Modification Report
The provision of Letters of Credit for energy balancing credit cover
Modification Reference Number 0572

Version 4.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

All shippers are required to provide security to support their energy balancing activity, namely Letters of Credit "LoCs" from approved banks with an "Aa3" or higher credit rating, or cash.

This should be enough to cover all their anticipated exposures. As with the BSC, this approach is non-discriminatory as it applies to all market participants irrespective of size. Currently, un-rated entities may have a PCG from a parent, but if the parent defaults there is no protection from debt accruing. This proposal is therefore for all such entities to lodge Letters of Credit.

However, Transco would still need robust systems to immediately act if the Letters of Credit or other credit support was insufficient.

2. Transco's Opinion

Although Transco has a neutral stance in respect of Energy Balancing Charges, it sees the benefit that would be obtained from measures that strengthen the financial stability and security of the industry as a whole. It is, however, of the opinion that matters such as this should be considered in conjunction with other industry developments relating to the credit regime. Transco believes that it would be advantageous to consider this proposal in light of the conclusions of the Ofgem Consultation; "Arrangements for gas and electricity supply and gas shipping credit cover" and while this proposal could provide one solution to a particular issue highlighted by recent events, a more comprehensive assessment of the total credit requirements could provide a more comprehensive and lasting solution. Transco is of the opinion that implementation may reduce the risk that energy balancing debts are not recovered in the event of a User failure but, in many cases, additional costs would be incurred by Users with no corresponding rise in security.

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

Powergen UK plc has not indicated, and Transco is unclear, how the relevant objectives would be better facilitated in the event of implementation.

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

a) implications for the operation of the System:

There would be no implication for the operation of the system.

b) development and capital cost and operating cost implications:

It is expected that development costs would be incurred but they would be minimal.

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:

No special cost recovery arrangements are envisaged.

d) analysis of the consequences (if any) this proposal would have on price regulation:

Transco does not believe that this proposal would have any effect on price regulation.

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

This proposal deals with security levels for energy imbalances; consequently, Transco does not directly face extra contractual risk if the proposal is implemented.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

Implementation would not result in any significant systems development for Transco.

7. The implications of implementing the Modification Proposal for Users

Individual Users would be required to provide financial security by the prescribed method. Fewer alternatives would be available in respect of forms of acceptable security, and in turn, Users could incur increased costs by providing such security.

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

The current rules allow Users to provide the required levels of security by a variety of means and give Users scope to obtain the most financially efficient cover. This proposal prescribes the types of security that can be used and could require some Users to source alternative, and more costly, security which could in turn result in increased overheads, which might be expected to, affect wholesale and retail gas prices.

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 not aware of any impact on legislative and regulatory obligations.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages

The provision of LoC or Cash as security would provide tighter security to the energy balancing cash neutrality process. Users, as a group, would be exposed to less risk, since generally a Letter of Credit or cash would be regarded as easier to recover against compared to a Parent Company Guarantee in the event of default.

Disadvantages

Users that currently use Parent Company Guarantees as security may have to change the means by which they provide their security, which could in turn require them to enter new contractual arrangements.

Currently there are a number of instances where a guarantee is provided by a Parent Company with an independent credit rating above Aa3. If implemented, the proposal would require these Users to obtain Letters of Credit from entities with a credit rating of at least Aa3, the result could be to increase the default probability for some Users. This would also be the case where a User has an independent credit rating above Aa3 and does not provide any other form of security.

The capacity of financial institutions to provide a User with a Letter of Credit could be reduced as a result of the additional facilities required by the market. In turn, the potential to exceed the maximum acceptable exposure to any counter party could be increased.

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Representation have been received from seventeen Users; **J. Aron & Company, BG Gas Services Ltd., BP Gas Ltd., British Gas Trading Ltd., Chevron UK Ltd., Conoco (U.K.) Ltd., EnMO Ltd., Entergy-Koch Trading Europe Ltd., ExxonMobil International Ltd, (representing ExxonMobil Gas Marketing Europe Ltd., Esso Exploration and Production Ltd.** and **Mobil Gas Ltd.), Innogy plc, London Electricity Group Plc, Powergen UK Plc (proposer), Scottish Power Energy Trading Ltd., Shell Gas Direct, SSE Energy Supply Ltd., Statoil (UK) Gas Ltd.** and **TotalFinaElf Gas and Power Ltd. ("TFE").**

The balance of views is thirteen representations against implementation and just four in favour.

