Modification Report
Termination of User in Receivership
Modification Reference Number 0441

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 proposal made was as follows:

"The discretionary powers afforded to Transco relating to the Notice of Termination should be replaced with a mandatory obligation to issue such a notice following the notification of a User entering into receivership.

We propose that a Termination Notice is issued one business day after Transco is notified of a receiver being appointed, unless, a written commitment, in a form satisfactory to the Energy Balancing Credit Committee (EBCC), is provided to Transco, by the receiver, that all Energy Balancing Debt accrued from the date of appointment of the receiver will be paid. In such an event, normal enforcement steps will be pursued as provided for in the Supplement.

The current arrangements in the Network Code Supplement, Energy Balancing Credit Management, stipulate the measures which can be taken following a Users failure to pay a Cash Call. "

The proposer justified the Modification Proposal as follows;

"On failing to pay a Cash Call Transco is entitled to give Termination Notice which will have the effect of removing the Users ability to operate under the Network Code.

Section V 4.3 of the Network Code considers the issue of termination and identifies events or circumstances where upon the User can be categorised as being in default. Paragraph 4.3.3 states that in such circumstances where a User is in default, Transco may give Termination Notice. In other words, consistent with the Supplement the issuing of a Termination Notice is not mandatory and is at the discretion of Transco.

The issue of Receivership is cited in Section V4.3.1 of the Network Code and is included as one of the events or circumstances contributing to the classification of a User as a defaulting User and, henceforward, empowering Transco with the option to give Notice of Termination.

In the case of the Energy Balancing Debt, Transco is financially neutral to the payment or otherwise of outstanding invoices. For this reason the Energy Balancing Credit Committee was established to provide the impacted parties, the Shipping community, with limited powers to control debt escalation.

The Powers and Duties of the Committee are outlined in Section 2.2 of the Energy Balancing Credit Rules, most pertinent of which relate to the discontinuation, or otherwise, of recovery action regarding Energy Balancing Debt. These powers are consistent with the Enforcement and Recovery Steps provided for in Section 3.4 of the Supplement.

The community through the EBCC was required to test the robustness of the Code during a recent incident involving a Shipper in receivership. Whilst in receivership, it was apparent that the relevant administrative receiver was unwilling to finance the Energy Balancing Debt which continued to accrue during the period the company remained in receivership.

If a Receiver wishes to sell a business as a going concern, it is normal practice that he makes provisions for contractual supplies. At present, debt is incurred by the Community, whilst the party appointing the Receiver gains increasing benefit.

We believe that it is in the interest of the industry to protect the Users from exponential and uncontrollable accrual of Energy Balancing Debt and suggest that the Network Code should be modified to halt such debt escalation."

Discussions in the Energy Workstream on 20/12/2000 generally endorsed the views of the proposer and emphasised that the proposal had been developed with care by the EBCC

2. Transco's Opinion

In respect of energy balancing, Transco is essentially neutral as it is not exposed to the financial risks involved and acts in the interests of the Users as a whole under the Energy Balancing Credit Rules.

Transco recognises that this Modification Proposal may assist in obtaining from the receiver the necessary commitment that the ongoing debt arising from the User's Supply Point portfolio would be covered. This may be achieved by the receiver finding another User who is able to take on the Supply Point portfolio as a going concern. Transco agrees that the Energy Balancing Credit Committee (EBCC) would be the appropriate body to review the submissions made by the receiver which would seek to give the required commitment, and believes that

the results of any such review should be central when decisions are taken regarding the issue of a Notice of Termination.

Transco does not, however, believe that the receiver would always be able to make arrangements with another User by the following business day and is concerned that this might lead to premature termination. Transco would therefore prefer the receiver to be given a reasonable period in which to make these arrangements. Furthermore, Transco noted that the Modification Proposal did not specify a maximum period between the service of a Termination Notice and the date on which that Termination becomes effective. It therefore sought to clarify this by requesting representations on this point.

Transco also believes there would be advantages if there were greater clarity regarding the adequacy of present arrangements for retaining gas supplies to a Terminated User's Supply Points and believes this matter should be considered concurrently with this Modification Proposal. If, for example, a Termination Notice becomes effective as a result of implementing this Modification Proposal, but physical supplies continue, the industry would continue to bear the associated costs. Transco is therefore working with Ofgem and the community with a view to supporting the introduction of more robust and timely arrangements under which the Supplier of Last Resort (SOLR) may be appointed.

