Modification Report
Revision to Indebtedness Cash Call Trigger
Modification Reference Number 0446

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:

"It is proposed that when aggregated over a rolling seven day period the User has an energy balancing debt, the following additional calculations shall be carried out in order to update the Users anticipated credit position.

F or each Gas Day within the measurement period set the energy balancing deficit or surplus (in kWh) to the value n days previously. Where n is the number of calendar days equivalent to the previous seven Business Days.

Apply to these deficits and surpluses the System Average Price for that Gas Day to derive an equivalent debit/credits for each Gas Day

Aggregate these debits and credits for the measurement period and derive a net debit

Add this net debit to the Outstanding Relevant Balancing Indebtedness prevailing immediately prior to the commencement of the measurement period.

For the purpose of Cash Call this revised debt shall be the Outstanding Relevant Balance Indebtedness."

The proposer justified the Modification Proposal as follows:

"The recent failure of Independent Energy has exposed the shipping community to some £1.5M of pre-receivership energy balancing debt. This has focused attention on the need to tighten-up current credit management procedures, which have remained largely unchanged (other than Modification 103 implemented on 1 October 1997) since the introduction of the Network Code in 1996. Of particular concern is the potential for Users to rapidly increase indebtedness through trading at the National Balancing Point (NBP) that result in large imbalance positions. Members of the Energy Balancing Credit Committee (EBCC) have concluded that a better measure of indebtedness is required.

Prior to the due date of a Balancing Invoice, Users can build up levels of indebtedness if, day after day, they have a consistent deficit on their daily energy balance. The number of days which the Network Code allows for finalising energy allocation at entry plus the period for preparation and payment, would, in the extreme, allow Users to accrue up over two months of imbalance debt. If on the due date, the User were unable to pay the invoice, the Users as a whole are required to fund this deficit in expected payments, which in the absence of additional controls could be substantial.

Transco, therefore, on behalf of all the Users, operates procedures that seek to track each User's ongoing energy debt position. This allows action to be taken to protect the exposure of all the Users to a single User's excess debt. One of the key actions available to Transco is a Cash Call. This operates once a User has established an Energy Imbalance debt that exceeds 85% of its Secured Credit Limit.

Transco's actions have to be in accordance with both the Network Code and the Energy Balancing Credit Rules and the latter are subject to the approval of the Energy Balancing Committee. This committee is established by the Network Code as a committee of Users under the non-voting chairmanship of Transco. Ofgem also routinely attends the committee meetings in a non-voting capacity.

This Energy Balancing Credit Committee has identified an issue arising from the present Network Code rules. With respect to each Gas Day, initial allocation at entry does not need to take place until seven Business Days later and this is the first date that the scale of the debt can be identified. At this time the User may have

effectively accumulated a further debt in the intervening period (the "unmeasured period"), which would be a minimum of nine calendar days.

There is therefore a need for a Network Code Modification, which estimates the indebtedness of a User on the day that the debt is reviewed. This estimate of indebtedness would then be compared with the Cash Call Limit and a decision to Cash Call would be made on that basis."

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 community as a whole under the Energy Balancing Credit Rules.

Transco has, however, some sympathy with this Modification Proposal as it would give a more up to date energy balancing debt position for each User. This would allow Transco's Credit Risk team to take actions that limit the exposure of Users as a whole, based on the best information available at that time.

Transco also concurs that, where a User enters receivership, this Modification Proposal should limit the unrecoverable energy balancing debt to a lower level than would be the case at present.

Transco notes the argument that this Modification Proposal would not result in an increase in the number of Users entering receivership but would, in the extreme, only hasten the process. Transco believes that Representations on this point have confirmed this view.

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 would create a potential 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.

Transco also notes the argument that such subsidies might hinder the development of competition and a history of debt burdens absorbed by the User community might be considered as a barrier to entry of new Users.

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

a) implications for the operation of the System:

Transco is unaware of any implications for the operation of the System.

b) development and capital cost and operating cost implications:

Providing the implementation of this Modification Proposal does not increase the likelihood of Users entering receivership, the only implications that Transco has identified are in the area of credit risk management and the computer applications that support Transco in that role. Transco believes that development, capital and operating costs arising from changes to its operations and the systems which support them would be minor.

If, however, the likelihood of Users entering receivership was increased by the implementation of this Modification Proposal there would be operating cost implications in transferring Supply Points to alternative Suppliers.

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 believes it is appropriate to fund any changes to its computer applications, arising from this Modification Proposal using existing revenue.

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

Transco does not believe that implementing this Modification Proposal would have any consequence on the level of contractual risk to Transco under the Network Code.

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

Transco has identified the development implications for its computer systems and has concluded the minor changes needed to its credit risk support systems could be accommodated to meet immediate implementation.

Users might wish to modify any existing systems that they have which mirror those used by Transco in credit risk management but it is expected that these systems changes would also be minor.

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 considered by the proposer to be of 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

Providing implementation of this Modification Proposal would not increase the likelihood of Users entering receivership, but only hasten the process, it is believed that implementation could be in the interests of Non-Network Code parties. This would be due to the shorter period of uncertainty for Non-Network Code parties that have a contractual relationship with the User concerned and the credit exposure that they might face during that period.

If implementation of this Modification Proposal did lead to an increase in the likelihood of Users entering receivership, consumers would potentially incur additional costs arising from the change of Supplier.

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 obligations or contractual relationship of Transco, Users or Non-Network Code Parties 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:

Transco's credit risk management processes would be managing the risk to Users based on more up to date information. Having up to date debt information is generally recognised as good practice for credit risk management processes.

In the event that a User that was Cash-Called ultimately entered receivership, this Modification Proposal could reduce the existing exposure of Users through balancing neutrality as a result of non-recovery of energy balancing debt.

Disadvantages of implementing this Modification Proposal are that:

It might lead to an increase in the number of Cash-Call notices if Users continued to incur existing levels of energy balancing debt. This would have implications for cash flow.

It can be argued that increasing a User's exposure to Cash-Calls would increase its financial vulnerability which might result in it entering receivership.

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

Twelve representations have been received all of which supported this Modification Proposal.

Users in support of the Modification Proposal were: British Gas Trading (BGT), Dynegy, Exxon Mobil Gas Marketing (Exxon Mobil), Innogy pIc, Northern Electric and Gas Limited (NEAGL), Powergen, Scottish and Southern Energy pIc (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).

Achievement of Up to Date Debt Position

Dynegy supported this Modification Proposal "as it utilises a level of current debt more reflective of a shipper's ongoing position". Exxon Mobil believed that implementation of this Modification Proposal would lead to "earlier and more accurate cash-calls". Innogy saw implementation as representing "an improved methodology for calculating the level of a User's indebtedness. NEAGL considered that use of the most up-to-date information was "good practice for credit risk management processes". Powergen believed that implementation would "provide for a better measure of such indebtedness for an 'unmeasured period'" and believed that it would "capture negative (and indeed positive) trends earlier than would otherwise have been the case under the current rules". SSE saw similar benefits from implementation arising from "working on the basis of more up-to-date information and closing the current time lag in its monitoring of User indebtedness". TXU believed that the change in calculation "would create a more realistic view of user indebtedness.

Transco's Response

Using existing data Transco has carried out its own evaluation of whether implementation of this Modification Proposal would lead to a more accurate calculation of a User's up to date debt position than that presently calculated and used for cash-call purposes. As a result of these calculations it has concluded that there would be an improvement in accuracy and therefore agrees with the statements summarised above.

