

Modification proposal:	Uniform Network Code (UNC) 113: Availability of Unsecured Credit Based on User Payment Record or Independent Assessment (UNC113)		
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:	26 January 2007	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. Part of those recommendations included that unrated companies should be able to access a line of unsecured credit on the basis of their payment record or on the basis of an independent assessment of their creditworthiness. It was also recommended that companies with a rating of B+ and below should be able to access unsecured credit through similar mechanisms to those applying to unrated companies.

The current provisions of the UNC mean that Transporters only extend unsecured credit to a User if that User has a public or a specially commissioned credit rating from either Moody's KMV or Standard & Poors. National Grid perceived that this situation may not represent best practice and considered that an alternative approach may better facilitate the achievement of Relevant UNC Objective (d)(i), as this would help to ensure that there was no inappropriate discrimination and no inappropriate barrier to entry in the market.

The modification proposal

UNC113 proposes that a User without a credit rating allocated by Moody's and Standard & Poors, or with a public credit rating allocated by those agencies but below the current prescribed minimum, should be able to obtain unsecured credit by one of two means.

Payment Record

UNC113 proposes that a User which settles all of its Transportation invoices by the due date on an ongoing basis would obtain an unsecured credit level of 0.4% per 12 month period (escalating on an evenly graduated basis each month) up to a maximum of 2% of the Transporter's maximum credit limit (obtained after 60 months unblemished payment record). Any failure to pay a transportation invoice by the due date would return the User to 0% unsecured credit.

Independent Assessment

Under this option it was proposed that an assessment by one of a panel of three appointed agencies selected by the Transporter would allocate a rating allowing the User:

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

- for unrated Users from 3⅓% up to 20% of the Transporter's maximum credit limit,
- for Users with a Moody's or Standard & Poors rating below the prescribed minimum from 3⅓% up to 13⅓% of the Transporter's maximum credit limit.

It was noted that where unsecured credit is afforded by the relevant Transporter on the basis of an independent assessment, an annual re-assessment will be required. It was proposed that 80% of the cost of the initial assessment and annual re-assessment would be borne by the Relevant Transporter, with the other 20% being paid for by the User. It was further proposed that the cost of any additional interim reviews procured outside the initial assessment and annual re-assessment would be borne by the User.

Where such assessments are obtained, unsecured credit would be allocated based upon a score between 0 and 10 in accordance with the following:

Standard and Poors Credit Rating	Independent Assessment Score		Credit allowance as % of Transporter's maximum credit limit.
	Unrated Users	Users with rating below prescribed minimum	
BBB+	10	-	20
BBB	9	-	19
BBB-	8	-	18
BB+	7	-	17
BB	6	-	16
BB-	5	-	15
<BB-	4	4	13 1/3
	3	3	10
	2	2	6 2/3
	1	1	3 1/3
	0	0	0

It was noted that a User could only use one of these mechanisms to obtain credit at any particular time.

UNC Panel⁴ recommendation

At the Modification Panel meeting held on 21 December 2006, 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 recommended 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 22 December 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:

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

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

Reasons for the Authority's decision

Payment Record

The first technique introduced by UNC113 to enable a User to obtain a line of unsecured credit from the Network Transporter is based on the payment record of the User will help achieve an appropriate balance between extending some credit towards smaller parties whilst providing appropriate safeguards for immediate withdrawal of this facility on the first indication of potential difficulty. In so doing it will help to reduce barriers to market entry, which particularly impact smaller independent parties, by enabling those companies to use their available operational capital to fund aspects of their business unrelated to the provision of credit cover. These cost savings should eventually be passed onto the consumer. The modification will also reduce the potential for discrimination within the market by providing a standard approach across the networks. Ofgem considers that in this way UNC113 will better facilitate the achievement of Relevant UNC Objective (d).

We note the assumption of some parties that from the date of implementation the payment record of a User will be assessed on a historical basis, as opposed to the User needing to build up a payment history 'from scratch'. Ofgem is strongly of the view that such an approach would help bring about the benefits associated with the introduction of payment history as a means of obtaining a line of unsecured credit, and in so doing would better facilitate the achievement of Relevant UNC Objective (d). We are however concerned that such a provision is not included in the legal text for this modification.

Ofgem notes that a number of respondents to the consultation have commented to the effect that past payment is not a good indicator of a party's future ability to pay. Ofgem recognises that past performance is not always a strong positive indicator of a User's financial health. However, Ofgem does consider it is a strong negative indicator inasmuch as a User with problems paying its bills on time is likely to be financially weak and possibly in some difficulty. We therefore consider the assessment of a User's payment history, coupled with a mechanism which enables a User's unsecured credit limit to be removed, to be an appropriate safeguard to the risks involved in making a line of credit available on this basis.

