Stage 04: Final Modification Report

At what stage is this document in the process?

01 Modification
02 Workgroup Report
03 Draft Modification Report
04 Final Modification Report

0569S:

Removal of the minimum security requirement from the Energy Balancing Credit Rules

The current £10,000 minimum security requirement for balancing credit is an arbitrary figure and acts as a barrier to entry for smaller Users with new, innovative business models, thus hampering competition. This modification proposes that balancing credit requirements be determined for each User on the basis of the formula currently contained within Section 2.1 of the Energy Balancing Credit Rules and based on each User's individual throughput and that the arbitrary minimum security requirement be removed from the Energy Balancing Credit Rules.

The Panel determined that this self-governance modification be implemented.

High Impact: None

Medium Impact: None

Low Impact: Shippers, Transporters and Transporters Agent

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About this document:

This Final Modification Report was considered by the Panel on 18 February 2016.

The Panel determined that this modification should be implemented.

Modification timetable:

Amended modification considered by Workgroup	07 January 2016
Workgroup Report presented to Panel	21 January 2016
Draft Modification Report issued for consultation	21 January 2016
Consultation Close-out for representations	11 February 2016
Final Modification Report available for Panel	12 February 2016
UNC Modification Panel decision	18 February 2016

Any questions?

Contact:
Code Administrator

enquiries@gasgovernance.co.uk

0121 288 2107

Proposer:
Locus Energy

rob@locusenergy.co.uk

07776 137403

Transporter:
National Grid NTS

fergus.healy@nationalgrid.com

01926 655031

Systems Provider:
Xoserve

commercial.enquiries@xoserve.com

1 Summary

Is this a Self-Governance Modification?

The Proposer believed this was not a Self-Governance Modification as the proposed removal of the minimum balancing credit requirement from the Energy Balancing Credit Rules (EBCR) represents a material change to that document.

However, at its meeting on 17 December 2015, the Panel determined that the criteria for Self-Governance are met, as this modification is not expected to have a material impact on transportation and competition.

Why Change?

The Energy Balancing Credit Rules state in Section 2.1:

"All Users are required to maintain a minimum level of security at all times, which is currently set at £10,000, in order to provide sufficient protection for the gas community from User failures".

While the Proposer fully appreciates that this requirement is driven by the desire to avoid outstanding costs being recovered from other Users in the case of default, it feels that there is a strong need to carefully balance this risk with the overarching objective to encourage competition and avoid creating barriers to entry.

It is the Proposer's view that a more level playing field could be created by enforcing the already existing requirement within the Energy Balancing Credit Rules that the minimum security requirement for New Users be based on 3 days non-deliverability at 12 months average System Average Price (SAP) to represent 85% of the Secured Credit limit based upon an estimate of projected annual throughput. This is both reasonable and equitable. All that needs to be removed is the arbitrary minimum security requirement, which ignores the result of the above calculation if that result is less than £10,000.

Solution

Amend the Energy Balancing Credit Rules, Section 2.1c "Cash Call Limit Calculations", to remove the £10,000 minimum level of security:

"All Users are required to maintain a minimum level of security at all times~~, which is currently set at £10,000,~~ in order to provide sufficient protection for the gas community from User failures. For the avoidance of doubt any monies held in a Users Cash Call Account shall be excluded from the calculation of peak indebtedness over the last 12 months."

Relevant Objectives

Implementation of this modification would facilitate relevant objective d) i) and ii) securing of effective competition between shippers and suppliers.

Implementation

No implementation timescales are proposed, however the Proposer requested implementation as soon as possible following a decision by Panel.

The change proposed is a simple one without any attendant costs attached in relation to implementation and this proposal has already been the subject of discussion at several EBCC meetings with Xoserve conducting analysis in relation to this.

Does this modification impact a Significant Code Review (SCR) or other significant industry change projects, if so, how?

No.

2 Why Change?

The current minimum security requirement for balancing credit is an arbitrary figure and acts as a barrier to entry for smaller Users with new, innovative business models, thus hampering competition. This modification proposes that balancing credit requirements be determined for each User on the basis of the formula currently contained within the Energy Balancing Credit Rules and each User's individual throughput and that the minimum security requirement be removed from the Energy Balancing Credit Rules.