Reduction of Users' Risk

Dynegy believed that the implementation of this Modification Proposal should ensure that Transco's Credit Risk team had "sufficient information to invoke existing Code provisions to limit the exposure of the community". Exxon Mobil believed that implementation would lead to shippers receiving earlier and more accurate cash calls and concluded that it "therefore reduces community risk". It did point out, however, that implementation would provide "only partial protection" and therefore linked its support of this Modification Proposal with support of Modification Proposal 0441. Innogy also linked its support of the same two Modification Proposals and stated that together "the two modifications provide existing Users with increased protection against credit risk whilst establishing levels of security that are unlikely to act as barriers to the entry of prospective new Users." Both Powergen and TFEG&P quantified the reduction of exposure which would have arisen from implementation by estimating the effect this would have had in the case of Independent Energy's receivership. They claimed that an earlier cash-call would have reduced the shipping community exposure by £0.1m. SSE in supporting implementation emphasised the need to minimise "the liabilities faced by all Users in the event that there is a default". Scottish Power linked Modification Proposals 0441, 0446 and 0441 believing that implementation of each would contribute "to an overall reduction in the exposure to risk of the entire community". TFEG&P considered that implementation would represent "a positive step towards reducing the amount of potential debt incurred by the community in the event of any future shipper failures". TXU supported implementation on the grounds that it would "reduce that exposure of Users to a User in default" YE supported implementation "as a positive step to ensure that indebtedness will not rise after a party defaults on payments".

Transco's Response

Transco concurs that implementation of this Modification Proposal by strengthening the cash-call processes should lead to a reduction in the exposure of Users.

Increasing Risk of Users Entering Receivership

Powergen did not believe that implementation would increase the risk of Users entering receivership and in fact put forward the opposite view in that: "Better management of energy balancing credit may well help avoid players getting into financial difficulties in the first place". SSE found comfort in the fact that implementation would not "preclude the right for a User to raise an appeal". TXU concluded that implementation would not lead to an increase in Users entering receivership.

Transco's Response

Transco concurs that whilst there is evidence that implementation would lead to earlier cash-calls this need not imply that implementation would lead to more Users entering receivership.

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 3(5) or the statement furnished by Transco under Standard Condition 3(1) of the Licence

Transco is unaware of any such requirement

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

The only works of which Transco is aware concern the changes required in the computer applications used in its credit risk management process and similar applications which Users might have. Transco can complete these works within seven days of any decision on implementation.

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

If the decision was taken to implement this Modification Proposal, it could take effect seven days following direction by GEMA.

Not withstanding the comments in Section 16 below, implementation of this proposal is not necessarily dependent upon the outcome of either Modification Proposal 0441 or 0447.

16. Recommendation concerning the implementation of the Modification Proposal

In view of the general support expressed by Users, Transco recommends implementation of this Modification Proposal.

Transco believes that GEMA should seek to take a consistent view across the gas and electricity markets and may believe that this Modification Proposal, together with Modification Proposals 0441 and 0447, should be considered as part of a wider package of potential changes.

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

NETWORK CODE SUPPLEMENT: ENERGY BALANCING CREDIT MANAGEMENT

Amend paragraph 2.5.2 *to read as follows:*

"…….

(c) **"Anticipated Balancing Indebtedness"** for each User is an amount calculated, in respect of all days in the relevant period (each such day ('i')), in accordance with the following formula:

where:

ABI is the Anticipated Balancing Indebtedness;

SAP_i is the System Average Price for the Day falling *'i'* days prior to day *'d';* and

DI_{i-n} is the User's Daily Imbalance for the Day falling *'n'* days prior to day *'i'* (being a positive or (as the case may be) negative amount in accordance with Section E5.1.2),

n is the number of days in the relevant period,

and the **"relevant period"** is the period from (and including) the 7th Business Day preceding the relevant Day until (and including) the Day preceding the relevant Day ('d-1');

(d) **"Outstanding Relevant Balancing Indebtedness"** for each User means (subject to paragraph (f)) the sum of:

(i) the net aggregate……

(ii) the Net Invoice Amounts.…

(iii) the Net Invoice Amounts….

(iv) the User's Anticipated Balancing Indebtedness,

less…..;

Amend paragraph 2.5.3 *to read as follows:*

"The Relevant Balancing Charges and a User's Anticipated Balancing Indebtedness will be calculated…..".

Amend paragraph 2.5.4 *to read as follows:*

"…..

(i) …..the calculation of Relevant Balancing Charges and a User's Anticipated Balancing Indebtedness will disregard... .".

Signed for and on behalf of Transco,

Signature:

Davis

Gas and Electricity Markets Authority Response:

In accordance with Condition 7 (10) (b) of the Standard Conditions of Public Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference 0446, version 1.0 dated 22/02/2001) 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.

Signahu-e:

Proccss Manager -Nc~ork Code 'fransco

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 Of gem 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.