



*Bringing choice and value
to customers*

Shippers, Transco and Other Interested Parties

Our Ref: Net/Cod/Mod/0596
Direct Dial: 020 7901 7355
Email: nick.simpson@ofgem.gov.uk

20 May 2003

Dear Colleague,

Modification Proposal 0596: 'Revision to the process for recovering unpaid energy balancing charges invoices'

Ofgem has carefully considered the issues raised in modification proposal 0596 'Revision to the process for recovering unpaid energy balancing charges invoices' and has decided not to direct Transco to implement the modification. This letter explains the background to the modification proposal and outlines the reasons for Ofgem's decision.

Background to the proposal

Currently, all aspects of energy balancing credit risk are governed by a combination of provisions in the Network Code and the Energy Balancing Credit Rules (EBCR). The EBCR were agreed by the industry during the introduction of Network Code and are modified by the Energy Balancing Credit Committee (EBCC), whose members are drawn from and represent the interests of the shipping community operating on Transco's network.

Subsequent to the implementation of Network Code in 1996, Transco has operated as the Credit Risk Manager (Energy) (CRM(E)) on behalf of shippers on its network, applying the EBCR in accordance with the instructions of the EBCC. In acting as the CRM(E), Transco remains neutral to energy balancing transactions.

The neutrality adjustment mechanism (also agreed by industry at the introduction of code) operates so that in the event of a default, where the debt cannot be recovered from the defaulting party through an instrument of security, the debt is smeared across Users. Currently any outstanding debts are automatically recovered from users via an 'Additional Monthly Adjustment Neutrality Cost'. This charge is calculated according to shipper inputs and outputs on a particular day according to Transco's invoicing cycle.

The modification proposal

It is proposed that 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 Balancing Invoices, Transco must make an application to the Authority for a direction to Transco on the amount that Transco may recover from Users. The Authority would also direct how Transco may recover any amounts from Users.

Since, Transco would not be able to recover any unpaid amounts associated with Balancing Invoices without a direction from the Authority, the proposal challenges the existing concept of an intrinsically neutral credit operator, as it could result in Transco bearing some or all of outstanding amounts owed.

The Proposer suggested that implementation would better facilitate the relevant objectives of the economic and efficient operation of the pipeline system and securing effective 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.

Respondents' views

There were ten responses to the modification proposal, of those four were in favour of implementation, and six were against. Common to many responses, both for and against this proposal, was the concern that the current mechanism for distributing the Monthly Adjustment Neutrality Amount between Users is in need of review.

Those respondents in favour of implementation raised a number of issues including the following:

The proposer suggested that Transco, as the industry's agent, should be incentivised to perform this role. A number of responses stated the belief that the existing mechanism is arbitrary and unfair and that involvement of the Authority would ensure that the most fair and equitable way of recovering debts is found. One respondent offered support based on the understanding that Transco would be exempt from the financial implications of the proposal if it acted 'reasonably and commercially' in its role as CRM(E), which would be satisfied by adherence to the EBCR.

Those respondents who were opposed to implementation raised a number of issues, including the following:

A number of respondents commented that they do not consider it reasonable for Transco to be exposed to regulatory risk of facing liability for any unrecoverable debt, and therefore favour Transco retaining a neutral role. Recognition was also given to the role of the EBCC in energy balancing credit management and the ability of shippers to contribute to the development of the credit rules, which makes current methodology, although not ideal, preferable to a referral to Ofgem.

Opposition was noted to increased involvement of the Authority in contractual arrangements between shippers and Transco, which it was suggested would add complexity and uncertainty in the process, through less transparent practices.

Transco's view

In its Final Modification Report, Transco highlights that the proposal challenges the principle of neutrality, without reward for the level of risk involved, and suggests that there would be little incentive to undertake this role on behalf of the community. Transco is of the opinion that it is inappropriate for it to incur any costs if it is demonstrated that it has applied the EBCR and the instructions of the EBCC. It states that due to the inherent neutrality of its position there is no conflict of interests that would cause it not to apply the EBCR in a correct a proper manner. It also suggests that the proposal could be seen as a challenge role of the EBCC and could undermine its mandate to make decisions and instruct Transco.

Transco suggests that the proposal would not ensure that recovery from shippers is fair and equitable, as the apportionment would be determined in each event and inevitably, at least one party would feel that the process had not been 'fair and equitable'. Additionally, the proposal would result in a longer cycle between failure and the debt being smeared.

Transco suggests that changes to the neutrality adjustments by way of modification proposal would provide Users the opportunity to comment on the precise change and Ofgem could be involved throughout the process, concluding with a direction to implement or not.

Ofgem's view

In Ofgem's recent conclusions and proposals document; 'Arrangements for gas and electricity network operator credit cover' February 2003¹, it set out a number of principles in relation to credit cover. One of those principles underlying the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable.

The effect of proposals in line with the principles in the document, such as modification 0572 'The provision of Letters of Credit for energy balancing credit cover', is likely to be a reduction in potential exposure of shippers through the introduction of robust credit arrangements.

Nevertheless, Ofgem recognises the potential for some exposure remains in the event of a default, and also notes shippers' concerns in respect of the existing neutrality adjustment mechanism. However, Ofgem considers that the introduction of individual post-event determinations would provide less certainty and visibility to shippers than existing defined arrangements. In this regard, Ofgem notes respondents' comments that alternate options, such as amendment of the mechanism via modification proposal, remain available for consideration. It will be for EBCC to consider whether it is appropriate to undertake such a review.

Ofgem notes that Transco's role as CRM(E) is on behalf of shippers on its network, applying the EBCR in accordance with the instructions of the EBCC. As such, Transco is unable to freely determine its actions in the event of shipper default or termination. Therefore, the effect of these

¹ www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/1836_14feb03.pdf

arrangements under this proposal would be that Transco could potentially face liability for events outside of its control.

In addition, Ofgem continues to hold the belief stated in its recent document that Transco's EBCR, which currently sit outside of the network code modification procedures, should be brought within the network code modification procedures. This would provide a means for the industry as a whole to influence the nature of those rules, but should not in itself diminish the role of the EBCC.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to consent to this modification, as we do not believe that it better facilitates the achievement of the relevant objectives as outlined under Amended Standard Condition 9 of Transco's GT licence.

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,

A handwritten signature in black ink, appearing to read 'A. N. Simpson', written over a horizontal line.

Nick Simpson
Director of Industry Code Development