Joint Office of Gas Transporters

Stage 03: Final Modification Report

What stage is this document in the process?

01 Proposal

02 Workgroup Report

03 Draft Modification Report

04 Final Modification Report

0360:

Removal of Credit Rating Restrictions from Definition of Parent Company

This modification seeks to amend the definition of "Parent Company" to remove the requirement to hold a long term debt rating of at least BB-. This would allow additional parties to be supported by parent company guarantees, creating a more equitable competitive environment.

Other changes to Section V may be required to meet this aim and these proposed changes are laid out below.

Panel recommended that Modification 0360 is not implemented.

High Impact:
Some small Shippers

Medium Impact:

Low Impact:
Transporters and other Shippers

Contents

About this document:

This document is a Final Modification Report, presented to the Panel on 16 June 2011. The Authority will consider the Panel's Recommendation and decide whether or not this change should be made.

Any questions?

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1 Summary

Is this a Self-Governance Modification

This modification impacts credit requirements and is seeking a shortened assessment period. It does not meet the self-governance criteria since implementation would have a material impact on a number of Shippers.

Why Change?

Implementation of recent changes to the credit arrangements within the UNC have highlighted consequences which will adversely impact some smaller parties. In particular, the removal of some credit tools means that some parties may seek to rely on parent company guarantees. By defining a parent company as one with a long term debt rating of at least BB- provided by Standard and Poor's or an equivalent rating, smaller companies are excluded from this avenue. This exclusion imposes higher costs on some parties than others, and change is needed to create equitable competitive conditions.

Solution

It is proposed that the credit rating requirement be removed from the definition of parent company. By this means, parent company guarantees could be provided irrespective of the credit rating, with the credit impact being dependent on the rating of the parent company rather than being arbitrarily removed at a specific (high) level.

Impacts & Costs

Implementation would enable more Shippers to benefit from parent company guarantees in preference to more expensive forms of credit, including the posting of cash which could severely damage a Shipper's ability to compete in the market. However, the precise impact is dependent on each Shipper's commercial position, which is subject to commercial confidentiality. The proposer has shared with Ofgem the potential impacts in its own circumstances and would urge others to do likewise.

Implementation

Implementation should be as soon as reasonably practicable after direction from the Authority.

The preference for implementation of this modification is prior to 1st July 2011.

The Case for Change

Some members consider by creating more equitable competitive conditions and removing a barrier to entry, implementation would facilitate the relevant objective of securing effective competition.

2 Why Change?

The implementation of UNC Modification 0305: "Unsecured Credit Limit Allocated Through Payment History", which is due to come into effect at 06:00 on February 7th, 2011, will withdraw the current ability to accrue Unsecured Credit based on payment history for those Users who have been signatories to the UNC for a period greater than 2 years.

With the loss of this facility, First Utility approached Graydons (one of the Independent Credit Rating Agencies listed in the table contained in UNC TPD Section V 3.1.7 as a result of the implementation of UNC Modification 0304: "Introduction of a Rating Table for Independent Credit Rating Agencies for Use with Independent Assessment") and requested that a Level 3 report be provided for both First Utility and its parent, Impello plc.

Based on the results of these assessments, First Utility contacted the Gas Transporters to request that Impello plc provide security on behalf of its 100% subsidiary First Utility in the form of a Parent Company Guarantee (PCG).

The Gas Transporters declined to accept this on the grounds that Impello plc does not have an Approved Credit Rating of at least BB- and so does not meet the UNC definition of a Parent Company (see below). This means that it cannot provide a Parent Company Guarantee under the UNC as it currently stands.

A Parent Company is currently defined in UNC TPD Section V 3.4.5 as follows:

"Parent Company" shall mean:

(i) In the case of a company registered in England and Wales a public or private company within the meaning of Section 1(3) of the Companies Act 1985 with a long term debt rating of at least BB- provided by Standard and Poor's Corporation or equivalent rating by Moody's Investors Services (where such ratings conflict, the lower of the ratings will be used) that is either a shareholder or the User or any holding company of such shareholder (the expression holding company having the meaning assigned thereto by Section 736, Companies Act 1985 as supplemented by Section 144(3) Companies Act 1989); or

(ii) In the case of an entity registered outside of England and Wales, such equivalent entity to (i) above that is acceptable to the Transporter, acting reasonably.

3 Solution

This Urgent Modification proposes that the above definition of a Parent Company in UNC TPD Section V 3.4.5 be amended to read:

"Parent Company" shall mean:

(i) In the case of a company registered in England and Wales a public or private company within the meaning of Section 1(3) of the Companies Act 1985 that is either a shareholder or the User or any holding company of such shareholder (the expression holding company having the meaning assigned thereto by Section 736, Companies Act 1985 as supplemented by Section 144(3) Companies Act 1989); or

(ii) In the case of an entity registered outside of England and Wales, such equivalent entity to (i) above that is acceptable to the Transporter, acting reasonably.

It is also proposed that UNC TPD Section V 3.1.3(b) be amended to read:

"Subject to paragraph 3.1.3(c), where a Qualifying Company or Parent Company provides surety in respect of a User in the form of a Guarantee (the "Surety Provider"), then the Approved Credit Rating or Independent Credit Rating of such Surety Provider may be used in place of the User's to calculate such User's Unsecured Credit Limit in accordance with the table set out in paragraph 3.1.3(a) in the case of a Qualifying Company or paragraph 3.1.7(b) in the case of a Parent Company".

In addition, it is proposed that UNC TPD Section V 3.1.7 be amended to read:

"Upon request from a User or Parent Company, the User or Parent Company may select any one of the specified agencies for the Transporter to use to allocate an Unsecured Credit Limit to the User as follows:

(a) Where such User or Parent Company is unable to obtain an Approved Credit Rating (up to a maximum of 20% of the relevant Transporter's Maximum Unsecured Credit Limit); or
(b) Where such User or Parent Company has an Approved Credit Rating less than that in 3.1.3(a) (up to a maximum of 13 1/3% of the relevant Transporter's Maximum Unsecured Credit Limit).

A score of between 0 and 10 will be allocated to the User or Parent Company in accordance with the following table to calculate the User's Unsecured Credit Limit:

[table]

The Transporter will set the User's Unsecured Credit Limit no higher than the lower of the credit value recommended within the User's Independent Assessment and the value calculated by applying the User's Independent Assessment Score to the Transporter's Maximum Unsecured Credit Limit or, where a Parent Company has so requested, no higher than the lower of the credit value recommended within the Parent Company's Independent Assessment and the value calculated by applying the

Parent Company's Independent Assessment Score to the Transporter's Maximum Unsecured Credit Limit where the Parent Company has agreed to provide surety in the form of a Guarantee".

This amended definition, along with the associated changes to TPD Section V above, would then allow smaller Users whose parent company does not meet the credit requirements in the current definition to provide a Parent Company Guarantee based on an assessment of that Parent Company by one of the three Independent Credit Rating Agencies listed in the table in UNC TPD Section V 3.1.7.

This would then provide smaller Users with an alternative to more expensive forms of credit such as posting cash which could severely damage a smaller User's ability to compete in the market. Implementation would therefore result in more equitable competitive conditions.

4 Relevant Objectives

Implementation will better facilitate the achievement of **Relevant Objective d.**

Proposer's view of the benefits against the Code Relevant Objectives	
Description of Relevant Objective	Identified impact
a) Efficient and economic operation of the pipe-line system.	
b) 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.	
c) Efficient discharge of the licensee's obligations.	
d) 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.	Will allow more equitable credit arrangements for smaller Users, thus removing a barrier to entry and helping to secure effective competition between relevant shippers and suppliers. Implementation of this modification could increase exposure to failure and increase risk for market participants.
e) Provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards… are satisfied as respects the availability of gas to their domestic customers.	
f) Promotion of efficiency in the implementation and administration of the Code	

E.ON do not believe this proposal would better facilitate any of the relevant objectives as it is potentially increasing the risk that the costs of a Shipper default cannot be recovered from the defaulting party. Competition between Shippers is likely to be adversely affected due to the increased risk of the remaining Shippers having to pick up these costs.

National Grid Distribution believe that while some Users having parent companies may benefit from having more flexibility in terms of the use of Independent Assessments, this could in turn increase financial risk to the industry arising in the event of insolvency. Conversely larger Users who may be better able to take advantage of the flexibility arising from a credit rated parent could be perceived as having an advantage in terms of the availability of credit tools which in turn may not be consistent with facilitating competition in the gas market.

Gazprom considers this modification will allow more equitable credit arrangements for smaller Users thus removing a barrier to entry and helping secure effective competition.

