

## **OFGEM DECISION LETTER No. 0521**

**"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"**

Version 1.0

Our Ref: Net/Cod/Mod / 521  
Direct Dial: 020 7901 7491  
Email: [nick.simpson@ofgem.gov.uk](mailto:nick.simpson@ofgem.gov.uk)

14 March 2002

Transco, Shippers and Other Interested Parties

Dear Colleague,

### **Modification Proposal 0521: 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**

Ofgem has considered the issues raised in Modification Proposal 0521 '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'. Ofgem has decided to direct Transco to implement the modification because we believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

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

### **Background to the proposal**

Transco have separate credit rules for transportation and energy balancing activities. Under the network code, all shippers must obtain a code credit limit from Transco prior to trading. The code credit limit represents the maximum indebtedness that Transco will extend to a shipper for transportation service. Under energy balancing rules the secured limit is the value of security provided by a shipper which, in the event of a default, would be realised to meet outstanding energy balancing indebtedness. In both instances the escalation procedure is similar, a shipper will be issued a cash call notice if its outstanding indebtedness reaches 85% of its code credit limit/ secured limit, and could be terminated from code if the debt is not cleared.

Currently, Shippers can provide credit cover in the form of an unsecured credit limit if the shipper has an approved investment grade credit rating Transco currently accepts ratings from any of the following agencies: Duff Phelps, Fitch Investor Services, Moodys Investor Services, Standard & Poors and IBCA., a secured credit limit (parent guarantee, guarantee issued by an acceptable financial institution, or a letter of credit) or prepayment of charges (for transportation only).

The recent events surrounding Enron have raised a number of issues regarding the use of credit ratings as an acceptable form of credit cover. This modification seeks to address some of the concerns raised to date.

### **The Modification proposal**

It is proposed that where any credit rating of a guarantor or any other person providing surety for the shipper is revised downwards to a speculative grade rating, the existing 30 day notice period shall be removed and Transco shall be entitled to reduce the Secured Credit Limit and Code Credit Limit immediately such that the security will not be included in the calculation of the Secured Credit Limit or Code Credit Limit. Similarly, it is proposed that where any credit rating of a shipper is revised downwards to a speculative grade rating, the existing 30 day notice period shall be removed and Transco shall be entitled to reduce the Secured Credit Limit and the Code Credit Limit immediately to either zero, or to a level relative to other third party securities that may be provided to Transco in support of the shippers liabilities. It is further proposed that these rules shall apply to any such 30 day notices that have been issued for which the 30 day notice period remains unexpired.

Implementation of this modification proposal is intended to reduce the credit risk on shippers via the energy balancing neutrality smearing mechanism.

### **Respondents' views**

Eight representations have been received in respect of this Modification Proposal. Seven are supportive; one is confidential and does not support implementation of the proposal.

Four of the seven respondents supported the modification proposal fully, believing that the proposal will reduce shipper's and Transco's exposure to financial loss. They agree that the existing 30 day notice period provides the potential for increasing exposure for the community as the administrator may continue to use revenues from the imbalance regime, which is essentially shippers' money. Recent experience has shown that it is possible for grade ratings to change rapidly and therefore it is appropriate that Transco should be able to take timely action in its role in managing credit risk for the community.

Three respondents although agreeing that the existing notice period of 30 days is too long, believe there is a risk that the credit rating agencies may take an over cautious approach. This they argue could cause the premature removal of a secured credit rating and cause a company regarded as investment grade by other agencies to provide new and relatively expensive short term credit cover causing a greater problem than the downgrade justified. Therefore they suggest that the notice period should only be reduced where more than one agency has downgraded the credit rating of a guarantor or any other person providing surety for the User.

### **Transco's view**

Transco recognises the benefits of this modification proposal, believing it would assist Transco in managing the Credit Risk framework more effectively to protect both Transco and shippers as a whole from any potential financial loss. The proposal would reduce a shipper's Secured Credit Limit or a Code Credit Limit with immediate effect upon the downward revision of that shipper's,

or any related security provider's, published or private rating to a speculative grade. In Transco's view this minimises the community's potential exposure to financial loss as it removes the requirement for a 30 Day notice period which currently leaves both Transco and shippers facing exposure following such an event.

With respect to the suggestion by some shippers that the notice period should only be reduced where more than one agency has down graded the credit rating, Transco believes that it and shippers may be commercially disadvantaged if this suggestion were not to be implemented. Transco argues in other commercial environments that are not subject to regulatory restrictions such decisions would be subject to individual companies commercial credit policies. Transco believes that in the event of a shipper's, or related company's credit rating being downgraded by only one of the recognised rating agencies, other parties trading with that shipper may take action to limit their exposure, thereby leaving Transco and shipper's as a whole open to an increased level of financial risk.

### **Ofgem's view**

Ofgem welcomes the community's commitment to reforming the current credit arrangements regarding energy balancing and transportation. We also acknowledge the concerns raised by the industry in their responses to this modification. One concern relates to the fact that it is only one credit rating agency that needs to downgrade the shipper's or a related security provider's rating to speculative status for its Credit Limits to be set to zero. Also, there is no notice period to allow the shipper, with a speculative credit rating, to make alternative credit arrangements. However, in response, Transco point out that other parties trading with that shipper may take action to limit their exposure, thereby leaving Transco and shippers as a whole open to an increased level of financial risk. Ofgem supports Transco's view and agree that a single downgrade to speculative status should lead immediately to the shipper's Credit Limits being set to zero, or to a level relative to other third party securities that may be provided to Transco in support of the User's liabilities.

The current situation is such that many companies already have to provide alternative credit cover, such as a Letter of Credit, as they do not have an acceptable credit rating. Hence, it is appropriate that shippers, who are at risk of losing their investment grade credit rating, put in place alternative arrangements.

Ofgem believe there may be further ways of reducing the credit risk faced by the community and these are discussed in the consultation paper, 'Arrangements for Gas and Electricity Supply and Gas Shipping Credit Cover' which was published on 11 March 2002.

### **Ofgem's decision**

We believe this modification proposal will further reduce the community's exposure to debt if a shipper defaults. We therefore believe that the modification will further Transco's relevant objective to run an efficient and economic pipeline system.

Accordingly, Ofgem has decided to consent to this modification, because we believe that it will better facilitate the achievement of the relevant objectives as outlined in 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, Industry Code Development***