

Representation - Modification UNC 0791 (Urgent)

Contingency Gas Procurement Arrangements when a Supplier acts under a Deed of Undertaking

Responses invited by: Midday on 24 December 2021

To: enquiries@gasgovernance.co.uk

Please note submission of your representation confirms your consent for publication/circulation.

Representative:	Phil Hobbins
Organisation:	National Grid NTS
Date of Representation:	22 nd December 2021
Support or oppose implementation?	Support
Relevant Objective:	a) Positive c) Positive d) Positive

Reason for support: *Please summarise (in one paragraph) the key reason(s)*

In the current market conditions, there remains a heightened risk of shipper insolvency and hence termination from the UNC, potentially leading to suppliers not having shipping arrangements in place and hence no party delivering gas to the system to meet the demand from a terminated shipper's portfolio of supply points. The implementation of Modification 0788 and the potential application of the Special Administration Regime provide some mitigation for this scenario, however, as the former is a voluntary arrangement and the latter dependent on the circumstances in a particular case and subject to Secretary of State approval, we believe that the solution proposed by Modification 0791 is required.

If the criteria for National Grid NTS to commence gas procurement contained in the Modification were to be triggered, implementation would be likely to result in lower system prices than would otherwise be the case, helping to alleviate the current financial challenges being faced by many market participants and thereby helping to secure effective competition under Relevant Objective (d). Enabling National Grid NTS to trade in markets other than the OCM to fulfil the procurement requirement manages the risk of it becoming a dominant party in the within-day market and promotes the fulfilment of its obligations in a more efficient manner to the benefit of Relevant Objective (c), whilst also reducing the scope for system prices not being reflective of supply/demand fundamentals which should result in more efficient system usage and operation, to the benefit of Relevant Objective (a).

We believe that it is neither appropriate nor desirable for National Grid NTS in its role as the residual balancer to procure gas in these circumstances and have demonstrated the potential scale of the debt that the balancing neutrality account could be required to support if this continues to be the case. We have also listened to feedback from our customers who believe that an alternative solution of placing responsibility on all other shippers to directly procure gas in this situation would cause practical difficulties and inequitable outcomes. Therefore, until a more comprehensive regulatory review can be completed which addresses the core issue of a lack of continuity in shipping arrangements in these circumstances, we believe that the solution proposed in UNC0791 represents a pragmatic and proportionate response to work in conjunction with the already implemented Modification 0788.

Implementation: *What lead-time do you wish to see prior to implementation and why?*

We believe that it would be possible to commence the new gas procurement activity with a minimal lead-time following an Ofgem direction to implement UNC0791, although this would only be required if the criteria to trigger the proposed gas procurement activity actually arises.

There is a requirement for the CDSP to deliver an automated tool in order to process the balancing neutrality reconciliation (as envisaged in stage 2 on the schematic on page 14 of the Modification Proposal). However, given that this tool is only required to be in place from two months after any gas procurement activity, this Modification could still be implemented before the tool is available. Due to the relatively low cost of delivering this tool compared to the potential benefit of UNC0791, National Grid NTS has already

instructed the CDSP to start development work on it and we expect it to be available by mid-March 2022.

As also mentioned in the Modification, there are some additional information requirements that we would need from the CDSP to enable estimation of the procurement volume requirements and these are included within the same Change Proposal as the reconciliation solution. Additional processes need to be set up by the CDSP to deliver this on an enduring basis but if the Modification were approved and gas procurement activity required before mid-March 2022 then this information would still be obtainable via manual processes until the Change Proposal is implemented.

Impacts and Costs: *What analysis, development and ongoing costs would you face?*

The CDSP provided an initial estimate of between £9k and £18k to deliver the automated reconciliation tool which we reported in the Modification Proposal. Since then, the CDSP has examined the requirements in more detail and has provided a Business Evaluation Report quoting costs of £20.4k to deliver the automated reconciliation tool and additional processes to provide the data to inform the procurement requirement. Additionally, we are working internally to put in place the necessary procedures and processes to enable National Grid NTS to undertake this role should a positive implementation decision be made, however we expect any associated further development costs to be minimal.

Legal Text: *Are you satisfied that the legal text will deliver the intent of the Solution?*

Yes.

Modification Panel Members have requested that the following questions are addressed:

Q1: CPoSD role start trigger:

Do you believe the trigger of 10,000,000 kWh for commencement of the CPoSD role is appropriate? This figure of 10,000,000 kWh is considered to be a reasonable threshold for action to be taken separately to residual balancing, given that the average absolute shipper imbalance on days when no residual balancing trades were undertaken by National Grid NTS over the period 01/10/20 to 30/09/21 was 13.3GWh/day and was 13.1 GWh/day over the same period when the system was short of gas. If not, please justify your answer - do you have an alternative figure and why is this more appropriate?

