Modification Report
Re-assessment of User Unsecured Credit Limits
Modification Reference Number 0041
Version 2.0

This Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 9.6.

1. The Modification Proposal

This Proposal seeks to implement some of the 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 outlined further work needed 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.

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 a Transporter. The overall cap for Unsecured credit exposure to any company or group of related companies is currently set at £250million.

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 the Transporter based on an Investment Grade Rating provided by an approved rating agency being either *Moody's Investors Service* or *Standards & Poor's*. 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 and below BBB- (or Moody's Investors Service equivalent). Therefore using 'Basel 2' exclusively would imply maximum credit allowances of, 100 percent for AAA/AA, 40 percent for A, 20 percent for BBB/BB/Unrated and $13^{1/3}$ percent for below BB-, of the NWO's maximum credit limit for a single counterparty.

The proposer believes that although 'Basel 2' is useful as an approximation to unsecured credit levels, it is not appropriate to be used as the sole basis for its determination. Transco is unable to choose its counterparties (unlike banks which predominately use 'Basel 2') and the credit limits should be adjusted to reflect this.

Total proposes that these suggested maximum credit limits should be detailed to take account of historically observed default rates across the rating spectrum. In order to capture the significant differences in credit worthiness for companies in the BBB band we propose a further sub-division with the unsecured credit limits as follows:

***Standard & Poor's* Credit rating**	**Credit allowance as % of maximum credit limit**
AAA/AA	100
A	40
BBB+	20
BBB/Unrated	18
BBB-	15
<BB	10

The step changes between these bands are based on information complied by Moody's on historic default rates for the period 1983-2004:

Credit rating	**Percentage Chance of Default within 5 years (%)**
BBB+	1.46
BBB/Unrated	2.11
BBB-	3.60
BB+	6.76
BB	8.82
BB-	19.14

As is demonstrated by the above information, there is a significant increase in a default by companies rated BBB- or below compared to BBB/BBB+ companies.

Any change in unsecured credit ratings must balance the level of unsecured exposure to the market, against the cost to Users of securing credit. The possible chance of default indicated by Moody's research point to a significant risk to the market from <BBB- companies. On this basis we have proposed the step changes above.

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

The proposer believes that the measures identified within this Modification Proposal further the GT Licence 'code relevant objective' of facilitating the efficient and economic operation by the licensee of its pipe-line system by ensuring that robust procedures and best practice measures are in place to reduce the impact on the industry of User failure.

In respect of similar Modification Proposals 0023 and 0031, the Distribution Workstream concluded that 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.

WWU concluded that of the three related proposals (0023, 0031 and 0041) "*0041 best facilitates the relevant objective of securing effective competition between Relevant Shippers*".

UKT confirmed it was in agreement "*with the proposer that this Proposal may facilitate greater competition where appropriate to do so. As the Proposal seeks to mitigate the exposure…in proportion to the User's credit rating…this Proposal, in comparison to 0031 would strike an appropriate balance and would further the relevant objectives to a greater degree than…0031*".

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 Transporters have suggested that some additional monitoring costs have the potential to be incurred relative to the existing position and that proposed under Modification Proposal 0023, reflecting the additional risk of default through increased unsecured credit limits. A one off development cost would also be incurred to establish a process for assessing the unsecured credit limits associated with BB+ to BB- rated Users.

Users have requested that Transporters quantify and provide evidence of the potential cost increase as part of the consultation process for Modification Proposal 0031 and could therefore be applied to this proposal.

WWU suggested that "*there may be additional costs in relation to monitoring Users credit positions and developing a process for assessing limits for the lower bands, BB+ to BB-, however we are of the view that they are unlikely to be significant*".

RWE observed that "*Transporters have suggested … that they might incur additional costs in monitoring a BB or below rated company. It seems unlikely that they would not have been monitoring any such companies previously*".

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

Transco Distribution 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.

With an increased risk of default with unsecured sums due, additional costs could be passed through to Users.

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

No significant 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 default costs.

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. Five parties support implementation, three parties offered qualified support and three parties oppose implementation.

Organisation	Abbreviation	Position
Wales & West Utilities	WWU	Support
Transco UKD	UKD	Qualified Support
Transco UKT	UKT	Qualified Support
Scotia Gas Networks	SGN	Oppose
Northern Gas Networks	NGN	Qualified Support
British Gas Trading	BGT	Support
RWE npower	RWE	Oppose
Total Gas & Power	TGP	Support
Total E&P	TEP	Support
E.ON	EON	Oppose
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…The significant step change in risk of default attributable to companies with ratings below BBB- must be taken into account…more considered and robust means should be developed to determine appropriate levels of unsecured credit for those companies which fall into this category …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".

WWU added that "*the table in the legal drafting is rather ambiguous. Firstly, the final category infers that any rated company can obtain an unsecured credit rating. In order to ensure consistency with the Ofgem conclusions document, we suggest that the final category group should be amended to include: BB+, BB and BB-. Secondly, the fourth category refers to BBB/Unrated. We are unclear as to the inclusion of "unrated" as this refers to companies which have not acquired a Standard and Poor's rating which, in accordance with this proposal, would not obtain an unsecured credit limit. We suggest that this reference should be removed*".

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*" but "*recognises the increased risk of default by Users with an…(IGR) below BBB-*"

UKD highlighted the "*rating definition for 'BB' rated entities is "...less vulnerable to non-payment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.""* adding "*we believe that BB rated entities should have a reduced entitlement in respect of unsecured credit to mitigate financial risk to the industry and acknowledge that in recognition of this risk, this Proposal advocates a lower level of available credit for BB entities in comparison to...0031*".

UKD also noted that its "*support is also qualified in respect of the allocation of unsecured credit (18% of RAV) to BBB and unrated companies. Transco does not support the provision of this level of unsecured credit to an unrated company*".

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 "*this Proposal attempts to quantify the likelihood of the risk, from default, and apply an appropriate unsecured credit …such considerations go some way to mitigate potential exposure to default to the industry, whilst extending Unsecured Credit to lower rated companies*"

UKT noted that "*the proposer has included a table detailing 'Standard and Poor's Credit Rating and the proposed credit allowance as a maximum credit limit, we also note that the table provides a percentage for triple B or 'Unrated' Users…also…reflected in the legal text…We therefore ask that the SME please confirm that the proposer did not intend to include 'Unrated' within this table*".

SGN observed that "*the likelihood of default where there is a credit rating of BB is much higher than with BBB ratings. We do not believe that it is appropriate or efficient to give a User with a BB- rating a 10% limit, compared to a 15% limit for company with a BBB- rating when they are up to 13 times more likely to default…it would be more appropriate to amend the table in…0041 such that "BBB/Unrated" would be replaced with "BBB". There should not be unsecured credit to any User with a rating lower than BBB-*".

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*".

Having consulted the proposer, the SME can confirm that the proposer acknowledged "*There has been an error in our drafting and unrated should not have been included in the table*" and in respect of the final category in the table "*it should be <BB+ and would extend to BB, BB-, with no credit limit for those parties below BB-*".

RWE noted that in respect of the second paragraph in section 2 of Modification poroposal 0031 "*It is interesting to note that this paragraph is not included in the Draft Mod Report for Proposal 0041 although this proposes to include the same bands of credit ratings.*".

The SME would respond that at no point was Modification Proposal 0041 formally discussed within the Distribution Workstream. It was raised on 1 August 2005 and the Modification Panel directed that it proceed to consultation on 8 August 2005. Despite this it appeared appropriate to incorporate a Workstream view (in respect of Proposals concerning the same topic) with which all members concurred ('In respect of similar Modification Proposals 0023 and 0031, the Distribution Workstream concluded …'). It appeared less appropriate to incorporate the 'non-majority' views of a number of members. Such observations were of course able to be submitted in formal representations and will be incorporated where necessary. It must be remembered that the Modification Report initially issued for consultation is a <u>draft</u> report and is not the final version upon which the Authority will base its decision.

RWE suggest that "*not to support the selection of all the recommendations identified within Ofgem's conclusion document… is discriminatory…the various pros and cons of the proposals were debated and a balanced position… was established*".

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".

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*".

TGP and TEP expressed "*serious reservations about the unsecured credit limit values stated in the Ofgem Best Practice Conclusions Document. Ofgem acknowledges that there was no industry consensus on the use of Basel II rules… the only time the…scale of credit values is mentioned is in the Ofgem conclusion document (paragraph 3.7), not the consultation document, and there is also a complete lack of evidence to justify the descending scale of 20% for BBB+ to 15% for BB-. Given this lack of information on their origin we can only conclude that the percentage values… represent the views of Ofgem only…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*".

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 It is for this reason that we cannot support implementation of…modification proposal 041*".

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)

The proposer believes that this Modification 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, 7 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

TPD 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 Ba3 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	18
BBB-	Baa3	15
BB+, BB and BB-	Ba1, Ba2 and Ba3	10

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 :