value of this capacity (plus Value Added Tax at the prevailing rate). This security provision would be in addition to the current provisions that concentrate on QSEC and AMSEC bookings for year Y0 and Y1, ie it would be conducted as a separate process to the current credit arrangements set out in Section V of the UNC.

2.37. During the auction, NGG NTS will reject all capacity bids for a user where their revised user's Security Value (USV), which reflects the cover required for their existing holding and "anticipated" capacity allocation (plus VAT), would have resulted in that bid window being the final bid window and exceeded the user's prevailing security. This will ensure that a "defaulting" user's bids do not affect reporting during the auction and are disregarded prior to determining whether the auction has reached stability.

2.38. For the purpose of completing the QSEC within the current timelines, NGG NTS propose that the current ten business day window for the QSEC auction period is changed to eight business days during which users will be sent bid information by 20:00 hours on each business day. Previous QSEC auctions have been analysed and NGG NTS has found that stability has always been reached by the seventh consecutive day. Reducing the number of bid windows would not have changed any previous auction outcomes and NGG NTS believe it will have no material effect in the future.

2.39. The proposal lists three circumstances where a user would be in default:

- Taken in aggregate across all QSEC Auctions, the user had put less security in place than is required
- The security tools in place had less than 30 day's validity remaining
- The financial institution providing security was downgraded to below that set out in Section V of the UNC Transportation Principal Document (i.e. Moody's A rating)

2.40. If a user default occurs, a "default process" will be triggered whereby NGG NTS inform and require the user to provide the necessary security to cover at least the user's USV within the next 10 business days.

2.41. If a user has not provided security after 10 business days (or if the user has been terminated under UNC TPD Section V) then the user's QSEC capacity holding across all ASEPs in years Y+2 to Y+16 will be recalled and offered in subsequent auctions and the user charged a "cancellation fee" equivalent to the value of the security held for the purpose of underwriting the user's holding of NTS Entry Capacity for Years Y+2 to Y+16. NGG NTS will also reject any further applications made to acquire System Capacity under Section B or via a System Capacity Trade

until the following day after the bids are allocated by National Grid in the next year's annual QSEC auction.

2.42. Where a user fails to provide or maintain the security required by this proposal, the user's prevailing QSEC capacity holding across all ASEPs in Years Y+2 to Y+16 that has been previously subject to Transfer will be treated as though the user had been terminated under UNC TPD Section B5.4, ie the transferee user may elect to be registered as holding that capacity and subsequently be held liable for capacity charges in respect of the transferred capacity.

UNC modification proposal 246A

2.43. Modification proposal 246A was proposed by EDF Energy as a way of overcoming perceived problems with proposal 246. It proposes the same credit cover mechanisms as UNC246, but expands on the range of credit cover tools available to shippers.

2.44. EDF Energy's main concern relates to the acceptable forms of credit tools being either a LoC or Deposit Deed provided by a financial institution with an A rating from Moody's (or Standard and Poor's equivalent). In effect this would mean that a Parent Company Guarantee (PCG) from a company with a rating higher than A would be less credit worthy than a LoC from a bank with an A rating. In addition, some Shippers are owned by banks and so under UNC246, a PCG would again not be acceptable but a LoC from the same institution would be.

2.45. EDF propose that the changes to the acceptable credit tools contained within modification proposal 246 are removed and the current credit tools detailed within UNC Section TPD V 3.4.6 remain in place. For clarity, these are listed below:

- Bi-lateral insurance
- Deposit deed
- Letter of Credit
- Guarantee

2.46. Note that the proposer agreed with NGG that although prepayment agreements are also listed in TPD V 3.4.6, these are not applicable for the securitization of long-term capacity.

UNC modification proposal 246B

2.47. British Gas Trading (BGT), while agreeing that the current security arrangements are untenable, submitted 246B as a way to prevent the worst financial aspects of user default from impacting on Shippers and consumers.

2.48. The proposal seeks to make two main changes to the UNC. The first change, which is largely the same as the first part of proposal 246, is that users can no longer defer the provision of security. The second change is to require that all new

baseline and incremental QSEC capacity bids must be securitised in advance of the auction. However, unlike proposal UNC246, it does not require users to securitize all existing QSEC capacity holdings.

2.49. Proposal UNC246B also does not seek to restrict the range of credit tools available to shippers. Like UNC246A, it allows the full suite of UNC transportation credit tools to remain available.

2.50. Proposal UNC246B does not use the term "cancellation fee", as BGT believe this terminology legitimises the actions of users who renege on previous auction commitments.

2.51. A table summarising the key points of UNC246 and its alternatives follows.

Table 2.1: Summary of key features of modification proposals

	UNC246	UNC246A	UNC246B
Prevents deferral of security	√	√	√
Securitizes existing capacity bids	√	√	X
Allows full range of credit tools	X	√	√

Consultation responses

2.52. The three modification proposals were consulted on through the Joint Office of Gas Transporters. In total, 21 responses were received with most respondents choosing to issue one response which covered all three consultations.

2.53. Respondents indicated a strong preference for the implementation of proposals UNC246A and UNC246B. Fifteen respondents supported the implementation of UNC246B with 10 supporting the implementation of UNC246A. Where respondents indicated a preference for both proposals there was a clear majority in favour of the implementation of UNC246B over UNC246A. Only 1 respondent supported the implementation of modification UNC246. Three respondents objected to the implementation of any of the proposals.

2.54. Respondents generally accepted the closure of the loophole which allows single entry point users to defer the provision of long term entry capacity at no cost to them. Respondents also accepted the need to reduce the amount of time between making a commitment to capacity and demonstrating a financial commitment to secure that capacity.

2.55. Modification proposal UNC246B was accepted by the majority of respondents as the being the most economic and efficient to implement. Support for UNC246B centred on several areas:

- First, in contrast to UNC246, UNC246B does not restrict the range of credit tools which can be provided by Shippers to securitize capacity. The range of eligible tools would remain as currently stated in the UNC
- Respondents also supported the fact that UNC246B does not entail elements of retrospectivity, which is in contrast to UNC246/246A which would apply the revised security proposals to new and existing capacity holdings. It was suggested that the bidding strategy of users for long term capacity would have been different if they had known of the potentially higher costs re-securitization could bring.
- Some respondents also favoured the removal of the "cancellation fee" term in UNC246B, claiming that its use in UNC246/246A may legitimise user default behaviour and undermine the under commitment principle.

2.56. Three respondents did not support any of the modification proposals, with the general view being they did not bring an appropriate balance of risk mitigation against implementation cost. This issue was also mentioned by other supporters of UNC246B, who queried the assumed annual £4m cost of UNC246 against a perceived value at risk of £20m p.a.

2.57. A number of respondents made reference to the rejection of planning permission and the potential impact that might have on smeared costs going forward, and urged Ofgem to consider this wider issue (which was outside the remit of the review group) as part of any IA being issued to consider the UNC246/246A/246B proposals.

2.58. Two respondents suggested that an alternative to the current mutual credit cover arrangements could be for NGG to seek insurance cover against the risk of shipper failure, and then recover the premiums through transportation tariffs. We would welcome views from parties as to the feasibility of such a scheme.

Modification panel

2.59. The UNC Modification Panel met on 21 May 2009 to consider the proposals. Of the nine voting members present, capable of casting ten votes, one vote was cast in favour of implementing modification proposal UNC246. Therefore, the Panel did not recommend implementation of proposal UNC246.

2.60. Two votes were cast in favour of implementing Alternative Proposal UNC246A. The Panel did not recommend implementation of Alternative Proposal UNC246A.

2.61. Nine votes were cast in favour of implementing Alternative Proposal UNC246B. Therefore the Panel recommended implementation of Alternative Proposal UNC246B.

2.62. The Panel then voted on which of the three proposals would be expected to better facilitate achievement of the relevant objectives. One vote was cast in favour of implementing proposal UNC246 in preference to alternative proposals UNC246A and UNC246B. No votes were cast in favour of implementing the alternative proposal UNC246A in preference to proposals UNC246 and UNC246B. Nine votes

were cast in favour of implementing the alternative proposal UNC246B in preference to proposals UNC246 and UNC246A.

2.63. Therefore, the Panel determined that, of the three proposals, proposal UNC246B would better facilitate the achievement of the relevant objectives.

Legal framework for the decisions

2.64. In this section we set out the legal framework in which the Authority will be required to decide on the modification proposals that have been raised.

Applicable Objectives of the Uniform Network Code

2.65. The assessment of proposals to modify the UNC is governed by Standard Special Condition A11 of the National Grid Gas (NGG) National Transmission System (NTS) Gas Transporter licence. Under standard special condition A11, modifications to the UNC can only be made with the consent of the Authority. The test applied by the Authority in assessing a UNC modification proposal is whether the proposal will better facilitate, consistent with the licensee's duties under section 9 of the Gas Act, the achievement of the relevant objectives of the UNC. These objectives are set out in paragraph 1 of Standard Special Condition A11 and are as follows:

- The efficient and economic operation of the pipeline system to which the NGG NTS licence relates;
- So far as is consistent with sub-paragraph (a), the coordinated, efficient and economic operation of (i) the combined pipe-line system, and/or (ii) the pipe-line system of one of more other relevant gas transporters;
- So far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under the licence;
- So far as is consistent with sub-paragraphs (a) to (c), the securing of effective competition:
 - Between relevant shippers;
 - Between relevant suppliers; and/or
 - Between GDN operators (who have entered into transportation arrangements with other relevant transporters) and relevant shippers.

