Modification Report
Adjustment to the number of days in the V A R calculation to bring the Code Credit Rules into line with the Best Practice Guidelines, Conclusions document Feb 2005
Modification Reference Number 0032

Version 3.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 9.6.

1. The Modification Proposal

This is one of a number of Proposals which seek to implement recommendations identified within Ofgem's conclusion document "Best Practice Guidelines for Gas and Electricity Network Operator Credit Cover" 58/05. This concluded the high-level principles that should be applied and further work required in respect of credit cover arrangements for transportation.

This Proposal seeks to implement the recommendation detailed within paragraph 3.30 of the conclusion document.

The Value at Risk mechanism is a widely established process to determine the predicted level of business activity and to determine the basis for the calculation of the Code Credit Limit. For a new User a value of 63 days of peak trading activity is used.

It is proposed that 46 days peak trading activity is used for both existing and new users in the calculation of the Code Credit Limit for Use of System (UoS) charges:

- The Best Practice Guidelines recommend that the VAR for UoS charges should be the sum of all the Charges billed plus 15 days worth of the peak same daily average implied in the billed charges.
- UoS charges are billed on a monthly basis, as the majority of months have 31 days it seems reasonable to use this as part of the equation. Thus 31 +15 make the 46 days proposed.

2. Extent to which implementation of the proposed modification would better facilitate the relevant objectives

Implementing consistent credit processes which move towards recognised best practice would help ensure that there is no inappropriate discrimination, and no inappropriate barrier to entry, thereby facilitating the securing of effective competition between Relevant Shippers.

WWU sated that it "*believes that the costs of implementation are likely to outweigh the benefits and therefore, will not better facilitate the relevant objectives*".

UKT concluded that "*we do not believe that the proposed change better facilitates the relevant objectives for the following reasons: -*

- *We do not believe that this Proposal strikes an appropriate balance between applying security provisions...sufficient to mitigate…financial risks… and the occasions on which cash calls and sanctions…are required.*

- *… an increased likelihood of Users exceeding the 70% and 85% credit usage and in some cases exceeding 100% of …increasing the potential for applying sanctions and for User terminations.*

- *… increases in instances where Users may come close to, or exceed their credit usage percentages, requires an increase in monitoring and administration, which we do not believe to be economic or efficient.*

- *… less credit cover will be available for the Relevant Transporter… historically, User failures have occurred when indebtedness is at its highest.*

- *…on the assumption that 'Pass Through' is … User failure may adversely impact other Users…this would be detrimental to any improvements in … facilitating greater competition between Shippers and between Suppliers*".

TGP and TEP stated "*We…believe that modification 0032 promotes the Transporters ability to operate the network in an efficient and economic manner and so fulfills the relevant objectives of licence condition A11*".

3. The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation

No such implications on security of supply or operation of the Total System have been identified. Incorporating elements of the existing Code Credit Rules within the UNC may help to reduce the impacts of industry fragmentation.

4. The implications for Transporters and each Transporter of implementing the Modification Proposal, including

a) implications for operation of the System:

No implications for operation of the system have been identified.

b) development and capital cost and operating cost implications:

The Transporters have suggested that operating costs would be increased as a result of an increased administrative burden.

Users requested that Transporters quantify and provide evidence of the potential cost increase as part of the consultation process.

WWU reflected that "a *forty-six day application is likely to generate additional operating costs for transporters, due to increased cash-calling activity, and constant readjustments of credit limits*".

UKD commented that "*Using historical data, Transco estimates that during the winter period, the number of notices (70%, 85% 100%) could increase by 400% increasing Transco's administrative costs*".

Referring to Transporters concerns in respect of additional monitioring costs, RWE commented that "*we believe that over the last few winters Transco performed this function anyway. The new DNOs have not yet been through a winter cycle, so the argument of additional work is not valid*".

c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:

No cost recovery mechanism is proposed.

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

No such consequences are anticipated.

5. The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal

No such consequence is anticipated.

