ofgem

Promoting choice and value for all gas and electricity customers

Modification proposal:	**Uniform Network Code (UNC) 125: Introduction of new balancing neutrality charge for cost of residual balancer collateral on the OCM (UNC 125)**		
Decision:	**The Authority[1] directs that this proposal be made**		
Target audience:	**The Joint Office, Parties to the UNC and other interested parties**		
Date of publication:	**30 January 2007**	Implementation Date:	**1 February 2007**

Background to the modification proposal

The On the Day Commodity Market (OCM) was designed to allow Shippers to balance their own supply-demand portfolios and National Grid Gas NTS (National Grid) to balance the National Transmission System in aggregate. EnMO (now APX gas Ltd) was appointed by National Grid as operator of the OCM on 4 June 1998.

Last year APX decided to apply for FSA authorisation[2], a requirement of which is the full collateralisation of all the markets it operates, which includes the OCM[3]. This means that APX must comply with all the relevant FSA requirements for operating a traded market, including any associated legislation.

This raises a number of issues relating to the implementation of the Markets in Financial Instruments Directive (MiFID), due to come into effect from 1 November 2007[4]. APX believes that the implementation of this Directive will change the rules for determining whether a product is classified as an investment[5]. As part of this, APX has indicated that certain OCM trades will be classed as investments and will therefore require collateralisation.

To facilitate this change, last September APX amended the OCM rules to reflect the new collateralisation requirements. As a result of this change, National Grid, as an active participant on the OCM in its role as System Operator, is required to provide collateral for trades it conducts on the OCM[6]. National Grid are of the view that as the balancing actions it takes on the OCM are undertaken on behalf of, and are funded by, gas Shippers, the costs associated with providing the necessary collateral for these trading activities should be funded by the community.

The modification proposal

UNC 125 (the proposal) was raised by National Grid on 1 December 2006. The proposal seeks to introduce a new element to the balancing neutrality charge. This would enable

[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] APX Group decided to apply for authorisation to allow APX to bring both APX power and APX gas under a single legal entity and ultimately one trading platform.

[3] Previously, EnMO had obtained an exemption from HM Treasury from direct regulation by the FSA.

[4] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. The Directive introduces a regime governing organisational and operating requirements for investment firms.

[5] Under the current rules a product that is delivered within seven days is not classified as an investment, i.e. gas sold forward but delivered within seven days would not be classed as an investment. However, under MiFID this period is expected to be reduced to two business days.

[6] Although APX amended the rules in September 2006 they have yet to receive authorisation from the FSA which they expect to obtain on 1 February 2007. Hence, NG has not incurred collateral costs over this period.

National Grid to pass through the cost of providing collateral to cover its residual balancing trades on the OCM. With APX's FSA authorisation expected to be granted on 1 February 2007, National Grid has indicated that without the proposal they will be unable to recover costs incurred for collateral on the OCM from 1 February onwards.

National Grid has proposed that in order to recover these costs, the balancing neutrality charge would comprise a daily proportion of the prevailing annual cost of collateral to be allocated to all Users on each Gas Day. The amount allocated to each User would be in proportion to the User's system throughput in the month that the costs are incurred. The charges would be paid by Users on a monthly basis.

National Grid estimates that the annual costs to Users of implementing the proposal will be between £30,000 and £50,000.

Recommendation of the UNC Panel[7] (the Panel)

At its meeting held on 18 January 2007 the Modification Panel unanimously recommended the implementation of UNC 125.

The Authority's decision

The Authority has considered the issues raised in UNC 125 and in the Final Modification Report (FMR)[8]. The Authority has also considered and taken into account the responses received to the Joint Office's consultation on UNC 125 which are attached to the FMR, as well as the UNC Panel recommendation. The Authority has concluded that:

1. implementation of **UNC 125** will better facilitate the achievement of the relevant objectives of the UNC[9]; and
2. directing that **UNC 125** be made part of the UNC is consistent with the Authority's principal objective and statutory duties[10].

Reasons for the Authority's decision

Ofgem considers that the proposal impacts on the facilitation of relevant objective (d) most significantly. Ofgem has considered the merits of the proposal against all UNC objectives, however for the purpose of our decision we consider objective (d) to be of most relevance and have outlined our views below.

Relevant Objective (d) – so far as is consistent with sub-paragraphs (a) to (c) the 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

Ofgem recognises that APX's decision to apply for full authorisation from the FSA means that National Grid will incur additional costs to support its trading activities on the OCM in its role as residual System balancer. We agree with National Grid, and the majority of

[7] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[8] This report is dated 18 January 2007. UNC Modification proposals, Modification Reports and Representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[9] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=8797
[10] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed primarily in the Gas Act 1986.

respondents, that as National Grid undertakes these balancing actions on their behalf, it is appropriate that these costs are borne by Users.

Ofgem believes that NG's proposed methodology for allocating the costs of collateral is fair and proportionate, and consistent with the redistribution of other balancing costs. Ofgem considers that this mechanism will better facilitate competition between relevant parties. Whilst it would be more cost reflective for the costs of collateral, incurred by NG on behalf of Users, to be allocated to those Users who caused those costs to be incurred (i.e. those Users out of balance), rather than on the basis of throughput, Ofgem believes that the proposed arrangements represent an improvement on the current position.

Ofgem recognises the concern raised by some respondents regarding the transparency of National Grid's proposed arrangements, in particular, that information regarding the actual volumes of collateral to be provided will not be released. However, we would note that in carrying out its activities National Grid has licence obligations to operate the system in an economic and efficient manner[11]. As such, in taking actions on the OCM, costs incurred by National Grid will therefore not only be subject to scrutiny by Ofgem (to ensure that costs are efficiently incurred), but will also be subject to external oversight as part of its annual System Management Principles Statement and Procurement Guidelines audit[12]. We consider that the existence of these arrangements should provide Users with reassurance that these costs will be efficiently incurred.

A number of respondents expressed further concern that the financial obligations on User's were unclear in the event that National Grid was required to provide significant levels of additional collateral to cover actions taken (e.g. in the event of large or prolonged price spikes). Respondents noted that this could result in Users facing the risk of unlimited liability. While we note that the proposed cost allocation mechanism will not target the costs to those parties that are most out of balance (and are therefore creating the most costs to National Grid), we consider that the cash out arrangements do continue to provide strong commercial incentives on parties to balance their own positions. As such, while we recognise that at such times, where higher levels of collateral cover are required, that these costs will be passed through to Users, which would likely result in increased financial exposure, in our view the proposed mechanism provides an improvement to the current arrangements where these costs would not be appropriately targeted to Users.

Further, as indicated above, we consider that the obligations on National Grid to ensure that any costs it incurs in carrying out its role as residual balancer are done so in an efficient and economic manner. The existence of arrangements to monitor these costs by Ofgem and external parties should also provide reassurance to Users that these costs are efficiently incurred.

To the extent that parties continue to hold concerns regarding the methodology for incurring these costs, we note that it is open to them to raise further modifications to revise the methodology. However, we would also note that there is balance to be struck between the relative efficiency of a simple allocation mechanism and a more accurate targeting of charges relating to the imbalance position of relevant shippers.

Ofgem also notes the view expressed by some respondents that the cost recovery methodology is unduly complex and costly. We consider that rather than introducing

[11] Special Condition C5 of National Grid Gas (NTS)'s Gas Transporters Licence.

[12] National Grid is subject to an annual external audit under Special Condition C5(7) of its Gas Transporters Licence.

other, potentially costly or complicated, mechanisms for recovering collateral costs, use of the existing balancing neutrality charge mechanism to allocate these costs appears to be a more proportionate means of achieving this. In doing so we agree with National Grid that this is likely to reduce the administrative burden and hence cost of revenue recovery. Therefore, on balance, we believe that the method proposed appears to be an efficient way of allocating collateral costs to Users.

Finally, we note that the approach proposed by National Grid to allocating the costs relating to the provision of collateral is consistent with that in place in the wholesale electricity market. In the electricity market, National Grid is required, to post sufficient collateral to undertake trading on the power exchanges, with the associated cost recovered fully from industry participants via BSUoS charges.

Ofgem therefore believes that the proposed changes would better facilitate the achievement of the Relevant Objective (d).

Ofgem's view against the relevant objective

Overall Ofgem considers that the proposal would better facilitate the achievement of the relevant objective (d) by targeting costs incurred by National Grid in carrying out its role as residual balancer, by allowing these costs to be shared equitably between relevant Shippers.

Ofgem believes that the proposed collateral cost recovery mechanism would better facilitate the relevant objectives, if and when NG is required to provide any such collateral.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority hereby directs that modification proposal UNC 125: Introduction of new balancing neutrality charge for cost of residual balancer collateral on the OCM be made.

Stephen Smith
Managing Director, Markets
Signed on behalf of the Authority and authorised for that purpose.