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Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification proposal 0628 'Revision to Credit Cover required in respect of participation in Auctions and Allocations of System Entry Capacity'

Ofgem has carefully considered the issues raised in modification proposal 0628 'Revision to Credit Cover required in respect of participation in Auctions and Allocations of System Entry Capacity'. Ofgem has decided not to direct Transco to implement the modification, as we do not believe that it will better facilitate the achievement of the relevant objectives of Transco's network code.

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

Background to the proposal

Network code modification 0500, 'Long Term Capacity Allocation', introduced auctions for long-term system entry capacity (SEC) to Transco's national transmission system, in which capacity is made available up to 15 years ahead of use. These auctions are designed to give Transco improved signals of the demand for entry capacity and it is incentivised to respond to these signals and provide additional capacity where that is demanded.

The modification also amended the level of credit cover, which users would be required to provide in order to participate in these processes. Network code Section B2.2.15 states this level as follows:

> 'Where at 17:00 hours in the first Business Day of a calendar month in relation to a user the sum of:
>
> a) the aggregate System Entry Charges payable by the user in respect of its Registered Quarterly Firm SEC for each Day in the twelve (12) calendar months commencing from the first Day of the following calendar month ('relevant months'); and
> b) the user's Relevant Code Indebtedness at such time,

exceeds 85% of its Code Credit Limit Transco shall not later than five (5) Business Days after the first Business Day of the calendar month inform the user.'

In accordance with section B2.2.16 following the notice period defined in B2.2.15 the user is required to provide sufficient surety or security within (10) business days of the notice.

Under Transco's Gas Transporter (GT) licence, in the event that it serves a termination notice on a shipper, it must re-offer for sale any holdings of obligated entry capacity of the shipper. In the event that Transco suffers a loss on the re-sale of such capacity (ie, the revenues from the re-sale are less than the revenues that would have been derived from the original sale), Transco may make an application to the Authority to treat such loss as an income adjusting event (IAE).

As stated in Ofgem's letter of 27 September 2002, which accompanied the modifications to Transco's GT licence, in the event that Transco applies for an IAE, Ofgem would consider whether the credit arrangements Transco had established were reasonable and commercial in nature, having regard to other credit arrangements adopted for long-term supply contracts in the gas and electricity sectors. Until this has been demonstrated, it would be Transco, and not its customers, that carry the risk of shipper default with respect to entry capacity.

Transco held the first long-term entry capacity auctions in January 2003 and made allocations of capacity in March 2003. There was not sustained demand for incremental capacity and Transco did not make any applications to the Authority to release obligated incremental entry capacity.

The modification proposal

It is proposed that the sum associated with Section B2.2.15 a), as detailed above, be removed from the determination of network code credit requirements. It is proposed that the standard level of credit cover for transportation debts (63 days) is also sufficient for the purpose of acquisition of long-term SEC.

The proposer suggests that the extended level of security is not required in practice, because there were no signals for incremental capacity coming out of the long-term auctions. It suggests that the current credit rules are not related to the risk faced by Transco or the wider community and the modification proposal would serve to facilitate the Transporter's relevant objectives by facilitating competition in acquisition of SEC. The proposer also states that by removing these impediments to competition, it is intended to assist in maintaining an efficient and economic system in that users' actual requirements for SEC will be more complete.

Respondents' views

There were eight responses to this modification proposal, of which five respondents (including the proposer) supported implementation, one offered qualified support, and two were opposed.

Those respondents in favour raised the following:

It is the view of the proposer that the current arrangements are in no way related to the risk attached to Transco, or the wider community, in making the capacity available. The proposer suggested that the risk that was intended to be addressed relates to incremental capacity, where costs may be borne by community as a whole should a failure occur among the shippers allocated with that capacity. However, it states that in practice there has been no indication of demand for incremental capacity.

One respondent, whilst recognising Transco's concerns that this modification proposal would lead to an increased exposure to bad debt for themselves and the community, indicated its belief that the benefits afforded to shippers in the cutting of their credit requirements outweighs any potential community exposure. Two respondents felt that arrangements exist which could cover the resale of any capacity holdings which the holder will forfeit on termination, which would reduce the level of exposure faced.

Two respondents indicated support for alignment of credit rules for SEC with those for other transportation indebtedness. One respondent, who offered qualified support, also agreed that the 12 month credit cover level is too high. The respondent stated that since the implementation of modification 500 the industry credit rules have been substantially improved with all market participants aware of the risks in the market and their responsibilities. The respondent also stated that increased participation in the auctions could be aided by the removal of the 12 month level of credit cover, thus increasing competition and potentially giving Transco better long term signals.

Those respondents who were opposed to implementation raised the following:

One respondent indicated its belief that the current level of credit cover provides an appropriate balance between the cost of such cover and the risk of default. A further respondent indicated concern that this proposal could weaken current credit arrangements and increase the potential for bad debt to occur, which would be passed to other users. Both these respondents commented that participation in the LTSEC auction should be backed by a reasonably firm commitment and security from participants.

Transco's view

Transco does not support the implementation of this modification proposal.