It is the Proposer's view that a more level playing field could be created by enforcing the already existing requirement within the Energy Balancing Credit Rules that the minimum security requirement for New Users be based on 3 days non-deliverability at 12 months average System Average Price (SAP) to represent 85% of the Secured Credit limit based upon an estimate of projected annual throughput. This is both reasonable and equitable. All that needs to be removed is the arbitrary minimum security requirement, which ignores the result of the above calculation if that result is less than £10,000.

By way of example, a User with a supply portfolio of 1,000 domestic properties could expect an annual throughput of 12,500,000 kWh (based on the recently adopted Ofgem average domestic gas usage of 12,500 kWh). The formula for New User Cash Call Limit determination within the Energy Balancing Credit Rules results in the following Secured Credit Limit:

12,500,000 kWh / 365

X3

X 12 month average SAP (1.52p for 12 months to November 30, 2015)

= £1,561.64

+15% to find Secured Credit Limit

= £1,795.89 (Rounded = £2,000)

1,000 domestic properties could, in the Proposer's view, be a perfectly feasible first year target for a small User with an initial local focus that aspired to gradual growth to begin with. The calculation above demonstrates that, for small supply businesses of this type who wish to ship for themselves rather than incur the cost of paying a third party User to perform this function on their behalf, the current minimum security limit acts as a significant barrier to entry.

The Proposer believes that it is the current policy intent of both the Government and the Regulator to encourage participation in the energy market at a small scale, local level. It seems to the Proposer that energy suppliers that commence operations on this basis are better positioned to engage with consumers and restore trust in suppliers than the large, vertically integrated market participants which operate at a national level. These suppliers aim to base their business models on the provision of high quality customer service, connection with local communities and getting the basics right before attempting to expand to a national presence.

The Proposer wished to reiterate that, while it understand the intent behind the setting of the minimum level of security at its current level, namely to insulate the rest of the market from any risk of default, it feels that the existing basis for setting the minimum level of security for new Users serves this purpose as it is based on estimation of annual throughput, 3 days of non-deliverability (a very rare occurrence outside of extreme market conditions, where all participants could expect to be affected by these) and a 12 month average reference price for SAP.

However, the benefit of this proportionate and measured approach to minimum security calculation is outweighed by the effect on competition that the arbitrary current minimum required security level of £10,000 creates. It is self-evident that the wider market will be as equally unaffected by the default of a company with £10,000 posted in security as it will be by the default of a company with £2,000 posted in security. On the other hand, the £8,000 differential between these two figures which the new User is required to post will, if it is a supply business of the type already described, have a detrimental and wholly unnecessary effect on its cash flow position and uselessly tie up cash which it could make use of for other purposes without achieving any increased risk benefits for other Users.

The Proposer believes that significant benefit will accrue to both consumers and competition by removing the minimum security level but continuing to enforce the rule basing required minimum security levels on estimates of throughput coupled with actual, publicly available data in relation to 3 days non-deliverability at 12 months average SAP. This could then be reviewed for each User when required by the EBCC, thus creating a proportionate requirement for balancing security while avoiding undermining competition and new market entry.

3 Solution

Amend the Energy Balancing Credit Rules, section 2.1c "Cash Call Limit Calculations", to remove the £10,000 minimum level of security

All Users are required to maintain a minimum level of security at all times~~, which is currently set at £10,000,~~ in order to provide sufficient protection for the gas community from User failures. For the avoidance of doubt any monies held in a Users Cash Call Account shall be excluded from the calculation of peak indebtedness over the last 12 months.

