

Modification Report
Revision to Indebtedness Cash-Call Trigger
Modification Reference Number 0474
Version 2.0

This 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

The proposal made was as follows:

"It is proposed that when aggregated over a rolling seven day period the User has an energy balancing debt, the following additional calculations shall be carried out in order to update the Users anticipated credit position.

For each Gas Day within the measurement period set the energy balancing deficit or surplus (in kWh) to the average of the previous ten days. Where ten has been identified as the number of calendar days required to cover the previous seven Business Days indebtedness.

The average is calculated by summing the previous ten daily balances and dividing by 10. Apply to these deficits and surpluses the System Average Prices for that Gas Day to derive an equivalent debit/credits for each Gas Day.

The value of the SAP is confined to be within the 95% confidence interval based on the mean of the previous ten days. This is calculated as follows; if the SAP is greater than the upper 95% confidence interval, or less than the lower 95% confidence interval then the value will be increased or decreased accordingly to the limit of the confidence interval. If the SAP is within the limits then this value will be used

Where the confidence interval is created using the mean average plus or minus 1.96 times the standard error.

Aggregate these debits and credits for the measurement period and derive a net debit.

Add this net debit to the Outstanding Relevant Balancing Indebtedness prevailing immediately prior to the commencement of the measurement period.

For the purpose of Cash Call this revised debt shall be the Outstanding Relevant Balance Indebtedness."

The proposer justified the Modification Proposal as follows:

"The failure of Independent Energy in September 2000 exposed the shipping community to some £1.5M of pre-receivership energy balancing debt. This focused attention on the need to tighten-up current credit management procedures, which have remained largely unchanged (other than Modification 103 implemented on 1 October 1997) since the introduction of the Network Code in 1996. Of particular concern is the potential for Users to rapidly increase indebtedness through trading at the National Balancing Point (NBP) that result in large imbalance positions. Members of the Energy Balancing Credit Committee (EBCC) have concluded that a better measure of indebtedness is required.

Prior to the due date of a Balancing Invoice, Users can build up levels of indebtedness if, day after day, they have a consistent deficit on their daily energy balance. The number of days which the Network Code allows for finalising energy allocation at entry plus the period for preparation and payment would, in the extreme, allow Users to accrue up over two months of imbalance debt. If on the due date, the User were unable to pay the invoice, the Users as a whole are required to fund this deficit in expected payments, which in the absence of additional controls could be substantial.

Transco, therefore, on behalf of all the Users, operates procedures that seek to track each User's ongoing energy debt position. This allows action to be taken to protect the exposure of all the Users to a single User's excess debt. One of the key actions available to Transco is a Cash Call. This operates once a User has established an Energy Imbalance debt that exceeds 85% of its Secured Credit Limit. Transco's actions have to be in accordance with both the Network Code and the Energy Balancing Credit Rules and the latter are subject to the approval of the Energy Balancing Committee. This committee is established by the Network Code as a committee of Users under the non-voting chairmanship of Transco. Ofgem also routinely attends the committee meetings in a non-voting capacity.

This Energy Balancing Credit Committee has identified an issue arising from the present Network Code rules. With respect to each Gas Day, initial allocation at entry does not need to take place until seven Business Days later and this is the first date that the scale of the debt can be identified. At this time the User may have effectively accumulated a further debt in the intervening period (the "unmeasured period"), which would be a minimum of nine calendar days. There is therefore a need for a Network Code Modification, which estimates the indebtedness of a User on the day that the debt is reviewed. This estimate of indebtedness would then be compared with the Cash Call Limit and a decision to Cash Call would be made on that basis."

The legal text shows the calculation in detail but in response to a request from the Modification Panel Transco has prepared an example which is attached as an appendix.

2. Transco's Opinion

In respect of energy balancing, Transco is essentially neutral as it is not exposed to the financial risks involved and acts in the interests of the community as a whole under the Energy Balancing Credit Rules.

Transco has, however, some sympathy with this Modification Proposal as it would give a more up to date energy balancing debt position for each User. This would allow Transco's Credit Risk team to take actions that limit the exposure of Users as a whole, based on the best information available at that time.

Transco also concurs that, where a User enters receivership, this Modification Proposal should limit the unrecoverable energy balancing debt to a lower level than would be the case at present.