6. The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users

No systems impacts are anticipated by either Transporters or Users.

7. The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk

Users would incur costs in optimising their commercial position, but would only incur costs to the extent that they are offset by savings made.

UKD believes that "*both Transporters (in terms of administration and monitoring of credit limit usage) and Users (in terms of frequent amendment of credit security value) would incur a degree of cost in the event of implementation of this Proposal*".

UKD noted that "*less credit cover would be available…in a default situation…[which would]… increase any…amount claimed back via…'Pass Through'…User failures have occurred when indebtedness is at its highest… User failure may adversely impact a reputable and 'well-run' User*".

RWE commented that if implemented "*Shippers need only provide the level of security that is needed to reflect their seasonal commitments. There will be savings in the reduced cost of obtaining security*".

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

No such implications have been identified.

9. Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

No such consequences are anticipated.

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

Advantages

- Ensures credit cover continues to be sought on a non-discriminatory basis.
- Ensures there continue to be no inappropriate barriers to entry as a result of credit requirements.
- Provides Users with an opportunity to optimise their commercial position.
- VAR to whole industry may be reduced.
- Earlier visibility of VAR breaches.

Disadvantages

- May create inconsistency between the UNC and each set of Code Credit Rules
- Increased administrative costs for Transporters due to more cash calling.
- Increased risk to Users of Transporter imposed sanctions.

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

Ten representations (from the following) were received with respect to this Modification Proposal. Six parties support implementation and four parties oppose implementation.

Organisation	Abbreviation	Position
Wales & West Utilities	WWU	Oppose
Transco UKD	UKD	Oppose
Transco UKT	UKT	Oppose
Scotia Gas Networks	SGN	Oppose
Northern Gas Networks	NGN	Support
British Gas Trading	BGT	Support
RWE npower	RWE	Support
Total Gas & Power	TGP	Support
Total E&P	TEP	Support
E.ON	EON	Support

WWU stated that "*although we welcome a review of the current value at risk mechanism…the proposal is too simplistic and…not consistent with the seasonal nature of the gas market*".

UKD reflected that "*the proposer…is seeking to implement a recommendation of Ofgem Conclusions Document…the scope of such recommendation was sought at…the Distribution Workstream…[and]…was detailed within the minutes subsequently issued:*

"Ofgem can confirm that the approach set out in the February 2005 conclusions document, paragraph 3.30 (a), is based on actual indebtedness in terms of amounts billed, but not necessarily due), rather than on peak trading activity."

We are concerned whether this Proposal accurately reflects Ofgem's recommendation".

UKD commented that "*Credit Cover based on a 46 day period of peak trading activity…would be insufficient to adequately mitigate financial risk inherent within the current billing cycle….some [Workstream] members suggested that Users would 'top up' credit…despite this Transco remains concerned that a lower level of credit would result in many Users utilising a greater proportion of their credit limit with the increased risk of breaching the credit limit usage triggers…with the attendant consequences*".

UKT expressed a view that it did "*not believe that this Proposal reflects the objective…there is an issue regarding whether or not the Proposal is in-line with the intent of Ofgem's 'Best Practices Guidelines'…[which] recommended that: "This additional amount provides a proxy for UoS charges that are accrued but unbilled at any point in time, broadly in line with the time-weighted average of such charges arising in each monthly billing period." This is not consistent with the Proposal*". UKT further stated that "*Ofgem were requested to provide a note of clarification regarding its recommendations…Ofgem stated:*

"Ofgem wishes to clarify that the VaR at any time shall be calculated as the sum of all invoices outstanding and unpaid (whether or not due for payment) plus a further sum equivalent to fifteen day usage charges at the same average daily rate implicit in the invoice amounts."

Ofgem did not recommend that the VaR be calculated utilising a suggested number of days peak trading…we consider that this Proposal is not in-line with the Ofgem recommendations stated".

SGN stated that "*We believe that given current billing cycles the existing 60 days should be retained for VAR calculations…The assumption should be that default will happen on the worst possible day. SGN believes that this should reflect the 31 days + the full 20 days which is the normal payment cycle plus at least a further 5 business days / 7 calendar days to allow for the provisions of Mod 0025. This gives a total of at least 58 days*".

Explaining the reasoning for its support, BGT commented "*The proposal… would apply one calendar month…plus 15 days of the peak daily average…*
We believe that this is a much more realistic assessment of the maximum exposure".

RWE stated "*we believe the recommendations as identified within Ofgem's conclusion document…represent a pragmatic and equitable solution…*" adding "*…generally in the summer months Shippers enjoy lower levels of consumption than in the winter…credit cover required through the year will vary and reflect the amount of gas consumed…Based on an analysis of our own…Transportation invoices…[for] 5 months…the monthly total is less than 50% of our highest monthly cost….In fact…one month…was about one third of the winter maximum*". RWE believes that "*This is clearly an inefficient and unnecessary cost to shippers…Nor would it be an efficient or cost effective process for Shippers and Transporters to vary the amount of credit cover on a monthly basis*".

RWE suggested that "*the available credit might not be sufficient to cover a Users requirement in the peak winter months…if this were to happen than the Transporter would, at the 80% level of utilization issue a Cash Call. Upon receipt of such a notice Shippers have 2 options:*
a) Pay the invoice early, on the day the cash call is due. This will immediately bring the Shipper well within its credit limit.
b) Pay the cash call and recover the money once the invoice has been paid".

RWE highlighted a "*third option…[for] the Shipper to proactively manage its position that is to provide additional cover in the appropriate form (eg Letter of credit) over the winter month…nothing in the Code rules that prevents…providing more security than the minimum…this option provides an efficient and cost effective solution*".

TGP and TEP expressed a view that it was "*appropriate to base…(VAR) on a combination of outstanding billed UoS charges…and an estimate of unbilled charges outstanding at any time…[and]…will provide Users with ability to optimise their commercial position…We also agree that some Users may be subject to more cash calls…however, this will be offset by the relative predictability of VAR and hence we do not see this as a major disadvantage*".

TGP and TEP added "*the credit rules would need to be changed to align with UNC and so we do not consider that this modification will create inconsistencies between the credit rules and the UNC*".

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

Implementation is not required to enable each Transporter 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 paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence

Implementation is not required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence.

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

The Proposer believes that minimal changes would be required in respect of operational processes and procedures.

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

In light of the limited works required to implement, the proposer believes this Modification Proposal could be implemented with immediate effect if appropriate direction is received from the Authority.

The Transporters agreed to consider appropriate lead times as part of the consultation process.

16. Implications of implementing this Modification Proposal upon existing Code Standards of Service

No implications of implementing this Modification Proposal upon existing Code Standards of Service have been identified.

17. Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel

At the Modification Panel meeting held on 20 October 2005, of the 9 Voting Members present, capable of casting 10 votes, 5 votes were cast in favour of implementing this Modification Proposal. Therefore the Panel recommend non-implementation of this Proposal.

18. Transporter's Proposal

This Modification Report contains the Transporter's proposal to modify the Code and the Transporter now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

<u>TPD SECTION V: GENERAL</u>

Add new paragraph 3.1.6 as follows:

<u>In determining a User's required Code Credit Limit, the Value at Risk mechanism shall be used to determine such Code Credit Limit. The Value at Risk mechanism detailed in a Transporter's Code Credit Rules shall utilise an assessment of the number of peak trading activity days, the number of such peak trading being forty-six (46) for both new and existing Users. For the avoidance of doubt the number of peak trading activity days shall only be amended by modification of the Code.</u>

Subject Matter Expert sign off:

I confirm that I have prepared this modification report in accordance with the Modification Rules.

Signature:

Date :

Signed for and on behalf of Relevant Gas Transporters:

Tim Davis
Chief Executive Joint Office of Gas Transporters

Signature:

Date :