2.66. Modification proposals are also assessed in the context of section 9 of the Gas Act. This requires NGG to develop and maintain an efficient and economical pipe-line system for the conveyance of gas. Section 9 also requires NGG to avoid any undue preferences or undue discrimination in connections or the terms under which it undertakes the conveyance of gas through its system.

The Authority's wider duties

2.67. Following an assessment of a proposal against the relevant objectives, the Authority must consider whether it is compliant with its wider statutory duties,

including those arising under European law (e.g., but not exhaustively, Directive 2003/55 and Regulation No 1775/2005). The Authority's statutory duties are set out in Appendix 5.

Principal objective

2.68. The final stage of the assessment process is to determine which of the options available to the Authority is best calculated to further the Authority's principal objective of protecting the interests of consumers, both present and future, wherever appropriate through the promotion of effective competition.

3. Quantitative analysis of costs and benefits

Chapter summary

This chapter sets out Ofgem's views on the quantifiable costs and benefits for consumers arising from the implementation of UNC246, UNC246A or UNC246B.

Question box

Question 1: Do you agree with the analysis of the risks involved? Are there any quantifiable risks that have been omitted?

Question 2: Is the level of securitization being proposed appropriate? If not, why?

Question 3: Do you agree with the benefits as presented here? Are there any other ways in which the quantitative benefits could be presented?

Question 4: How do the risk ranges presented for each of the proposals rank against your perceived risk of default for future capacity bookings?

Question 5: Do you have any preference amongst the proposals on the basis of the quantitative analysis?

Overview

3.1. The gas auction regime for the provision of long term entry capacity based on user commitment was introduced through Ofgem's approval of Mod 500¹¹. Since then, NGG has received 12 signals for the provision of incremental capacity underpinned by user commitment at the QSEC. This equates to a total of 3,341 GWh/day of entry capacity. For comparison, aggregate baseline (which excludes all of this incremental capacity) is almost 7,450 GWh/day, while the peak demand for a 1-in-20 winter is approximately 5,900 GWh/day.

3.2. In addition to incremental capacity signals, the auctions provide a means for shippers to acquire baseline capacity over the long term. The split between bookings for baseline and other capacity is about 50:50, both in terms of capacity and value.

3.3. As of this moment, the total value of bookings through the QSEC (representing capacity from 2009 to 2025) is £1.33 billion. The profile of these bookings over time is shown in figure 3.1.

3.4. Of this £1.33 billion of capacity bookings, £656 million relates to baseline capacity, while £666 million is from bookings made which triggered incremental capacity. There is an additional £4m in bookings which comprise revenues from non-obligated incremental capacity.

¹¹ Ofgem decision letter No. 500, "Long term capacity allocation", 30 September 2002

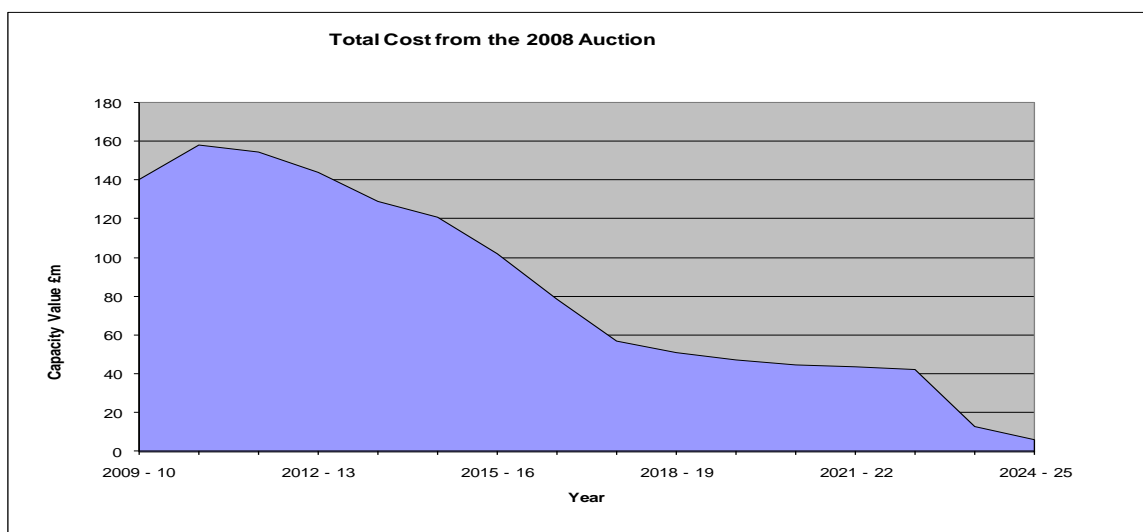


Figure 3.1: Aggregate QSEC bookings by value going forward

Costs of the different proposals

System development costs

3.5. Common to all three proposals will be the costs of updating the UK Link system which are estimated under the Rough Order of Magnitude¹² (ROM) process to be between £250,000 and £500,000.

Securitization costs

UNC246

3.6. UNC246 would require 10% of all capacity holdings to be securitised, ie £133m would need to be securitised. With the application of 15% VAT this would represent a sum of £152m which shippers would have to secure. This could be done using cash, letters of credit (LoCs) or deposit deeds.

3.7. A major discussion during the review group was the cost of each of these credit instruments. Parties submitted estimates for the cost of LoCs of the order of 1 – 7% of the value of the sum to be covered. Representatives of small developers indicated that they would be unable to get LoCs unless either: (a) they deposited an amount equivalent to the sum to be covered with the LoC issuer or (b) they lodged the cash with NGG (in which case they would be entitled to the bi-annual interest payments

¹² A Rough Order of Magnitude (ROM) is a high level systems impact assessment produced by xoserve, on request, in relation to modification proposals which have not previously been allocated funding (i.e. User Pays proposals). Whilst they are non-binding, they give an indication of the feasibility of the proposed approach, likely implementation timescales and associated costs. Subject to the scale and spread of the initial estimate, the panel may request a more accurate (and therefore of itself costly) Detailed Cost Assessment (DCA).

equal to the Bank of England base rate). In either of these latter two instances, the cost to the small developer would be the opportunity cost of the capital, less the interest rate received.

3.8. We have assumed, for the purpose of this analysis, that those shippers with credit ratings of A or above will be able to secure LoCs at an average cost of between 1 - 2%, while those with a lower or non-existent credit rating will have to use capital at an opportunity cost of 3% net (ie after interest on the capital is accounted for) for the low case and between 5 - 7% for the upper case. These figures are based on industry feedback to NGG NTS during the review Group discussions and do not represent Ofgem's view of the cost of raising finance in these circumstances. This would result in total costs (including VAT) of securing a LoC of between £2.71m and £4.88m as shown in table 3.1.

Table 3.1: Annual costs & NPV of costs of direct securitizing capacity

Credit Rating	Cost of Modification 246 (£m)		Cost of Modification 246A (£m)	
	Lower	Upper	Lower	Upper
A or above	1.06	1.06	-	-
Below A	1.65	3.82	1.65	3.82
TOTAL	2.71	4.88	1.65	3.82
NPV Total	12.0	21.7	7.3	17.0

3.9. These figures represent ongoing annual costs for securitising capacity bookings. If we assume that the profile of bookings going forward is the same as the current profile, then the Net Present Value (NPV) of the UNC246 costs over the next five years, when discounted at NGG NTS's current allowed cost of capital¹³ of 6.25% pre-tax, gives a range of between £12m and £21.7m.

UNC246A

3.10. As the alternative proposal UNC246A is similar to UNC246 except that it allows for an increased range of credit tools being accepted, we assume that users with a credit rating of A or above will have access to cheaper forms of security. This will open out the range of credit tools to include bi-lateral insurance and parent company guarantees which we assume users with a credit rating of A or above can acquire for little or no incremental cost. Those on lower or non-existent credit ratings will have similar costs as those considered for UNC246. This would result in costs of securing their capacity holdings of between £1.65m and £3.82m as shown in table 3.1.

3.11. Looking at the five year NPV of these costs, again assuming the same capacity booking profile going forward and discounting at 6.25%, gives a range of between £7.3m to £17.0m.

¹³ Whereas it might be more appropriate to discount at the relevant shippers' costs of capital, this information is not known and would over-complicate the resulting calculations. When comparing the costs and benefits arising from the proposals, it is more important to ensure that they are all discounted in the same manner so that the resulting comparison is appropriate.

UNC246B

3.12. As this proposal would not look for security on existing capacity holdings then relative to the other variants there are no costs for securing current capacity. However, it would incur the same costs with respect to new capacity bookings and would eventually impose the same costs as the other proposals (though not until the current bookings expire in 2025).

3.13. To estimate the cost of this proposal, we assume the capacity value profile going forward is represented by the current profile (as illustrated in figure 3.1). By shifting the curve one year to the right, and comparing the capacity under this new curve with the capacity already booked under the original curve, it indicates that about £90m of additional capacity would be booked each year to maintain the same forward 5 year capacity profile, ie a total of £450m. We take this to represent the low case for capacity bookings over 5 years under UNC246B.

3.14. By making the further assumption that the cost of security required is in line with the lower cost for UNC246A¹⁴, the NPV of security costs is estimated to be £1.34m.

3.15. The high case for the value of capacity to be securitised while keeping the profile the same would be the sum of capacity bookings for years 1-5, which equates to £740m. Using the assumption of equal tranches of capacity being booked through the period (ie £148m p.a.), and using the higher costs of securitising capacity under UNC246A¹⁵, we get a NPV over the five years of £5.1m.

Default costs from current capacity bookings

3.16. One issue that arises from these proposals is that current capacity holders might consider there is an opportunity to discard their holdings¹⁶, especially if they consider that these holdings could be re-acquired for less in the future. This could be feasible for shippers whose capacity holdings are predominantly at a single ASEP at which they have made long term bookings, but at which there is an expectation of declining supplies in the future.