The majority of the representations against implementation of the proposal raise the point that this issue should be considered in conjunction with the Ofgem Credit Consultation and other Modification Proposals currently under discussion in this subject area. Many see the proposal as a "knee-jerk" reaction to recent failures, a view typified by SSE Energy Supply; "*We need to ensure there is a balance struck between ensuring that the appropriate level of credit cover provides protection to Transco and shippers without putting in place excessive costs on all shippers or deterring efficient entry into the supply market.*"

Nearly all of the representations against implementation raise the point that mandatory Letters of Credit to cover Energy Balancing Charges would raise industry costs, some pointing out that such increases would be totally unjustified since many Users carry Approved Credit Ratings "ACRs" or Parent Company Guarantees "PCGs" offering excellent credit worthiness. Typical comments were "*The provision of Letters of credit will increase costs, both to Transco and to shippers.*" (Scottish Power) and "*Companies should be allowed more flexibility to obtain the most cost efficient means of cover. Letters of Credit are likely to increase industry costs for provision of security, and in turn may raise costs for customers.*" (BP Gas)

Five of the representations expressed concern that the proposed solution may reduce levels of security in certain instances since the bank providing the credit may be less credit worthy than the entity, (or the parent), being guaranteed and is typified by British Gas Trading's comment "*It is our view that the widespread use of Letters of Credit may concentrate the energy industry risk upon particular areas of the banking industry, which itself may undermine the security of cover. It is also worthy of note that banks may have lower credit ratings than a number of the energy industry participants and it would therefore be paradoxical for the risk to be underwritten by a body holding a lower credit rating."*

Exxon raises the point "*The cost of security is likely covered more than once in the supply chain producer-Shipper-trader-supplier. Allowing PCGs from shippers rated 'Aa3' or above will likely eliminate some duplicate costs to the consumer.*" Transco concurs that the imposition of LoCs would increase User costs.

Of those representations supporting implementation, three state that if additional costs are involved it is better that they are borne by the User than the consequential risk being passed to the community. Powergen goes on to state that the proposal only relates to energy balancing charges and the cost (about 1% of the collateral required) would be relatively modest.

TFE states that implementation, even if only as an interim measure, should be considered.

Powergen supports its stance by stating that implementation would remove risk since "*..... companies can quickly lose their Approved Credit Ratings status and be downgraded from investment to junk status in a very short period of time. When a party fails, there is no guarantee of recovery of money under an ACR. Even a PCG is no protection as we have seen from recent failures where a Parent company also failed.*"

Transco's response: The possibility for ACRs to be downgraded at short notice is not exclusive to Users, or their guarantors, and as such, the risk highlighted by Powergen is equally applicable to banks providing LoCs. Implementation of Modification Proposal 0598 would remove a large proportion of this risk since it would allow Transco to respond promptly to the downgrading of a company or Parent.

Powergen further support its proposal by stating that following the failure of Independent Energy, provisions in the Balancing and Settlement Code "BSC" were tightened by the use of LoCs "*.... which meant there were no debts incurred .....*"

As a supplementary point, EnMO observed that if the proposal was implemented, the additional costs that would be imposed on some Users could be could be reduced if the settlement cycle time period was reduced.

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

This modification is not required to facilitate compliance with safety or other legislation.

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

This modification is not proposed as a result of changes to the methodology established under Standard Condition 4(5).

14. Programme of works required as a consequence of implementing the ModificationProposal

Implementation would require an amendment to the Energy Balancing Credit Rules (which would be carried out by Transco with EBCC approval in accordance with Section X2.1.5 of the Network Code). Following amendment, Transco would be required to modify its procedures for recording and monitoring the types of financial security provided by individual Users.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

This proposal could be implemented very soon after direction by undertaking the work detailed above. The main UK-Link system does not require modification and, consequently, no implementation delays for Transco IS reasons are anticipated. Transco is not aware of the lead-time required by individual Users to secure the alternative forms of security although it is of the opinion that implementation could result in an increase to a User's administrative workload since such alternative form of security would need to be obtained and maintained.

16. Recommendation concerning the implementation of the Modification Proposal

Although Transco is cash neutral to the effects of this proposal, and is in principle supportive of measures that reduce levels of risk, in view of the balance of representations, Transco does not recommend implementation.

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 not to modify the Network Code and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

As Transco is not recommending implementation, legal text is not included in this report.

Signed for and on behalf of Transco.

Signature:

Steve R Phillips
Director of Shipper Services

Date: