Modification proposal:	**Uniform Network Code (UNC) 0261: Annual NTS Exit (Flat) Capacity Credit Arrangements (UNC261)**		
Decision:	The Authority[1] directs that this proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	8 December 2009	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Following on from the review of arrangements for securing entry capacity, National Grid Gas (NGG) assessed the level of risk to the shipper community from a shipper defaulting on credit requirements for annual National Transmission System (NTS) exit (flat) capacity. The analysis concluded that the overall risk of shipper default at exit points is low, with a total value of under £2 million across the industry.

However, NGG identified that a specific risk exists in relation to a user's ability to defer their capacity commitments by 12 months by failing to provide adequate security. This could result in revenue that would have been recovered from the defaulting user being spread across the shipper community. This risk was considered to be higher for users with exit capacity at a single exit point - users with exit capacity at multiple exit points would lose capacity at all exit points if they defaulted (which would act as a greater incentive on the party in question). The proposals contained within Uniform Network Code (UNC) proposal UNC261 seek to mitigate the risk of default by parties utilising a single exit point and applies to users holding annual NTS exit (flat) capacity[3].

The modification proposal

There are currently two main credit security checks for exit capacity set out in the UNC. The first of these is a security check one year in advance of the date from which capacity will be used. Where the sum of the user's deemed value at risk[4] exceeds the amount of security that a user has in place[5], then NGG notifies the user within five working days. Following such a notice, if the user does not provide adequate security[6] within ten working days, then the user's annual NTS exit (flat) capacity bookings will lapse at all exit points for the following 12 months i.e. deferring their capacity entitlements. This defers the date by which NGG has to deliver the capacity rights but also defers the user's obligations to pay NGG for these capacity rights.

---

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] These capacity products are: Existing Enduring Annual NTS exit (Flat) capacity, Enduring Annual NTS exit (flat) capacity (ad hoc applications), Enduring Annual NTS exit (flat) capacity (annual applications), and Annual NTS exit (flat) capacity.
[4] The 'deemed value at risk' is the sum of (i) user's aggregated invoiced amount which is yet to be paid, plus (ii) the average daily aggregate amount invoiced to the user in the previous month multiplied by 20, and (iii) the aggregate NTS exit (flat) capacity charges payable by the user in each day in the following twelve months starting from the first day of the next month.
[5] This is defined as the 'code credit limit' in the UNC.
[6] The adequate security level is to cover the user's deemed value at risk and is set out in the Code Credit Rules.

The second security check takes place around the time of the capacity use date. Where the user's actual value at risk[7] exceeds the amount of security that a user has in place NGG notifies the user. If, after two days, the user has not provided adequate security the user will face a number of sanctions. Should the user not provide the required level of security and the charges become payable, then the user could be terminated[8] from the NTS.

Under the proposed modification UNC261, there will continue to be the same two main security checks as currently performed by NGG. However, users will no longer be able to defer their capacity requirements by not providing sufficient security 12 months in advance of the capacity delivery date and therefore they will be exposed to the financial liability of the allocated exit capacity charges.

In addition, in the first security check, one year in advance of the capacity use date, NGG will notify the user where its deemed value at risk is greater than the security that the user has in place. After two business days, if the user has not provided the required security[9] NGG will be able to impose the following sanctions:

- NGG will have the authority to refuse bids for entry or exit capacity; and
- NGG will have the authority to refuse the user the right to trade or assign its capacity rights

The second security check will be the same as per the current arrangements, such that if the user's actual value at risk exceeds the amount of security they have in place, then NGG will notify the user. The user will then have two business days to provide the required security.

If a user does not provide the required level of security, then the user will be subject to a number of sanctions. These sanctions continue to apply until the required security is provided. Should the user not provide the required level of security and the charges become payable, then the user could be terminated from the NTS.

The proposer, NGG, considers that these changes will prevent users deferring their capacity commitments and, will therefore hold users to their financial liabilities. The proposer also considers the modification will prevent speculative applications for capacity and the triggering of unnecessary infrastructure investment. Therefore, NGG considered that UNC261 would further the following relevant objectives of the UNC:

- the efficient and economic operation of the pipe-line system
- so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under its licence
- so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition between relevant shippers, suppliers and Distribution Network Operators (DNOs)

[7] The 'actual value at risk' is the sum of (i) user's aggregated invoiced amount which is yet to be paid, plus (ii) the average daily aggregate amount invoiced to the user in the previous month multiplied by 20. Note that the difference between the 'actual value at risk' and 'deemed value at risk' is that for the actual value at risk the aggregate exit capacity charges due by the user in the next year are not included.
[8] Termination results in all the user's capacity rights being recalled. NGG will take appropriate action to recover any outstanding invoiced amounts and NGG will try to sell the capacity in order to minimise the amount of revenue that will otherwise be recovered from the shipper community.
[9] The security required is a level such that the user's deemed value at risk is less than the amount of security it has in place.