The introduction of UNC113 will enable parties to build up a credit limit based on payment record climbing at 0.4% per year (escalating on an evenly graduated basis each month within year) of the (Network Operator's) NWO's maximum credit limit up to a maximum of 2% after 5 years of perfect payment history. We recognise suggestions have been made to the effect that this period is too long, or that the limit on the amount of credit which can be obtained in this way has been set too high. We consider that a maximum of 2%, (achievable only after 5 years of perfect payment history) is an appropriate amount. Specifically we note that although the theoretical amount available may seem high, the amount of unsecured credit which can be accessed by a User will be

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

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

limited by the extent of its liability to network charges. In other words a User will probably not be capable of accessing the full value of its unsecured credit.

A party to consultation suggested that there were material costs in operating a system which would potentially provide 60 incremental increases as a User established a credit record. Ofgem acknowledges that the introduction of a credit limit provided on the basis of a User's payment record will result in Transporters bearing some administrative costs. We do not consider those costs will be significant.

The same party noted that there was no latitude for Transporters to use should a User unwittingly miss a payment, stating that in such an event the Transporter would be forced to reduce a User's payment history to zero. Ofgem consider that the requirement for parties to make timely payments is a critical aspect of this feature, but it is important to note that this requirement should not override the exercise of sensible commercial practice. For example we consider that when exercising such discretion, the Transporters may take the view that late payment of a trivial invoice, or the failure to pay an invoice which can be demonstrably be proven to be due to an administrative error would not lead to withdrawal of this facility. We consider that to the extent the modification does not allow this, this provision negatively impacts the achievement of Relevant UNC Objective (d). We note that the respondent suggested that if discretion did exist on this matter Users may be faced with two tier credit limits based on Transporters' interpretation of those events. Whilst we recognise this is a risk we would expect that sensible commercial practice is likely to be applied in a broadly similar manner by similar companies acting independently of one-another in the same environment.

Payment History

The second method introduced by UNC113 is the concept of Users obtaining an independent assessment. In the main respondents to consultation were supportive of the introduction of such a technique for similar reasons to those set out in relation to the provision of a credit limit on the basis of a User's payment history. Ofgem is also of the view that allowing unrated parties to obtain an independent assessment is an appropriate mechanism for them to obtain access to unsecured credit. We consider such an approach will help to reduce barriers to market entry, and also reduce the potential for discrimination within the market, thus facilitating the achievement of Relevant UNC Objective (d).

An unrated User could be as creditworthy as a User in the two lower bands and should therefore be able to achieve a credit allowance of 20% of a network operator's maximum credit limit. It is for this reason Ofgem advocated some overlap between credit assessment scores and the credit allowance available through conventional credit ratings. One industry party commented that this method could result in a higher rating being given to unrated Users when compared to a rated User with a credit limit below a certain level. We expect that an independent assessment would represent (in the same way that an investment grade credit rating represents) a statement that a User is adequately collateralised, uses appropriate risk mitigation techniques, and has good systems, processes and management in place. As such we would not expect that the use of an independent assessment would routinely result in a higher level of unsecured credit being made available to a User than under an investment grade credit rating as these two techniques are not intended to be greatly dissimilar to one another. Whilst this is the case it should be expected that this will occur in some cases, as the particular methods used within an Independent Assessment may be more closely geared to assessing the type of company to which they are applied, and this greater degree of suitability for

purpose could conceivably lead to a higher rating being applied than might be awarded through the investment grade rating route. We also consider that the amount of credit which can be accessed by a User through this mechanism is appropriate having taken into account the frequency with which such a rating is likely to be reviewed.

We note that a number of parties have commented that it is inappropriate that 80% of the costs associated with providing an Independent Assessment should be borne by the Transporter. Some also drew the distinction between this mechanism and the payment arrangements for specially commissioned credit ratings. We acknowledge this difference, but consider that it is appropriate for the Transporters to bear the bulk of the cost because they will benefit from seeing the contents of any report provided by the agency providing the independent assessment in terms of gaining assurances that a User is a good or bad risk.

It has been suggested that there may be times when an independent assessment is carried out, but this does not result in a User being given a rating which it can use to obtain a line of credit. Ofgem does not consider that Users will apply for a rating on a speculative basis. If it should prove to be the case that a high percentage of ratings result in an outcome which is of little use to the User this may be indicative of two things. The first of these is that Users are applying for an independent assessment without a reasonable prospect of success, the second is that the Independent Assessments process has been inappropriately defined.

Whilst we have approved modification 113, we have two outstanding concerns with the legal text, one which we regard as ambiguous, the other inappropriate. The first of these relates to the mechanism through which the independent assessment agencies are appointed. We expect that a Panel of 3 agencies would be convened, the User would pick one of these, and that company would be appointed by the Transporter. The second issue relates to how reassessments of an independent assessment are paid for (i.e. those undertaken outside of the initial assessment and the annual reassessment). Ofgem considers that the current drafting, which requires that where any additional reassessments are required by the User or the Transporter the User shall meet the full cost of the reassessment. We do consider that this provision negatively impacts the achievement of Relevant UNC Objective (d). Notwithstanding the above, we consider that overall UNC113 better facilitates the achievement of the Relevant UNC Objectives.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC113: "Availability of Unsecured Credit Based on User Payment Record or Independent Assessment" be made.



Sarah Harrison
Managing Director, Corporate Affairs

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