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Shippers, Transco and Other Interested Parties

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30 September 2003

Dear Colleague,

**Modification proposal 0629 'Minimum Level of Security for Energy Balancing'**

Ofgem has carefully considered the issues raised in modification proposal 0629 'Minimum Level of Security for Energy Balancing'. Ofgem has decided to direct Transco to implement the modification, as we 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**

Currently, all aspects of energy balancing credit risk are governed by a combination of provisions in the network code supplement (section X) and the Energy Balancing Credit Rules ('EBCR'). The EBCR were agreed by the industry during the introduction of network code and are modified by the Energy Balancing Credit Committee ('EBCC'), whose members are drawn from and represent the interests of the shipping community operating on Transco's network.

Subsequent to the implementation of Network Code in 1996, Transco has operated as the Credit Risk Manager (Energy) ('CRM(E)') on behalf of shippers on its network, applying the EBCR in accordance with the instructions of the EBCC. In acting as the CRM(E), Transco remains neutral to energy balancing transactions.

Each user is responsible for the financial implications of balancing its daily gas flows in and out of Transco's network. All users also assume a share of the credit risk associated with other users' energy balancing activity, as in the event of a shipper failure unpaid charges are apportioned ('smeared') between all users.

Following the implementation of modification 0572, 'The provision of Letters of Credit for energy balancing credit cover', accepted forms of security for energy balancing are cash or Letters of Credit (LoC) only, of which the amount provided will be the shipper's secured credit limit. However, network code does not currently require users to provide a minimum amount of security. As such, Transco negotiates with users, but is unable to require a specific level of security be put in place.

Each user is allocated a cash call limit, which will be a value not exceeding 85% of its secured credit limit. This will be the limit on the user's outstanding relevant balancing indebtedness. Where a user does not provide security, its cash call limit will therefore be set at £0. Transco monitors each user's outstanding relevant balancing indebtedness on a daily basis. Where a user's indebtedness (which includes amounts due under energy balancing invoices) exceeds its cash call limit, Transco will issue a cash call notice ('CCN'). Users are required to pay amounts set out in CCNs within the next day. If Transco does not receive these funds it issues a failure to pay cash call notice, if a user does not pay within three days Transco can at its discretion issue a termination notice.

Through the selection of a low secured credit limit inconsistent to the level of energy balancing activity, and misuse of the cash call system, a user could delay payments to Transco thereby creating a potential exposure for other users in the event of default. Whilst optimisation of this type may offer some cash flow benefits to individual users, this would create significant concern to the community where it created a large potential exposure.

**The modification proposal**

It is proposed that where a user is served with two cash-call notices (irrespective of whether this is the first notice, a revision to, or a re-issue of a previous notice) within any rolling 28 calendar day period, ('the measurement period'), Transco would issue a 'Notice to Provide Increased Security', as soon as reasonably practicable after the second cash-call notice. The notice would advise the user that in accordance with the EBCR it is required to fully secure a credit limit agreed between Transco and the user, which in any event would be no less than the user's reported peak indebtedness during the measurement period. The user would be required to provide the requested increased security within seven Business Days from the date of the notice.

Additionally, the 'Notice to Provide Increased Security' would specify that the additional security must not expire within 90 days of the date of the Notice, although a lesser period could be agreed between the user and Transco where both parties are in agreement.

The user would have a right of appeal against the 'Notice to Provide Increased Security' within five business days of the notice being served. The user would be required to provide evidence to demonstrate why the required Secured Credit Limit does not reflect their typical energy balancing activities. Where an appeal is lodged, under section X1.2.3, Transco may convene the Energy Balancing Credit Committee ('EBCC') to consider any such appeal. Any consultation would be carried out in accordance with section X1.2.5 in relation to the protection of the user's identity.

If the user fails to comply with the 'Notice to Provide Increased Security', a 'Failure to Provide Increased Security Notice' would be issued on the eighth Business Day. In the event that the user does not provide the required security cover within a further seven Business Days from the date of the Failure Notice, the user would be classified 'In Default', and Transco would be entitled to call upon any security already lodged or serve a Termination Notice.

Where Transco has issued a 'Notice to Provide Increased Security', and until such request has been satisfied, Transco would be entitled to withhold payment pursuant to any Energy Balancing Invoice in respect of any amounts payable to the user in respect of Energy Balancing Charges (irrespective of the Invoice Due Date) and the user would not be entitled to late payment interest in accordance with section S3.5. In addition, Transco would be entitled to disregard any request made by the user under section X2.8.6 to release any monies held in the user's cash-call account.

Both notices would be included in template form as appendices to the EBCR.

The proposer, Transco, indicates that a user entering insolvency with a cash shortfall arising from energy imbalances might create a burden on all other users via the balancing neutrality mechanism, and that this potential debt burden can be viewed as a form of subsidy. Transco states that 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.

**Respondents' views**

There were six responses to this modification proposal, of which four support implementation, one offers qualified support, and one is opposed.

A common concern among respondents is that the introduction of modification 0572 may lead to a general reduction in the overall level of energy balancing credit cover, as shippers seek to minimise the cost of providing credit cover and seek to more actively manage credit utilisation. One respondent also suggests that secured credit limits look to be breached more often as the credit cover ceiling reduces. A number of responses indicate that this reduction, in turn, increases all shippers' exposure to smeared energy debt in the case of shipper failure.

Those respondents in favour of implementation raise the following:

In offering its support, a respondent indicates that more robust security arrangements are necessary to protect users from those who can potentially take advantage of the current arrangements. A further respondent agrees that it would be better if a user operated with an appropriate credit limit rather than rely on the cash call approach as they believe that the risk to the community of financial loss is increased where users are regularly cash-called. The respondent therefore supports Transco having an agreed route that can be followed to reduce the credit risk exposure.

