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Dear Colleague,

Modification proposal 0609 'Changes to Energy Balancing Credit Arrangements for the Trading System Operator'

Ofgem has carefully considered the issues raised in modification proposal 0609 'Changes to the energy balancing credit arrangements for the trading system operator. Ofgem has decided to direct Transco to implement the modification, as we believe that it will better facilitate the achievement of the relevant objectives of Transco's network code.

In this letter we explain the background to the modification proposal and outline the reasons for making our decision.

Background to the proposal

The gas balancing regime introduced under the New Gas Trading Arrangements created an independently operated, screen-based, on-the-day commodity market ('OCM'), which replaced the Contingency Balancing Arrangements (the 'flexibility mechanism'). The OCM is used by shippers to fine-tune their own gas balance and by Transco in its role as residual gas balancer.

The OCM operator (Trading System Operator or 'TSO'), which is a signatory to network code as a restricted user, is automatically counter-party to all OCM trades (in order to maintain participants' anonymity). Whilst its position is intrinsically balanced in both energy and value at all times, it cannot directly control the volume or value of transactions beyond restricting trading participant's accounts. The current TSO was appointed following competitive tender, with designation from 1 October 1999 until 30 September 2003, and thereafter until determined. However, the existence of a designated OCM operator does not prevent the establishment of other market operators, nor oblige shippers or Transco to trade on the market.

When the system is long and Transco sells gas, trades undertaken lead to an increase in the TSO's network code energy balancing indebtedness. Transco's selling is determined by the length of the system, which is in turn determined by the aggregation of the notified position of individual users. Transco therefore has little discretion with regard to the volumes to be sold, and any restriction of its ability to trade on the OCM as required would, by necessity, lead to reintroduction of the flexibility mechanism.

Transco's energy balancing credit regime is embodied in the network code supplement (section X) and the Energy Balancing Credit Rules ('EBCR'). Transco operates as the (revenue neutral) Credit Risk Manager (Energy) on behalf of shippers on its network, applying the EBCR in accordance with the instructions of the Energy Balancing Credit Committee ('EBCC'). Following the implementation of modification 0572, 'The provision of Letters of Credit for energy balancing credit cover', on 1 August 2003, accepted forms of security under network code for energy balancing are cash or letters of credit (LoC) only.

Through the occurrence of events beyond its control, as outlined above, the TSO could be required to put in place a secured network code credit limit of theoretically unlimited value at short notice. Experience has shown that there is potential for the TSO's energy balancing indebtedness to escalate rapidly at short notice. The risk of it not being able to comply with Transco's request to source increased security within very limited timescales is therefore very real. Should the TSO be unable to meet this requirement the OCM would become unavailable to Transco.

There is recognition from EBCC members that in not having direct control of its trading positions the TSO is in a unique situation, for which the EBCR do not make provision. EBCC discussion has determined that the present energy balancing credit regime produces a risk to the continued viability of existing balancing arrangements. However, as a restricted user of the network code, the existing TSO is unable to raise a modification itself, and therefore sought a change to the EBCR via Transco and the EBCC. On the direction of the EBCC, Transco raised this modification proposal.

Subsequent to the above EBCC discussions the existing TSO indicated that the implementation of modification 0572 constituted a significant development, resulting in a change to the way that its credit limit with Transco is secured, and that its chosen solution will enable it to be more flexible in the amount of security that is provided. The TSO therefore requested that this modification proposal be withdrawn. However, following discussion the consensus of EBCC members was that the proposal should not be withdrawn.

The modification proposal

It is proposed that the network code supplement (section X) should be changed to introduce an additional trigger action by Transco in the event that the TSO's energy balancing indebtedness exceeds 60%, rather than 85%, of its secured credit limit. Transco shall be required to convene an emergency operational meeting of the EBCC to determine action to be taken. The proposal further seeks to extend the provisions within both the network code supplement and EBCR in the following areas, in order that the appropriate action may be taken:

- To grant the EBCC the powers to make such information requests to the TSO and Transco as and when it deems relevant, to include but not be limited to:

    - Trend analysis of trades and data on movement in the TSO's energy balancing indebtedness, together with any actions taken (e.g. Cash Call/Failure to Pay Notices Issued) for the relevant period, determined by the EBCC;

    - The security that the TSO has in place from its customers, credit insurance cover if the security were to fail and any indication that failure was likely, current credit limit and credit usage data. (Note that individual customers should not be identified without their prior permission.)

    - Cash flow projections, to cover the period up to which the TSO forecasts its indebtedness to fall below 60% of its secured credit limit, and assumptions made.

  All data provided by the TSO should be subject to verification from independent audit, the scope of such audit to be determined by the EBCC. It is the EBCC's view that it would be appropriate to engage the TSO's auditors to carry out this role, with the costs of such audits being borne by the TSO. The auditor will report directly to the EBCC. It is expected that such a report would include, but not be limited to, confirmation of compliance with stated processes and procedures of the TSO, e.g. security from customers, validity of credit insurance, and analysis of the cash flow projections including the appropriateness of the assumptions made and sensitivities around these assumptions.

- Introduction of provisions extending the powers and duties of the EBCC to determine acceptable levels of exposure and to allow the TSO to trade in excess of 100% of its secured credit limit to a maximum level determined by EBCC with triggers for periodic review.

- Provisions under section X 3.2.4 allowing Transco to withhold payments to the TSO in the event that its exposure exceeds 85% of its secured credit limit or other such limit as is agreed by EBCC under bullet point 1 above until such time that its exposure is reduced below that same limit.

- To suspend Transco's obligations under S3.6 to pay credit interest to the TSO in the event such payment is suspended for the purposes outlined above.

Nothing in this modification proposal would change the existing EBCR, their application to the TSO or the remedies within the team.

The proposer (Transco) suggests that this modification proposal would better facilitate the relevant objectives as implementation would reduce the risk that the OCM for system balancing could be withdrawn. However, in the event of a decision to revert to the flexibility mechanism to limit the TSO's exposure, there would be a period of time between the decision point and the operational reintroduction of the flexibility mechanism during which users could prepare. The reduced risk of failure of the OCM, coupled with the introduction of procedures allowing early preventative actions to be taken, provide a more secure, and therefore competitive environment, for users to operate in.

Respondents' views

There were eight responses to this modification proposal, of which six support implementation, and two are opposed.

The majority of representations in support of the proposal agree that the unique circumstances of the TSO allow it to be treated differently to other users. They also suggest that the proposal provides a pragmatic alternative to the existing procedure that is unhelpful for market liquidity, thereby reducing unnecessary risk of the OCM becoming unavailable to Transco for system balancing purposes. A number of respondents also offered support for 60% as an appropriate indebtedness trigger specific to the TSO.

In general the majority of views support the involvement of the EBCC in the process. In recognising that a slight risk could be created by the proposal, one respondent highlighted the need for the EBCC to use its extra powers carefully. However, the respondent stated that the slight risk is justified to avoid the alternative of potentially unnecessarily having to suspend the OCM, when in reality there is no major risk to the community.

One respondent, who opposed implementation, suggested that it is doubtful whether decisions would be made within appropriate timescales, particularly where additional information is requested and required to be reviewed or verified by independent auditors.

A further respondent, the existing TSO, indicated that following the implementation of modification 0572 its chosen method of securing its credit limit with Transco will enable it to be more flexible in the amount of security that is provided, which will mitigate the market availability risk more effectively than this modification proposal would do. The TSO also states that the modification would be likely to result in unnecessary 60% triggers (leading to unnecessary EBCC meetings) when further security was actually available to be provided as the TSO's energy balancing indebtedness approached 85% of its secured credit limit.

Transco's view

Transco, who raised this modification proposal at the request of the EBCC, is of the opinion that it should be implemented. Transco suggests that a 60% trigger would provide an early indication to the current and likely future financial position of the TSO given the prevailing market and trading conditions. Furthermore, obligations on the TSO to provide audited information would give the EBCC confidence in the TSO's financial position and additional time to react to events should the TSO's indebtedness continue to increase.

Transco states that implementation would help protect its ability to utilise the OCM and reduce the risk of the flexibility mechanism being invoked since it is expected that the new procedures would permit the TSO's energy balancing indebtedness to exceed the limit normally associated with the security in place.

Transco highlights that a situation of the type envisaged under this proposal occurred in December 2001, when its application of the provisions set out in the network code supplement and the EBCR led to the TSO having to provide significantly increased levels of security for two months at very short notice. Transco notes that had the TSO been unable to meet its obligations the OCM would have been suspended and the flexibility mechanism would have been invoked.

Transco notes a disadvantage of the proposal is that whilst the EBCC considers the TSO's financial ability to pay, the TSO may exceed 100% of its secured credit limit. Even though the TSO is intrinsically neutral in terms of both gas and money, there is a very small risk that the simultaneous failure of a purchaser, coupled with a failure by its guarantor to honour the debt, may result in the failure of the TSO. This could result in a bad debt that would give rise to adjustment neutrality charges for remaining users.

Ofgem's view

In light of the relevant objectives of Transco's network code and Ofgem's statutory duties, Ofgem has decided to direct Transco to implement the modification.

Ofgem notes that subsequent to the implementation of modification 0572 the initial support of the existing TSO for this modification proposal was withdrawn, on the basis that its chosen method of provision of security would remove the need for this proposal. Whilst Ofgem is aware that the existing TSO requested the development of this proposal, Ofgem recognises the potential for the establishment of other market operators, and that the unique position of any TSO remains unchanged.

As noted above, the OCM represents a key tool to Transco and shippers in carrying out gas balancing. Ofgem therefore agrees that early warning that the OCM may become unavailable would be beneficial to the above parties, and considers that a 60% indebtedness trigger could act as such a warning, in exposing the inability or unwillingness to provide increased security. Ofgem also recognises that access to reliable and meaningful information could enable the EBCC to determine acceptable levels of exposure, thereby avoiding suspension of the OCM by allowing the TSO to trade in excess of 100% of its secured credit limit.

Ofgem notes that a suggested implication of the implementation of modification 0572 may be a reduction in levels of energy balancing security, such that users may operate closer to 85% indebtedness. Ofgem appreciates that in regard to a TSO, in combination with this modification proposal, this could result in frequent 60% triggers. In line with this Ofgem notes that in its response, the existing TSO stated that its chosen method of securing its credit limit would be likely to result in unnecessary 60% triggers when further security was actually available.

Ofgem appreciates that frequent 60% triggers could lead to unnecessary EBCC meetings and information requests to the TSO, particularly where further security is available, potentially creating administrative and financial burdens on both parties. Furthermore, given that gas balancing debt can escalate very quickly, Ofgem appreciates the concern highlighted by one respondent that it is doubtful whether decisions would be made by the EBCC within appropriate timescales.

Ofgem also notes the risk highlighted by one respondent, that whilst the EBCC considers the TSO's financial ability to pay, the TSO may exceed 100% of its secured credit limit, and that there is a very small risk that the simultaneous failure of a purchaser, coupled with a failure by its guarantor to honour the debt, may result in the failure of the TSO. Ofgem agrees that this could result in a bad debt that would give rise to adjustment neutrality charges for remaining users.

Whilst recognising the above issues, Ofgem understands that this modification proposal would not change the existing EBCR, their application to the TSO, or remedies. As such, in line with current practice, it would be open to the EBCC to both determine the need for, and hold meetings, remotely. Additionally, whilst the proposal would grant the EBCC the power to make information requests, they would not be obliged to do so. Ofgem also notes that whilst the draft legal text appears to impose an obligation upon the TSO to provide information where requested by the EBCC, failure to comply would not give rise sanctions. Therefore, the TSO would not be penalised for failure to comply and could chose to only respond where it wished the EBCC to make use of its extended powers.

In addition to the above, while the EBCC might be unable to fully review information to make decisions in some cases, the 60% trigger could still act as an early warning, and the EBCC could act proportionally to the available information that could be reviewed.

In approving this modification proposal, Ofgem recognises that it may not in itself prevent the loss of the OCM to Transco for its gas balancing activities. However, Ofgem considers that it has the potential to provide access to more information at an earlier point in time than is presently possible, which could serve to reduce the likelihood of loss of the OCM. Therefore, Ofgem believes that this proposal constitutes an improvement on current arrangements and has the ability to better facilitate Transco's relevant objectives.

Going forward, in recognising that Transco is not obliged to trade on the OCM, and that this proposal may not prevent the OCM becoming unavailable, Ofgem would highlight that its implementation does not preclude the development of robust contingency arrangements.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to consent to this modification, as we believe that it better facilitates the achievement of the relevant objectives as outlined under Amended Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Nick Simpson
Director of Industry Code Development