

Modification proposal:	Uniform Network Code (UNC) 309: (UNC309) 'Timeframes for establishing and extending Guarantees and Letters of Credit'		
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 Review Group considered that while Guarantees and Letters of Credit (LoC) may provide an equivalent level of surety, credit risks may arise as they approach their expiry dates. There is also a difference in their relative values as they approach their expiry dates. The Review Group considered that once a LoC has expired it has zero value and that it cannot be utilised to recover unpaid invoices, including those raised prior to its expiry date. In contrast, while a Guarantee will cease to have any value as surety once it has expired, it can still be utilised to recover unpaid invoices which were raised prior to its expiration.

The modification proposal

This modification proposal seeks to clarify that both Guarantees and LoCs will be deemed to have zero value for a User's Code Credit Limit purposes 30 days before expiry. However, whilst a replacement guarantee facility put in place before this point will only have to be valid from the date of expiry of the old facility, a replacement letter of credit will need to be effective from the point 30 days before expiry of the old facility.

The Proposer considers that UNC309 will further relevant objective (f)⁴ by more clearly defining the timeframes within which shippers may opt to use the surety available to them to maintain their Code Credit Limits with Gas Transporters (GTs).

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>

⁴ 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

The proposer also considered that this proposal would further secure effective competition between shippers by reducing the risk of GTs being 'timed out' from claiming on certain surety credit forms, which could lead to bad debt being passed through to Users via transportation charges.

UNC Panel³ 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 FMR⁵. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties⁶.

Reasons for the Authority's decision

Of the eleven responses to the Joint Office's consultation, ten were in support of its implementation with one opposed, though few provided substantive comments or related them to the relevant objectives. Like the UNC Panel, we have considered UNC309 against relevant objectives d) and f). We consider that UNC309 has no discernible impact upon the other relevant objectives.

Relevant Objective (d): so far as is consistent with subparagraphs (a) to (c) the securing of effective competition between relevant shippers and between relevant suppliers;

Whilst we agree that a reduction in the risk of bad debt may have a positive impact upon confidence in the market and therefore upon competition, no evidence has been provided on the number of instances where a GT has been unable to recover debt owing to the expiration of a Guarantee or a LoC, nor have we been provided with any information profiling the typical duration of such instruments of surety or lead times for their renewal. We are therefore unable to reach any conclusions on the extent to which the existing provisions may contribute to the risk of bad debt. However, we agree with those respondents who suggested that the implementation of this modification would reduce the risk of GTs being 'timed out' of their ability to make claims against these credit instruments. This may, in turn, reduce the likelihood of bad debt being incurred and potentially passed through to shippers.

The respondent who was opposed to the implementation of this proposal suggested that it would be inappropriate to deem that a form of credit has zero value before it has expired. They also considered that this would lead to additional costs owing to the need

for a new LoC to be in place while the old one is still in effect. They suggested that it should be sufficient for the shipper and GT simply to agree the Code Credit Limit one month prior to the expiry of any form of surety or security.

We understand that the terms and conditions of a particular Guarantee or LoC may differ on a case by case basis. However, the UNC must provide a robust and transparent framework upon which all parties can base their credit arrangements.

Charges incurred under the UNC do not immediately become payable and in the event of an overdue invoice various steps must be followed in accordance with Section V of the UNC before any credit instrument can be drawn upon for payment. We therefore consider that it is reasonable for the UNC to include a 'buffer period' to ensure that any credit instrument in place may be appropriately utilised. The existing provisions give rise to some risk of a gap in credit cover because replacement agreements cannot be relied upon as surety for the period prior to the commencement of their validity.

In the absence of any evidence to the contrary, we consider that a 30 day buffer provides a reasonable period ahead of which credit arrangements must be rearranged. Although this may impose a degree of additional cost during the transitional period, this will be subject to the terms and conditions of that credit arrangement and shippers should be in a position to manage them effectively. However, we would be open to a substantiated proposal for this 30 day period to be revised downward if practicable, potentially reducing costs to Users.

We consider that it is appropriate for the UNC to have a clear and standard cut off period for all such credit instruments, though this does not necessarily preclude the relevant GT agreeing to a shorter period on a bi-lateral, but objective and non-discriminatory basis. The GT must also be mindful that any deviation from established best practice may be taken into account in the event that the agreement results in a bad debt which they then wish to pass through to transportation charges.

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

We consider that this proposal will better facilitate the efficient administration of the UNC to the extent it will provide for the clear and unambiguous treatment of credit instruments which are approaching their expiry date. This should allow shippers a sufficient notice period in which to make alternative arrangements and avoid any misinterpretation or disputes about when the relevant credit tool is deemed to lapse.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification UNC309: '*Timeframes for establishing and extending Guarantees and Letters of Credit*' be made.

Rachel Fletcher
Partner, Distribution

Signed on behalf of the Authority and authorised for that purpose