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The Joint Office, Transporters, Shippers and other interested parties

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Dear Colleague,

Uniform Network Code modification proposals 0023, 0031 and 0041: 'Re-assessment of User Unsecured Credit Limits'

Ofgem[1] has considered the issues raised in the modification reports in respect of proposals 023, 031 and 041 and having regard to the principal objective and statutory duties of the Authority[2], has decided to direct the implementation of modification 031, and not to direct the implementation of modification proposals 023 and 041.

Ofgem considers that modification proposal 031 would better facilitate the achievement of the relevant objectives of the Uniform Network Code (UNC), as set out in Standard Special Condition A11[3] of relevant Gas Transporters' Licences as compared with the existing provisions of the UNC and modification proposals 023 and 041. Ofgem also considers that modification proposal 031 would be consistent with its wider statutory duties.

This letter explains the background to the modification proposals and outlines the reasons for Ofgem's decision.

Background to the proposals

In February 2005 Ofgem published its conclusions on best practice guidelines for gas and electricity network operator credit cover[4] following extensive consultation. The conclusions document indicated that appropriate changes would need to be brought forward by parties to industry codes in order to arrive at credit cover arrangements consistent with the best practice guidelines.

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[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter
[2] Set out in Section 4AA of the Gas Act 1986, as amended.
[3] This Licence Condition can be viewed at: http://62.173.69.60/document_fetch.php?documentid=6547
[4] This document can be found on the Ofgem website at: http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/creditcover

In summary[5], Ofgem's conclusions in respect of setting unsecured credit limits are:

- User's unsecured credit limits should be set as a proportion of each Transporter's maximum unsecured credit limit for each User;
- The maximum unsecured credit limit for each User should be based on 2 per cent of the Transporter's Regulatory Asset Value (RAV);
- An individual User's unsecured credit limit should be set using credit ratings, (or in the case of unrated Users and those with credit ratings of B+ or below, using either payment record or independent assessment of creditworthiness);
- Only credit ratings issued by Moody's Investors Service[6] and Standard and Poor's should be accepted;
- Publicly and specially commissioned ratings should be accepted, although in the latter case provided that these are reviewed at least annually;
- Where credit ratings produced by the agencies differ, the lowest assigned rating should be applied; and
- Users may aggregate their credit positions or use group ratings (for instance through Parent Company Guarantees (PCGs)), providing the arrangements are robust and unconditional. The limit will be applied to the contracting party or, subject to conditions, an affiliated credit support provider.

Modification proposal 023

It is proposed that:

- Unsecured credit limits would be set as a proportion of each relevant Transporter's maximum unsecured credit limit for each User;
- The maximum unsecured credit limit for each User would be based on 2 per cent of the relevant Transporter's RAV;
- Individual User credit limits and those that use PCGs or aggregates of both would be set using credit ratings, with maximum credit allowances of:

Credit rating *(or Moody's Investors Service equivalent)*	Credit allowance as % of maximum credit limit for a single User
AAA/AA	100
A	40
BBB+	20
BBB	19
BBB-	18

- Only public credit ratings issued by Moody's Investors Service and Standard and Poor's would be accepted; and
- Where credit ratings produced by the agencies differ, the lowest assigned rating would be applied.

Modification proposal 031

In addition to the points raised in modification proposal 023, this proposal would provide the following rated entities with maximum credit allowances of:

5 For full details, readers should refer to the conclusions document.
6 This replaces the reference in the conclusions document to Moody's KMV

Credit rating *(or Moody's Investors Service equivalent)*	Credit allowance as % of maximum credit limit for a single User
BB+	17
BB	16
BB-	15

Modification proposal 041

It is proposed that maximum credit allowances should take account of historically observed default rates across the rating spectrum. Information compiled by Moody's on historic default rates for the period 1983-2004 has formed the basis of the proposed allowances. In order to capture these perceived significant differences in creditworthiness for Users in the BBB band, the proposal suggests the following unsecured credit limits:

Credit rating *(or Moody's Investors Service equivalent)*	Credit allowance as % of maximum credit limit for a single User
AAA/AA	100
A	40
BBB+	20
BBB	18
BBB-	15
BB+/BB/BB-	10

Respondents' views[7]

A high level of support was offered for the principle of developing a consistent approach to credit arrangements across networks, which it was considered would facilitate the securing of effective competition between shippers. In particular, a number of respondents gave specific support for an aspect common to all three proposals, of setting maximum unsecured credit limits for each User at 2 per cent of a Transporter's RAV.

In relation to the differing proposals for setting individual counterparty credit limits, several respondents believed that more than one proposal would further the relevant objectives, but went on to rank them in terms of preference.

Modification proposal 023

Three respondents offered support for modification proposal 023, in preference to proposals 031 and 041, with an additional two providing qualified support. Supporting comments included that the proposal mirrors current Code Credit Rules and that it appropriately balances the provision of unsecured credit against increased risk of exposure to the industry. One respondent offered qualified support on the basis that the proposal does not address all associated aspects of the best practice guidelines.

[7] This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. These can be found on the Gas Transporters information service (formally known as Nemysis) https://gtis.gasgovernance.com

Modification proposal 031

One respondent expressed support for modification proposal 031, seeing no justification for the omission of the BB band of credit ratings from the range of companies entitled to a level of unsecured credit. In contrast, one respondent expressed concern that this might extend a disproportionately large amount of unsecured credit allowance to users with a rating below BB+.

Modification proposal 041

Four respondents expressed preference for this proposal, a number of which stated that it best balanced the risk of default with providing non-discriminatory arrangements for provision of unsecured credit. Whilst considering Basel II to be a useful guide, two respondents also believed that this proposal set out a more robust basis for the proposed range of allowances.

Panel Recommendation

At the modification panel meeting held on 20 October 2005, of the 9 voting members present, capable of casting 10 votes:

Modification proposal 023 – 8 votes were cast in favour of implementing this modification proposal. Therefore the panel recommended implementation of this proposal;

Modification proposal 031 – 2 votes were cast in favour of implementing this modification proposal. Therefore the panel did not recommend implementation of this proposal;

Modification proposal 041 – 7 votes were cast in favour of implementing this modification proposal. Therefore the panel recommended implementation of this proposal.

Whilst not a formal determination, given the similarities between the three modification proposals the panel also expressed a preference, with 6 of the voting members preferring proposal 023 and 4 preferring 041.

Ofgem's view

In the review of gas and electricity network operator credit cover, Ofgem has previously expressed concern that various arrangements were not appropriate. Amongst other things, Ofgem noted the natural inclination of NWOs to minimise their exposure to risk, and highlighted the need to strike an appropriate balance between protecting against the risk of exposure in the event of default and the costs of mitigating that risk. The resulting suite of documents detailed principles to which Ofgem would have regard when considering proposals to modify codes, including that credit arrangements must not be unduly discriminatory, nor prevent the promotion of competition.

In addition to the above, the conclusions document stated that arrangements for credit cover should be governed by robust and transparent modification procedures. In this respect, the incorporation of appropriate credit arrangements within the UNC would provide a clear and consistent approach across relevant networks, making it easier for both new entrants and existing participants to familiarise themselves with market rules, thereby better facilitating the achievement of competition between shippers.

It is noted that all three modifications would incorporate provisions into the UNC in relation to unsecured credit limits. Ofgem considers that the application of 2 per cent of RAV to calculate maximum unsecured credit limits, common to all three proposals, would avoid undue variation across the UNC.

In respect of individual User credit limits, Ofgem is aware that extending the availability of unsecured credit allowances would increase potential exposure to GTs, and therefore to Users (and consequently consumers) in the event that a GT qualifies for pass through of bad debt. However, Ofgem also notes the costs associated with the application of restrictive allowances, through provision of security that would otherwise be available as working capital, may act as a barrier to entry, inhibiting the benefits to consumers that can be expected through increased competition. Therefore, as discussed above, there is a need to find an appropriate balance.

Given the above, Ofgem considers that all three proposals would better facilitate relevant objectives of the UNC, in particular d) *securing of effective competition between the relevant shippers and suppliers*, than the prevailing provisions. However, as these three proposals are effectively alternatives to each other, Ofgem can only direct the implementation of one of them and must therefore consider which of the three would *best* facilitate the relevant objectives.

Ofgem considers that of the three proposals, 031 strikes the best balance between protection against risk and the costs associated with that protection. Ofgem notes that in contrast to modification proposals 031 and 041, modification proposal 023 would not offer an unsecured credit allowance to parties with a credit rating below BBB-. In Ofgem's view this restriction in unsecured credit does not strike such a good balance between risk and cost of security as modification proposals 031 and 041. Therefore, Ofgem considers that modification proposal 023 does not facilitate the relevant objectives as well as 031 and 041.

The difference between proposals 031 and 041 lies in the reduced unsecured credit allowances that would be offered to Users with ratings below BBB+ in proposal 041. These reductions have been based on historically observed default rates for all companies rated by Moody's. It was suggested that this approach would more accurately capture the relationship between risk and cost of security.

Ofgem recognises that it is possible to refine the conclusions that were reached in the February conclusions document following the two years of discussion and consultation. Nevertheless, Ofgem, in reaching its conclusions were aware of, and took into account the default probabilities that ratings agencies publish and the indicators that investment ratings assess. Account was also taken of the relevance of this information to the specific and unusual credit arrangements that apply in gas and electricity supply. Other factors considered were the benefits of a simple and graduated arrangement that broadly reflected the principles of the Basel II approach.

For these reasons, Ofgem still hold the view that in the interests of ensuring that appropriate levels of unsecured credit are available to new entrants and other Users who may not qualify for an investment grade rating, modification proposal 031 better facilitates the relevant objectives over 041.

Notwithstanding the above, Ofgem notes that the proposed definition of an Approved Credit Rating does not encompass the full range of Ofgem's conclusions, which indicated that specially commissioned ratings (which may not necessarily be published, nor monitored) should be accepted, provided that they are reviewed at least annually. Going forward, it is open to parties to the UNC to raise a modification proposal to build in flexibility to accept such ratings from the eligible agencies, provided that these were appropriately evidenced to the relevant NWO.

Moreover, it is also noted that the legal text does not provide for the aggregation of credit positions, or use of group ratings (for instance through PCGs). However, following a query by Ofgem on this issue, all three proposers confirmed that the proposed legal text appropriately reflected the intent of their proposals. As above, it is open to UNC signatories to raise a further modification proposal on this topic.

Ofgem's decision

For the reasons outlined above, and having regard to its principal objective and statutory duties, Ofgem has decided to direct the implementation of modification proposal 031, and not to direct the implementation of modification proposals 023 and 041. Ofgem believes that modification 031 will better facilitate the achievement of the relevant objectives of the UNC, as set out in standard special condition A11 of relevant Gas Transporters' Licences; in particular (d) the securing of effective competition between relevant shippers.

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 Codes and Licensing