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

Respondents have suggested that a User entering receivership with a cash shortfall arising from energy imbalances might create a debt burden on all other Users via the balancing neutrality mechanism. This potential debt burden can be viewed as a form of subsidy. If it is considered that such subsidies are symptoms of inefficient or uneconomic operation of Transco's pipeline system, to the extent that this Modification Proposal would be expected to reduce this burden, implementation could be considered as enhancing efficient and economic operation. Such subsidies might also hinder the development of competition since a history of debt burdens absorbed by the Users community might be considered to be a barrier to entry. Implementation of this Modification Proposal could, therefore, be seen as securing effective competition between relevant shippers.

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

a) implications for the operation of the System:

Transco's operation of the system would be affected if there were an increased likelihood of serving a Notice of Termination on the User. Under present arrangements, it is possible such a termination might lead to isolation of certain individual Supply Points. Transco believes that allowing the receiver a further business day to provide a written commitment would reduce the probability that implementation of this Modification Proposal would lead to an increase in the number of Notices of Termination.

b) development and capital cost and operating cost implications:

Transco is not aware of any development or capital costs arising from implementation of this Modification Proposal. If implementation of this Modification Proposal increased the likelihood of serving a Notice of Termination, there would be operating costs implications. However, by hastening the arrangements for transfer to another User or service of a Notice of Termination, backed up by suitable SOLR arrangements, this Modification Proposal would restrict the amount of transportation charge debt exposure.

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:

Transco does not believe that it would be appropriate to have any special cost recovery measures in place should the implementation of the Modification Proposal lead to increased costs for Transco.

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

Transco is unaware of any such consequence.

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

As Transco's discretion would be reduced if this Modification Proposal were implemented the level of contractual risk to Transco could also be expected to reduce.

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

Transco is not aware of any implications for computer systems.

7. The implications of implementing the Modification Proposal for Users

This Modification Proposal is intended to reduce the credit risk on Users through balancing neutrality and is therefore of potential benefit to Users as a whole.

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

When a User enters receivership there is potentially an effect on a number of parties, including suppliers, producers and consumers. Implementation of this Modification Proposal, linked with appropriate SOLR provisions, should limit the period of uncertainty for these parties and with it any ongoing debt exposure. Implementation therefore could be considered to be of benefit to Non-Network Code Parties.

However, in the absence of robust SOLR arrangements, consumers are responsible for establishing alternative arrangements for their gas supply and might incur additional costs in doing so. If implementation of this Modification Proposal increased the likelihood of Termination then implementation could be viewed as increasing the financial risk to these 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 unaware of any change in legislative, regulatory obligation or contractual relationship of Transco, Users or Non-Network Code Party as a consequence of implementing this Modification Proposal.

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

Advantages of implementing this Modification Proposal are that it would:

- Increase the leverage which Transco has on the receiver to provide a commitment to cover ongoing debts
- Reduce the exposure of Users as a whole to costs arising through balancing neutrality as a result of non-recovery of energy balancing debt
- Strengthen the role of the EBCC in assessing whether satisfactory ongoing debt commitments have been made.

Disadvantages of implementing this Modification Proposal are that it would:

- Increase the likelihood of serving a Notice of Termination. However, if the receiver had more time than the one business day specified in this Modification Proposal, there would be more opportunity to transfer the Supply Point portfolio to another User and so avoid the need for such a notice to be served.
- If a Notice of Termination was served, create a situation in which, in the absence of an appointed SOLR, unsecured debts might continue to accrue for an indefinite period.

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

Eleven representations have been received of which ten supported this Modification Proposal.

Users in support of the Modification Proposal were: British Gas Trading (BGT), Exxon Mobil Gas Marketing (Exxon Mobil), Northern Electric and Gas Limited (NEAG), Powergen, Scottish and Southern Energy plc (SSE), Scottish Power, TotalFinaElf Gas and Power Limited (TFEG&P), TXU Europe Energy Trading Limited (TXU) and Yorkshire Energy Limited (YE). A representation in support of the Modification Proposal was also received from the Energy Balancing Credit Committee (EBCC).

Dynegy did not support implementation of the Modification Proposal.

General Comments

Exxon Mobil suggested that implementation of this Modification Proposal would provide "a workable framework for Transco to manage a shipper receivership situation." NEAG argued the proposal would "lead to a reduction in the credit risk placed on all users through balancing neutrality and is therefore of potential benefit to the Community". SSE agreed that implementation of this Modification Proposal "would go some way to alleviate the community's concerns about the risks of spiralling debt in the event that a shipper gets into financial difficulties". TFEG&P referred to the unanimous support of the EBCC. TXU supported this Modification Proposal as it would "reduce the exposure of shippers to escalating energy balancing costs associated with a user in receivership". YE believed that implementation would "prevent any debts from escalating excessively" and would "ensure a more accurate allocation of costs incurred".

Experience of Failure of Independent Energy

The EBCC cited the "events of last Autumn concerning the failure of Independent Energy" and that "the EBCC has been looking to learn from the experience and tighten the area of Energy Balancing Credit/Security". The EBCC made it clear that this Modification Proposal is one of three that resulted from this learning process. Exxon Mobil reviewed the events of September 2000 where "the receiver was marketing the trade and assets of the shipper in order to maximise the return to the secured lenders" but that this activity was being "financed by the shipping community". Powergen detailed the "unsatisfactory" process when Independent Energy entered receivership and expressed the view that implementation of this Modification Proposal would "ensure that appropriate guarantees with respect of post-receivership energy balancing debts will be obtained promptly from the receiver." Scottish Power supported the Modification Proposal believing that the events surrounding the failure of Independent Energy "has focussed the mind of the community on these issues and prompted a long overdue look at the existing rules which have been in place since 1996, with very little change despite the growing and developing market". TFEG&P also related to delays in establishing "meaningful dialogue with the receiver" and that during this period of uncertainty Users' potential unsecured debt "was escalating dramatically".

Transco's Response

The failure of Independent Energy provided the focus which gave rise to this Modification Proposal. Transco would, however, wish to make it clear that its Credit Risk Management team does not only respond to shipper failures. Since the inception of the Network Code, Transco has pro-actively provided input to the EBCC on issues of concern and informed the ensuing debate on potential solutions, such as rule changes or Network Code Modification Proposals and is continuing to fulfil this role.

Supplier of Last Resort (SOLR) Implications

SSE referred to Ofgem's undertaking to review the current supply of last resort arrangements and wished to emphasise the importance of introducing "more robust arrangements". Dynegy pointed out that whilst the assignment of domestic licences is provided by arrangements introduced in the Utilities Act 2000 the situation is less clear with respect to Ofgem directing a supplier to be a SOLR for a non-domestic portfolio.

Transco's Response

Transco shares the concerns of these respondents with the existing SOLR arrangements for supply points and is working with Ofgem and the community with a view to supporting the introduction of more robust arrangements. Transco believes there is merit in seeking to learn lessons from the events surrounding the failure of Independent Energy across both the gas and electricity sectors. This Modification Proposal should be seen within the context of such a wide ranging review which would include a study of the potential linkages between gas and electricity suppliers.

Mandatory Aspect of Termination and Role of the EBCC

Whilst supporting the Modification Proposal, BGT expressed the belief that "Transco should only issue a termination notice once an operational meeting of the Energy Balancing Credit Committee had approved such a course of action" NEAG agreed that "the discretionary powers currently held by Transco should be replaced with a mandatory obligation to issue a Termination Notice". SSE believed that the EBCC should have "a key role in determining whether the undertaking provided by the receiver.. is appropriate". It felt, however, that a guidance note from the EBCC on the criteria to be applied would be helpful. Scottish Power, whilst supporting this Modification Proposal, added that "the termination notice should be served after the EBCC has met and decided not to instruct Transco to defer serving a termination notice". TFEG&P believed that if this Modification Proposal were implemented "we can be certain that the Receiver will act promptly to provide Transco and in turn the EBCC (on behalf of the shipping community) with a satisfactory undertaking". Where the Receiver had difficulty in providing the undertaking, TFEG&P believed that EBCC would be "empowered to direct Transco to defer proceeding with the termination.....". TXU also pointed out that the Modification Proposal "only requires the receiver to give assurance of debt management suitable to the EBCC."

Dynegy did not support the Modification Proposal and considered "that Transco's relevant objectives are better served if the decision to issue a Termination Notice is left to Transco at their discretion". Dynegy believed that retaining discretion would allow for "flexibility of approach" where the receiver was unable to underwrite debt but where there was a "possibility of continuing the business as a going concern....".

Transco's Response

Transco notes the view that the mandatory service of a Termination Notice would increase the leverage on the receiver and would be expected to lead to a written undertaking by the following business day. The Modification Proposal does not, however, appear to give the EBCC the right to instruct Transco to defer the serving of a Termination Notice where no undertaking had been received. It might even be argued that essentially transferring discretion from Transco to the EBCC would undermine the additional leverage that implementation of this Modification Proposal might give.

Transco agrees that where an undertaking has been given, the EBCC is the correct forum to discuss whether that undertaking provides sufficient protection in respect of ongoing debt. It also agrees that a clear understanding of the criteria to be applied by the EBCC in these circumstances is required. It therefore recommends that the EBCC is given the opportunity to assess the requirements for consequent updating of the Energy Balancing Credit Rules and the Network Code Supplement before implementing this Modification Proposal.

Time-Scales

Transco requested the views of the Users on whether one business day was sufficiently long for the receiver to provide an undertaking of meeting ongoing debt. Transco also requested the views of Users with respect to the interval between the serving of a Termination Notice and it taking effect.

NEAG supported the view expressed within the Modification Proposal that the Termination Notice should be served the business day following entry into receivership. TFEG&P referred to Transco's view that the receiver may not have sufficient time to make necessary arrangements and stated that it did "not agree with this opinion". It was certain that the receiver would act promptly to provide the relevant undertakings. TXU stated that it did "not feel it necessary to give any additional time to the receiver as it only requires the receiver to give assurance of debt management suitable to the EBCC not necessarily find another user to manage the position".

With respect to the interval between the service of a Termination Notice and it taking effect, BGT considered that it should be no more than two business days. Similarly, Exxon Mobil recommended that it should be two business days. It also believed that during that period the Termination Notice could be withdrawn given the consent of the EBCC. SSE believed that the interval should be determined on a case by case basis. TXU believed that the Termination Notice should take immediate effect "or in the very least the following business day"

Transco's Response

Whilst noting the comments of Users, Transco still believes that one business day would not always leave sufficient time for the receiver to provide an appropriate written undertaking. It therefore recommends that if the Modification Proposal is implemented, the receiver should be given a reasonable period in which to provide the necessary undertaking. Transco would expect to be in discussions

with the EBCC whenever a receiver was appointed and this would include the question of whether a reasonable period had elapsed.

Transco agrees that an interval of two business days should elapse between the notice being served and that notice taking effect. Transco also agrees that if the receiver provides a satisfactory undertaking within that period the notice should be withdrawn.

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

Transco is unaware of any such requirement

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

Transco is unaware of any such requirement

14. Programme of works required as a consequence of implementing the ModificationProposal

Transco is unaware of any works required to implement this Modification Proposal. The main changes would be in the operational controls within the credit control function of Transco. Such changes would need to be discussed and agreed with the EBCC. Transco believes that the routine meetings of EBCC are sufficient to ensure that credit control procedures take into account the implementation of this Modification Proposal.

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

If the decision were taken to implement this Modification Proposal, Transco recommends that an implementation date should only be agreed when the EBCC had satisfactorily concluded its discussions on changes required to the Energy Balancing Credit Rules and/or the Network Code Supplement. This would allow all relevant changes to take effect simultaneously.

16. Recommendation concerning the implementation of the Modification Proposal

In view of the general support expressed by Users, Transco does not oppose implementation of this Modification Proposal. However, Transco would support GEMA if it desired to take a consistent view across the gas and electricity markets. Transco would also support the view that this Modification Proposal, together with Modification Proposals 0446 and 0447, should be considered as part of a wider package of potential changes. In particular Transco believes that responsibility for costs should be clarified in the event that a Termination Notice became effective but physical supplies were maintained. Transco

believes that appropriate arrangements can be agreed by the industry and would be willing to facilitate discussions to develop proposals.

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 to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

Section V: GENERAL

Amend paragraph 4.3.3 to read as follows:

"4.3.3. Upon the occurrence of a User Default **(save for a User Default arising by reason of the circumstances set out in paragraph 4.3.1.(e).(ii)**.), and at any time after such occurrence at which the User Default is continuing Transco may give notice ("Termination Notice") to the Defaulting User to the effect that the User shall cease to be a User with effect from the date (which may be any date on or after the date on which the notice is given) specified in the notice. **Where a User Default occurs by reason of the circumstances set out in paragraph 4.3.1.(e).(ii). Transco shall, unless the receiver as soon as reasonably practicable after being appointed provides adequate assurances to Transco in compliance with the principles established in the Code Credit Rules, Energy Balancing Credit Management Supplement or Energy Balancing Credit Rules as appropriate, issue a Termination Notice and such notice shall specify a maximum of no more than 2 business days from the giving of the notice whereby the User shall cease to be a User from the date specified in the notice.**"

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

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 **0441**, version **1.0** dated **21/02/2001**) 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.