Modification proposal:	**Uniform Network Code (114): Quantification of Value At Risk (VAR) to determine maximum User Credit Security Requirements (UNC114)**		
Decision:	**The Authority[1] has decided to reject this proposal**		
Target audience:	**The Joint Office, Parties to the UNC and other interested parties**		
Date of publication:	**26 January 2007**	Implementation Date:	**N/A**

Background to the modification proposal

Network Operator credit cover has been the subject of a number of consultations and workgroups since March 2003. In February 2005, Ofgem issued its Best practice guidelines for gas and electricity network operator credit cover[2] (the guidelines). On 18 January 2006, Ofgem did not approve UNC modification 032 Adjustment to the number of days in the VAR calculation to bring the Code Credit Rules into line with the Best Practice Guidelines, Conclusions document Feb 2005[3]. Modification proposal 114 was raised to correct a perceived defect which, it was considered, would bring the UNC into line with a specific aspect of the guidelines.

UNC section V3 establishes that each Transporter will, in accordance with the Code Credit Rules (CCR) determine and assign to each User a Code Credit Limit (CCL), which represents the maximum indebtedness that the Transporter will extend to the relevant User. This is the amount a User will need to secure. Users that possess acceptable investment grade ratings are afforded some unsecured credit. To the extent that this unsecured credit is not sufficient to cover the CCL, User's must lodge additional security or prepay charges. User's code indebtedness is monitored every day and cash calls are made on a User when the indebtedness exceeds 85% of its CCL.

The guidelines provide that all Users must be capable of earning some amount of unsecured credit, which can be determined by their investment grade credit rating, independent assessments or good payment history. How much of this credit is deemed to be taken is to be determined by the concept of VAR. To the extent that VAR exceeds any unsecured credit, additional security must be provided. Counterparties should be issued warning notices when their VAR exceeds 85% of their credit limits and cash calls only made when they breach their credit limits.

The modification proposal

The proposal introduces the definition of VAR into the UNC. It provides that a User's VAR will equal the total amount of the previous calendar month's invoices plus an additional fifteen days of this sum averaged out. The proposal also specifies that a User's CCL must at all times be equal to or greater than its VAR.

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[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] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/creditcover

[3] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/13615_UNC032D.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasgovernance

The proposer considers this will determine the minimum value of credit limit required to be in place and the VAR figure will determine the maximum value of security a User may have to provide, dependent on the value of its credit limit.

The proposer contends that implementation of UNC114 will ensure there was no inappropriate discrimination and no inappropriate barrier to entry thereby better facilitating applicable UNC objective (d)[4], the securing of effective competition between relevant shippers.

UNC Panel[5] recommendation

At the Modification Panel meeting held on 21 December 2006, the UNC Panel recommended by majority decision implementation of modification UNC114.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 22 December 2006. 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[6].

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[7].

Reasons for the Authority's decision

The title of this modification suggests that a User's maximum Credit Security requirements under the UNC can be determined by calculating a User's VAR. However, on review of the legal text for this proposal we consider that this is not the case.

The proposal introduces a definition of CCL into the UNC and provides that this limit must be equal to or greater than the User's VAR. Using the calculation provided for VAR, it is likely that a User's minimum CCL would be considerably reduced compared to the current calculations. Ofgem notes that the current clauses which refer Users to the CCR for the calculation of CCLs have been left unaltered and consequently UNC114 would have introduced ambiguity over the correct calculation for a User's CCL. Notwithstanding this potential ambiguity, modification UNC114 seems to introduce a methodology to calculate a <u>minimum</u> value for which a User must provide security.

This minimum amount however is unlikely to prove sufficient for a User on a day to day working basis. UNC114 leaves unchanged the methodology which activates the triggers for cash calls in the UNC, which is based around assessing a User's Relevant Code

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[4] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547

[5] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

[6] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

[7] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547

Indebtedness. This is the total amount, at any point in time, the User actually owes to the Transporter, whether the amounts have been billed or not.

Notwithstanding the changes being proposed under UNC111, the UNC still provides that when assessing when a User must be sent a warning notice or in fact be sanctioned because they have breached their CCL, the Transporter must compare the User's Relevant Code Indebtedness against its CCL. The practical implications therefore of introducing UNC114 would have been a substantial increase in the number of warning notices and cash calls being made on Users unless they provided security considerably over their minimum requirement as calculated using the VAR Calculation.

It is likely that if UNC114 was implemented, Users and Transporters would have been required to increase their monitoring and administrative actions considerably. Ofgem considers that one of the underlying principles of the arrangements for credit cover is that credit arrangements should provide as secure and stable business environment as is reasonable. The increase in monitoring and administration with associated costs for both Users and Transporters could in fact reduce stability and efficiency compared against the existing arrangements.

Greater stability and efficiency could be achieved by comparing the VAR against the relevant credit limit to determine whether a given counter-party is taking more unsecured credit than allowed, in which case it must pay off some (or all) of what it owes and/or prepay future charges to bring its VAR below its limit, or post additional collateral to cover the excess.

Ofgem considers that this proposal could have benefited considerably from going through the development process where industry experts would have had the opportunity to iron out ambiguities and inconsistencies that have come through in this proposal.

Sarah Harrison
Managing Director, Corporate Affairs
Signed on behalf of the Authority and authorised for that purpose.