Modification proposal:	**Uniform Network Code (UNC) 360: Removal of Credit Rating Restrictions from Definition of Parent Company (UNC360)**
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:	29 June 2011
Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

On 5 November 2010 the Authority directed that UNC modification 305 '*Unsecured Credit Limit allocated through payment history*' be accepted. The effect of this modification was to limit the availability of unsecured credit based on payment history alone to the first two years of the User's accession to the UNC. After that time, the User would be required to utilise alternative mechanisms in order to obtain unsecured credit. UNC305 is scheduled to be implemented with effect 1 July 2011.

Users who do not have an approved credit rating allocated by an agency such as Moody's, Standard & Poor's or Fitch, or with a rating below the UNC prescribed minimum of BB- or Ba3, are instead able to obtain an independent credit assessment, under paragraph 3.1.7 of Section V of the UNC. In either case, the rating provided in relation to the User designates a percentage value of the relevant Gas Transporter's Maximum Unsecured Credit Limit[3] to be the highest amount allowed as the User's unsecured credit limit.

In instances where a User's credit rating is insufficient to generate an adequate credit limit, it is possible for a parent company's rating to be considered instead, where that parent company provides a suitable guarantee in respect of the User's liabilities. However, the prevailing UNC provisions require the parent company to have a Moody's, Standard & Poor's or Fitch rating of not less than BB- or Ba3. An independent credit assessment of the parent company is presently not admissible for this purpose.

The modification proposal

UNC360 seeks to remove the current restriction on parent companies which do not hold a Moody's, Standard & Poor's or Fitch rating providing an effective parent company guarantee (PCG). The proposal provides for a parent's independent credit assessment rating to be used in the place of the User's to designate a maximum level of unsecured credit limit for the User provided a suitable PCG is provided.

UNC Panel[4] recommendation

At its meeting of 16 June 2011 the UNC Panel voted to recommend rejection of this proposal citing concerns that the modification could increase the general level of credit risk to which Transporters and Users generally are exposed.

[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] The Maximum Unsecured Credit Limit is set at 2% of a Transporter's Regulatory Asset Value (RAV),
[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 16 June 2011. The Authority has also 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[6]; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[7].

Reasons for the Authority's decision

There were 11 responses to the Joint Office's consultation. Of these, five were in favour and five were opposed, with the remaining respondent offering comments only. We agree with the proposer and the UNC Panel that this proposal should be assessed against relevant objective (d), as it is of neutral impact to the other objectives.

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

A common theme amongst those respondents who were opposed to this proposal was that it would increase the risks of bad debt to the Gas Transporters who would then seek to pass it through to the wider industry and ultimately consumers. No respondent attempted to quantify this increased risk or give any indication of its materiality, though some suggested that the lack of quantification of risk contributed to their opposition.

One respondent included a quote from the Standard & Poor's website which defined companies with a BB- credit rating as being "*Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions*"[8]. The respondent therefore considered that allowing companies with a credit rating lower than BB- greater access to credit is not be in the long term interests of the market.

Those who were in favour of UNC360 all cited the benefits to competition. Some elaborated that this would facilitate market entry and growth by small participants who would not typically qualify for an approved credit rating or who could not justify the expense of obtaining a rating from a major ratings agency.

The respondent who offered comments only recognised that this proposal would potentially benefit smaller participants while increasing the risk of exposure to bad debt, leading them on balance to be neither for nor against the proposal.

One shipper noted that the use of PCGs has been dealt with differently in relation to energy balancing credit cover, for which the option of using a PCG as an acceptable form of security was removed by (what was then National Grid Network Code) Modification

[5] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[6] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/index.php?pk=folder590301
[7] 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.
[8] www.standardandpoors.com/ratings/definitions-and-faqs/en/us

572[9]. However, as noted in our decision letter on modification 572 and consistently throughout the development of the Best Practice Guidelines[10], we consider that the treatment of credit cover for energy balancing is fundamentally different to that for network charges, to which UNC360 relates.

More recently, we directed that modification UNC146[11] be made. This modification specified a range of tools that could be utilised in order to secure any exposure beyond Users' unsecured credit limits. Our decision was based in part on the potential for UNC146 to lower barriers to entry. In that decision we stated that:

> "Ofgem agrees it is appropriate to allow the substitution of a User's credit limit with any higher unsecured credit limit applicable to another entity (be that entity affiliated with the User or not). Such a guarantee must however be sufficiently robust. It must also be either unlimited or, if limited, it must ensure that the unsecured credit limit assigned to a User does not exceed the limit of the guarantor's ability to take on and successfully manage risk."

We consider that in limiting the use of a PCG in generating an unsecured credit limit for a User, to a maximum amount designated by an independent credit assessment of the parent company, UNC360 does adequately reflect the parent's ability to take on and manage the financial commitment concerned. There is still a degree of dependence on the terms of the PCG being robust and monitoring to ensure that the parent is not able to offer guarantees to more than one User which in aggregate exceed the amount indicated by its own credit assessment rating. However, we consider that this is a reasonable expectation of a prudent Gas Transporter in managing its own exposure to risk.

It is also important to note that UNC146 sought to specify a range of tools that could be used above and beyond existing unsecured credit limits. With the withdrawal of unsecured credit based on payment history alone (for all but the very recent market entrants), it is all the more appropriate to ensure that market entrants are able to utilise whatever credit tools are available to them.

In light of the above considerations, we agree with those respondents who suggested that implementation of UNC360 should better facilitate effective competition, in particular by reducing barriers to entry into the market and allowing new entrants to grow their business without unnecessarily tying up cash which could otherwise be used as working capital.

The legal text produced for UNC360 also takes the opportunity to revise certain references to the Companies Act 1985, which has been substantively replaced by the Companies Act 2006. Whilst these revisions were not specifically cited by the proposer, they did acknowledge that certain ancillary changes may be required to Section V in order to meet the aim of the proposal. We consider that these additional changes are in keeping with the intent of the proposal and ensure that the legal text is fit for purpose.

---

[9] Network Code modification 572: 'The provision of Letters of Credit for energy balancing credit cover', which the Authority directed to be implemented 29 April 2003.
[10] Best practice guidelines for gas and electricity network operator credit cover, February 2005: Ref 58/05. See: www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=9791-5805.pdf&refer=Licensing/IndCodes/CreditCover
[11] UNC146: 'Acceptable Security Tools available to Users for Transportation Credit Arrangements'

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC360: '*Removal of Credit Rating Restrictions from Definition of Parent Company*' be made.

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