



Shippers, Transco and Other
Interested Parties

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22 March 2004

Dear Colleague,

Modification proposal 0666 'Revisions to the Management of Cash Call Accounts (Breach of Security Limit)'

Ofgem has carefully considered the issues raised in modification proposal 0666 'Revisions to the Management of Cash Call Accounts (Breach of Security Limit)'. 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 as set out in Transco's Gas Transporters Licence.

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

Background to the proposal

Currently, all aspects of energy balancing credit risk are governed by a combination of provisions in the Network Code supplement (section X) and the Energy Balancing Credit Rules (EBCR). The EBCR were agreed by the industry during the introduction of Transco's Network Code and are modified by the Energy Balancing Credit Committee (EBCC), whose members are drawn from and represent the interests of the shipping community operating on Transco's network.

Transco operates as the Credit Risk Manager (Energy) (CRM-E) on behalf of shippers on its network, applying the EBCR in accordance with the instructions of the EBCC. In acting as the CRM-E, Transco remains neutral to energy balancing transactions. All shippers therefore assume a share of the credit risk associated with energy

balancing activity as, in the event of a shipper's failure, unpaid charges are apportioned ('smeared') between remaining shippers.

Security provided in respect of energy balancing activity will form a shipper's Secured Credit Limit (SCL) which, in the event of default, would be realised to meet outstanding indebtedness. In accordance with section X each shipper will have a Cash Call Limit (CCL), which will be a value not exceeding 85% of its SCL. The CCL will be the limit on the shipper's outstanding relevant balancing indebtedness, which Transco monitors on a daily basis.

Where a shipper exceeds its CCL Transco issues a Cash Call Notice (CCN) requiring the shipper to make payment into a designated Cash Call Account (CCA), in order to reduce its indebtedness. If a shipper fails to pay a CCN, Transco will issue a notice of final demand for payment (a Failure to Pay Cash Call Notice). Until the demand is met 'Transco will withhold payment pursuant to any energy balancing invoice in respect of, any amounts payable to the shipper in respect of energy balancing charges'. Currently, where Transco withholds payment to a shipper in the above circumstances, Transco is required to pay interest on the withheld credit value from the due date until payment is made.

The modification proposal

It is proposed that Section X of the Network Code is modified as follows:

Where a User's indebtedness exceeds 85% of their credit limit, Transco would be allowed to withhold payment of any Energy Balancing Invoice credit item until the User's indebtedness fell below the 85% threshold¹. In such circumstances, Transco would not pay late-payment interest on the withheld credit value.

Transco, the proposer, considers that this modification proposal would better facilitate the relevant objectives as tighter management of cash call accounts for shippers exceeding 85% of their credit limits would reduce the risk to all shippers and, therefore, could be better expected to facilitate a more secure and competitive environment in which to operate.

Respondents' views

Six representations were received for this modification proposal, of which four offered support and two opposed its implementation.

¹ As below this right already exists under Transco's Network Code section X2.9.2.

A common view expressed by those respondents who support implementation is that the proposal would reduce the risk of financial exposure to the shipper community, thereby creating a more secure and competitive environment in which to operate. One respondent, whilst offering its support, observed that the credit amount due to the shipper could be far greater than the amount of 'identified risk' from breach of credit cover limit. The respondent suggested that there is potential for a mechanism to relate the maximum withholding of the credit due to the assessed level of risk to the community and to set this as a limitation on the amount withheld.

Of those respondents who opposed implementation, one suggested that the proposal does not tackle fundamental issues (although they did not clarify what was meant by this), and believed that if modifications of this type are to be implemented there would need to be additional warnings that a shipper is approaching its cash call limit. Whilst supporting the principle behind the proposal, the remaining respondent was concerned that it is not entirely clear how these proposals are intended to work and was concerned that focus should be on the cash call process rather than the billing process.

Transco's view

Transco's view is that this proposal mitigates some of the risks associated with shipper failure by placing tighter controls on the management of CCAs. Following a review of the Network Code and the Energy Balancing Credit Rules ('EBCR'), it was identified that by revising the rules governing the management of CCAs the level of risk faced by shippers could be reduced, thus limiting the risk of financial loss to the shipper community from the operation of the Energy Balancing regime. The principle of the proposal has been discussed with the Energy Balancing Credit Committee and, in accordance with its recommendation, Transco has raised this proposal.

If the existing provisions for the management of shippers' cash call accounts were maintained and a shipper became insolvent when its indebtedness had exceeded 85% of its credit limit, remaining shippers may be faced with higher smearing charges than would be the case if Transco had retained the funds and used these against outstanding credit exposures.

Ofgem's view

Ofgem recognises that this proposal has two effects. Firstly, it would extend section X2.9.2, which enables Transco to withhold payment of energy balancing credits to a shipper that has been issued with a Failure to Pay Cash Call notice, so that Transco would no longer have to pay interest on such amounts. Secondly, amounts

withheld under section X2.9.2 would be paid into the shipper's CCA, which may be used to offset that shipper's energy balancing indebtedness.

Whilst shippers should be able to choose how to operate their businesses, this should be consistent with reasonable and prudent behaviour. In line with this, shippers should provide security consistent with their level of energy balancing activity. Following the implementation of modification 0629 'Minimum Level of Security for Energy Balancing', where a shipper has not provided sufficient security and has been issued with two CCNs, Transco has the ability to require the shipper to put in place a minimum level of security.

Notwithstanding the above, an enforced level of security based on previous peak indebtedness may not reflect future activity, and therefore does not prevent further application of the cash call process. Although abuse of the cash call process may not give rise to significant concern where small financial values are involved, the potential for large exposure exists. Given that Transco acts on behalf of shippers on its network, it is fitting that Network Code should provide it with appropriate tools to enable it to minimise potential exposure to the community and incentivise reasonable and prudent behaviour.

Under section X2.5.2 (d) (ii) calculation of a shipper's energy balancing indebtedness is based on its net invoice position. Therefore, payment of invoice credit items by Transco to a shipper will increase that shipper's indebtedness position, and the potential community exposure in the event of shipper default. It is therefore correct that where a shipper breaches its CCL and it subsequently fails to pay a CCN, Transco should have the ability to withhold payment of invoice credit items to that shipper. Ofgem also endorses the removal of Transco's obligation to pay interest on withheld amounts, and considers that this would remove a financial incentive (albeit a small one) for shippers to use the cash call process as a means to manage cash flow.

Whilst Transco may have the ability to withhold payment to a shipper, Transco's Network Code does not currently provide for such amounts being used to offset that shipper's indebtedness. Ofgem agrees that enabling Transco to pay withheld amounts into the relevant shipper's CCA would further strengthen the existing credit regime by providing Transco with an effective tool to minimise potential exposure to the community, thereby creating a more secure environment in which to compete.

Ofgem notes respondent's suggested amendments to this proposal, including the potential for a mechanism to relate the maximum withholding of the credit due to the assessed level of risk to the community and the need for additional warnings that a shipper is

approaching its cash call limit. Whilst these recommendations are not part of this modification proposal, Ofgem would note that its implementation does not preclude further changes to code, including to the cash call procedures.

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, in particular the securing of effective competition between relevant shippers and between relevant suppliers, as outlined under 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
Director, Modifications