

Modification Report
Revision to the process for recovering unpaid capacity and commodity invoices
Modification Reference Number 0595

Version 2.0

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

Where a User is in default and/or is terminated from the Network Code 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 will provide a direction to Transco on the amount that Transco may recover from Users. The Authority will also direct how Transco may recover any amounts from users.

Transco will not be able to recover any unpaid amounts associated with Capacity and Commodity invoices without a direction from the Authority.

2. Transco's Opinion

Transco is of the opinion that this proposal should not be implemented.

Transco's opinion has been formed by analysing what it believes to be the four principal elements of the proposal, namely the "reasonable and commercial" operation of the credit risk process, the application and consequences of an Income Adjusting Event, the commercial incentives that exist for Transco to collect capacity neutrality revenues, and the smearing mechanism that would be used in the event that a capacity neutrality adjustment was required.

Transco believes this issue is primarily one that relates to credit risk management and, secondarily, and only in the event of a User failure, to capacity neutrality smearing. In terms of the credit risk element, Transco is firmly of the opinion that credit risk should be managed proactively by establishing a User's credit worthiness, monitoring their indebtedness and assessing the risk of default. Given this position, Transco has established robust Credit Management Rules (the "Code Credit Rules") to ensure that User indebtedness is secured by suitable instruments of security ranging from Approved Credit Ratings ("ACR"), Parent Company Guarantees ("PCG"), Letters of Credit ("LOC") to the lodgement of cash via a Deposit Agreements ("DAG") or prepayment.

To minimise risk of default:

- a prospective User is only permitted to become a User on the system once security is in place to secure its credit limit;
- exposure against the credit limit is monitored daily;
- sanctions exist in Section V of the Network Code to prevent a rapid increase in indebtedness once the User breaches 85% of its credit facility;

- the User can be terminated once it reaches 100% of its credit facility;
- all security providers and Users secured by virtue of their ACR are placed on on-line watch with credit rating agencies.

Transco is of the opinion that the credit arrangements in place are tried and tested and provide a robust commercial framework that was initially established to protect transportation revenues but now serves Users' interests by protecting the collection of capacity neutrality charges. However, Transco is always receptive to proposals that strengthen the credit framework in order to protect industry participants from capacity neutrality adjustments caused by bad debt.

In terms of two of the remaining elements of the proposal, the statements made in the justification are factually incorrect:

First, Income Adjusting Events do not form part of the Network Code: 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. In the event that an adjustment was deemed appropriate, the mechanism would be by increasing NTS SO maximum allowed revenue which might ultimately lead to recovery in the following year through SO 'K'.

Secondly, 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, the resulting bad debt is not smeared across Users but is borne by Transco. It is important to note that to date that no bad debt against Entry Capacity charges (which includes Capacity and Neutrality charges) have been incurred, and consequently no industry participant has suffered a Capacity Neutrality smear which would indicate that the current credit regime is affording the industry and Transco the required level of protection.

To summarise,

- Transco is strongly incentivised to ensure shippers do not contractually or commercially default and that all revenue is collected since the majority of money at stake is Transco revenue.
- Transco is prepared to consider proposals that would enhance protection against default.
- Transco believes that credit risk should be managed proactively using instruments of security and, in the event of a User failure, Transco's liability should not extend to uncollected Capacity Neutrality Charges.
- Transco is prepared to discuss options for changing the capacity neutrality smearing rules at the NT & T Workstream should a User initiate such a debate.
- Income Adjusting Events are not relevant when discussing Network Code Capacity Neutrality Adjustments.

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

The proposer states that implementation 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. In the proposer's opinion competition would be promoted since implementation would ensure that any recovery from shippers of unpaid amounts is fair and equitable.

As stated in the previous section, Transco believes that the premise on which this proposal is based, namely that it is not subject to strong commercial incentives to manage its credit arrangements appropriately, is flawed, and consequently implementation would not further any of the relevant objectives.

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:

Transco is unclear as to the full operational ramifications of implementation, however it is expected that development and operating costs would be incurred, the extent of which would be dependent on the administrative procedures required to support implementation.

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 would increase Transco's contractual risk since its liability would be dependant on its ability to demonstrate to the Authority that it had acted "reasonably and commercially", (in the words of AEP), in managing credit risk.

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

Implementation would result in system development for Transco if it were forced to change the current methodology for recovery of debt..

7. The implications of implementing the Modification Proposal for Users

Where a User is terminated and there is insufficient security in place to cover the failed User's debts, the remaining Users could benefit from a lower amount

of smeared debt or no smeared debt where the Authority deems that Transco had not acted in a "reasonable and commercial" manner in its application of its credit rules.

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

The proposer suggests that customers will benefit from implementation as risk of unpaid debt will be reduced on shippers and therefore less costs will be passed through to Consumers.

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 proposer believes that implementation would provide the following advantages:

- the risk of smearing debt across the community will be reduced, thereby reducing the risk of cost pass through to customers.
Transco comment: The principal device for reducing bad debt would be to increase the robustness of the instruments of security. Since this proposal was submitted, Ofgem have indicated that they are minded to direct implementation of Modification Proposal 0572 ("The provision of Letters of Credit (or cash) for energy balancing credit cover") similar initiatives for managing transportation exposures would also significantly reduce User risk.
- the current smearing mechanism is arbitrary and inappropriate and could lead to perverse behaviour in the capacity market
Transco comment: The smearing rules are specific and designed to mirror energy balancing charges smearing. While it is Transco view that good credit management should be the tool for avoiding the need to smear, it is open to suggestions as to how the smearing mechanism could be modified to remove perverse behavioural drivers.
- the proposal introduces an incentive on Transco to act economically and efficiently in setting up credit arrangements and managing credit risk.
Transco comment: Transco is incentivised to act economically and efficiently since the majority of the revenue relates to transportation charges
- implementation would ensure that any "barrier to entry" into the market for small players is reduced.
Transco comment: Uncertainty regarding the smearing mechanism could increase risk for small players and therefore any effect on a "barrier to entry" is debatable.

- implementation would ensure that recovery from shippers of unpaid amounts is fair and equitable.
Transco comment: This could not be assured as the method of recovery would be determined in each event. Inevitably a least one party would feel that the process had not been "fair and equitable"

Disadvantages

While Transco believes that the advantages described by the proposer, (listed above), would not be delivered by implementation, it also believes that implementation would give rise to the following disadvantage:

- The involvement of a third party and the requirement to gather information relating to Transco "reasonable and commercial management of the credit exposure" would result in a longer cycle between User failure and any debt being smeared.
- The introduction of an additional step in smearing mechanism, that is the referral to Ofgem, could vary the amount that individual Users would be liable in the event capacity neutrality invoice remained unpaid, which in turn would introduce uncertainty and additional risk for Users.
- A referral to Ofgem could increase the settlement cycle for an unpaid capacity neutrality invoice and would place a financing cost on Transco.
- The proposal promotes the ex-post resolution of issues and would permit Network Code provisions to be varied after the event on a case-by-case. Transco believes that the interests of Network Code parties would not be best served by the introduction of a retrospective arrangement such as the one proposed.

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

Representations have been received from 7 companies: **British Gas Trading Ltd. ("BGT")**, **ConocoPhillips (U.K.) Ltd.**, **London Electricity Group Plc ("LEG")**, **Powergen UK plc**, **Shell Gas Direct ("SGD")**, **SSE Energy Supply Ltd.** and **Statoil (UK) Gas Ltd.**

The balance of representations is not in favour of implementation. Three Users stated that they were in favour of implementation, or offered a degree of conditional support, with the remaining four Users stating that they were opposed to implementation.

All of the Users that supported implementation expressed a view that Transco should, in certain circumstances, be *"..... in some way some way responsible for ensuring sufficient credit cover is in place"* (**ConocoPhillips**), and *"..... if the Authority decided that Transco has not applied these rules, we agree they should be liable for some of the debt incurred"* (**Powergen**). **LEG** suggested, as

a further refinement, that the amount that Transco should be liable for could be predetermined so that the liability would not be open-ended.

Transco Comment, as stated previously in this report, Transco is strongly incentivised to ensure that its credit arrangements for transportation are robust and applied diligently since the majority of revenue collected is Transco revenue. The capacity charges, (and associated neutrality adjustments), defined in Section B2.13 of the Network Code are the exception to this rule. To the extent that Transco is neutral to these charges, there are strong similarities between managing this activity and Transco's role as Credit Risk Manager (Energy) ("CRM(E)"), as in both cases Transco collects and distributes revenues to the community for the benefit of the community. The principal difference is that for capacity, the credit rules are developed and operated by Transco, whereas for energy, the Energy Balancing Credit Rules are developed by the Energy Balancing Credit Committee and operated by Transco. However, as with energy balancing neutrality, Transco operates as a non-income agency and, as such, it does not believe it should carry any more risk in this role than it does as CRM(E). Recent developments in the credit risk arena have shown that there is increasing scope for this is not to be the case as the security arrangements for transportation and energy continue to diverge.

The current transportation security arrangements have shown that they offer protection for Transco and the community and are proportionate to the current level of risk being carried. Should the proposal be implemented, Transco's level of risk would increase and, as such, Transco's measures for mitigating this risk would need to be reviewed, and measures such as those included in **Statoil's** representation, would need to be considered.

Shippers opposing implementation raised the following concerns:

- A number of Users expressed a view that the distribution of neutrality amounts is not a matter that should need to be referred to Ofgem: *"this modification seeks to include the Regulator in the process to make judgement on the relevance of smeared costs. As stated in our response to that proposal (0596), we do not believe that this is either appropriate or desirable"* (BGT) is typical of User comments on this matter.
Transco comment: Transco is also of this opinion. The rules for dealing with capacity neutrality adjustments lie within Section B of Network Code. Transco believes, that if a User is of the opinion that the rules should be changed, it should propose the rule change by way a modification proposal. By doing so, the change would need to be detailed, Users would get the opportunity to comment on the precise change and Ofgem would be involved throughout the process, concluding with a direction to implement or not. In this way the Network code would always be the reference by which matters such as those described in the proposal would be resolved and would avoid the need for Ofgem to intervene after the event on a case-by-case basis.
- Users opposed to implementation also raise the point that shipper risk levels would increase if Ofgem could direct on the smearing methodology after a failure event: Comments such as *"Our primary concern relates to the proposal that the Authority could direct ex-post the methodology by which Transco will recover unpaid invoices. Any methodology holds the potential to create winners and losers and ex-post decisions may exacerbate this*

effect" (SGD) and "We are concerned that this could lead to even greater uncertainty for shippers as their liability on each occasion would be completely unknown" (SSE) were included in the submissions.

Transco comment: In line with these comments and other responses, Transco believes that any methodology, whether determined by Ofgem or otherwise, derived after the event would have the potential to increase or decrease the amount that individual shippers would be liable. On the assumption that Transco remains neutral, the aggregate charge for which Users would be liable would not reduce but would simply be redistributed in accordance with any "new methodology". Since a "review" after the event could vary the amount of reapportioned neutrality charge that individual Users could be liable for, the effect would be to raise the level of risk that individual Users would have to account for when assessing events involving User failure.

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 Modification Proposal

Implementation would require an amendment to the Network Code to amend the methodology that Transco uses to recover capacity neutrality charges from the community where such charges are not collected from the defaulting / terminated shipper or guarantor.

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

Transco does not recommend implementation and therefore no implementation timetable is proposed.

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

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

Signed for and on behalf of Transco.

Signature:

**Debbie Dowling
Finance Manager**

Support Services

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 **0595**, version **2.0** dated **28/02/2003**) 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 **2.0**.

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.