

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

Version 1.0

This Draft 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

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) and has applied the Energy Balancing Credit Rules ("EBCRs") in accordance with the wishes of the Energy Balancing Credit Committee. Due to the inherent neutrality of its 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 regarding Energy Balancing credit risk, Transco is opposed to the proposal that the Authority should be placed in a position where it is required to decide, first, whether Transco has applied the EBCRs correctly and, secondly, to direct on the method of recovery of debt from Network Code parties which could result in Transco bearing some of the cost.

Transco is firmly of the opinion that credit risk should be managed prospectively to assess the risk of default, through looking at a User's credit worthiness and monitoring their indebtedness. Matters involving Energy Balancing credit risk are governed by the EBCRs. These rules, by which the Energy Credit Risk manager is bound have been developed, and are modified by, the "at risk" parties in the form of Energy Balancing Credit Committee ("EBCC"). In the event of a default and 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 whole and neutral to energy balancing transactions. The EBCRs and methodology was 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 rules of the EBCRs.

This proposal challenges the concept of an intrinsically neutral Credit manager 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

AEP suggest that this 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 AEP'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 AEP), in managing 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: The principal device for reducing bad debt would be increase the robustness of the 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 placing a liability of 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 method of recovery 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 EBCRs credit arrangements and Transco behaviour in implementing the EBCRs could result in a Transco liability when both matters of rule development and implementation are the responsibility of the EBCC. The closed nature of the EBCC ensure that all matters relating to Energy Balancing risk are considered in the round by User, Ofgem and Transco representatives. 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 "reasonable and commercial management of the credit exposure" would result in a longer cycle between User failure and the debt being smeared.
- The proposal questions the decision of the EBCC to appoint Transco as credit risk manager and be custodian of the EBCRs in accordance with the wishes of the EBCC.
- The Proposal challenges the principle of neutrality and without an element of reward to cover a risk position, going forward 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 are now invited.

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 use 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.

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to Suspense Clause set out in the attached Annex. 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.

17. Text

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

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Steve R Phillips
Director of Shipper Services

Date: