

Modification Report
Revision to Credit Cover required in respect of participation in Auctions and
Allocations of System Entry Capacity
Modification Reference Number 0628

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 Proposer stated that :

"It is proposed that this additional level of credit cover be removed from the Entry Capacity processes. It is proposed that the standard level of credit cover for transportation debts (63 days) is sufficient for the purpose of acquisition of SEC also."

The reference to the additional level of credit cover relates to the aggregate System Entry Charges payable by the User in respect of its Registered Quarterly Firm System Entry Capacity for each Day in the twelve (12) calendar months commencing from the first day of the following calendar month.

2. Transco's Opinion

Transco does not support the implementation of this Proposal.

Modification Proposal 0500 implemented the present 12-month credit arrangements to strike an appropriate balance between credit arrangements that create prohibitive cost for some who may otherwise wish to take part in Long Term System Entry Capacity auctions, and weak arrangements that might enable any costs of failure to be passed on to other Users. The 12-month arrangements were introduced for QSEC as an addition to the "standard" arrangements for transportation services. Transco believes that a 12-month capacity credit requirement is the maximum term of credit guarantee that can be obtained without recourse to bespoke and therefore expensive products. Had longer term credit provision been readily available it might have been appropriate to further extend the duration of credit provision. The release of a long term firm product should not be treated as an option to pay, rather it should necessitate a firm commitment on the part of Users. This approach could be undermined if short term credit provisions become the only requirement when obtaining long term firm capacity.

Transco considers it to be inappropriate that a reduction in the level of credit cover should be allowed to increase the potential for bad debt or uncertainty about the revenue stream resulting from the sale of entry capacity in long term auctions. A reduction in the level of credit cover would increase the probability of Transco (in respect of bad debt) and Users (in respect of the uncertainty of revenues associated with the sale of entry capacity in long term auctions) being exposed to the costs of a User default.

Transco also note that Ofgem is presently reviewing the arrangements for gas and electricity network operator credit cover which might inform consideration of change to the credit arrangements.

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

The proposer argued that the Proposal serves to facilitate the Transporter's relevant objectives by facilitating competition in the acquisition of System Entry Capacity.

In Transco's opinion a reduced credit requirement might enable more Users to bid for Long Term System Entry Capacity, however it is possible that reduced credit provisions could prejudice the efficient and economic operation by the licensee of its pipeline system. For example a reduction in credit requirements could lead to greater uncertainty of revenues to be received for capacity sales and might distort any investment signals that may arise from a long term auction. This might therefore seek to offset the benefit identified by the Proposer of easier access to the auctions. The proposal might also be expected to reduce the time available to re-offer any capacity arising from default by a User which could increase operational uncertainties about the pattern of gas flow at entry points.

Transco also considers that this proposal could diminish the efficient discharge of its obligations if the possibility of default is increased to the extent that both Transco and Users have an increased exposure to the costs arising from a defaulting User.

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

a) implications for the operation of the System:

The implementation of this Proposal could prejudice the economic and efficient operation of the system as explained in 2.

b) development and capital cost and operating cost implications:

There are no such implications.

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:

Any increased costs would be borne by Users of the System.

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

There are no such consequences.

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

There are no such consequences.

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

There are no such implications

7. The implications of implementing the Modification Proposal for Users

A reduction in the level of credit cover would lead to increased risk of User default and increased financial exposure for other Users and Transco.

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

There are no such implications.

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 believes that the modification proposal is not consistent with its licence arrangements to operate its pipeline system in an economic, efficient and coordinated manner.

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

Advantages:

Users may be required to provide less credit cover

Disadvantages:

Increased potential for bad debt to occur with a consequent increase in the probability of Transco and Users being exposed to the costs of a User defaulting on financial commitments.

Implementation may conflict with Ofgem's review of credit cover arrangements

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

Summary of Representations

Representations have been received from:

British Gas Trading (BGT)
Innogy (INN)
London Electricity (LEG)
Powergen (POW)
Scottish Power (SP)
Scottish and Southern Energy (SSE)
Statoil UK (STUK)
TotalFinaElf Gas and Power (TFE)

Five respondents, including the Proposer, supported implementation of the proposal (BGT, INN, SP, STUK, TFE), one respondent offered qualified support (LEG) and two respondents (POW, SSE) did not support implementation of the proposal.

11.1 Consideration of Issue

Three respondents commented on the process for development of Network Code Modification Proposal 0500, “Long Term Capacity Allocation”, which put in place revised arrangements where Users acquire rights to System Entry Capacity (SEC) and in particular whether the issue of credit cover was given due consideration.

BGT believes that the issue was not given due consideration. TFE believes that full discussion of the issue was avoided in the industry debate and that the final amendments to the credit rules were introduced very late in the process. INN stated that there was considerable debate on appropriate credit arrangements during the Modification Proposal 0500 discussions which focused on striking the correct balance between credit arrangements that protected the interests of both Transco and the wider shipping community but did not present a barrier to participate in the auctions.

Transco Response

Transco believes that the considerable debate on this issue and the Modification Proposal 0500 development process presented participants with a full opportunity to influence the development of the proposal. The discussions led, in Transco’s view, to a recognition that the issues of credit were largely about effecting a compromise between providing low barriers to participation and protecting all Users and Transco from the consequences of default. Transco is of the opinion that the final proposal was of a pragmatic nature which sought to define an appropriate level of credit provision without driving a substantial increase in barriers to participation.

11.2 Level of Credit Cover

All respondents commented on an appropriate level of credit cover required for acquiring rights to long term capacity.

It is the view of BGT that the current arrangement to provide credit cover equivalent to future 12 months of capacity requirements is in no way related to

the risk attached to Transco, or the wider community, in making the capacity available. Neither does it provide any security for Transco that they would receive revenue at a time of the intended use of capacity, which will be beyond the 12 months.

STUK whilst acknowledging that requiring credit cover for 13 years worth of capacity may prove a barrier to entry state that it would seem inappropriate for shippers to require cover for one years worth of QSEC when all other years remain uncovered.

SP state that the costs of credit cover have been rising and that twelve months credit cover could be seen as a barrier to entry and that 63 days of cover is consistent with other arrangements.

INN comment that the present arrangements will lead to a User needing to put in place higher levels of credit as the rolling calculation crosses two capacity periods adding that the arrangements should mirror those for transportation and be factored into the User's Code Credit Limit as determined prior to the upcoming Gas Year.

Both INN and SP state that the level of Transco's exposure would be reduced by the resale of capacity should the capacity holder default.

LEG comment that credit awareness in the community has improved and feel that the standard level for transportation debts (63 days) is appropriate. However LEG is unclear as to the level of costs should the modification proposal not be implemented stating that some forms of credit cover are not difficult to administer.

POW believe that the current level of credit cover for LTSEC provides an appropriate balance between the cost of such cover and the risk of default.

POW comment that a long-term commitment should not in practice become a long-term option through weakening of credit cover arrangements.

SSE are concerned that (implementation of) the proposal would weaken credit arrangements and increase the potential for bad debt to occur, the cost of which would eventually be passed on to other participants.

SSE believe that given the nature of the product it is appropriate that participation in the LTSEC auction should be backed by a reasonably firm commitment and security from participants.

Transco Response

Transco supports the view of those that believe that the nature of LTSEC as a long term product should require a long term commitment from Users. The prospect of this commitment becoming effectively an option to purchase long term capacity would be detrimental to LTSEC.

Transco also supports those respondents that realise that a weakening of the credit arrangements would increase the potential for bad debt and for increased costs to be passed on to other Users.

On whether Users exposure would be reduced by the resale of capacity should a capacity holder default it is unclear whether this would be the case. For those ASEPs where there is demand for recalled capacity this might be the case, although it is uncertain as to whether the same price for the capacity would be obtained. At those ASEPs where there is low demand and insufficient competition to achieve the price of the recalled capacity in the earlier primary auction then the situation is potentially more serious. This might be of particular significance where Transco had received a signal to invest at these entry points and Users were able to walk away from their commitment it may prove difficult or impossible to resell the capacity.

With regard to whether Transco believes 12-months is an appropriate level of credit cover for say thirteen years worth of capacity it is worth re-iterating the arguments put forward during the development of Modification Proposal 0500. Transco argued that minimising credit risk would imply that appropriate credit should be put in place for the full period demanded by a User, and it continues to believe that this has merit. Unfortunately credit cover products covering terms as long as thirteen years are not readily available and bespoke solutions are likely to be expensive and could, therefore, represent a barrier for many Users to participate in the LTSEC auctions. The “standard” 63 days of indebtedness was felt to be inappropriate to cover such a long term product, in part because it gave no recognition that a long term commitment had been made. The 12 months of cover is therefore thought, by Transco and by some respondents to this consultation, to strike a balance between potentially expensive long term credit cover and weak short term arrangements where there is greater potential for default and increased costs.

SP have argued that the costs of credit cover are rising, which leads it to support this proposal in order to maintain a low barrier to entry. Transco would observe that rising costs in the marketplace may reflect an increased perception of risk which it would argue is why capacity credit provisions should not be weakened.

Transco acknowledges Innogy’s observation that holding long term capacity can lead to an increased credit requirement, however, Transco does not see any conflict between holding increased quantities of entry capacity and increased levels of credit.

11.3 LTSEC Auction Experience

Some respondents drew linkages between the credit arrangements and the experience of the previous LTSEC allocation.

BGT state that the issue relates to incremental capacity where costs may be borne by the community as a whole should a failure occur among shippers allocated with that capacity. BGT add that in the LTSEC process that has been conducted

there has been no indication that any signals have indicated a demand to release incremental capacity.

TFE argue that as no obligated incremental capacity was triggered in the first LTSEC auction then the current situation is no different to the one that existed prior to the auction in terms of Transco's credit exposure.

LEG feel that increasing the participation in the auctions would be aided by the removal of the 12 month level of credit cover which in turn would lead to Transco receiving better long term signals.

SSE believe that given the current lack of experience in relation to LTSEC auctions it is inappropriate to implement the proposed modification.

Transco Response

It is Transco's view that the 12-month credit arrangements enable Users to make a commitment to long term capacity and a balance to be struck between credit arrangements that otherwise would create prohibitive cost for some, and weak arrangements that might enable any costs of failure to be passed on to other Users.

Transco is among those that thought that the first LTSEC auction was well supported and does not believe that evidence from the previous LTSEC auction signalled a reduced level of participation by Users which might be ascribed to Users being required to provide increased levels of credit. Transco observes that participation at St Fergus (in the early periods only) was broadly similar to levels of participation experienced in past Monthly System Entry Capacity auctions.

In terms of the relationship between the release of incremental capacity and the credit arrangements it is Transco's view that the arrangements were not put in place solely to cover incremental capacity release. It would be invidious to have a situation where credit arrangements differed year on year depending on whether incremental capacity was released in an LTSEC auction or not.

11.4 Ofgem Credit Review

Several respondents were aware of the wider review presently being conducted by Ofgem into credit arrangements for gas and electricity participants.

BGT stated that it was aware of Ofgem currently reviewing the credit arrangements but believes that the issue needs to be addressed prior to the next LTSEC process. SP appreciates that the industry is fresh from a credit consultation. TFE believe that if Transco believe that some changes are required these should be discussed as part of the wider Credit Review.

LEG feel that it would be prudent to wait for the outcome of the (Ofgem) review to be published before any modifications are made to the rules that are currently in place. SSE stated that they would like to express concern at the number of adhoc modifications being raised when the outcome of the wider Ofgem consultation is still unknown adding that there is a risk that inappropriate

priorities and solutions could be progressed and potentially implemented without considering the wider impact of the end to end process.

Transco Response

Transco supports those views that there should be no change to the present credit arrangements ahead of the conclusion of the wider Ofgem review.

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

Implementation is not required for this purpose.

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

Implementation is not required having regard to any such proposed change.

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

There would not be a significant programme of works.

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

Draft Modification Report issued	20nd May 2003
Close-out for representation	11th June 2003
Final Modification Report issued by	2nd July 2003

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of this Proposal.

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

Signed for and on behalf of Transco.

Signature:

Nigel Sisman
Development Manager, Gas Balancing
NT & T

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 **0628**, version **1.0** dated **01/07/2003**) 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.