

Modification proposal:	Uniform Network Code (UNC) 0145: Management of Users Approaching and Exceeding Code Credit Limit (UNC0145)		
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 proposal

Network Operator credit cover has been the subject of a number of consultations and workgroups since March 2002. During the course of the debate, Ofgem has indicated the principles to which it will have regard when discharging its functions in relation to credit issues. These being;

- Incentives placed on Network Operators to manage debt efficiently.
- Arrangements not to be unduly discriminatory, or prevent the promotion of competition.
- Arrangements to provide a secure and stable business environment.
- Ofgem to take measures to protect consumers from loss of supply, in the event of a supplier or shipper's failure to maintain adequate levels of credit cover or default on payments due.

In February 2005, Ofgem issued its Best Practice Guidelines for Network Operator Credit Cover (the guidelines) encapsulating the conclusions of this debate³. Since then, industry participants have raised modification proposals against the background of these guidelines, justifying changes to the UNC against the relevant objectives.

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 Value at Risk (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.

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 [Best Practice Guidelines for Network operator credit cover](#)

Modification proposals UNC0144 and 144AV introduce the concept of VaR into the UNC and also provide that a User's VaR will determine the minimum value of the CCL a User has to establish with the Transporter. The modifications seek to replace the provisions which require the CCL to be established in accordance with the relevant Transporter's CCR with a reference to the UNC itself. Ofgem has today approved modification proposal UNC0144AV.

On 26 January 2007, the Authority rejected modification proposal UNC 0111, of the same title as this modification proposal. The detailed reasons for the Authority's decision on that proposal are provided in the decision letter for UNC0111⁴. In summary Ofgem expressed concerns that UNC0111 did not alter the mechanism determining when a Transporter would issue notices and/or take remedial action requiring a User to reduce its exposure or increase its security cover. Under UNC0111 this continued to be referenced against a Users Relevant Code Indebtedness (RCI) as opposed to the principle of VaR as defined in Ofgem's conclusions document. Ofgem considered that this would continue to require Users to over collateralise and hence was detrimental to relevant objective (d)⁵. This was considered to be the case even though UNC 0111 changed the actual values of when the triggers would be activated in a manner which was considered to promote administrative efficiencies and allow Users to utilise 100% of their CCL.

The modification proposal

The proposal provides several refinements associated with the management of Users approaching and exceeding their CCL, as follows.

- Removing the current notice requirements and availability of sanctions at 70% and 85% of RCI as a percentage of CCL respectively and introducing the requirement for the Transporter to issue a notice and ability to instigate sanctions when a User's VaR breaches 80% and 100% of its CCL respectively.
- Where a User's VaR exceeds 100% of the value of the CCL in place, the User be required to provide additional security within two business days of being notified of such, sufficient to bring its VaR to below 100% of its CCL. Where additional security is provided after two business days, the security should be sufficient to bring the User's VaR down to 80% of its CCL and the User would be required to maintain its VaR at this level for the following 12 months.
- To allow the Transporter to claim liquidated damages in accordance with the Late Payment of Commercial Debts (Interest) Act 1998 based on the value of additional security outstanding. The timetable for such sanctions to apply is detailed in the Modification Report received by the Authority⁶.
- Where a User experiences a material level of change to its level of trade, as a consequence of an increase in the relevant Transporter's transportation charges, the User to be allowed a period of one month to post any additional security. A

⁴ <http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/16833-UNC%20111%20D.pdf>

⁵ 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

⁶ UNC modification reports can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

material change being an increase in the User's VaR of 20% or greater from the previous day.

- For the Transporter to be entitled to issue a termination notice when a User's VaR exceeds 100% of its CCL.

The proposer considers that implementation of this proposal would help ensure that there was no inappropriate discrimination and no inappropriate barrier to entry. The proposer considered these measures would therefore facilitate the securing of effective competition between relevant shippers and hence better facilitate the achievement of relevant objective (d).

UNC Panel⁷ recommendation

At the Modification Panel meeting held on 19 July 2007, six out of nine voting members present voted that this proposal should not be implemented. The Panel recommendation therefore was that this proposal should not be implemented.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 19 September 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 FMR⁸. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC⁹; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties¹⁰.

Reasons for the Authority's decision

Modification proposal UNC 144AV, also approved by the Authority today, introduces the concept of VaR into the UNC. The reasons for approving that decision are provided in the Authority's decision letter for UNC 144/144AV. The proposal essentially provides that the minimum level of security a User must provide must be sufficient to cover its VaR as defined in the proposal.

