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Shippers, Transco and Other Interested Parties

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26 February 2003

Dear Colleague,

Modification proposal 0598 'Revision of Notice Period in the Event of a Users Credit Rating being Downgraded'

Ofgem has carefully considered the issues raised in modification proposal 0598 'Revision of notice period in the event of a users credit rating being downgraded'. Ofgem has decided not to direct Transco to implement the modification, as we do not believe that it will better facilitate the achievement of the relevant objectives of Transco's network code.

In this letter we explain the background to the modification proposal and outline the reasons for making our decision.

Background to the proposal

Transco's Network Code currently provides that under certain circumstances, Transco may review a User's secured credit limit (energy balancing debt) and a user's code credit limit (transportation debt), and require, by way of notice, the user to revise its credit security following a thirty day notice period. This notice period can be reduced by agreement with the user.

One such circumstance that would result in a user's energy balancing secured credit limit being reviewed, and potentially revised, would be a downward revision of a user's credit rating or of its guarantor. Similarly, for transportation, a review of a user's code credit limit would be triggered by the reduction of any credit rating of the user or any person providing surety for the user.

The modification proposal

Transco has put forward Modification proposal 598, which would extend the provisions of Modification 521 'Where a guarantor is downgraded to any speculative rating, removal of the notice period required for the revision of a User's Secured Credit Limit and Code Credit Limit', implemented on 15 March 2002. It would give Transco the right to issue notice of an immediate revision to a user's credit security should there be any downward revision of a credit rating, either published or privately obtained, of the user, guarantor or any other security provider.

Additionally, the proposal seeks to give Transco the right to review, and if appropriate, require the user to revise immediately, its level of credit security in the event it is necessary to make a demand on any existing instrument of security provided by the user.

Consequently, in both circumstances, rather than waiting for 30 days for remedial measures to take effect, Transco would be able to review, and require a user to take action immediately following a revision of its Secured Credit Limit or Code Credit Limit.

Respondents' views

Twelve representations were received in respect of this modification proposal. Of those responses, three gave unqualified support to the proposal, a further five offered qualified support and the remaining four were against implementation. Those in favour of implementation noted that this would give Transco more flexibility to manage credit security and to respond promptly, which would give the shipping community better protection from potential exposure to energy balancing and transportation debt.

Those respondents who offered qualified support did so in recognition of the principle that Transco should be enabled to protect both the shipping community and itself from avoidable financial loss, and that existing arrangements are inadequate. It was also acknowledged that where there is a need for additional security from a shipper, that this should be put in place immediately.

However, a number of concerns were raised over the content of the proposal, which would require resolution before respondents would support implementation. These included establishment of a reasonable and quantified notice period, in place of the existing 30 days. Suggestions for alternative notice periods included alignment with electricity arrangements, which provide between 3 to 10 days to put alternative cover in place, or a sliding scale, dependent on the credit rating in place.

A further concern requiring resolution was that the proposal currently lacks clarity and provides significant discretion to Transco. Respondents stated that clearer definitions of the criteria on which Transco may act are needed and also suggested introduction of checks, such as a requirement for Transco to consult with the Energy Balancing Credit Committee (EBCC), monitoring of Transco actions, and an appeal mechanism. A further comment not specific to this proposal suggested that the level at the lowest investment grade rating at which a shipper is not required to post security (currently BBB-) should be reconsidered.

Respondents opposed to implementation also raised concerns regarding the discretion available to Transco under this proposal, suggesting that this would provide it too much freedom to act unilaterally. It was stated that the framework by which amendments to credit requirements are made should be clear and transparent, and that the proposal does not meet this criterion, as there is little or no visibility available to other stakeholders. Therefore, the

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lack of detail made it difficult to ascertain whether the proposal would effectively reduce risk. A further comment in regard to timing was the need to await publication of the Ofgem consultation document, and to develop a solution in line with its recommendations.

Transco's view

Transco considers that the proposal should be implemented without delay. In response to respondents' comments, Transco agrees that where there is need for additional security to be put in place by the shipper, this should be immediate. Should a user fail to provide security immediately, Transco indicates that the cash call process for energy and the 70 % and 80% notice process would be triggered.

In regard to the introduction of an alternative notice period, Transco considers that by delaying action for a period the user may be unable to satisfy Transco's requirements as credit lines may have already been exhausted. Transco states that it is not seeking further discretion in the application of existing provisions and believes that the criteria for the revision of a user's credit limit is clearly defined in network code and code credit rules. Therefore, it is simply the deployment timescales that would be modified by this proposal. Transco also believes that any disadvantage to a shipper should be balanced against improved protection for the shipping community as a whole.

In response to respondents' comments on consultation with EBCC, Transco's view is that a downgrade event, in itself, is not sufficient circumstances to convene an extraordinary meeting of the EBCC, but where circumstances dictate a meeting could be held. Transco also comments that, whilst not related to this proposal, it agrees that a BBB- rating, being a notch above 'junk status' should not support an unsecured credit facility.

Ofgem's view

Ofgem recognises that market experience to date has highlighted the ability of credit ratings to fall rapidly, to which market rules have proved unable to respond. These issues, among others, are considered in Ofgem's consultation document; 'Arrangements for gas and electricity network operator credit cover: conclusions and proposals', February 2003.

Ofgem wishes to see, to the extent that is reasonable, a stable business environment. This leads it to consider the speed at which a company's creditworthiness can decline and the appropriateness of precipitous actions. The use of Approved Credit Ratings as a determinant of whether a counter-party must provide further security for its credit could cause liquidity problems for a company when its rating is downgraded. Such rating 'triggers' have been criticised for the role they have played in a number of recent failures, exacerbating the difficulties faced by the company without improving the position of the counter-parties. Measures that allow Transco to act precipitously may undermine the incentive for it to manage debt in an orderly way, by anticipating downgrades rather than reacting to them. Therefore, Ofgem considers that escalation plans should not include (as an early step) increased demands for cash or Letters of Credit, which could be the effect of this proposal.

Further, whilst the rating agencies provide an important and independent assessment of the capacity of companies to discharge their liabilities, the agencies' ratings are designed primarily to inform investors of a company's debt obligations. Credit ratings should not therefore be relied upon as the sole method of assessing all counter-party risk. If used in so-called ratings triggers, their use can cause or increase general risk to the gas community.

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Accordingly, Ofgem is of the view that credit ratings are not necessarily the only criteria by which counter-party risk should be assessed for credit cover purposes. Ofgem would encourage parties to develop and propose more sophisticated assessment techniques, that for instance, take into account the company's payment record, its performance, its fundamental characteristics and the relative size and duration of the exposure. Ofgem would also expect reasonable notice periods for any change to credit terms, sufficient to allow the required cover to be put in place.

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,

Nick Simpson
Director of Industry Code Development

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