



*Bringing choice and value
to customers*

Shippers, Transco and Other Interested Parties

Your Ref:
Our Ref: Net/Cod/Mod/0595
Direct Dial: 020 7901 7355
Email: nick.simpson@ofgem.gov.uk

20 August 2003

Dear Colleague,

Modification proposal 0595 'Revision to the process for recovering unpaid capacity and commodity invoices'

Ofgem has carefully considered the issues raised in modification proposal 0595 'Revision to the process for recovering unpaid capacity and commodity invoices'. Ofgem has decided not to direct Transco to implement the modification, as we do not 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

Transco is responsible for the development and operation of Code Credit Rules in respect of daily capacity and commodity charges (and associated neutrality adjustments), which contain procedures for monitoring the indebtedness of users, individually and collectively. In line with these rules, Transco operates as a revenue neutral agency on behalf of users on its network.

In maintaining a revenue neutral position, under the provisions of its network code (NC) the costs of Transco's entry capacity buy-back actions and the revenue from within-day sales of daily firm system entry capacity, non-obligated incremental entry capacity, interruptible entry capacity, and overrun charges are addressed via capacity neutrality arrangements. These arrangements (contained in NC section B) provide that the net costs and revenues associated with buy-backs, overruns, non-obligated incremental capacity sales and within day firm capacity sales are automatically recovered on the basis of an individual shipper's end of day firm capacity holdings. In some circumstances this may result in payments being made by Transco to shippers

whereas, depending on the extent of buy-back costs, shippers may in other circumstances have to make payments to Transco.

The above is distinct from arrangements in respect of entry capacity. Under the provisions of its Gas Transporter (GT) licence, Transco is provided funding for the period April 2002 to 2007 to cover the efficient level of operating and capital expenditure required to provide agreed baseline levels of NTS capacity known as the Transmission Asset Owner (TO) output measures. Under its System Operator (SO) incentives Transco is obligated to offer for sale 90 per cent of the TO output measures through a series of long and shorter-term allocations.

Transco's licence provides that following the termination of a shipper, Transco would be required to re-offer for sale any entry capacity that it previously had an obligation under its licence to make available. This could include baseline entry capacity or obligated incremental entry capacity that Transco had sold to the relevant shipper prior to termination.

In contrast to the automatic application of the capacity neutrality arrangements, should Transco fail to recover the full amount owed by a shipper in respect of baseline entry capacity or obligated incremental entry capacity, automatic recovery would not apply. Under the terms of its licence, Transco would be able to apply to Ofgem for an Income Adjusting Event (IAE). If Ofgem accepted such an application, Transco could be permitted to increase transportation charges to recover the shortfall. However, in the absence of approval, Transco would be exposed to the value of any such cost or expense.

The modification proposal

The modification proposal suggests that where a user is in default and/or is terminated from the NC and Transco does not have sufficient credit cover in place to cover any outstanding amounts owed in relation to System Capacity and/or System Commodity Charges, Transco must make an application to the Authority. The Authority would provide a direction to Transco on the amount that Transco may recover from users. The Authority would also direct how Transco may recover any amount from users.

Transco would not be able to recover any unpaid amounts associated with Capacity and Commodity invoices without a direction from the Authority. This would replace the capacity neutrality arrangements outlined above, and Transco's assured neutral position.

The proposer states that the proposal would better facilitate the relevant objectives of the economic and efficient operation of the pipeline system and competition between shippers and suppliers, since the proposal will provide a strong incentive on Transco to act economically and efficiently in setting up appropriate credit arrangements and managing credit risk appropriately. The proposer believes that competition would be promoted since implementation would ensure that any recovery from shippers of unpaid amounts is fair and equitable.

Respondents' views

There were seven responses to the modification proposal, of those, three were in favour of implementation or offered qualified support, and four were against. All those supporting implementation expressed the view that Transco should be in some way responsible for ensuring

that sufficient credit cover is in place, and if the Authority decides that Transco has not done so, Transco should be liable for some of the debt incurred.

One respondent noted that the industry relies on Transco to manage credit risk exposures diligently and that there is therefore an argument that Transco should be liable to a certain extent, for some of the costs. However, the respondent qualified that the above should be subject to clearly stated and published costs that Transco could be liable for, rather than ex-post individual determinations.

It was suggested that the current arrangements lack transparency and lead to winners and losers in debt recovery, and that the proposal would ensure that any recovery from shippers of unpaid amounts is fair and equitable.

Of those respondents who were opposed to implementation some expressed the view that the distribution of neutrality amounts is not a matter that should need to be referred to the Authority. Instead, they indicated that the Authority's involvement in contractual arrangements between shippers and Transco should be avoided. It was also stated that shipper risk levels would increase if the Authority could direct on the smearing methodology after a failure event, leading to greater uncertainty for shippers, as transparency would be reduced and their liability on each occasion would be completely unknown.