User Pays	
Classification of the modification as User Pays, or not, and the justification for such classification.	No User Pays service would be created or amended by implementation of this modification and it is not, therefore, classified as a User Pays Modification.
Identification of Users of the service, the proposed split of the recovery between Gas Transporters and Users for User Pays costs and the justification for such view.	N/A
Proposed charge(s) for application of User Pays charges to Shippers.	N/A
Proposed charge for inclusion in the Agency Charging Statement (ACS) – to be completed upon receipt of a cost estimate from Xoserve.	N/A

4 Relevant Objectives

Impact of the modification on the Relevant Objectives:	
Relevant Objective	Identified impact
a) Efficient and economic operation of the pipe-line system.	None
b) Coordinated, efficient and economic operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant gas transporters.	None
c) Efficient discharge of the licensee's obligations.	None
d) Securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers.	Positive
e) Provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards… are satisfied as respects the availability of gas to their domestic customers.	None
f) Promotion of efficiency in the implementation and administration of the Code.	None
g) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators.	None

Relevant Objective d) Securing of effective competition: (i) between relevant shippers; and (ii) between relevant suppliers; ……

Implementation of this modification will create a level playing field for smaller entrants in that they are not constrained by having to post levels of credit that are not reflective of the risk that they pose to the wider market. Instead, by virtue of basing balancing credit requirements for each Shipper on the basis of the formula contained in the Energy Balancing Credit Rules, this barrier to entry and competition will be removed while the market will continue to be adequately protected against any default risk, which furthers relevant objective d.

Workgroup Assessment

Workgroup participants heard that the Energy Balancing Credit Committee (EBCC) had been in discussion with the Proposer in an effort to reach a mutually agreeable position. A proposal had been made by the EBCC to amend the 'days' multiplier (in the formula in the New Users section of the EBCR Section 2.1c and as shown in Why Change? above) to 9 (from 3) and to remove the £10,000 minimum security, however the Proposer felt this was still a barrier to entry for new users.

The Workgroup considered the materiality associated with this proposal:

32 Users currently provided security at the minimum of £10,000, of which:

- 7 are in the Voluntary Discontinuance process (and could therefore still incur credit exposure)

- 20 currently have no activity and would provide no security under this proposal (and could therefore still incur credit exposure)
- 2 existing users would secure a combined £9,000 (ie £11k less than at present)
- 2 new users would secure a combined £6,000 (ie £14k less than at present)

In total, this proposal would remove around £300,000 of security (around 0.1% of the total security in place).

The Workgroup observed that, following this change, a new User could post zero balancing credit to participate in the market. It was noted that exposure is limited to 12 days, at which time the Credit Manager would be able to intervene. The Proposer argued that £10,000 of security offered little real protection for the industry in extreme cases.

5 Implementation

The Proposer does not believe that any costs would result from implementation of this modification beyond minor administrative costs relating to the change to the Energy Balancing Credit Rules.

No implementation timescales are proposed, however the Proposer would request implementation as soon as possible following a decision by Panel.

6 Impacts

Does this modification impact a Significant Code Review (SCR) or other significant industry change projects, if so, how?

No.

7 Legal Text

No change is required to the text of the Uniform Network Code.

Change to Energy Balancing Credit Rules

Please note that the EBCR changed with effect from 21 January 2016. The following revised text was provided on 26 January 2016 by National Grid NTS during consultation:

Energy Balancing Credit Rules, Section 2: Operation of the Credit Risk Framework

2.1c Cash Call Limit Calculations

All Users are required to maintain ~~a minimum level of~~ security at all times, ~~which is currently set at £10,000,~~which will be calculated in accordance with this section 2.1c "Cash Call Limit Calculation", in order to provide sufficient protection for the gas community from User failures.

~~Where it is determined that a~~ A New User's (a User with less than 12 months trading history) Cash Call Limit should be ~~set at a level less than the prevailing minimum level of security (currently set at £10,000) their Cash Call Limit will be recalculated~~ based on 9 days non-deliverability in order to align with the imbalance period within the Anticipated Balancing Indebtedness calculation. ~~The User's Cash Call Limit will be set at the lesser value of the two calculations.~~

For the avoidance of doubt any monies held in a Users Cash Call Account shall be excluded from the calculation of peak indebtedness over the last 12 months.

8 Consultation Responses

Of the 6 representations received 2 supported implementation, 1 provided comments and 3 were not in support.

