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Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification proposal 685 'Amendments to Provisions for the Calculation of Relevant Balancing Indebtedness of a Trading System Operator'

Ofgem has carefully considered the issues raised in modification proposal 685 'Amendments to Provisions for the Calculation of Relevant Balancing Indebtedness of a 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

Under network code Transco is responsible for the physical balance of the National Transmission System (NTS). Each shipper is responsible on a daily basis for controlling how much gas it inputs into the pipeline system and for monitoring its suppliers' customers' offtakes. If there is a difference in aggregate between the inputs made by shippers and offtakes taken by their customers Transco buy and/or sells gas to maintain overall system balance.

The New Gas Trading Arrangements (NGTA), implemented in October 1999, saw the introduction of the on-the-day commodity market (OCM) for gas balancing. The OCM is an anonymous, screen-based market used by shippers to trade with Transco and each other for short-term within-day and day-ahead gas balancing. The OCM is used by Transco to perform its responsibilities as the residual system balancer and by shippers to balance their portfolios thereby minimising any balancing costs. Transco has obligations and incentives to balance the system in an economic, efficient and coordinated manner. However, Transco is not directly exposed to energy balancing costs, as these are recovered from all shippers. Any shipper

imbalances are subject to cash-out prices reflecting the cost of Transco's balancing actions, which is normally the prices traded in the OCM.

The OCM operator (Trading System Operator), 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 Trading System Operator (SO) 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.

All users must comply with the energy balancing credit regime specified in the network code supplement (section X) and the Energy Balancing Credit Rules (EBCR). Transco operates as the (revenue neutral) Credit Risk Manager (Energy) (CRM(E)) on behalf of users on its network, applying the EBCR in accordance with the instructions of the Energy Balancing Credit Committee (EBCC), whose members are drawn from and represent the interests of shippers operating on Transco's network. The EBCC and Transco CRM(E), seek to minimise the potential financial risk to the shipping community, who assume a share of the credit risk associated with other user's energy balancing activity. Defaulting shippers' unpaid charges are apportioned (smeared) across all users.

Transco in its role as CRM(E) has an obligation to monitor each user's relevant balancing charges and the amount of the user's outstanding relevant balancing indebtedness. When assessing a user's total exposure on any one day, Transco applies an accrual; 'Anticipated Balancing Indebtedness' (ABI)[1], which is designed to take into account the previous 9 days' allocations (for which actual data will not normally be available)[2]. However, in the case of the Trading SO, whilst it is not currently used to calculate indebtedness, actual trading activity data will be available to Transco on the following business day.

Each user is allocated a cash call limit, which will be a value not exceeding 85% of its secured credit limit. This will be the limit on the user's outstanding relevant balancing indebtedness. Where a user's indebtedness (which includes amounts due under energy balancing invoices) exceeds its cash call limit, Transco will issue a cash call notice (CCN). Users are required to pay amounts set out in CCNs within the next day. If Transco does not receive these funds it issues a failure to pay cash call notice, if a user does not pay within three days Transco can at its discretion issue a termination notice.

As noted above, as a result of being counter-party to all OCM trades the Trading SO has little control of its trading position. For instance, when the NTS is long[3] Transco sells gas on the OCM resulting in an increase in the Trading SO's energy balancing indebtedness. The Trading SO's indebtedness can and has escalated rapidly at short notice. Under the credit regime the

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[1] As introduced by modification 0474 'Revision of Indebtedness Cash Call Trigger'

[2] ABI is calculated based on a formula that takes account of the previous 10 days' activity adjusted to account for standard deviation.

[3] Where aggregate shipper offtakes are less than inputs

Trading SO could be required to put in place a secured credit limit of theoretically unlimited value at short notice.

The credit regime recognises the unique risks faced by the Trading SO with the existence of an additional trigger when the Trading SO's outstanding relevant energy balancing indebtedness exceeds 60% of its secured credit limit. Where the 60% trigger is activated, Transco is required to convene an emergency operational meeting of the EBCC to determine action to be taken. These credit arrangements are in place to avoid potential loss of use of the OCM to Transco, through restrictions being applied to its trading account, should the Trading SO be unable or unwilling to increase its security.

Given that it is available to Transco, if the Trading SO's outstanding indebtedness were calculated based on actual trading data, rather than by applying an accrual, superfluous emergency operational meetings of the EBCC might be avoided, thereby avoiding unnecessary administrative costs.

The modification proposal

Transco has proposed that the calculation of the Trading SO's outstanding relevant balancing indebtedness is based on actual data of the Trading SO's trading activities rather than on the ABI.

This proposal has been raised on the basis that the use of actual trading data will reduce the likelihood of the Trading SO breaching it credit limits and consequently reduce the likelihood of unnecessarily convening an Emergency Operational Meeting of the EBCC.

Respondents' views

Five representations were made, all of which supported the implementation of the modification proposal. Respondents consistently stated that the use of actual data would improve the measurement of indebtedness and that the Modification Proposal would reduce the risk of Emergency Operational Meetings of the EBCC being called unnecessarily. RWE Innogy noted that the proposal ensures that the Trading SO has lodged credit cover for their actual position and there is less risk on other market participants. Powergen suggests that Transco considers the rate of change of indebtedness and the normal operating band of the organisation in monitoring and assessing the balancing indebtedness of the Trading SO. Transco agreed with the views of representatives.

Transco's view

Transco supports the implementation of this modification proposal.

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 recognises that access to reliable and meaningful information could enable the EBCC to determine acceptable levels of exposure, thereby avoiding the effective suspension of the OCM by allowing the Trading SO to trade in excess of 100% of its secured credit limit. An improved

measure of outstanding relevant balancing indebtedness may reduce the risk of Transco's OCM trading account being restricted and therefore the unavailability of the key tool currently employed by Transco in gas balancing.

Ofgem considers the implementation of this modification proposal would better facilitate the achievement of the code relevant objectives for the following reasons. Ofgem concurs that accurate information provides transparency and may reduce unnecessary administrative procedures thereby securing effective competition between relevant shippers and between relevant suppliers. Furthermore, Ofgem believes that more robust information regarding the Trading SO may have implications for the availability of the OCM (when the Trading SO has breached its credit limit). A more accurate measure of balancing indebtedness should allow the EBCC to make better informed decisions regarding the availability of the OCM or increases in the Trading SO's secured credit limit. The availability of the OCM which is an effective mechanism for balancing the NTS as well as individual portfolios facilitates the efficient and economic operation of the transmission network.

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, Modifications