

Modification proposal:	<b>Uniform Network Code (UNC) 299: (UNC299) 'RG252 Proposal 2: Alignment of portfolio sanctions across Sections V and S of the UNC'</b>		
Decision:	The Authority <sup>1</sup> rejects this proposal <sup>2</sup>		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	28 September 2010	Implementation Date:	Not applicable

## Background to the modification proposal

As with any competitive market, there is a possibility that an energy company using the gas and electricity networks to supply their customers may face financial difficulties at some point in its life. Given that those networks are natural monopolies their operators are required to offer access on equitable terms, while Users are not able to go elsewhere if they do not like those terms.

A balance therefore needs to be struck, to ensure that network operators are able to properly manage the financial risk that network Users may impose, while maintaining credit cover and payment terms which do not unduly restrict access to and use of those networks. With this in mind, in 2005 Ofgem published its best practice guidelines for gas and electricity network operator credit cover ('the guidelines')<sup>3</sup>.

The aim of the guidelines was to ensure that network operators' credit cover and payment terms were proportionate, allowing network operators to properly manage, rather than wholly avoid, any exposure to financial risk. The guidelines also set out our views and criteria for the pass through of any bad debt. This could be summarised as requiring a demonstration of adherence to best practice, as may be set out in the guidelines or elsewhere. In recognition that best practice is constantly evolving, we suggested that the guidelines should remain under periodic review.

Review Proposal 252 was raised in April 2009. Its aim was to review the UNC credit arrangements for transportation charges and consider whether they remained fit for purpose in light of the many credit issues since the publication of the guidelines. Examples of such issues are the collapse of financial institutions such as Lehman Brothers and the wider 'credit crunch'. The Review Group came forward with 14 recommendations, each of which has now been raised as an individual modification proposal.

## The modification proposal

UNC299 seeks to align the timescales in which the Gas Transporter (GT) may elect to apply portfolio sanctions on Users, entitling them to refuse to accept a Supply Point Nomination or Supply Point Confirmation. These sanctions are currently set out in both Sections S and V of the UNC.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

<sup>3</sup> <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=9791-5805.pdf&refer=Licensing/IndCodes/CreditCover>

The Section S sanction may apply where an invoice of not less than £10,000 has become due for payment. It may be applied from the day after the due date and last until the User has paid the amount owing in full.

The Section V sanction may be applied in circumstances where the User's Value at Risk (VAR)<sup>4</sup> exceeds 100% of their Code Credit Limit (CCL)<sup>5</sup>. If a User's VAR exceeds their CCL they will receive a Notice from the GT requesting that they put in place further security. The sanction may be applied from the fifth Business Day after the date specified in the Notice.

UNC299 seeks to amend Section V3.3.1 such that sanctions for a User's CCL exceeding their VAR will apply after one business day.

### **UNC Panel<sup>6</sup> recommendation**

At its meeting of 19 August 2010 the UNC Panel recommended by a majority that the proposal be implemented.

### **The Authority's decision**

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 23 August 2010. 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<sup>7</sup>. The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC<sup>8</sup>.

### **Reasons for the Authority's decision**

We note that of the eleven responses to the Joint Office's consultation, nine were in support, with a further respondent offering qualified support. Only one respondent was opposed.

A common theme in responses from those in support, including a smaller and relative new entrant to the market, was that it is appropriate for the GTs to be able to trigger sanctions in order to ensure that parties maintain an appropriate CCL. There were few other substantive comments.

The respondent who offered qualified support suggested that the legal text needed to clarify what was meant by "the date specified in the notice"; i.e. whether it was the date the Notice was issued or some other date the GT may set.

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<sup>4</sup> The VAR is a dynamic value and is at any point in time the sum of the aggregate amount invoiced to the User (excluding Energy Balancing Charges) which are unpaid, and the average daily amount invoiced to that User (again, excluding Energy Balancing Charges) over the previous calendar month \* 20.

<sup>5</sup> The CCL is the sum of the User's Unsecured Credit Limit and any additional security the User may have provided. The User is expected to ensure that their CCL remains at least equal to their VAR.

<sup>6</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

<sup>7</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.com](http://www.gasgovernance.com)

<sup>8</sup> 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](http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547)

The respondent who was opposed to the implementation of UNC299 suggested that the reduction from 5 to 1 day in which portfolio sanctions could be applied seemed overly harsh, potentially disproportionate and leaves little room for remedial action from the User for mistakes to be queried and corrected. They noted that unlike energy balancing, transportation credit debt is more slowly and predictably accrued, with correspondingly less pressing timescales. They were concerned that GTs may act to hastily, which could have serious consequences for the User if they act prematurely.

In order to assist our assessment of these credit proposals we have referred back to the principles<sup>9</sup> which set the framework for the development of the guidelines, which were that:

- Incentives need to be placed upon the network operators to manage debt efficiently;
- Arrangements must not be discriminatory, or prevent the promotion of competition;
- Credit arrangements should provide as secure and stable a business environment as is reasonable; and,
- Ofgem should take measures to protect consumers from loss of supply in the event of a shipper or supplier's failure to maintain adequate levels of cover or default on payments due

In the context of UNC299 we consider that these principles can largely be captured under relevant objective d), though we also consider that this proposal may have implications for relevant objective f). We have not identified any material impacts upon the other relevant objectives.

***Relevant Objective (d): the securing of effective competition between relevant shippers; between relevant suppliers; and/or between DN operators;***

With respect to the credit cover best practice principles, we considered that there are two ways that incentives can be placed on network operators. First, an ex-ante approach where an up-front allowance is made in the price control for bad debt. Second, where no explicit ex-ante allowance is made, the network operator has to demonstrate to Ofgem that it has managed the debt appropriately (for example by requiring appropriate collateral and acting efficiently in billing and collecting debts) before being able to claim for an exceptional bad debt.

We continue to view the latter approach as being the more effective, as an ex-ante arrangement could create a strong incentive for the network operators, left to their own devices, to take a disproportionately cautious view on unsecured credit, which in turn may lead to precipitous actions. To the extent that the GTs can demonstrate that they have adhered to the code rules and best practice more generally, they are protected insofar as they can apply for a pass through of that debt, allowing them to recover it through future charges. For instance in electricity Distribution Price Control Review 5 we admitted total bad debt costs of £6.4m because best practice and prevailing code requirements had been adhered to.

Therefore, while we agree that it is necessary for the UNC to provide the GTs with sufficient sanctions in order to ensure both that an appropriate Code Credit Limit (CCL) is

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<sup>9</sup> Arrangements for gas and electricity network operator credit cover. Conclusions and proposals document 06/03.

maintained and that invoices are paid in a timely manner, we do not consider that UNC299 represents an improvement to the existing arrangements. All else being equal, we consider that the non-payment of an invoice which is past due is a more serious contravention of the UNC credit rules than an extended VAR. The late payment of an invoice may be a useful indicator of a User's financial situation, whereas the CCL and VAR are necessarily dynamic values and an instance of the CCL being exceeded may simply indicate that the User is becoming more active and/or that their business is growing, rather than it being in any financial difficulty.

An increase in a User's activity may not necessarily translate into an increase in cash readily available to them and alternative forms of Security or Surety may take a reasonable amount of time to arrange. We therefore consider that there are good reasons why timescales for the application of sanctions currently differs between Sections S and V of the UNC. Reducing the time available for Users to increase their CCL from 5 to 1 Business Day could be unduly precipitous. We note the comments of GT respondents, that they would give due regard to the particular circumstances and not act in a precipitous manner. However, that degree of discretion also raises the concern that sanctions may be applied in a subjective rather than entirely objective and non-discriminatory fashion.

For the reasons set out above, we consider that this proposal will have a disproportionate and detrimental impact upon new entrants and smaller parties who may require a flexible CCL but not necessarily have immediate access to cash or other forms of security. To the extent that this proposal would constitute a barrier to entry and/or a subsequent constraint on their growth, we consider that it would be detrimental to securing effective competition between shippers and between suppliers.

***Relevant Objective (f): the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;***

To the extent the implementation of UNC299 would align the credit requirements in Sections S and V of the UNC and facilitate a single process which is clear to all Users, we would agree that it could further the efficient administration of the UNC. However, we also note that while the proposal intends to reduce the Section V Sanction to one Business Day, the Sanctions in Section S do not refer to Business Days and could apply from the next Calendar Day.

Notwithstanding this drafting anomaly, we consider that any benefits to the efficient administration of the UNC would be outweighed by the detrimental impacts to competition, as outlined under relevant objective d) above. We therefore reject UNC modification proposal 299: '*RG252 Proposal 2: Alignment of portfolio sanctions across Sections V and S of the UNC*'.

**Rachel Fletcher**

**Partner, Distribution**

Signed on behalf of the Authority and authorised for that purpose