Representations were received from the following parties:			
Organisation	**Response**	**Relevant Objectives**	**Key Points**
British Gas	Oppose	d- none	• No evidence has been provided to support the assertion that the current minimum security requirement acts as a barrier to entry for smaller Users. Evidence to the contrary was provided to the workgroup where it was stated that 32 Users currently provide the minimum £10,000 security. • Noted that the Energy Balancing Credit Committee recently decided to expedite a modification to the cash call limit calculations of the Energy Balancing Credit Rules in response to the Proposer's concerns. This should be sufficient. • Implementation of this modification could remove up to £300,000 of energy balancing credit cover. Although this represents a very small proportion of the total amount it is still sufficiently material. • Does not support self-governance for this modification. • Believes it would be useful to obtain a view from the Energy Balancing Credit Committee on a suitable lead-time for implementation.
EBCC	Oppose	d - negative	• Members of the EBCC are not supportive of the removal of the minimum level of security, currently set at £10,000. Members believe that the drivers that existed when implementing this limit within the Energy Balancing Credit Rules have not changed and believe that the removal of the limit has the potential to expose the community to avoidable financial loss. • Agrees with Self-Governance status.
Locus Energy	Support	d- positive	• Aware that the EBCC has unilaterally removed the £10,000 minimum requirement for balancing credit following the raising of this modification, which itself raises questions over the governance process around changes to the Energy Balancing Credit Rules, and are of the view that its proposed solution retains the barrier to both entry and competition by other means. • The original intent, which was reflected in the suggested legal text, was that all reference to a

			minimum credit requirement would be removed and that all Users would be required to post credit on the basis of their expected throughput based on 12 month average SAP and three days non-delivery as provided for in the formula contained in 2.1c) of the Energy Balancing Credit Rules. However, as that section of the EBCR has now been changed to state that new entrants (i.e. those with less than 12 months trading history) will post credit on the basis of nine days (as opposed to three days) non-delivery, Locus Energy have no option but to accept what is currently contained within the EBCR (and the newly circulated legal text for this modification) without restarting what has already been an extremely lengthy process. • Do not believe that there are suitable grounds or assumption that new Users pose a greater risk to the wider market in terms of possible default than established Users so that those new Users should therefore be required to post a greater level of balancing credit. They accept that this solution is better than the existing arbitrary £10,000 minimum credit requirement as it potentially requires new Users with low levels of expected throughput to post credit of less than £10,000, thus freeing up some cash which would otherwise be tied up for credit purposes for other operational uses. • Are very concerned about the governance as this proposed UNC modification as they believe it has now been reduced to the status of seeking approval for a change which has already been made and which was not the change that would best facilitate competition and the removal of barriers to entry in relation to a minimum balancing credit requirement. • The legal text is not reflective of the original intent of the modification. However, they believe that the proposed legal text reflects what is currently in the EBCR although this solution is better than what previously existed, it still requires new Users to potentially post more balancing credit than would be necessary if this requirement were simply based on three days non-delivery and the User's expected throughput as originally proposed and retains an element of undue discrimination between new and established Users. • Notes that some Users have expressed concerns that removal of the minimum credit requirement for balancing could mean that trading parties could carry

			out this function without posting balancing credit as it is usual for market participants of this type to estimate zero throughput. This is due to the fact that, unless something goes wrong, they will not normally have any physical position in relation to which credit would need to be posted. However, they note that, in the case of the last unplanned exit of a large trader participant, that participant had only £10,000 balancing credit in place, which represented a tiny fraction of its overall market exposure. The excess (which amounted to millions of pounds) was socialised across the market and that this amply demonstrates the fact that the £10,000 minimum credit requirement, while negatively impacting competition, provided no real insulation against default to the wider market. • Does not support self-governance for this modification as they had originally requested that it should not be treated as self- governance as they remain of the view that a change to the Energy Balancing Credit Rules should be treated as material.
National Grid NTS	Comments	d- positive	• The modification removes around £300,000 of security (around 0.1% of the total security in place). However, as the costs of energy balancing go through neutrality then this is a risk, and a potential additional cost, that the shipper community would bear. • There is a risk that reducing the minimum security requirement for new users may leave the market exposed to shipper default. However, any debt that arises in this situation would be smeared across the industry due to the neutrality mechanism. They believe Shippers who should make the decision on this modification as they bear the risk. • The legal text provided reflects the modification proposal. However, National Grid NTS are obliged to provide legal text based solely on the content of the modification proposal and therefore have removed the £10,000 minimum security payment. • Notes that the intent of the modification was to completely remove the minimum security requirement. The legal text has not been able to do this due to the subsequent changes to the Energy Balancing Credit Rules, which introduced additional criteria to evaluate a new minimum security threshold. • Noted that raising this modification has highlighted the process, as it currently stands, has allowed two changes to the same rule being initiated at the same

