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### Note:

On 16 June 1999, the former regulatory offices, Ofgas and Offer, were renamed the Office of Gas and Electricity Markets (Ofgem). References in the text to documents and events before this date use the name of the original regulatory office.

# 1 Introduction

## **1.1 Purpose of this Document**

A major part of the new gas trading arrangements, to be introduced from 1 October 1999, is the launch of the on-the-day commodity market (OCM) for gas. The introduction of the OCM is conditional upon, amongst other things, the Director General of Gas Supply (DGGS) designating the market operator, EnMO. This document sets out the reasons for the DGGS' decision to designate EnMO as the market operator for the OCM. It also outlines in detail the framework for the regulation of all participants in the OCM including shippers, Transco and the market operator.

## **1.2 New Gas Trading Arrangements**

The NGTA include the introduction of:

### ***For the Gas Balancing Regime:***

- ◆ an independently operated, screen-based, on-the-day commodity market (OCM), which shippers can use to fine-tune their own gas balance and which Transco can use in its role as residual gas balancer. This should reduce overall gas balancing costs through increased liquidity and transparency in the within-day market for gas; and
- ◆ commercial incentives on Transco as residual gas balancer which should reduce the overall costs Transco incurs in balancing the system, as well as unwarranted price volatility and extremes in cash-out prices for out of balance shippers.

### ***For the Capacity Regime:***

- ◆ an efficient, non-discriminatory method of selling firm entry rights to the National Transmission System (NTS) related to the physical capacity available. This will be achieved through the introduction of price auctions for the sale of entry capacity; and
- ◆ appropriate commercial incentives for Transco to maximise the availability of capacity.

### **1.3 Market Operator and Designation**

As part of the review of gas trading arrangements, Ofgas and Transco issued a Request for Proposals in May 1998 for an independent market operator to run the OCM. Forty-eight interested parties responded and from this, a short list of seven companies was selected.

Subsequently, a competitive tender was organised and evaluation of bids by the Tender Evaluation Panel (TEP)<sup>1</sup> led to EnMO being awarded the tender to operate the OCM in June 1999. EnMO is a consortium made up of ESIS (a wholly owned subsidiary of the National Grid Company which currently manages and operates the England and Wales Pool system for electricity), and Altra (a US energy trading company that runs a number of gas markets in North America). Following detailed contractual negotiations, an appointment contract between Transco and EnMO for EnMO to operate the OCM was signed on 1 September 1999.

Ofgem recently made a number of modifications to BG plc's Public Gas Transporter (PGT) licence to facilitate the implementation of the new gas trading arrangements. Ofgem modified Standard Condition 7 of the licence to allow for effective regulation of the OCM. Standard Condition 7 requires Transco, when appointing an independent market operator for gas balancing, to appoint an independent market operator (IMO) that meets a number of requirements. The requirements are satisfied if Transco appoints a person that is either recognised as an investment exchange under the Financial Services Act 1986 (FS Act) or is designated by the DGGS. Designation by the DGGS is on the basis of a set of Designation Criteria.

As EnMO is not recognised as an investment exchange under the FS Act, it has sought designation by the DGGS.

### **1.4 Outline of the Document**

Chapter 2 sets out the regulatory environment in which the OCM and market participants will operate. Chapter 3 details the Designation decision, the reasons for that decision and the process followed by Ofgem in reaching that decision. Chapter 4

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<sup>1</sup> Comprised of Transco, shipper and Ofgas representatives.

outlines how Ofgem will regulate OCM participants: the market operator, Transco and shippers.

Appendix 1 sets out the notice of Designation of EnMO as market operator and the Designation criteria. Appendix 2 sets out Ofgem's amendments to EnMO's draft market rules to be incorporated prior to market launch. Appendix 3 contains an open letter from Ofgem to the industry. Appendix 4 contains copies of letters from EnMO to Ofgem setting out its agreement to Ofgem's pre-conditions for market launch.

## **1.5 The Way Forward**

### **1.5.1 Network Code Modifications**

On 1 September 1999, Ofgem published a document<sup>2</sup> setting out our decisions in relation to three proposed modifications to Transco's network code (modifications 313, 314 and 350) which were required in order to implement new gas balancing and new entry capacity arrangements from 1 October 1999.

#### **a) The Gas Balancing Regime**

On 1 September 1999, the DGGs approved Transco's modification proposal 313 and directed Transco to implement the proposal with effect from 1 October 1999. Implementation of modification 313 is subject to a number of key conditions that must be met before the modification can be put into effect.

#### **b) The Entry Capacity Regime**

On 1 September 1999, the DGGs directed Transco to implement modification proposals 314 and 350. The DGGs has also approved Transco's revised pricing consultations PC 48 and PC 49 that set out the methodology for calculating the reserve prices for the monthly and daily auctions. The initial auctions of 25% of NTS system entry capacity, commenced on 8 September 1999. Subsequent auctions (each covering a further 25% were scheduled at two working day intervals, ie. on 10 September, 14 September and 16 September. The new entry capacity regime will take effect from 1 October 1999.

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<sup>2</sup> The new gas trading arrangements: A decision document, Ofgem, September 1999.

### **1.5.2 BG plc's PGT Licence Modifications**

On 7 September 1999<sup>3</sup> Ofgem, by agreement with BG plc, made a number of modifications to BG plc's PGT licence to facilitate the implementation of new gas trading arrangements. The modifications provided for:

- ◆ designation of an independent market operator for the OCM and regulation of that market (Standard Condition 7);
- ◆ the setting of reserve prices for entry capacity auctions within Transco's charging methodology statements (Standard Conditions 3 and 4); and
- ◆ changes to ensure the proper functioning of Transco's capacity and gas balancing incentive schemes (Standard Condition 9C).

### **1.5.3 Designation of OCM Market Operator**

As set out in this document, the DGGS has formally designated EnMO as market operator for the OCM. HM Treasury will now be seeking an Order, exempting EnMO from the relevant provisions of the Financial Services Act 1986. Subject to this order being put in place and a number of other conditions being met, trading on the OCM will begin on 1 October 1999.

### **1.5.4 The Health and Safety Executive's Approval of Transco's Revised PGT Safety Case**

The Health and Safety Executive (HSE) have identified the following issues that are key to its acceptance of Transco's revised safety case. (The issues identified by the HSE are a sub set of the conditions precedent identified by Transco, EnMO and Ofgem.)

The issues identified by the HSE are that:

- ◆ a contract between Transco and the Independent Market Operator (IMO) has been agreed;
- ◆ the computer systems essential to the operation of the OCM are in place, tested and functioning;

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<sup>3</sup> The new gas trading arrangements – Modifications to BG plc's PGT licence: A decision document, Ofgem, September 1999.

- ◆ a sufficient number of shippers have signed contracts to participate in the OCM to allow the market to operate adequately; and
- ◆ adequate arrangements are in place for co-operation between the IMO, Transco and the National Emergency Co-ordinator (NEC) in the event of a network gas supply emergency.

HSE has indicated that, subject to written confirmation from Transco that all of these issues have been resolved, it will approve Transco's revised safety case prior to the introduction of the new trading arrangements.

If you wish to discuss any aspect of this document, Stephen Smith (0207 932 5927) or Adam Cooper (0207 932 5938) would be pleased to help.

## **2 The Regulatory Framework**

### **2.1 Regulation of the on-the-day Commodity Market**

#### ***The Need for Appropriate Regulation***

The need for appropriate regulation of the OCM was originally outlined in Ofgem's February 1999 document.<sup>4</sup> In that document it was argued that confidence in the OCM will be enhanced by putting in place measures to minimise the possibility of abuse of the market. Regulation needs to minimise the risk of market abuse by both market participants and the market operator. The DGGs, however, is equally aware that inappropriate regulation could increase costs, hinder rather than enhance market liquidity and discourage market participation.

Conduct of participants on the OCM will already be subject to a significant degree of regulatory control by Ofgem through the conditions of their Gas Act licences. Transco's conduct is subject to regulatory control through BG plc's PGT licence. Shippers are subject to control through their shippers' licence. EnMO as independent market operator will be subject to control through its Designation by the DGGs. In addition all participants are subject to general competition legislation where the DGGs has concurrent powers with the Director General of Fair Trading. From March 2000 participants will be subject to strengthened competition legislation set down in the Competition Act 1998.

### **2.2 Exemption from Financial Services Act Regulation**

Ofgem has long recognised that it is possible that trading on the OCM will amount to 'investment business' for the purposes of the FS Act. This was recognised in relation to trading through the flexibility mechanism, the existing mechanism for trading with-in-day gas, and traders on that mechanism are exempt from the requirements of the FS Act by the Financial Services Act 1986 (Gas Industry Exemption) Order. The contract for the OCM was awarded in June 1999 and EnMO, a joint consortium between ESIS and Altra, was formed thereafter. EnMO is currently neither authorised under, nor exempted from the FS Act. Given that the OCM will act as a replacement for the flexibility mechanism, in which shippers source gas for balancing purposes, it is questionable whether it is

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<sup>4</sup> Reform of Gas Trading Arrangements: Proposals and Consultation, Ofgas, February 1999.

appropriate to impose the fully rigour of FS Act regulation on market participants. It was therefore proposed that trading on the OCM should be exempt from the FS Act by means of an Exemption Order similar to that used to exempt the flexibility mechanism.

HM Treasury is in the process of arranging a suitable order to be made. HM Treasury have indicated that subject to Parliamentary scrutiny, the Order will be in place for the start of the market on 1 October 1999.

### ***2.3 The Regulatory Framework for the OCM***

Although the market will be exempt from Financial Services Authority's (FSA) regulation, Ofgem has put in place a regulatory framework similar to that used by the FSA in regulating Recognised Investment Exchanges (RIEs). Under this model, market regulation is primarily the responsibility of the market operator and the FSA only intervenes if the market operator fails in that duty. In a similar manner, the OCM operator, EnMO will be required to ensure that the OCM is run in a fair and orderly manner and that there is no abuse. Ofgem will be responsible for regulating EnMO as independent market operator through the Designation. Where compliance with the criteria is not met, the DGGS has the option to revoke the market operator's designation. In addition, market participants are required to comply with their Gas Act licence obligations and general competition law.



## 3 Designation of the Market Operator

### 3.1 Designation

The recent modification to Standard Condition 7 of BG plc's PGT Licence requires Transco, when appointing an independent market operator for gas balancing, to appoint a market operator that meets a number of requirements including: adequate financial resources, skilled and experienced personnel and systems necessary to operate an orderly market. The requirements are treated as satisfied if Transco appoints a market operator that is either recognised as an investment exchange under the FS Act or is designated by the DGGS. A decision by the DGGS to designate an independent market operator is taken on the basis of a set of Designation criteria (see Appendix 1).

Ofgem has proposed an initial designation period of EnMO as independent market operator for four years. Ofgem believes that this will ensure an element of market stability in the OCM. However, the designation can be revoked by the DGGS on 30 day's notice (and within a minimum period of two months from an initial compliance notice) where the market operator does not continue to meet the Designation criteria. Transco is required to terminate the market operator's appointment contract in such circumstances.

Designation is a necessary, but not sufficient, condition for the market operator to run the market. It does not place any obligation on shippers or Transco to trade on the market, but is merely a pre-condition to ensure that the market operator has the necessary skills and resources to operate an orderly market. Transco only has a one year contract with EnMO to trade exclusively on EnMO's system for gas balancing purposes. At the end of this period it is conceivable that one or more other market operators might have sought designation from the DGGS or recognition from the FSA as an RIE in order to compete with EnMO for Transco's and other participants' business. Whilst it has been suggested that designation of EnMO for 12 months is more appropriate, we believe it is sensible to offer initial designation for a longer period in order to increase confidence in the OCM.

The designation allows Ofgem to check that the market operator meets certain standards appropriate for a market of this kind. In addition, the designation requires the market

operator to co-operate with Ofgem in providing information that will allow Ofgem to effectively regulate conduct on the market and to ensure that participants are complying with their licence requirements.

### **3.2 Designation Process**

Before taking the decision on the designation of EnMO, Ofgem has undertaken a rigorous assessment of the performance of EnMO against the Designation criteria. This assessment included:

- ◆ a diagnostic review performed by KPMG, on Ofgem's behalf, that included a detailed analysis of EnMO's procedures, systems and processes;
- ◆ a legal review performed by Simmons and Simmons, on Ofgem's behalf, of EnMO's draft market rules and other trading contracts; and
- ◆ an Ofgem review of EnMO's access and pricing arrangements to ensure that they are non-discriminatory.

#### **a) KPMG's Review**

KPMG carried out a review of EnMO's readiness for market launch on 1 October 1999. KPMG reported to Ofgem on 7 September. Since then EnMO have made considerable progress in resolving the outstanding issues identified by KPMG.

KPMG reported that the project to implement the OCM is well managed and that EnMO are making good progress against very demanding timescales. In addition, EnMO had scored well on most of the designation criteria. However, KPMG found a number of outstanding issues that needed to be resolved before EnMO could be judged to be meeting the designation criteria. In particular, KPMG identified the following issues relating to each of the designation criteria:

#### *Availability of Facilities*

EnMO plans to sub-contract work to ESIS and EPFAL (two subsidiaries of the National Grid Company), but the relevant contracts were not in place. Testing of EnMO's IT systems had yet to take place. EnMO had not yet agreed the final version of the market rules with market participants and as a result no subscription agreements had been signed. EnMO's business processes had yet to be translated into day-to-day operational

procedures for staff to follow. Finally, documentation of all of EnMO's operational procedures was outstanding.

#### *Fitness*

EnMO is using NGC human resources policies. These are not fully in line with FSA requirements. KPMG recommended that EnMO consider the introduction of a self-certification scheme based upon guidelines issued by the FSA and seek legal guidance to meet full FSA requirements, when and as required. Testing of the Central Trading System systems had yet to take place, although the system had been well tested in live operation in the North American market. EnMO had not yet translated its business processes in to operational procedures and documented them.

#### *Financial Resources*

EnMO was in the process of organising an overdraft facility of £10 million to cover late payment by any market participant and the lead time for credit insurance. This will be secured by credit insurance over the book debts. KPMG expressed concern that overdraft facilities can commonly be withdrawn by a bank with 24 hours notice. EnMO is in the process of organising credit insurance of £25 million but this had yet to be signed. EnMO has working capital of £450,000 and access to loans of £500,000 from National Grid Holdings. EnMO intended to put in place professional indemnity insurance but this has yet to be signed. EnMO was negotiating fidelity insurance to cover fraud and dishonesty but this had yet to be signed. KPMG said that if the market has significantly more volume than is expected, there may be a requirement to review the extent of credit insurance. EnMO had very little contingency reserves of its own.

#### *Co-operation with the DGGS*

KPMG recognised that detailed discussions had taken place on the regular provision of market information to Ofgem and on agreeing a non-legally binding business level agreement between Ofgem and EnMO (setting out, inter alia, Ofgem's regular and ad hoc data requirements and the delivery timescales). At the time of their report Ofgem's regulatory requirements had not been agreed.

#### *Promotion of Good Market Conduct*

KPMG had no adverse comments to make on this criterion.

### *Market Arrangements*

EPFAL will clear and settle the OCM. However, no contract between EnMO and EPFAL was yet in place.

### *Clearing*

The process for clearing is based on EPFAL's experience as market funds administrator in the Electricity Pool. The credit insurance requires that the defaulting company be put into administration or receivership. KPMG noted that this is a severe step in the event of default, although it is quite common in financial markets.

### *Emergency Suspension*

Although business processes have been agreed, these had yet to be translated into operational procedures.

### ***Conclusion on KPMG's Report***

At the time of KPMG's report, EnMO has not fully satisfied the designation criteria. However, KPMG pointed out that although all of the criteria had not been met at the time of its report, EnMO expected to have met all of the criteria in time for the market launch. EnMO's project plan already identified most of the outstanding issues raised by KPMG and work was in hand to resolve them prior to market launch.

### ***b) Simmons and Simmons Review***

Simmons and Simmons reviewed, on Ofgem's behalf, the draft market rules and other OCM related contracts. It reported to Ofgem on 7 September. As a result of their review, Ofgem will require some modifications to the market rules to allow for better alignment with the rules of FSA regulated commodity markets and to increase confidence in the OCM.

Ofgem will require that the market rules place two further obligations on all market participants (initially shippers and Transco). These obligations would increase EnMO's ability to ensure good market conduct by placing a contractual obligation on participants not to try to manipulate the market. The proposed obligations would require participants to:

- (i) act in such a manner so as not to put EnMO in breach of any of the Designation criteria; and
- (ii) observe the equivalent of the FSA's Statement of Principles.

Ofgem has set out the required amendments to the market rules in Appendix 2.

The legal review also highlighted a concern about the risk of exposure to EnMO as a result of counter-party default. EnMO is required under the Designation criteria to put in place sufficient financial resources to avoid the risks of counter-party default. EnMO intends to take out insurance (for default, etc) as is common amongst clearing houses, but the contract has yet to be agreed.

**c) *Ofgem's Review***

Ofgem identified three major concerns as part of our review of EnMO's access and pricing arrangements. They concerned: liabilities in the event that EnMO fails to post a completed OCM trade on Transco's systems; the ability of participants to connect to the OCM by frame relay in time for market launch; and EnMO's proposed pricing structure for market maker schemes.

*Liabilities*

In industry discussions on the proposed market rules, shippers have raised concerns about facing liabilities if trades completed on the OCM are not recorded on Transco's AT Link system. Although the probability of a failure to transmit the necessary information between Transco and EnMO's system is extremely small, the resulting consequential losses to shippers may be relatively large. If the trade nominations are not logged on Transco's systems, shippers may be out of balance at the end of the day and may be cashed out at relatively high prices. Shippers have argued that EnMO, as market operator should pick up all liabilities resulting from a failure to nominate a completed trade on EnMO's system.

EnMO has indicated that it is willing to take responsibility for the liabilities but it is unwilling to face unlimited liabilities on a low margin business. Transco has indicated that it is unwilling to face liabilities over which it has no control. Shippers are concerned that if the liabilities remain with them, it undermines the concept of a cleared

market. Under the conditions of the standard National Balancing Point (NBP) contract used to trade gas on the system between shippers, shippers face unlimited liability.

Ofgem made clear in a recent open letter to the industry (see Appendix 3)<sup>5</sup> that it does not believe that it is appropriate for shippers to face the possibility of substantial losses for a failure by EnMO to nominate a completed trade to Transco. Once they have received confirmation of a trade from EnMO, shippers should be protected from any failure to transmit the necessary information. Ofgem believes that any liability should be placed on whoever is responsible for the liability arising. In the event of a failure on EnMO's part to transmit the necessary data to Transco's system after confirming a trade between market participants, liabilities should rest with EnMO.

Ofgem does not believe that the comparison that has been drawn with the conditions of the NBP contract is appropriate. Although shippers face unlimited liabilities, they freely determine the volume and price of any trade with a counter-party and can therefore quantify any liabilities they face and manage any risk of exposure, EnMO is automatically counter-party to all OCM trades and cannot directly control the volume or value of transactions. EnMO can and should minimise the risk of failing to notify a trade on Transco's system. Recognising EnMO's concerns about facing potentially unlimited liabilities, Ofgem asked EnMO to seek quotes for insurance of the risks. Ofgem argued that this was likely to be the most cost effective route given the very low probability associated with a failure to nominate. EnMO has now arranged insurance, has agreed to absorb the cost and has not attempted to increase any of its fees to participants. The insurance will cover liabilities in the event of a failure to nominate trades of up to £50m.

Ofgem believes that, given the low probability of a failure to nominate trades and the likely value and volume of trades on the OCM, the proposed level of liability insurance is adequate. EnMO has proposed that it will inform Ofgem in the event that the insurance is called upon so that Ofgem can monitor any payments relative to the total level of insurance. In the unlikely event that the insured amount might be breached, leaving shippers to face liabilities, Ofgem would require EnMO to seek alternative arrangements.

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<sup>5</sup> An open letter to the industry on Implementation of the On the Commodity Market on 26 August 1999.

### *Connections to the OCM*

Thirty shippers have signed up for the OCM pilot programme<sup>6</sup> indicating that they are likely to trade on the OCM. A number of shippers however have expressed concern to Ofgem that EnMO were unable to guarantee connection to the market via their preferred connection route in time for market start up on 1 October. EnMO had committed to ensuring that all participants who had placed orders would have an ISDN link to the market but shippers said it was unable to guarantee the installation of a faster frame relay link in time for market start up. By 2 September, 9 shippers and Transco had ordered frame relay connections but only one shipper had been connected.

EnMO has now assured Ofgem that subject to the installation of BT kilostream for one shipper, Transco and the relevant nine shippers will all have frame relay connections installed for market start up on 1 October. EnMO has also assured Ofgem that it will ensure that any new requests for frame relay connections are dealt with quickly and that the connections are installed as quickly as possible.

Ofgem is concerned that all participants have had to use Energis (an NGC subsidiary) to connect via frame relay to the OCM. We understand that Energis claim that it is necessary to have some of the hardware for frame relay installed by them for technical reasons. However, a number of participants have indicated that Energis may not be competitive on price and also offer a poorer service in relation to installation timescales. Guaranteed installation by Energis is within 60 days whereas competitors offer in the region of 25 days. Ofgem has raised this issue with NGC. Ofgem believes participants should be free to use companies other than Energis to connect to the OCM. If participants have incurred additional costs as a result of using Energis, Ofgem would look to NGC to compensate them.

### *Non Discriminatory Pricing*

EnMO has proposed a market maker scheme during the early stages of the OCM to ensure adequate liquidity. This will involve participants being entitled to discounts on transaction fees if they are willing to guarantee that they will always have bids and offers posted for at least a defined quantity of gas.

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<sup>6</sup> The pilot programme forms part of EnMO's system testing and user training prior to market launch.

Ofgem made clear in its recent open industry letter that any volume discounts must be proportionate to the benefits which market makers bring to the market. Ofgem also set out its view that disproportionately high discounts could be discriminatory by favouring dominant players over smaller shippers. To address this concern, EnMO has agreed to gain Ofgem's approval of any market maker schemes before offering them to participants.

EnMO has recently announced that it will not charge any transaction fees for the first two months of OCM operation to encourage participation. EnMO has also announced that transaction and subscription fees will be capped at the previously published levels for the first year of operation to address any concerns of market participants in relation to its pricing. Ofgem welcomes these announcements.

### ***3.3 Ofgem's Decision on Designation***

Following assessment of EnMO's performance against the Designation criteria, Ofgem has written to EnMO detailing the outstanding issues that EnMO must resolve before the OCM can start trading. EnMO has subsequently agreed, in writing, to resolve any outstanding issues before trading commences on 1 October 1999. A copy of EnMO's letter is contained in Appendix 3.

The outstanding issues that EnMO must resolve prior to the launch of the OCM are:

- ◆ the contractual framework between EnMO, ESIS and EPFAL;
- ◆ agreement of the market rules, with the inclusion of Ofgem's amendments and additions;
- ◆ completion of subscription agreements with shippers and Transco;
- ◆ testing of the OCM system, completion of the hardware and software configuration including the link to Transco;
- ◆ arranging adequate financial resources including: the overdraft facility; credit insurance policy; liability insurance policy; professional indemnity insurance policy; and fidelity insurance;
- ◆ defined, documented operational procedures;
- ◆ adequate procedures for market monitoring and the provision of information to Ofgem;



- ◆ a finalised management framework for EnMO; and
- ◆ installation of frame relay connections for Transco and the none shippers.

In response to the concerns expressed by Ofgem relating to EnMO's financial resources, EnMO has put in place a parent company guarantee with National Grid for £10m. This is in addition to the £10m that National Grid will provide as a letter of credit on EnMO's behalf when it accedes to Transco's network code.

To provide further assurance to Ofgem that these issues have been resolved, KPMG will undertake a second review later in September, to confirm that all of the outstanding issues have been resolved. Trading will not commence on the OCM until EnMO are deemed to meet the Designation criteria.

On this basis, the DGGS has designated EnMO as the OCM independent market operator. HM Treasury is aware of this arrangement and is satisfied that the DGGS will revoke the designation of EnMO if it fails to meet the designation criteria to Ofgem's satisfaction. HM Treasury is preparing the exemption order that it will lay before Parliament. Subject to parliamentary scrutiny, the exemption order will take effect from the 1 October 1999.

## **4 Regulation of the OCM**

A key element of the regulation of the OCM will be the active monitoring of the market by Ofgem. Ofgem will monitor the actions of EnMO, as designated independent market operator, Transco in its role as residual gas balancing operator, and shippers who trade on the OCM.

### ***4.1 Monitoring the Market Operator***

Ofgem will monitor the market operator's compliance with the Designation criteria on a continuing basis. Should a breach be found, the market operator will be given an opportunity to remedy this. Failure to remedy a breach could result in the revocation by the DGGS of the independent market operator's designation. In particular, Ofgem will ensure that:

- ◆ adequate and agreed market information is provided to participants in a timely manner;
- ◆ any changes to the market operator's charges are applied in a fair and non-discriminatory manner;
- ◆ systems and facilities provided by the market operator are sufficient and reliable;
- ◆ access to these systems and facilities is provided on a fair and non-discriminatory basis; and
- ◆ good market conduct is being promoted.

### ***The Market Operator's Reporting to Market Participants***

Ofgem believes that the market operator should provide market participants with regular (anonymous) reports on the performance of the OCM in the same way that Transco reported on the operation of the flexibility mechanism. These should include, amongst other things, the number, duration and reasons for any failures of its systems, and the number of market participants, volumes and price movements. Additional information will be provided to Ofgem as appropriate.

### ***Market Maker Scheme***

If a market maker scheme is introduced to ensure adequate liquidity, Ofgem believes that any volume discounts should be proportionate to the benefits which market makers bring to the market. Disproportionately high discounts could be discriminatory by

favouring larger shippers over small. EnMO has agreed to gain Ofgem's approval for its pricing policy to address this concern. Any subsequent changes to its pricing policy will be monitored on a similar basis.

### ***Market Participant Reporting***

Where a market participant believes that the market operator is not continuing to meet its Designation criteria, it can request that Ofgem investigate this suspected breach.

### ***Ofgem's Review***

Ofgem will undertake a review of EnMO within six months of the market launch to ensure its ongoing compliance with the designation criteria. This review will be based on the same model as that undertaken by KPMG on behalf of Ofgem, for the initial designation decision. If the review uncovers any failures by EnMO to comply with the Designation criteria, a notice to comply will be issued by Ofgem.

## ***4.2 Monitoring Transco***

Under the incentive regime introduced under network code modification 313, Transco will be incentivised to undertake its gas balancing actions in a more efficient manner. Initially, Transco will continue to abide by Operational Guidelines (OGs) that are currently being modified to be consistent with the incentive regime. However, Ofgem recognises that in the light of the increased discretion given to Transco under the OGs that there is an important regulatory role in ensuring that Transco is behaving in the market in a non-discriminatory and transparent manner.

To fulfil this regulatory role, the DGGs will require Transco to report on its balancing actions as part of its obligations under the OGs. The information that will be required from Transco is likely to include the timing, prices, volumes and reasons for its trades on the OCM. Ofgem will also monitor Transco's balancing trades as part of its ongoing OCM monitoring.

If it is found that Transco is behaving in the OCM in a manner that is unfair or discriminatory, action may be taken for breach BG plc's PGT licence.

### **4.3 Monitoring Shippers**

#### ***EnMO's Monitoring***

As market operator, EnMO is required under its designation to promote good market conduct. As is common in other markets EnMO has drafted a set of market rules for the OCM to ensure that participants comply with the market rules. In the event of non-compliance by a participant, EnMO can apply a number of sanctions as outlined in the market rules. These include suspending a users access to the OCM when the user has failed to rectify a breach of the market rules in the time provided for and levying financial penalties for failures to pay accounts on time.

The market rules governing the conduct of the market operator and market participants are the subject of commercial agreement between EnMO and market participants. In order to develop these rules, detailed consultation with the industry began in June 1999 following the appointment by Transco of EnMO as market operator. Throughout this consultation process, differences of opinion have arisen between EnMO and market participants with regard to certain key issues. As noted above, on 26 August 1999, Ofgem issued a letter that set out our concerns and suggested resolutions for the outstanding issues (see Appendix 4). A timescale has now been agreed for the resolution of these issues and the finalisation of the market rules. Ofgem will continue to monitor the evolution of the market rules until completion.

Market monitoring by EnMO will provide valuable insights into possible improvements to the market and market software. EnMO's software is designed to learn from live market operation and can be adapted to minimise the risk of price manipulation by participants in future.

#### ***Ofgem Monitoring***

As part of its Designation, EnMO is required to co-operate with the DGGS to facilitate the on-going regulation by Ofgem of OCM participants.

Ofgem has been in discussions with EnMO concerning the routine transfer of trading data that will be subject to analysis. Arrangements are also being developed for requesting specific data and analysis from EnMO. The confidential nature of the information is recognised, and it will be treated with the same level of confidentiality and security that Ofgem currently gives to information from the flexibility mechanism.

Once the OCM commences EnMO will provide Ofgem, on a regular basis, with the following data after each trading day. If necessary, this information will be augmented by specific requests by Ofgem to EnMO:

- ◆ all completed trades;
- ◆ agreed prices;
- ◆ counter parties;
- ◆ volumes;
- ◆ types of trades (including location where appropriate); and
- ◆ time of trades.

This data will be provided through an existing data link between ESIS (EnMO's parent company) and Ofgem.

Ofgem will also have access to a live trader screen from 1 October, and the analytical tools that form part of a subscriber's package. In addition, EnMO will provide Ofgem with incident reports in the event of rapid movements in OCM prices outside of normal trading bands.

EnMO have confirmed that have recruited a number of experienced operational staff from Altra's North American operations to monitor the market. The results from EnMO's analysis will be made available to Ofgem on a regular basis.

## **Appendix 1 – Notice of Designation and Designation**

### **Criteria**

#### **Designation for the purpose of paragraph (4B) of Standard Condition 7 of the Public Gas Transporter Licence of BG plc**

The Director General of Gas Supply (the Director) for the purpose of paragraph (4B) of Standard Condition 7 of the public gas transporter licence of BG plc hereby designates E<sup>n</sup>MO (the Operator) subject to the following conditions.

1. This designation shall take effect on 1 October 1999 and shall continue in force until 30 September 2003 and thereafter until determined at or after that date by notice in writing served by the Director or the Operator on a day at least one year before the notice is to take effect, unless previously revoked in the manner hereinafter provided.
  
2. The Director may at any time revoke this designation by not less than the requisite period of notice in writing given to the Operator –
  - (a) if the Operator requests or otherwise agrees in writing with the Director that this designation should be revoked;
  - (b) if the Operator fails to comply with the requirements of a notice issued by the Director calling upon the Operator within a period specified in the notice to take the action specified in the notice to make good a failure described in the notice to continue to meet the criteria for designation applied and published by the Director at the time of making the designation;
  - (c) if the Operator –
    - (i) is unable to pay its debts (within the meaning of section 123(1) or (2) of the Insolvency Act 1986 but subject to paragraph 2 below) or any voluntary arrangement is proposed in relation to it under section 1 of that Act or it enters into any composition or scheme of arrangement (other than for the purpose of reconstruction or amalgamation upon terms and within such period as may previously have been approved in writing by the Director),

- (ii) has a receiver (which expression shall include an administrative receiver within the meaning of section 29 of the Insolvency Act 1986) of the whole or any material part of its assets or undertaking appointed;
- (iii) has an administration order under section 8 of the Insolvency Act 1986 made in relation to it;
- (iv) passes any resolution for winding-up other than a resolution previously approved in writing by the Director; or
- (v) becomes subject to an order by the High Court for winding-up.

3. For the purposes of paragraph 2 (c)(i) above, section 123 (1)(a) of the Insolvency Act 1986 shall have effect as if for "£750" there were substituted "£10,000" or such higher figure as the Director may from time to time determine and the said section 123(1)(a) shall not apply if the demand therein referred to is being contested in good faith by the Operator with recourse to all appropriate measures and procedures or if the demand is satisfied prior to the expiry of the notice to the Operator given by the Director.

4. The requisite period of notice shall be-
- (a) for the purposes of sub-paragraph 2 (c), 24 hours; and
  - (b) for all other purposes, 30 days.

The Official Seal of the Director General of  
Gas Supply hereunto affixed is  
authenticated by:



Authorised in that behalf of the Director  
General of Gas Supply

14 September 1999

## **Criteria for the designation by the Director General of Gas Supply of a Market Operator for the On-the-day Commodity Market for gas**

The following criteria are based on the criteria applied or to be applied under the regime for the recognition of Investment Exchanges by the Financial Services Authority, the Office of Gas and Electricity Markets is grateful for the assistance offered by the Financial Services Authority in relation to this manner.

### **AVAILABILITY OF FACILITIES**

1. The Operator must make available and operate market facilities which enable Transco and holders of gas shippers' licences using those facilities to participate in a market through which they can buy and sell gas for the balancing-
  - (a) by Transco of its pipeline system; and
  - (b) by shippers of the gas they arrange with Transco to introduce into and take off its system.

### **FITNESS**

2. The Operator must be a fit and proper person to operate the market described in paragraph 1 and in particular must ensure that-
  - (a) the systems and controls used, or to be used, in the operation of the Operator's market facilities, in particular those concerning the transmission of information, the assessment and management of risk and the effecting and monitoring of transactions, are appropriate for the scale and nature of the market;
  - (b) adequate procedures are adopted for making and amending rules for the market and for keeping the rules under review;
  - (c) its conduct as market operator and its systems are such that –
    - (i) it obtains no unfair commercial advantage as compared with any other participant in the market described in paragraph 1,
    - (ii) it avoids undue preference or undue discrimination between such market participants, and
    - (iii) no such market participant obtains any unfair commercial advantage.



### **FINANCIAL RESOURCES**

3. The Operator must have financial resources sufficient for the proper operation of the market described in paragraph 1 and taking into account any other activity carried on by the Operator.

### **CO-OPERATION WITH THE DIRECTOR GENERAL**

4. The Operator must be able and willing, by the sharing of information and otherwise, to co-operate with the Director-
  - (a) generally;
  - (b) in relation to the consideration by the Director of whether any participant in the market described in paragraph 1 is in breach of any obligation arising under the Gas Act 1986 or under the terms and conditions of any licence granted or order made under that Act; and
  - (c) in relation to the consideration by the Director of whether the Operator is continuing to meet these criteria.

### **PROMOTION OF GOOD MARKET CONDUCT**

5. The Operator must be able and willing to promote and maintain high standards of integrity and fair dealing in the conduct of business on the market described in paragraph 1, including by ensuring that -
  - (a) participants in the market have equally open access to information that may be relevant in determining the price of gas traded on the market;
  - (b) business conducted through the Operator's facilities is conducted in an orderly manner; and
  - (c) appropriate measures are adopted to prevent abuse of the market, facilitate its detection and monitor its incidence.

### **MARKET ARRANGEMENTS**

6. The Operator must have satisfactory arrangements in relation to the market described in paragraph 1 for -
  - (a) facilitate the timely discharge of rights and liabilities of the parties to transactions effected on the market, whether by performance, compromise or otherwise;
  - (b) recording the transactions effected on the market;

- (c) monitoring and enforcing compliance with its rules and any arrangements made by its as mentioned in paragraph (a);
- (d) the investigation of complaints in respect of the use of its facilities for the operation of the market.

#### **CLEARING**

- 7. The Operator must have default rules in relation to the market described in paragraph 1 which -
  - (a) in the event of a participant in the market appearing unable to meet his obligations in respect of one or more contract entered into through the market, enable action to be taken to close out his position in relation to all such contracts to which he is party that are unsettled; and
  - (b) may authorise the taking of the same or similar action in relation to a participant in the market who appears to be likely to become unable to meet his obligations in respect of one or more contracts entered into through the market.

#### **EMERGENCY SUSPENSION**

- 8. The Operator must have satisfactory arrangements in relation to the market described in paragraph 1 for the rapid and orderly suspension of trading -
  - (a) in the event of the failure of the facilities made available by the Operator for the operation of the market; and
  - (b) in the event of a Network Gas Supply Emergency (as defined in the Transco Network code).

## **Appendix 2 – Ofgem’s Amendments to EnMO’s Market Rules**

### **Market principles to be incorporated into the market rules (to be inserted in Clause 18.2)**

18.2.3 The subscriber shall observe and comply with the following principles in relation to any activity engaged on the NBP market.

- (i) The Subscriber shall observe high standards of integrity and fair dealing.
- (ii) The Subscriber shall act with due skill, care and diligence.
- (iii) The Subscriber shall observe high standards of market conduct. It should also, to the extent endorsed for the purpose of this principle, comply with any code or standard as in force from time to time and as it applies to the participant either according to its terms or by rulings made under it.
- (iv) The Subscriber shall ensure that it maintains adequate financial resources to meet its NBP Market commitments and to withstand the risks to which its business is subject.
- (v) The Subscriber shall organise and control its internal affairs in a responsible manner, keeping proper records, and where subscriber employs staff or is responsible for the conduct of NBP Market by others, shall have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well defined compliance procedures.
- (vi) The Subscriber shall deal with the Director in an open and cooperative manner and keep the Director properly informed of anything concerning the market participant which might reasonably be expected to be disclosed to it.

**Additional clause relating to market participant compliance with Rules (To replace draft Clause 18.1)**

18.1 Market Participants and EnMO shall at all times co-operate in accordance with the NBP Market Rules and shall ensure that they do not act in such a manner as to cause EnMO to breach the Designation Criteria or in such a manner as to cause EnMO or any Market Participant to breach the Financial Services Act.

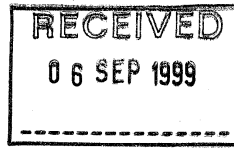
## **Appendix 3 – Letters from EnMO to Ofgem**

2 September 1999

PGlaji

Mr S Smith  
Director of Trading Arrangements  
Ofgas  
130 Wilton Road  
London  
SW1V 1LQ

Fax: 0171 932 1675



**EnMO**

EnMO Limited  
Fairham House  
Green Lane  
Clifton  
Nottingham  
NG11 9LN

Tel: 0115 945 6790  
Fax: 0115 945 6664

Dear

*Stephen*

### **Provision of Market Information to OFGEM**

With reference to your letter of 26 August and various meetings between our organisations, I am pleased to detail below the arrangements proposed by EnMO for the provision of data to OFGEM. The other points in your letter will be addressed in separate correspondence.

#### **Daily Trade Data**

EnMO will provide a daily report of all trades conducted on the OCM during the previous day. This can be provided using the existing OFGEM/ESIS modem link (an established, secure path currently used for Electricity Pool data). The report will be provided as a Microsoft Excel spreadsheet which can be readily imported into your own spreadsheets or databases. A sample of the report is attached with a key to the field contents. It is proposed that the report will be available by 10.00am on the following working day.

#### **Additional Information**

Further information in support of specific queries or investigations will be provided on a best endeavours basis. The Altrade system enables our operators to gain access to detailed information on-line, and hence response times will be far shorter than equivalent enquiries relating to the Electricity Pool. The actual response time will, naturally, relate to the complexity and volume of information required, however I am confident that all reasonable requests will be met within agreed timescales.

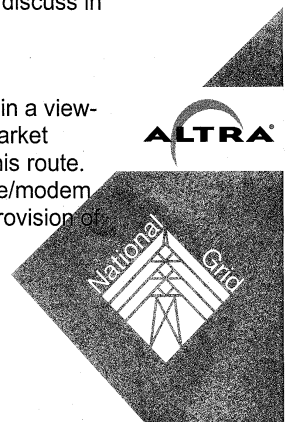
#### **Future Requirements**

I would be pleased to arrange a meeting with our Business Consultants to discuss in detail your requirements for more "raw" data.

#### **Access to Altrade Trader Screens**

In addition OFGEM will be provided with access to the live trading system in a view-only capacity. This will provide a real time view onto the market, as per Market Participants. A number of non-confidential reports are available through this route. Please advise me if you require EnMO to assist in procuring your hardware/modem connection. Our software team will be in touch in due course to discuss provision of the software.

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**Charging Arrangements**

Subject to OFGEM providing its own hardware and communications link, it is proposed that no charges are made for the daily information and Altrade access. Additional information will also be provided on this basis where the work can be accommodated by our support team. It may be necessary to agree in advance a charge based on Time and Materials rates where additional resources need to be deployed to meet a request.

I hope that the detail provided above satisfactorily addresses your requirements. Should you require any further clarification please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. Griffin', written over a horizontal dashed line.

**Paul Griffin**  
**Director**

Attached: Sample daily report

### Sample Daily Trade Report to OFGEM

NB report can be provided on a flow-day basis or transaction day basis

Order No	Transaction time	Price p/kWh	Volume kWh	Delivery start	Delivery end	Trade Type	Location	Buyer	Seller	Lead Time (note 1)	Meter No (note 2)
GD21890	01/09/99 11:44:23	0.43 0.4300	400000	1 01 Sep 99 13:00	02 Sep 99 06:00	3 NBP Locational	PLNGSW	0 Charity Co 5	Charity Co 6	1	
CF02990	01/09/99 11:38:49	0.35 0.3600	100000	1 01 Sep 99 14:00	02 Sep 99 06:00	3 NBP Locational	DLNGSW	0 B Trading Company	Charity Co 7	2	
XE08900	01/09/99 12:40:51	0.75 0.7500	200000	1 01 Sep 99 14:00	02 Sep 99 06:00	3 NBP Locational	VLDMC	0 A Trading Company	Charity Co 6	1	2222222
KK47960	01/09/99 13:25:41	0.705 0.7050	1000000	1 01 Sep 99 15:00	02 Sep 99 06:00	3 NBP Locational	VLDMC	0 A Trading Company	Charity Co 4	1	99876
TA69990	01/09/99 11:53:20	0.99 0.9900	1000000	1 01 Sep 99 16:00	02 Sep 99 06:00	3 NBP Locational	ILNGSW	0 B Trading Company	A Trading Company	4	
PG94430	02/09/99 09:55:40	0.29 0.2900	300000	1 02 Sep 99 13:00	03 Sep 99 06:00	3 NBP Locational	ALNGSI	0 A Trading Company	Charity Co 5	3	
PN97370	02/09/99 09:41:40	0.325 0.3250	500000	1 02 Sep 99 13:00	03 Sep 99 06:00	3 NBP Locational	ALNGSI	0 A Trading Company	Charity Co 5	3	
LD04470	01/09/99 11:40:03	0.4 0.4000	400000	1 01 Sep 99 13:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 Charity Co 7	B Trading Company	1	
VP87940	01/09/99 09:36:20	0.36 0.3600	600000	1 01 Sep 99 13:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 A Trading Company	B Trading Company	3	
RJ09000	01/09/99 11:45:45	0.32 0.3200	100000	1 01 Sep 99 14:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 B Trading Company	Charity Co 5	2	
KE64530	01/09/99 11:28:50	0.32 0.3200	200000	1 01 Sep 99 14:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 B Trading Company	A Trading Company	2	
RW00500	01/09/99 18:07:10	0.45 0.4500	700000	1 01 Sep 99 18:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 A Trading Company	Charity Co 8	1	
MQ94590	01/09/99 16:31:25	0.405 0.4050	1300000	1 01 Sep 99 19:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 A Trading Company	Charity Co 8	2	
SX21200	01/09/99 14:26:44	0.38 0.3800	1000000	1 01 Sep 99 19:00	02 Sep 99 06:00	2 NBP Physical	NBP Physic	0 A Trading Company	B Trading Company	4	
NC47020	02/09/99 09:55:22	0.31 0.3100	100000	1 02 Sep 99 11:00	03 Sep 99 06:00	2 NBP Physical	NBP Physic	0 A Trading Company	Charity Co 5	1	
FN67120	02/09/99 09:52:39	0.34 0.3400	300000	1 02 Sep 99 12:00	03 Sep 99 06:00	2 NBP Physical	NBP Physic	0 Charity Co 5	A Trading Company	2	
LZ69340	01/09/99 16:08:38	0.33 0.3300	200000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 Charity Co 7	A Trading Company		
JC64500	01/09/99 16:08:38	0.34 0.3400	300000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 Charity Co 8	A Trading Company		
CS25840	01/09/99 16:03:21	0.4 0.4000	400000	1 01 Sep 99 08:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 A Trading Company	Charity Co 8		
DL61420	01/09/99 15:05:01	0.349 0.3490	500000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 Charity Co 4	A Trading Company		
EV69630	01/09/99 14:35:46	0.35 0.3500	300000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 A Trading Company	Charity Co 7		
RS41310	01/09/99 16:08:38	0.34 0.3400	500000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 Charity Co 6	A Trading Company		
UH98410	01/09/99 11:28:35	0.345 0.3450	100000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 A Trading Company	B Trading Company		
PM7530	01/09/99 11:28:28	0.33 0.3300	100000	1 01 Sep 99 06:00	02 Sep 99 06:00	1 NBP Title	NBP Title	0 B Trading Company	A Trading Company		

Note 1: Lead time applicable to Physical and Locational trades only  
 Note 2: Meter number applicable to Locational VLDMC and DMC trades only



ENMO/PG/L004

7<sup>th</sup> September 1999

Mr S Smith  
Director, Trading Arrangements  
Ofgem  
Stockley House  
130 Wilton Road  
London  
SW1V 1LQ

**EnMO**

**EnMO Limited**  
Fairham House  
Green Lane  
Clifton  
Nottingham  
NG11 9LN

Tel: 0115 945 6790  
Fax: 0115 945 6664

Dear Stephen

**Re: Ofgem designation and ongoing regulation of EnMO and the On the day Commodity Market (6/9/99)**

With regard to your recent letter on the above, my aim is that this note will clarify the remaining issues to which you refer.

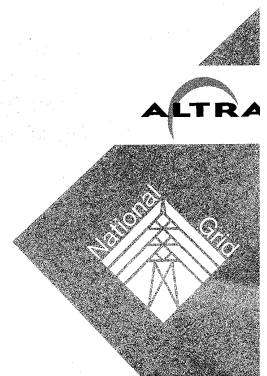
***Non Discriminatory Market Access***

I can confirm that our investigations have determined that the greatest message size likely to go across the network is 4 kb. Therefore, we conclude, that the figures that we recently provided will enable you to determine that there is very little discrimination in response times across the 3 options that we offer. It is also worth noting that the fact that each method is available to all Market Participants leads us to believe that there is no discrimination for any Market Participant.

***Non Discriminatory Pricing***

We have met internally on this subject, and we are all in agreement that any proposal we make should be cleared through Ofgem. We are still unsure about our precise "break points" and will require time to assess the viability of them. Our conclusion is that as we have announced a "transaction fee holiday" for the first 2 months of the OCM, that this should allow us time to both 1) monitor the market and 2) discuss openly with you in a more relaxed timeframe. With your agreement, we would therefore envisage more concrete proposals being put to you after the opening of the market.

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***Market Monitoring by EnMO***

We will be utilising two very experienced operational people from Altra, namely Al Perry and Alex Dolaptchiev, in addition to this, Neil Rabbitts will be seconded to EnMO. We have also recruited 2 other people, one from Powergen Gas Trading.

With regard to the policing of the Market, we believe that this should be discussed with Ofgem prior to any decision being made. I would propose that we initiate discussions to achieve this aim.