A number of respondents noted that the modification proposal would impose additional costs on those users who breach their credit limits. However, the respondents state that the benefit of additional security to the wider community outweighs this cost, and that shippers should provide security at a level that is consistent with their level of activity.

One respondent, who offers qualified support, believes that the modification proposal will be one way to resolve any gap resulting from shippers reducing the credit cover that they have in place following the implementation of modification 0572, and strengthen network code rules, under which Transco currently has little recourse to effectively deal with a shipper who is constantly breaching their limit. However, the respondent also states that since the level of securitisation calculation is not set out in the network code or EBCR, it is Transco's ultimate responsibility to accept certain levels of credit for shippers. The respondent suggests that Transco should therefore, in accepting this role, be to a certain extent, responsible for failing to set the bar at a realistic level.

The respondent who opposes implementation believes that two cash call notices issued to a shipper within a rolling 28 calendar period does not provide a clear indication of the potential default of a shipper and may in fact be the result of a variety of problems, for example, production shortfall or higher end user off-take due to prolonged cold weather.

**Transco's view**

Transco highlights that in respect of energy balancing, it is essentially neutral as it is not exposed to financial risks involved and acts in the interests of the users as a whole under the EBCR.

Transco recognises that while each user has an obligation to balance its gas inputs and outputs on a daily basis, on any given day circumstances may arise which result in imbalances for some users. However, where there is a continued period of imbalance resulting in a cash shortfall, Transco considers that it is prudent to have measures in place to protect the community. Transco believes that this modification proposal should be of benefit to users as a whole as it could reduce any potential risk of energy balancing debt exposure to the community.

Transco notes that implementation of this modification proposal could have implications on those users that continually fail to balance daily. It indicates that by increasing security cover to meet the minimum credit limit requirement a user may be financially vulnerable. However, Transco highlights that in the absence of this modification proposal, the community is at present effectively financing such users trading patterns

**Ofgem's view**

In light of the relevant objectives of Transco's network code and Ofgem's statutory duties, Ofgem has decided to direct Transco to implement the modification.

In Ofgem's conclusions and proposals document; 'Arrangements for gas and electricity network operator credit cover' February 2003[1], a principle underlying the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable. The effect of proposals in line with the principles in the document, such as modification 0572 'The provision of Letters of Credit for energy balancing credit cover', is likely to reduce potential exposure of shippers through the introduction of robust credit arrangements. Nevertheless, Ofgem recognises the potential for some exposure remains in the event of default.

[1] www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/1836_14feb03.pdf

Ofgem recognises that as network code does not currently enable Transco, as the CRM(E), to require shippers to provide a minimum level of security in respect of energy balancing activities, shippers may chose to provide inadequate amounts of security, thereby creating potential community exposure in the event of default. Ofgem is aware that frequent cash call notices could indicate an insufficient secured credit limit. Although abuse of the cash call process may not give rise to significant concern where small financial values are involved, the potential for large exposure exists.

Ofgem accepts respondents comments that modification 0572 may lead to some reduction in the overall level of energy balancing credit cover, as shippers seek to minimise the cost of providing credit cover and seek to more actively manage credit utilisation. Ofgem notes that the minutes of the EBCC meeting on 08 August 2003 indicate that implementation has resulted in a reduction from £247.25 million, to £203.65, a fall of £43.6 million. Although any such reduction could be a reflection of previous over securitisation, Ofgem would be concerned if it led to an increase in numbers of cash calls, and corresponding increase in all shippers' exposure to smeared energy debt in the case of shipper failure.

Ofgem is concerned that whilst shippers should be able to choose how to operate their businesses, this should be consistent with reasonable and prudent behaviour. In line with this, Ofgem agrees with respondents' comments that shippers should provide security consistent with their level of activity. Ofgem therefore agrees that in acting as the CRM(E), Transco should have the ability to enforce the provision of adequate security in line with the shipper's ongoing performance, in order to minimise the potential exposure to the community. Ofgem considers that this will further strengthen the existing credit regime, and could serve to incentivise shippers to put appropriate levels of credit cover in place.

Although this proposal could impose additional costs on shippers who breach their credit limits, Ofgem agrees with respondents that the benefit of additional security to the wider community outweighs this cost. Additionally, Ofgem considers that in contrast to the previously rejected modification proposal 0447 'Provision Enforcement of a Minimum Level of Energy Balancing Security', on which this proposal is based, the requirement of a revised credit limit of 100% of peak indebtedness (as opposed to a requirement of 120%) would not be punitive in effect. Furthermore, as a result of the implementation of modification 0572, whereby additional security would be provided as either cash or LoC, the concern raised by proposal 0447 of potential for discriminatory effects between users does not arise.

Ofgem notes the suggestion in one response that Transco should in some way be responsible for failing to set shippers' credit limits at realistic levels. However, as the CRM(E) role is financially neutral, on behalf of shippers on its network, applying the network code supplement provisions and the EBCR in accordance with the instructions of the EBCC, Ofgem considers that it would be inappropriate for it to be exposed to debt arising in the event of a shipper default.

In addition to the above, Ofgem continues to hold the belief stated in its recent document that Transco's EBCR, which currently sit outside of the network code modification procedures, should be brought within the network code modification procedures. This would provide a means for the industry as a whole to influence the nature of those rules, but should not in itself diminish the role of the EBCC.

**Ofgem's decision**

For the reasons outlined above, Ofgem has decided to consent to this modification, as we 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