Transco notes the argument that this Modification Proposal would not result in an increase in the number of Users entering receivership but would, in the extreme, only hasten the process. Transco believes that the representations on this point have confirmed this view.

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

The proposer has suggested that a User entering receivership with a cash shortfall arising from energy imbalances would create a potential debt burden on all other Users via the balancing neutrality mechanism. This potential debt burden can be viewed as a form of subsidy. If it is considered that such subsidies are symptoms of inefficient or uneconomic operation of Transco's pipeline system, to the extent that this Modification Proposal would be expected to reduce this burden, implementation could be considered as enhancing efficient and economic operation.

Transco also notes the argument that such subsidies might hinder the development of competition and a history of debt burdens absorbed by the User community might be considered as a barrier to entry of new Users.

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

a) implications for the operation of the System:

Transco is unaware of any implications for the operation of the System.

b) development and capital cost and operating cost implications:

Providing the implementation of this Modification Proposal does not increase the likelihood of Users entering receivership, the only implications that Transco has identified are in the area of credit risk management and the computer applications that support Transco in that role. Transco believes that development, capital and operating costs arising from changes to its operations and the systems which support them would be minor.

If, however, the likelihood of Users entering receivership was increased by the implementation of this Modification Proposal there would be operating cost implications in transferring Supply Points to alternative Suppliers.

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 believes it is appropriate to fund any changes to its computer applications, arising from this Modification Proposal using existing revenue.

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

Transco is unaware 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

Transco does not believe that implementing this Modification Proposal would have any consequence on the level of contractual risk to Transco under the Network Code.

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

Transco has identified the development implications for its computer systems and has concluded that the changes needed to its credit risk support systems could be accommodated to meet implementation six weeks after approval by GEMA.

Users might wish to modify any existing systems that they have which mirror those used by Transco in credit risk management but it is expected that these systems changes would be minor.

7. The implications of implementing the Modification Proposal for Users

This Modification Proposal is intended to reduce the credit risk on Users through balancing neutrality and is therefore considered by the proposer to be of benefit to Users as a whole.

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

Providing implementation of this Modification Proposal would not increase the likelihood of Users entering receivership, but only hasten the process, it is believed that implementation could be in the interests of Non-Network Code parties. This would be due to the shorter period of uncertainty for Non-Network Code parties that have a contractual relationship with the User concerned and the credit exposure that they might face during that period.

If implementation of this Modification Proposal did lead to an increase in the likelihood of Users entering receivership, consumers would potentially incur additional costs arising from the change of Supplier.

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 relationship of Transco, Users or Non-Network Code Parties as a consequence of implementing this Modification Proposal.

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

Advantages of implementing this Modification Proposal are that:

Transco's credit risk management processes would be managing the risk to Users based on more up to date information. Having up to date debt information is generally recognised as good practice for credit risk management processes.

In the event that a User that was Cash-Called ultimately entered receivership, this Modification Proposal could reduce the existing exposure of Users through balancing neutrality as a result of non-recovery of energy balancing debt.

Disadvantages of implementing this Modification Proposal are that:

It might lead to an increase in the number of Cash-Call notices if Users continued to incur existing levels of energy balancing debt. This would have implications for cash flow.

It can be argued that increasing a User's exposure to Cash-Calls would increase its financial vulnerability which might result in it entering receivership.

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

Transco has received representations from the following parties :

Exxon Mobil Gas Marketing (Exxon Mobil)

Total Fina Elf Gas and Power Limited (TFEG&P)

Powergen

Alliance Gas

TXU Europe Energy Trading Limited (TXU)

British Gas Trading (BGT)

Innogy

Scottish and Southern Energy (SSE)

Shell Gas Direct Limited (SGD)

General Comments

All respondents were in support of Modification Proposal 0474. SSE, BGT, TFEG&P and Exxon Mobil drew attention to the views expressed during the consultation for Modification Proposal 0446 (Revision to Indebtedness Cash Call Trigger) which had the same general objective. TFGE&P stated that "the revised proposal differs from mod 446 only in respect of the determination of weighted SAP calculation used to determine a more accurate estimate of a Users outstanding energy balancing debt."

Transco's Response

Transco agrees with the comments of Users on the essential similarities and differences between Modification Proposals 0446 and 0474.

Relevant Objectives

SGD, TFEG&P and Alliance Gas stated that implementation of this Modification Proposal would further facilitate the relevant objectives. In particular, Alliance Gas referring to the credit risk stated that it "could potentially be viewed as a barrier to entry" and that implementation of this Modification Proposal "will act to reduce this risk" and "will also act to encourage competition between relevant Shippers". Similarly, TFEG&P believed that implementation of this Modification Proposal "would encourage competition by reducing the potential for this risk to act as a barrier to entry for new Users."

Transco's Response

The comments of Users on facilitation of the relevant objectives confirm the view expressed within section 3 of this Modification Report

Exposure to Cash-Calls

Innogy commented on the statement in the draft Modification Report that implementation of the proposal may increase a User's exposure to cash-calls. It argued that "a corollary to this proposal is that Users put in place a level of credit cover that is appropriate to their balancing behaviour."

Transco's Response

Transco has sympathy with the view that the level of credit cover should be appropriate to a User's balancing behaviour.

Community Exposure

Exxon Mobil argued that implementation of this Modification Proposal "may reduce the overall exposure of the shipper community". TFEGP believed that implementation "would serve to reduce the potential size of any debt burdens

arising out of any future shipper failures that are ultimately born by the shipping community." Innogy believed that implementation "will reduce the exposure faced by System Users and allow remedial actions to be brought forward." Exxon Mobil referred to managing counterparty credit risk and that implementation would mean that "All shippers irrespective of size will benefit from the reduction of an uncontrollable risk." Powergen believed that implementation would give "added protection to the community from incurring debt over an extended period". SSE was supportive of measures "that would tighten up the current energy balancing credit management procedures and thereby reduce the financial risk of a User Default for all parties" and for this reason supported this Modification Proposal. Alliance Gas referred to the fact that implementation of this Modification Proposal would lead to Transco being better informed and that this "should lead to a reduction in the credit risk presently faced by Users under the existing regime." TXU argued that "All Users will benefit from the modification as it will indicate earlier when a User is experiencing difficulties and therefore could potentially limit the exposure of the community." SGD believed that implementation "would limit the amount of unrecoverable energy balancing debt to which all other Shippers are exposed".

Transco's Response

Transco agrees that implementation of this Modification Proposal should reduce the community risk resulting from the unrecoverable energy balancing debt of a User.

Need for Timely Implementation

BGT, Powergen, Alliance Gas and TFEG&P argued that an implementation decision should be made on the proposal as soon as possible. Alliance Gas welcomed "the input received from Ofgem in the development of this proposal" and "would urge Ofgem to reach a quick decision in relation to this modification". TFEG&P expressed concern "with the lack of urgency on Ofgem's part in reaching their decision to reject mod 441 and the associated mods 446 and 441." It also expressed a similar concern at "a further lack of urgency by Ofgem in resolving their concerns with the original mods which has effectively delayed introducing what we consider to be important improvements to the existing credit arrangements."

Transco's Response

Transco has no objection to the implementation of this Modification Proposal taking place as soon as the system modification timetable allows. This is six weeks following any approval by GEMA but would suggest that the actual implementation date be aligned with the energy balancing invoice period.

Methodology for Calculating Indebtedness Position

Exxon Mobil believed that the methodology under Modification Proposal 0474 "will give an acceptable estimate of indebtedness for the unmeasured period but is no longer consistent with existing Code methodology." SSE stated that it was "unclear about the impact that the revised cashout arrangements and removal of balancing tolerances from 1 April would have on the monitoring of a shipper's credit position." This resulted from the fact that shipper's imbalance are now primarily cashed out at SMP rather than SAP. SSE therefore requested "comfort that the use of a modified SAP (rather than, for example, a modified SMP) would not be misleading, and would instead give a more accurate picture of shipper's anticipated credit position than the current methodology." Innogy expressed a preference "to apply SAP to the average imbalance volume, as this price is more representative of the actual indebtedness. However, we do recognise that the proposed approach retains some of the features of using SAP but dilutes the impact of price spikes. BGT supported this Modification Proposal but advocated that the method of calculation "is reviewed periodically by Transco in liaison with the Energy Balancing Credit Committee."

