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Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification proposal 0612 'In the Event of User Insolvency all Network Code Charges shall become Immediately Payable'

Ofgem has carefully considered the issues raised in modification proposal 0612 'In the Event of User Insolvency all Network Code Charges shall become Immediately Payable'. 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

Under Section V4.3 of Transco's network code, Transco has the discretion to issue a termination notice to a user in certain circumstances, which include, where the user becomes insolvent. The issue of the termination notice has the effect that the user shall cease to be a user for the purposes of the network code. However, there may be occasions where Transco does not issue a termination notice immediately on a user's insolvency, for example where the receiver, administrator, trustee-in-bankruptcy or foreign insolvency practitioner (as appropriate) provides adequate assurances to pay Transco all debt accruing from the date of its appointment, so that the insolvent user could continue to be a party to the network code and to accrue debt.

Where Transco has not terminated an insolvent user, the provisions relating to invoicing schedules and payment periods would continue to apply as set out in Section S of network code. Invoices are issued for NTS Entry Capacity Invoices, NTS Exit Capacity Invoices, LDZ Capacity Invoices, Balancing Invoices, Commodity Invoices, Reconciliation Invoices, Adjustment Invoices, Interest Invoices and Ad-hoc Invoices.

Each invoice will relate to a billing period (one calendar month for all invoices apart from Reconciliation), with submission after the billing period varying according to invoice type. For invoices other than Adjustment, Interest or Ad-hoc (where payment will be due on the 12th day after the day on which the invoice was deemed received), payment will fall due on whichever is later of the 12th day after the day on which the invoice was deemed received, and the 20th day after the last day of the relevant billing period.

Once Transco issues a termination notice to a user, different arrangements will apply, paragraph 1.7 of Section S enables Transco to submit any invoice in respect of any full, or part, billing period ending at or before the time the invoice is submitted. Additionally, all amounts due (whether the relevant invoice for such amounts was submitted before or after the date of the termination notice) shall be immediately payable.

The modification proposal

The modification proposal seeks to amend paragraph 1.7 of Section S of the network code so that where a user becomes insolvent, that is, a receiver, administrator, trustee-in-bankruptcy or other insolvency practitioner, either foreign or domestic is appointed, but a termination has not been effected:

- Transco would have the right to immediately submit invoices for all services up to and including the effective date of insolvency
- Transco would have the right to invoice for all services consumed post the date of insolvency at intervals determined at its discretion to be appropriate
- All invoices, irrespective of when issued, would be deemed to be immediately due for payment
- Additionally, where appropriate, Transco would have the right to estimate invoices, (typically, but not exclusively, relating to energy balancing or reconciliation). Where such an invoice is issued, following any close-out period or actual data becoming available, Transco would reconcile the invoice and issue an adjustment.
- These provisions would apply to both Energy and Transportation charges.

The proposer (Transco) considers that the modification proposal would better facilitate the relevant objectives as, by ensuring that all services consumed by the user prior to insolvency, or required while in administration, are invoiced in a manner that induces prompt settlement, probability of recovery increases. Transco states that each Energy Balancing and Capacity Neutrality invoice settled reduces the risk of the industry being exposed to bad debt smears, and that implementation of the remedies described above would reduce risk for all parties concerned and, therefore, could be expected to facilitate a more secure and competitive environment in which shippers operate.

Respondents' views

There were nine responses to the modification proposal, of those, seven were in favour of implementation, one offered qualified support, and one was opposed.

Of those respondents in favour of implementation, two specifically noted that the immediate termination of a user who has become insolvent is not always the most effective way of

managing risk to the community. Favourable respondents widely accepted that Transco should have the ability to manage credit exposures in order to protect both the industry and itself from bad debt, and that this proposal allows the flexibility to manage any resulting debt in the interim period between insolvency and termination.

One respondent suggested that the proposal seeks to allow Transco to do what other companies are able to do under similar circumstances. Supporting respondents also generally agreed that the proposal could help minimise the exposure of the industry to bad debt smears, and secure access to security, thus minimising the impact on other users. One respondent went on to suggest that this would facilitate a more secure and competitive environment in which shippers can operate.