			time, and this has caused some confusion. • Agrees with Self-Governance status.
Opus Energy Ltd	Support	d- positive	• Support removal of the current arbitrary minimum figure of £10,000 security as this minimum level of security acts as a barrier to entry for smaller Users in particular, and so hampers competition. • Agrees with the Self-Governance status.
Scottish Power	Oppose	d - negative	• Aware that the Energy Balancing Credit Committee have been involved in detailed discussions with the Proposer and have already amended the Energy Balancing Credit Rules to take appropriate account of the their concerns. They believe that those rule changes are balanced and proportionate in providing the correct safeguards to the market while not imposing unduly onerous requirements on new entrants. • To reduce those safeguards further may create a potentially greater risk exposure that may actually be detrimental to the securing of effective competition. • Do not agree with the assertion that the previous credit provisions represented a significant barrier to entry, as illustrated by the data provided by Xoserve regarding the number of parties who are already subject to and meet those minimum credit requirements. • Agrees with the Self-Governance status.

Representations are published alongside the Final Modification Report.

9 Panel Discussions

The Panel Chair summarised that Modification 0569S would amend the Energy Balancing Credit Rules (EBCR), to determine the balancing credit for each User based on each User's individual throughput on the basis of the formula currently contained within Section 2.1 Cash Call Limit Calculations and remove the £10,000 minimum level of security.

Members considered the representations made noting that, of the 6 representations received 2 supported implementation, 1 provided comments and 3 were not in support. In particular, the Chair drew attention to comments made about the change introduced by the EBCC into the EBCR during the assessment phase of this modification, noting that the UNC Committee were considering the governance issues raised by this action and that Panel Members should disregard any governance-related comments for the purposes of considering the merits of 0569S.

Moving on, the Chair suggested that representations demonstrated some confusion potentially introduced by the late change to the EBCR. The current rules (effective 21 January 2016) provided different treatment for Users with less than 12 months trading history (lower of £10k or 9 days of non-deliverability) to other Users (higher of £10k or a percentage of historic peak indebtedness) and therefore the intent of this modification remained appropriate – removal of the £10k figure would still provide arrangements that offered protection for the industry against default of new- and existing-Users on the basis of the assessed indebtedness risk.

It was observed that there was an implicit assumption in some representations that, because 30 parties had placed the minimum £10k of security, that it was by definition acceptable to have that limit. Further, many of these parties were believed to be associated with major parent companies and £10k might not be an issue for them. Some Members believed that this could therefore be seen to be a barrier to entry for smaller parties.

Members considered that comments about the cumulative exposure of £300k somewhat overstated the likely risk; for this to materialise 30 such parties would need to default in close succession, which was though to be extremely unlikely. Views suggested that a more realistic additional risk could be in the range £10-30k or less, as their actual indebtedness could well be below the security in place, which was not thought to be material against the £300m of security in place. The Chair encouraged Members to consider this in assessing the balance between protecting the interests of existing Users versus the potential of the action being seen as a barrier to entry.

Members, in consideration of comments about whether the suggested barrier to entry had been demonstrated, felt that the proposer had clearly demonstrated the barrier he faced.

Members considered relevant objective d), agreeing that implementation would have a positive impact on securing of effective competition because it would remove a barrier to entry for smaller entrants by applying levels of credit reflective to the risk.

Members voted with 10 votes in favour (out of a possible 11), to implement of Modification 0569S.

10 Recommendation

Panel Recommendation

Having considered the Modification Report, the Panel determined that proposed self-governance Modification 0569S should made.