Modification Report
Quantification of Value At Risk (VAR) to determine a User's minimum Code Credit Limit Requirement
Modification Reference Numbers 0144AV

Version 3.0

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

A separate Final Modification Report has been produced for 0144, however both 0144 and 0144AV Final Modifications Reports are identical (to incorporate the comparisons made within the Representations received) apart from the Legal Text.

1 The Modification Proposal

Both Proposals

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 its VAR.

Proposal 0144AV

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.

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

National Grid raised Modification Proposal 0144 to incorporate the VAR element of Best Practice Guidelines (58/05) ("the Guidelines") into the UNC. We do not believe that the definition of VAR within Proposal 0144 accurately reflects the intention of the Guidelines or is in line with the recent decision relating to Code Credit VAR within the electricity industry (Calculation and Securing the Value at Risk (VAR) – CUSC Modification CAP127).

This Alternative Proposal seeks to define VAR, in line with the Guidelines and as a basis for the minimum value for which a User must provide security. In the Ofgem decision letter for CAP127 it is made clear that the additional 15 days usage reflects the invoice due date for the appropriate CUSC invoices being the 15th of each month. The equivalent due date for UNC invoices is the 20th (based on the usual Capacity Invoice due date).

Modification Proposal 0144 seeks to create a VAR calculation that can result in a negative or zero value at certain times of the month. This creates the potential for under securitisation which goes against one of the underlying principles of the arrangements for credit cover in that credit arrangements should provide as secure and stable a business environment as is reasonable.

This Alternative Modification Proposal therefore proposes the following calculation of VAR as a basis for the minimum value for which a User must provide security. The VAR at any one point in time is deemed to be:

- The aggregate amount of Transportation Charges invoiced to the User but remaining unpaid (irrespective of whether such amount has become due for payment); plus

- The average daily rate of the aggregate amount of Transportation Charges invoiced to the User in the previous calendar month multiplied by 20.

If this Proposal is not implemented, the 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.

Suggested Text

Proposal 0144

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 <u>Code</u>…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 <u>BB- (as provided by Standard and Poor's or such equivalent rating by Moody's Investors Service),</u> then such User's Code Credit Limit may be immediately reviewed and revised by the Transporter in accordance with the <u>Code</u>, 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…"

Proposal 0144AV

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(i) The aggregate amount (other than 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

(ii) The average daily rate of the aggregate amount (other than Energy Balancing Charges) invoiced to the User in the previous calendar month multiplied by 20.

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~~where:~~

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Amend paragraph 3.4.4 to read as follows:

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

Standard Special Condition A11.1 (a): ***the efficient and economic operation of the pipe-line system to which this licence relates;***

Implementation would not be expected to better facilitate this relevant objective.

Standard Special Condition A11.1 (b): ***so far as is consistent with sub-paragraph (a), the coordinated, efficient and economic operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant gas transporters;***

Implementation would not be expected to better facilitate this relevant objective.

Standard Special Condition A11.1 (c): ***so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence;***

Implementation would not be expected to better facilitate this relevant objective.

Standard Special Condition A11.1 (d): ***so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;***

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.

BGT believe that the primary aim of proposal 0144AV is to seek to reduce barriers to market entry through reducing the costs of credit cover. They agree that where this is achieved, competition between relevant shippers could be expected to be better facilitated, albeit at the cost of increased exposure to the shipping community of smeared charges in the event of a shipper failure, and increased implementation/operating costs.

Corona believed that the Proposals undervalue the amount of credit which should be lodged to support a gas shipping activity. For this reason they are of the view that Users will be insufficiently covered and incidences of default are likely to increase. Corona believes that it would lead to instability which is not conducive to fostering a competitive environment.

Standard Special Condition A11.1 (e): ***so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards (within the meaning of paragraph 4 of standard condition 32A (Security of Supply – Domestic Customers) of the standard conditions of Gas Suppliers' licences) are satisfied as respects the availability of gas to their domestic customers;***

Implementation would not be expected to better facilitate this relevant objective.

Standard Special Condition A11.1 (f): ***so far as is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code.***

Implementation would not be expected to better facilitate this relevant objective.

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:

Transporters 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) 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.

NG NTS consider any costs would fall into the category of Transmission Operator operating costs and would therefore treat these costs in the same way as their existing Transmission Operator operating costs.

d) Analysis of the consequences (if any) this proposal would have on price regulation:

No such consequence is 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

Both Proposals

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.

Modification Proposal 0144AV seeks to provide for a more stable level of VAR than Modification Proposal 0144. This in turn reduces the instances and value of risk to each Transporter.

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.

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

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, implementation of this Modification Proposal 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 Users with trading levels that are subject to significant fluctuations (e.g. seasonal demand).

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.

Consequence for the level of contractual risk of Users

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 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

Both Proposals

- Alignment with Ofgem's Best Practice Guidelines
- For Users, reduces the minimum level of credit security required to be in place
- Proposal 0144AV may provide a more stable security environment than Proposal 0144.

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 at present.
- For Users, if a Transporter can demonstrate compliance with Ofgem's 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)

Organisation		Comparison	
		0144	0144AV
British Gas Trading	BGT	Not in Support	Qualified Support
Corona Energy	COR	Not in Support	Not in Support
E.ON UK	EON	Support	Support
National Grid Distribution	NGUKD	Support	Not in Support
National Grid NTS	NG NTS	Qualified Support	Qualified Support
Northern Gas Networks	NGN	Not in Support	Qualified Support
RWE npower	RWE	Not in Support	Not in Support
Scotia Gas Networks	SGN	Not in Support	Qualified Support
Scottish and Southern	SSE	Not in Support	Not in Support
Wales & West Utilities	WWU	Not in Support	Support

Corona, although not in support of either 0144 or 0144AV, stated a preference for 0144AV.

E.ON UK, supportive of both 0144 and 0144AV, stated a preference for 0144AV.

NG NTS offered Qualified support for 0144 and 0144AV but stated a preference for 0144AV.

Some respondents expressed concerns relating to Credit Cover and the risk of Users being under-securitised and ultimately placing an additional burden on industry participants in the event of default.

NG UKD undertook a comparative analysis of Credit Cover requirements between 0144 and 0144AV and provided an illustration.

RWE npower highlighted a number of concerns:

- There is inconsistency in the suggested legal text for both Modification Proposals. For example; reference to Code Credit Rules is not deleted in 3.2.4 (d) and 3.4.4.
- The Relevant Transporters Code Credit Rules are not currently subject to UNC governance arrangements (UNC Section V, Paragraph 3.1.3), but neither proposer has made necessary provisions and procedures as to the enforceability of such inclusion into the UNC.
- Both are reliant on the Authority's approval of Modification proposal 0145. Current wording of the UNC Section V, Paragraphs 3.1.3; 3.1.4; 3.3; 3.3.1; 3.3.2 and 3.3.3 further illustrates the dependence on the decision regarding Modification Proposal 0145.

12 The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation

No such requirement has been identified.

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

No such requirement has been identified.

14 Programme for works required as a consequence of implementing the Modification Proposal

No programme for works has been identified.

15 Proposed implementation timetable (including timetable for any necessary information systems changes and detailing any potentially retrospective impacts)

In light of the work required for implementation, the Proposers believe that either Modification Proposal could be implemented with effect from three 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 19 July 2007, of the 9 Voting Members present, capable of casting 9 votes, 4 votes were cast in favour of implementing Modification Proposal 0144. Therefore the Panel did not recommend implementation of Modification Proposal 0144. At the same meeting, 5 votes were cast in favour of implementing Alternative Proposal 0144AV. Therefore the Panel recommend implementation of Alternative Proposal 0144AV.

The Panel then proceeded to vote on which of the two Proposals would be expected to better facilitate achievement of the Relevant Objectives. Of the 9 Voting Members present, capable of casting 9 votes, 1 vote was cast in favour of implementing Proposal 0144 in preference to Alternative Proposal 0144AV, and 8 votes were cast in favour of implementing the Alternative Proposal 0144AV in preference to Proposal 0144. Therefore, the Panel determined that, of the two Proposals, Proposal 0144AV would better facilitate the achievement of the Relevant Objectives.

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

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(ii) The average daily rate of the aggregate amount (other than Energy Balancing Charges) invoiced to the User in the previous calendar month multiplied by 20.

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 3.2.4(d) to read as follows:

"where any instrument of surety or security expires or is determined;"

Amend paragraph 3.2.5 to read as follows:

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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, determined in accordance with Code on the basis…"

For and on behalf of the Relevant Gas Transporters:

Tim Davis
Chief Executive, Joint Office of Gas Transporters