



Shippers, Transco and Other
Interested Parties

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Dear Colleague,

Modification proposal 0665 'Revisions to the Management of Cash Call Accounts (User in Default)'

Ofgem has carefully considered the issues raised in modification proposal 0665 'Revisions to the Management of Cash Call Accounts (Users in Default)'. 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 as set out in Transco's Gas Transporters Licence.

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

Background to the proposal

Currently, all aspects of energy balancing credit risk are governed by a combination of provisions in the Network Code supplement (section X) 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.

Transco operates 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. All shippers therefore assume a share of the credit risk associated with energy

balancing activity, as in the event of a shipper's failure unpaid charges are apportioned ('smeared') between remaining shippers.

Security provided by a shipper in respect of energy balancing activity will form a shipper's Secured Credit Limit (SCL) which, in the event of default, would be realised to meet outstanding indebtedness. In accordance with section X each shipper will have a Cash Call Limit (CCL), which will be a value not exceeding 85% of its SCL. The CCL will be the limit on the shipper's outstanding relevant balancing indebtedness, which Transco monitors on a daily basis.

Where a shipper exceeds its CCL Transco will issue a Cash Call Notice (CCN) requiring the shipper to make payment into a designated Cash Call Account (CCA) in order to reduce its indebtedness. In line with section X Transco may use funds held in a shipper's CCA to offset amounts owed by the shipper under energy balancing invoices. Presently, section X.2.8.6 enables a shipper to request the return of the whole, or part, of CCA funds. Whilst there are conditions that limit Transco's obligation to release funds, these do not include situations where a shipper is in administration or receivership and / or is in default, as defined by section V.4.3.

Although section X.3.2.4 does enable Transco to withhold payment pursuant to any energy balancing invoice amounts payable to the shipper in respect of energy balancing charges, this is only in circumstances where Transco has notified the shipper that it has not made full payment of an energy balancing invoice on the due date.

The modification proposal

It is proposed that section X of the Network Code is modified as follows:

'Where a User is in Administration or Receivership and / or is in Default, as defined by Section V.4.3 of the Network Code;

- The User would not be permitted to request the return of monies held in their Cash Call Account until such time that all billing for the period prior to such appointment is completed. (Modify Section X.2.8.7).
- Transco would be allowed to withhold payment of any Energy Balancing Invoice Credit item due to a User until such time as the creditors claim has been agreed. In such circumstances Transco would not be obliged to pay interest on the withheld credit value. (Modify Section X.3.2.4).'

Transco, the proposer, considers that that the modification proposal would better facilitate the relevant objectives as tighter

management of Cash Call Accounts for Defaulting and Insolvent shippers would reduce the risk for all shippers and, therefore, could be expected to facilitate a more secure and competitive environment in which to operate.

Respondents' views

Six representations were received with regard to this modification proposal, of which three supported implementation and three offered qualified support, encouraging additions to be made to the proposal.

Three respondents agreed that the proposal would reduce the level of risk faced by the shipper community, should a shipper enter into administration or receivership, by decreasing the chances of the community receiving financial penalties. A further respondent offered support, noting that the proposal largely reflects arrangements in the Balancing and Settlement Code, but suggested that additions should be made to the proposal so that accrued interest will be used to meet:

- any sums due from the party in administration
- additional costs incurred by Transco in dealing with administration issues
- any other costs that if not paid by the company in administration would be recovered by the other shippers

Whilst endorsing Transco having rigorous procedures in place in order to minimise the collective exposure of the industry to non-payment or failure, another respondent observed that the credit amount due to the shipper could be far greater than the amount of 'identified risk' from the failure. The respondent therefore advocated some mechanism to relate the maximum withholding of the credit due to the assessed level of risk to the community and set this as a limitation on the amount withheld.

Although supportive of the intent of the proposal, the remaining respondent was concerned that it was not entirely reflected by the draft legal text, and believed that it was not entirely clear when shippers would be allowed to request or gain access to money held, or whether it would be used to offset outstanding invoices. The respondent was also concerned that the proposed arrangements would impact on a wider group than just insolvent shippers, and was unclear whether consideration was given to developing arrangements specifically for instances where an administrator or receiver has been appointed.

The respondent went on to say that the proposed changes to section X2.8.6 and X2.8.7 should include the proposal that a request for return of money could be made once billing and payment for the period has been completed. Similarly changes to X.3.2.4 should

specify under what circumstances money would be refunded, i.e. once creditors' claims have been agreed.

In response to the above respondent's comments, Transco indicated that it has amended the legal text accordingly.

Transco's view

Transco's view is that this proposal mitigates some of the risks associated with an insolvent shipper failure by placing tighter controls on the management of CCAs. Following a review of the Network Code and the Energy Balancing Credit Rules ('EBCR'), it was identified that by revising the rules governing the management of CCAs, the level of risk faced by shippers could be reduced thus limiting the risk of financial loss to the shipper community from the operation of the Energy Balancing regime. The principle of the proposal has been discussed with the EBCC, and in accordance with its recommendation, Transco has raised this proposal.

If the existing provisions for the management of shippers' CCAs were maintained, and a shipper became insolvent, remaining shippers may be faced with higher smearing charges than would be the case if Transco had retained the funds and used them against outstanding credit exposures.

Ofgem's view

Ofgem believes that this modification proposal would have four effects:

- the extension of section X2.8.6 so that a shipper would be unable to request the return of funds held in its CCA where it is in default (as defined in section V4.3);
- the expansion of section X3.2.4 so that Transco would withhold payment of energy balancing invoice credit amounts due to a shipper where that shipper is in default;
- where Transco withholds amounts under section X3.2.4 it would no longer have to pay interest on such amounts; and
- amounts withheld under section X3.2.4 would be paid into the shipper's CCA.

Ofgem believes that whilst shippers should be able to choose how to operate their businesses, this should be consistent with reasonable and prudent behaviour. Given that Transco (as the CRM-E) acts on behalf of shippers on its network, it is fitting that Network Code should provide appropriate tools to enable it to incentivise such behaviour and to minimise potential community exposure where shippers do not act accordingly.

As noted above, funds in a shipper's CCA may be used to offset its energy balancing indebtedness. In the event that Transco is required to return funds from a CCA to a shipper and that shipper subsequently fails to pay energy balancing debts falling due, bad debt outstanding after the realisation of any security would be smeared amongst the shipper community. Therefore, Ofgem considers that where a shipper is in default under the terms of Network Code it is appropriate that such funds be retained by Transco.

Under section X2.5.2 (d) (ii) the calculation of a shipper's energy balancing indebtedness is based on its net invoice position. Therefore, the payment of invoice credit items by Transco to a shipper would increase that shipper's indebtedness position and potential community exposure in the event of failure. Consistent with above, Ofgem agrees that where a shipper is in default Transco should have the ability to withhold invoice credit amounts. In addition, given the shipper's ongoing failure to meet its obligations under Network Code, Ofgem also endorses the removal of Transco's obligation to pay interest on withheld amounts.

In addition to the ability to withhold payment to a shipper, Ofgem believes that enabling Transco to direct withheld amounts into the relevant shipper's CCA would further strengthen the existing credit

regime by providing Transco with an effective tool to minimise potential exposure to the community, thereby creating a more secure environment in which to compete.

Ofgem notes respondent's suggested additions to this proposal on uses for accrued interest, the potential to relate withholding of credit to the assessed level of risk to the community and the need for clarity on when shippers would be allowed to request or gain access to withheld amounts. Whilst it may not fully reflect suggested changes, Ofgem believes that the introduction of payment of withheld credit items into the relevant shipper's CCA does address the issue of interest and provides clarity on the use of, and access to, withheld amounts. Ofgem would also note that whilst recommendations may not form part of this modification proposal, its implementation does not preclude further changes to code.

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, in particular the securing of effective competition between relevant shippers and between relevant suppliers, as outlined under 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, Modifications