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The Joint Office, Transporters, Shippers and
other interested parties

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Dear Colleague,

Uniform Network Code modification proposal 025: 'Notice Period for Credit Limit Downgrade and Remedies for Non-compliance'

Ofgem¹ has considered the issues raised in the modification report in respect of this proposal and has come to the view that modification proposal 025 would not better facilitate the achievement of the relevant objectives of the Uniform Network Code (UNC), as set out under Standard Special Condition A11² of the relevant Gas Transporters' Licences as compared with the existing provisions of the UNC.

This letter explains the background to the modification proposal and outlines the reasons for Ofgem's decision.

Background to the proposals

The Best Practice Guidelines

In February 2005 Ofgem published its conclusions on best practice guidelines for gas and electricity Network Operator credit cover³. The document was the result of two years of detailed discussion and consultation with electricity and gas industry parties. The document covers a wide range of issues which in Ofgem's view strike an appropriate balance between providing protection against the risk of exposure in the event of default, and the costs of mitigating that risk. The conclusions document indicated that appropriate changes would need to be brought forward by parties to industry codes in order to arrive at credit cover arrangements consistent with the best practice guidelines.

Relevant aspects⁴ of Ofgem's conclusions in relation to this proposal are:

¹ Ofgem is the Office of the Gas and Electricity Markets Authority and. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

² This Licence Condition can be viewed at: http://62.173.69.60/document_fetch.php?documentid=6547

³ This can be found on the Ofgem website at:

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areasofwork/creditcover

⁴ For full details, readers should refer to the conclusions document

- In relation to each User, the deemed Value at Risk for Use of System (UoS) charges at any time should be the amount in money which is equal to the sum of:
 - (a) the aggregate value of all charges which at that time have been billed to such User (but not necessarily due) but remain unpaid; and
 - (b) a deemed amount equal to the aggregate value of all UoS charges that would be incurred in a fifteen day period at the same average daily rate implicit in billed charges under (a).
- Where the reassessment of a User's credit scoring or credit rating has led to a revision in its Unsecured Credit Limit (UCL) and consequently to the need for increased security to be posted, the applicable notice period for the provision of such additional security should be 2 business days;
- In the event that a User does not comply with a request to provide, or increase the level of, security, and is therefore in default, the following should apply:

Number of days after default	Action suggested
Day 0	Due date
Day +1	Interest and administration fee trigger
Day +1	Transporter to issue a formal notice of default as to statement of position and how default is to be remedied
Day +3	Formal response is required
Day +5	Ability to suspend registrations of (inwards) transfers

The notice of default should be issued to the notified contract manager of the User's staff
This notice of default and associated response should be copied to Ofgem

- In all instances interest and administration fees should be charged, in line with the above timetable. These should not be extreme or excessive.

Current UNC arrangements

Each Transporter will determine and assign to each User a Code Credit Limit (CCL), which may comprise of an Unsecured Credit Limit (UCL) and/or security or surety. For Users with Approved Credit Ratings (BB- or above) UCL will be set at the applicable percentage of each relevant Transporter's Maximum UCL for a single User, which will be based on 2 per cent of the relevant Transporter's Regulatory Asset Value.

User Relevant Code Indebtedness is the aggregate amount (other than in respect of Energy Balancing Charges), for which a User is at any time liable to the Transporter pursuant to the Code or any Ancillary Agreement, less any prepayment.

Currently, where any published credit rating of a User or any person providing surety for the User is revised downwards, the User's CCL may be reduced on notice of no less than 30 days (or any lesser period agreed by the User). One exception is in circumstances where the rating is revised downwards to the extent that it less than the minimum prescribed credit rating, in which case the User's CCL may be immediately revised, on notice to the User.

Where a User's Relevant Code Indebtedness has exceeded 70%, and subsequently 85% of its CCL, and the User has been notified respectively, for so long as indebtedness continues to exceed 85%, the Transporter shall be entitled to reject or refuse to accept all or any of the following by the relevant User:

- Application for System Capacity or increased System Capacity at any system point

- In relation to the NTS, a System Capacity Trade in respect of which the User is the Transferee User;
- A Supply Point Nomination or Supply Point Confirmation other than a Supply Point Renomination or Supply Point Reconfirmation

Should Relevant Code Indebtedness exceed (and continue to exceed) 100% of the CCL the Transporter may issue a Termination Notice⁵. Where a termination notice is issued the Transporter may invoice the User for services provided, with all amounts being immediately due for payment.

The modification proposal

It is proposed that where a credit rating is reduced, this is reflected by the Transporter with a minimum notice period of two Business Days or a lesser period agreed by the User.

It is further proposed that where a User does not comply with any request to provide additional security, the following would apply. The User will be in default (all monies will effectively become overdue and payable):

Number of days after default	Action suggested
Day 0	Due date
Day +1	Interest and administration fee trigger
Day +1	Transporter to issue a formal notice of default as to statement of position and how default is to be remedied
Day +3	Formal User response is required
Day +5	Ability to suspend registrations of Supply Points

It is proposed that in all instances, administration and daily fees should be charged in accordance with the above timetable in line with the amounts detailed as follows:

Size of Credit 'shortfall'	Administration fee that can be claimed
Up to £999.99	£40
£1,000 to £9,999.99	£70
£10,000 or more	£100

It is proposed that a daily fee is charged in respect of the credit 'shortfall' at a rate equal to the Bank of England base interest rate plus eight percentage points per annum. This rate is calculated by adding 8 percentage points to the reference rate, which is the Bank of England base rate on 30 June and 31 December each year. This rate is applicable for the following 6 month periods.

It is further proposed to utilise any other legal remedy available. It is anticipated that this would prompt a User to take the required action.

⁵ The issue of a Termination Notice has the effect that the User shall cease to be a User for the purposes of the UNC

Respondents' views⁶

There were eleven responses to this modification proposal, eight of which were in favour of implementation, one gave qualified support and two were opposed.

Supporting comments included that the proposal would introduce robust, pragmatic and cost effective arrangements that would serve as a greater incentive for Users to address their credit position more expeditiously, and may minimise the impact of User failure on the industry. It was also suggested that incorporating arrangements into the UNC would provide consistency across the network and ensure that there is no inappropriate discrimination or barrier to entry.

In relation to the relevant code objectives, two of the above respondents believed that the proposal would facilitate greater competition between Users, and one considered that it would facilitate Transporters' ability to operate the network in an efficient and economic manner.

A number of comments were made regarding legal text, including that the timetable for actions in the event of default should have been included. One respondent offered qualified support for the proposal on the basis that notice period for proposed section V3.2.4 (d)⁷ should also be reduced to 2 days.

One respondent, who opposed implementation, believed that the text could result in a User, whose credit rating is unaffected, having to find additional security because the credit rating of another person is downgraded.

Comments against implementation of the proposal included that sufficient penalties already exist and that the provisions are too onerous and could fatally contribute to financial problems, which could lead to reduction in the competitive environment. It was also stated that the current method of calculating VAR means that the increase in security is required when exposure is least, and that as a large amount of security is already held, the potential exposure by continuing 30 days notice would be very small.

One of the above respondents subsequently raised concerns regarding post consultation changes to the legal text, however these were discussed by the modification panel of 20 October 2005, who determined that this was in keeping with ordinary process where improvements to legal text are identified and did not of themselves require re-consultation.

Panel Recommendation

At the modification panel meeting held on 20 October 2005, of the 9 voting members present, capable of casting 10 votes, 10 votes were cast in favour of implementing this modification proposal. Therefore, by panel majority, the implementation of this proposal is recommended.

⁶ This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. These can be found on the Gas Transporters information service (formally known as Nemysis) <https://gtis.gasgovernance.com>

⁷ V3.2.4(d) where (but without prejudice to any requirement of the Code Credit Rules) any instrument of surety or security expires or is determined

Ofgem's view

Ofgem agrees that Transporters should normally have the ability to react to downgrades in the creditworthiness of Users in a timely manner, thereby managing the risk posed by counterparties. In this respect, the proposal could serve to identify at an earlier point in time Users who are less likely to meet their obligations, potentially reducing the amount of exposure in the event of default.

Ofgem notes that the proposed timescale is slightly shorter than that set out in the conclusions document⁸. In addition, Ofgem notes that under current UNC credit arrangements Relevant Code Indebtedness is assessed against the User's CCL. The use of this approach, rather than Value at Risk as set out in the conclusions document, calculated by the sum of amounts that are billed but unpaid plus an amount equivalent to fifteen further days' use, may mean that Users need to post more credit cover than Ofgem consider appropriate.

The proposal made clear that where a User fails to comply with a request to provide additional security the User would be in default, with all monies effectively becoming overdue and payable.

Events constituting User Default are set out in UNC section V4.3.1. Upon a User Default a Transporter may issue a Termination Notice, following which, section S1.7 enables Transporters to issue Invoice Documents in respect of any full or part Billing Period ending at or before the submission of the invoice, with all amounts being immediately due for payment. Alternatively, where a User is insolvent, as detailed in section V4.3.1(e), Transporters may submit invoices as described above, without first issuing a Termination Notice.

Whilst believing that remedies should apply in situations where a User fails to provide additional security, Ofgem considers that this element of the proposal in the context of current UNC credit and payment arrangements would be more onerous than the above comparable arrangements, and could have the ability to cause the failure of an otherwise creditworthy party.

For this reason Ofgem does not consider that this modification proposal meets any of the relevant UNC objectives.

Ofgem notes a comment made by one respondent in respect of the notice period for situations where any instrument of surety or security expires or is determined. It is open to code signatories to raise modification proposals in this area.

Ofgem is of the opinion that all parties should make arrangements to meet their obligations in a timely manner. Where this does not occur in relation to the provision of security, Ofgem believes that a number of remedies, including interest and administration charges, should be applied. As indicated above, such charges should not be extreme or excessive. In this regard, the application of charges consistent with prevailing legislation, namely the Late Payment of Commercial Debts (Interest) Act 1998, would appear reasonable.

⁸ In which paragraph 3.11 indicated that a NWO should revise the unsecured credit limit on one working days notice, with the change being effected immediately on the expiry of that notice, with paragraph 3.51 setting out that where this led to the need for increased security to be posted, the applicable notice period should be two business days, making a total of three business days.

The ability of Transporters to restrict the (inward) registration of supply points, effectively removing the ability of a User to grow its portfolio, could also curb the amount of exposure in the event of User default.

Ofgem considers that such arrangements should be applied across relevant networks in a clear and consistent manner. This would remove the potential for discrimination and make it easier for both new entrants and existing participants to familiarise themselves with the market rules and arrange their businesses accordingly, thereby better facilitating the achievement of competition between relevant shippers.

Ofgem is concerned that the provided legal text does not achieve the intent of the proposal in its entirety. If Ofgem had considered that this proposal better facilitated the relevant objectives then it would have been unable to direct the change due to this deficiency.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct the implementation of this modification. Ofgem does not consider it would better facilitate the achievement of the relevant objectives of the UNC, as set out in standard special condition A11 of relevant Gas Transporters Licences.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

Nick Simpson
Director, Industry Codes and Licensing