Modification Report
Provision Enforcement of a Minimum Level of Energy Balancing Security
Modification Reference Number 0447

Version 1.0

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 if a User is required to pay two Cash Call Notices (whether the Notice is revised, re-issued, or first issue) within any rolling 28 calendar day period, Transco will issue a "Request to Provide Security Notice" (which will form a new appendix to the Energy Balancing Credit Rules), as soon as reasonably practicable. This Notice will request the User to provide security in accordance with the Energy Balancing Credit Rules to fully support a Secured Credit Limit. This limit shall be equivalent to 120% of the peak indebtedness level during that 28 calendar day period within eight Business Days from the date of the Notice. Additionally, the "Request to Provide Security" Notice will specify that the additional security must not expire within 90 days of the date of the Notice.

Alternatively, the User may appeal against the "Request to Provide Security" Notice within five Business Days from the date of the Notice. In such an instance the User will be required to provide information and evidence demonstrating why the required Secured Credit Limit is not suitable for their energy balancing behaviour. Under 1.2.3 of the Network Code Supplement, Transco may consult the Energy Balancing Credit Committee in relation to any aspect of its functions under the Supplement and therefore may exercise this right when considering any such appeal. Any consultation will be carried out in accordance with 1.2.5 of the Supplement in relation to the protection of the User's identity.

If the User fails to comply with the "Request to Provide Security" Notice, a "Failure to Provide Security" Notice (which will form a new appendix to the Energy Balancing Credit Rules), will be issued. This will notify the User that Transco shall be entitled to give a Termination Notice to the User if the User does not provide an increased level of security within a further fifteen Business Days from the date of that Notice.

Where Transco has issued a "Failure to Provide Security" Notice and until the required total value of security is provided in accordance with the Energy Balancing Credit Rules, Transco will not pay and (irrespective of the Invoice Due Date) shall 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.

Furthermore, in the event that under contingency arrangements the Flexibility Mechanism is in use, the User shall not be entitled, nor will Transco accept, any flexibility bid.

The relevant figures will be contained within the Notices that will form appendices to the Energy Balancing Credit Rules. This reflects the current process for Notices already governed by the Energy Balancing Credit Rules"

The proposer justified the Modification Proposal as follows:

"The recent failure of Independent Energy has exposed the shipping community to some £1.5M of pre-receivership energy balancing debt. This has focused attention on the need to tighten-up current credit management procedures, which have (other than Modification 103 implemented on 1 October 1997) remained largely unchanged 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 results in large imbalance positions. Members of the Energy Balancing Credit Committee (EBCC) have concluded that enforcement of minimum levels of security that better reflect the current activities of particular Users are required.

Under the Network Code Supplement, Users are required to elect a Secured Credit Limit in relation to their energy balancing position. For those Users that have not been assigned an Investment Grade rating by a designated credit rating agency, a suitable form of security must be provided to support that limit, in compliance with the Energy Balancing Credit Rules. A "Cash Call Limit" is allocated for each User that is equivalent to 85% of the Secured Credit Limit. Outstanding Relevant Balancing Indebtedness, which represents the cumulative debt position, is then measured against this limit.

On behalf of all Users, Transco operates procedures to track each User's ongoing energy debt position. Upon identification of an unsecured excess, appropriate action is taken in order to protect all Users from this exposure. This action is encapsulated within the Cash Call Notice process.

This process is carried out in accordance with the Network Code and the Energy Balancing Credit Rules and the latter are subject to the approval of the Energy Balancing Credit Committee. This committee is established by the Network Code as a committee of Users under the non-voting chairmanship of Transco. Ofgem also attends the committee meetings in a non-voting capacity.

The Energy Balancing Credit Committee has identified an issue arising from the present Energy Balancing Credit Rules. If a User is regularly required to pay Cash Call Notices, this is an indication that its Secured Credit Limit is insufficient for its energy balancing behaviour. In such an event, Transco does not have the right to insist on a minimum Secured Credit Limit nor a minimum supporting security.

There is therefore a need for a Network Code Modification which allows Transco to implement a more appropriate Secured Credit Limit and obtain relevant security in support of that limit."

