

Modification proposal:	<b>Uniform Network Code (UNC): Removal of Failure Notices in respect of Energy Balancing Credit (UNC102)</b>		
Decision:	The Authority <sup>1</sup> has decided to reject this proposal <sup>2</sup>		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	23 November 2006	Implementation Date:	N/A

## Background to the modification proposal

Section X of the UNC details the powers and obligations through which National Grid NTS (NTS) and the Energy Balancing Credit Committee (EBCC) may limit Users' liability for energy balancing debt.

Following the termination of two Users during the winter of 2005/06 the EBCC carried out a review of events with a view to identifying areas where controls could be tightened in order to reduce future exposure to financial loss<sup>3</sup>. UNC102 was raised in response to that review.

## The modification proposal

The modification proposes to reduce the lag time before a Termination Notice may be issued when one of the following events has occurred:

- a Failure to Pay Cash Call Notice has been issued to a User;
- a Failure to Supply Further Security Notice has been issued to a User; or
- a User has failed to pay its net Energy Balancing Invoices in full on the due date.

Currently when any of these events occurs the relevant Party will be notified that they must remedy the failure within a specified period. A Termination Notice may not be issued until after the defined period has lapsed and NTS has consulted with the EBCC.

UNC102 proposes to remove these remedy windows whilst retaining the requirement for NTS to consult with EBCC prior to issuing a Termination Notice.

The proposer contends that this will remove an unnecessary and avoidable window during which the communities financial exposure may escalate.

## UNC Panel<sup>4</sup> recommendation

At the Modification Panel meeting held on 19 October, the 10 Voting Members unanimously recommended implementation of this proposal.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

<sup>3</sup> A similar review was conducted in the electricity market within Balancing Settlement Code (BSC) Issue 22. Some of the ground covered was conceptually similar – for example: abridging the timetable between non-payment and the issuance of statutory demands. Its reports are on the BSC Website at [www.elexon.co.uk](http://www.elexon.co.uk).

<sup>4</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

## **The Authority's decision**

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 19 October 2006. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR<sup>5</sup>.

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC<sup>6</sup>.

## **Reasons for the Authority's decision**

### *Summary of decision*

We consider that objectives (d) (competition) and (f) (efficiency in the implementation and administration of the code) are most relevant to this proposal. We note that some responses were framed against objective (a) (efficient and economic pipeline operation) but considered that the content of these arguments made it more appropriate to consider their merits against objective (d).

The case for competition is mixed and whilst the proposal has significant strengths in allowing bad debt to be capped more quickly these are undermined by the lack of appropriate safeguards to ensure a proportionate and fair response to code infractions.

We have concluded that the case for efficiency is inconclusive.

On balance, we do not consider that the proposal better facilitates the code objectives.

### *Applicable objective (a) – the efficient and economic operation of the pipe-line system to which the Gas Transporter's licence relates*

It has been argued that this objective would be facilitated through limiting Shippers exposure to financial loss.

We agree that this is a likely outcome and consider this the strongest argument for approval, but we do not consider that it suggests improved efficiency or economy in the operation of *the pipeline system* (i.e. the transportation infrastructure). We have therefore considered this argument against applicable objective (d).

We have concluded that UNCO102 would neither facilitate nor impede this objective.

### *Applicable objective (d) – the securing of effective competition*

As with objective (a), it has been argued that this objective will be achieved through reducing Shippers exposure to financial loss.

---

<sup>5</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.com](http://www.gasgovernance.com)

<sup>6</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: [http://62.173.69.60/document\\_fetch.php?documentid=6547](http://62.173.69.60/document_fetch.php?documentid=6547)

UNC0102 would reduce the timescales before a termination notice may be issued against a User failing to meet its payment obligations. In so doing, it would help to prevent the escalation of bad debts that would otherwise be smeared across other Users.

We consider that mitigating the avoidable socialisation of bad debt would better deliver the polluter-pays principle that underpins the balancing arrangements and this aspect of the proposal is therefore consistent with helping to secure effective competition.

But whilst the proposal would allow debt to be capped more quickly, it lacks appropriate safeguards to ensure that an affected User is aware that they have infringed the code.

In removing the remedy windows associated with the specified events, UNC0102 has the side effect of removing the notification to the affected User that they have failed to comply with the code.

Operational experience suggests that many payment infractions will not lead to actual bad debt. Some may relate to banking or human errors, and it cannot be guaranteed that these will always be on the User's side of the transaction. Many cases may be quickly resolvable through dialogue.

Termination from the code is very much a 'nuclear option'. We do not consider that a User should be exposed to that sanction without being notified that this step is being considered. Such an approach may deny it the right to put its case if the infraction is disputed, and is therefore incompatible with the notion of natural justice.

UNC102 would introduce a risk that a prudent operator(s) could be expelled from the code. We consider that this risk would impede the securing of effective competition.

On balance, we have therefore concluded that this objective would be impeded, rather than facilitated, by UNC102. We wish to highlight that this conclusion is driven by concerns on the lack of notification to the affected User, rather than in relation to the acceleration of the timetable before termination may be considered. Taken in isolation, we are sympathetic to the latter concept, and a proposal that seeks to deliver this whilst providing appropriate safeguards to Users may present a more persuasive case for approval.

*Applicable objective (f) – promotion of efficiency in the implementation and administration of the network code and/or uniform network code*

The Proposer noted that this proposal was developed by the EBCC, which had concluded that its measures would ensure that robust procedures and best practice measures are in place to minimise the impact of User failure. It was argued that this would result in efficiency in the implementation and administration of the UNC.

We consider that the case for efficiency is mixed, as the removal of some processes may be counteracted by the increased frequency in which others are triggered.

For each of the three altered processes, a step will be removed whereby NTS notifies the affected User that a Termination Notice may be issued if it has not made good on the default by a forthcoming date. The removal of this warning stage will remove the overhead associated with administering it.

But the removal of these stages will also result in the earlier triggering of EBCC meetings to consider whether a Termination Notice should be issued or not.

Since the start of 2002, 126 Failure to Pay Cash Call Notices (FTPCCNs) have been issued and paid whilst 18 FTPCCNs have been issued and unpaid<sup>7</sup>. Under the current baseline, only those FTPCCNs that are unpaid on the following Business Day would trigger the provisions that allow for an EBCC meeting to consider whether a termination notice may be issued. But under the UNC0102 baseline, all failures to pay cash calls would trigger these provisions – even if the infracting User goes on to make payment next day.

Clearly, participant behaviour will be driven by the rules in place in the market at any given time. We would expect the sharpened incentives to comply suggested by this proposal would see the numbers of infractions reduce. But nonetheless, one must note that past experience suggests that the majority of infractions do not actually lead to bad debt. The introduction of provisions that may result in more infractions triggering EBCC meetings may increase the workload of the committee.

Overall, we find the case for efficiency inconclusive.

#### *Other code objectives*

We concur with respondents and the Modification Panel that objectives (b), (c) and (e) are not relevant to the consideration of this proposal.

#### *Other observations*

The EBCC has considerable powers, not least in its role in determining whether a Termination Notice should be issued to a defaulting User.

This role brings forward the potential for conflicts of interest, as decisions that may precipitate market exit of one participant may be taken by employees of other market participants (or for that matter, of the affected User). Ensuring that any potential for conflicts of interest in these powers is mitigated is particularly important as, unlike the Balancing and Settlement Code, signatories to the UNC may be expelled without the need for prior consultation with the Authority.

Taken in tandem, the EBCR and the UNC are ambiguous on whether the EBCC members are acting as representatives of the interests of Shippers in general, or the interests of their day-job employer. We understand that it is intended to be the former, and consider that experience suggests that EBCC members do act as responsible independent experts rather than pursuing a company line. But notwithstanding this, we consider that clarification of independence in this area may improve safeguards both for the EBCC and for Users.

---

<sup>7</sup> Source: Operational performance statistics reported to the EBCC meeting of 17 November 2006.

Yours sincerely

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

**Nick Simpson**

**Director, Industry Codes and Licensing**

Signed on behalf of the Authority and authorised for that purpose by the Authority.