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Dear Fran

Arrangements for gas and electricity supply and gas shipping credit arrangements

I write in response to the above consultation document. Ofgem has identified issues arising from recent supplier failures which it considers need to be addressed to protect consumers' interests. These concerns are threatened disconnection of consumers by network operators when the failed shipper/supplier fails to pay invoices and the possibility that inefficiently high costs are being generated by the current arrangements.

Ofgem makes several proposals to address these concerns. These include aligning the arrangements for credit cover in gas with those for electricity in the Balancing and Settlement Code; or only allowing Letters of Credit (LoC) or cash to be accepted as credit cover by network companies (ie gas transportation, electricity transmission and electricity distribution); or requirements for credit cover be addressed through the network operators' price controls; or some combination of these approaches.

Ofgem also outlines its view on a number of issues: that there is work required to identify if there is a requirement for clearer enforcement rules; that the Transco Code Credit Rules should be brought within its Network Code Modification Procedure; and that additional changes to the invoicing cycles and payment terms should be considered at a later date.

Shell Gas Direct has a number of comments to make on these proposals.

Protecting consumers

Ofgem's primary duty is to protect the interests of consumers. In Ofgem's view this means they should ensure that all consumers continue to be supplied by gas and electricity in the event of a supplier failure. However, given the complexity and resources which would be required to disconnect small sites for a limited reduction in exposure for the network operator, it does not appear likely that this threat would be carried out at this level. If network operators were to chose this approach, it would seem more likely that they would target larger consumers of gas and electricity.

The ability of large consumers to change supplier at short notice was discussed at the workshop and needs further consideration. Ofgem, rightly, does not wish to become involved in the contracts between customers and suppliers. However, it does not seem reasonable that a credit worthy customer is unable to switch to a new supplier to avoid

disconnection due to its incumbent supplier's debts. If this switch were possible, it should satisfy the network operator that invoices will be settled. However, there are, of course, many issues which are raised by this and Ofgem will want to consider the issues further before pursuing this. Any new 'right to switch' could undermine the ability for the business to be sold and would need to be cancelled once a new owner has been announced.

The threat of disconnection may exist although we are uncertain about the likelihood of it being carried out. We are not convinced by Ofgem's argument that this threat requires it to become involved in commercial decisions about credit arrangement, nor that its approach is an efficient one.

While Ofgem has a duty to protect consumers, it needs to also consider the extent to which it relieves customers of responsibility for ensuring that suppliers with whom they contract are credit worthy. More risky suppliers may offer lower prices in order to gain a foothold in the market. If they fail, the costs of this can be forced on to other suppliers and, ultimately, their customers. A credit regime which does not recognise this can be seen to be discriminatory and fetters effective competition.

Regulatory framework

Ofgem states that the current arrangements for making amendments to Transco's Code Credit Rules do not require consultation with affected parties and that there is no right of appeal to Ofgem. It is true that Transco does not need to consult with affected parties before making changes. It may be worthwhile to consider whether this needs to be changed. However, we are very concerned about the piecemeal approach that Ofgem is taking to changing the Network Code governance structure. In parallel to price control changes, Ofgem is already imposing changes to what is a contract between shippers and Transco. Although there was some discussion a few years ago about a programme of work to look at governance arrangements and related Code reform issues, this was not progressed. We do not support this proposal and do not consider that it should be progressed without further consultation with the industry.

If this change were to be implemented, we would want some assurance from Ofgem that decisions on any proposed modifications in this area would be dealt with in a timely manner. In light of extensive discussion through the Energy Balancing Credit Committee (EBCC), a proposal was made (Modification Proposal 0441) which would have obliged Transco to issue a termination notice unless the receiver provided acceptable assurances to the EBCC regarding payment. Responses on this were sought by 1 February 2001 but Ofgem rejected this on 29 May 2001. An amended, but similar proposal (Modification Proposal 0475) was made with shippers responding by the 6 July 2001. Ofgem accepted this on 9 November and it was implemented from 12 November 2001. It may be that if this change had been introduced earlier, the balancing costs now being smeared to shippers due to Enron's receivership would have been less.

Ofgem further suggests that there is no right of appeal to Ofgem if a shipper does not agree with any change to the Code Credit Rules proposed by Transco. This is not the case. Transco is subject to regulation both through the Gas Act (as amended) and the Competition Act. For the latter, it must ensure that it does not abuse its monopoly position. Under the Gas Act, section 9(2), Transco has a duty to avoid any undue preference or undue discrimination in the terms it makes for the conveyance of gas. A shipper could refer to the Authority any change which it considered was an abuse of monopoly power or discriminatory. Ofgem does not explain whether it considers this protection to be insufficient and why. We do not consider that additional regulation

should be introduced if the existing framework is sufficient. We discuss the implications of Transco's Gas Act duties, and the similar duties for the distribution and transmission companies, further below.