Transco's Response

Transco would confirm that use of an modified SAP as proposed in this Modification Proposal might lead to underestimation of the shipper's indebtedness. It would, however, point out that even this underestimated position is likely to be a better estimate than the debt position presently calculated under the Network Code.

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

Transco is unaware 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 3(5) or the statement furnished by Transco under Standard Condition 3(1) of the Licence

Transco is unaware of any such requirement.

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

The only works of which Transco is aware concern the changes required in the computer applications used in its credit risk management process and similar

applications which Users might have. Transco can complete these works within six weeks of any decision on implementation.

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 six weeks following direction by GEMA. However, Transco suggests that the implementation date be set to the beginning of a calendar month, to assist clarity within the invoicing process.

Notwithstanding the comments in Section 16 below, implementation of this Modification Proposal is not necessarily dependent upon the outcome of Modification Proposal 0475.

16. Recommendation concerning the implementation of the Modification Proposal

In view of the general support expressed by Users to a similar Modification Proposal 0446, Transco recommends implementation of this Modification Proposal.

Transco believes that GEMA should seek to take a consistent view across the gas and electricity markets and may believe that this Modification Proposal, together with Modification Proposals 0475 should be considered as part of a wider package of potential changes.

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 not to modify the Network Code and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

NETWORK CODE SUPPLEMENT: ENERGY BALANCING CREDIT MANAGEMENT

Amend paragraph 2.5.2 to read as follows:

"....

- (c) "Anticipated Balancing Indebtedness" for each User is an amount calculated, in respect of all Days in the relevant period (each and any such Day ('i')), in accordance with the following formula:

$$ABI = \sum_{i=d-n}^{d-1} ADSAP_i * \sum_{j=d-20}^{rp-1} \frac{DI_j}{m}$$

where:

ABI is the Anticipated Balancing Indebtedness;

ADSAP_i is the Adjusted System Average Price for a Day, 'i', being any Day falling during the relevant period, which shall be the System Average Price for that Day 'i', except where either:

(i) the SAP for the Day 'i', is greater than the mean of the SAPs for the previous 10 Days plus 1.96 times the standard deviation of the SAPs for the previous 10 Days ("the Upper Limit"), in which case the ADSAP shall be equal to the Upper Limit; or

(ii) the SAP for the Day 'i', is less than the mean of the SAPs for the previous 10 Days minus 1.96 times the standard deviation of the SAPs for the previous 10 Days ("the Lower Limit"), in which case the ADSAP shall be equal to the Lower Limit.

DI_j is the User's Daily Imbalance for a Day 'j' falling during the Imbalance Period (being a positive or (as the case may be) negative amount in accordance with Section E5.1.2),

d is the relevant Day

"Imbalance Period" is the period from and including 20 Days preceding 'd' ('d-20') until (and including) the Day preceding the beginning of the relevant period.

m is the number of days in the Imbalance Period

n is the number of days in the relevant period,

and the "relevant period" is the period from (and including) the 7th Business Day preceding the relevant Day, 'd', (such Day being "rp") until (and including) the Day preceding the relevant Day ('d-1');

- (d) **"Outstanding Relevant Balancing Indebtedness"** for each User means (subject to paragraph (g)) the sum of:

- (i) the net aggregate....
- (ii) the Net Invoice Amounts....
- (iii) the Net Invoice Amounts....
- (iv) the User's Anticipated Balancing Indebtedness,

less....;

Re-number following paragraphs and 2.5.2(e), which becomes 2.5.2(f), shall be amended to read as follows:

“(f) for the purposes of paragraph (d)(i)....”

Amend paragraph 2.5.3 to read as follows:

"The Relevant Balancing Charges and a User's Anticipated Balancing Indebtedness will be calculated....".

Amend paragraph 2.5.4 to read as follows:

"....

(i)the calculation of Relevant Balancing Charges and a User's Anticipated Balancing Indebtedness will disregard....".

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

Gas and Electricity Markets Authority Response:

In accordance with Condition 7 (10) (b) of the Standard Conditions of Public Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0474**, version **2.0** dated **30/07/2001**) 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 **2.0**.

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.