

Modification Report
Where a guarantor is downgraded to any speculative rating, removal of the notice period required for the revision of a User's Secured Credit Limit and Code Credit Limit
Limit
Modification Reference Number 0521
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 where any credit rating of a guarantor or any other person providing surety for the User is revised downwards to a speculative grade rating, the existing 30 day notice period shall be removed and Transco shall be entitled to reduce the Secured Credit Limit and Code Credit Limit immediately such that the security will not be included in the calculation of the Secured Credit Limit or Code Credit Limit. Similarly, it is proposed that where any credit rating of a User is revised downwards to a speculative grade rating (for the avoidance of doubt speculative grade ratings relate to sub investment grades i.e. below Baa3 or BBB-), the existing 30 day notice period shall be removed and Transco shall be entitled to reduce the Secured Credit Limit and the Code Credit Limit immediately to either zero, or to a level relative to other third party securities that may be provided to Transco in support of the User's liabilities.

It is further proposed that these rules shall apply to any such 30 day notices that have been issued for which the 30 day notice period remains unexpired.

2. Transco's Opinion

In respect of Energy Balancing, Transco is essentially neutral and acts in the interests of Users as a whole under the Energy Balancing Credit Rules. However, Transco recognises the benefits that this Modification Proposal would introduce assisting Transco in managing the Credit Risk frame work more effectively to protect both Transco and Users as a whole from any potential financial loss.

The Modification Proposal would reduce a User's Secured Credit Limit or a Code Credit Limit with immediate effect upon the downward revision of that Users, or any related security provider's, published or private rating to a speculative grade. In Transco's view this minimises the community's potential exposure to financial loss as it removes the requirement for a 30 Day notice period which currently leaves both Transco and Users facing exposure following such an event.

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

By reducing the risk of exposure to financial loss for all Users, and thereby reducing the potential debt burden via the balancing neutrality mechanism, this Modification Proposal could be viewed as facilitating the securing of effective competition between relevant shippers and between relevant suppliers as exposure to a potential debt burden may act as a barrier to entry. This potential debt burden could also be viewed as a form of subsidy, it could further be considered that subsidies are symptoms of inefficient or uneconomic operation of Transco's pipeline system, therefore the implementation of this Modification Proposal could be deemed as enhancing efficient and economic operation of the system.

4. The implications for Transco of implementing the Modification Proposal , including

a) implications for the operation of the System:

Transco is not aware of any implications for the operation of the system that would result from implementation of this Modification Proposal.

b) development and capital cost and operating cost implications:

Transco is not aware of any impact on capital cost and operating cost that would result from the implementation of this Modification Proposal

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:

Transco does not believe it appropriate to have any special cost recovery measures in place should the implementation of this Modification Proposal lead to increased costs for Transco.

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

Transco is not aware of any such consequence.

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

As implementation of this Modification Proposal would facilitate Transco's efficient management of the Energy Balancing and Transportation Credit Risk framework it is anticipated that the level of contractual risk may be reduced.

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

No systems impact is anticipated as a result of implementation of this Modification Proposal for Transco. Transco is not aware of any impact upon the systems of Users.

7. The implications of implementing the Modification Proposal for Users

Implementation of this Modification Proposal is intended to reduce the credit risk on Users via the energy balancing neutrality smearing mechanism and is therefore of potential benefit to Users as a whole.

Affected Users will, however, be immediately required to provide an alternative form of security. Failure to comply with this request may result in the application of credit sanctions in accordance with the Network Code, with the ultimate escalation route being termination of the User.

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

No direct impact on such parties is anticipated as a result of the implementation of this Modification Proposal.

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 unaware of any change in legislative, regulatory obligations or contractual relationships of Transco, Users or Non-Network Code Party as a consequence of the implementation of this Modification Proposal.

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

Advantages of implementing this Modification Proposal:

- Facilitates more effective management of energy balancing and transportation credit risk enabling Transco to respond in a more timely manner in the event that a Users or any related security providers credit rating is downgraded to a speculative grade, resulting in the reduction of all users potential exposure to financial loss.

Disadvantages of implementing this Modification Proposal:

- May reduce the time which the affected User has to put in place alternative security arrangements potentially increasing the likelihood of credit sanctions being applied.

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

Eight representations have been received in respect of this Modification Proposal. Seven are supportive, one is confidential and does not support implementation of the proposal.

Three respondents (Shell Gas Direct, TXU Europe Energy Trading and Scottish Power) although agreeing that the existing notice period of 30 days is too long, exposing Transco and Users to avoidable financial losses, believe there is a risk of the credit rating agencies themselves taking an over cautious approach. To mitigate this risk they suggest that the notice period only be reduced where more than one agency has down graded the credit rating of a guarantor or any other person providing surety for the User.

Shell Gas Direct states "...Shell Gas Direct broadly supports this modification. Recent events with Enron in the UK going into receivership have shown that 30 days is probably too long for action to be taken. However, credit rating agencies and others may also react to these events leading to an over cautious approach to credit rating. To mitigate against this, it may be more sensible for Transco to consider down rating by more than one credit agency before taking action."

Scottish Power states "... Scottish Power support this modification, but with some reservation. We believe that in these deliberations we have to consider minimising industry exposure by addressing the issues in escalation of a move towards bankruptcy / termination. We also need to make sure that procedures are not set up which help precipitate this.

We would feel more comfortable with a system which would take account of other ratings which a shipper may have, for example S & P. If the shipper is investment rated by a number of credit rating agencies, but downgraded to speculative by one - so long as this is not followed by any of the other agencies used, then the notice period could remain intact. If the only, rating applied, or more than one of the ratings fell below investment grade then we believe that the notice period should always be removed."

TXU Europe Energy Trading states "... TXU support this modification as it will provide greater protection to the community where greater risk of credit default may arise. However, it could be considered that the use of any speculative rating may be too broad a definition. It is more appropriate to specify any two rating agencies as differences can arise between rating agencies.

Such a discrepancy could cause the premature removal of a secured credit rating and cause a company regarded as investment grade by other agencies into providing expensive new short term credit cover and cause a greater problem than the downgrade justified. It is a greater probability that if two rating agencies regard the company as a speculative grade then the removal of the notice periods required for revision of a Users credit limits is justified."

Transco believes that it and Users may be commercially disadvantaged if these suggestions were to be implemented. In other commercial environments that are not subject to regulatory restrictions such decisions would be subject to individual companies commercial credit policies. Transco believes that in the event of a User's, or related company's, credit rating being downgraded by only one of the recognised rating agencies other parties trading with that User may take action to limit their exposure, thereby leaving Transco and User's as a whole open to an increased level of financial risk.

The remaining four respondents (British Gas Trading, Innogy , Powergen and Scottish & Southern Energy) fully support the implementation of this modification. They agree the proposal will reduce User's and Transco's exposure to financial loss, highlighting the consistency of its objective in protecting Users with those of Modifications 0474 and 0475, recently implemented. Further highlighting that the existing 30 day notice period provides the potential for increasing exposure for the community as the administrator may continue to use revenues from the imbalance regime, which is essentially User's money. It is also acknowledged that recent experience indicates that it is possible for grade ratings to change rapidly and therefore it is appropriate that Transco should be able to take timely action in its role in managing credit risk for the community as the current regime places undue risk on all participants, regardless of size.

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

Transco is not aware of any such requirement.

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

Transco is not aware of any such requirement.

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

Transco is not aware of any works required to implement this Modification Proposal. Changes identified relate to operational controls within Transco's Credit Risk Management functions. Transco can facilitate these changes with immediate effect.

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

If the decision was taken to implement this Modification Proposal, it could take effect immediately following direction from the Authority .

16. Recommendation concerning the implementation of the Modification Proposal

In view of the recent implementation of Modification Proposals 0474 (Revision to Indebtedness Cash-Call Trigger) and 0475 (Termination of User in Receivership) and given the general level of support expressed by Energy Balancing Credit Committee members for this Modification Proposal resulting from its consistent objective of protecting Users as a whole from the risk of financial loss, Transco recommends implementation of this Modification Proposal.

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

Section V

3.2.4(a) A User's Code Credit Limit may from time to time be reviewed and revised, in accordance with the Code Credit Rules, save where paragraph 3.2.4(b) applies on notice of not less than 30 Days (or any lesser period agreed by the User) to the User:

- (i) at intervals of approximately 12 months;
- (ii) at the User's request (but subject to paragraph 3.2.7);
- (iii) where any published credit rating of the User or any person providing surety for the User is revised downwards;
- (iv) where (but without prejudice to any requirement of the Code Credit Rules) any instrument of surety or security expires or is determined;
- (v) at Transco's request where at any time Transco has reasonable grounds to believe that the effect of the review will be to reduce the User's Code Credit Limit.

3.2.4(b) Where any published credit rating of the User or any person providing surety for the User is revised downwards to the extent that the said credit rating following such revision is less than the minimum prescribed credit rating as set out in the Code Credit Rules, a User's Code Credit Limit may be immediately reviewed and revised by Transco in accordance with the Code Credit Rules, on notice to the User.

The Supplement

2.2.6(a) A User's Secured Credit Limit may also be revised, in accordance with the Energy Balancing Credit Rules, save where paragraph 2.2.6(b) applies, on notice of not less than 30 Days (or any lesser period agreed by the User) to the User:

- 2.2.6(i) at intervals of approximately 12 months;
- 2.2.6(ii) where any published credit rating of the User or any guarantor is revised downwards;
- 2.2.6(iii) where (but without prejudice to any requirement of the Energy Balancing Credit Rules) any Guarantee or instrument of Security expires or is determined;

2.2.6(iv) where at any time Transco has reasonable grounds to believe that the effect of the review will be to reduce the User's Secured Credit Limit.

provided that nothing in this Supplement shall require Transco to undertake a review under paragraph 2.2.6(ii) or 2.2.6(iii).

2.2.6(b) Where any published credit rating of the User or any guarantor providing security for the User is revised downwards to the extent that the said credit rating following such revision is less than the minimum prescribed credit rating as set out in the Energy Balancing Credit Rules, a User's Secured Credit Limit may be immediately reviewed and revised by Transco in accordance with the Energy Balancing Credit Rules, on notice to the User.

Signed for and on behalf of Transco.

Signature:

Steve R Phillips
Director of Shipper 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 **0521**, version **1.0** dated **07/02/2002**) 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 appropriateprovided 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 (whether such approval is actual or deemed by effluxion of time) 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, had it not been repealed, would 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) or 2(2)(b)(ii) 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.