UNC Panel[10] recommendation

The Joint Office received eleven responses to its consultation on UNC261, ten of which supported UNC261. When the UNC Modification Panel met on 17 September 2009 to consider the proposal, 7 out of 9 votes were cast in favour of implementing UNC261. Therefore, the Panel recommended implementation of UNC261.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 21 October 2009. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[11]. The Authority has concluded that:

1. Implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC[12]; and
2. Directing that the modification be made is consistent with the Authority's principal objective and statutory duties[13].

Reasons for the Authority's decision

We consider that UNC261 will impose greater discipline on users when booking exit capacity such that they are more likely to book capacity levels that are actually required. This should reduce the risk of users defaulting on their capacity commitments and limit the risk of associated revenue being socialised and collected from the shipper community. We consider that UNC261 will have benefits in terms of furthering relevant objectives (a), (c) and (d) of the UNC. We have set out below why we expect UNC261 to further the achievement of these objectives.

Relevant Objective (a) - the efficient and economic operation of the pipe-line system

The proposer was of the view that UNC261 would ensure that users are held to their capacity commitments and reduce the possibility that speculative bids for capacity could be submitted. This was considered to be of benefit for the efficient and economic operation of the pipeline system. The majority of respondents agreed with these points.

The respondent that did not support UNC261 argued that if a user triggers investment through booking of exit capacity it should be exposed to the costs that to reflect the investment, consistent with the charging objective of cost reflectivity in Standard Special Condition A5 of NGG's NTS licence. It considered that the current arrangements are such that if adequate security is not provided then the delivery of capacity is delayed and so investment is avoided.

We do not consider this is an accurate representation of the situation. NGG is obliged to consider the merit of all investments in accordance with the requirement for it to operate

[10] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[11] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.co.uk.
[12] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547.
[13] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

an economic and efficient gas system. Even after a user defaults NGG may still consider the investment triggered by that user to be economic and efficient. The fact that the liability borne by that user remains unchanged is consistent with the principles of the charging objective.

Relevant Objective (c) - so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under its licence

The respondent that did not support UNC261 argued that if a user triggers investment by booking of exit capacity it should be exposed to the costs that reflect the investment, consistent with the charging objective of cost reflectivity in Standard Special Condition A5 of NGG's NTS licence. It considered that the current arrangements are such that if adequate security is not provided then the delivery of capacity is delayed and so investment is avoided.

We do not consider this is an accurate representation of the situation. NGG is obliged to consider the merit of all investments in accordance with the requirement for it to operate and economic and efficient gas system. Even after a user defaults, NGG may still consider the investment that was triggered by that user to be economic and efficient. The fact that the liability borne by that user remains unchanged is not inconsistent with the principles of the charging objective.

This respondent also argued that UNC261 would require NGG to invest and so, if the user defaulted, it would not be exposed to the costs of the investment. We consider this investment point to be fundamentally the same as discussed above against relevant objective (a), and do not consider this would result in investment that is not required.

The same respondent also made wider arguments, on securitisation, that lie outside the remit of UNC261; they reflect views about the securitisation policy within the NGG licence. As such, whilst we note their views, they are not of direct relevance for the decision as to whether UNC261 better faciliates the relevant UNC objectives.

We consider that the proposal will make users more accountable for their actions, and therefore may prevent speculative bidding behaviours. This would, in turn, prevent the triggering of unnecessary investment, which is consistent with NGG's licence obligations.

Relevant Objective (d) - so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition between relevant shippers, suppliers and DNs

UNC261 aims to remove the risk of the generality of users having to bear the costs of an individual shipper defaulting on its capacity commitments by ensuring that shippers are held to the financial consequences of these same commitments. We consider that acting to both attribute costs to their source and to prevent the smearing of costs on all users is consistent with the promotion of competition in the sector.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC261: '*Annual NTS Exit (Flat) Capacity Credit Arrangements*' be made.

Stuart Cook
Acting Senior Partner, Transmission and Governance

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