We note that Ofgem is considering looking at invoicing cycles. While there may be benefit in making some amendments, Ofgem should be aware that there are costs associated with making major changes. Many invoicing cycles are related to the time it takes to consolidate information. For the gas industry, this includes settling offshore claims through the claims validation process to agreed timetables.

Credit arrangements

Parent company guarantees

Ofgem states that approved credit ratings (ACRs) and/or parent company guarantees (PCGs) are not an acceptable form of credit cover in gas or electricity as they do not necessarily provide any money in the event of default and they introduce a cross-subsidy. We do not agree with this analysis.

PCGs when properly drawn up provide the network operator with the certainty that in the event that the supplier involved cannot pay a debt, it can approach the guarantor for payment. A parent company may be more or less likely to be able to provide this cover than a bank depending on its own credit rating (some companies will have capitalisation values that are larger than those of large banks such as Lloyds or Barclays). A company with a very high credit rating can be relied on more to be able to pay than one with a lesser rating. This is regardless of whether the companies giving the guarantee are banks, major energy companies, or car manufacturers. We do not see why a company like Shell with a long standing high credit rating should be required to seek a parent company guarantee from a possibly lower rated bank. Shippers licences have been given to subsidiaries of banks, mainly for those entering the traded market. Will these shippers be required to go outside their own group to get credit cover? We also note that Transco is required by its licence to keep an investor grade credit rating. We assume that Ofgem considers this to be satisfactory for the network operator.

We are concerned that events with Enron have biased Ofgem's view of PCGs. The collapse of Enron seems to have been associated with quite specific circumstances which will only be fully understood when the investigations into the conduct of the company, its auditors, banks, and of, course, the credit agencies are complete. There is every reason to believe that markets and regulatory authorities have already 'self-corrected' with credit rating agencies becoming more stringent in establishing and reviewing credit ratings and with moves to make financial reporting more robust already underway.

We do not understand how any 'cross –subsidy' from those companies without PCGs to those who do hold them is created. There is no subsidy from those who do not have one being provided. Companies may face different costs in providing credit depending on whether they have access to a PCG or need to make other arrangements. This reflects their credit worthiness. There is no more an issue of discrimination or cross-subsidy than what occurs in the domestic market where different prices are charged to consumers based on payment method, which in turn can reflect their credit worthiness. Ofgem has previously accepted the different prices paid for direct debit, credit and prepayment meter users as non-discriminatory.

When a bank does provide a guarantee, it will in turn ask for counter-indemnities (eg Parent Company Guarantees). In the even of payment default, Transco will be able to obtain payment from the bank but the bank will then exercise its claim on the shipper. It will then be the bank that will drive the shipper into insolvency rather than Transco. The end result could be the same.

Price control – incentives on network operators

We have previously set out our concerns regarding Ofgem's involvement in directing the credit arrangements of the network operators. While the network operators must offer terms to all who wish to use their networks, it cannot be concluded that they must offer the same credit arrangements to all to ensure non-discrimination. Given that the network operators have less choice as to who their customers it may be reasonable that the network operators are not totally exposed to the risks of failure. However, they should retain a significant portion (at least 50%) of this with only the balance being smeared to their customers. Such an arrangement should provide appropriate incentives to network operators to ensure that their credit arrangements are robust. As with any private company, exposure to debt is a risk which should be borne by the shareholders. As outlined above, non-discrimination obligations do not necessarily mean that the same terms need to be offered to all. Any party who feels that the network operator is abusing its monopoly position or unduly discriminating may, of course, make a referral to Ofgem.

Network parties and their customers should know of any incentive arrangements and the methodology for any potential smearing of costs in advance of any failure occurring. We do know how Ofgem will make judgements about whether Transco has taken reasonable steps to mitigate losses in the event of shipper failure resulting in losses for Transco in reselling capacity (paragraph 3.39 of Transco price control explanatory notes). If some or all of the proposals in this credit document are implemented, will Ofgem consider these to be sufficient? Shippers will face significant uncertainty while Ofgem considers whether it Ofgem will allow Transco to adjust prices through the income adjusting events. This cost of this risk will need to be borne by all shippers and will increase costs, which goes against Ofgem's stated aim in reviewing the credit arrangements.

Conclusions

We do not agree with Ofgem's view that PCGs do not provide an efficient and reliable protection in the event of supplier failure. While we recognise Ofgem's requirement to protect consumers, we do not consider that this means that Ofgem should be prescriptive in establishing credit arrangements for network operators. Ofgem should consider approaches that ensure that network operators provide robust, non-discriminatory credit terms.

Yours sincerely