National Grid NTS disagree that the modification will allow more equitable credit arrangements as they believe the modification will increase the risk to all Transporters and, via pass through arrangements, other Shipper Users. This proposal would therefore mean that Users (small and large) using other credit tools would be unfairly impacted and they believe this is not good for competition.

Northern Gas Networks, while sympathetic to the argument for lowering the requirements for obtaining unsecured credit for smaller shippers, highlight that implementation of this modification would also increase the potential for bad debt and put DNs and the wider community in a riskier position as more outstanding amounts are likely to become unsecured.

Wales & West Utilities also highlight that although this modification may allow Shippers to obtain "cheaper" forms of unsecured credit, it will also increase the risk of exposure to bad debt for other Shippers. On balance they believe this risk outweighs any financial implications for smaller Shippers.

5 Impacts and Costs

The ability of smaller Users to provide Parent Company Guarantees as an alternative to more expensive forms of credit will remove a potential barrier to competition.

Whilst National Grid NTS agree that this modification may reduce credit costs for some Users, it will increase the risk to the transporters and ultimately there is a risk any bad debt will be passed through to the wider shipper community.

Costs

Indicative industry costs – User Pays
Classification of the proposal as User Pays or not and justification for classification
This is not a User Pays modification as there is no systems impact and no User Pays Service is proposed nor amended.
Identification of Users, proposed split of the recovery between Gas Transporters and Users for User Pays costs and justification
NA
Proposed charge(s) for application of Users Pays charges to Shippers
NA
Proposed charge for inclusion in ACS – to be completed upon receipt of cost estimate from xoserve
NA

Impacts

Impact on Transporters' Systems and Process	
Transporters' System/Process	Potential impact
UK Link	• None
Operational Processes	• None
User Pays implications	• None

Impact on Users	
Area of Users' business	Potential impact
Administrative and operational	• Cost of providing credit potentially reduced
Development, capital and operating costs	• None
Contractual risks	• Potential for higher exposure to defaulting User

Where can I find details of the UNC Standards of Service?

In the Revised FMR for Transco's Network Code Modification **0565 Transco Proposal for Revision of Network Code Standards of Service** at the following location: http://www.gasgovernance.com/networkcodearchive/551-575/

Impact on Users	
Legislative, regulatory and contractual obligations and relationships	• None

Impact on Transporters	
Area of Transporters' business	Potential impact
System operation	• None
Development, capital and operating costs	• None
Recovery of costs	• None
Price regulation	• None
Contractual risks	• None
Legislative, regulatory and contractual obligations and relationships	• None
Standards of service	• None

Impact on Code Administration	
Area of Code Administration	Potential impact
Modification Rules	• None
UNC Committees	• None
General administration	• None

Impact on Code	
Code section	Potential impact
Section V 3.4.5	Changes as described

Impact on UNC Related Documents and Other Referenced Documents	
Related Document	Potential impact
Network Entry Agreement (TPD I1.3)	None
Network Exit Agreement (Including Connected System Exit Points) (TPD J1.5.4)	None
Storage Connection Agreement (TPD R1.3.1)	None

Impact on UNC Related Documents and Other Referenced Documents	
UK Link Manual (TPD U1.4)	None
Network Code Operations Reporting Manual (TPD V12)	None
Network Code Validation Rules (TPD V12)	None
ECQ Methodology (TPD V12)	None
Measurement Error Notification Guidelines (TPD V12)	None
Energy Balancing Credit Rules (TPD X2.1)	None
Uniform Network Code Standards of Service (Various)	None

Impact on Core Industry Documents and other documents	
Document	Potential impact
Safety Case or other document under Gas Safety (Management) Regulations	None
Gas Transporter Licence	None

Other Impacts	
Item impacted	Potential impact
Security of Supply	None
Operation of the Total System	None
Industry fragmentation	None
Terminal operators, consumers, connected system operators, suppliers, producers and other non code parties	None

6 Implementation

Implementation should be as soon as reasonably practicable after direction from the Authority.

The preference for implementation of this modification is prior to 1st July 2011.

7 The Case for Change

Advantages

No additional Advantages in addition to that identified the above

Disadvantages

No additional disadvantages in addition to that identified the above

8 Legal Text

Draft Legal Text (provided by National Grid Distribution)

TPD Section V

Amend paragraph 3.1.3 (b) to read as follows:

3.1.3(b)Subject to paragraph 3.1.3 (c), where a Qualifying Company or Parent Company with an Approved Credit Rating provides surety in respect of a User in the form of a Guarantee (the **"Surety Provider"**), then the Approved Credit Rating of such Surety Provider may be used in place of the User's to calculate such User's Unsecured Credit Limit in accordance with the table set out in paragraph 3.1.3 (a).

Amend paragraph 3.1.7 to read as follows:

3.1.7 Where a User or Parent Company does not have an Approved Credit Rating, then ~~U~~upon request from ~~a~~ such User, the User may select any one of the specified agencies for the Transporter to use to allocate an unsecured Credit Limit to the User based upon the Independent Assessment Score of the User or Parent Company as follows:

(a) where such User or Parent Company is unable to obtain an Approved Credit Rating (up to a maximum of 20% of the relevant Transporter's Maximum Unsecured Credit Limit); or

(b) where such User or Parent Company has an Approved Credit Rating less than that in 3.1.3(a) (up to a maximum of 13 $\frac{1}{3}$ % of the relevant Transporter's Maximum Unsecured Credit Limit).

A score of between 0 and 10 will be allocated to the User or Parent Company in accordance with the following table to calculate the User's Unsecured Credit Limit:

[table]

The Transporter will set the User's Unsecured Credit Limit no higher than the lower of the credit value recommended within the Independent Assessment and the value calculated by applying the Independent Assessment Score to the Transporter's Maximum Unsecured Credit Limit

Amend paragraph 3.4.5 to read as follows:

3.4.5 For the purposes of Code:

"Parent Company" shall mean:

(i) in the case of a company registered in England and Wales a public or private company within the meaning of Section 4 1~~(3)~~ of the Companies Act 2006 ~~1985 with a long term debt rating of at least BB- provided by Standard and Poor's Corporation or equivalent rating by Moody's Investors Services (where such ratings conflict, the lower of the ratings will be used)~~ that is either a shareholder of the User or any holding company of such shareholder (the expression holding company having the meaning assigned thereto by Section 1159 ~~736~~, Companies Act 2006 ~~1985~~ as supplemented by Schedule 6 Companies Act 2006 and Section 144(3) Companies Act 1989); or

(ii) in the case of an entity registered outside England and Wales, such equivalent entity to (i) above that is acceptable to the Transporter, acting reasonably;

9 Consultation Responses

Representations were received from the following parties:

Respondent	
Company/Organisation Name	Support Implementation or not?
British Gas	Not in Support
E.ON UK	Not in Support
First:Utility	Supports
Gazprom	Supports
National Grid Distribution	Comments
National Grid NTS	Not in Support
Northern Gas Networks	Not in Support
Opus Energy Ltd	Supports
RWE npower	Supports
Scottish Power	Supports
Wales & West Utilities	Not in Support

In summary, of the eleven representations received five supported implementation, one provided comments and five were not in support.

Summary Comments

British Gas consider the current UNC requirements are an acceptable balance, and fear that removing controls may result in a greater cost exposure to consumers were a company to default. Northern Gas Networks also believe that the current credit arrangements in the UNC balance the level of risk of bad debt to the wider industry, and reducing the level at which this unsecured credit can be obtained would increase that risk.

E.ON believe that allowing a lower standard of Parent Company Guarantee as an acceptable form of security may undermine the robustness of the arrangements and increase the risk of money not being recovered from the defaulting Shipper. Whilst they recognise that the proposal may lower the operating costs for affected Shippers, E.ON believe it carries the risk of potentially increasing, to the detriment of the wider Shipper community, the costs of default; which could far outweigh the administrative savings for some Shippers that this proposal may facilitate.

E.ON considers it is worth noting that under Energy Balancing Credit Rules, the credit arrangements have evolved in the opposite direction to that proposed by this modification, with Parent Company Guarantees of any rating being deemed unacceptable.

First:Utility observe that in the last ten years there have been three defaults which have had a major impact on the UK energy market, two of large and established energy companies and one of an investment bank. All three of these entities had approved credit ratings significantly better than BB- at the time of their demise. If a default on this scale occurred today, the consequences to smaller Users could be significant. Despite this, larger Users who have a parent with an approved credit rating of BB- or better are allowed to cover some or all of their unsecured credit amounts for Transportation by means of a simple Parent Company Guarantee rather than cash. It therefore seems counter intuitive that smaller Users, whose potential default would have a much smaller impact on the market, are currently denied this option. First:Utility accept that the implementation of this modification would slightly increase the risk to Users, but feel that the benefit that implementation would provide to competition outweighs this relatively small increase in risk to the market.

