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Shippers, Transco and Other Interested Parties

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29 April 2003

Dear Colleague,

Modification proposal 0572 'The provision of Letters of Credit for energy balancing credit cover'

Ofgem has carefully considered the issues raised in modification proposal 0572 'The provision of Letters of Credit for energy balancing credit cover'. 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 current provisions within Transco's network code, gas shippers are allowed a number of different ways to secure credit cover. These include an Approved Credit Rating (ACR) from a recognised credit rating agency, or a Parent Company Guarantee (PCG), or other guarantee from a company that has an ACR.

Recent market events highlighted that these provisions are insufficiently robust and do not provide protection against debt accruing, which led to discussions by Transco, Ofgem and the community on ways of improving the credit regime. Following careful consideration of responses to the March 2002 Ofgem consultation paper[1], which highlighted that use of Letters of Credit (LoC) or cash would be an effective way to do this, the subsequent February 2003

[1] Arrangements for gas and electricity supply and gas shipping credit cover. March 2002.

conclusions and proposals paper[2], concluded that the gas balancing arrangements could benefit from being entirely secured by cash or LoCs.

In electricity, Balancing and Settlement Code (BSC) arrangements already require LoC or cash. With the Enron failure, these arrangements proved to be successful in securing funds for imbalance exposure, in contrast to the gas regime where shippers face significant energy imbalance debts.

The proposal

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

Respondents' views

17 representations were made in respect of this proposal, in which a wide range of opinions were expressed.

Those respondents who opposed implementation highlighted reasons including timing of the proposal, risk allocation and cost implications. Respondents suggested that all current credit related modification proposals should be determined together, in the light of the Ofgem credit consultation document, once published. It was also stated that a reduction in the settlement cycle would be needed before this proposal would be effective.

Additionally, it was stated that the proposal would concentrate risk into areas of banking and could result in use of LoC from banks whose credit worthiness may be less than the company that would otherwise provide a PCG. With regard to cost, respondents stated that the modification proposal would increase industry costs and that those associated with the achievement and maintenance of an ACR should be taken into consideration. Respondents also stated that the proposal would tie up capital and lead to over securitisation of the market.

Comments received in support of this proposal in the main related to risk, cost and alignment with electricity arrangements. Respondents stated that the proposal would provide improvement to an area of ongoing concern by ensuring that any energy balancing debt that might otherwise be unrecoverable under ACR and PCG arrangements, which have proved not to be robust, would be fully recoverable. It was also suggested that the proposal appropriately focuses risk by promoting a market response, rather than socialising costs across users, and in reality that the associated costs of provision of LoCs would not be unduly onerous.

Responses on alignment with electricity noted that parallel BSC arrangements successfully secured funds to limit energy imbalance exposures and thereby prevented losses occurring following the failure of Enron.

Subsequent to publication of the final modification report, the proposal was subject to re-consultation in respect of the appropriate legal drafting to be used in the event of an Ofgem decision to accept. A further nine representations were received, of which seven were from

[2] Arrangements for gas and electricity network operator credit cover; Conclusions and proposals. February 2003.

previous respondents, and two were from new respondents. The views expressed generally reiterated points made during the original consultation, as outlined above. Additionally, two respondents specifically commented on, and were supportive of, the proposed legal drafting.

Transco's view

Transco highlights that although it has a neutral stance in respect of Energy Balancing Charges, it sees the benefit that would be obtained from measures that strengthen stability and security of the industry as a whole. It 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.

Transco is of the opinion that this modification proposal should be considered in conjunction with other industry developments relating to the credit regime, including the conclusions of the forthcoming Ofgem consultation. Transco also believes that 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.

Ofgem's view

Ofgem recognises that this modification proposal relates to an area of ongoing concern, which would benefit from timely resolution. As noted above, Ofgem's consultation paper 'Arrangements for gas and electricity supply and gas shipping credit cover' previously suggested that use of LoC and cash would be an effective improvement to the existing energy balancing regime. Following consideration of responses, both to that consultation document and to this modification proposal, Ofgem continues to hold that belief and recognises that this proposal will facilitate such an improvement.

Several of the representations against the proposal were ostensibly for reasons of it being 'premature', given the number of outstanding decisions on related modification proposals as well as the outcome of the Ofgem consultation. As noted above, the consultation has now been published, and this modification proposal is consistent with the principles set out in that paper. Furthermore, whilst further credit related modification proposals exist, the issues are such that these do not require simultaneous determination. Additionally, should parties consider that additional modifications to network code might be of benefit, for example reduction in settlement cycles, it remains open for these to be taken forward. Therefore, Ofgem does not consider it necessary to delay determination of this proposal.

The argument that energy companies may have higher credit ratings than the banks that could provide LoCs lacks weight. As banking and energy companies are in distinct and separate sectors of the economy, it is unlikely that the difficulties or even failure of an energy company will be simultaneous with that of the bank providing the LoC. This is in contrast to the situation with PCGs, where it is likely that the parent and subsidiary will be in the same or related industries and may face financial difficulties at the same time. This has been borne out in recent events.

Several respondents raise the issue of the increased costs of LoC or cash over PCGs. Ofgem note that this proposal relates only to energy balancing indebtedness, which generally has a relatively low level of indebtedness, with commensurate costs of additional security. Also, such costs would be borne by the relevant party, as appropriate, rather than smeared across the community as a whole as would be the case in the event of a failure.

Ofgem also acknowledges that the achievement and maintenance of a favourable ACR itself comes at a cost, and that the relevant company should be able to benefit from its efforts in this regard. However, it should also be taken into consideration that those same companies who have achieved an ACR will be able to benefit from lower charges for any LoC they obtain.

In situations where there is a combination of exposure to risk being managed on behalf of others, a potentially volatile debt, and where the scale of the potential debt is directly linked to the creditworthiness of the counter party (with a failing company, energy balancing performance is likely to deteriorate), there are strong arguments for cash or equivalent security. As the debt is managed on behalf of shippers through the neutrality arrangements, the event of a shipper failure would smear the costs of any bad debt proportionately across the whole community, regardless of the good practice or otherwise of others in that community. As a result additional security is called for, over and above normal commercial arrangements for debt management.

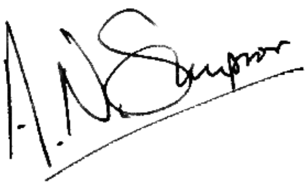
Ofgem notes responses in respect of alignment with electricity arrangements and considers that this would be beneficial in this instance, as such arrangements tend to reduce the risk of severe liquidity problems arising for a company when its credit rating is downgraded.

Ofgem's decision

As noted, the area of credit cover is one of ongoing concern, which requires further work in line with the proposals set out in the recently published Ofgem document, with which this proposal is itself consistent. For the reasons outlined above, Ofgem has decided to approve 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
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