Two respondents noted that the proposal could create cash flow problems for users who are already in financial difficulty. Of these, one considered this issue was outweighed by the above benefits. The other, who offered qualified support for the modification proposal, considered that it could just be delaying the inevitable need to terminate the shipper. This respondent indicated that the proposal has some merit, but requires further development; that consideration should be given to the individual circumstances relating to the insolvent shipper, so as not to accelerate their fall into liquidation for example where the chances for recovering outstanding debt would be even less.

One respondent, who opposed implementation, suggested that current network code provisions are sufficient and provide an appropriate level of protection against credit exposure for both Transco and the industry. It considered that the implementation of modification 0572 'the provision of Letters of Credit for energy balancing credit cover', will provide Transco with the necessary level of credit cover in the future should a shipper encounter any financial uncertainty. Furthermore, shippers would be prevented from making an orderly exit from the market due to a greater administrative burden, which was considered to be unreasonable.

Transco's view

Transco believes that where a user continues to trade whilst insolvent, it is appropriate for it to reduce its financial obligations promptly in order to protect both the industry and Transco from bad debt. It considers that current network code provisions do not provide the flexibility to reduce the amount of debt that an insolvent user could accrue. Whilst risk will be protected by alternative forms of credit cover under modification 0572, Transco considers that there is still considerable risk exposure to the community if that credit cover were due to expire and Transco was unable to levy a claim upon it due to current invoicing restrictions.

Transco suggests that by accelerating invoice submission and payment due dates for services supplied up to the point of insolvency, the full value of a user's security could be realised. Additionally, raising invoices for services consumed after insolvency, independently of the existing invoices schedules, would ensure that securities could be drawn upon promptly and, where no security is held, levels of debt minimised. Transco considers that the proposal would also provide a means of verifying that assurances given by an Administrator on behalf of the insolvent users would be delivered in practice.

It believes that all of the above remedies would enhance the prospects of recovery, reduce the potential for unsecured credit exposures and reduce the prospects of having to levy neutrality adjustments, caused by bad debt, on remaining users.

Ofgem's view

In light of the applicable objectives of the network code and in light of its wider statutory duties, Ofgem considers that the modification should be implemented. As detailed in Ofgem's recent conclusions and proposals document; 'Arrangements for gas and electricity network operator credit cover' February 2003 ('credit cover document'), Ofgem recognised that changes to invoicing cycles and the timing of payment terms may be needed. Whilst the document suggested that this should be further debated when the credit framework has been clarified, Ofgem must consider any modification before it in the normal way.

As detailed in the credit cover document, one of the principles underlying the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable. It was highlighted that credit arrangements should be designed to moderate the impact of financial failure and should not increase the risk that it will occur.

Ofgem notes that this modification proposal would not push a company into insolvency, as it would only apply once insolvency had already occurred. Nevertheless, this could lead to the termination of an insolvent user earlier than under existing invoicing and payment arrangements where it serves to demonstrate inability or unwillingness to pay at an earlier point in time, or leads to cash flow problems. However, given that financial failure will already have occurred where an insolvent user continues to trade (as reflected by Transco's ability under network code to terminate that user), arrangements should protect the community from the impact of that failure.

Ofgem considers security and continuity of supply to be of paramount importance in protecting the interests of customers. Where a company does fail, it is important that this does not cause a 'domino effect' leading to supply disruption. 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 a default.

Ofgem recognises that the immediate issue of a termination notice upon insolvency is not always the most effective way of managing risk to the community. Ofgem considers that this modification proposal could protect the community from exposure by enabling Transco to levy claims on credit cover that would otherwise expire. Additionally, it could ensure that securities could be drawn upon promptly, and where no security is held, reduce the amount of debt that an insolvent user could accrue through increasing Transco's ability to determine the need to effect a termination. Therefore, Ofgem agrees that the modification proposal could provide Transco the flexibility to minimise the financial impact of user failure on the community, thereby facilitating a more secure environment in which shippers can compete.

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 GasTransporter 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,

A handwritten signature in black ink, appearing to read 'A. N. Simpson', written over a horizontal line.

Nick Simpson
Director of Industry Code Development