Clearly there is a very close relationship between the minimum level of security a User is required to provide and the point at which the Transporter is entitled to take action if a User's trading suggests it will breach those security levels or in fact does breach those security levels.

⁷ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

⁸ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁹ 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

¹⁰The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

Currently, those trigger points are linked with a User's RCI. Where the actual amounts outstanding from a User breach 85% of its CCL, then the Transporter would be entitled to reject applications for system capacity, system capacity trades and refuse supply point nominations or confirmations.

Ofgem considers that changing the mechanism to determine when a notice should be sent out or more remedial be taken as proposed under UNC0145 will create a more secure and stable business environment. To have left the mechanism unchanged would have meant frequent cash calls being made on Users who chose to put in place the minimum level of security as provided for under UNC 0144AV, since this would have left the RCI rules unchanged. This would have meant the amounts to be secured would have been based against VaR but the triggers associated with the operation of the cash call process would have been based against RCI.

We consider that debt accrued as a result of transportation charges accrues at a relatively steady rate, in comparison to for example debt that can accrue for energy balancing charges. Therefore Ofgem considers, in relation to transportation debt, it is appropriate that Transporters do not take excessive or unnecessary action prior to any breach of security cover. Network Operators should closely monitor all Users individual VaR and issue a warning notice when the VaR approaches the User's CCL. Ofgem considers the timing for issuing the notice needs to be of practical benefit to the User. It should not be issued too early, and therefore likely to be ignored because the User considers there not to be a risk of a subsequent breach of its CCL. Conversely, the notice should not be issued too late, where a User could not take mitigating actions to prevent a breach of its CCL. UNC0145 provides for such notice to be issued when a User's VaR breaches 80% of its CCL. It is open for parties to propose a different trigger point, if they consider 80% does not strike the appropriate balance. Many respondents have commented that preventing Transporters from taking more remedial actions at the 80% stage, to stop a User's VaR breaching 100% of its CCL increases the contractual risk on the Transporter and potentially on the rest of the User community in the event of a subsequent User failure. Given the relative predictability of transportation debt, Ofgem considers this increase in risk is not outweighed by the benefit of reduced costs associated with Users having to otherwise over collateralise. These costs would be incurred because if a Transporter could take more remedial actions at a breach of 80%, then effectively this would be the equivalent of valuing the security in place by a User at only 80% of its true value. We consider therefore that this aspect of UNC145 better facilitates achievement of relevant objective (d).

Associated with closely monitoring a User's VaR, Ofgem considers Transporters should have the ability to take rapid action at the instance a User's VaR breaches its CCL. This should create an incentive for Users to ensure that any breach of its credit limit will not be taken lightly. The sanctions available to the Transporter under UNC145 are detailed in the Final Modification Report and summarised above. Ofgem considers the possibility of being subject to such sanctions should encourage Users to trade responsibly, decreasing the possibility of bad debt being smeared across the market. This should lead to an increase in market confidence which is a necessary ingredient for a competitive market. This should better facilitate achievement of applicable objective (d) and is also in accordance with the Authority's principal objective as it will ultimately lead to benefits for the end consumer. Provided that Transporters closely monitor in practice a User's trading profile, they will be in a position to quickly take decisive action, in appropriate circumstances, in the event of a User failure, thereby preventing the accrual of a large amount of bad debt which ultimately may have had to have been recovered from the end consumer.

Ofgem expects Users to be fully aware of the measures available to the Transporter under UNC0145 for a breach of their CCL. It may be beneficial for Users to give themselves sufficient flexibility to minimise the risk of a breach, which may occur if Users decided to post only the absolute minimum amount of security. However Ofgem considers it should be Users who manage the amount of security they post and determine a level sufficiently comfortable for their business and trading model.

Where a User is required to post additional security to bring its VaR down to 80% of its CCL and maintain it at this level for 12 months, some respondents questioned what would happen if the User's VaR then subsequently breached its CCL again, within this 12 month window. Ofgem considers the legal text provides that in the instance following the first breach, any security posted would be valued at 80% of its actual value. So for example, to cover a VaR of £100, the User would need to lodge £125 of security. The Users trading would then be monitored in the usual way and if its VaR went above £100 (to say £101), the Transporter would have the sanctions provided by UNC145 available, notwithstanding that the User has actually posted £125 of credit. Ofgem consider this to be an appropriate measure, to incentivise Users to manage their business responsibly, for the reasons outlined in the above paragraph.

Ofgem agrees in instances where Users are required to provide additional security as a result of an increase in Transportation Charges they be provided a period of one month to post such additional security.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 0145: Management of Users Approaching and Exceeding Code Credit Limit be made.



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