Modification proposal:	**Uniform Network Code (UNC) UNC144/UNC144AV: Quantification of Value at Risk (VAR) to determine a User's minimum Code Credit Limit Requirement**		
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:	24 October 2007	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposals

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[3] (the guidelines).

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 utilised is determined by the concept of VAR. To the extent that VAR exceeds any line of unsecured credit offered by the transporter, the User must provide additional security. The guidelines provide that 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.

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.

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*.[4] Modification proposal 114 *Quantification of Value At Risk (VAR) to determine maximum User Credit Security Requirements* was subsequently raised, although this was also rejected. This was because although a VAR calculation was introduced which formed the basis of the amounts to be secured by Users, the triggers associated with the operation of the cash call process were based on something other than VAR. This would have prevented the regime from operating effectively and led Ofgem to conclude that the modification proposal would not have better facilitated the Relevant UNC Objectives.

[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] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/creditcover
[4] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/13615_UNC032D.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasgovernance

The modification proposals

The proposals introduce the definition of VAR into the UNC. They provide that a User's VAR will equal the aggregate amount (other than in respect of Energy Balancing Charges) invoiced to the User in the previous month. They also provide that Users must also secure an additional amount derived from the amounts billed in the last month.

The modification proposals also provide that VAR will determine the minimum value of the Code Credit Limit a User has to establish with the Transporter. The modification proposals seek to replace the provisions which require the Code Credit Limit to be established in accordance with the relevant Transporter's Code Credit Rules with a set of rules placed in the UNC itself.

UNC144

UNC144 provides that the additional amount should be 15 days' worth of charges derived from the sums billed but unpaid during the previous month (i.e. [previous months billed but unpaid amounts / number of days in the month]*15).

UNC144AV

UNC144AV differed from UNC144 by providing that the second element of the VAR calculation should be 20 days' charges at the average daily rate of *invoiced* charges for the month in question, rather than 15 days of charges at the average daily rate *of billed but unpaid* charges for the month in question. The proposer suggested that this was appropriate as the UNC144 calculation can result in a negative or zero value calculation at certain times of the month.

The proposer also suggested that UNC144 would be inconsistent with a recent approved amendment to the CUSC dealing with VAR, CAP127. The proposer's reasoning was that CAP127 made it clear the additional 15 days' charges reflects the fact that the invoice date for the charges in question is the 15^{th} of the month. The proposer noted that the equivalent invoicing date on the UNC is the 20^{th} of the month, and therefore concluded that it would be appropriate to require security for an additional 5 days.

UNC Panel[5] recommendation

At its meeting of 19 July 2007 the UNC Modification Panel voted to recommend the approval of UNC144AV.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 02 August 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.[6] The Authority has concluded that:

[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

1. implementation of the modification proposal UNC144AV will better facilitate the achievement of the relevant objectives of the UNC;[7] and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties.[8]

Reasons for the Authority's decision

Both UNC144 and UNC144AV would introduce a mechanism which would significantly reduce the amount of collateral a User needs to post in order to participate in the arrangements. We consider that the current arrangements, which focus on peak trading volumes and require Users to put up more credit than necessary for the majority of the year, are inefficient. The capital which is unnecessarily tied up in those arrangements prevents more efficient use of those funds and therefore restricts competition. Accordingly, Ofgem considers that both UNC144 and UNC144 AV would help secure effective competition between relevant Shippers. Ofgem acknowledges that these competition gains require Transporters to bear more risk and take a more active role in credit monitoring than under the previous regime, but considers the positive impact on Relevant UNC Objective (d) more than outweighs these potential negatives.

Replacing the provisions which require the Code Credit Limit to be established in accordance with the relevant Transporter's Code Credit Rules with rules detailed in the UNC itself will increase the transparency and consistency of the processes under the UNC. We consider that this will also better facilitate Relevant UNC Objective (d).

The two modification proposals differ most in respect of the second aspect of the VAR calculation. UNC144 seeks to secure an additional amount equivalent to 15 days' charges at the rate implicit in the calculation of billed but unpaid charges in the previous month. UNC144AV would secure 20 days additional charges, but instead of basing this part of the calculation on the amounts billed but unpaid, base it on the amounts invoiced to Shippers, irrespective of whether the bills were paid or not.

Ofgem recognises that UNC144AV has the potential to offer a more stable credit regime than UNC144, and also exposes Transporters to less risk. It does this by providing that the amount to be secured in addition to the billed but unpaid charges in the previous month should be based on a proportion of the actual charges invoiced rather than only those billed but remaining unpaid. To do otherwise could lead to some parties needing to post no or minimal credit. We consider that this would, in general, mean that such Shippers would be inappropriately under-secured. This could act to the detriment of Relevant UNC Objective (d) as it would be more likely that costs arising from shipper failure would be smeared across shippers and ultimately potentially recovered from end consumers. Therefore, we consider that UNC144AV better facilitates the achievement of the Relevant UNC objectives than UNC144.

Although we agree the inputs to the VAR calculation used in UNC144AV are appropriate we are not convinced that the inclusion of a 20 day period acts to facilitate the achievement of the Relevant UNC Objectives. An extensive industry consultation exercise led to the conclusion that credit cover should be put in place for the equivalent of 45 days worth of charges. We do not consider the fact the relevant UNC invoices fall due on the 20th of each month justifies the addition of collateral amounting to a further 5

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[7] 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

[8] 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.

days' charges. Although the proposer of UNC144AV suggested that the CAP127 letter made clear that the additional 15 days' usage reflects the invoice due date for purchases being the 15th of each month we do not believe this is wholly accurate. In respect of calculating additional days usage the invoice date is not the relevant determinant. We considered that for bills issued monthly in respect of one month's usage, the average balance of billed and accrued usage charges during any two month period will be equivalent to approximately 45 days worth of daily charges (this being the amount billed in the preceding month plus the average of the amount accrued but unbilled at the close of each day in the succeeding month). Consequently we consider that a calculation which results in securitisation of 50 days trading charges risks require Users to lodge more collateral than necessary, and to this extent may be detrimental to Relevant UNC Objective (d). Nevertheless whilst we consider this is a deficiency with proposal UNC 0144AV we do not consider it to be significant enough to override the other stated benefits relating to this proposal.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC144AV: "Quantification of Value at Risk (VAR) to determine a User's minimum Code Credit Limit Requirement" be made.

Mark Feather
Associate Director, Industry Code and Licensing

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