

Modification proposal:	Uniform Network Code (UNC) 109: Acceptable Security Tools available to Users for Transportation Credit Arrangements (UNC109)		
Decision:	The Authority¹ has decided to reject this proposal		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	26 January 2007	Implementation Date:	N/A

Background to the modification proposal

At present each Transporter determines which forms of credit cover may be utilised on its network. In February 2005 Ofgem published a conclusions document in relation to the *Best practice guidelines for gas and electricity network operator credit cover*.² That document set out a number of recommendations including Ofgem's view on the tools which should be available to counterparties to allow them to cover any exposure beyond their unsecured credit limit. These tools included:

- ◆ An approved letter of credit (LoC) or equivalent bank guarantee from a bank with a long term debt rating of not less than A by Moody's KMV or Standard and Poors;
- ◆ Cash deposit /prepayment (payment made before the delivery of the service);
- ◆ Advance payment (payment made after the delivery of a service but before contract settlement);
- ◆ An approved ESCROW account;
- ◆ A performance bond (provided by an insurance company, not a bank);
- ◆ Bi-lateral insurance; and
- ◆ Independent security.

The modification proposal

The proposer of UNC109 considered it appropriate to raise a modification to the UNC aiming to reform the credit cover provisions of the UNC as it felt that a move towards recognised best practice would help ensure that there is no inappropriate discrimination and reduce inappropriate barriers to market entry. The proposer considered that in this way the modification would facilitate the securing of effective competition between relevant shippers.

UNC109 was described as seeking to introduce the following tools for posting security within the UNC; it also provided that these could be used in any combination:

- ◆ An approved Letter of Credit or equivalent bank guarantee from a bank with a long term debt rating of not less than A2 by Moody's or Standard & Poor's,
- ◆ Prepayment agreement (payment made before the delivery of the service),
- ◆ A performance bond (provided by an insurance company, not a bank),
- ◆ Independent security,
- ◆ Deposit Deed Agreement (including cash deposit, advance payment or payment made after the delivery of the service but before contract settlement), and
- ◆ Parent Company Guarantee.

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 http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf

National Grid considered that bilateral insurance would only be likely to cover the first or second transportation charge payments missed by the User, after which it was asserted the insurer effectively relinquishes its risk. National Grid therefore considered that the long term credit exposure would not be effectively transferred by such an insurance product, and this would be incompatible with the nature of the transportation billing process in which significant debt can be incurred. National Grid feared that such a tool could potentially expose the industry to significant financial risk and therefore did not advocate bi-lateral insurance within the modification proposal.

UNC Panel³ recommendation

At the Modification Panel meeting held on 21 December 2006, of the 9 Voting Members present, capable of casting 10 votes, 10 votes were cast in favour of implementing this Modification Proposal. Therefore, the Panel recommended implementation of this Proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 22 December 2006. 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.⁴

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC.⁵

Reasons for the Authority's decision

This modification proposal seeks to codify within the UNC the tools through which a User may secure any exposures it has to use of system charges over and above the extent of its unsecured credit limit. We note that a number of respondents supported the modification proposal on the basis that the tools covered by the modification proposal are already available within the UNC, but that the insertion of an ongoing obligation allowing the use of these tools by all Users was a positive step. We agree that the standardisation of the tools through which a User's credit exposure can be secured would lower barriers to entry. We also consider that to the extent these tools are not currently accepted by all Transporters, the development of a standardised approach to this issue would benefit the market by promoting consistency, which would thereby facilitate the achievement of Relevant UNC Objectives (d) and (f), even though this may mean some Transporters taking on an increased level of contractual risk.

We consider the proposed inclusion of a LoC as a credit tool is a positive step. We note the submission of one party that the definition for LoC could generate disputes as it does not clearly define what form is required, and this could be avoided were a standard form agreed between parties and included in the UNC. Whilst we agree that it may be useful

³ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

⁴ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁵ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547

for the industry to agree a standard form of the type suggested we do not consider it essential. Should a proposal be developed which included this element we would of course consider the suggestion on its merits.

The legal text for UNC109 also seeks to introduce what it described as “cash or advance payment in the form of a Deposit Deed” and a “Prepayment Agreement”. We assume these definitions in the legal text seek to cover circumstances where a User may seek to lodge money with the Transporter in order to cover bills as and when they arise (i.e. payment before the delivery of a service), as well as circumstances in which a User which has received an identifiable bill but wishes to pay the amount early (i.e. payment made after the delivery of a service but before contract settlement). The inclusion of such provisions within the UNC would provide Users more flexibility in relation to the payment of their bills. It could also reduce the burden on small companies which may otherwise need to more closely monitor their payment record with a view to establishing a line of unsecured credit based on their payment history. As such we consider this inclusion would better facilitate the achievement of Relevant UNC Objective (d). Notwithstanding the above, it is not immediately clear which of the proposed UNC definitions seeks to cover which type of ‘up-front’ payment, although it may be that both eventualities can be catered for within either definition in the legal text. To this extent we consider the intention of the modification is in line with the better facilitation of the Relevant UNC Objectives, although the legal drafting could perhaps be clearer.

We note the concept of bilateral insurance has not been included in modification proposal UNC109 on the basis that such a policy is only likely to provide cover for the first or second transportation charge payments missed by the User, after which the insurer effectively relinquishes its risk. Ofgem recognises that when a security tool is an insurance product the terms relating to the product should be 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. In the latter case another security tool should be used to cover any exposures above the combined limit of the User’s unsecured credit limit and the value of the bilateral insurance.

The definition of guarantee in the proposed amendment covers a guarantee made by either a parent company or a non-affiliated company. Ofgem agrees it is appropriate to allow the substitution of a User’s credit limit with the higher unsecured credit limit applicable to another entity (be that entity affiliated with the User or not). Such a guarantee must be sufficiently robust. It must also be either unlimited or, if limited, it must ensure that the unsecured credit limit assigned does not exceed the limit of the guarantor’s ability to take on risk.

In the event the parent company guarantees the obligations of the User and as a result the credit rating of the parent company is substituted for that of the User, the guarantee of the parent company or any other affiliate must not be used to secure credit in excess of the unsecured credit limit; to do otherwise would be ‘double counting’ (i.e. having the effect of the parent company securing a greater liability than its credit rating will support). Alternatively, if the unsecured credit limit assigned to the User is based on the User’s stand-alone credit limit, and a specific additional amount is secured by a parent company, that additional amount must not exceed the parent company’s ability to bear risk and must take into account the extent to which other companies are secured by the parent company under the UNC.

Whilst the drafting proposed for UNC109 broadly achieves the aims described in the two preceding paragraphs, and would therefore facilitate the achievement of the Relevant UNC Objectives, we have some concerns over related aspects of the legal text. Specifically we are concerned that the definition of Parent Company would exclude a User from obtaining a PGC from a parent company based outside the UK. We do not consider this would be appropriate. This failure of the legal text, taken in conjunction with the other deficiencies noted elsewhere in this letter are such that Ofgem is unable to approve modification proposal UNC109. Preventing certain companies from obtaining and using a PGC to obtain an unsecured credit limit (providing that guarantee is sufficiently robust), would be severely to the detriment of competition in the market. Accordingly we have decided to direct that UNC109 should not be approved.

Yours sincerely,



Sarah Harrison
Managing Director, Corporate Affairs

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