Modification proposal:	**Uniform Network Code (UNC) 298: (UNC298) 'Amend and remove Section V3 inconsistencies errors and bi-lateral insurance clause'**		
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:	14 January 2011	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

In 2005 Ofgem published its best practice guidelines for gas and electricity network operator credit cover ('the guidelines')[3]. 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.

Review Proposal 252 was raised in April 2009. Its aim was to review the Uniform Network Code (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

This modification proposal has three main elements as follows:

Credit Cover

Paragraph 3.47 of the guidelines stated that where a counterparty (User) experiences a material change in its level of trade, a reassessment of required credit cover may be necessary. Where this has occurred as a result of an improved charge forecast by the network operator, counterparties should have one month's notice of any need to increase collateral.

The Review Group considers that this provision has been misinterpreted within the UNC. The UNC currently allows an additional 30 days for a User to arrange credit facilities following a change of 20% or more to their credit requirement where this is linked to an increase in transportation charges.

The Review Group considered that the 20% threshold should be replaced with a materiality test, allowing for discussion between the Gas Transporter (GT) and the relevant User, which could take into account the specific circumstances. The Review Group also considered that the reasons for the change in the level of charges were

[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/Pages/MoreInformation.aspx?file=9791-5805.pdf&refer=Licensing/IndCodes/CreditCover

significant. For instance, a material change in credit cover requirements owing to a price change should be reasonably foreseeable (given notice requirements), whereas a change in the User's portfolio may be in reaction to an external driver and therefore not anticipated by the User. These differing circumstances may determine whether an additional 30 days to secure the necessary credit cover is considered appropriate.

Sanctions

Under existing provisions, where a User's Value at Risk (VAR[4]) exceeds 80% of its Code Credit Limit (CCL) the GT will notify them that they are approaching their CCL. If the User's VAR subsequently exceeds 100% of their CCL, the GT will issue a Notice giving the User two Business Days to provide an amount of additional Surety or Security specified in the Notice, in order to reduce VAR below their CCL.

Where the User fails to provide additional Surety or Security by the date specified in the Notice, the following measures apply under Section V3.3.2(a):

- the amount of surety or security required from the User is increased to the level required to reduce the User's Value at Risk to below 80% of its Code Credit Limit, and
- any surety or security provided by the User is re-valued at 80% of its face value for the following 12 calendar months.

The Review Group raised concerns over the enforceability of the two measures set out above and considered that it was unclear what the original intent of including them had been. They also questioned whether they are consistent with the guidelines. The group therefore considered that it would be appropriate to remove the two existing measures set out at Section V3.3.2(a).

Bi-lateral insurance

Paragraph 3.35 of the guidelines stated that various tools should be available to counterparties to allow them to cover any exposure beyond their unsecured credit limit. It also stated that it would be for each counterparty to determine which, how many, and in what percentage they are used, placing the makeup of the 'basket' within the control of the counterparty. Among the tools listed was *bi-lateral* insurance.

These elements of the guidelines were subsequently raised as UNC modification proposal 109: '*Acceptable Security tools available to Users for Transportation Credit Arrangements'.* Some respondents, in particular National Grid raised concerns over the use of bi-lateral insurance. It stated that bi-lateral insurance would only be likely to cover the first or second transportation charge payments missed by the User, after which the insurer may effectively relinquish its risk. National Grid therefore feared that such a tool could potentially expose the industry to significant financial risk and did not advocate bi-lateral insurance.

Ofgem rejected UNC109 due to concerns over its treatment of Parental Company Guarantees. However, we also commented on bi-lateral insurance, noting that when a security tool is an insurance product the terms relating to the product should be

[4] 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 multiplied by 20.

unconditional in all material matters for the tool to be rated at full value. If it is the case that a bilateral insurance policy will only pay out for the first and second payments then the tool should either be adjusted so that it provides appropriate security, or rated at below its face value.

The intent of UNC109 was largely fulfilled with the subsequent acceptance by the Authority of UNC146: '*Acceptable Security Tools available to Users for Transportation Credit Arrangements*', which was implemented on 23 October 2007. Amongst other things, UNC146 introduced into the UNC the concept of bi-lateral insurance being used as credit cover, being defined as follows:

> "**Bi-lateral Insurance**" shall mean a policy of insurance (that is unconditional in order to attain 100% of its face value) for the benefit of the Transporter, provided by a Qualifying Company and in such form as is acceptable to the Transporter.

However, the Review Group confirmed that to date no provider of such a bi-lateral insurance product for the purposes of the UNC has been identified and there is no known demand for one from GTs or UNC Users. UNC298 therefore seeks to remove references to such a product.

UNC298 also seeks to correct various typographical errors within Section V.

The proposer considered that, overall, this proposal would further competition between shippers by allowing for the adoption of appropriate credit terms. For instance, any User whose portfolio increases materially in an unanticipated manner will be given an appropriate time period to alter its credit limit position without any sanctions being applied. The proposer considered that this would further facilitate relevant objective d).

The proposer also considered that removing redundant references to bi-lateral insurance will promote efficiency in the administration of the UNC, facilitating relevant objective f), since no party will waste time considering a credit instrument which is unavailable.

UNC Panel[3] recommendation

At its meeting of 19 August 2010 the UNC Modification Panel voted unanimously to recommend that this 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 21 December 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[5]. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC; and

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

2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[6].

Reasons for the Authority's decision

Of the eleven responses to the Joint Office's consultation, eight were in support of its implementation, two offered qualified support and one provided comments only[7].

One of the respondents offering qualified support was uncertain whether UNC298 would remove the ability of a User to utilise a Performance Bond issued by an insurance company, which can be cheaper than a Letter of Credit. Whilst the proposal has not been amended to address this point, the proposer has confirmed that this proposal relates to bilateral insurance only and no other documents of security.

Like the UNC Panel, we have considered UNC298 against relevant objectives d) and f). We consider that UNC298 has no discernible impact upon the other relevant objectives.

Relevant Objective (d): the securing of effective competition between relevant shippers and between relevant suppliers;

We consider that while a reduction in the risk of bad debt will have a positive impact upon confidence in the market and therefore upon competition, this must be balanced with the need to ensure that credit arrangements are not unnecessarily burdensome and expensive to Users of the networks. Otherwise, those credit requirements could restrict access to and use of those networks and impinge upon competition.

While supporting most elements of the proposal, one of the respondents offering qualified support and another offering comment withheld full support owing to concerns over the trigger for a change in credit cover requirements being changed from an explicit 20% threshold to a materiality test. Both considered that this would create a risk of inconsistent interpretation and result in disputes. They stated a preference for greater definition of and guidance on what qualifies as a material change.

Whilst we agree that the replacement of a quantitative threshold with an element of discretion may make the application of Section V marginally less clear to users, the materiality test was at the heart of the proposer's rationale. They considered that a hard coded threshold removed the GT's ability reasonably to take into account differing circumstances. We agree that it is appropriate for the GT to use discretion in efficiently managing their credit risk. To the extent this may result in differing outcomes for different Users, this must be based on a reasonable assessment of the circumstances of each User and not unduly discriminate. We acknowledge that this flexibility may be marginally more of an administrative burden than a codified threshold, though it will allow the GT to more effectively manage their credit risk in keeping with the guidelines.

We also consider that this will only relate to a transitional period, as the other provisions of Section V will ensure that the User's CCL must be commensurate to their VAR.

[6] 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.
[7] The FMR records SSE as offering comments only, though its response letter dated 20 July 2010 supports all elements of the proposal.

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

We agree that the correction of typographical errors and the removal of redundant provisions, such as that relating to an unutilised bi-lateral insurance product will improve the administrative efficiency of the UNC. Should a suitable trade or credit insurance product in future be identified and made available to the market, it may be appropriate for the GTs to consider its inclusion amongst the range of credit tools available to Users. In the meantime, we agree with the proposer and those respondents who commented, that references to it are currently an unnecessary complication within the UNC, potentially leading to confusion and futile enquires.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC298: *'Amend and remove Section V3 inconsistencies errors and bi-lateral insurance clause'* be made.

Rachel Fletcher
Partner, Distribution
Signed on behalf of the Authority and authorised for that purpose