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

Version 1.0

This Modification Report is made pursuant to Rule 8.9 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 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 EBCC to determine action to be taken. The proposal further seeks to extend the provisions within both the Network Code Supplement and EBCR in the following areas, in order that the appropriate action may be determined.

- 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 that 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 auditors to carry out this role, with the cost of such audits being borne by the TSO. The auditor 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.

- Introduction of provisions extending 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.

- Provisions under section X 3.2.4 allowing 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.

- 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.

Nothing in this proposal changes the existing EBCR, their application to the TSO or the remedies within the team.

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").[1]

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.

[1] · *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 have been received from 8 Users:

TotalFina Elf Gas and Power Ltd (TFE), Scottish and Southern Energy (SSE), Powergen , British Gas Trading (BGT) London Electricity Group (LEG), EnMO, Scottish Power (SP), and Innogy .

The balance of views is six support the implementation of the Modification Proposal with two against implementation, one of these suggesting that the proposal should be withdrawn.

The majority of representations that support the proposal are in agreement that the modification proposal will allow Transco and the community to manage any risk exposure as a result of the TSO breaching it's secured credit limit. In particular those Users in support of the Modification Proposal provided the following views in respect of the implications in the event of reverting to the Flexibility Mechanism.

11.1 Contingency Arrangements

BGT stated " *the proposed modification reduces an unnecessary risk of the On-the-day Market becoming unavailable to Transco for system balancing purposes".*

Innogy made reference to the TSO being in a unique position in respect of the treatment of energy balancing indebtedness and stated " *this modification proposal will provide a mechanism that may lead to a better outcome than the potential suspension of the OCM and reinstatement of the flexibility mechanism"*

Although TFE did recognise that a slight downside risk could be created by the proposal it stated "*this is justified to avoid the alternative of potentially unnecessarily having to suspend the On-the-Day Market when in reality there is no major risk to the community"*

Scottishpower stated "*In potentially avoiding or delaying reversion to the contingency balancing arrangements "the Flexibility Mechanism", we believe that this modification Proposal could fulfil the relevant objective of more efficient use of the system".* This view was supported by LEG and stated *"the risks of enforcing current NWC obligations by Transco could unnecessary cause undue complications with reverting to using the Flexibility Mechanism under the Contingency Balancing Arrangements".*

Powergen provided qualified support and in making reference to the events in December 2001 where EnMO were requested to provide extra security at short notice it stated *"The default* *position for the TSO exceeding their credit limit and being closed out would be to go to the flexibility mechanism, which we believe is not helpful for market liquidity".*

SSE do not support the proposal and requested clarity on the reference to the OCM being suspended as stated within the Modification Report. It stated *"We are unclear on what basis and under what arrangements this would take place ".*

Transco Response: The only remedy for the TSO to prevent spiralling exposures to Transco is by suspending trading on the OCM and this would be the basis for this taking place as outlined in section 2 of this proposal.

11.2 Level of Secured Credit Limit

Further views expressed by those Users that support the Modification Proposal agreed that the 60% limit is set at a sensible level and LEG stated "*it will flag up a potential credit risk problem sooner rather than later which can then be brought to the attention of the Energy Balancing Credit Committee (EBCR) for an appropriate decision".* BGT stated *" The Modification Proposes an additional trigger requiring action by Transco in the event that the TSO's energy balancing indebtedness exceeds 60% rather than 85% of its Secured Credit Limit. BGT believes that this is appropriate for this one class of user given the TSO has no direct control over is trading position".*

In general the majority of views support the involvement of the EBCC in the process, particularly as this allows for the EBCC to request information in respect of the TSO's indebtedness and the security it has in place. BGT stated *"BGT believes that ability for the EBCC to request the above information, will serve to improve the EBCC's understanding of the TSO's credit position"*

SSE expressed concerns with the proposed limit and stated " *We have concerns regarding the way it is proposed the situation could be addressed through a reduction in the TSO's Secured Credit Limit threshold from 85% to 65%. There appears to be no information to justify this number".*

Transco Response: Data was presented to the EBCC demonstrating historic levels of exposure to identify a suitable limit. The limit of 60% (not 65% as above) was considered to provide a reasonable time frame to assess the level of financial risk prior to any further escalatory action having to be taken, allowing for a decision to be made by the EBCC.

11.3 General Issues

11.3.1.
SSE requested clarification on how the TSO's indebtedness situation arises and stated " *I am still unclear as to how this actually arises"* and further stated *"It would be helpful if the Final Modification Report could clarify these points with examples and time lines".*

Transco Response: Where the system is long Transco sells to the TSO creating a debit exposure. The TSO will in turn sell to a third party thus creating a debit exposure between the TSO and the third party. Whilst the TSO may have adequate security in place with the third party, Transco's contractual relationship is with the TSO and therefore can take no account of such arrangements, hence increases the TSO's exposure to Transco when the system is long.