One respondent noted that Transco already has a NC obligation to act reasonably and commercially in managing credit exposure, and suggested that this is demonstrated by the fact that to date there has not been a need for a smear of capacity neutrality debt associated with a terminated shipper. It was also suggested that emphasis should be placed upon the prevention of unpaid debt, rather than the means by which bad debt is shared, via review of credit arrangements, such as the accepted investment grade rating at which a shipper is not required to post security and increasing the robustness of security instruments.

Transco's view

Transco believes that this issue primarily relates to credit risk management and, secondarily, only in the event of a user failure, to capacity neutrality smearing. In terms of credit risk, Transco is of the opinion that it should be managed proactively and therefore has established the Credit Management Rules (Code Credit Rules) to ensure that suitable instruments of security secure user indebtedness and that risk of default is minimised.

Transco states that IAEs are not relevant when discussing NC capacity neutrality adjustments; the process for dealing with income shortfall is described in the GT licence and any revenue shortfall resulting from a capacity recall has to be approved by Ofgem. Furthermore, the majority of transportation charges (capacity neutrality charges being the exception) are Transco revenues and in the event that a user fails and the debt is not recovered, resulting bad debt is borne by Transco.

Transco highlights that, to date, no bad debt against entry capacity charges (which includes capacity and neutrality charges) have been incurred, and consequently no user has suffered a capacity neutrality smear, which it suggests would indicate that the current credit regime is affording the required level of protection. However, the capacity neutrality arrangements may be amended via modification proposal. Additionally, should the proposal be implemented,

Transco's states that its level of risk would increase and, as such, its measures for mitigating this risk would need to be reviewed.

Ofgem's view

In light of the applicable objectives of the network code and in light of its wider statutory duties, Ofgem considers that the modification should not be implemented.

As indicated in Ofgem's document, 'Arrangements for gas and electricity network operator credit cover; conclusions and proposals', February 2003 (the credit cover document), Ofgem believes that it would not be appropriate to allow network operators, such as Transco, to automatically recover any bad debts through raising transportation charges. In this respect, in determining any application for an IAE or an adjustment in a subsequent price control review, Ofgem will have regard to the credit arrangements put in place by Transco and the extent to which these have been effectively managed.

As noted above, under its GT licence Transco is both obliged and funded to make available TO output measures, including baseline entry capacity and obligated incremental entry capacity. A clear requirement exists for Transco to have incentives to introduce robust credit arrangements, given the need for the market to provide genuine clear investment signals to Transco for the above entry capacity. As these form a revenue stream, Transco is incentivised to minimise losses arising following a shipper termination, given that recovery is not automatic.

Given the importance of long-term security of supply, it is appropriate that Ofgem be involved in ensuring that the above Transco credit regime facilitates provision of accurate investment signals. Ofgem will determine applications for IAEs for the above under the auspice of Transco's licence, rather than under network code, to which it is not a party. Where Ofgem approves an application, the amount it specifies is recovered via an increase in transportation charges.

In contrast to the above, strong investment signals are not required in relation to daily capacity and commodity. In view of this, and given that Transco operates as a revenue neutral agent on behalf of the shippers on its network through the capacity neutrality arrangements, as opposed to an activity funded under its GT licence, the appropriateness of an Ofgem determination is not immediately apparent.

Whilst taking into account the above, Ofgem notes respondents' comments that the current neutrality arrangements lack transparency and lead to winners and losers in debt recovery. Additionally, whilst Ofgem notes Transco's belief that the fact that no user has suffered a capacity neutrality smear indicates that the current credit regime is affording the required level of protection, Ofgem recognises that Transco is not strongly incentivised in this role, given that automatic recovery applies.

As indicated in the credit cover document, one of the principles underlying the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable. However, Ofgem considers that the proposal that the Authority determines the method of recovery of debts for System Capacity and/or System Commodity Charges, thereby replacing the capacity neutrality arrangements, would provide less certainty and visibility to shippers than existing defined arrangements.

Going forward, Ofgem would encourage discussion of these issues, potentially in the ongoing industry credit working groups. Should comparable arrangements to those for baseline entry capacity and obligated incremental entry capacity be considered appropriate, it may be fitting that such changes be effected via industry consultation and, if appropriate, subsequent modification of Transco's GT licence.

In addition, Ofgem continues to hold the belief stated in its recent document that Transco's Code Credit Rules for gas transportation, which currently sit outside of the NC modification procedures, should be brought within the NC modification procedures. This would provide a means for the industry as a whole to influence the nature of those rules.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to consent to this modification, as we do not 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,

A handwritten signature in black ink, appearing to read 'A. N. Simpson', written over a horizontal line.

Nick Simpson
Director of Industry Code Development