***Market Rules Finalisation***

At the end of Thursday's meeting of the Legal Expert Group, EnMO "offered" the option of a lock-in session this week (W/C 6/9/99) in order to conclude these discussions. The Shippers representative did not consider this appropriate and the current agreed timescales are as follows:

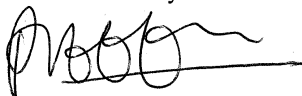
Tuesday 7<sup>th</sup> September  
Friday 10<sup>th</sup> September  
Monday 13<sup>th</sup> September (if required)

We are naturally concerned that this leaves no slack time for the signing of the contracts to participate in the opening bids to the OCM.

Current views suggest that there should be a "legal lock-in", we have therefore tentatively arranged for one to take place on Thursday/Friday (16/17) September. This will mean that the legal documents will not be available until 21st September. This is a severe risk if the documents are to have internal clearance from Market Participants.

I hope this clarifies the remaining issues and I look forward to hearing from you in due course.

Yours sincerely



**Paul Griffin**  
**Director**

cc Robin Birch  
Jeff Taylor

ENMO/PG/L008

14th September 1999

Mr S Smith  
 Director, Trading Arrangements  
 Office of Gas and Electricity Markets  
 Stockley House  
 130 Wilton Road  
 London  
 SW1V 1LQ

**EnMO**

**EnMO Limited**  
 Fairham House  
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 NG11 9LN

Tel: 0115 945 6790  
 Fax: 0115 945 6664

Dear Stephen

***Designation of EnMO as the OCM Market Operator***

Thank you for your letter of 10<sup>th</sup> September regarding the designation of EnMO as the OCM market operator. We understand the need to reassure market participants that the designation process is performed in a proper manner and can confirm that the issues outlined below will be resolved prior to the OCM commencing operation.

**1. Availability of Facilities**

- a) BSIS/EPFAL subcontracts have been drafted, and will be in place for 1/10.
- b) Testing of systems:
  - Unit and system testing are complete; AT-Link Interface Testing was completed on 5<sup>th</sup> Sept; User Acceptance Testing with Centrica, Statoil and Transco is due to complete 15<sup>th</sup> Sept, in accordance with our current plans.
- c) Contracts with market participants are dependent on finalisation of the market rules. The final Legal Expert Group is today, with a Legal 'snagging' session on Thursday and Friday. We are on target for issue of the final version of the Market Rules on 21<sup>st</sup> September. Speed of market participant sign-up after this is heavily dependent on the internal approvals processes of individual companies, though we will be facilitating the process wherever possible.
- d) Operational procedures are in draft, currently under review, and will be issued next week. The procedures will be used during the pilot, and (as will be the case throughout operation, in accordance with our QMS) may be amended should any improvements be identified.

**2. Fitness**

- a) Human Resources are currently considering the implementation of the requirements specified within FSA document "The Regulation of Approved Persons", July 1999, Consultation Paper 26. We will liaise with Ofgem as to how these may best be adopted for EnMO staff.
- b) System testing is described in 1(b) above.
- c) Operational procedures are discussed in 1(d) above.

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**3. Financial Resources**

- a) The £10 million facility on the trading account will not be an overdraft, but a committed borrowing facility specially arranged with Barclays Bank.
- b) An insurance company, NCM, has been selected to provide the credit insurance cover. However, final policy terms are dependent on finalisation of the Market Rules (due 21<sup>st</sup> September). The insurers are aware of the expected final requirements, and are progressing accordingly. We are therefore confident that this insurance will be in place for 30<sup>th</sup> September.
- c) Working capital of £450k, plus a borrowing facility of £500k is considered appropriate for the market structure envisaged. However, EnMO intends to have in place a parent company guarantee for £10 million.
- d) Professional Indemnity Insurance (£50 million cover) is in final negotiations with our insurer, and will be in place by 1/10.
- e) Fidelity Insurance (£25 million cover) is in final negotiations with our insurer, and will be in place by 1/10.
- f) We have already discussed with our brokers the potential requirement for additional credit insurance (e.g. should the level of market transactions be high). The details of such an extension would depend on the circumstances and required level of cover, and will be negotiated after 1/10.
- g) The market structure has been designed to minimise the need for contingency reserves. However, section (c) above describes additional financial strength available to EnMO.

**4. Co-operation with the Director General**

- a) Earlier discussions with Adam Cooper suggested that a letter of intent would be acceptable as a statement of service requirements, as provided in our letter of 2<sup>nd</sup> September, "Provision of Market Information to Ofgem". It was our understanding that such a letter would be sufficient as a business level agreement. If required, this will be discussed further with your staff to determine your precise needs, which of course we will endeavour to satisfy.

**5. Promotion of Good Market Conduct**

We are pleased to have been able to fully satisfy your requirement in this area.

**6. Market Arrangements**

- a) The EPFAL subcontract is discussed in Section 1(a) above.

**7. Clearing**

- a) Invocation of the credit insurance policy is only required if a company declares insolvent (late payment provisions cover all other circumstances). A condition of the credit insurance policy is that the company declares insolvency. The selected credit insurance company offers claim settlement immediately upon insolvency, without confirmation of debt from an insolvency practitioner or authorised agent.

**8. Emergency Suspension**

- a) Contingency procedures are in advanced draft form. Final versions will be available for inspection by the end of next week.
- b) EnMO has been in discussion with Transco concerning the suspension of the market in a Network Gas Supply Emergency, and our procedures now fully interface with the requirements of the National Emergency Coordinator. They are currently with Transco for review. EnMO are also supporting Transco in their discussions with the HSE.

**9. Simmons & Simmons Points**

- a) EnMO still awaits the proposed drafting for Section 18.4, but will modify the Market Rules as required for designation.
- b) Exposure to counterparty default will be covered by the imposition of credit limits (in accordance with the Credit Policy), and the interaction of this with our credit insurance. Credit insurance is discussed in 3(b) above.

**10. Other Points**

- a) We have assurances from Energis that 7 of the 9 ordered Frame Relay installations will be connected prior to 1/10. I am also assured that, subject to installation of BT Kilostream, the remaining two will be installed for market start up on 1/10.

I trust that the above discussion provides confidence in our preparations for the 1<sup>st</sup> October. We would be happy to discuss any of the above items further with KPMG during their visit in late September. If in the meantime you require any additional information, please do not hesitate to call me on 0115 945 6834.

Yours Sincerely



**Paul Griffin**  
Director, EnMO

cc: Roger Urwin, Managing Director, NGC  
Nick Winsor, Managing Director, ESIS

## Appendix 4 – Open Letter to the Industry



Direct Dial: 0171-932-5927

All interested parties

Reform of Gas Trading Arrangements

26 August 1999

Your Ref:

Our Ref :

Dear Colleague,

### **IMPLEMENTATION OF THE ON-THE-DAY COMMODITY MARKET (OCM)**

A key feature of the new gas trading arrangements is a screen-based on-the-day commodity market (OCM). The OCM will be used by Transco to balance the system, replacing the flexibility mechanism that is presently used for this purpose. The OCM can also be used by shippers, on a voluntary basis, to support within-day trading.

EnMO won a competitive tender to be the OCM market operator from 1 October 1999. However, to ensure the implementation of the OCM goes ahead as planned on 1 October 1999 the following key conditions need to be met:

1. an appointment contract between Transco and EnMO needs to be in place. This is targeted for 1 September 1999;
2. modifications to Transco's network code need to be agreed by the DGGs. These are targeted for 1 September 1999.
3. BG plc's Public Gas Transporter's (PGT) licence needs to be amended to ensure Gas Act regulation of the OCM, including providing for the designation by the DGGs of an approved market operator. Subject to consultation, this modification to the licence is targeted for 7 September;
4. EnMO needs to be designated by the DGGs as the approved market operator. Subject to consultation, this is targeted for 10 September 1999;
5. subscription agreements between EnMO and its customers for trading on the OCM need to be in place. These are targeted for 15 September 1999; and

6. HM Treasury needs to give to EnMO an exemption from financial services regulation before 1 October 1999;
7. HSE needs to approve Transco's revised safety case before 1 October 1999.

## **The Way Forward**

Progress has been made on each of these fronts. Ofgem will issue a document shortly covering all the main elements of the new gas trading arrangements, including implementation of the OCM. However, considerable further work needs to be concluded in a timely fashion to ensure the OCM timetable is not jeopardised. This letter is designed to facilitate rapid progress by providing all participants with a summary update of the present position and by setting out Ofgem's suggestions for taking forward some matters that appear at present to be proving difficult to resolve between the parties concerned.

### **1. Transco/EnMO Contract**

The OCM market operator Invitation To Tender (ITT) specified the requirements placed on the market operator. The tender evaluation panel recommended EnMO be appointed as market operator based on a range of criteria, including EnMO's assurance that the OCM could be implemented by 1 October. The main terms and conditions were specified in the ITT but details needed to be finalised as between Transco and EnMO. Ofgem has participated in a series of meetings with EnMO and Transco to safeguard the interests of shippers/customers and to help facilitate progress.

Both EnMO and Transco have given the DGGs assurance that the contract will be in place by the target date of 1 September. The main terms of the appointment contract will be made available to the community.

However, one issue has proved difficult to resolve, concerning EnMO liabilities in the event that trades completed on the OCM are not recorded on Transco's AT Link system. Although the probability of a failure to transmit the necessary information between Transco and EnMO's system is extremely small, the resulting consequential losses to shippers may be relatively large. If the trade nominations are not logged on Transco's systems, shippers may be out of balance at the end of the day and may be cashed out at relatively high prices.

EnMO has indicated that it is unwilling to face unlimited liabilities on a low margin business. Transco has indicated that it is unwilling to face liabilities over which it has no control. Shippers are concerned that if the liabilities remain with them, it undermines the concept of a cleared market that EnMO is offering.

Ofgem does not believe that it is appropriate for shippers to face the possibility of substantial losses for a failure by EnMO to nominate a completed trade to Transco. Once they have received confirmation of a trade from EnMO, shippers should be protected from any failure to transmit the necessary information. Ofgem believes that any liability should be placed on whoever is responsible for the liability arising. In the event of a failure on EnMO's part to transmit the necessary data to Transco's system after confirming a trade between market participants, liabilities should rest with EnMO.

Given that the scale of the potential liability and the probability of it arising are both quantifiable, Ofgem believes that it should be feasible to insure against this risk. Given the very low probability associated with a failure to nominate, the cost of this insurance

should be relatively low. This insurance would be to the benefit of the market and Ofgem believe that EnMO should arrange the insurance and recover any costs through its fees.

Ofgem accepts that EnMO may be unable to carry out the necessary risk analysis to put in place cost effective insurance arrangements in time for the introduction of the OCM. Ofgem has accepted EnMO's proposal that for the initial period of two months, during which time shippers will not be required to pay transaction fees on the OCM, EnMO's liabilities will be capped on a daily basis. During this time, EnMO will bring forward proposals to reinstate uncapped liabilities on the basis of insurance. Market members can then choose in December whether to have an insured market, with unlimited liabilities or to retain the capped liabilities.

## **2. Modification to Transco's Network Code**

Proposed modification 313 to the network code provides for the establishment of the OCM. It cannot be implemented unless the DGGS has made a direction to that effect. Pursuant to Standard Condition 7(10) of Transco's PGT licence, he can only make such a direction if he is satisfied that the modification better facilitates the relevant objectives as specified in Standard Condition 7 than those provisions currently in place or any alternative proposals. He would therefore not be able to direct implementation of modification 313 if he were not persuaded that replacing the flexibility mechanism with the OCM better facilitated the relevant objectives. If satisfactory progress is made the DGGS expects to approve the necessary network code modification on 1 September. Implementation of the proposals on 1 October will only take effect if all of the key conditions set out above have been met.

## **3. BG plc's Public Gas Transporter Licence Modification**

A modification to BG plc's PGT licence to provide for designation of a market operator for the OCM, including proposed criteria for the designation, is presently out for consultation. Main features of the proposed designation criteria, which have been based on those required by Recognised Investment Exchanges under Financial Services Act regulation, include fitness of the market operator, the availability of facilities and the promotion of good market conduct. Subject to consultation, a suitable licence modification is expected to be in place by 7 September as targeted.

## **4. Designation of EnMO as Market Operator**

As noted above, the proposed designation criteria are presently out for consultation. In the meantime, KPMG, on behalf of Ofgem, has begun a review of EnMO procedures on the basis of the draft designation criteria. Simmons and Simmons, on behalf of Ofgem, is carrying out a similar review of EnMO's draft market rules and other trading contracts.

Shippers and Transco have identified a number of key issues that require resolution before the designation of EnMO can take place. These include the following.

### **Non-Discriminatory Market Access**

It is important that the different methods of gaining access to the OCM are available by 1 October and that they all provide timely access in accordance with the ITT specification. To date, EnMO has received seven requests for frame relay links and has given Ofgem assurances that these requests received will be met in time for this method of access to be in place by 1 October. Other methods of access from 1 October will include ISDN links and dial up by modem.



EnMO has also assured Ofgem that the speed of access for transmitting bids and offers from all access sources will comply with those specified in the ITT. KPMG are analysing EnMO's proposed Service Level Agreements and EnMO's system performance for different access methods on Ofgem's behalf.

### **Non-Discriminatory Pricing**

A market maker scheme has been proposed during the early stages of the OCM to ensure adequate liquidity. This will involve participants being entitled to discounts on transaction fees if they are willing to guarantee that they will always have bids and offers posted for at least a defined quantity of gas.

However, it is important that any volume discounts are proportionate to the benefits which market makers bring to the market. Disproportionately high discounts could be discriminatory by favouring dominant players over smaller shippers. EnMO has agreed to gain Ofgem's approval of its pricing policies to address this concern.

### **Monitoring of the OCM**

Ofgem will require regular information from EnMO in order to be able to regulate the OCM effectively. The range of data and its provision is currently being agreed between Ofgem and EnMO. Ofgem/EnMO will have arrangements in place for monitoring to begin on 1 October.

Subject to consultation on the licence modifications and the designation criteria and satisfactory reports from KPMG and Simmons and Simmons, including resolution of the issues noted above, the DGGs expects to designate EnMO as approved OCM market operator by 10 September, on target.

When the designation decision is taken, Ofgem intends to publish a document setting out in more detail the basis of the decision to designate and how we intend to monitor the OCM and regulate market participants' conduct from 1 October.

## **5. Subscription Agreements Between EnMO and its Customers**

In discussions with EnMO, Ofgem has requested that subscription agreements for substantive volumes be in place by 15 September. Such agreements will help to give all concerned, including the HSE, the comfort that desirable levels of market liquidity can be expected. EnMO has told the DGGs that they are confident that the required subscriptions will be in place by that date.

A number of market participants, who between them are responsible for over 90% of existing flexibility trades, have ordered frame relay links from EnMO. A number of other shippers have ordered ISDN links. EnMO intends to have concluded subscription agreements by the 15<sup>th</sup> September with all of these market participants.

## **6. Exemption from FSA Regulation**

HM Treasury needs to lay before Parliament for 21 days an exemption from FSA regulation for EnMO as OCM market operator. It has indicated that before doing so, it will be necessary for the DGGs to have designated EnMO as market operator to ensure appropriate Gas Act regulation of the market is in place. Ideally, the exemption needs to be laid by 10 September in order for it to be in place by 1 October. However, HM Treasury has indicated that it would be willing to reduce this 21 day period if necessary.

## **7. HSE's Approval of Transco's Revised Safety Case**

The HSE has been closely involved in the preparations for the introduction of the OCM. Transco expects to obtain agreement to its modified safety case by 1 October, providing certain conditions are met. In particular the HSE needs to be assured that the introduction of the OCM will enable Transco to continue to gain access to short term 'balancing' gas in a timely fashion. For this condition to be met the OCM needs to provide at least as much liquidity as the flexibility mechanism presently provides. OCM liquidity in turn requires subscription agreements to be in place between EnMO and its customers to ensure sufficient trading takes place for the start of the market on 1 October.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Stephen Smith', with several overlapping loops and a long horizontal stroke at the bottom.

Stephen Smith  
Director, Trading Arrangements