



Shippers, Transco and Other Interested
Parties

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03 December 2003

Dear Colleague,

Modification proposal 0627 'Extension of Transco's rights to apply sanctions'

Ofgem has carefully considered the issues raised in modification proposal 0627 'Extension of Transco's rights to apply sanctions'. Ofgem has decided to direct Transco to implement the modification, as we 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

Presently, where a transportation invoice is not paid on its due date then Transco's network code provides that:

- Interest is payable at Barclays base rate, plus 3% (except where specified), (section S.3.6)

- If the invoice amount is (or aggregate invoice amounts are) greater than £10,000 and more than 5 business days past due date then Transco may terminate the shipper from network code, (section V.4.3)

Although termination is available as a contractual remedy for non-payment of an overdue debt in excess of £10,000, Transco believes that it should be an action of last resort. As such, in the absence of the ability to temporarily withdraw services to lever payment, Transco believes that there is the need for an escalation procedure that encourages payment but avoids the need to take precipitous action.

Transco believes that such a remedy exists in circumstances where a shipper exceeds 85% of its Code Credit Limit, whereby Transco is entitled to refuse to accept any or all of the following (these measures are collectively referred to as ‘sanctions’):

- Applications for system capacity or increases of system capacity;
- Applications to acquire capacity on the secondary market;
- Supply point nominations or Confirmation;

until such time as the shipper’s relevant code indebtedness is reduced to less than 85% of its Code Credit Limit (section V.3.3.2). Where a shipper’s relevant code indebtedness exceeds 100% of their code credit limit, then section V.3.3.3 provides that Transco may then issue a termination notice.

Transco believes that by being able to impose sanctions on occasions other than when a shipper exceeds the 85% indebtedness trigger, Transco would have an escalation process to stimulate payment by restricting portfolio growth without the threat of termination. Transco indicates that the introduction of an option to apply sanctions for debt would differentiate between shippers that ‘won’t pay’ as opposed to users that ‘can’t pay’. Where the shipper falls into the former category, sanctions would encourage adherence to its network code obligations. Where the latter category applies, termination may, ultimately, be the best course of action for all network code parties.

The modification proposal

The purpose of the proposal is to increase the remedies available for prompting payments from shippers while removing the need to take termination or insolvency action as a first step. The proposal would extend the circumstances when the

sanctions available under the provisions of section V.3.3.2 (as outlined above) may be applied, to include instances where a shipper fails to pay a transportation invoice for an amount greater than £10,000 on the invoice payment due date. The application of such sanctions would also restrict the financial indebtedness of a shipper by constraining the ability to grow its business when it is in a contractual default position.

The modification proposal would not affect the availability to Transco of existing remedies for non-payment, which include the application of late paid interest, the enforcement of security, litigation via the County or High Courts, and termination from the network code.

Transco, the proposer, states that the modification proposal would better facilitate the relevant objectives as the ability to provide a measured response to non-payment which avoids precipitous action would reduce risk for all parties concerned and, therefore, could be expected to facilitate a more competitive environment for users.

Respondents' views

There were seven responses to this modification proposal, of which two support implementation, one offers qualified support, and four are opposed.

Of those respondents in favour of the proposal, one states that terminating a shipper would ultimately be to the cost of other shippers. The respondent states that this proposal would therefore minimise financial exposure to shippers, and prevent shippers from taking advantage of the current arrangements. The second respondent believes that providing Transco with an additional means to prevent debt is desirable, but suggests that Transco should allow a period to elapse after the default, prior to applying the remedies, to allow for genuine payment processing mishaps.

One respondent, who offers qualified support, agrees with Transco having additional tools for dealing with the late payment of transportation invoices. The respondent also supports Transco taking into account shipper's payment histories before imposing any sanctions, to minimise the probability of these being imposed on shippers with good track records who fail to pay as a result of administrative errors. However, the respondent feels that it would be prudent to wait for the outcome of

the Ofgem review of credit cover arrangements before any modifications are made to the rules that are currently in place.

The views expressed by those respondents who were opposed to implementation of this modification proposal were supportive of the overall concept to reduce exposure of non-payment, but consider that alternative approaches needed to be fully explored. One respondent believes that the sanctions proposed are too severe for what may be an operational error or misunderstanding, and another respondent indicates concern that allowing Transco discretion will make the credit management process less clear and more uncertain.

One respondent, whilst agreeing that termination may not always be an appropriate solution, is concerned that no information has been provided to quantify the scale of the current problem or to justify the need for reform. The respondent also states that it is unclear how the £10,000 figure has been arrived at and suggests that as it is not reflective of an individual's level of activity, risk, or potential exposure, it is inequitable and likely to be inefficient.

