Modification Report
Quantification of Value At Risk (VAR) to determine maximum User Credit Security Requirements
Modification Reference Number 0114
Version 2.0

This Modification Report is made pursuant to Rule 9.3.1 of the Modification Rules and follows the format required under Rule 9.4

1. The Modification Proposal

In respect of transportation credit arrangements, Ofgem published a number of recommendations in its conclusions document *"Best practice guidelines for gas and electricity network operator credit cover" 58/05* in February 2005.

Pursuant to recommendations contained within the conclusions document it is proposed that Transporters adopt a 'Value at Risk' (VAR) mechanism[1] to determine the minimum value of credit limit required to be in place. The Value at Risk at any one point in time is deemed to be:

- the value of all Transportation charges invoiced to the User within the previous calendar month, plus
- a value equivalent to fifteen days of the average daily charge in respect of the above.

It is proposed that this VAR figure determines the maximum value of the security a User may have to provide to the Transporter dependant on the value of its credit limit.

If this Proposal is not implemented, UNC will not reflect the recommendations contained within the Ofgem conclusions document and Transporters will not be obliged to operate this aspect of their credit arrangements in a consistent manner.

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

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. It believes that this measure facilitates the securing of effective competition between relevant shippers.

Corona argued that the Proposal undervalues the amount of credit which should be lodged to support a gas shipping activity, suggesting that implementation would lead to instability and increased financial risk which could deter entrants and is not conducive to fostering a competitive environment.

[1] Ofgem Conclusions Document (58/05) para 3.30

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 credit rules within the UNC may help to reduce the impacts of any 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:

Although no development, capital or operating cost implications have been identified there will be costs associated with making significant changes to operational processes and procedures due to the monitoring of Users respective Value at Risk quantities and the administration requirements of an increased volume of amendments to credit security by Users.

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:

Where a Transporter secures pass through of any bad debt it incurs, Ofgem clarified in its Best Practice Guidelines that at the subsequent price control review the Transporter will be permitted to raise up to the full value of the bad debt from regulated charges including an allowance for the cost of funding the loss pending recovery.[2]

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

The minimum level of credit required to be posted by a User would be less than is required under existing rules. In periods of peak User indebtedness, this may result in Transporters being exposed to risk which is not covered by any form of credit security.

As the minimum level of credit required to be posted by a User is dictated by amounts billed in the previous calendar month, Transporter risk will be particularly apparent where there is a significant increase in the value of

[2] Ofgem Conclusions Document (58/05) paras 4.1 – 4.7

amounts billable to a User. This is because the increased level of credit will not be required to be in place until the commencement of the following month.

This Proposal seeks to implement one aspect of the arrangements identified in Ofgem’s Best Practice Guidelines. Where a Transporter is able to demonstrate that it has implemented credit control, billing and collection procedures in line with the Guidelines, it may be in a position to recover bad debt incurred (see section 4d above) which mitigates the Transporter’s increased contractual risk associated with implementation of aspects of the Guidelines.

TGP suggested a forty-five day window would result in a reduction in the credit cover lodged by Users and so increase the contractual risk for Transporters

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 UK Link systems implications have been identified.

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

Whereas Users are currently required to provide credit security to cover peak trading levels, this Modification would require a lower level of credit security to address closer to actual trading levels. This is likely to be of particular relevance to User’s whose trading levels are subject to significant fluctuations (for example seasonal demand).

The potential reduction in the cost of credit cover arrangements may be mitigated by the associated cost of any within year adjustment of the credit security in place in response to the varying Value at Risk.

Where a User establishes a credit limit which is equal to, or not significantly greater than the Value at Risk, a greater proportion of its credit security is likely to be utilised. In such circumstances there would be a greater chance that the User inadvertently breaches its credit limit and hence be subject to the UNC measures available to Transporters in such circumstances.

Where a Transporter obtains approval to pass though bad debt, this is likely to be subsequently reflected in increased Transportation Charges which would be payable by Users in the subsequent price control period.

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

A User may deem it appropriate to reflect any operational cost efficiencies in the level of charges it levies to its suppliers which may subsequently be reflected in the level of charges a supplier levies to its customers.

Dependent on the contractual arrangements in place between the respective parties, bad debt costs which are reflected in subsequent Transportation Charges may be borne in part or in full by Suppliers and subsequently consumers.

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

Where a Transporter secures pass through of any bad debt it incurs and demonstrates that a delay in recovery would have a material adverse effect on its financial position, Ofgem clarified in its Best Practice Guidelines that it may consider early licence modifications such that amounts can be recovered prior to the next price control period.

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

Advantages

- Alignment with Best Practice Guidelines
- For Users reduces the minimum level of credit security required to be in place.
- Provided clarity on amount of security required.
- Codifies current practice, preventing industry fragmentation.

Disadvantages

- For Transporters, additional monitoring costs (Value at Risk).
- For Transporters, potentially additional administration costs associated with a User amending its credit security on a more frequent basis than current.
- For Users, if a Transporter can demonstrate compliance with Best Practice Guidelines (of which this is one element), Users may be subject to a level of financial risk of bad debt incurred by the Transporter.

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

Representations were received from the following parties:

Organisation	Abbreviation	Position
British Gas Trading	BGT	Qualified Support
Corona Energy	Corona	Not in Support
E.ON UK	EON	Qualified Support
National Grid Distribution	NG UKD	Supports
National Grid Transmission	NG NTS	Qualified Support
Northern Gas Networks	NGN	Not in Support
RWE Npower	RWE	Supports
Scotia Gas Networks	SGN	Supports
Statoil UK	STUK	Supports
Total Gas & Power	TGP	Supports
Wales & West Utilities	WWU	Not in Support

BGT suggested that this Proposal should only be implemented where costs are considered to be reasonable, and low enough not to overshadow any financial benefits that might accrue from this proposal.

Corona highlighted an inconsistency in the wording of the Proposal. The legal text suggests that the VAR figure is used to determine minimum levels of credit. While believing this is the correct interpretation, Corona recommended that the Final Modification Report should clearly outline the intention of the Proposal.

Corona and two DNs argued the proposed calculation of VAR is inappropriate - the minimum credit period granted by virtue of the payment due dates of CAP and CAZ invoices is 20 days into the month following the month of supply, and the proposed calculation only takes into consideration the actual charges in the previous month, not the peak charges in the previous 12 months. Corona provided a view on how the VAR should be calculated.

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

Significant changes would be required in respect of operational processes and procedures in the event of implementation of this Modification Proposal.

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

This Modification Proposal could be implemented with effect from 3 months following the appropriate direction being 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 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.

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 3.2.1 to read as follows:

"For the purposes of the Code:

(a) "**Code Credit Limit**" is the maximum permitted Relevant Code Indebtedness, being the sum of a User's Unsecured Credit Limit and any security provided by a User pursuant to paragraph 3.4, provided that such amount shall be equal to or greater than the User's Value at Risk;

(b) …

(c) …

(d) "**Value at Risk**" at any point in time is the sum of:

(i) The aggregate amount (other than Energy Balancing Charges) invoiced to the User in the previous calendar month pursuant to Section S (irrespective of whether such amount has become due for payment); and

(ii) the daily average of (i) above multiplied by 15.

Signed for and on behalf of Relevant Gas Transporters:

Tim Davis
Chief Executive, Joint Office of Gas Transporters

Signature:

Date :