Modification Report
Re-assessment of User Unsecured Credit Limits
Modification Reference Number 0023
Version 2.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 9.6.

1. The Modification Proposal

This is one of a number of Proposals which seek to implement recommendations identified within Ofgem's conclusion document "Best Practice Guidelines for Gas and Electricity Network Operator Credit Cover" 58/05. This concluded the high-level principles that should be applied and further work required in respect of credit cover arrangements for transportation.

This Proposal seeks to implement elements of recommendations detailed within paragraphs 3.4 to 3.9 of the conclusion document.

In accordance with the Code Credit Rules, UNC Section V3.1 details the Code Credit Limits to which Transporters and Users are obliged to adhere. A Code Credit Limit is the amount representing a Users maximum permitted Relevant Code Indebtedness being the aggregate amount, other than Energy Balancing Charges, for which a User is liable to Transco. The overall cap for unsecured credit exposure to any company or group of related companies is currently set at £250million. Any credit requirement in excess of this must be secured by the User.

It is proposed that a Relevant Transporter sets a maximum unsecured credit limit based on 2% of its Regulatory Asset Value. Whilst this would not constrain Relevant Transporters, those who seek other levels of risk may not obtain full pass through in the event of a failure and/or may be subject to objections and disputes from counterparties.

In respect of an individual User's Unsecured Credit limit, this is currently assessed by Transco based on an Investment Grade Rating provided by an approved rating agency being either *Moody's Investors Service* or *Standards & Poor's*. Where such bandings conflict, the Transco will utilise the lower of the ratings provided by the approved rating agencies.

Ofgem's paper concluded that individual counterparty credit limits and those that use Parent Company Guarantees or aggregates of both, should be set using credit ratings (provided by the aforementioned rating agencies) applied under the 'Basel 2' rules for determining bank capital adequacy. These currently are in the ratio of 1 : 2.5,1 : 5,1: 7.5, for *Standards & Poor's* AAA/AA, A, BBB ratings (or *Moody's Investors Service* equivalent). These respectively would imply maximum credit allowances of, 100 percent for AAA/AA and 40 percent for A.

For the third band, (BBB) Ofgem proposes that the above allowance be further sub-divided, such that the following are applied to rated entities:

Standard & Poor's Credit rating	Credit allowance as a percentage of maximum credit limit
BBB+	20
BBB	19
BBB-	18

Transco therefore proposes to amend the UNC to reflect the above method of assessment of User Unsecured Credit Limits.

The scope of the above unsecured credit arrangements mirror the scope currently contained within the 'Code Credit Rules' and therefore Transco does not propose to facilitate unsecured credit limits for entities with *Standards & Poor's* ratings of BB+, BB or BB- (or *Moody's Investors Service* equivalent).

2. Extent to which implementation of the proposed modification would better facilitate the relevant objectives

Implementing consistent credit processes which move towards recognised best practice would help ensure that there is no inappropriate discrimination, and no inappropriate barrier to entry, thereby facilitating the securing of effective competition between Relevant Shippers.

UKD advocate that "*incorporation of credit arrangements within the Uniform Network Code that oblige Transporters to implement consistent rules would ensure that there is no inappropriate discrimination, and no inappropriate barrier to entry, thereby facilitating the securing of effective competition between Relevant Shippers*".

UKT believe that "*formalising a consistent approach to the assessment and application of User unsecured Credit Limits across all Transporters will facilitate greater competition between Shippers and between Suppliers…in terms of the application of unsecured credit, may provide Users with a 'level playing field' across all Transportation Networks*" and may "*'free up' capital which may have otherwise been required for security purposes*". UKT "*believe that the changes proposed demonstrate further improvements to our GT Licence Relevant Objectives over and above those set out in UNC0031 and UNC0041*".

TGP and TEP "*believe that modifications 0023 and 0031 do not further the relevant objectives…as only modification 0041 promotes competition without affecting the Transporters ability to operate the network in an efficient and economic manner*".

3. The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation

No such implications on security of supply or operation of the Total System have been identified. Incorporating elements of the existing Code Credit Rules within the UNC may help to reduce the impacts of industry fragmentation.

4. The implications for Transporters and each Transporter of implementing the Modification Proposal, including

a) implications for operation of the System:

No implications for operation of the system have been identified.

b) development and capital cost and operating cost implications:

The proposer has suggested that any costs would be minimal.

c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:

No cost recovery mechanism is proposed.

d) analysis of the consequences (if any) this proposal would have on price regulation:

No such consequences are anticipated.

5. The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal

No such consequence is anticipated.

6. The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users

No systems impacts are anticipated by either Transporters or Users.

7. The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk

The proposer believes the level of credit cover to be provided to Transco by some Users would reduce, thereby potentially reducing Users' costs. Other Relevant Transporters have identified that additional credit cover may be called for, potentially increasing costs for some Users.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party

No such implications have been identified.

9. Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

No such consequences are anticipated.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages

- Increased alignment of the UNC with best practice as identified in Ofgem's conclusions document.
- Ensures credit cover continues to be sought on a non-discriminatory basis.
- Ensures there continue to be no inappropriate barriers to entry as a result of credit requirements.
- Reduced credit cover requirements could reduce costs for some Users.

Disadvantages

- Does not fully implement the best practice approach identified in Ofgem's conclusions document.
- May create inconsistency between the UNC and each set of Code Credit Rules.
- Potential for increased credit cover requirements, increasing costs for some Users.

11. Summary of representations received (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Eleven representations (from the following) were received with respect to this Modification Proposal. Four parties support implementation, two parties offered qualified support and five parties oppose implementation.

Organisation	Abbreviation	Position
Wales & West Utilities	WWU	Oppose
Transco UKD	UKD	Support
Transco UKT	UKT	Qualified Support
Scotia Gas Networks	SGN	Qualified Support
Northern Gas Networks	NGN	Support
British Gas Trading	BGT	Oppose
RWE npower	RWE	Oppose
Total Gas & Power	TGP	Oppose
Total E&P	TEP	Oppose
E.ON	EON	Support
EdF Energy	EDF	Support

Commenting on the three proposals concerning User Unsecured Credit Limits, WWU stated "*proposal 0041 is the most appropriate and should be implemented… Mod proposals 23 and 31 are at the two extremes of the spectrum, whereas Mod proposal 41 strikes the correct balance, between total industry risks/costs and consistent, non-discriminatory terms of access*".

UKD supports "*affording a maximum level of unsecured credit based on the asset value of a Transporter" believing this "is a more effective mitigation of risk than reference to a static figure*" and "*Affording unsecured credit to Users based upon its Investment Grade Rating (above 'junk'status only) as allocated by two recognised Credit Rating Agencies is an efficient method of operating unsecured credit arrangements*".

In respect of setting a maximum credit limit As a proportion of the Regulatory Asset Value (RAV), UKT commented "*We support this aspect of all three Proposals*". UKT recognised in respect of the allocation of individual Unsecured limits "*there is a balance to be achieved between facilitating greater competition through extending an unsecured credit allowance to all levels of credit rated Users where appropriate and ensuring that the community is not exposed to un-necessary or disproportionate credit risk resulting from defaulting Users*".

UKT recognised that "*extending Unsecured Credit Allowances to Users with a rating of BBB- and above, only, may be viewed as anti-competitive…and as such there may be a widening gap between the advantages extended to higher credit rated Users and less 'strong companies'*".

SGN stated that "Whilst SGN *supports this modification proposal and the suggested ratings over and above competing proposals 0031 and 0041 we do not believe it addresses all associated aspects of the Best Practice Guidelines...SGN notes that clearly some Users will have higher concentrations of business in some LDZs. We note that a User who does not have geographical diversity could be adversely affected by such proposal*".

BGT reflected that "*companies with established high credit ratings should be afforded maximum credit allowances…we support a more cautious approach as the degree between a low rating and no rating can be very fine and this situation may change over a short period of time*".

RWE highlighted a number of observations in respect of the Draft Modification Report. First, "*In the third paragraph starting "In accordance with the Code Credit Rules....." The wording seems to infer that the Code Credit Rules are superior to the UNC…I would be concerned if this statement was meant to suggest that the rules within the UNC could be overridden by the Code Credit Rules*".

Having addressed this view with the proposer, the proposer confirms that there was no intention to infer that the Code Credit Rules are 'superior' to the Uniform Network Code and recognises that the UNC is the primary contract.

Additionally, RWE highlighted "*a number of references to Transco rather than Transporter which do not seem appropriate. For instance in the 5th paragraph of section 1 (the Modification Proposal) it refers to a Users Unsecured Credit Limit being assessed by Transco*".

The SME would point out that the purpose of the paragraph highlighted appears to be to convey the method by which Transco affords Unsecured Credit (in respect of arrangements specific to Transco owned Networks) and does not appear to infer that Transco assesses such in respect of transportation networks managed by other Network Operators.

RWE confirmed that it did "*not support the selection of only part of the recommendations identified within Ofgem's conclusion document...For the Proposer then to select only certain aspects of the particular topic and to ignore other parts of the subject seems opportune*". RWE "*believe that there has been a misunderstanding as to the purpose of a Credit Rating…it has a…specific role, namely that of determining the likelihood of a company defaulting on a 5 year corporate debt…the maximum period that a transporter is exposed to is 2 months rather than 5 years*".

RWE highlighted an alternative view of payment risk by JP Morgan known as CreditMetrics ™ "*This well established and relatively simple method facilitates an analysis of the risk of default on short term debt (90days).*

	45 days	*90 days*
AAA	*0.00%*	*0.00%*
AA	*0.00%*	*0.00%*
A	*0.00%*	*0.01%*
BBB	*0.04%*	*0.08%*
BB	*0.13%*	*0.28%*
B	*0.72%*	*1.46%*
CCC	*5.23%*	*9.99%*

The above…shows that the likelihood of a BB rated company defaulting on its short term debt is not materially different to that of an AAA rated company".

RWE suggested that as the proposer "*only wish[es] to "mirror the scope" of their current arrangements leads one to suspect that they are only interested in keeping costs down to a minimum…We see no justification for the omission of the BB band of credit ratings*".

TGP and TEP noted that "*extension of the code credit rules to increase the number of users with unsecured credit limits will logically increase the potential of default costs. This can only be justified if the increase in risk is outweighed by the increase in competition …Of the three modifications only…0041 has detailed on what basis its credit limits are derived…As Modifications 0023 and 0031 have no analysis backing up their values, they are not fit for purpose*".

TGP and TEP observed that they "*fail to see why not aligning with Ofgem s individual view is a disadvantage to Modifications 0023 and 0041. The modification process is designed to ensure reasoned debate on any changes to the gas market. To assume that modifications must correspond to a pre-determined and…unjustified view fatally undermines that modification process…we cannot see why increased alignment with Ofgem s opinion is an advantage for modification 0023 and 0031*".

EON noted that "increasing *the availability of unsecured credit would likely increase costs in the event of default…increasing costs for other Users. It is for this reason that we…support implementation of 023, which correctly mirrors the scope currently contained within the Code Credit Rules*".

EDF commented that "*all of these modifications are an improvement over the current baseline; however, we believe that that 0041 is significantly better than the other two…a tight overall credit regime will be of mutual benefit to all…0041 better achieves this than either of the other two*".

12. The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation

Implementation is not required to enable each Transporter to facilitate compliance with safety or other legislation.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence

Implementation is not required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence.

14. Programme for works required as a consequence of implementing the Modification Proposal

The Proposer believes that minimal changes would be required in respect of operational processes and procedures in the event that this Modification Proposal is implemented.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

In light of the limited works required to implement, the proposer believes that this Modification Proposal could be implemented with immediate effect if appropriate direction is received from the Authority.

16. Implications of implementing this Modification Proposal upon existing Code Standards of Service

No implications of implementing this Modification Proposal upon existing Code Standards of Service have been identified.

17. Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel

At the Modification Panel meeting held on 20 October 2005, of the 9 Voting Members present, capable of casting 10 votes, 8 votes were cast in favour of implementing this Modification Proposal. Therefore the Panel recommend implementation of this Proposal.

18. Transporter's Proposal

This Modification Report contains the Transporter's proposal to modify the Code and the Transporter now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

UNIFORM NETWORK CODE - TRANSPORTATION PRINCIPAL DOCUMENT

SECTION V: GENERAL

Amend paragraph 3.1.1 as follows:

For the purposes of the Code:

(a) the "**Regulatory Asset Value**" is the value of the relevant Transporter's regulated assets as published from time to time by the Authority.

(b) An "**Approved Credit Rating**" is a published and monitored long term issuer rating (not including private ratings) of not less than Baa3 by Moody's Investors Service or equivalent rating by Standard and Poor's.

(c) The "**Unsecured Credit Limit**" is that proportion of the Maximum Unsecured Credit Limit extended to a User by the Transporter as calculated in accordance with the table set out in paragraph 3.1.6.

"The Transporter will~~, in accordance with the Code Credit Rules,~~ determine and assign to each User a Code Credit Limit, which may comprise of an Unsecured Credit Limit calculated in accordance with paragraph 3.1.6 and/or security or surety provided in accordance with paragraph 3.4. ~~and will~~ The Transporter shall keep each User informed of its Code Credit Limit (as revised in accordance with the Code) for the time being. The Transporter shall limit the Unsecured Credit Limit to any User and related company to a maximum of two percent (2%) of the Regulatory Asset Value (The "**Maximum Unsecured Credit Limit**").

Amend 3.1.2 (a) as follows:

"the principles on which the Transporter will assess ~~and from time to time revise (in accordance with paragraph 3.2.2) its assessment of the credit-worthiness of Users (and persons providing surety for Users)~~ and establish Code Credit Limits;

Add new paragraph 3.1.6 as follows:

Where a User has an Approved Credit Rating, such User's Unsecured Credit Limit at any time shall be calculated as that percentage (%) of the Maximum

Unsecured Credit Limit by reference to the User's Approved Credit Rating as follows:

Approved Credit Rating		***User's % of Maximum Unsecured Credit Limit***
Standard and Poor's	**Moody's Investors Service**	
AAA/AA	Aaa/Aa	100
A	A	40
BBB+	Baa1	20
BBB	Baa2	19
BBB-	Baa3	18

Subject Matter Expert sign off:

I confirm that I have prepared this modification report in accordance with the Modification Rules.

Signature:

Date :

Signed for and on behalf of Relevant Gas Transporters:

Tim Davis
Chief Executive Joint Office of Gas Transporters

Signature:

Date :