3.17. Work done by NGG during the review group 221 discussions highlighted that there is some £725m of capacity that could be considered to fall into this category. Some shippers might be willing to surrender this capacity in order to either bid for it again in later auctions (but at a lower price) or to try and get it at a discounted rate in the short term auctions. Under such a scenario, the surrendered capacity would be offered for sale again, and any deficit between the original revenue due and the revenue recovered from its resale would be socialised through the commodity charge.

¹⁴ This equates to about 1.1% of the security value, or 0.11% of the value of the capacity being securitised

¹⁵ This equates to about 2.5% of the security value

¹⁶ It could be argued that this opportunity already exists, but at the moment there is not any particular driver which forces shippers to consider the issue

3.18. Given the potential changes in the entry capacity allocation regime under way (in particular, entry capacity substitution and the transmission charging review), the adoption of a capacity surrender policy would be very risky. There would also be reputational issues to be considered, and possibly issues with licence breach. However, a number of respondents raised the issue, speculating that had shippers known of the extra security costs involved, in some instances those shippers would not have committed to acquiring that long-term capacity¹⁷. Given the magnitude of the sums involved, we believe it to be a risk that needs to be considered.

UNC246

3.19. UNC246 requires shippers, prior to the QSEC, to lodge credit (in the form of a LoC or Deposit Deed) sufficient to cover both existing capacity holdings and anticipated additional holdings resulting from their participation in the auction. If the shipper fails to provide this credit, then its capacity holdings for years Y+2 to Y+16 across all ASEPs will be revoked and NGG will also reject any further applications for capacity until the day after bids from the next year's annual QSEC auction are allocated. Though not envisaged at the time of the modification's proposal, we are also assuming that the legal text will specify that the shipper will not be able to prevent the revoked capacity being substituted.

3.20. Note that under UNC246, such a shipper would be able to continue utilising its existing short term capacity bookings (though it would not be able to add to them), since the proposed credit arrangements for long-term capacity are outside of the normal credit arrangements in Section V of the UNC.

3.21. Given the comparatively restrictive nature of the credit tools available under UNC246 (relative to its alternatives), we consider the likelihood of a shipper opting to default on the credit arrangements greatest under this proposal than any of the other variants. However, given the risk involved for the shipper, we believe this risk to be small, and so have chosen to quantify this as a 1-2% risk of default on this category of capacity¹⁸. This results in a potential one-off cost ranging between £7.25m and £14.5m¹⁹ for this proposal.

UNC246A

3.22. We consider the risk that parties would willingly default on their credit cover for existing capacity holdings to be less under UNC246A than under UNC246. This is for two reasons:

¹⁷ Although we find it difficult to attach much weight to this argument given the amounts involved, ie the upper cost of £4.88m from table 3.1 applied to £1.33bn is a very small percentage on user capacity costs, even though it is not uniformly distributed across users.

¹⁸ NGG has provided us with analysis which further breaks this £725m into low, medium and high risk amounts (approximately £350m, £185m and £190m respectively). For the sake of simplicity we have applied a uniform default rate across the capacity rather than differing default rates to each tranche of capacity.

¹⁹ We have chosen to exclude VAT on this capacity from the analysis

- The range of credit tools available to participants, allied to the fact that about 60% (by value) of such capacity is held by parties (or their affiliates) that have credit ratings of A or better, means that the proposal does not impose as significant a cost on the majority of participants.
- Under the current drafting of UNC246A, failure to provide the credit for capacity would constitute a default under section V of the UNC, which is a very serious matter. This could quickly escalate to termination of that shipper, and therefore represents a far more risky option than default under UNC246.

3.23. Accordingly, we believe the combined capacity under risk/risk of default under this option to about half of that under UNC246 as it still retains the risk of default from the high risk capacity. This would represent a potential cost of between £3.1m to £7.25m for UNC246A.

UNC246B

3.24. A single ASEP shipper should be no more likely to initially default under UNC246B as under the current arrangements, since if it doesn't require any additional capacity it doesn't have to incur the extra cost of putting forward any related credit cover. However, if it required any further capacity going forward, then the risk of default would be similar to UNC246A for that additional capacity.

3.25. Assuming a capacity take-up in line with the long-term profile, the additional risk goes from zero to £3.1m-£7.25m of UNC246A over the 15 year period. However, since the majority of these additions will occur in the first five years, the value at risk increases in a non-linear way through time, ie initially it increases quite quickly. Accordingly, we have reflected this by assigning a weighting of approximately two-thirds of the end value as the median risk of this proposal, ie £2m to £5m.

Summary of costs

3.26. The table below summarises the NPV of the costs for each of the three proposals.

Table 3.2: Summary of implementation costs over first 5 years

Item	UNC246		UNC246A		UNC246B	
	Low	High	Low	High	Low	High
IT costs	£0.25m	£0.5m	£0.25m	£0.5m	£0.25m	£0.5m
Credit	£12.0m	£21.7m	£7.3m	£17.0m	£1.34m	£5.1m
Default risk	£7.25m	£14.5m	£3.1m	£7.25m	£2m	£5m
Total	£19.5m	£36.7m	£10.65	£24.75m	£3.59m	£10.6m

Benefits from the different proposals

3.27. All of the proposals under consideration are based on the premise that only sound projects will be able to obtain advance funding to securitize capacity in a QSEC, and as a consequence of the proposals reduces the risk of project default. If we assume this to be the case, the benefits that each of the proposals bring need to be evaluated against the current option where shippers only have to submit credit 12 months in advance of the capacity being made available, ie there is no long term credit requirement for long term capacity.

3.28. We have, in previous IAs²⁰, commented on the benefits of the Transmission Operator receiving financially backed investment signals from users. In the context of the proposals under consideration in this IA, the problem is not so much that the TO is not receiving appropriate signals, it is that some of those signals do not have the same degree of financial backing as others (due to the different impact of default for capacity holders at single ASEPs against those capacity holders at multiple ASEPs), and this exposes the shipper community to the risk that one of these less robust signals will default.

3.29. The current arrangements expose the shipping community to the full financial impact of default. None of the proposed modifications, if implemented, would have any effect in the case of capacity which has already been booked and which might default in the future. However, all proposals would prevent shippers who default from retaining their capacity holdings in the event of such credit default, thereby crystallising the potential deficit rather than maintaining the current ongoing uncertainty.

3.30. The main potential benefit of these proposals is that they might prevent the consumer having to pick up the cost of a credit default which might otherwise occur. Mathematically, the size of this benefit is defined by the product of the change in the risk of default and the aggregate cost of the capacity charges

3.31. If we assume that the capacity booking profile remains constant going forward (as was done in the analysis of affected capacity for UNC246B), then the value of capacity bookings affected over the coming 5 year period would range from £90m/£148m in year 1 to a cumulative £450m/£740m in year 5.

3.32. Trying to predict the change in the risk of default of any capacity holdings going forward is impractical, especially when there is no history of defaults against which to compare; these are low probability but high impact events. However, if you compare the capacity values affected against the costs for implementing the proposal, through "break-even" analysis you can derive values for the change in risk that would be required to generate a positive result from the cost benefit analysis (CBA). This can then be used as a yardstick to consider whether the costs outweigh the risks.

²⁰ For example, in the Impact Assessments relating to CAP131-User Commitment for New and Existing Generators (81/08) and the NTS Offtake Arrangements (103/08)

3.33. The table below illustrates this analysis for the three proposals under consideration, using the total costs data from table 3.2 earlier. The low scenario is calculated by using the low cost and the high capacity booking value, as this gives the lowest likely risk requirement for a positive CBA; conversely, the high scenario uses the low capacity booking value to illustrate the high risk.

Table 3.3: Changes in default risk ranges required for a positive CBA

	UNC246		UNC246A		UNC246B	
	Low	High	Low	High	Low	High
Implementation cost (£m)	19.5	36.7	10.65	24.75	3.59	10.6
Value of capacity (£m)	740	450	740	450	740	450
Default risk for +ve CBA (%)	2.6	8.2	1.5	5.5	0.5	2.4

3.34. This indicates that to get a positive CBA for each of the modification proposals would require the average risk of default to decrease by more than the following ranges:

- UNC246: 2.6 - 8.2%
- UNC246A: 1.5 - 5.5%
- UNC246B: 0.5 - 2.4%

3.35. These default rate reductions represent average reductions across all future capacity bookings; we would still expect a significant proportion of capacity going forward to be booked by very low risk incumbents. Therefore, the ranges above would need to be scaled up further to reflect the risk of the remaining capacity, eg if you consider that half of the capacity going forward is very low risk, then the ranges would need to be doubled to reflect the likely reduction in risk of the remaining capacity defaulting, in order to justify the implementation costs of the proposals. We would welcome views on whether such risk reductions are likely.

3.36. All of these proposals have the secondary benefit that if, post implementation, a shipper defaults on existing capacity holdings, then 10% of the value of the capacity holding is covered through the security being held by NGG NTS. Again, quantification of the benefit of such an event is largely dependent on the probability assigned to the likelihood of default.

4. Qualitative issues

Chapter summary

This chapter sets out the qualitative issues to be considered in relation to the three alternatives under consideration. It focuses on how implementation of any of these modifications might affect the issues of competition and discrimination.

Question box

Question 1: Do you think that the implementation of any of these proposals would have an adverse effect on competition? Please give reasons for your answer.

Question 2: Do you think any of these proposals are unduly discriminatory?

Question 3: Do you think the proposals are sufficiently simple and transparent?

Question 4: What is your preference on the basis of the qualitative issues?

Overview

4.1. In addition to the quantitative issues identified in the previous chapter, the Authority's powers and duties allow for the consideration of a number of qualitative issues related to the potential implementation of the modification proposals. These are:

- Promotion of competition
- Discrimination
- Simplicity & transparency
- Security of supply
- Distributional impacts
- Impacts on small businesses
- Sustainable development
- Health & safety
- Risks and unintended consequences

4.2. Each of these will be discussed in turn in the following sections.

Promotion of competition

4.3. As indicated in chapter 2, much of the review group 221's discussion was centred on the issue of the timing of the provision of security by shippers. Whereas it was recognised by all parties that the provision of credit ahead of any auction was the most secure manner of proceeding, representatives of smaller developers considered that this would be seriously detrimental to competition in the sector.

4.4. Notwithstanding the transparency around the capacity allocation processes, the view from developer representatives was that financial institutions are only willing to

give funding to projects once they have been allocated capacity from the auctions. Having firm capacity rights is the only means by which the shipper can demonstrate the certainty of access to the system which can be an important aspect of the evidence of project viability.

4.5. A number of parties have expressed the view that in the absence of such developers being able to obtain funding for securitising capacity in advance of the auctions, the gas transmission sector would become far less attractive for developers. This might lead to a concentration of new development by, for example, the larger players who may have more ready access to funds. It was also suggested that most of the recently completed projects, including those in planning stages, have been started by smaller developers, and only on completion have been acquired by the larger industry players. It was stated that the loss of these smaller players runs the risk of reducing innovation and leaving the more marginal but commercially viable projects untouched.

4.6. It is clear that the incremental costs imposed by any of these proposals in relation to the booking of baseline capacity is minor when compared to the investment required for the delivery of gas to the ASEP, be it through storage, LNG terminal or offshore development. However, due to the longer lead times and the Net Present Value hurdle for those looking to trigger incremental capacity, the additional costs imposed by these proposals can be a significant component of the money that needs to be invested at that stage of the project.

4.7. An alternative view is that these proposals are intended to protect consumers from the likelihood of underwriting the impacts of default, and that if a developer cannot bear the additional cost of securing the capacity then it calls into question the financial viability of that developer and the project. It is precisely to avoid incurring such risks that the modifications were originated. It has been argued that viable projects should be able to attract the necessary funding to overcome the security funding hurdle.

Discrimination

4.8. Some aspects of these proposals need to be considered in relation to the prohibition under European legislation on undue discrimination²¹.

Current and future capacity holders

4.9. Proposals UNC246 and UNC246A differ from UNC246B in that the former apply uniformly to both current and future QSEC capacity holdings, whereas UNC246B only applies to QSEC capacity holdings acquired from the time of implementation of the proposal. Ofgem is considering whether this may unduly discriminate in favour of incumbents and would welcome informed views on this issue.

²¹ Regulation 1775/2005 "...aims at setting non-discriminatory rules for access conditions to natural gas transmission systems"

Small and large developers

4.10. A number of review group members had concerns that the requirement to post credit in advance of any auction discriminates against the smaller developers, although other respondents considered that this (along with the use of credit ratings to determine the levels of credit to lodge) was due discrimination as it fairly reflected the risks posed by competitors in the market.

Simplicity & transparency

4.11. All of the proposals apply the same levels of security to all capacity covered within the modification's scope, and as such, would appear to be simple and transparent. However, users are required to estimate their capacity requirements and associated costs in advance of the QSEC and failure to do so (or anticipate the level of competition for capacity at a given ASEP) may result in capacity bids being rejected. Therefore, we would be interested to get views from shippers on whether they consider this to be a reasonable requirement.

Security of supply

4.12. It is unclear how security of supply will be affected by the implementation of either of these proposals. On the one hand, it is claimed that the imposition of the requirement for advance credit will make it very difficult for new developers to come to the market. New developers are more likely to be able and interested to bring innovative schemes for the development of marginal supplies than the major suppliers, so posing barriers to their entry is likely to be of detriment to security of supply.

4.13. On the other hand, it is these more risky projects which are most likely to fail, thereby imposing unnecessary costs on consumers and undermining confidence in investment in the sector. Prevention of such failures through a self-imposed screening process may be beneficial for attracting future investment and aid security of supply.

4.14. Project Discovery is a major investigation of Ofgem's into whether or not future security of supply can be delivered by the existing market arrangements over the coming decade. We will be reviewing the output of this project to inform our decision on this aspect of these proposals.

Distributional impacts

4.15. Implementation of any of these proposals would result in a redistribution of risk from consumers to industry incumbents. Currently, consumers underwrite the risk of project default, since any unrecovered revenues are smeared across shippers and these will ultimately be passed on to consumers. Requiring 10% of the value of capacity to be securitised in advance places more of the risk on the shippers that are

looking to profit from the capacity, which seems to be more appropriate than the current set-up.

Impacts on small businesses

4.16. Small developers consider that the implementation of any of these proposals would constitute a significant barrier to entry for this sector of the industry. Although all parties are required to put up credit in the same proportion to the value of the capacity being securitized, it is argued that the larger players benefit from having this subsidised at little or no cost through parent company guarantees (in UNC246A/246B) and they also have more ready access to the necessary capital. Larger players argue that any such impacts are due to their financial prudence and reflect the low risk they pose to the consumer, thereby constituting a form of due discrimination.

Sustainable development

4.17. We do not believe that there are sustainable development issues associated with any of these modification proposals.

Health & safety

4.18. We do not believe that there are health & safety issues associated with any of these modification proposals.

Risks and unintended consequences

4.19. Given the Authority's principle objective to protect consumer's interests, one of the key risks associated with these proposals is that the net expected benefits are not realised. This could occur where the estimated potential consumers benefits are not realised or the estimated potential consumer costs are an understatement of the actual costs incurred. As with any IA, our cost benefit analysis seeks to measure the potential impact of a set of proposed arrangements that do not yet exist. If one of the alternatives was implemented, the actual outcome could be better or worse than was presented in this document. This is a likely result in any exercise in which predictions of market behaviour are made.

4.20. There are also qualitative issues that carry risks/unintended consequences. The implementation of any proposal could prove to be too great a barrier for small developers to participate in the market, thereby adversely affecting competition and security of supply. The additional credit requirements could adversely affect the financial position of small shippers, and precipitate their failure, thereby hastening the type of event it is designed to prevent. There is also a risk that it might make the long-term auctions less attractive for shippers and result in a dependence on the short-term auctions which are not covered by these proposals.

5. Alternative approaches

Chapter summary

This chapter discusses other potential means of addressing the perceived issues with the gas entry capacity credit arrangements, which were outside the remit of the UNC review group. The majority of these relate to NGG's gas transporter licence, and as such, would require the approval of the licensee before any such changes could be made.

Question box

Question 1: Do you think that shipper termination is a tool that should be more widely used to deal with credit default issues?

Question 2: Do you agree that the Income Adjusting Event clause in the gas transporter licence should be reviewed? If so, what manner of changes would you recommend?

Question 3: Do you agree that the revenue driver mechanism for gas entry capacity could be improved? If so, how?

Question 4: Do you have a view as to whether the Authority's role in the approval of NGG NTS proposals to release incremental capacity is no longer required?

Question 5: Are there any other options, outside of the UNC, that could be considered for making the entry capacity credit arrangements more robust?

5.1. During the review group discussions, it became apparent that some parties considered there were other ways to improve the credit arrangements, but that these involved areas that were outside the remit of the UNC. For example, whereas the current proposals look to protect consumers' exposure through reducing the likelihood of default, there are other means of mitigating the financial risk to consumers without necessarily increasing the risk levels of the transporter. Members suggested that changes to NGG's gas transporter licence could effect a similar protection for consumers, but clearly that would be a matter for discussion between Ofgem and the licensee. The following sections discuss potential changes in the licence and methodologies that could either augment the effect of the modification proposals, or possibly render them redundant.

Potential licence changes

Shipper termination

5.2. Where a user of the NTS defaults on a payment and continues to default despite the requisite notice having been given by NGG NTS, then in accordance with Section V 4.3.3 of the UNC, NGG NTS may issue a "Termination notice". This requires the defaulting user to cease using the NTS from the day following the notice.

5.3. If a termination notice is issued, the user loses all rights to capacity bookings and NGG can apply to the Authority to recover lost revenues through the "Income Adjusting Event" licence condition.

5.4. Termination is typically regarded as a last resort option, and so it is only proper that it is used in a judicious manner. However, there are occasions where it might constitute appropriate action for NGG NTS to make, eg where a shipper defaults on capacity that cannot be used by others and the associated assets would be stranded. In this instance, we would expect NGG NTS to approach the Authority on the grounds that it would not be economic and efficient to continue with the capacity obligation. We would welcome views on whether shipper termination is a tool that should be more widely used to deal with credit default issues.

Income Adjusting Event (IAE)

5.5. The purpose of IAE provisions in licences is to enable an adjustment where costs have been incurred or saved which were not foreseen at the time of setting allowed revenues. Special Condition C8C 3 (b) of the NGG NTS licence defines the situations which may result in an IAE and where the Authority can determine any adjustment factor to be applied to the maximum NTS System Operator (SO) revenue. These are:

- a force majeure;
- an event resulting in declaration of network gas supply emergency;
- where NGG NTS serves a termination notice; and
- an event which the Authority considers to be an IAE

whereby either "relevant system operation costs" or internal operating costs have changed by more than specified threshold amounts.

5.6. The range of events by which an IAE can be triggered is restrictive and, in particular, excludes instances which relate to changes in revenues, rather than changes in costs. We would welcome views as to whether it would be sensible to expand the list of trigger events, so that it is more compatible with recent changes to other licences²² which allow for IAEs to be used for other unforeseen events.

5.7. Expansion of the grounds on which claims can be made for an IAE could help to redress the risk-reward balance for NGG NTS; for example, if shippers were able to raise an IAE in instances where they believe NGG NTS is making a windfall gain, it would allow the Authority to arbitrate on the related NGG revenues accordingly.

5.8. We also consider that the drafting relating to the time window within which parties can raise an IAE could benefit from some additional clarity and would welcome views on suitable criteria for IAE trigger events.

²² For example, IAE provisions under NGG's licence have been expanded to include the recovery of security costs

Revenue drivers

5.9. A revenue driver is a mechanism to adjust automatically NGG NTS's revenue allowances in response to meeting a request for the provision of incremental capacity. Revenue drivers for entry capacity are generally agreed on between Ofgem and NGG (as part of a consultation process) so that shippers can acquire incremental capacity for a known price and NGG gets some certainty on their revenue stream for the provision of the capacity. Revenue drivers seek to represent the opex, depreciation and return on a deemed amount of investment at a particular exit point and to remunerate NGG accordingly.

5.10. Revenue drivers for entry capacity are set out in Table 3 of section C8D, Part A, paragraph 2(c) (v) of NGG's Gas Transporter licence. If a signal in the QSEC results in the passing of the NPV test for that investment, then NGG will apply to the Authority for approval of the capacity release. Following approval of the application by the Authority, a five year revenue stream for NGG is automatically triggered from the month that the capacity has to be provided (which is normally 42 months from the point at which the capacity requirement is signalled).

5.11. Some members of review group 221 considered that the mechanistic triggering of the revenue stream was too inflexible and could be amended to be able to react to changing circumstances, eg if the shipper initiating the request was not able to carry through on the commitment. While acknowledging that NGG NTS needs some certainty in order to commit to the necessary investment, these group members considered that there should be a means to ensure that NGG do not receive windfall gains from the misfortune of others, and to the detriment of consumers.

5.12. One proposal from the group was the introduction of phased release of the revenue stream in accordance with the initiator passing various criteria, for example, in relation to the progression of the project eg, on obtaining planning permission, consents, etc. Their view was that NGG NTS would only be required to spend as necessary on projects, thereby providing a degree of protection for consumers. Given that the initial spending on projects revolve around time consuming but relatively inexpensive elements such as conducting environmental studies, design work and obtaining consents, releasing funding on this basis shouldn't act to hinder NGG's progression of a project while still not exposing consumers to the risk of NGG receiving windfall gains.

5.13. NGG NTS have expressed concerns that the ability to defer capacity signals would adversely impact on its ability to optimise the network as it would no longer have certainty on the operational status of facilities at a given point in time. This would be likely to result in additional project complexity and require a greater lead time for capacity delivery. There could also be logistic issues in that NGG does need to commit to contracts for construction materials at an early stage of the project, and they would be unlikely to enter into such agreements without more certainty on the timing of the project's revenue stream.

5.14. One situation that was discussed at several stages of the review group was that of the Canatxx project at Fleetwood entry point. This developer signalled for

entry capacity in the September 2006 QSEC ahead of getting planning permission, since the storage facility's construction lead time was less than the default lead time that NGG NTS have to make the necessary investments to provide the associated incremental capacity. However, subsequent to the approval of the incremental capacity and activation of the revenue driver, the developer's planning application was rejected. This has left an unsatisfactory situation whereby the developer has no prospect of meeting the intended date for commencement of operation (October 2010) and NGG NTS have an obligation to provide capacity at an entry point that no other party can access. In this instance, the ability to defer the project would make sense for the developer, as it would give it an opportunity to obtain the necessary consents before the obligation to pay for capacity it cannot use comes into play.

5.15. Ideally, the system should be sufficiently flexible to accommodate the deferral of the revenues due and the postponement of the associated capacity delivery obligations of NGG NTS, while not disadvantaging involved parties. We would welcome views from respondents as to the merits of introducing changes to the regime to correct this perceived problem.

5.16. Alternatively, one other means of incentivising parties in similar circumstances to avoid default would be to allow them to extract value from the capacity, eg by allowing it to be traded or transferred. We would welcome views on this or similarly minded ways of how value could be extracted from such capacity.

Changes to capacity allocation approval mechanism

5.17. When a shipper signals for incremental capacity through the QSEC and successfully passes the NPV test, NGG NTS notifies Ofgem of the outcome and requests the Authority's approval of its proposal to release the incremental capacity. Licence condition C8D 9(k) provides that the Authority may suspend implementation of the proposal if it needs further information to assess whether it is consistent with the Incremental Entry Capacity Release (IECR) methodology. Once the Authority has issued its approval, the revenue driver is automatically triggered.

5.18. During the review group discussions, it was stated that this further approval stage in the process of acquiring capacity was a hindrance to being able to obtain funding for securing capacity in advance of the QSEC, as it introduced a further element of risk for backers of potential bidders²³.

5.19. To date, there have been no rejections of proposals from NGG NTS in instances where the NPV test has been passed. Given that the system seems to have worked largely as intended, it might be appropriate to consider the removal of this stage of the process, if it were to facilitate the advance securitization of QSEC bids. The implications for the triggering of revenue drivers would need to be thought through if such a change were to take effect, as would the impact on proposals to meet incremental capacity signals through capacity substitution.

²³ Notwithstanding the limited scope for the Authority to reject the capacity application

5.20. We would welcome views on whether the approval stage of the IECR process should be removed, whether its removal would facilitate the ability of parties to obtain funds to securitize bids in advance of the QSEC and whether this would have any negative impacts in relation to the triggering of revenue drivers.

Risk exposure

5.21. We note that the current application of the rules on credit default by NGG NTS result in it having a zero risk on capacity revenues. If a shipper defaults on the payment for baseline entry capacity then NGG's TO allowed revenues as set by the term TOZ_t (in Condition C8B 3(a)) will not be affected. Any reduced revenues received from users defaulting on baseline entry capacity will be recovered through higher TO commodity charges, paid by all users. Similarly, if a shipper defaults on the payment for incremental entry capacity then NGG's SO allowed revenue as set through revenue drivers or unit cost allowances will not be affected. Any reduced revenues received from users defaulting on incremental entry capacity will be recovered through higher SO commodity charges, paid for by all other users. Therefore NGG's income is not affected by a shipper defaulting – it will be other shippers that pick up the cost of a shipper defaulting on payment.

5.22. This is clearly not the policy intent that underlay the Ofgem position on credit arrangements and credit risk exposure, as specified in the letter that accompanied the 2002 - 7 licence changes (as detailed in Chapter 1 previously).

5.23. We acknowledge that putting the full burden of credit risk for capacity on NGG NTS would be inappropriate, and at best, lead to a hardening of credit arrangements which could constitute a barrier to entry. However, we would welcome views on how the current position could be changed to incentivise better behaviour.

5.24. All of the licence issues highlighted in this chapter would require the consent of the licensee to progress. To date, none of these suggestions have been formally discussed with the licensee.

6. Conclusions and next steps

6.1. The previous sections of this IA have presented Ofgem's view of the quantitative and qualitative issues related to the potential implementation of UNC modification proposals UNC246, UNC246A and UNC246B. We concluded that whereas we were able to produce estimates of the implementation costs, it was not possible to present a straightforward estimate of the quantitative benefits. Accordingly, we have framed the benefits as a measure of the change in risk that would be required to generate a positive result from the cost benefit analysis.

6.2. There are a number of qualitative aspects to the proposals on which we are seeking views: the promotion of competition, discrimination, security of supply and impacts on small businesses. In particular, we need to explore whether UNC246B discriminates in favour of current incumbents, and we would welcome informed views on this issue.

6.3. Some members of the UNC review group that originated the modification proposals thought that it might be more appropriate to consider possible licence changes as a more effective and efficient means of ensuring there are robust credit arrangements in place. We have indicated a number of potential changes that could be considered, and would welcome views on these.

6.4. We are looking for responses to this document by 18 November 2009. Our expectation is that, following consideration of the responses received, we would be able to make a decision on the modification proposals before the end of December 2009.

Appendices

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 13 November 2009 and should be sent to:

Paul O'Donovan
Head of Gas Transmission Policy
Ofgem
9 Millbank
London
SW1P 3GE
020 7901 7414
gas.transmissionresponse@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to review them in light of the modification proposals, with a view to informing the Authority's decision process. The Authority intends to make a decision on the proposals in December 2009. Any questions on this document should, in the first instance, be directed to:

Paul O'Donovan
Head of Gas Transmission Policy
Ofgem
9 Millbank
London
SW1P 3GE
020 7901 7414
gas.transmissionresponse@ofgem.gov.uk

CHAPTER: Two

Question 1: Do you have any additional views on the merits/disadvantages of the options for securitization of capacity to add to those of the review group?

Question 2: Do you have views on the ability for NGG to cover the potential of shipper default through commercial insurance instruments?

CHAPTER: Three

Question 1: Do you agree with the analysis of the risks involved? Are there any quantifiable risks that have been omitted?

Question 2: Is the level of securitization being proposed appropriate? If not, why?

Question 3: Do you agree with the benefits as presented here? Are there any other ways in which the quantitative benefits could be presented?

Question 4: How do the risk ranges presented for each of the proposals rank against your perceived risk of default for future capacity bookings?

Question 5: Do you have any preference amongst the proposals on the basis of the quantitative analysis?

CHAPTER: Four

Question 1: Do you think that the implementation of any of these proposals would have an adverse effect on competition? Please give reasons for your answer.

Question 2: Do you think any of these proposals are unduly discriminatory?

Question 3: Do you think the proposals are sufficiently simple and transparent?

Question 4: What is your preference on the basis of the qualitative issues?

CHAPTER: Five

Question 1: Do you think that shipper termination is a tool that should be more widely used to deal with credit default issues?

Question 2: Do you agree that the Income Adjusting Event clause in the gas transporter licence should be reviewed? If so, what manner of changes would you recommend?

Question 3: Do you agree that the revenue driver mechanism for gas entry capacity could be improved? If so, how?

Question 4: Do you have a view as to whether the Authority's role in the approval of NGG NTS proposals to release incremental capacity is no longer required?

Question 5: Are there any other options, outside of the UNC, that could be considered for making the entry capacity credit arrangements more robust?

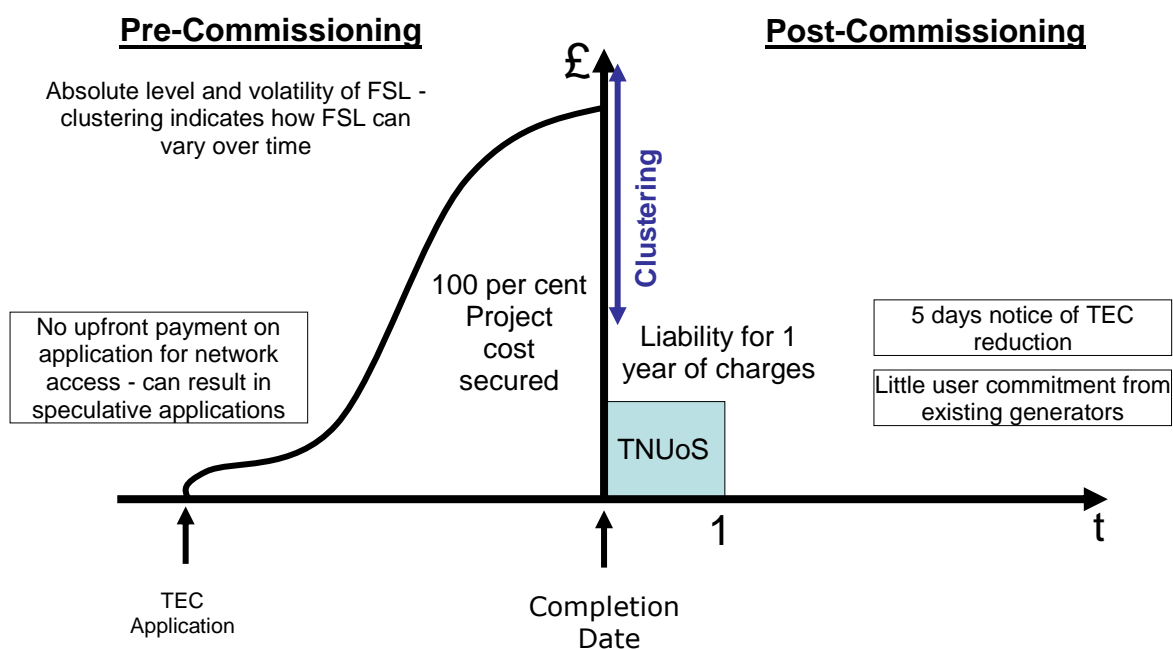
Appendix 2 – Generators' security requirements for the electricity transmission system

1.1. This note sets out the two ways to work out a generator's liabilities under the CUSC: Final Sums Liability (FSL) and Interim Generic User Commitment (IGUC). Section 4 looks at how, in practice, the relevant amounts can be securitised. Section 5 describes the changes CAP131 would have introduced and the Authority's reasons for rejecting that proposal.

Final Sums Liability

1.2. A generator can currently choose between two options to define its liabilities. The most common way is for the generator to underwrite the actual costs committed to works by transmission licensees under the FSL arrangements. At any point in time, the FSL value is the total cost incurred by the transmission licensee up to that point during the construction of the connection, and increases over the period of construction along what is known as an "S-curve" (see figure 1 below). The FSL system ensures that any investment triggered by the generator is fully secured during its construction and the risk of inefficient investment is held with the generator and there is no risk to consumers. Following completion of the transmission asset, the generator will always be liable for the current TNUoS charges.

Figure 1 Final Sums Liabilities (FSL)

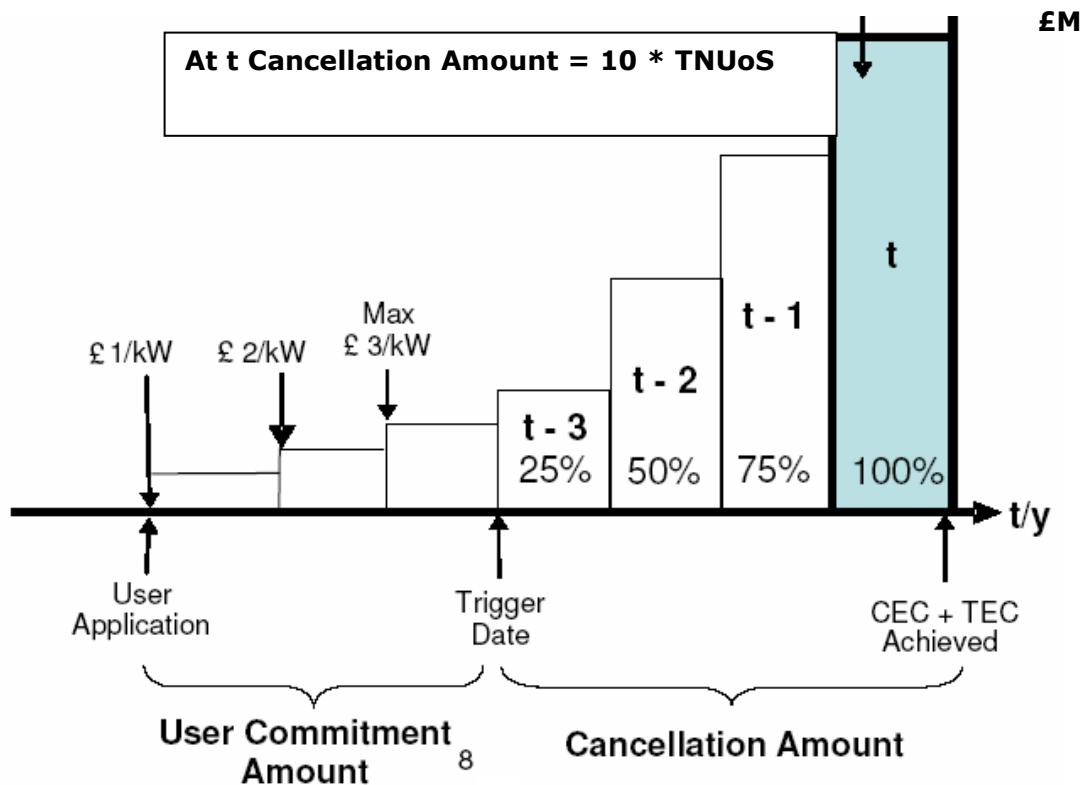


1.3. A further feature of the current FSL arrangements is that some projects are grouped together when identifying the transmission works necessary for their connection. This approach is termed 'clustering'. This mechanism is adopted when a number of applications for connection to the transmission system are being assessed at the same time. 'Clustering' enables the securities for works to be shared between the generators triggering them. This process aims to provide a better solution for the development of the transmission system and for the total level of security against the costs of those works by considering the requirements of all generators together rather than individually.

Interim Generic User Commitment

1.4. A generator has another option, which is to provide security on a generic basis. In 2006, the voluntary 'Interim Generic User Commitment' (IGUC) methodology introduced the concept of providing security on a generic basis, de-linking the actual costs that a generator imposes on the system through triggering specific transmission investment. Instead of providing FSL reflecting the actual costs of specific transmission works a party can opt to provide securities for those works calculated on a generic basis. Upon acceptance of the connection offer a generator becomes liable for a charge, the user Commitment Charge. This charge increases from £1/kW in year one, increasing by £1/kW each year up to a maximum of £3/kW in year three (see figure 2). Following consents being granted under the IGUC methodology, security requirements ramp up over a four year period to a total of ten times the annual TNUoS charges. As with FSL, once transmission assets are completed under IGUC, generators are only liable for the current TNUoS charges.

1.5. The multiplier used on TNUoS charges to derive the total amount that a generator is liable for is determined by National Grid at the beginning of each price control period. This multiplier is set in accordance with the level of investment which needs to be covered based on the current connection offers for the price control period 2007-12.

Figure 2: IGUC methodology

1.6. As at September 2007, total securities for the period October 2007 to March 2008 are estimated at £328m for FSL and £22m for IGUC. There are several reasons why the majority of new applicants opt for FSL rather than IGUC, but the most likely reason is that unlike IGUC, parties opting for FSL will not be required to place any securities until their construction works begin. Therefore for certain generators it may be cheaper in the early stages of the build to opt for FSL.

Practicalities of security provision

1.7. There are a number of options for generators to provide security. These are set out in the CUSC in Paragraphs 2.19 to 2.22. The arrangements differ depending on whether or not the connectee has a "Company Credit Rating" (An A- rating from S&P's or an A3 rating from Moody's). There are three types of security provision:

1.8. Performance Bond/ letter of credit from a bank – here, the connectee provides a guarantee through a bank.

1.9. Performance Bond/ letter of credit from a company – in this case, the guarantee is provided through another company. This would usually be a company in the same group of companies, such as the parent company.

1.10. Cash deposit in a bank account – this is the most basic, but possibly costly method for generators to provide security.

CAP131

1.11. In September 2006 National Grid submitted an amendment proposal to the CUSC Panel to alter the arrangements for calculating the securities faced by new and existing generators. The proposal (and its various alternatives) sought to change the arrangements for generators connecting to and using the GB transmission system, including those generators connecting via the distribution system with bilateral connection agreements with National Grid. These changes were related to the monies that a generator must provide to secure the costs of works undertaken to connect them and ultimately to protect customers from incurring unnecessary costs. The proposal also sought to introduce a principle whereby existing generators also provide commitment for using the system so network assets can be more readily used by other parties in the event they reduce their export capacity.

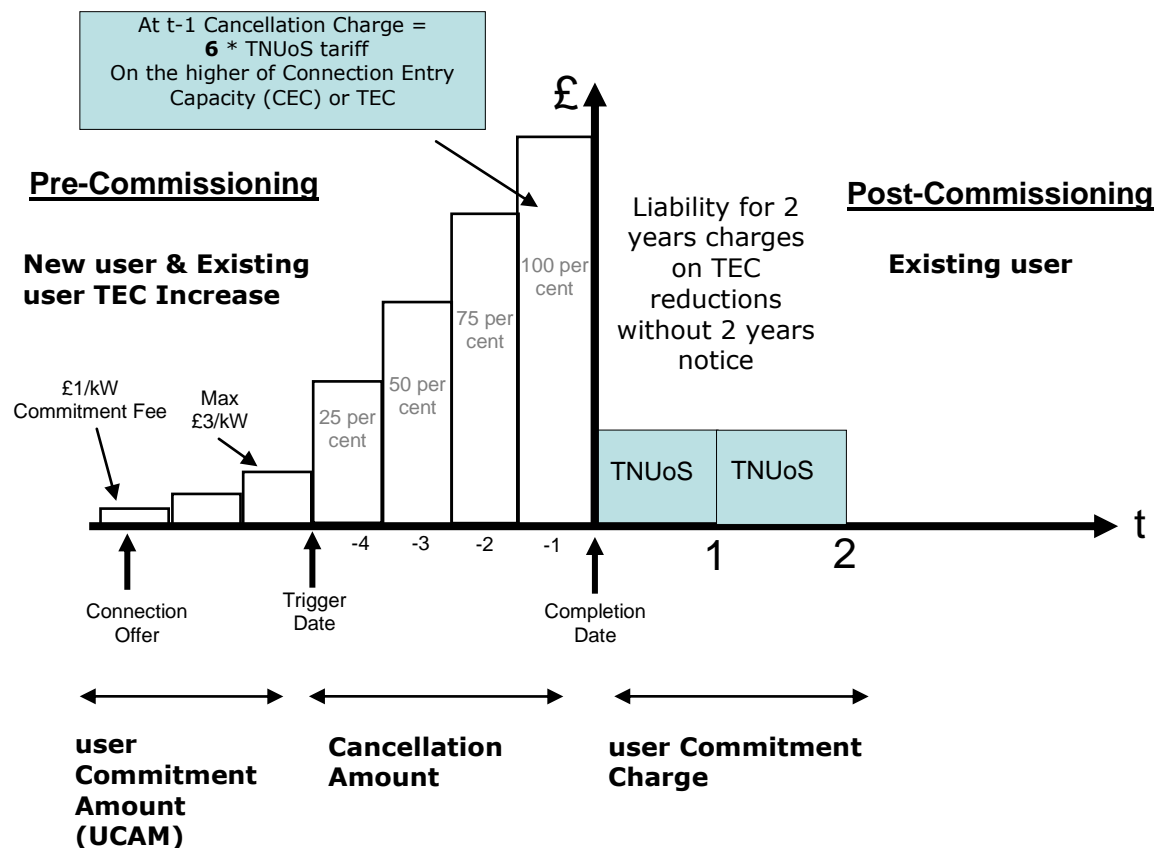
1.12. CAP131 sought to introduce an enduring change to securities faced by new and existing users. At a high level it sought to:

- Introduce a non-refundable holding fee in the period before works commence;
- Replace the existing FSL mechanism with a generic profile of securities, based on TNUoS charges;
- Reduce the total level of costs secured by generators by 50 per cent;
- Introduce a charge for generators who alter their capacity before connection; and
- Increase the level of user commitment provided by existing generators by introducing a requirement to provide 2 years notice of station closure or face financial penalties.

1.13. This approach aimed to be predictable, and on aggregate, to lower the amount generators have to secure, in comparison with the existing arrangements, thus eliminating the uncertainty and volatility of the current FSL. In addition to the original proposal, there were numerous working group and consultation alternatives, many of which can be combined, which meant that there were 33 proposals to be assessed.

1.14. Figure 3 below illustrates the key features of the original amendment proposal.

**Figure 3: CAP131 user Commitment for New and Existing Generators
Common Features**



1.15. Ofgem rejected CAP131 because of concerns that it may be discriminatory against new generators. CAP131 would have required more securities from new generators than from existing ones. We considered that this was inappropriate, because we did not consider them to be any more likely to cause asset stranding than existing generators. Given the substantially different economics of renewable generation plant (very low marginal cost once constructed and substantial financial support from the ROC mechanism), there is an argument that those already with planning consent and finance in place are significantly lower risk than some existing generators (especially those that are close to the end of their planned life such as certain nuclear stations or are under restricted operating hours under environmental legislation such as the Large Combustion Plant Directive (LCPD)), and are therefore less likely to terminate and potentially strand transmission assets. As a consequence, there is an argument that these new generators should be required to provide the same or less security than existing generators to avoid any undue discrimination. We were also concerned that CAP131 may not be consistent with EU and domestic legislation.

Appendix 3 – Capacity and revenue sections in the Gas Transporter Licence

1.1. There are a number of sections of the Gas Transporter's Licence which have an impact on or are impacted by, credit arrangements. These interactions are described below.

Capacity release obligation sections

1.2. Both baseline and incremental capacity release obligations are in Special Condition C8D 9. NGG is obligated to release at each entry point a specific amount of capacity each day in advance of the day of use of that capacity. The total amount that it must offer for sale is equal to the baseline plus incremental capacity less capacity already sold. Specific details of the derivation of baseline and incremental amounts in the licence are as follows.

Baseline capacity obligations

1.3. Special Condition C8D 9 (c) sets out the different baseline amounts of capacity which NGG has to make available at each entry point. If capacity is being sold more than 18 months in advance, NGG is required to offer for sale 90% of the baseline amount (plus or minus any capacity substituted to and away from that entry point). If capacity is being sold less than 18 months in advance, NGG is obligated to make the full baseline amount available for sale (plus or minus any capacity substituted to and away from that entry point).

Incremental capacity obligations

1.4. Special Condition C8D 9 (d) sets out how much incremental capacity NGG is obligated to make available at each entry point. This is the sum of any incremental capacity signalled prior to April 2007 (which is set out in Table 8 in NGG's gas transporter licence) and any incremental capacity signalled after April 2007. For incremental entry capacity signalled after April 2007, NGG must have the proposal approved by the Authority.

Revenue sections

Baseline revenue

1.5. The term TOZ_t in Special Condition C8B 3 (a) is the revenue that NGG is allowed for opex, depreciation and the return on assets required to deliver the baseline capacity. If the revenue from auctions of baseline capacity falls short of this amount then a unit commodity charge is applied to actual gas entry flows in order to recover the target amount.

Incremental revenue

1.6. There are two treatments of the revenues associated with incremental capacity, depending on whether it was triggered before or after 1 April 2007.

Incremental capacity triggered before 1 April 2007

1.7. For incremental entry capacity triggered before 1 April 2007, there are changes to both SO and TO allowed revenues.

1.8. Paragraph 14 (5) (a) of the Annex to Special Condition C8D sets out how the SO allowed revenue is affected. For the first five years after contractual delivery of the incremental entry capacity, NGG's SO allowed revenue automatically increases to give a rate of return of between 5.25% and 12.25% on the unit cost allowance (UCA) multiplied by the incremental capacity amount released. For the period from five years after contractual delivery of the incremental entry capacity until the end of the then current price control (i.e. up to a maximum of five years), NGG's allowed SO revenue becomes the UCA multiplied by the incremental entry capacity released with a fixed rate of return of 6.25% applied.

1.9. In the five year price control which follows the release of the incremental entry capacity, NGG's TO Regulatory Asset Value is adjusted by the deemed investment (defined as the SO investment deemed to have occurred from the incremental entry capacity after accounting for depreciation, where the deemed SO investment is calculated by the unit cost allowance multiplied by the capacity released) less the actual investment. NGG then earns an amount of opex, depreciation and return on the adjusted RAV. At the end of this five year period the deemed investment is then added to the RAV through which NGG derives TO allowed revenue in the subsequent years. In the current licence the amount of revenue derived from the RAV is included in the TOZ_t term in Special Condition C8B 3 (a).

1.10. A worked example of how this applies in the case of the signal for incremental capacity at Fleetwood from the September 2006 QSEC is given as Appendix 3.

Incremental capacity triggered on/after 1 April 2007

1.11. For incremental entry capacity triggered on/after 1 April 2007, Special Condition C8D 2 sets out unit revenue drivers for each entry point. These are multiplied by the amount of incremental capacity released to provide an increase in NGG's SO allowed revenue for a fixed five year period. NGG's SO allowed revenue is automatically increased through this mechanism on receipt of approval of a proposal NGG makes for additional capacity to be treated as incremental obligated entry capacity as per Special Condition C8D 9 (f). At the end of the five year period, the efficiently incurred expenditure (less depreciation) is added to the TO RAV, with a remaining life of 40 years.

Appendix 4 - Worked example: Fleetwood allowed revenues

1.1. The calculation of NGG NTS's allowed revenues for incremental entry capacity depends on whether the capacity was signalled before or after 1 April 2007. For signals received before 1 April 2007 (such as Fleetwood) Annex A to Special Condition C8D of the Licence provides details on how the allowed revenue is derived. There are two streams from which NGG derives revenue from any incremental entry capacity - the SO and TO - and within each of these streams are distinct time periods on which the calculation of allowed revenue depends.

1.2. The SO allowed revenue is derived as follows for the following time periods:

- Five years immediately following the contractual delivery of entry capacity (the 'Incentive Period') - the SO allowed revenue is calculated by capacity released multiplied by the unit cost allowance (the latter has an implicit rate of return of between 6.25% and 12.25%)
- The period immediately after the Incentive Period until the end of the current price control period - the SO allowed revenue is calculated again from capacity released multiplied by the unit cost allowance (this time with a 6.25% rate of return)

1.3. The TO allowed revenue is derived as follows for the following time periods:

- Immediately following contractual delivery of the entry capacity until the start of the next price control period - the TO allowed revenue is zero
- During the entire five year price control period which follows the contractual delivery of capacity - the TO RAV is adjusted by *actual investment less deemed SO RAV*²⁴ and the adjusted TO RAV provides NGG NTS with its allowed revenue via items for return, depreciation and opex
- After this price control period - the deemed SO investment is included in the TO RAV and this provides NGG NTS with a TO allowed revenue via items for return, depreciation and opex

1.4. The annex shows the various terms used to derive the allowed revenues from Fleetwood. As the signal for Fleetwood was received at the 2006 QSEC auction then the derivation of its allowed revenue is per the description above. The signal was for 650 GWh/day (or 237,250 GWh per non-leap year) from 1 October 2010. Therefore NGG NTS's SO allowed revenue for the period:

- 1 October 2010 - 30 September 2015: is at the rate of return of between 6.25% and 12.25% (between £9m and £20m)
- 1 October 2015 - 31 March 2017: is at the rate of return of 6.25% (£15m to £18m)

1.5. NGG NTS's TO allowed revenue for the period:

²⁴ The deemed SO RAV results from the SO investment deemed to have occurred from the incremental entry capacity after accounting for depreciation. The deemed SO investment is calculated by the unit cost allowance multiplied by the capacity released.

- 1 October 2010 - 30 March 2012: is zero
- 1 April 2012 - 31 March 2017: the TO RAV is adjusted by the actual investment less the deemed SO investment which then provides for a TO Allowed revenue via a return, depreciation and opex. As there is very little actual investment compared to the deemed SO investment the TO RAV is actually adjusted downwards which reduces NGG NTS's allowed revenue by between £11m and £18m.
- 1 April 2017 onwards: the deemed SO RAV is added to the TO RAV which provides NGG NTS with the TO allowed revenue via a return, depreciation and opex on the small amount of actual investment made.

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
SO		High return period					Low return period			
TO										
SO		10	20	20	20	20	18	16		
TO				-11	-18	-18	-17	-17		
Total		10	20	9	2	2	1	-1		

1.6. Therefore when total allowed revenues are aggregated for TO and SO, NGG will earn a net revenue of £30m until the next price control periods starts in April 2012. After that the positive SO allowed revenues are offset by the negative TO allowed revenues resulting from the fact that the TO RAV is reduced from there being very little actual investment compared with the deemed SO investment.

7 October 2009

IA on entry capacity credit arrangements

All figures £m, 2006/07 prices												
Year commencing 1 April	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Capacity released (GWh) IPOEC < 5 yrs					118,300	237,900	237,250	237,250	237,250	118,950	118,300	118,300
Capacity released (GWh) IPOEC > 5 yrs										118,950	118,300	118,300
Max allowed revenue					17,645	35,386	35,386	35,386	35,386	17,693		
Min allowed revenue					9,775	19,605	19,605	19,605	19,605	9,802		
Normal revenue (SOREVIBEC)										7.97		15.81
Auction revenue					9.82	19.75	19.69	19.69	19.69	9.87		15.59
Allowed SO revenue					9.82	19.75	19.69	19.69	19.69	17.69		15.81
Actual Investment												
Opening SO RAV	2.00	2.00	4.96	9.84	9.62	9.40	9.18	8.96	8.73	8.51	8.29	8.29
Investment	2.00	3.00	5.00	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22	0.22
Depreciation		0.04	0.11									
Closing SO RAV	2.00	4.96	9.84	9.62	9.40	9.18	8.96	8.73	8.51	8.29	8.07	8.07
Deemed Investment												
Opening deemed SO RAV												
Deemed investment (20:80 split)			40.58	40.58	202.02	197.51	193.00	188.49	183.98	179.48	174.97	174.97
Depreciation			0.90	0.90	4.51	4.51	4.51	4.51	4.51	4.51	4.51	4.51
Closing deemed SO RAV			40.58	202.02	197.51	193.00	188.49	183.98	179.48	174.97	170.46	170.46
TO Control												
Opening TO RAV												
RAV adjustment							-183.83	-179.54	-175.25	-170.96	-166.68	8.07
Depreciation							-4.29	-4.29	-4.29	-4.29	-4.29	0.22
Closing RAV							-179.54	-175.25	-170.96	-166.68	-162.39	7.84
TO allowed revenue												
TO allowed return							-5.61	-11.09	-10.82	-10.55	-10.28	-10.28
TO allowed depreciation							-4.29	-4.29	-4.29	-4.29	-4.29	-4.29
TO allowed opex							-1.35	-2.66	-2.60	-2.53	-2.47	-2.47
TO allowed revenue							-11.24	-18.04	-17.70	-17.37	-17.04	-17.04
Revenue summary												
Allowed SO revenue					9.82	19.75	19.69	19.69	19.69	17.69	15.81	15.81
Allowed TO revenue							-11.24	-18.04	-17.70	-17.37	-17.04	-17.04
Total revenue					9.82	19.75	8.45	1.66	1.99	0.32	-1.23	-1.23

Appendix 5 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.²⁵

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly²⁶.

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them²⁷;
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.²⁸

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

²⁵ Entitled “Gas Supply” and “Electricity Supply” respectively.

²⁶ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

²⁷ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

²⁸ The Authority may have regard to other descriptions of consumers.

- promote efficiency and economy on the part of those licensed²⁹ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation³⁰ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

²⁹ or persons authorised by exemptions to carry on any activity.

³⁰ Council Regulation (EC) 1/2003

Appendix 6 - Glossary

A

Annual Monthly System Entry Capacity (AMSEC) auction

The Monthly System Entry Capacity (MSEC) product, which allows users to enter capacity onto the National Transmission System (NTS) for the duration of a calendar month, is sold for each aggregate system entry point via Annual Monthly System Entry Capacity (AMSEC) auctions. These are held annually in February and users can bid for capacity up to 18 months in advance.

B

Baseline

Baselines define the levels of capacity that the transmission licensee is obligated to release. Baselines also determine the levels above which incremental capacity is defined.

F

Final Sums Liabilities (FSL)

In electricity transmission Final Sums Liabilities (FSL) is the specific calculation of securities required for generators requesting access to the electricity transmission system which will be called upon in the event of a the project not going ahead. The FSL relates to generator specific works and for works that they will share with other users. A generator can either underwrite the actual costs incurred during construction of the relevant works, or provide security on a generic basis under the Interim Generic user Commitment (IGUC) methodology under which the security requirements ramp up over time according to a set profile based on annual generation 'use of system' charges.

I

Income Adjusting Event (IAE)

An event provided for in licences to enable an adjustment to allowed revenues where costs have been incurred or saved which were not foreseen at the time of setting allowed revenues.

Incremental Entry Capacity Release (IECR) methodology

The Incremental Entry Capacity Release (IECR) methodology sets out the method by which National Grid Gas (NGG) will determine whether to make incremental entry capacity available to National Transmission System (NTS) users. The current methodology is such that NGG will release incremental entry capacity if the Net Present Value (NPV) of the revenue from Quarterly System Entry Capacity (QSEC)

bids over an eight year period is at least 50 per cent of the estimated value of delivering the incremental entry capacity.

[Interim Generic user Commitment \(IGUC\)](#)

See definition for FSL

N

[Net Present Value \(NPV\)](#)

In economics the value of a pound today is not the same value as a pound in two years' time. In order to assess the monetary value of a stream of future cash flows, the future cash flows are converted into present value monetary equivalents. The Net Present Value is the sum of the stream of cash flows over the period of time converted into present values.

Q

[Quarterly System Entry Capacity \(QSEC\)](#)

Firm National Transmission System (NTS) Entry Capacity which may be bid for in the Quarterly System Entry Capacity (QSEC) auctions and registered as held by a user for each day in a particular calendar quarter. Entry capacity is sold via QSEC Auctions which offer capacity at each aggregate system entry point between two and seventeen gas years in advance.

R

[Revenue Driver](#)

A means of linking revenue allowances under a price control to specific measurable events which are considered to influence costs. An example might be to allow a specified additional revenue allowance for each GWh/day of new entry capacity to the National Transmission System (NTS).

T

[Termination](#)

A process by which NGG NTS may issue a notice requiring a defaulting user to cease using the NTS from the day following the notice.

U

[user's Security Value \(USV\)](#)

This reflects the credit cover required for a shippers existing capacity holding and their anticipated capacity holding (plus VAT) prior to a QSEC, as proposed by UNC246

Appendix 7 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments

1.2. Please send your comments to:

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andrew.macfaul@ofgem.gov.uk