National Grid NTS highlight that Parent Company Guarantees may not offer the same protection in the event of insolvency of the Guarantor, as there is a risk that the Guarantor will not be able to fulfill its obligation in the event that the relevant User does not meet its obligations. National Grid NTS highlight some of the disadvantages of using Parent Company Guarantees as part of an Independent Assessment. They also point out that, as analysis has not been provided to indicate the likely levels of unsecured credit, it is difficult to assess the balance between financial risk and maintaining credit cover and payment terms that do not unduly restrict users.

National Grid Distribution believe the modification could create a risk of overtrading with a possibility of driving companies into receivership. This gives rise to a financial risk to the User community in the event that costs to the Transporter arising from insolvency are 'passed though'. However, they appreciate that the existing arrangements could be construed as being disadvantageous to the smaller organisation in that there is an argument that they should have an opportunity to utilise their parent for the purposes of obtaining unsecured credit to the same extent as a credit rated organisation. They can envisage that removing this restriction could in principle reduce the credit costs of smaller Users and therefore facilitate competition.

RWE npower believe there may be additional risk through implementation of this modification due to transportation credit debts not being recovered from a defaulting party. However, RWE npower does not believe this risk significantly exceeds that posed by the current Payment History arrangements.

Scottish Power believe that the current provisions concerning who may provide a Parent Company Guarantee are strict and work to the detriment of Shippers whose parent company has a low credit rating. They are of the view that if a Shipper has a parent that is more financially sound than the Shipper itself then, regardless of whether that Parent is rated BB- or above, a Parent Company Guarantee should be an allowable option in such circumstances. Relaxing the current provisions should reduce barriers to entry for smaller shippers, although they recognise that this may result in a slightly increased risk exposure. Currently any such increased risk has not been quantified, but they do not believe that it would be substantive and consider that it is equally important that an appropriate balance is struck that is not overly restrictive.

Wales & West Utilities appreciate that implementation could benefit smaller Shippers by way of the ability to obtain an increased amount of unsecured credit. However, on balance they do not believe that this is an appropriate change and could be detrimental to the robust transportation credit arrangements currently in place.

Wales & West Utilities and National Grid NTS also believe that the risk associated with implementation of this modification proposal would be significantly increased should modification 0375 also be implemented.

10 Panel Discussions

The Panel Chair summarised that the modification seeks to remove an existing restriction that, to be acceptable as security, any Parent Company Guarantee (PCG) must be from a parent with a BB- or better rating. In practice, this tends to mean that PCGs are not accepted from some smaller Shippers. The modification is seeking to establish that any parent company can provide a PCG, albeit with the value reflecting the credit rating of the parent concerned.

Panel Members recognised that implementation could reduce costs for some Shippers and therefore facilitate the development of effective competition, for example by alleviating cashflow constraints which may hamper business development. Members also recognised that allowing unsecured credit that is commensurate with the rating of any parent company could be regarded as creating a level playing field – removing the BB- hurdle. Removing this hurdle could therefore reduce a barrier to entry, and could also facilitate the development of effective competition.

Set against this, Members also recognised that the credit arrangements within the UNC were established, and have been subsequently developed, following extensive consultation and debate, and are intended to provide protection to all parties from the impact of default. Implementation of the modification would be expected to increase unsecured credit levels and hence market exposure and consequent costs. This could be regarded as inappropriate – with the potential for increased liabilities deterring both existing competitive activity and market entry. Implementation could therefore be expected to adversely impact the development of effective competition.

With three votes cast in favour and six against implementation, Panel Members determined to recommend that Modification 0360 should not be implemented.

The benefits against the Code Relevant Objectives	
Description of Relevant Objective	Identified impact
a) Efficient and economic operation of the pipe-line system.	None
b) 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.	None
c) Efficient discharge of the licensee's obligations.	None
d) Securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered	Balanced

into transportation arrangements with other relevant gas transporters) and relevant shippers.	
e) Provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards… are satisfied as respects the availability of gas to their domestic customers.	None
f) Promotion of efficiency in the implementation and administration of the Code	None

11 Recommendation

Panel Recommendation

Panel Members determined to recommend that Modification 0360 should not be implemented.