Another respondent indicates that it does not believe that this proposal would deliver any appreciable benefit in protecting the exposure of the industry as a whole to the problems of late payment and bad debt. The respondent states that the preferred alternative would be to adopt an agreed industry procedure with recognised steps of escalation and mechanism to appeal sanctions.

Transco's view

Transco, the proposer, believes that this modification proposal should be implemented.

Transco is of the opinion it is sensible to have an escalation procedure for shippers in default, which encourages payment whilst minimising the risk of bad debt to Transco and the shipping community and avoiding any precipitous action. Transco indicates that the justification to support this change results from it not being in a commercial position to temporarily withdraw services as a lever to force payment. Transco therefore suggests that restricting the rate at which the debt increases, while still allowing the shipper to trade, should be seen as a prudent commercial measure.

Ofgem's view

In light of the relevant objectives of Transco's network code and Ofgem's statutory duties, Ofgem has decided to direct Transco to implement the modification.

In a truly commercial environment parties are free to decide who they trade with, and on what terms. As such, the failure to pay debts falling due can result in a range of responses, including the withdrawal of credit facilities, and/or services. Given that Transco is not in an equivalent position, and that potential for industry exposure arises as a result, it is important that Transco has appropriate tools to manage credit exposure.

In addition to the ability to mitigate losses arising from events of default, Ofgem agrees that Transco needs to have appropriate measures in place to encourage adherence to network code obligations. Whilst recent credit modifications have increased the range of tools available to Transco, further incremental improvements may be beneficial. Ofgem agrees that existing remedies for failure to pay transportation invoices may be one area that would benefit from enhancement, as these may not effectively incentivise shippers to make timely payment. Transco's evidence for the period of October 2002 to March 2003 highlights that 201 invoices of above £10,000 were paid late, with an aggregate financial value of £49.9 million.

Whilst a distinction may be drawn between shippers who 'won't pay' and those that 'can't pay', in practice Ofgem recognises that termination of those in the former category would likely be excessive, and for the latter, the immediate issue of a termination notice is not always the most effective way of managing risk to the community. Therefore, there is both the need to restrict credit exposure, and to deter shippers in the 'won't pay' category from withholding payments. In this respect, the ability of Transco to limit the power of a defaulting shipper to expand its portfolio could provide a solution by enabling escalation without needing to resort to termination.

Ofgem is aware of concern that the proposed trigger of £10,000 for sanctions is arbitrary, but considers that any fixed sum would involve an element of arbitrariness. Whilst Ofgem appreciates that the trigger would not relate to the level of shipping activity, it is relevant to the existing remedies for failure to pay transportation invoices, and would require a level of materiality. However, Ofgem accepts that a fixed sum may not be appropriate in every circumstance. Going

forward, the acceptance of this modification proposal does not preclude the proposal of more sophisticated methods of calculation to determine an appropriate trigger value, or values.

Ofgem notes the desire expressed to await the conclusion of the review of credit cover arrangements prior to modification of current rules. However, Ofgem would highlight that its conclusions and proposals document; 'Arrangements for gas and electricity network operator credit cover'¹ (the credit cover paper) was published in February 2003. Whilst industry-wide work-groups are currently in the process of establishing best commercial practice guidelines, these will be developed against the principles set out in that paper, with which this modification proposal is consistent. Therefore, Ofgem does not consider it necessary to delay determination of this proposal.

As set out in the credit cover paper, a principle underlying the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable. Although it is suggested that Transco's discretion in the application of sanctions will make the credit management process less clear and more uncertain, such discretion will also avoid the blanket application of sanctions, which may not be warranted on the facts. Ofgem therefore considers that the introduction of such discretion is reasonable. In addition, given that the proposed provisions are discretionary and, as indicated by Transco, will be applied on the basis of available payment records, Ofgem believes that it is not necessary to build in delay to allow for genuine payment mistakes. Where sanctions are applied, Ofgem would expect Transco to notify the relevant shipper.

Ofgem notes that the proposal could act to moderate the impact of financial failure, by enabling Transco to reduce the amount of debt that could accrue, and would not increase the risk that it will occur. Ofgem therefore considers that this proposal will further strengthen the existing credit regime. Given that the proposal could act to remove the need for precipitous action and minimise financial exposure, consistent with the principles set out in the credit cover paper, Ofgem agrees that this could be expected to better facilitate the relevant objectives by facilitating a more competitive environment for shippers.

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

The legal text which brings this modification into effect will be consistent with the new style of paragraph numbering as consented to under CO80.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to consent to this modification, as we believe that it better facilitates the achievement of the relevant objectives as outlined under Amended Standard Condition 9 of Transco's GasTransporter 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