CODE MODIFICATION PROPOSAL No. 0144
Quantification of Value At Risk (VAR) to determine a User's minimum Code Credit Limit Requirement
Version 1.0

Date: 04/05/2007

Proposed Implementation Date: 01/12/2007

Urgency: Non Urgent

1   **The Modification Proposal**

a)   **Nature and Purpose of this 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 to determine the minimum value of Code Credit Limit required to be in place. The VAR at any one point in time is deemed to be:

- the aggregate value of all Transportation charges which at that time have been invoiced to the User that remain unpaid (regardless of whether the Invoice Due Date has passed), plus

- a deemed amount equal to the aggregate value of all Transportation charges that would be incurred in a fifteen day period at the same average daily rate implicit in the invoiced amounts identified above.

It is proposed that this VAR figure determines the minimum value of the Code Credit Limit a User has to establish with the Transporter. This requirement is proposed to replace existing provisions that require the User's Code Credit Limit to be established in accordance with the relevant Transporter's Code Credit Rules.

At any point in time, the User's Code Credit Limit must be equal to or greater than it's VAR.

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.

b)   **Justification for Urgency and recommendation on the procedure and timetable to be followed (if applicable)**

N/A.

c) **Recommendation on whether this Proposal should proceed to the review procedures, the Development Phase, the Consultation Phase or be referred to a Workstream for discussion.**

This Modification Proposal has been developed within the Uniform Network Code (UNC) Distribution Workstream. General consensus on its objectives was forthcoming. 'Proceed to consultation' is therefore requested.

2 **Extent to which implementation of this Modification Proposal would better facilitate the achievement (for the purposes of each Transporter's Licence) of 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. This measure facilitates the securing of effective competition between relevant shippers.

3 **The implications of implementing this 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 this Modification Proposal, including:**

a) **The implications for operation of the System:**

No implications for operation of the system have been identified.

b) **The development and capital cost and operating cost implications:**

The proposer has identified that it would incur costs of making significant changes to operational processes and procedures due to the monitoring of Users respective Value at Risk quantities and the administration requirements of potentially an increased volume of amendments to credit security by Users.

c) **Whether it is appropriate to recover all or any of the costs and, if so, a proposal for the most appropriate way for these costs to be recovered:**

No cost recovery mechanism is proposed.

d) **The consequence (if any) on the level of contractual risk of each Transporter under the Uniform Network Code of the Individual Network Codes proposed to be modified by this Modification Proposal**

The minimum level of credit required to be posted by a User would be less than is required under existing rules. With the minimum credit value requirements closer to peak User debt levels, there is greater chance of

Transporters being exposed to risk which is not covered by any form of credit security.

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 secure pass through of any bad debt it incurs. In such cases, 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. Where a Transporter is able recover bad debt incurred this mitigates the Transporter's increased contractual risk associated with implementation of aspects of the Best Practice Guidelines.

5   The extent to which the implementation is required to enable each Transporter to facilitate compliance with a safety notice from the Health and Safety Executive pursuant to Standard Condition A11 (14) (Transporters Only)

Implementation is not required for such.

6   The development implications and other implications for the UK Link System of the Transporter, related computer systems of each Transporter and related computer systems of Users

No UK Link systems implications have been identified.

7   The implications for Users of implementing the Modification Proposal, including:

a)   The administrative and operational implications (including impact upon manual processes and procedures)

Whereas Users are currently required to provide credit security to cover peak trading levels, this Modification would require (as a minimum) a lower level of credit security to address 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).

b)   The development and capital cost and operating cost implications

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.

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.

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c)   **The consequence (if any) on the level of contractual risk of Users under the Uniform Network Code of the Individual Network Codes proposed to be modified by this Modification Proposal**

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 Code Credit Limit and hence be subject to the UNC measures available to Transporters in such circumstances.

8   The implications of the implementation for other relevant persons (including, but without limitation, Users, Connected System Operators, Consumers, Terminal Operators, Storage Operators, Suppliers and producers and, to the extent not so otherwise addressed, 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 the Transporters

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 not otherwise identified in paragraphs 2 to 9 above

Advantages

- Alignment with Best Practice Guidelines
- For Users reduces the minimum level of credit security required to be in place.

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.

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11   Summary of representations received as a result of consultation by the Proposer (to the extent that the import of those representations are not reflected elsewhere in this Proposal)

No representations have been invited at this stage.

12   Detail of all other representations received and considered by the Proposer

No such representations have been received.

13   Any other matter the Proposer considers needs to be addressed

No such additional matters (related with this proposal) have been identified.

14   Recommendations on the time scale for the implementation of the whole or any part of this Modification Proposal

In light of the work required for implementation, the Proposer believes that this Modification Proposal could be implemented with effect from 3 months following the appropriate direction being received from the Authority.

15   Comments on Suggested Text

None

16   Suggested Text

TPD SECTION V: GENERAL

Delete Paragraphs 3.1.2(a) and 3.1.2(b), and renumber 3.1.2 (c) so that it shall read as follows:

"The Code Credit Rules…to Users setting out (inter alia) procedures by which a User may discuss its Code Credit Limit with the Transporter".

Amend paragraph 3.2.1 to read as follows:

"For the purposes of the Code:

(a) **"Code Credit Limit"** is 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 must be equal to or greater than the User's Value at Risk;

(b) …

(c) …

(d) "**Value at Risk**" at any point in time is: $A + (15*(A/B))$

where:

A is the aggregate amount (other than in respect of Energy Balancing Charges) invoiced to the User pursuant to Section S but remaining unpaid

(irrespective of whether such amount has become due for payment); and

B is the number of calendar days in the month in which the amount invoiced in A was accrued.

(for the avoidance of doubt, where the aggregate amount in A comprises invoice amounts accrued in different months, a separate calculation will be made in respect of the amount accrued in each month).

Amend paragraph 3.2.4 to read as follows:

"A User's Code Credit Limit may from time to time…in accordance with the Code…Limit".

Amend paragraph 3.2.5 to read as follows:

"Where any published credit rating of a User or any person providing surety for a User is revised downwards to the extent that the credit rating following such revision is less than BB- (as provided by Standard and Poor's or such equivalent rating by Moody's Investors Service), then such User's Code Credit Limit may be immediately reviewed and revised by the Transporter in accordance with the Code, on notice to the User."

Amend paragraph 3.4.4 to read as follows:

"3.4.4 The condition referred to in paragraph 3.4.3 is that the amount of the User's Value at Risk, at the date of such release or reduction is not more than 100% of the amount of a User's Code Credit Limit…"

Code Concerned, sections and paragraphs

Uniform Network Code

Transportation Principal Document

Section(s)   V

Proposer's Representative

Phil Lucas (*National Grid*)

Proposer

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