URGENT Modification Report
Revision of Notice Period in the Event of a Users Credit Rating being Downgraded
Modification Reference Number 0598

Version 2.0

This Modification Report is made pursuant to Rule 9 of the Modification Rules and follows the format required under Rule 8.9.3.

Circumstances Making this Modification Proposal Urgent:

In accordance with Rule 9.1.2 Ofgem has agreed that this Modification Proposal should be treated as Urgent because recent events have shown that contractual restrictions preventing prudent commercial actions by Transco could adversely affect revenue recovery and should be revised. Failure to do so could have a significant financial impact on Users and Transco alike.

Procedures Followed:

Transco agreed with Ofgem (and has followed) the following procedures for this Proposal:

Proposal agreed as Urgent	23/10/2002
Circulate proposal to Users requesting representations	23/10/2002
Representation Close-Out	30/10/2002
Final Modification Report to Ofgem	04/11/2002
Ofgem Decision Expected	06/11/2002

1. The Modification Proposal

It is proposed that the provisions of Modification 0521 ("Where a guarantor is downgraded to any speculative rating, removal of the notice period required for the revision of a users secured credit limit and code credit limit"), implemented on 15th March 2002, are extended to give Transco the right to issue notice of an immediate revision to a User's credit security should there be any downward revision of a credit rating, either published or privately obtained, of the user, guarantor or any other security provider. (Unlike Modification 0521, the revision would not be dependant on whether the revised rating remained of investment grade.)

Additionally, Transco seeks the right to review, and if appropriate, require the User to revise immediately, its level of credit security in the event it is necessary to make a demand on any existing instrument of security provided by the User.

Consequently, in both circumstances described above, rather than waiting for 30 days for the remedial measures to take effect, Transco would be able review, and require the User to take action immediately following a revision of its Secured Credit Limit or Code Credit Limit.

2. Transco's Opinion

Transco is of the opinion that the proposal should be implemented.

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

The purpose of the proposal is to allow Transco to vary a User's Secured Credit Limit and / or its Code Credit Limit in response to what may be rapidly changing financial circumstances. The ability to respond promptly, and invoke escalatory actions where necessary, would reduce the risk of unsecured credit exposures for all parties concerned and, therefore, could be expected to facilitate a more competitive environment for shippers to operate.

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

Implementation would reduce Transco's contractual risk as the ablity to react to a change of a User's financial status by changing its Credit Limits would enable Transco to seek alternative security. The ability to carry out these actions quickly following a User's change in financial circumstances would secure revenues relating to transportation services. Transco is neutral to this proposal in respect of energy balancing charges.

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

Implementation would not result in any significant systems development for Transco.

7. The implications of implementing the Modification Proposal for Users

The effect of a User credit rating downgrade would be to reduce both a User's Secured Credit Limit and Code Credit Limit. A reduction in either of the Limits could result in a request for additional security. Implementation would require the User to rectify the situation promptly by either increasing its security provisions or settling part of the debt.

In the case of energy balancing charges, prompt correction of the User's indebtedness to Secured Credit Limit ratio serves to protect this revenue stream for the benefit of all other Users, thereby reducing the consequential exposure resulting from a change of financial circumstances of another.

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 non-Network Code parties.

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

Advantage

Transco would be able to respond in a prudent and timely manner to the change in financial circumstances of a User. Consequently, the risk of failing to collect due revenue would be reduced, thereby serving to protect other Users and itself from the risk of bad debt.

Disadvantage

Any reduction in a User's credit limit may result in the User being unable to provide the required level of security.

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

Twelve representations have been received in respect of this Modification Proposal, seven are supportive of the proposal and three of the remaining five support the principle that Transco should be enabled to protect both the shipping community and itself from avoidable financial loss.

Three respondents (**Agip (UK)Ltd, Powergen UK Plc** and **Total Fina Elf Gas and Power Ltd**) fully support the proposal and agree that the ability to respond promptly

and invoke escalatory actions would reduce risk for all parties concerned and therefore could be expected to facilitate a more competitive environment.

Three respondents (**British Gas Trading Ltd, Exxon Mobil Gas Marketing** and **Scottish Power Energy Trading Ltd**) are supportive in principal but raise concerns over the removal of the notice period.

British Gas Trading states "*We recognise that the purpose of this modification is to afford further protection to the industry as a whole from exposure to a User failure. However, we do have reservations that the mechanistic removal of the notice period may be unnecessary in some cases where a User still holds a rating which is commensurate with their value at risk. That being the case, we support the inclusion of Transco having the "right" to make this revision rather than an automatic obligation.*" And further states "*Although it may not be a part of the current process we believe that consideration be given to some consultation with the Energy Balancing Credit Committee, which could be convened at short notice or by teleconference. This would ensure that the action of suspension of the notice period was only taken where necessary in light of circumstances.*"
Transco response: A downgrade event, in itself, is not sufficient circumstances to convene an extraordinary meeting of the EBCC but where circumstances dictate a meeting could be held.

Exxon Mobil Gas Marketing states "*As there is no notice period, theoretically Transco can suspend on the day they deliver notice. Again this seems to pose unacceptable risk for all shippers, irrespective of their credit standing or the rating downgrade in question.*" In addition Exxon raises the concern that Transco can request immediate delivery of security on any downgrade; "*An 'Aaa' downgrade to 'Aa1' appears to trigger the same rights for Transco.*"
Transco response: As the risk of default increases when a User's published rating reduces, it is prudent to reassess the level of credit being extended to that User however, such a revision may not necessarily trigger a request for additional security as the Users actual credit limit may be lower than the maximum implied by its previous rating.

Scottish Power Energy Trading Ltd offers qualified support for this Modification Proposal on condition that a reasonable and quantified notice period be established and states **"***We believe that we should be looking for synergy in arrangements across the energy regimes. We believe that corresponding arrangements in electricity are preferable to those in gas.*" Scottish Powers' further concerns and suggestions are summarised below:

a) *"There may be confusion over which ratings this is based on – is it all – and what if there are significant discrepancies between rating agencies – does the shipper have arbitrage on which one should be used, i.e. the ability to switch?*"
Transco response: The purpose of the proposal is to permit Transco to apply the Modification 0521 review security mechanism to the existing security level review triggers and any decision would be based on the ratings given by agencies defined in the Energy Balancing Code Credit Rules.

b) *"If the designated credit rating agency as per Sect X 2.1.2. (ii) is consistent should this be the only one used by Transco in the event of upgrade & downgrade (since all shippers will be rated by one agency) otherwise companies with multiple ratings are being disadvantaged. This is not an issue which is specific to this modification alone, but it will be exacerbated because there is more scope for one rating to fall and another to follow shortly afterwards, after the notice period has expired."*
Transco response: This point lies outside the scope of the present Proposal, however experience has shown that not all companies are rated by a single agency and therefore to implement such a restriction on Transco may be disadvantageous to some Users.

c) *"Any agreed solution arising from the implementation of this proposal should be considered in line with other industry developments and the findings of the Ofgem review. However, pending the outcome of this review, the current arrangements are not adequate and we therefore support implementation of this proposal without delay.*"
Transco response: Transco concurs with the view that this proposal should be implemented without delay.

d) *"Is there going to be any change in the notice period in the opposite direction – i.e. in the event of an upward revision? This may or may not be reduced depending on which part of X 2.2.6. is revised."*
Transco response: Transco considers that the existing rule under X2.2.6 (or V3.2.4(a)) would not require revision as, whilst it provides the restriction of no less than 30 days notice, it makes provision for Transco to agree a lesser period with the Users agreement.

e) *"The provision of additional security which may be required by the affected shipper will take some time and will be unable to be effected "immediately".*
Transco response: In the absence of alternative security being provided the community's and Transco's exposure would be administered using the cash call process for Energy and issue of 70 and 85% notices respectively for transportation. Cash payments would be requested to maintain exposure within the agreed limits or a User could provide alternative forms of security.

Scottish Power goes on to suggest that the notice period could be reduced to either "*the 3-10 days in line with the time frame for alternative cover to be in place in electricity trading arrangements*, or *the statutory 5 days adopted by the FSA for unauthorised credit*,

Transco response: Considerable demands could be made upon the User by numerous creditors as a result of the downgrade of a published credit rating. By delaying action for a period the User may be unable to satisfy Transco's requirements as credit lines may have already been exhausted.

Statoil (UK) Gas Ltd and **SSE** (point 2) raise a similar point stating they could not support an "immediate" revision but could support a process with a built in time delay to allow the User to reduce its indebtedness where an indebtedness trigger is exceeded.

Transco response: If a User fails to provide security immediately, the cash call process for energy and the 70% and 85% notice process would be triggered. This gives a period of time for the User to lodge cash or alternative security with Transco.

f) *"given that differing risks are associated with downgrades at various levels, e.g. community risk is less (to use S & P) at AA+ to AA than BBB to BBB- – perhaps a sliding scale of notice might be more appropriate"* (also raised by **Shell Gas Direct** and **SSE** (point 6))

Transco response: Transco would agree that this view is correct in terms of there being differential levels of risk in respect of default probability, there are considerable step changes in level of security provided by such ratings. In December 2001 the EBCC agreed differential maximum credit limits for Baa rated companies (e.g Baa1 - £15m; Baa2 - £10m; Baa3 - £2.5m) that recognise that the greater level of risk rests at the lower end of the range.

g) *in all cases we believe that acknowledgement of the need for additional security to be put in place by the shipper should be immediate.* Transco response: Transco agrees with this.

SSE Energy Supply Ltd support the proposal in principal but make the following comments;

SSE's initial point asks whether " ..... *Transco would always initiate a credit limit review in the event of a downgrade."*
Transco response: Every downgrade would result in a review but the User would only be given notice if a there was to be a reduction of the credit limit.

SSE point 1 "*We also believe that the Network Code and/or the Credit Rules should be more specific about the criteria upon which Transco would base its decision to review/revise a shipper's credit limit."*
Transco response: Transco believes the criteria for the revision of a User's credit limit is clearly defined in the Network Code and Code Credit Rules.

SSE point 4 "*Under the existing Code Credit Rules a BBB- rating is the lowest investment grade rating at which a shipper is not required to post security. SSE considers that this level ought to be reconsidered and that this could be a means of addressing the way that credit limits are managed in the event of a rating downgrade."*
Transco response: This Proposal does not seek to change to the rules on this issue, however Transco agrees that a BBB- rating, being a notch above "junk status" should not support an unsecured credit facility, as demonstrated in its response to the Ofgem Credit Consultation.

SSE point 5 "*This would mean that in the event that a rating was revised downwards, it would trigger an automatic revision to the credit limit. Then shippers would be aware of the process that would be invoked in this event and each party would be treated equitably under the Code Credit Rules."*

Transco response: Downgrade of a public credit rating would not automatically trigger a review of credit limits. The publishing of credit limits based on credit ratings is not an issue for this proposal but, in essence, the idea that the review should promptly follow a downgrade event is the purpose of this Proposal. Transco believes that it's internal processes ensure that all Users are treated equitably.

Shell Gas Direct, Chevron Texaco, BP Gas Ltd, and **Entergy-Koch Trading Europe Ltd** ("**EKTL**") submitted representations stating that they do not support implementation.

Shell Gas Direct expresses concerns that the proposal *"provides Transco with too much freedom to act unilaterally"* and such action could *"disadvantage the shipper"*. **BP Gas** raises a similar point.
Transco response; The actions that Transco can undertake are already described in the Network Code, it is simply the deployment timescales that would be modified by this Proposal thus enabling more rapid application of existing contractual provisions. As regards "disadvantaging the shipper" this view should be balanced against improved protection for the shipping community as a whole.

Chevron Texaco states a concern "*about the wide discretion sought by Transco 'should there be any downward ..... of the User.'*". **EKTL** raised a similar point.
Transco response: Transco is not seeking further discretion in the application of existing provisions V3.2.4(a)(iii) and X2.2.6(a)(ii) merely the ability to bring such credit rating downgrades in line with rule V3.2.4(b) and X2.2.6(b) respectively.

BP Gas, **EKTL** and **SSE** (point 3) raise similar points regarding the sourcing of credit ratings.
Transco response: The credit rating will continue to be sourced in line with the respective Credit Rules.

BP Gas states that the act of revising credit limits following a demand on security may " ..... *lead to Transco acting prematurely and exacerbating the situation.*"
Transco response: In the event that security is called upon effective credit cover is reduced. In order to protect Users and Transco security levels would need to be replenished as detailed in the respective credit rules, and if security was not forthcoming, credit limits reduced accordingly. The purpose of this Proposal is to remove the delay inbuilt to the present provisions and thereby remove the potential to disadvantage to Users and Transco.

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

This modification is not required 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 for issuing notices in response to events which affect a User's Credit status.

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

This proposal could be implemented very soon after direction by modifying existing procedures. The main UK-Link system does not require modification and, consequently, no implementation delays for Transco IS reasons are anticipated.

16. Recommendation concerning the implementation of the Modification Proposal

Transco notes that the great majority of the responses to this Proposal are supportive and that a number of points are raised which are outside the scope of the Proposal. It is Transco's view that this reflects the level of attention presently being given to this area and believes that these points should be pursued within the existing industry work groups. Transco therefore recommends that the Network Code is modified in accordance with this Proposal as this would reduce the levels of risk presently borne by the industry.

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 X AMEND PARAGRAPH 2.2.6 (a) AND 2.2.6 (b) AS FOLLOWS:

Delete 2.2.6 (a) (ii) and renumber 2.2.6 (a) (iii) and (iv) accordingly:

Delete reference to 2.2.6 (iii);

Delete Paragraph 2.2.6 (b) and replace with:

2.2.6 (b) Where:

(i) any published credit rating of the User or any guarantor providing Security for the User is revised downwards; or

(ii) Transco has made a demand upon any existing Guarantee or instrument of Security in accordance with the terms of such Guarantee or instrument of Security provided by the User or any guarantor providing Security for the User;"

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.

SECTION V AMEND PARAGRAPH 3.2.4 (a) AND 3.2.4 (b) AS FOLLOWS:

Delete 3.2.4 (a) (iii) and renumber 3.2.4 (a) (iv) and 3.2.4 (a) (v);

Delete 3.2.4 (b) and replace with:

3.2.4 (b) Where

(i) any published credit rating of the User or any person providing surety or security for the User is revised downwards; or

(ii) Transco has made a demand upon any existing instrument of surety or security in accordance with the terms of such instrument of surety or security provided by the User or any person providing surety or security for the User;

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.

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 **0598**, version **2.0** dated **11/11/2002**) 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 **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 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 (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.