Modification proposal:	**Uniform Network Code (UNC) 315: To enhance Section X of the UNC Transportation Principal Document to improve Energy Balancing Further Security Process (UNC315)**		
Decision:	The Authority[1] has decided to reject this proposal		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	17 December 2010	Implementation Date:	N/A

Background to the modification proposal

Shippers are invoiced for any Energy Balancing charges that they may have incurred for a given Settlement Date. A monthly invoice is sent two months after the relevant Settlement Date, eg a shipper will receive invoices for October's daily Energy Balancing charges on 1 December. Credit cover arrangements exist to help protect shippers from collectively having to cover the costs of a shipper that is unable to meet its Energy Balancing charge liability. Under the credit cover arrangements, each shipper is required to lodge security with National Grid NTS. This is known as a shipper's 'Secured Credit Limit' and it can be in the form of cash and/or a Letter of Credit.

The 'Cash Call Limit' is 85% of the Secured Credit Limit. If a shipper's indebtedness exceeds the Cash Call Limit, then it will be required to increase its Secured Credit Limit by lodging additional security so that its level of indebtedness falls below the Cash Call Limit. If it exceeds the Cash Call Limit twice within 28 calendar days, it will receive a 'Further Security Request' (FSR). An FSR requires a shipper to lodge additional security and prevents it from recovering this security for 90 calendar days, even if its indebtedness falls below its new Cash Call Limit.

A shipper is able to increase its Secured Credit Limit by lodging additional credit, for example, if its indebtedness increases. The Cash Call Limit remains at 85% of the Secured Credit Limit irrespective of how many times or how frequently the shipper has exceeded the Cash Call Limit or increased its Secured Credit Limit.

The modification proposal

This modification proposal seeks to disincentivise shippers from repeatedly exceeding their Cash Call Limit. It would do this by scaling back a shipper's Secured Credit Limit by 20% should they receive three FSRs within a period of 28 days. This new Cash Call Limit would apply for a further 12 months before it is re-assessed; assuming no further Cash Calls are made within this period.

This proposal was originally identified by the Energy Balancing Credit Committee (EBCC)[2] as a potential solution to the issue of shippers constantly increasing their security in response to cash calls. It was raised by Corona Energy on 7 July 2010 on behalf of the EBCC.

[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] The EBCC is a body of shipper representatives with certain rights and responsibilities relating to the management of Energy Balancing Credit Risk.

The proposer considers that this modification will better facilitate the relevant UNC objectives (c) and (d)[3]. In summary, this is because it will decrease the risk faced by shippers that they will be required to cover the costs of a shipper that has not been able to pay its Energy Balancing charges. It considers that this decreased risk will result in a more effective and economic process operated by gas transporters and decreased costs of entry and operation for shippers.

UNC Panel[4] recommendation

At its meeting on 18 November 2010, the UNC Panel recommended that the proposal should not be implemented. Of the 11 panel members, four votes were cast in favour of implementing this modification.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 23 November 2010. 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[5].

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC.

Reasons for the Authority's decision

We consider that UNC315 may lead to a marginal improvement in the extent to which relevant objective (c) is met. However, we consider that this is outweighed by the arguments against relevant objective (d). We consider that the proposal is neutral in relation to the remaining relevant objectives.

Relevant Objective (c): the efficient discharge of the licensee's obligation

Gas transporters are obliged by Standard Special Condition A15 of their licences to establish a Transporter's Agency (the 'Agent'), and ensure that the services and systems provided by this Agent are "operated and developed on an economic and efficient basis".

In its response, National Grid NTS noted that implementing the proposal may decrease the number of Cash Calls and FSRs issued, and that this would represent an improvement in efficiency. We note that issuing fewer Cash Calls will reduce workload and that this may lead to an efficiency gain. However, the extent of this gain is not clearly set out considering that the modification proposal will lead to a significant change in the operation of the credit arrangements. We consider that this efficiency gain is unlikely to be material.

Some respondents noted that the proposal will place a greater onus on shippers to monitor their indebtedness to ensure they do not receive three FSRs within 28 days. This may result in a reduced workload for National Grid NTS, Xoserve and the EBCC. We

[3] 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
[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[5] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

consider that incentivising shippers to monitor their indebtedness more proactively may lead to more credit being lodged to avoid the consequences of their Cash Call Limit being reduced by 20%. However, we do not consider that a strong case has been made on why this, on balance, is a proportionate response to the potential costs faced by shippers.

For the reasons set out above we consider that this modification proposal may in principle better facilitate objective (c). However, based on the evidence provided, we consider that the extent to which any efficiency gains are probable is unlikely to be material.

Relevant Objective (d): the securing of effective competition between: (i) relevant shippers; (ii) relevant suppliers; and/or (iii) DN operators and relevant shippers

The proposer, and respondents to the FMR that support the modification, consider that a shipper that has been issued with three FSRs within 28 days presents a financial risk to other shippers. They consider that there is an increased likelihood that this shipper will go into administration and not be able to meet all of its Energy Balancing charges. They consider that this proposal will reduce the risk to other shippers should that shipper go into administration and be unable to pay all of its Energy Balancing charges.

One respondent considers that this proposal unfairly prejudices smaller shippers. Smaller shippers may be more likely to use cash for their secured credit limit as they may be less able to obtain Letters of Credit. This may result in a smaller shipper lodging additional cash as credit after each FSR and then having their Cash Call Limit reduced so they would have to post more cash. In this scenario the shipper would have reduced funds for day-to-day operational purposes. The respondent also highlighted that smaller shippers are more likely to be exposed to the imbalance market due to their trading strategies and therefore are more likely to be affected by this proposal than other shippers.

One respondent questioned why the new Cash Call Limit would need to be effective for 12 months. It considers that this is an unfair requirement as it may not reflect a shipper's current indebtedness, but would be based on past indebtedness figures from up to a year ago.

We recognise the potential for this modification to reduce the risk that the shipper community will be required to pick up the costs of a failing shipper. Although, we note that the modification may have a limited impact if a shipper were to fail suddenly.

We consider that shippers that are more sensitive to the impact of managing cash flow and shippers that have a less predictable exposure to imbalance would be likely to be most affected by this modification proposal. We consider that many small, growing and new entrant shippers may fall into this category. Other shippers that are backed by Letters of Credit and those with larger, more stable portfolios may be less impacted.

We note that this proposal was raised to address a perceived gap in the current credit arrangements. However, we are concerned that the burden of this particular proposal is likely to fall hardest on small, growing and new entrant shippers. We are concerned that this may have a detrimental impact on competition and that a case has not been made that the benefits of reduced risk outweigh the potential reduction of new entrants and growth of small parties who may be constrained by their increased credit requirements. We consider that the risk of a shipper repeatedly exceeding its Cash Call Limit is to some extent already mitigated by the current process for shippers to respond to an FSR and to increase their Secured Credit Limit if they exceed the Cash Call Limit twice in 28 days.

Summary

For the above stated reasons we do not consider that this modification proposal better facilitates relevant objective (d) and the concerns under this objective outweigh the potential benefits under relevant objective (c). We therefore consider that this modification proposal does not better meet the relevant objectives of the UNC.

Whilst, in this instance, we are directing that this modification proposal should not be implemented, we recognise the positive work carried out by the EBCC and Review Group 0252 in highlighting the current inconsistencies and potential issues in the current credit arrangements, and raising modifications to address these issues. We would welcome any further modifications that sought to address identified issues with the UNC credit arrangements, including those that address the risk of a failing shipper.

Emma Kelso
Associate Partner, Retail and Market Processes

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