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 Users as a whole under the Energy Balancing Credit Rules.

Transco considers that this Modification Proposal could be of benefit to Users as a whole and may reduce the risk of energy balancing debt exposure over the community. However, it is also aware of the effect that this Modification Proposal may have on some small shippers in particular in that increased costs of securities may have the adverse effect of making

them more financially vulnerable and, as a consequence, more likely to enter into receivership.

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

Respondents have suggested that a User entering receivership with a cash shortfall arising from energy imbalances might create a 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. Such subsidies might also hinder the development of competition since a history of debt burdens absorbed by the Users community might be considered to be a barrier to entry. Implementation of this Proposal could, therefore, be seen as securing effective competition between relevant shippers.

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

a) implications for the operation of the System:

Transco is not aware of any impact to the operation of the system. It is anticipated that enforcing the minimum credit limit would reduce the necessity of making further cash calls on the User. However there is the possibility of increased financial risk to that User in that increasing securities to the minimum credit limit may cause a User to enter receivership. This would have operational implications on Transco if it were obliged to serve a termination notice.

b) development and capital cost and operating cost implications:

Transco is not aware of any development or capital costs arising from the implementation of the Modification Proposal.

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 does not believe that it would be appropriate to have any special cost recovery measures in place should the implementation of the Modification Proposal lead to increased costs for Transco.

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 is not aware of any implications for computer systems.

7. The implications of implementing the Modification Proposal for Users

The Modification Proposal is intended to reduce the credit risk on Users through balancing neutrality and therefore be of benefit to Users as a whole. Implementation of this Modification Proposal could also have implications for some smaller shippers in particular in that it could be argued that increasing securities to meet the minimum credit limit may have the effect of making the shipper financially vulnerable and hence more likely to enter receivership.

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

Transco is unaware of any change in legislative, regulatory obligation or contractual relationship of Transco, Users or Non-Network Code Party as a consequence of implementing this Modification Proposal.

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, and each User or Non-Network Code Party 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 more effectively manage the risk of exposure to Users.

The managing and monitoring of a User's credit limit to energy balancing indebtedness would reduce the risk of the User moving into a position of receivership.

A disadvantage of implementing this Modification Proposal is that:

Increasing a User's security to a minimum credit limit may potentially increase its financial vulnerability which might ultimately 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)

Twelve representations have been received of which eleven supported this Modification Proposal.

Users in support of the Modification Proposal were: British Gas Trading (BGT), Exxon Mobil Gas Marketing (Exxon Mobil), Innogy plc, Northern Electric and Gas Limited (NEAG), Powergen, Scottish and Southern Energy plc (SSE), Scottish Power, TotalFinaElf Gas and Power Limited (TFEG&P), TXU Europe Energy Trading Limited (TXU) and Yorkshire Energy Limited (YE). A representation in support of the Modification Proposal, signed on behalf of the Energy Balancing Credit Committee (EBCC), was also received

Dynegy did not support implementation of the Modification Proposal

General

Scottish Power welcomed this Modification Proposal, together with Modification Proposals 0441 and 0446 as representing the efforts of Transco, EBCC and Ofgem "in taking the regime forward and focussing on the issues since the collapse of Independent Energy". EBCC also suggested that the implementation of the same three Modification Proposals would ensure that "the community risk to energy balancing debt will be significantly reduced" TFEG&P also recognised the association with Modification Proposals 0441 and 0446 and maintained that "All three modification proposals will introduce positive improvements to the current Energy Balancing risk management procedures" and emphasised the unanimous support given by EBCC.

SSE suggested that "it would be beneficial to all participants to widely publicise any revision to the current energy credit procedures."

Transco's Response

Transco concurs that this Modification Proposal did result from discussions within EBCC and agrees that publicising the revisions to the risk management procedures would be helpful.