As the Proposer of this Modification, we feel that it is appropriate to base the volume trigger for such gas procurement activity to begin on a historical level of shipper imbalance for which no residual balancing trades were taken, as proposed in the Modification. We would also note that this threshold would be net of any contributions to the terminated shipper's imbalance as a result of Modification 0788.

Q2: CPoSD role end trigger:

Do you believe the trigger of 100,000 kWh for ending of the role of the CPoSD is appropriate? A minimum volume of 100,000 kWh is proposed because this is approximately the minimum trade quantity available on the OCM. If not, please justify your answer.

As Proposer of this Modification, we also agree that 100,000 kWh is an appropriate trigger to cease the gas procurement activity; in our view it would neither be meaningful nor practical to seek to source gas for a lower volume than this. Once this role starts, the aim is to minimise the impact of the shipper failure on residual balancing activity, therefore, as Proposer we believe that it is prudent for the role to continue until such time as the volumes are small to keep the requirement outside of the residual balancer role for the reasons outlined in the Modification. We would note that the thresholds to start and stop the proposed procurement arrangement were discussed as part of the Modification 0789/A workshops with no dissenting views.

Q3: CPoSD role performance

Considering the new role for National Grid NTS of CPoSD and the need for economic and efficiency in decision making, do you believe that the wording in the commentary (see below) relating to UNC Section D 6.3.4 "on an economic basis"

<i>New paragraph 6.3.4</i>	<i>And when purchasing gas under paragraph 6 National Grid NTS will aim to do so on an economic basis.</i>
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- i) has a legal definition,*
- ii) provides sufficient protection to industry or not and*
- iii) could have any unintended consequences or not?*

Please provide an explanation for each response.

- i) We do not believe that the wording "on an economic basis" has a specific legal definition. Rather, the section of the legal text that requires purchases and any sales of gas to be conducted "with a view to the economic purchase" of the required volume means that economy in such procurement shall be the aim of National Grid NTS, which in practice would be discharged by a mix of forward and prompt gas trades.

It is appropriate that this is an aim rather than an absolute obligation because it cannot be guaranteed; for example, if the gas price were to fall materially between forward trades and the day of delivery then prompt purchases alone could – with the benefit of hindsight – have been the cheaper option. However, forward purchasing to hedge this risk is the prudent approach to secure some of the volume requirement ahead of delivery in order to avoid potential liquidity issues, provide cost certainty ahead of delivery and mitigate exposure to market volatility. Whilst we would have some freedom to structure the actual procurement strategy, this wording effectively creates an obligation on National Grid NTS to select the best possible price when trading and to endeavour to secure a reasonable proportion of the forecast volume requirement on a forward basis.

- ii) In developing UNC0791, we have tried to strike a balance between setting an explicit trading strategy whilst retaining a degree of flexibility to procure volumes based on our view of market prices at the time. We feel that the approach we have proposed fulfils this given the inherent uncertainty in how market prices will move between the point of trade execution and the day of delivery. We feel that an

obligation to endeavour to procure this gas economically, consistent with the wider efficiency and economy obligations in our Licence, is sufficient to assure industry that the activity will be undertaken with the right amount of diligence and control.

- iii) We are not aware of any unintended consequences that could arise from obliging National Grid NTS to endeavour to conduct this gas procurement activity economically. The obligation to endeavour to buy some of the forecast requirement in the forward markets should minimise the risk of National Grid buying material volumes and occupying a dominant position in the market.

Q4. CPoSD monitoring and audit

Do you have any views on an appropriate monitoring and audit process for this new CPoSD role?

Transparency in relation to the CPoSD role was an issue that was debated in the Modification 0789 workshops, and we believe that an obligation to announce to the market when the role has been triggered and when it has ceased – as is proposed in UNC0791 – was the majority view. It was recognised in this discussion that National Grid NTS has obligations in its Licence to undertake its activities on an economic and efficient basis which are further reinforced by the legal text for this Modification.

Aggregate gas procurement costs as a consequence of this role will be available on the monthly balancing neutrality statement published by the CDSP. We do not see value in reporting individual transactions and indeed this may be unhelpful because it may then be possible to argue that gas could have been procured at a lower cost but only with the benefit of hindsight.

Ofgem have requested that the following questions are addressed:

Q5. What is the likely impact on consumers, industry and the market if the status quo for shipperless sites was maintained this winter (the status quo being National Grid NTS procuring the gas for shipperless sites through Residual Balancing)? Please justify if you think it is necessary to have an alternative solution in place.

It is impossible to be precise about the impact of maintaining the status quo because we do not know whether any more shipping businesses will cease trading and leave unsupported demand in the market. Rather, the 0791 proposal recognises that there is a *risk* of this happening and seeks to apply further mitigations to limit the impact, should it happen.

Our latest analysis contained within the Modification shows that where a shipper with a portfolio of 800,000 meter points fails and the associated Supplier/s elect to operate under a deed of undertaking, the peak exposure for the balancing neutrality account would be £374m. We would now regard this portfolio size as a reasonable worst-case scenario but would also note that this assumed a gas price of 225p/therm, which is somewhat below the current market prices for the remainder of the winter. This value would be materially reduced in all the scenarios we have modelled if UNC0791 were implemented. The costs of residual balancing trades feed into cash-out prices which shippers are exposed to and if the volumes associated to such trades were material then these could be expected to lead to higher system prices, the costs of which would ultimately be borne by consumers.

We therefore believe that it is appropriate to have an alternative solution in place that mitigates this risk by enabling a more considered procurement strategy, avoids such costs feeding into cash-out prices and which reduces the risk of the balancing neutrality account accumulating significant and potentially unsustainable debt pending cost recovery via Balancing Neutrality Charges.

Q6. What is the likely impact – both positive benefits and negative consequences/risk - of UNC0791 and the Contingency Gas Procurement Arrangements on consumers, industry and the market?

We believe that the implementation of UNC0791 would lead to reduced costs for consumers when compared with maintenance of the status quo (if the criteria for these contingency arrangements were met).

Under existing arrangements, the costs of residual balancing actions are socialised across all Shipper Users. The proposed approach would avoid additional gas procurement activity being undertaken by National Grid NTS in its residual balancing role, with such gas being alternatively procured via a wider range of tools and timescales. We would expect this to result in lower system prices than would otherwise be the case, therefore ultimately resulting in lower costs being passed through to consumers.

By enabling a solution in which price risk can be hedged, the potential for the additional gas volumes to be sourced more economically than purely on prompt markets is increased. It would also help manage the risks of National Grid NTS being unable to secure the volumes required and taking a dominant and distressed position in a particular market which would drive higher prices. By mitigating these price effects, the proposed CPoSD role should help to minimise the risk of other shippers becoming insolvent and thereby help to maintain the integrity of the GB gas market.

When operating under its 'deed of undertaking' in these circumstances, a supplier would still be exposed to cash-out at the SMP buy price. We believe this is appropriate because it incentivises the party operating in this way to put in place new shipping arrangements, whether this be via the utilisation of the Modification 0788 solution (which itself reduces the likelihood of arrangements under this Modification 0791 being triggered) or via putting in place a new Registered User. Additionally, this treatment of an imbalance at SMP buy maintains consistency with all other parties who are short of gas on the day. We would expect the SMP buy price to be lower than it would otherwise be had the gas been procured via the residual balancer, so parties who are exposed to that price under the deed of undertaking are still likely to be in a more favourable position compared to the status quo.

Q7. What do you see as the costs and/or risks of National Grid NTS operating in markets outside of the OCM in this manner?

We already have arrangements in place to conduct 'over the counter' trading and trading on exchanges as well as on the OCM for shrinkage purposes, and so therefore do not envisage there to be any additional costs for National Grid NTS of operating in markets outside the OCM. Set up of this new trading function will ensure separate accounting for shrinkage and CPoSD trades.

We do not consider there to be a risk of National Grid NTS essentially assuming the role of a shipper as a consequence of this Modification because there would be no contractual arrangement with either suppliers or consumers to sell the gas on to; rather, our position of cash-neutrality would be maintained. Any risks of National Grid NTS being a dominant player in a particular market would be further mitigated by an ability to access a variety of market venues and procurement timescales compared to those available in the residual balancer role.

Other mitigations exist that may prevent the need for the CPoSD role to be performed, including the Special Administration Regime, Last Resort User appointments and opportunities for relevant supplier(s) to mitigate their SMP buy exposure via the provisions in Modification 0788. Furthermore, as supply points associated to a terminated shipper would transfer to other shippers over time, any such procurement activity would be temporary in nature.

We therefore regard this solution as a pragmatic response that is appropriate for the current market circumstances until a more comprehensive review of regulatory arrangements in these circumstances can be completed and an enduring solution established that addresses the core issue of maintaining continuity in shipping arrangements in all cases.

Larger market risks arise in our view from maintaining existing arrangements where National Grid NTS has the potential to become a counterparty to large proportion of 'on the day' trades which would (a) threaten its ability to secure the required volumes (b) drive up system prices and therefore costs for shippers and (c), threaten to burden the balancing neutrality account with potentially unsustainable debt.

Are there any errors or omissions in this Modification Report that you think should be taken into account? *Include details of any impacts/costs to your organisation that are directly related to this.*

No.

Please provide below any additional analysis or information to support your representation

No.