

Modification proposal:	Uniform Network Code (UNC) 107V: Specially Commissioned Credit Ratings (UNC107V)		
Decision:	The Authority¹ directs that this proposal be made²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	19 December 2006	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

In February 2005 Ofgem published its conclusions on best practice guidelines for gas and electricity network operator credit cover³ 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. One such recommendation was that a User should be able to utilise a Specially Commissioned Rating (obtained from either Moody's or Standard and Poors) to obtain unsecured credit from the Transporter.

Unsecured credit obtained via a public rating is already provided for within the UNC following the implementation of modification proposal 0031 'Re-assessment of User Unsecured Credit Limits'. Modification proposal 031 was approved by Ofgem on 18 January 2006. The modification provided 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
BB+	17
BB	16
BB-	15

- ◆ 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.

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

²This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areasofwork/creditcover

The modification proposal

UNC107V proposes to add provisions to the UNC which allow a User to utilise a Specially Commissioned Rating obtained from either Moody's or Standard & Poors in order to receive unsecured credit from the Transporter. The modification also proposed that:

- ◆ In the event that both approved agencies are commissioned to provide a rating and those ratings conflict, the rating that affords the lower level of unsecured credit would be utilised;
- ◆ The ratings must be monitored and re-assessed at least annually; and
- ◆ The User would bear the cost of any initial assessment and any periodic reviews (for the duration that the User utilises such rating to obtain unsecured credit from the Transporter).

A Specially Commissioned Credit Rating would be subject to all UNC provisions relating to public ratings, including for example the level of credit afforded in respect of each acceptable rating and those concerning consequences of a rating downgrade.

The proposer suggested that implementation of consistent credit processes which move towards recognised best practice would help ensure that there is no inappropriate discrimination and no inappropriate barrier to entry. The proposer believed that this would facilitate the achievement of Relevant UNC Objective (d).

UNC Panel⁴ recommendation

At the Modification Panel meeting held on 16 November 2006, of the 8 Voting Members present, capable of casting 10 votes, 10 votes were cast in favour of implementing this Modification Proposal. Therefore the Panel recommend implementation of this Proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 17 November 2006. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR.⁵ The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC;⁶ and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties.⁷

⁴ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁶ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547

⁷ The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

Reasons for the Authority's decision

Modification proposal 107V will promote consistency in the application of the credit cover rules within the UNC and will thereby facilitate the achievement of Relevant UNC Objective (d). By providing a mechanism through which users can make use of specially commissioned ratings as well as those which are publicly available, 107V provides another standardised mechanism through which Users can access a line of unsecured credit in relation to their payment of network charges. We consider that in so doing this amendment to the UNC will help reduce the potential for discrimination within the market, remove a barrier to entry which might otherwise exist, and help prevent fragmentation of the industry.

We note that the implementation of 107V is likely to result in an increased amount of unsecured credit within the UNC community. Some respondents suggested that the risk of bad debt may increase because of this, whilst others also recognised that the likelihood of an individual user failing will not increase as the amount of credit available under a Specially Commissioned Rating are equivalent to that available to Users with an Approved Credit Rating. Ofgem considers that although some increase in risk can be associated with the introduction of a mechanism such as Specially Commissioned Ratings, it should be recognised that restrictive credit cover arrangements can act as a barrier to entry, inhibiting the benefits to consumers which can be expected through increased competition. It is important to find an appropriate balance between these competing factors. We consider that, taking into account the specific scope of 107V, the solution developed achieves this balance more effectively, and therefore facilitates the achievement of Relevant UNC Objective (d), more effectively than the current baseline.

We note that one respondent to the consultation was concerned that the legal drafting does not appear to contain any provisions which would ensure that, in the event that both approved agencies are commissioned to provide a rating, the lowest rating is used. Ofgem shares the concern raised by the party in this regard and agrees that to this extent the legal text may not fully fulfil the intention of the modification proposal. It is for parties to the UNC to consider how to best ensure that this aspiration can be fulfilled, should they consider this appropriate. We also note that a party has suggested that the UNC should include a provision to the effect that unsecured credit provided on the basis of a Specially Commissioned Rating will only be extended by the transporter upon receipt of a letter from the rating agency confirming the Party's credit rating. Although we agree that certainty over the status of a Party's credit rating is an important part of the arrangements, we do not consider that 107V is particularly deficient in this regard, and consider that it should be possible for good working practice to address this issue. Whilst this is the case, should any party consider an amendment of this type would better facilitate the achievement of the Relevant UNC Objectives they are free to raise an amendment to the code.

One respondent to consultation expressed concern about the process through which Specially Commissioned Ratings are reviewed. Specifically, the respondent was concerned that a Specially Commissioned Rating has greater stature than an Approved Credit Rating as it is not continually verified and is only reviewed on an Annual Basis, despite the legal text including a reference to daily monitoring. The respondent suggested that 107V therefore discriminated against Users operating under the traditionally publicly approved ratings, and also commented that parties operating under Specially Commissioned Ratings would pose a greater financial risk to the market than those under the Approved Credit Rating mechanism.

Ofgem considers that the provision of Specially Commissioned Ratings is not discriminatory as any party wishing to use such a Specially Commissioned Rating is free to do so. We consider that the reference to daily monitoring in the legal text relates to the fact that one of the stated aims of the modification is to ensure that Specially Commissioned Ratings are monitored and revised at least annually. The legal text provides only for the ratings to be reassessed on an annual basis, rather than at least annually. Had the legal text provided that ratings could be reviewed within-year, the provision relating to daily monitoring would be more appropriate as this would have allowed the status of the Specially Commissioned Rating to be monitored by the NWOs within year in order to facilitate an alteration of the level of credit cover within the expected duration of the Specially Commissioned Rating.

We agree that the introduction of Specially Commissioned Ratings carries with it some increased financial risk to the market as the ratings will not be reviewed by the commissioning body until they either run to term or are reviewed. As discussed above however the setting of credit cover rules balances a number of competing factors and we are satisfied that 107V better facilitates the Applicable UNC Objectives than the corresponding provisions in the current UNC baseline. We also note that it may be good commercial practice for the NWO to instigate a review of any Specially Commissioned Rating in place should it consider that the creditworthiness of its counterparty was not accurately reflected in its credit rating.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC107V: Specially Commissioned Credit Ratings be made.

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

Nick Simpson
Director, ECM Programme

Signed on behalf of the Authority and authorised for that purpose.