

**Draft Modification Report**  
**Changes to Energy Balancing Credit Arrangements for the Trading System Operator**  
**Modification Reference Number 0609**

Version 3.0

This Draft Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

**1. The Modification Proposal**

It is proposed that the Network Code Supplement should be changed to introduce an additional trigger requiring action by Transco in the event that the Trading System Operator's ("TSO's") energy balancing indebtedness exceeds 60%, rather than 85%, of its Secured Credit Limit. Transco shall be required to convene an emergency operational meeting of the Energy Balancing Credit Committee ("EBCC") to determine action to be taken. The proposal seeks to extend the provisions within the Network Code Supplement in the following areas to enable to EBCC to make informed decisions and take appropriate action.

- To grant the EBCC the powers to make such information requests to the TSO and Transco as and when it deems relevant, to include but not be limited to:
  - trend analysis of trades and data on movement in the TSO's energy balancing indebtedness, together with any actions taken (e.g. Cash Call / Failure to Pay Notices Issued) for the relevant period, determined by the EBCC;
  - the security that the TSO has in place from its customers, credit insurance cover if the security were to fail and any indication that failure was likely, current credit limit and credit usage data. (Note: individual customers should not be identified without their prior agreement.)
  - cash flow projections, to cover the period up to which the TSO forecasts its indebtedness to fall below 60% of its secured credit limit, and assumptions made

All data provided by the TSO should be subject to verification from independent audit, the scope of such audit to be determined by the EBCC. It is the EBCC's view that it would be appropriate to engage the TSO's external auditors to carry out this role, with the cost of such audits being borne by the TSO. The auditors will report directly to the EBCC. It is expected that such a report would include, but not be limited to, confirmation of compliance with stated processes and procedures of the TSO, e.g. security from customers, validity of credit insurance, and analysis of the cash flow projections including the appropriateness of the assumptions made and sensitivities around these assumptions.

The proposal also seeks to amend the following provisions for the TSO in certain circumstances:

1. To introduce provisions that would extend the powers and duties of the EBCC to determine acceptable levels of exposure and to allow the TSO to trade in excess of 100% of its Secured Credit Limit to a maximum level determined by EBCC with triggers for periodic review.
2. To amend the operation of section X 3.2.4 to allow Transco to withhold payments to the TSO in the event that its exposure exceeds 85% of its secured credit limit or such other limit as is agreed by EBCC under bullet point 1 above until such time that its exposure is reduced below that same limit.
3. To suspend Transco's obligations under S3.6 to pay credit interest to the TSO in the event such payment is suspended for the purposes outlined above.

Implementation of the proposal would not require the Energy Balancing Credit Rules ("EBCR") to be modified or affect their application in respect of the TSO.

## **2. Transco's Opinion**

Transco's opinion is that this modification proposal should be implemented. This opinion has been formed using the following rationale.

Following recent discussions with the EBCC, it was identified that the Energy Balancing Credit regime, and the strict EBCR provisions, give rise to a risk in respect of the continued viability of current market based balancing arrangements.

This risk stems from the application of the EBCR on the TSO. There is recognition from members of the EBCC that the TSO is in a unique situation, for which the EBCR do not make provision, in that the TSO does not have direct control of its trading positions. This situation arises because of the nature of the On-the-Day Market ("ODM"), in which Trading Participants initiate all transactions via the TSO acting as the central counterparty in order to maintain the participants' anonymity. The TSO's position is intrinsically balanced in both energy and value at all times, but its only control over the values of its trades is achieved by restricting Trading Participants' accounts.

When the system is long and Transco sells gas, the trades undertaken lead to an increase in the TSO's energy balancing indebtedness. Transco's selling is determined by the length of the system, which is in turn determined by the aggregation of the notified position of individual Users. Transco, therefore, has little discretion with regard to the volumes to be sold, and any restriction of its ability to trade as required would lead to invocation of Contingency Balancing Arrangements (which would mean the temporary reintroduction of the "flexibility mechanism").<sup>1</sup>

Due to events beyond its control, the TSO could be required to put in place theoretically unlimited security to support its Secured Credit Limit at short notice. An event of this type occurred in December 2001 when Transco's application of the provisions set out in the Network Code Supplement and the EBCR led to the TSO having to provide significantly increased levels of security for two months at very short notice. Had the TSO been unable to

meet its obligations the ODM would have been suspended and Contingency Balancing Arrangements would have been invoked.

The credit regime embodied in the Network Code Supplement and the EBCR exists to protect Users collectively from potential financial loss as a result of User default. This proposal aims to extend those rules to make provision for the unique position of the TSO.

It should be noted that members of the EBCC have requested Transco to raise this proposal on behalf of EnMO, since the TSO is classed as a Restricted User and is therefore unable to raise Modification Proposals.

<sup>1</sup> *It is important to note, however, that this would have no effect on the TSO's ability to meet its financial obligations with regard to existing transactions and that the risk is of loss of service availability, not of financial default.*

**3. Extent to which the proposed modification would better facilitate the relevant objectives**

Implementation of the proposal would reduce the risk that the ODM for system balancing could be withdrawn. However, in the event of a decision to revert to the Contingency Balancing Arrangements to limit the TSO's exposure, there would be a period of time between the decision point and the operational reintroduction of Contingency Balancing Arrangements during which Users could prepare. The reduced risk of failure of the ODM, coupled with the introduction of procedures allowing early preventative actions to be taken, provide a more secure, and therefore competitive environment, for Users to operate in.

**4. The implications for Transco of implementing the Modification Proposal , including  
a) implications for the operation of the System:**

There would be no implication for the operation of the system.

**b) development and capital cost and operating cost implications:**

Transco believes that implementation would not result in any additional costs being incurred.

**c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:**

No special cost recovery arrangements are envisaged.

**d) analysis of the consequences (if any) this proposal would have on price regulation:**

Transco does not believe that this proposal would have any effect on price regulation.

**5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal**

Transco's level of contractual risk would be unaffected by implementation.

**6. The development implications and other implications for computer systems of Transco and related computer systems of Users**

Implementation would require Transco to modify one of its credit risk management systems.

**7. The implications of implementing the Modification Proposal for Users**

Transco does not anticipate that Users would be required to modify their systems. The commercial implication for Users are detailed in Section 10 of this report.

**8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party**

It is not anticipated that this proposal would have any effect on any non-Network Code Party.

**9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal**

Transco is not aware of any impact on legislative and regulatory obligations.

**10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal**

**Advantages**

The adoption of the 60% trigger would provide an early indication of the current and likely future financial position of the TSO given the prevailing market and trading conditions. The obligations placed on the TSO to provide audited information would give the EBCC confidence in the TSO's financial position and additional time to react to events should the TSO's indebtedness continue to increase.

Implementation would help to protect Transco's ability to utilise the ODM and reduce the risk of Contingency Balancing Arrangements being invoked since it is expected that the new procedures would permit the TSO's energy balancing indebtedness to exceed the limit normally associated with the security in place. Without implementation there is a risk that the TSO would not be able to comply with Transco's request to source increased security within very limited timescales which could pose a significant threat to the ability of the TSO to continue to purchase should the system be consistently long.

**Disadvantages**

The purpose of the proposal is to permit the EBCC to consider the TSO's financial ability to pay, during which time the TSO may exceed 100% of its secured credit limit. Even though the TSO is intrinsically neutral in terms of both gas and money, and any transitional debt position incurred by the TSO should be secured on a back-to-back basis through its purchase contracts, there is a very small risk that the simultaneous failure of a purchaser, coupled with a failure by its guarantor to honour the debt, may result in the failure of the TSO. This could result in a bad debt that would give rise to adjustment neutrality charges for remaining Users.

**11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)**

Representations are now invited.

**12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation**

This modification is not proposed as a result of having to facilitate compliance with safety or other legislation.

**13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence**

This modification is not proposed as a result of changes to the methodology established under Standard Condition 4(5).

**14. Programme of works required as a consequence of implementing the Modification Proposal**

Transco would be required to modify its procedures and the system for monitoring indebtedness to include a 60% trigger against the TSO indebtedness. Additionally, the TSO would be required to produce an "information pack" for the EBCC to demonstrate that its indebtedness position is covered by way of third party securities. The information pack would have to be comprehensive enough to allow the EBCC to have confidence that any financial obligation would be settled without risk to Users.

**15. Proposed implementation timetable (including timetable for any necessary information systems changes)**

It is estimated that this proposal could be implemented within three months of Ofgem's direction by modifying procedures and systems. Although the UK-Link system does not require modification, it would be necessary to modify the credit risk management indebtedness monitoring system ("PIMS") to recognise the new debt triggers.

**16. Recommendation concerning the implementation of the Modification Proposal**

Transco recommends that this proposal is implemented.

## 17. Text

### **Section X NETWORK CODE SUPPLEMENT: Energy Balancing Credit Management**

*Add new paragraph 2.10 to read as follows:*

#### **"2.10 Trading System Operator**

2.10.1 Without prejudice to the implementation of the other provisions of this Supplement in relation to the Trading System Operator, paragraph 2.10.2 shall also apply in relation to the Trading System Operator (and not in relation to any other User).

2.10.2 Where the amount of the Trading System Operator's Outstanding Relevant Balancing Indebtedness exceeds 60% of its Secured Credit Limit:

- (a) Transco shall convene a meeting of the Energy Balancing Credit Committee, to be held as soon as is reasonable;
- (b) the Energy Balancing Credit Committee shall consider the delayed or modified implementation of the provisions of this Supplement in relation to the Trading System Operator; and
- (c) where the Energy Balancing Credit Committee approve the delayed or modified implementation of the provisions of this Supplement in relation to the Trading System Operator, Transco shall implement the provisions of this Supplement in the manner and for such period as the Energy Balancing Credit Committee have approved.

2.10.3 For the purposes of paragraph 2.10.2(b), the Energy Balancing Credit Committee may:

- (a) delay the application of paragraph 2.6 until such time as the Trading System Operator's Outstanding Relevant Balancing Indebtedness exceeds such other amount as the Energy Balancing Credit Committee approve (which such amount may exceed 100% of the Trading System Operator's Secured Credit Limit);
- (b) authorise Transco to withhold amounts payable to the Trading System Operator by Transco pursuant to any Energy Balancing Invoice until such time as the Trading System Operator's Outstanding Relevant Balancing Indebtedness no longer exceeds such amount as the Energy Balancing Credit Committee have approved;
- (c) authorise Transco to withhold the payment of interest payable to the Trading System Operator pursuant to Section S (and where Transco is so authorised Transco shall be relieved from its obligation to pay interest under Section S);
- (d) authorise Transco to take other such steps in respect of the implementation of the provisions of this Supplements as it considers to be reasonable; and

- (e) require the Trading System Operator to take such steps as it considers, in the context of this Supplement, to be reasonable.

2.10.4 For the purposes of this paragraph 2.10, the Energy Balancing Credit Committee may, for such period as the Energy Balancing Credit Committee determines, request:

- (a) Transco provide details of any steps taken by Transco in implementing the provisions of this Supplement in relation to the Trading System Operator;
- (b) the Trading System Operator provide details of:
  - (i) the levels of security cover and other credit facility and security arrangements in place with Users and third parties for the purposes of the Trading System Arrangements ("**other credit arrangements**");
  - (ii) historic and current levels of utilisation of credit facilities by Users under the other credit arrangements;
  - (iii) current projections of its future cash flows; and
  - (iv) of any steps taken by the Trading System Operator in relation to Users pursuant to the other credit arrangements,
  - (v) In the proposal there was also the provision of details/ trend analysis relating to trading activities.

and where requested Transco and the Trading System Operator shall provide such information as soon as is reasonably practicable.

2.10.5 Nothing in paragraph 2.10.4 shall require Transco or the Trading System Operator to disclose information which it is otherwise prohibited from disclosing pursuant to the Section V5 or the Trading System Arrangements.

***Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report***

Signed for and on behalf of Transco.

Signature:

**Debbie Dowling**  
**Finance Manager**

**Support Services**

Date: