

Modification proposal:	Connection and Use of System Code (CUSC) CAP126: Clarification of the Applicability and Definition of Qualifying Guarantee and Independent Security (CAP126)		
Decision:	The Authority¹ has decided not to direct a change to the CUSC		
Target audience:	National Grid Electricity Transmission PLC (The Company), Parties to the CUSC and other interested parties		
Date of publication:	18 April 2007	Implementation Date:	N / A

Background to the Proposed Amendment

As part of a wholesale review of network operator credit arrangements, following wide scale discussion and consultation with the industry, Ofgem published in February 2005 its conclusions guidelines for best practice in gas and electricity network operator credit cover².

Those conclusions included a variety of tools which counterparties could use to provide the relevant amount of credit to the network operator, including but not limited to, independent security and parent company guarantees.

In December 2005, Ofgem approved CUSC modifications CAP89/90/91³ and CAP099⁴. CAP89/90/91 amended the definition of Qualifying Guarantee and CAP099 introduced a new definition of Independent Security Arrangement. Both these proposals progressed independently of each other, and encompassed a wide range of issues, which when assessed as a whole were considered to better facilitate achievement of the applicable CUSC objectives⁵ and to be in line with the Authority's statutory duties⁶. However, as outlined in the respective decision letters, there were aspects of the proposals which when considered in isolation were considered not to facilitate achievement of the applicable CUSC objectives. One such aspect was the consequential overlap created between the definitions of Qualifying Guarantee and Independent Security Arrangement and the lack of clarity around the use of Parent Company Guarantees.

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/Licensing/IndCodes/CreditCover/Documents1/9791-5805.pdf>

³ <http://www.ofgem.gov.uk/Licensing/ElecCodes/CUSC/Amend/Documents1/12413-CAP89.90.91%20D.pdf>

⁴ <http://www.ofgem.gov.uk/Licensing/ElecCodes/CUSC/Amend/Documents1/12267-CAP099%20D.pdf>

⁵ As set out in Standard Condition C10(1) of NGET's Transmission Licence, see:

http://62.173.69.60/document_fetch.php?documentid=5327

⁶ The Authority's statutory duties are wider than the matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989.

The Proposed Amendment

CAP126 provides that;

- Qualifying Guarantees shall only be able to be provided by a Parent Company and such guarantees shall only be used in a manner that would allow the User to rely on the Parents credit rating when calculating its Allowed Credit.
- Where a Parent Company provides more than one guarantee for more than one User, the aggregate value of all of its Qualifying Guarantees shall not exceed the maximum amount of credit it could obtain for itself dependent upon its credit rating.
- Parent Companies shall only be those companies that fall within the definition of a public or private company within the meaning of section 1(3) of the Companies Act 1985.
- An Independent Security Arrangement can not be provided by a Parent Company.
- Independent Security Arrangements shall only be used as a collateral tool.

The proposer considers that clarifying the applicability and definitions of Qualifying Guarantees and Independent Security Arrangements in this manner would make the arrangements more transparent. This would better facilitate both CUSC objectives by increasing efficiency and allowing Users to make more informed decisions about which credit tools they wish to utilise.

Recommendation of the CUSC Amendments Panel⁷ (the Panel)

The CUSC Amendments Panel, at its meeting on 23 February 2007 unanimously recommended implementation of CAP126, considering that it better facilitated achievement of the applicable CUSC objectives.

The CUSC Panel agreed that the implementation date should be 10 business days after an Authority decision.

The Authority's decision

The Authority has considered the issues raised by CAP126 and the final Amendment Report (AR) dated 15 March 2007. The Authority has considered and taken into account the responses to NGET's consultation on CAP126 which are attached to the AR⁸.

The Authority has concluded that implementation of the proposal put forward under CAP126 would not better facilitate the achievement of the Applicable CUSC Objectives and be consistent with the Authority's Principle Objective and General Duties.

⁷ The CUSC Panel is established and constituted from time to time pursuant to and in accordance with the section 8 of the CUSC.

⁸ CUSC amendment proposals, amendment reports and representations can be viewed on the NGET website at <http://www.nationalgrid.com/uk/Electricity/Codes/systemcode/amendments/>

Reasons for the Authority's decision

An important aspect of the credit cover arrangements is to allow counterparties the opportunity to benefit from a wide range of credit cover tools in a manner that they judge to be most efficient for them. The flexibility to use a combination of tools needs to be carefully managed so that the network operator is not exposed to undue risk but not so stringently so as to constrain the use of any particular tool.

In terms of the specific aspects of the proposal, Ofgem agrees with the proposer that where a parent company provides a *Qualifying Guarantee* for more than one User, then the aggregate value of the guarantees should be capped at the maximum level of credit the parent could have obtained in its own right.

However, Ofgem has a number of concerns with the other elements of the proposal. In particular, Ofgem considers that CAP126 introduces a number of constraints, that although clarify the ambiguity between *Qualifying Guarantees* and *Independent Security* reduces the flexibility of these tools to the extent that implementing CAP126 would be detrimental to the achievement of the applicable CUSC objectives, particularly objective (b), by potentially decreasing competition.

The first of these concerns is that CAP126 provides that *Qualifying Guarantees* can only be provided by parent companies and introduces into the CUSC a definition of Parent Company, which references the Companies Act 1985. Ofgem are concerned that this definition would exclude a User from obtaining a *Qualifying Guarantee* from a parent that is based outside the UK. Ofgem consider this to be detrimental to the achievement of applicable CUSC Objective (b).

Second, Ofgem consider that limiting the use of parent company guarantees as an *allowance* and specifically preventing the ability of a User to obtain an independent security arrangement from a parent company is restrictive and would not better facilitate the achievement of objective (b). For example, there may be circumstances when either the parent wishes to give or a User wishes to obtain credit cover via a combination of parent company security arrangements and parent company guarantee which this modification proposal would otherwise prevent.

Thirdly, a parent may wish to provide or a User may wish to obtain a capped level of security by way of a parent company guarantee, which this proposal would also prevent. In this sense a *Qualifying Guarantee* would be similar to an *Independent Security Arrangement*. Ofgem consider preventing the use of parent company guarantees in this manner to be against the achievement of the applicable CUSC Objectives. It should be possible to clarify the existing ambiguity around *Independent Security Arrangements* and *Qualifying Guarantees* and to introduce the safeguards of capping aggregate guarantees in a manner that would not be so restrictive.

Ofgem consider that the boundaries between a guarantee that is used as an *allowance* and one that is used as a *tool* can be imprecise. In both cases, the level of robustness associated with the credit cover will be dependent on the extent to which risk is transferred to the guarantor and any conditionality associated with the transfer of such risk. It may therefore be more desirable to maintain the flexibility associated with such products and focus on the robustness of their use, as opposed to introducing restrictions of the nature set out in this proposal.

Lastly, Ofgem also consider that provided the arrangements are satisfactorily robust, it should be open to Users to obtain guarantees from non affiliated companies that would allow a User to benefit from the superior credit rating of the non affiliate in substitution of its own rating i.e. as an *allowance*. In this regard such arrangements would be similar to *Qualifying Guarantees* as provided in CAP126. As such, we do not consider that restricting the grant of Qualifying Guarantees to parent companies would better facilitate the achievement of objective (b).

In summary therefore, Ofgem considers that the majority of the restrictions imposed by this proposal do not better facilitate the achievement of objective (b) and therefore that the proposal should be rejected.

A handwritten signature in black ink, appearing to read 'Mark Feather', is positioned above the printed name.

Mark Feather, Associate Director, Industry Codes and Licensing

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