Modification proposal:	**Uniform Network Code (UNC) 148: Aggregation of Credit Positions or Use of Group Ratings(UNC148)**		
Decision:	The Authority[1] directs that this proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	19 October 2007	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Following two years of consultation with the industry Ofgem published its best practice credit arrangement guidelines (the Guidelines) in 2005. Amongst other things, the Guidelines suggested mechanisms by which network operators should adopt consistent credit arrangements that would promote the efficiency of the network and that would promote competition between Users.

The Guidelines sought to strike a balance between enabling network operators (NWOs) to adequately and fairly mitigate their exposure to financial risks when trading with Users and affording Users an appropriate credit regime to allow them to maximise their trading capabilities and promote competition.

The Guidelines proposed a number of mechanisms by which a NWO could determine the unsecured credit limit for a User and further, mechanisms by which the User may enhance their unsecured credit limit. In this regard, the Guidelines provided that, inter alia, counterparties may aggregate their credit positions or use group ratings (e.g. through Parent Company Guarantees (PCGs)) provided the arrangements are robust and unconditional.

Currently within the UNC a User's unsecured credit limit is determined by its approved credit rating. This rating may be set by two assessment companies; Standard and Poor's and /or Moody's Investment Services[3]. In addition where Users have a Standard and Poor's and /or Moody's Investment Services below the prescribed minimum the Users unsecured credit limit may be based on the User's payment history record or independent assessment.

A User may extend their level of exposure beyond their unsecured credit limit by providing additional sources of security. These additional sources may be in the form of a Letter of Credit (LoC) or an equivalent bank guarantee from an independent security provider (ISP). The ISP must be a credit support provider that is outside the ownership structure of the User and which has no formal or informal control of the security provided by the User, its parent company or affiliated companies. The proposer perceives this limitation as a restriction.

It is this restriction that UNC modification Proposal 148 is seeking to alleviate by allowing Users to enhance their unsecured credit limit by aggregating their credit positions with affiliates or by using group ratings in the form of PCGs.

[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.
[2]This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] Moody's Investment Services is a corporate group of which Moddy's KMV is a subsidiary.

The modification proposal

The proposal seeks to introduce into the UNC new tools that will allow a User to enhance their unsecured credit rating which may enable the User to increase its trading capability

The proposal provides that a PCG could be used in two ways:

1. The unsecured credit limit assigned to the User would be based on the credit strength of the parent guarantor. Thus for example, a BB rated User guaranteed by an A rated parent would obtain an unsecured limit equal to 40 per cent of the relevant Transporter's maximum credit limit. Where more than one User obtains credit from a single PCG, the aggregate counterparty credit limits (obtained via that PCG) shall not exceed the credit entitlement of the parent.

2. As a guarantee for an amount in addition to an Unsecured Credit Limit assigned to the User based on its stand alone credit rating. In such a case, the additional amount secured by the parent must not exceed the parent company's ability to bear risk and must take into account the extent to which other Users are secured by the parent under the UNC.

The proposer considered that the underpinning arrangements for aggregated credit positions or group ratings must be robust and unconditional. In that regard, UNC 148 refers to the following requirements:

- The credit support provider must offer a guarantee which is legally enforceable in England and Wales. Guarantors registered outside England and Wales may be required to provide to a Transporter (acting reasonably) a legal opinion of enforceability,
- The guarantor entity will be subject to the same credit scoring process as the buyer, and must also be willing to provide information to facilitate the completion of this process,
- The country of residence of a guarantor registered outside England and Wales must have a sovereign credit rating of at least A awarded by Moody's Investors Service (or equivalent rating by Standard & Poor's). If the rating agencies differ, the lower rating will apply, and
- The minimum acceptable rating is Ba3 awarded by Moody's Investors Services (or an equivalent rating by Standard & Poor's). If the rating agencies differ, the lower rating will apply.

The proposer is of the view that the implementation of these credit tools underpinned by the safeguards detailed above will better facilitate the achievement of relevant objective (d). It is their view that competition between Users would be enhanced because implementation of additional consistent credit processes which further move towards recognised best practice, as set out in the Guidelines, would help ensure that there is no inappropriate discrimination and no inappropriate barrier to entry. Therefore, the proposer considers that this measure facilitates the securing of effective competition between relevant shippers.

UNC Panel[4] recommendation

At the Modification Panel meeting held on 19 July 2007, of the 9 Voting Members present, capable of casting 9 votes, 8 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 September 2007. 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 proposal be made is consistent with the Authority's principal objective and statutory duties[7].

Reasons for the Authority's decision

Effective credit arrangements need to strike a balance that will protect the interests of Transporters without requiring Users to over collateralise. When determining how much collateral a User needs to have in place, taking account of its Approved Credit Rating provides an effective indication of the risk a User may pose to the Transporter. Paragraph 3.1.6 of section V of the UNC provides a table listing the level of unsecured credit a User should be afforded dependent upon its Approved Credit Rating.

Modification proposal UNC148 seeks to extend the options available to a User in relation to determining its Approved Credit Rating. As well as using its own Approved Credit Rating, a User could be afforded an unsecured credit limit based on the Approved Credit Rating of either its parent or a Qualifying Company. Ofgem considers that such arrangements could facilitate competition amongst Users provided appropriate attendant safeguards are in place in a robust and unconditional manner. Ofgem is of the view that safeguards outlined above are sufficiently robust to ensure that the risk taken on by the credit support provider should not be greater than any risk it itself would be able to incur. In such circumstances we consider allowing the transfer of risk from the User to the credit support provider to better facilitate the achievement of relevant objective (d), allowing Users to benefit from a superior credit rating of a credit support provider.

Of the ten representations received to the proposal, one offered a qualified support and one respondent was not in support of the modification proposal. The remaining eight respondents were in support of the proposal. One respondent considered that the proposal did not specify how, in the case of parent company guarantees, multiple credit ratings would be treated if they conflicted. Another respondent believes that the legal text is inappropriate for companies outside England and Wales.

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[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://epr.ofgem.gov.uk/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.

Taking these two concerns voiced by the respondents in turn, one concern relates to the issue that a company[8] providing a guarantee may have at least two credit ratings. As the modification proposal is silent on this point this may lead to uncertainty with regard to the credit strength of any guarantee provider.

Modification proposal UNC 146 introduces a definition of a Parent Company and Qualifying Company. This definition forms part of UNC 148. The definition states that, inter alia *" in the case of a company……………… with a long term debt rating of at least BB- provided by Standard and Poor's Corporation or equivalent rating by Moody's Investors Service (where such ratings conflict, the lower of the two will be used)…."*. Ofgem, having directed the implementation of modification UNC146 believe that the legal text of UNC146 has adequately addressed this concern.

The other respondent believes that the legal drafting for UNC146, upon which this proposal is partially dependent, and UNC 148 is inadequate and discriminatory to Users that have a parent company domiciled outside England and Wales. The respondent states that 'the issues required to be addressed to determine the enforceability of guarantors domiciled outside England and Wales need to be unequivocally defined'. However, the respondent does not expand further on the nature of these issues.

Ofgem is keen that Users with parent companies registered outside of England and Wales are afforded the same treatment as those that are registered inside England and Wales as far as possible. Although there is an additional requirement placed on a User whose parent company is not registered in England and Wales i.e. a particular sovereign credit and a potential requirement (if reasonably required by the Transporter) i.e. a legal opinion as to enforceability, it is Ofgem's view that these obligations are reasonable to the extent they are necessary to ensure that additional risk faced by the NWO is appropriately covered.

Considering the issues outlined above Ofgem is of the view that this proposal better facilitates the relevant objective (d) of the UNC.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 148: Aggregation of Credit Positions or Use of Group ratings be made.

Mark Feather,
Associate Director, Industry Codes and Licensing.

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

[8] A Parent Company or a Qualifying Company.