

Direct Dial: 0207-901-7433

16 October 2001

Transco, Shippers and Other Interested Parties

Your Ref:
Our Ref: Net/Cod/Mod/474

Dear Colleague,

Modification Proposal 474: Revision to indebtedness cash call trigger

Ofgem has considered the issues raised in modification proposal 474: Revision to indebtedness cash call trigger. Ofgem has decided to direct Transco to implement the modification, because we believe that the proposal will better facilitate the relevant objectives of Transco's Network Code. The modification will be implemented on 1 December 2001.

In this letter, we explain the background to the modification proposal and give our reasons for making our decision.

Background to the proposal

Independent Energy's collapse in September 2000 raised a number of issues concerning the operation of credit cover as set out in the network code. When a shipper defaults on paying its balancing costs, the costs are smeared across the shipping community. The Energy Balancing Credit Committee (EBCC) represents shippers' interests relating to discontinuation and recovery action regarding energy balancing debt. Events following Independent Energy's failure have highlighted the need to amend current credit management procedures.

Currently shippers determine their own credit limit. In accordance with the Credit Risk Management Procedures, Transco is required to determine whether the shipper's credit rating is sufficiently high to meet the secured credit limit or whether further guarantees of security are required. If a shipper exceeds 85% of its secured credit limit Transco will issue a cash call notice. Shippers are required to pay the amount set out in the cash call notice by the next business day. If Transco does not receive these funds it issues a failure to pay a cash call notice, requesting payment within three business days. If a shipper fails to pay within this period Transco can, at its discretion, issue a termination notice. In the interim period Transco may withhold payments to the shipper of energy balancing invoice charges. These procedures have been largely unchanged since the introduction of the network code in 1996.

The experience of Independent Energy's collapse has raised the issue of how to recover debt when a shipper goes into receivership. A shipper's credit position is calculated seven business days after the gas day. Therefore, when the shipper enters receivership it could take up to nine calendar days before the scale of the debt can be identified. Three modification proposals were originally raised to address these concerns, namely, 441, Termination of User in receivership, 446, Revision to Indebtedness Cash Call Trigger and 447, Provision Enforcement of a Minimum Level of Energy Balancing Security. Ofgem rejected all three proposals due to concerns over their potential impact on Users.

Modification 446 was the predecessor to modification 474. The modification proposed that an estimate would be used to calculate a User's energy balancing debt for each of the seven days where data is not available. It was proposed that the SAP on the day and the shipper's imbalance position seven business days previously would

be used to estimate the balancing debt. This estimate would be used to calculate whether, over a seven day rolling period, the shipper has incurred debt greater than 85% of its secured credit limit. If so, Transco would send out a cash call notice and follow the cash call procedures.

We were concerned about how the estimate for a User's energy balancing debt was calculated. In particular, there was the potential that too many cash call notices could be issued and given the timetable procedures, result in a shipper being terminated from the network code on the basis of an inaccurate estimate of debt before the actual debt position is known.

The modification proposal

Modification 474 proposes an amendment to the methodology for estimating a shipper's debt position. If over a seven day rolling period the User has an energy balancing debt it proposes that anticipated debt is calculated using SAP on the day which is confined to a 95% confidence interval based on the mean of the previous ten days. If SAP is greater than the 95% confidence interval it is scaled down to the maximum limit and vice versa if it is less than the 95% confidence interval. This ensures that extreme SAP prices are normalised for the calculation of indebtedness. Furthermore, the modification proposes that the shipper's balancing position is averaged over a 10 day period. If this total amount is greater than 85% of the shipper's secured credit limit then Transco will issue a cash call notice and follow cash call procedures.

Respondents' views

Nine representations were received in response to the modification proposal. All the respondents supported the modification proposal on the basis that it gives a more accurate estimate of a shipper's indebtedness which could indicate earlier whether a User is experiencing difficulties and could, therefore, potentially limit the shipping community's exposure to energy balancing debt.

A number of respondents made reference to the process for estimating indebtedness. One respondent suggested that applying SAP on the day to an average of the imbalance volume would have been preferential but appreciated that the proposal retains SAP trends but dilutes the impact of price spikes. Transco argued that the proposed calculation of anticipated debt may underestimate a shipper's indebtedness position but is likely to be a better estimate than the debt position currently calculated under the network code. One respondent suggested that the method for calculating indebtedness is reviewed periodically by Transco and the EBCC to ensure that it protects the industry from exposure to debt without affecting an individual shipper's ability to manage its own indebtedness.

One respondent argued that this modification alone will not sufficiently protect the industry from debt incurred from a shipper default and believes that a minimum level of security is required from shippers who frequently exceed their secured credit limit as formerly proposed in modification 447.

Ofgem's view

Ofgem supports the industry's moves to develop prudent credit arrangements that take account of the needs of the entire shipping community and ensures a fair and efficient system. The proposals should not place unnecessary risk on the community by increasing the likelihood of shipper defaults. Therefore, we have advocated a cautious

approach to determining a methodology for calculating anticipated indebtedness. The timetable for terminating a User using the cash call process is such that it is possible, if the estimate is higher than the actual debt, for a shipper to be terminated from the Network Code before the actual indebtedness position is known.

By using an average of a shipper's imbalance position and a 95% confidence interval that reduces extreme volatility in SAP it is possible that a shipper's imbalance position may be underestimated. However, it will give an indication of whether a User is heading towards a cash call notice.

We agree that the process for calculating indebtedness should be monitored by Transco and the EBCC. If it becomes apparent that the incentives are insufficient to ensure that shippers have adequate credit in place or that the shipping community continues to be exposed to the risk of unduly high debt following a shipper default, it may be appropriate to tighten the indebtedness methodology.

Ofgem's decision

Ofgem believes that modification 474 sets out a prudent approach for estimating a shipper's debt position. We believe that this process will encourage shippers to ensure that they have sufficient credit in place and will minimise the community's exposure to debt if a shipper defaults. We therefore believe that the modification will further Transco's relevant objective to run an efficient and economic pipeline system.

In its final modification report Transco states that it can implement the modification six weeks following Ofgem's decision however it is suggested that the implementation date should be set for the beginning of the month for clarity in the invoicing process. The modification will therefore be implemented on 1 December 2001.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Nick Simpson
Director, Industry Code Development