Direct Dial: 020 7901 7433

25 May 2001

Transco, Shippers and Other Interested Parties

Your Ref:
Our Ref : Net/Cod/Mod/446

Dear Colleague,

Modification Proposal 446: Revision to indebtedness cash-call trigger

Ofgem has considered the issues raised in modification proposal 446: Revision to indebtedness cash-call trigger. Ofgem has decided not to direct Transco to implement the modification, because we do not believe that the proposal will better facilitate the relevant objectives of Transco's Network Code. In this letter, we explain the background to the modification proposal and give our reasons for making our decision.

Background to the proposal

Independent Energy's collapse in September 2000 raised a number of issues concerning the operation of credit cover set out in the network code. When a shipper defaults on paying its balancing costs, the costs are smeared across the shipping community and Transco is not liable for the payment of outstanding energy balancing debt. The Energy Balancing Credit Committee (EBCC) represents the shippers' interests and has limited powers relating to discontinuation and recovery action regarding energy balancing debt. Current credit practises attempt to mitigate this risk. However, the events following Independent Energy's failure have highlighted the need to address current credit management procedures.

Currently shippers determine their own credit limit. In accordance with the Credit Risk Management Procedures, Transco is required to determine whether the shipper's credit rating is sufficiently high to meet the secured credit limit or whether further guarantees of security are required. If a shipper exceeds 85% of its secured credit limit Transco will issue a cash call notice. Shippers are required to pay the amount set out in the cash call notice within the next day. If Transco does not receive these funds it issues a failure to pay a cash call notice, if a shipper is unable to pay within three days Transco can, at its discretion, issue a termination notice. In the interim period Transco may withhold payments to the shipper of energy balancing invoice charges. These procedures have been largely unchanged since the introduction of the network code in 1996. It should be noted that the recent increase in gas prices has resulted in a significant increase in cash call and failure to pay cash call notices.

The experience of Independent Energy's collapse has raised the issue of how to recover debt when a shipper goes into receivership. A shipper's credit position is calculated seven

business days after the gas day. Therefore, when the shipper goes into receivership it could take up to nine calendar days before the scale of the debt can be identified. In this instance it was found that the Receiver was unwilling to finance the energy balancing debt which continued to accrue during the period the company remained in receivership. As a result, debt was incurred by all shippers whilst the party appointing the Receiver gained increasing benefit. In the event the Receiver managed to sell Independent Energy's business as an ongoing concern to a supplier willing to accept the post receivership debt.

Shippers need to ensure that the credit management requirements are sufficiently robust so as to reduce their financial risk. Three modification proposals, 441, Termination of User in receivership, 446, Revision to Indebtedness Cash Call Trigger and 447, Provision Enforcement of a Minimum Level of Energy Balancing Security, were raised to address their concerns.

The modification proposal

It is proposed that shippers' balancing positions are calculated over a seven day rolling period. If this reveals that the shipper is in deficit the current System Average Price (SAP) will be used to calculate the balancing debt which will determine whether Transco should send out a cash call notice. This will avoid the situation of a shipper's debt being exposed seven business days after the gas day and will prevent the shipper from accruing further debt within the seven days.

Respondents' views

Twelve representations were received in response to the modification proposal. All the representations supported the modification proposal on the basis that the proposal will give a more realistic view of a shipper's indebtedness. Further security would be required of the shipper and the overall effect would be to reduce the shipper community's exposure to a defaulting shipper. One respondent argued that better management of credit risk would help to prevent shippers from getting into financial difficulties in the first place. Another respondent argued that the network code should not allow shippers to finance the working capital of their business by running persistent energy imbalances. One respondent argued that the proposal would provide current and potential shippers with greater confidence in the robustness of credit management which would be of benefit to competition and customers. Another respondent noted that there is a greater risk of trading at the NBP which should be reflected in the credit process.

One respondent suggested that shippers and Transco should discuss whether further security is required such as insurance cover, to protect the community from defaulting shipper debt.

Overall respondents stated that this modification proposal, in conjunction with modification 447 would result in a robust credit management process.

Ofgem's view

Ofgem supports the drive towards better information on shipper indebtedness. The tightening credit arrangements will ensure that shippers are better protected from the costs of a defaulting shipper. However, our analysis suggests that the proposed formula could either over or under estimate shipper imbalances depending on the volatility of SAP on the day.

The implementation of this modification proposal could lead to issuing too many or too few cash call notices.

We therefore believe that Transco's relevant objective to run an efficient and economic pipeline system would not be furthered if it were issuing cash call notices unnecessarily.

Ofgem's decision

Ofgem believes that this modification proposal does not sufficiently ensure that cash call notices are issued appropriately by Transco and therefore that it does not further Transco's relevant objectives in most instances.

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,

Nick Simpson
Director, Industry Code Development