Appropriate Level of Security

Exxon Mobil argued that if the Modification Proposal were implemented one of the benefits would be "that the level of security that is called is set by Shipper balancing behaviour". It concluded from this that "the perceived problem of the community being over-secured will not arise." Innogy believed that implementation would embody the principle of "matching the level of indebtedness with the level of credit". It also believed that implementation would provide existing Users "with increased protection against credit risk whilst establishing levels of security that are unlikely to act as barriers to the entry of prospective new Users." Powergen acknowledged the difficulties of setting initial levels of security but argued that once operational data was available which established that levels of security cover were inadequate, such levels should be increased. It therefore believed that implementation would merely ensure "that shippers provide appropriate (but not excessive) levels of security." TFEG&P argued that "existing Secured Credit Limits are insufficient to support a shipper's current balancing behaviour". It believed that implementation would lead to the setting of "a more appropriate Secured Credit Limit" and the acquiring of "relevant security in support of that limit". TXU supported implementation as "it will require Users to have the appropriate security in place to cover the potential debt they could accrue".

Dynegy, who did not support implementation, considered that "120% of peak indebtedness for a 28 day period may be too onerous for smaller players (discouraging new entry), and benefits those companies with ready access to funds, who are unlikely to ever be caught by

this intended provision. Equally the requirement to maintain this cover throughout a financial quarter is over zealous".

Transco's View

Transco supports the view that implementation of this Modification Proposal would ensure that appropriate, but not excessive, levels of security would be set in place. It does not see implementation as placing barriers to entry of new players.

Repeated Cash-Calls

NEAG agreed with the proposer's premise that regular cash-call notices indicate an insufficient Secured Credit Limit, Powergen referred to the record of Independent Energy which included frequent cash-calls, albeit paid in full. It therefore concluded that this "was a clear indication that IE security cover was inadequate". SSE also drew the same conclusions from this experience and stated that "one of the lessons learnt after the Independent Energy failure was that there is no mechanism to amend a User's Secured Credit Limit under the specific circumstances of repeated Cash Calls". TFEG&P supported the argument that repeated cash call notices "do illustrate that existing Secured Credit Limits are insufficient to support a shipper's current balancing behaviour".

Transco's View

Transco confirms the view of certain respondents that there were frequent cash call notices prior to Independent Energy's failure. It is reasonable to conclude from this and from a general credit control perspective, that additional security is appropriate for Users who are frequently the subject of cash calls.

Risk of Precipitating Failures

Powergen did not take the view that implementation of this Modification Proposal would increase the number of Users entering receivership. On the contrary they believed that "Better management of the energy balancing credit may well avoid players getting into financial difficulties in the first place". TFEG&P referred to the fact that it had given careful consideration to the possibility that these measures could precipitate shipper failures. It concluded however that "On balance, TFEG&P believes that there is a far greater probability of increased risk of greater Energy Balancing (EB) debt accruing to the community as a consequence of its failure to take effective action, as prescribed by this modification, in response to the 'warning signs' associated with repeated Cash Call Notices issued to a shipper that subsequently goes out of business."

Transco's Response

Transco does not believe that implementation of this Modification Proposal would increase the numbers of Users entering receivership.

Appeals

SSE referred in their response to the protection given to Users in the event that a request for additional security was inappropriate by stating: "We understand that a User would have the right to appeal to the Energy Balancing Credit Committee if it felt that the revised security

limit was not appropriate." TFEG&P also supported "the proposed appeals and escalation procedures specified in the proposal, and consider that they reflect an appropriate and balanced approach."

Transco's Response

Transco supports the principle of an appeals process for Users in the event that an additional Secured Credit Limit is requested and has successfully operated similar appeals processes within Credit Risk Management.

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 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Transco is unaware of any such requirement.

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

Transco is unaware of any such consequence

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 immediately.

Notwithstanding the comments in Section 16 below, implementation of this proposal is not necessarily dependent upon the outcome of either Modification Proposal 0441 or 0446.

16. Recommendation concerning the implementation of the Modification Proposal

In view of the general support expressed by Users, 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 0441 and 0446, 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 to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

Add new paragraph 2.6.4 to read as follows (and renumber existing paragraphs 2.6.4 and 2.6.5 as paragraphs 2.6.5 and 2.6.6 respectively):

"Paragraph 2.10 shall apply where within 28 days of the submission of a Cash Call to a User Transco submits a further Cash Call (including a revised Cash Call pursuant to paragraph 2.7.3) to the same User.".

Amend renumbered paragraph 2.6.5 to read as follows:

"?.where a Cash Call or Further Security Request is submitted?.".

Amend renumbered paragraph 2.6.6 to read as follows:

"Paragraph 2.6.5?.".

Add new paragraph 2.10 to read as follows:

2.10 Further Security Request

2.10.1 Where this paragraph 2.10 applies Transco will as soon as reasonably practicable on or after the [date] on which the further Cash Call (referred to in paragraph 2.6.4) is submitted submit to the User a Further Security Request.

2.10.2 For the purposes of this Supplement a "Further Security Request" is a notice, in a form set out in the Energy Balancing Credit Rules, requiring the User to provide a further, additional or revised Guarantee or Security in such amount and for such period as determined in accordance with the Energy Balancing Credit Rules.

2.10.3 Where:

(i) a Further Security Request (the "relevant" Further Security Request) has been submitted to a User;
(ii) the User considers it inappropriate that is should be required to provide a further, additional or revised Guarantee or Security,

the User may, not later than 12:00 hours on the 5th Business Day following the Day on which the Further Security Request was submitted, so notify Transco, specifying in as much detail as possible the User's reasons for so considering.

2.10.4 Where a User gives a notification under paragraph 2.10.3:

(i) the relevant Further Security Request (and the obligation to provide further, additional [or revised] Guarantee or Security) will be suspended, subject to paragraph 2.10.5;

(ii) Transco will review the details provided by the User and will review the calculations made of the User's Outstanding Relevant Code Indebtedness;

(iii) if requested by Transco the User shall provide by telephone or facsimile any further details or explanation of its view.

2.10.5 Following its review under paragraph 2.10.4, Transco will as soon as reasonably practicable (and wherever possible within 24 hours after the User's notification under paragraph 2.10.3):

(i) where it is reasonably satisfied that it is inappropriate that the User provide further, additional or revised Guarantee or Security in accordance with the Further Security Request, withdraw the Further Security Request or revise the further, additional or revised Guarantee or Security requested accordingly and submit the revised Further Security Request to the User;

(ii) otherwise, notify the User that the Further Security Request remains valid (and is no longer suspended),

and such revised Further Security Request or notification shall be substantially in the form set out in the Energy Balancing Credit Rules, and if given on a Day which is not a Business Day or after 17:00 hours on a Business Day shall be treated as having been given on the next following Business Day.

2.10.6 A User may not give a further notification under paragraph 2.10.3 to Transco in respect of a relevant Further Security Request (whether or not revised under paragraph 2.10.5).

2.10.7 Where Transco has submitted a Further Security Request to a User, the User shall, subject to paragraph 2.10.4, provide further, additional or revised Guarantee or Security in such amount and for such period as determined in accordance with the Energy Balancing Credit Rules.

2.10.8 Where Transco has submitted a revised Further Security Request or notified a User that a Further Security Request remains valid pursuant to paragraph 2.10.5 until the further additional or revised Guarantee or Security is provided in accordance with the Further Security Request Transco shall 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

2.10.9 Where a User has not provided the further, additional or revised Guarantee or Security in accordance with the Further Security Request by 12:00 hours on the 15th Business Day following:

(i) the date the Further Security Request was submitted;

(ii) where the User has given a notification under paragraph 2.10.4, the date the revised Further Security Request was submitted or the date the User was notified that the Further Security Request remains valid pursuant to paragraph 2.10.5,

and irrespective of the User's Outstanding Relevant Code Indebtedness as at any Day after the submission of the Further Security Request, Transco shall be entitled to, and as soon as reasonably practicable thereafter will, give Termination Notice to the User (for the purposes of Section V4.3.3) to the effect that the User shall cease to be a User with effect

from the Day following the date of the Termination Notice and Transco shall send a copy of any notice given under this paragraph 2.10.9 to the Director.".

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

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 **0447**, version **1.0** dated **22/02/2001**) 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 **1.0**.

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.