Below is outlined an example of a typical Billing cycle demonstrating the number of days such exposures would remain outstanding prior to payment under the existing rules:

Trade Date	Date EBI Invoice Issued	Payment Date
1 Jan 03	5 March 03	17 March 03

In the above example if a trade went through on the system on 1 January, then there would be 76 days exposure before the payment was due. Although the TSO is intrinsically in balance and maintain anonymity, it has financial exposure to the third party and an equal exposure to Transco.

11.3.2

SSE expressed concerns regarding proposals to hold meetings and stated" *It is doubtful whether decisions would be made within appropriate timescales, particularly where additional information is requested and required to be reviewed or verified by independent auditors".*

Transco Response: It is envisaged that the procedures being developed by Transco with the EBCC to support this Modification Proposal will provide a workable solution to this issue, whereby verification rules will be agreed ahead of the process.

11.3.3

In raising concerns with the proposal SSE stated "*It also seems inconsistent that elsewhere in the document it is proposed to allow the TSO to continue to trade when it has exceeded 100% of its Secured Credit Limit"* and added *"perhaps a more appropriate solution would be to review the Secured Credit Limit".*

Transco Response: The TSO been working in conjunction with the EBCC over a 12 month period to develop a suitable solution to the problem and would point out that the Modification Proposal is to facilitate a process for the EBCC to consider allowing the TSO to trade in excess of 100% upon the provision of suitable surety.

A further concern raised by SSE was that this issue was being looked at in isolation and stated *"We are aware of Ofgem's review of credit arrangement and wonder how this proposal would fit in with that"*

Transco Response: Ofgem have identified within the Credit Consultation document that all Credit Modification Proposals will be reviewed on their own merit and that the Consultation process should not prejudice continued development of the contract.

11.4 Further Review of Modification Proposal by the EBCC

Following a decision by the May Modification Panel it was agreed that the timescales for producing this Final Modification Report could be extended to allow for further discussions with the EBCC, Transco and EnMO to determine whether this proposal should be withdrawn. This proposal was originally raised by Transco on behalf of the EBCC following a recommendation by EnMO to seek a change in the Energy Balancing Arrangement following the events of December 2001 as detailed in the report. However, during the period when the proposal was being developed EnMO's view is that there has been a significant development and as a result of this requested that the proposal should be withdrawn. EnMO stated *"This is reflected in Modification Reference Number 0572 and in particular in the recent notification that it is to be implemented with effect from 1 August 2003"*. EnMO also stated that *"this modification will necessarily involve a change in the way that its credit limit with Transco is secured, and the solution that EnMO has chosen will also enable it to be more flexible in the amount of security that is provided"*. EnMO further added "*EnMO's chosen solution therefore mitigates the market availability risk more effectively than Draft Modification 0609 would do"*.

In addition, EnMO stated that the Modification as proposed "*would be likely to result in unnecessary "60%" triggers (leading to unnecessary EBCC meetings) when further security was actually available to be provided as the TSO's energy balancing indebtedness approached 85% of its Secured Credit Limit"*

Transco Response: Further to the changing circumstances effecting this Modification Proposal, Transco has sought a recommendation from the EBCC to advise on whether Transco should withdraw this proposal given the current situation. At the EBCC meeting on 5 June, EnMO presented its case on opposing the implementation of the proposal as detailed above and requested EBCC members to reconsider.

The consensus of opinion by EBCC members was that this Modification Proposal should not be withdrawn as although Modification Proposal 0572 provided additional protection, there was still merit in progressing this proposal as it provides additional protection for the community against any potential risk in the future from other TSO's. However, whilst the EBCC recognises that the obligation to convene a meeting where the TSO is at 60%, it was agreed that the operational procedures should consider this process to avoid any unnecessary meetings.

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 ModificationProposal

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. Restrictive Trade Practices Act

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

18. Transco's Proposal

This Modification Report contains Transco's proposal to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

NB: Numbering of Legal text is subject to change pending implementation of other Credit related Modification Proposals

19. 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;

(iv) of any steps taken by the Trading System Operator in relation to Users pursuant to the other credit arrangements; <u>and</u>

(v) <u>a trend analysis of the Trading System Operator's trading activities and data on the movement of the Trading System Operator's Outstanding Relevant Balancing Indebtedness,</u>

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.

Signed for and on behalf of Transco.

Signature:

Debbie Dowling
Finance Manager

Support Services

Date:

Gas and Electricity Markets Authority Response:

In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0609**, version **1.0** dated **18/06/2003**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **1.0**.

Signature:

Process Manager - Network Code

Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTPA"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:

   (i) if a copy of the Agreement is not provided to the Gas and Electricity Markets Authority ("the Authority") within 28 days of the date on which the Agreement is made; or

   (ii) if, within 28 days of the provision of the copy, the Authority gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriate

   provided that if the Authority does not so approve the Agreement then Clause 3 shall apply.

2. If the Authority does so approve this Agreement in accordance with the terms of the Order <u>(whether such approval is actual or deemed by effluxion of time)</u> any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.

3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, <u>had it not been repealed, would</u> apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) <u>or 2(2)(b)(ii)</u> of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.

4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.