



Shippers, E. S. Pipelines and Other Interested Parties

Your Ref:
Our Ref: Net/Cod/Mod/ESP039
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Email: nick.simpson@ofgem.gov.uk

12 August 2004

Dear Colleague,

Modification proposal ESP039 'Extension of sanctions for bad debt'

Ofgem has carefully considered the issues raised in modification proposal ESP039 'Extension of sanctions for bad debt'. Ofgem has decided to direct ES Pipelines to implement the modification, as we believe that it will better facilitate the achievement of the relevant objectives of ES Pipelines' 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

ES Pipelines has indicated that it reviews the provisions of its network code on annual basis to seek to facilitate competition by allowing shippers to adopt, as far as possible, the same procedures in their dealings with ES Pipelines as they must adopt in dealing with Transco.

Presently, ES Pipelines does not operate a credit procedure, relying instead on shippers to pay promptly. Where a shipper fails to meet debts falling due for payment (excluding those that are the subject of an invoice query) ES Pipelines may apply late payment interest charges and ultimately may terminate the shipper from code. However, it considers that termination is likely to be disproportionate in most circumstances of late payment. In comparison, the implementation of modification 0627 'Extension of Transco's rights to apply sanctions' to Transco's network code on 03 December 2003, increased the remedies available to Transco to prompt payments from shippers, while removing the need to take termination or insolvency action as a first step.

Modification 0627 made available to Transco sanctions that may be applied in circumstances where a shipper fails to pay a transportation invoice (or aggregate invoices) for an amount greater than £10,000 on the invoice payment due date, which will restrict the financial indebtedness of a shipper by constraining the ability to grow its business when it is in a contractual default position. However, it did 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.

In view of the above, ES Pipelines is seeking to amend its network code to achieve consistency with Transco's network code.

The modification proposal

Where a shipper owes ES Pipelines £5,000 or more (excluding money owed but not yet due for payment and queried invoices), then ES Pipelines would be entitled to refuse to accept an application for an increase in Daily Metered (DM) capacity or a supply point nomination or confirmation until the debt is paid in full.

Respondents' views

There was one response to this modification proposal, which considered the proposal to be in line with other market documentation and therefore offered full support to its implementation.

ES Pipeline's view

ES Pipelines supports this proposal as it believes that it provides some limited incentive on shippers towards prompt payment, which would facilitate efficient and economic operation of the pipeline system and also provide for a normal commercial sanction that any non-regulated business might reasonably apply if faced by tardy payment.

Ofgem's view

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

In a normal competitive 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 network operators (NWOs) are not in an equivalent position in respect of regulated service offerings and that potential for industry exposure arises as a result, it is important that they have appropriate tools to manage credit exposure.

In this regard, industry-wide work-groups have sought to establish best commercial practice guidelines, developed against the principles set out in Ofgem's February 2003 conclusions and proposals document; 'Arrangements for gas and electricity network operator credit cover'¹ (the credit cover paper). Both these and Ofgem's criteria for the pass through of bad debt will be

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

published shortly. However, in the interim, Ofgem considers that this proposal conforms to the underlying principles for credit cover.

In addition to the ability to mitigate losses arising from events of default, Ofgem agrees that ES Pipelines needs to have appropriate measures in place to encourage adherence to the ES Pipelines network code obligations. Therefore Ofgem agrees that remedies for failure to pay transportation invoices may benefit from enhancement, in order to effectively incentivise shippers to make timely payment.

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 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.

Although the proposed trigger of £5,000 for sanctions is somewhat arbitrary, it does introduce a level of materiality before the application of sanctions may occur. 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.

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 this proposal would provide ES Pipelines with a level of discretion in the application of sanctions, which could have the effect of 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. Where sanctions are applied, Ofgem would expect ES Pipelines to give notice to the relevant shipper.

Ofgem notes that the proposal could act to moderate the impact of financial failure, by enabling ES Pipelines 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.

In addition to the above, Ofgem recognises that consistency in arrangements across networks may increase clarity and enable efficiency savings, thus providing an incentive to market entry and facilitating competition. In this regard, following conclusion of the review of credit cover arrangements, Ofgem anticipates that the implementation of the resulting best practice guidelines by NWOs through review and amendment (as necessary) to existing code arrangements should result in synchronisation between credit cover provisions for similar processes.

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 ES Pipelines' 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,

A handwritten signature in black ink, appearing to read 'Nick Simpson', written over a faint, illegible background.

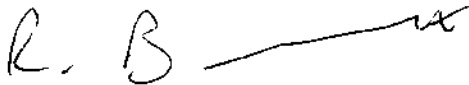
Nick Simpson
Director of Industry Code Development

8. E. S. Pipelines' proposal

This Modification Report contains E. S. Pipelines Limited's proposal to modify the Network Code and E. S. Pipelines now seeks direction from the Gas and Electricity Markets Authority in accordance with this report.

Signed for and on behalf of E. S. Pipelines Limited.

Signature:



Name: Robert Barnett

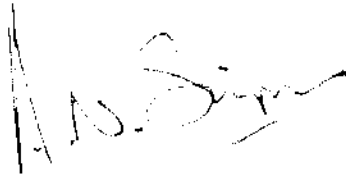
Position: Consultant acting as agent for E. S. Pipelines Limited **Date:** 16th July 2004

Authority Response:

In accordance with Condition 9 of the Standard Conditions of Gas Transporters' Licences dated 1st April 2000 I hereby direct E. S. Pipelines that the above proposal (as contained in Modification Report Reference **Report ESP039** dated 16th July 2004) be made as a modification to the Network Code.

Signed for and on behalf of the Gas and Electricity Markets Authority.

Signature:



Date:

The Network Code is hereby modified, with effect from _____, in accordance with the proposal as set out in this Modification Report.

Signature:

Name:

Position:

Date: