Direct Dial: 0207 901 7433

22 May 2001

Transco, Shippers and Other Interested Parties

Your Ref:
Our Ref : Net/Cod/Mod/447

Dear Colleague,

Modification Proposal 0447: Provision Enforcement of a Minimum Level of Energy Balancing Security

Ofgem has considered the issues raised in modification proposal 0447: 'Provision Enforcement of a Minimum Level of Energy Balancing Security'. Ofgem has decided not to direct Transco to implement the modification, because we do not believe that the proposal will better facilitate the relevant objectives of Transco's Network Code.

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

Background to the proposal

Independent Energy's collapse in September 2000 raised a number of issues concerning the operation of credit cover set out in the network code. When a shipper defaults on paying its balancing costs, the costs are smeared across the shipping community and Transco is not liable for the payment of outstanding energy balancing debt. The Energy Balancing Credit Committee (EBCC) represents the shippers' interests and has limited powers relating to discontinuation and recovery action regarding energy balancing debt. Current credit practises attempt to mitigate this risk. However, the events following Independent Energy's failure have highlighted the need to address current credit management procedures.

Currently shippers determine their own credit limit. In accordance with the credit risk management procedures Transco is required to determine whether the shipper's credit rating is sufficiently high to meet the secured credit limit or whether further guarantees of security are required. If a shipper exceeds 85% of its secured credit limit Transco will issue a cash call notice. Shippers are required to pay the amount set out in the cash call notice within the next day. If Transco does not receive these funds it issues a failure to pay cash call notice, if a shipper is unable to pay within three days Transco can at its discretion, issue a termination notice. In the interim period Transco may withhold payments to the shipper of energy balancing invoice charges. These procedures have been largely unchanged since the introduction of the network code in 1996. It should be noted that the recent increase in gas prices has resulted in a significant increase in cash call and failure to pay cash call notices.

The experience of Independent Energy's collapse has raised the issue of how to recover debt when a shipper goes into receivership. A shipper's credit position is calculated seven business days after the Gas Day. Therefore when the shipper goes into receivership it could take up to nine calendar days before the scale of the debt can be identified. In this instance it was found that the receiver was unwilling to finance the energy balancing debt which continued to accrue during the period the company remained in receivership. As a result, debt was incurred by all shippers whilst the party appointing the Receiver gained increasing

benefit. In the event the Receiver managed to sell Independent Energy's business as an ongoing concern to a supplier willing to accept the post receivership debt.

Shippers need to ensure that the credit management requirements are sufficiently robust so as to reduce their financial risk. Three modification proposals, 441, Termination of user in receivership, 446, Revision to Indebtedness Cash Call Trigger and 447, Provision Enforcement of a Minimum Level of Energy Balancing Security, were raised to address their concerns.

The modification proposal

The proposed modification seeks to introduce a more appropriate secured credit limit that better reflects the current activities of particular Users. Currently, a User is cash called if its credit exceeds 85% of its secured credit limit. The modification proposes that if a User is required to pay two cash call notices within any rolling 28-calendar day period, Transco will issue a "Request to Provide Security" notice. 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 and make payment 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. However, the User may appeal against the "Request to Provide Security" notice within five business days from the date of the notice.

If the User fails to comply with the "Request to Provide Security" notice, a "Failure to Provide Security" notice 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 the notice.

Where Transco has issued a "Failure to Provide Security" notice and until the revised security is provided, Transco shall be entitled to withhold payment pursuant to any energy balancing invoice payable to the User in respect of energy balancing charges.

Respondents' views

Twelve representations were received of which eleven supported the modification proposal. Generally shippers are of the opinion that the modification will ensure that appropriate levels of security would be set and will minimise exposure resulting from a defaulting shipper to the rest of the shipping community. Many shippers mentioned the importance of recognising that frequent cash calls indicate insufficient security cover. Indeed, two shippers noted that prior to Independent Energy's collapse it received a number of cash call notices but there was no mechanism for Transco to increase its secured limit. Overall, shippers believe that modification proposal 447, together with modification proposal 446 will improve the current credit management procedures as it will introduce a mechanism to amend a User's secured credit limit under the specific circumstances of repeated cash calls.

However, one respondent considered that 120% of peak indebtedness for a 28 day period may be too onerous for smaller players thereby discouraging new entry. It was also argued that the proposal would benefit those companies with ready access to funds who are unlikely to be caught by the intended provision. Equally the requirement to maintain this cover

throughout a financial quarter was viewed by one shipper as “over-zealous”. Transco did not agree that the levels of security set in place by the proposal would be excessive.

It was considered whether the implementation of this modification proposal would increase the number of Users entering receivership. In answer to these concerns, a number of respondents suggested that better credit management would help avoid shippers getting into financial difficulties. Transco agreed that implementation of this modification proposal would not increase the number of Users entering receivership.

The idea of an appeals process was supported by a number of respondents such that a User could appeal to the Energy Balancing & Credit Committee if it felt that the revised security limit was not appropriate.

Ofgem’s view

In coming to a decision, Ofgem has not only considered the current risk that presently exists in the industry but also what impact these modifications could have on competition if implemented.

Although this modification would impact upon a number of different sized shippers, Users with a recognised credit rating of Baa or above would not have to lodge any further security with Transco, whereas all other Users would. Given the recent increase in cash calls, Ofgem is concerned whether these shippers would be able to increase their levels of security. Indeed, we are concerned that the increase in cash calls could be further exacerbated if this modification is implemented such that a User is required to provide excessively high security. The impact could have a disproportionate impact on small shippers.

The requirement to maintain the increased level of cover throughout a quarter could be viewed as excessive. Ofgem acknowledge that frequent cash call notices could indicate an insufficient secured credit limit and that at present there is no mechanism for Transco to amend a User’s secured credit limit should they be cash called regularly. However, it should be recognised that any change in the secured credit limit should represent a User’s ongoing performance. Ofgem view the revised credit limit of 120% of peak indebtedness as punitive rather than appropriate and hence could create a barrier to entry.

We recognise the need for a shipper’s credit cover to reflect its balancing performance but we also recognise the need to minimise barriers of entry to the market by not overestimating a User’s debt.

Ofgem’s decision

Taking account of the issues set out above, Ofgem have decided not to instruct Transco to implement this modification as we believe it could potentially restrict competition in the market. As the modification proposal currently stands, there is the risk that a User’s debt will be over-estimated contributing to a company’s premature receivership.

Nevertheless, Ofgem are supportive of moves towards tightening the Energy Balancing Credit & Security Rules and recognise the importance of introducing a more appropriate secured credit limit.

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, Industry Code Development