Transco indicates its view that the credit arrangements were not put in place solely to cover incremental capacity release. Transco also considers that modification 0500 implemented the present 12-month credit arrangements to strike an appropriate balance between credit arrangements that create prohibitive cost for some who may otherwise wish to take part in LTSEC auctions, and weak arrangements that might enable any costs of failure to be passed on to other users.

Transco believes that a 12-month capacity credit requirement is the maximum term of credit guarantee that can be obtained without recourse to bespoke and therefore expensive products. However, had longer term credit provision been readily available, Transco considers that it might have been appropriate to further extend the duration of credit provision.

Transco states that the release of a long term firm product should not be treated as an option to pay, but rather it should necessitate a firm commitment on the part of users. It believes that this approach is undermined if short term credit provisions become the only requirement when obtaining long term firm capacity, which would be detrimental to LTSEC.

Transco considers it to be inappropriate that a reduction in the level of credit cover should be allowed to increase the potential for bad debt to occur with a consequent increase in the probability of Transco and users being exposed to the costs of a user defaulting on financial commitments associated with long term capacity. In addition, Transco indicates that it is unclear whether exposure would be reduced by the resale of capacity should a capacity holder default, as this would depend on the demand for recalled capacity and the price that could be obtained for it.

Ofgem's view

In light of the relevant objectives of Transco's network code and Ofgem's statutory duties, Ofgem has decided not to direct Transco to implement the modification.

Transco's licence obligations contain the risk that Transco will be exposed to any bad debt loss arising from the sale of entry capacity. In its conclusions and proposals document; 'Arrangements for gas and electricity network operator credit cover', February 2003 ('the credit cover document'), Ofgem indicated that unless Transco demonstrates that it has put in place credit arrangements which are reasonable and commercial it will carry the risk of shipper default.

Ofgem recognises that, in setting credit requirements for participation in long-term entry capacity allocation, there is a trade-off between avoiding the creation of barriers to entry and protecting customers from the costs of bad debt. Whilst Ofgem recognises respondents' comments that this modification proposal might reduce barriers to entry, Ofgem considers any benefit accruing would be outweighed by the associated increase in the risk of exposure to bad debt.

As noted in responses to this modification proposal, the default of a holder of long-term capacity could expose Transco and users to bad debt. Such views were also expressed in response to modification 500, which introduced the concept of LTSEC. At that time, a number of respondents were concerned that the proposed credit arrangements were not strong enough. Ofgem also notes Transco's view that had longer term credit provision been readily available, it may have been appropriate to further extend the duration of credit provision. Whilst the resale of capacity holdings forfeited on termination would reduce the level of exposure faced, Ofgem also recognises Transco's concern that such facility may be unpredictable.

For the above reasons, it is appropriate that credit arrangements should fully address the liabilities associated with the purchase of both long-term capacity and incremental capacity rights. Ofgem would also agree with Transco that it would not be desirable to have credit arrangements which change year on year, depending on whether incremental capacity has been released or not.

The long-term entry capacity auctions were introduced to improve the signals available to Transco in making investment decisions in relation to entry capacity. Such signals should be backed by a firm financial commitment to pay for the capacity, and in this respect, it is important that Transco has in place commercial credit arrangements which ensure that bids placed in the long-term auctions are reliable. Ofgem considers that the reduction of credit cover to a level unrelated to the likely exposure in the event of the default of a holder capacity rights could serve to reduce the reliability of long-term auction bids.

In the credit cover document Ofgem promoted the additional use of information arising from secondary market trading in establishing Transco's entry capacity credit cover. This approach moved away from application of arbitrary amounts of credit cover which may not bear direct relation to the level of risk to Transco or the wider community, and advocated a stronger role for Transco in entry capacity credit management. In this regard, the use of arbitrary amounts of credit cover in both the existing credit cover arrangements and in this proposal would not be appropriate.

Ofgem indicated in the credit cover document that, going forward, Transco could give consideration to a credit management approach that is based upon a regular review of the value of a shipper's entry capacity rights against the value at which those rights were originally sold to the shipper. In other words, Transco could make an assessment of the value that could be recovered from the sale of the capacity, in the event that the shipper that owned the capacity defaulted and was terminated. Where the value of the capacity was lower than the original sale value then Transco could make additional margin calls on the capacity. It was indicated that the degree and nature of the credit requirements that Transco would apply in these circumstances would be a matter for it to establish after considering the context of each credit situation. However, Transco should secure additional commitments where necessary that are similar to those applied in comparable competitive situations.

Ofgem considers that modification proposal 628 is not consistent with the principles of the credit cover document, and for the reasons set out above, does not represent reasonable and commercial credit arrangements for entry capacity. Ofgem does not therefore consider that the modification proposal better facilitates the achievement of the economic and efficient operation of Transco's system or the securing of effective competition between relevant shippers. Going forward, Ofgem would expect either Transco or the industry credit working groups to suggest how exposure can be proactively managed in a way that meets those principles in an efficient, cost effective manner.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to consent to this modification, as we do not believe that it better facilitates the achievement of the relevant objectives as outlined under Amended Standard Condition 9 of Transco's GT licence.

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 of Industry Code Development