

OFGEM DECISION LETTER No. 0506
"Cancellation of NBP Sale Trades in the event of a Termination of a User"
Version 1.0

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Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification Proposal 0506 'Cancellation of NBP Sale Trades in the event of a Termination of a User'

Ofgem has considered the issues raised in Modification Proposal 0506 '*Cancellation of NBP Sale Trades in the event of a Termination of a User*'. Ofgem has decided to direct Transco not to implement the modification.

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

Background to the proposal

This modification proposal was raised in light of recent market events relating to the termination of User status for two of Enron's gas shipping companies. With effect from 6am 1st December 2001 Enron Gas and Petrochemicals Trading Ltd and Enron Capital and Trade Resources Limited were terminated as Network Code Users in accordance with Section V4.3.3.

This termination raised concerns amongst some industry participants that the current Network Code provisions relating to the treatment of a terminated shipper's National Balancing Point (NBP) trades may not be sufficiently clear. In particular, a failure on the part of Transco to declare a terminated shipper's sale trades as being void could result in imbalance costs associated with significant volumes of gas being taken off the National Transmission System without being replaced. In these circumstances concerns have been raised that the terminated shipper could accrue substantial imbalance charges that may ultimately be unpaid and therefore distributed across shippers through the energy neutrality mechanism. Under the present gas balancing regime shippers have commercial incentives under the Network Code to balance their inputs and offtakes each day. In particular, shippers who enter more gas into the system to what they have offtaken or conversely, fail to enter sufficient quantities to match their offtakes are exposed to imbalance cash-out charges. Transco as system operator incurs/receives the costs/revenues associated with imbalance charges. At present the net costs of the cash-out regime are recharged to shippers via a neutrality charge.

The Network Code currently provides for the rules that govern the nomination of NBP trades. Under the current Network Code provisions a number of conditions must be met before trade nominations are accepted. Section C 6.2.1 requires that a trade nomination should identify the User either making a Disposing (or an Acquiring) trade nomination as well as the identity of the User making the corresponding nomination. Where the identity of either User is not specified the trade will be rejected. Section V 4.3.3 allows Transco to issue a termination notice to a User, after which a User ceases to be a User. Transco has indicated that, in this context, any trade nomination with a terminated user will not be effective after the date specified in the termination notice and will therefore be rejected.

Under section C 6.2 of the Network Code, a trade nomination shall not be effective and shall be rejected by Transco where a corresponding trade nomination is not submitted by 07:00 hours on the gas day in circumstances where the first trade nomination was submitted before the gas day. Outside of these circumstances Transco can reject a trade nomination if the corresponding nomination is not submitted within 60 minutes before or after the first trade nomination was made. This provision therefore envisages that trade nominations can occur within the gas day.

British Gas Trading Ltd (BGT) raised urgent modification proposal 0506, '*Cancellation of NBP Sale Trades in the event of a Termination of a User*' on 30 November 2001. This modification sought to clarify the process by which sale trade nominations would be dealt with in the event of Transco issuing a termination notification.

The modification proposal

The modification proposal seeks to introduce a mechanism whereby, in the event that a User is terminated, all its sale trades at the NBP will be rendered null and void. The proposal would oblige any counter-party to such a trade with a terminated user to source the lost volume of gas from another shipper or from the system.

Respondents' views

The majority of respondents supported the proposals or the principles underlying the proposal. In general, these respondents supported the proposal on the basis that it would reduce shippers' exposure to smeared imbalance costs arising out of the termination of a Network Code User.

One respondent indicated that it is the counter-parties to trades with the terminated User who should bear the costs of correcting an imbalance position as a result of a termination.

A number of respondents noted that the current Network Code provisions relating to the cancellation of trades are unclear. These respondents suggested that the modification proposal should be accepted on the basis that it clarifies Transco's obligations. In particular, one respondent commented that the absence of clarity as to whether Transco is obliged to remove sale trades from the system could lead to a large amount of gas being taken off the system but not replaced.

One respondent, whilst offering support for the proposal in principle, has questioned whether the proposal modification was necessary since the Network Code already provides for the withdrawal of all existing trade nomination made by a terminated user. One respondent requested that Transco clarify the actions it would take once a termination notice has been issued.

A number of respondents, whilst offering general support for the proposal, noted that it was restricted to sell trades. Many of these respondents therefore suggested that upon termination of a User both its buy and sell trades should be declared void to provide additional protection. In particular one respondent argued that the proposal should apply equally for counter-parties who have sold gas to the terminated User, since transfer of gas to a terminated User could result in an over supply of gas leading to possible balancing actions. The costs of these actions would be smeared across shippers. Finally, this respondent argued that there should be no time limits on when counter-parties to the terminated User should close their long or short positions.

One respondent argued that the obligation to source alternative gas should only be placed on shippers for their gas requirements at the time of termination. The respondent went on to suggest that where the gas was surplus to portfolio requirements no obligation should be placed on shippers nor should any gas to be provided to the terminated shipper carry any obligation for its disposal.

Two respondents opposed the modification proposal. One of these respondents noted that without declaring void both the sell and buy trades of a terminated User, the proposal is likely to increase the users out of balance position, creating greater exposure to the community. The other respondent indicated that it did not support the proposal as the asymmetric treatment of buy and sell trades could create instability in the market. This respondent also stated that cancelling both buy and sell trades would force the terminated shipper into a position of imbalance. In addition the respondent commented that the current credit arrangements are inadequate to deal with imbalance costs that may arise upon termination of a user and are in need of review, as, currently, any unpaid imbalance is smeared across shippers.

Transco's view

Transco did not support the modification proposal. Transco believed that the current Network Code provisions for the treatment of gas trades in the event of the termination of a User are adequate. Transco therefore believed that a modification is not required. Specifically, Transco noted that the current Network Code provisions would ensure that any trade nomination with a terminated User will not be effective after the date specified in the termination notice and will therefore be rejected. Transco went on to argue that any risk arising from the rejection of a trade nomination will be borne by the counter-party of the terminated User.

Transco suggested that a wider debate of the issues surrounding the termination of Users would be helpful and would provide an opportunity to clarify the current Network Code provisions regarding NBP trade nominations and credit issues.

Correspondence between Ofgem and Transco

Following the release of Transco's Final Modification report, Ofgem wrote to Transco on 13 December 2001 seeking clarification as to the status and treatment under the Network Code of any trade nominations made within day by a User that is subsequently terminated later on the same day. Ofgem raised this issue as Transco indicated in its Final Modification report that any nominated trades by a terminated User would not be effective after the date specified in the termination notice.

In response to this letter, Transco indicated that should a termination notice become effective within-day then trade nominations for that gas day and made before the effective time of the

termination notice would have effect for daily imbalance calculation purposes. Transco also indicated that its policy is to issue termination notices at 06:00 hours thereby ensuring that it is able to reject any trade nomination that would have otherwise involved the terminated User for that or any subsequent gas day.

Transco indicated that were a termination to become effective within-day (contrary to its policy) this could increase the exposure to individual shipper counter parties who would have to trade on the day to achieve their desired imbalance position. Transco considers that this could create considerable distress to shippers within-day particularly if the termination is issued later in the day. Transco states that this is to be contrasted with the position under the current arrangements which provides shippers with some certainty in so far as a trade that has been made within day would stand post termination. Transco contends that in these circumstances it is more appropriate for Transco to manage the system balance position rather than to await shipper responses to a within day termination.

Ofgem's view

Whilst Ofgem supports the objective of minimising the extent to which the costs associated with the imbalances of a terminated shipper are distributed through neutrality, there are nevertheless a number of factors associated with this proposal that cause concern.

First, the voiding of sale trade nominations following a termination that occurs within-day would produce undesirable consequences relative to the existing arrangements whereby trade nominations made before the effective time of a within day termination would continue to have effect for that gas day. In particular, Ofgem agrees with Transco that under the existing daily balancing regime the voiding of trade nominations within-day following a within-day termination may place counter-parties in a distressed position with little opportunity to redress any resulting imbalance particularly in circumstances where the notice is issued late in the day. Ofgem would note that these concerns may not be as significant under a regime with within-day allocations and shipper access to linepack services.

Secondly, Ofgem is also concerned that the modification proposal is asymmetric in nature in so far as it applies to sale trade nominations and not buy nominations. In this respect, the inconsistent treatment of sale and buy trade nominations would not better facilitate the securing of competition between relevant shippers. For example shippers on the buy side of a trade could be required to redress an imbalance position within day following a within day termination whereas shippers on the sell side of a trade would not. The inconsistent treatment of these trades may distort competition between shippers.

On a separate, but related, issue, Ofgem notes the concern raised by one respondent regarding the current Network Code credit arrangements and the rules associated with apportioning the costs associated with terminated shipper unpaid imbalance charges. In this respect, in March 2002 Ofgem published its consultation document on credit issues entitled, *'Arrangements for gas and electricity supply and gas shipping credit cover'*. This document consults on the arrangements associated with managing the risk of gas or electricity suppliers and gas shippers failing and the minimisation of the overall costs of actual and potential failure.

Ofgem's decision

Ofgem has therefore decided to direct Transco not to implement this modification proposal, as for the reasons outlined above we do not consider that it better facilitates the achievement of the

relevant objectives as outlined under Standard Condition 9 of Transco's Gas Transporter's 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,

Mark Feather
Head of New Gas Trading Arrangements