

Modification Report
Revision to the process for recovering unpaid energy balancing charges invoices
Modification Reference Number 0596

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

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. The Authority will provide a direction to Transco on the amount that Transco may recover from Users. The Authority will also direct how Transco may recover any amounts from users.

Transco will not be able to recover any unpaid amounts associated with Balancing Invoices without a direction from the Authority.

2. Transco's Opinion

Transco is of the opinion that this proposal should not be implemented.

At present, Transco has a neutral stance in respect of Energy Balancing Charges, and as part of the initial implementation of the Network Code in 1996, has operated as the Credit Risk Manager (Energy) ("CRM(E)") and has applied the Energy Balancing Credit Rules ("EBCRs") in accordance with instructions issued by the Energy Balancing Credit Committee ("EBCC"). Due to the inherent neutrality of Transco's position there is no conflict of interests that would cause it not to apply the Energy Balancing Credit Rules in a correct and proper manner.

Given the above, Transco is opposed to a proposal where the Authority is required to decide, first, whether Transco has applied the EBCRs correctly and, secondly, to direct on the method of recovery of the debt from Network Code parties which could result in Transco bearing some or all of the cost.

Transco is firmly of the opinion that credit risk should be managed proactively by assessing the risk of default, identifying a User's credit worthiness and monitoring credit exposures. All aspects of Energy Balancing credit risk are governed by a combination of provisions in the Network Code and the EBCRs. The EBCRs, which govern the actions of the CRM(E), have been developed, and are modified by, the representatives of the parties that are at risk, namely the EBCC. In the event of a default, and where the debt cannot be recovered from the defaulting party through an instrument of security, the Network Code provides a mechanism for smearing the debt across Users. These provisions ensure that Transco remains neutral to energy balancing transactions. The EBCRs and neutrality adjustment mechanism were agreed by the industry during the introduction of Network Code and there is already a route for Users (via the EBCC) to make proposed amendments to the EBCRs. It is, therefore, inappropriate for Transco to

incur any costs if it is demonstrable that it has applied the EBCRs and the instructions of the EBCC.

This proposal challenges the concept of an intrinsically neutral credit operator and Transco, therefore, does not believe that the proposal should be implemented.

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

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

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

a) implications for the operation of the System:

There would be no implication for the operation of the system.

b) development and capital cost and operating cost implications:

It is expected that development costs would be incurred but they would be minimal but this would depend on the extent that the current smearing mechanism would be amended.

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:

No special cost recovery arrangements are envisaged.

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

Transco does not believe that this proposal would have any effect on price regulation.

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

This proposal would increase Transco's contractual risk since its liability would be dependant on its ability to demonstrate to the Authority that it had acted "reasonably and commercially", (in the words of the Proposer), in managing industry credit risk.

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

Implementation would result in system development for Transco if it were forced to change the current methodology for recovery of debt.

7. The implications of implementing the Modification Proposal for Users

Where a User is terminated and there is insufficient security in place to cover the failed User's debts the remaining Users could benefit from a lower amount of smeared debt or no smeared debt where the Authority deems that Transco had not acted in a "reasonable and commercial" manner when it applied the EBCRs.

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

The Proposer suggests that customers will benefit from implementation as risk of unpaid debt will be reduced on shippers and therefore less costs will be passed through to 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 not aware of any impact on legislative and regulatory obligations.

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

Advantages

The Proposer believes that:

- the risk of smearing debt across the community will be reduced, thereby reducing the risk of cost pass through to customers.
Transco comment: An aid to reducing bad debt would be to increase the protection offered by instruments of security. Since this proposal was submitted, Ofgem have indicated that they are minded to direct implementation of Modification Proposal 0572 (Letters of Credit or cash for Securing Energy Balancing) and it is this, rather than placing a liability on Transco, that would reduce User risk.
- the proposal introduces an incentive on Transco to act economically and efficiently in setting up credit arrangements and managing credit risk.
Transco comment: Transco acts under instruction as a User agent and does not require incentives to act economically and efficiently.
- implementation would ensure that any "barrier to entry" into the market for small players is reduced.
Transco comment: Uncertainty regarding the smearing mechanism could increase risk for small players and therefore the any effect on a "barrier to entry" is debatable.
- implementation would ensure that recovery from shippers of unpaid amounts is fair

and equitable.

Transco comment: This could not be assured as the apportionment would be determined in each event. Inevitably, a least one party would feel that the process had not been "fair and equitable"

Disadvantages

Transco believes that proposal has several disadvantageous aspects:

- It is inappropriate that the management of the EBCRs and Transco's application thereof could result in a Transco liability when both matters of rule development and implementation are the responsibility of the EBCC. The nature of the EBCC ensures that all matters relating to Energy Balancing credit risk are considered fully by individuals representing the shipping community, Ofgem and Transco. Transco and Ofgem are, however, specifically excluded from voting on amendments and matters of implementation.
- The involvement of a third party, and the requirement to gather information relating to Transco's "reasonable and commercial management of the credit exposure", would result in a longer cycle between User failure and the debt being smeared. On the basis that the method of apportionment would be issued to Transco at the end of the investigation process, during period prior to resolution, individual User's risk levels would increase.
- The proposal could be seen as a challenge to the role of the EBCC for dealing with such matters and could undermine its mandate to make decisions and instruct Transco.
- The proposal challenges the principle of neutrality, and without any reward for the level of risk involved, there would be little incentive for any party to undertake this role on behalf of the community.

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

Representations have been received from 10 companies: **AEP Energy Services Ltd. ("the Proposer")**, **British Gas Trading Ltd. ("BGT")**, **Conoco (U.K.) Ltd.**, **Innogy plc**, **Powergen UK Plc**, **Scottish Power UK Plc**, **Shell Gas Direct ("SGD")**, **SSE Energy Supply Ltd. ("SSE")**, **Statoil (UK) Gas Ltd. ("STUK")**, and **TotalFinaElf Gas & Power Ltd. ("TFE")**

The balance of representations is not in favour of implementation. Four Users (including the Proposer) stated that they were in favour of implementation with six Users against.

Of those Users that supported implementation, **TFE** give the most detailed interpretation of how it sees implementation being effected. **TFE's** support for the proposal is 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). **TFE** further qualifies its support by stating that adherence to the EBCRs, and instructions issued to it by the EBCC, would constitute appropriate behaviour and, consequently, Transco would not be liable for a share of any unpaid balancing charges. Transco would, therefore, only be liable by exception where it did not act in accordance with the rules or correctly action EBCC instructions. **TFE** further state that they believe that the smearing mechanism should only be changed by "a process of full consultation"

Transco comment: It is a condition of the GT Licence that Transco can only modify the Network Code in accordance

with the Modification Rules, and on the basis that the smearing mechanism is contained in the Network Code, to change it would require a modification. Therefore, on the basis of TFE's interpretation, the only difference between the situation now, and the situation should the proposal be implemented, would be the circumstances in which Transco would be liable and the process for establishing the extent of any liability. Transco believes that, on the basis of the existing risk and reward balance, the circumstances where Transco is currently liable, and associated remedy, (detailed in Section X 1.3 of the Network Code), is appropriate.

Other points raised by Users in favour of implementation:

- **Powergen** believes that it is appropriate for the Authority to direct how the outstanding debt should be recovered. The Proposer, suggests that direction would be subsequent to the development of a "robust and reasonable methodology" on the cost recovery mechanism
Transco comment: In line with a number of responses, Transco believes that any methodology, whether determined by Ofgem or otherwise, derived after the event would have, to quote **SGD**, "the potential to create winners and losers". On the assumption that Transco remains neutral, the aggregate charge for which Users would be liable would not reduce but would simply be redistributed in accordance with any "new methodology". Since a "review" after the event could vary the amount of reapportioned neutrality charge that individual Users could be liable for, the effect would be to raise the level of risk that individual Users would have to account for when assessing events involving User failure.
- The mechanism for distributing the Monthly Adjustment Neutrality Amount between Users was a recurring theme in representations with a number of Users indicating that the appropriateness of the existing rules should be examined.
Transco comment: Transco is willing to discuss options for changing the neutrality smearing rules for unpaid energy balancing charges at the Supply Point & Billing Workstream. Such a debate would help clarify the views of Users since comments in the representations, such as "arbitrary and unfair", could relate to the timing of the smear, or the way it is divided amongst Users, or both.

A number of issues were raised in the representations opposed to implementation:

- A number of Users expressed a view that the distribution of neutrality amounts is not a matter that should need to be referred to Ofgem: statements such as "introducing the Authority into the process to decide upon the level of the unpaid indebtedness to be recovered from shippers and the mechanism to be used creates additional uncertainty" (**Innogy**) and "Shippers have an opportunity to contribute to the development of the credit rules and STUK believe that this methodology is preferable to a referral to Ofgem" were included in representations.
Transco comment: Transco is also of this opinion. The rules for dealing with neutrality adjustments lie within Section F of Network Code. Transco believes, that if a User is of the opinion that the rules should be changed, it should propose the

rule change by way a modification proposal. By doing so, the change would need to be detailed, Users would get the opportunity to comment on the precise change and Ofgem would be involved throughout the process, concluding with a direction to implement or not. In this way the Network code would always be the reference by which matters such as those described in the proposal would be resolved and would avoid the need for Ofgem to intervene after the event on a case-by-case basis.

- In terms of Transco risk profile, **SSE** state "the proposal raises the wider question as to whether Transco itself should face a liability for any of the unrecoverable debt. We do not consider it reasonable for Transco to be exposed to such regulatory risk" and **BGT** comment "Whilst there may be a case for a review of the current smearing mechanism, we do not support the view that the problem is best served by simply exposing Transco to a portion of the charges."
Transco comment: Transco agrees with these sentiments. Transco undertakes the role of CRM(E) on the understanding that Users acknowledge it will act in good faith and only in limited and specific circumstances be subject to liability. As previously stated, Transco believes that the current regime fairly reflects the fact it operates as a non-income agency.

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

This Modification is not required 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 Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

This Modification is not proposed as a result of changes to the methodology established under Standard Condition 4(5).

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

Implementation would require an amendment to the Network Code to amend the methodology that Transco uses to recover energy balancing costs from the community where the defaulting/terminated shipper has insufficient credit cover in place. Amendment would also be required to the Energy Balancing Credit Rules which would require the Energy Balancing Credit Committee approval.

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

Transco does not recommend implementation and therefore no implementation timetable is proposed.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of this proposal.

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 not to modify the Network Code and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

As Transco is not recommending implementation, legal text is not included in this report.

Signed for and on behalf of Transco.

Signature:

Steve R Phillips
Director of Shipper Services

Date: