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The Joint Office, Transporters, Shippers and other
interested parties

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24 November 2005

Dear Colleague,

Uniform Network Code modification proposals 0024: 'Independent security provision by an entity with an Investment Grade Rating of 'A' or above'

Ofgem¹ has considered the issues raised in the modification report in respect of this proposal and having regard to the principal objective and statutory duties of the Authority², has decided to direct the implementation of the modification.

Ofgem considers that modification proposal 0024 would better facilitate the achievement of the relevant objectives of the uniform network code (UNC), as set out under Standard Special Condition A11³ of the relevant Gas Transporters' Licences as compared with the existing provisions of the UNC. Ofgem also considers that modification proposal 0024 would be consistent with its wider statutory duties.

This letter explains the background to the modification proposal and outlines the reasons for Ofgem's decision.

Background to the proposals

In February 2005 Ofgem published its conclusions⁴ on best practice guidelines for gas and electricity Network Operator (NWO) credit cover following extensive industry consultation. The

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

² Set out in Section 4AA of the Gas Act 1986, as amended.

³ This Licence Condition can be viewed at: http://62.173.69.60/document_fetch.php?documentid=6547

⁴ This document can be found on the Ofgem website at:
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10370_5805.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areasofwork/creditcover

conclusions document indicated that appropriate changes would need to be brought forward by parties to industry codes in order to arrive at credit cover arrangements consistent with the best practice guidelines.

In relation to protection of credit exposure⁵, the conclusions document set out the tools, including independent security, which should be available to counterparties to allow them to cover any exposure beyond their unsecured credit limit. The document went on to say that the relevant NWO will rate the chosen tools according to the effectiveness with which risk is transferred and the conditionality of the instrument, in accordance with clear, objective and appropriate criteria.

The conclusions document detailed that independent security covers security from unrelated entities, and concluded that independent security valued (as discussed above) at 100 per cent of face value may be accepted subject to a number of conditions.

The modification proposal

It is proposed that a User may arrange for the provision of credit security by an independent third party (a credit support provider outside the ownership structure of the buyer and which has no formal or informal control of security provider by buyer, its parent company or its affiliated companies). Furthermore, that independent security valued at 100 per cent of face value would be accepted subject to the following conditions:

- Credit support must be from an entity with a long term debt rating of not less than A by Standard and Poor's or Moody's Investor Services;
- Credit support shall be legally enforceable in the UK;
- The country of residence of the support provider must have a sovereign credit rating of A or better for non local currency obligations; and
- There are no material conditions preventing exercise of the security.

Respondents' views⁶

Of the ten respondents, eight offered support for this proposal, one gave qualified support, and one opposed its implementation.

Comments in support of the proposal included that incorporating these provisions within the UNC would increase transparency and consistency of the credit provision process, and ensure that credit cover is provided in a non-discriminatory fashion. It was also stated that the suggested criteria are consistent with the conclusions document, proportionate and pragmatic, and allow users to source appropriate credit easily. One respondent suggested that the proposal

⁵ Paragraphs 3.34 to 3.47 of the conclusions document

⁶ This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. These can be found on the Gas Transporters information service (formally known as Nemysis) <https://gtis.gasgovernance.com>

is particularly relevant to new participants to the market and effectively removes a potential barrier to entry

Respondents who offered support for the proposal considered that it would further the achievement of relevant objects, in particular the efficient and economic operation of the pipeline system and the securing of effective competition between relevant shippers.

One respondent, whilst supportive of the principle, expressed concern that this proposal does not cover the full extent of Ofgem's proposals, as a number of alternative instruments listed in the conclusions document as being acceptable are not covered. One respondent opposed this proposal, believing that it would be more appropriate to require the security providers to be AAA/AA rated.

Panel Recommendation

At the modification panel meeting held on 20 October 2005, of the 9 voting members present, capable of casting 10 votes, 9 votes were cast in favour of implementing this Modification Proposal. Therefore, by panel majority, the implementation of this proposal is recommended.

Ofgem's view

Ofgem considers that arrangements for credit cover should be governed by robust and transparent modification procedures. In this regard, Ofgem believes that the incorporation of appropriate credit arrangements within the UNC would provide a clear and consistent approach across relevant networks, making it easier for both new entrants and existing participants to familiarise themselves within the market rules and arrange their businesses accordingly.

Ofgem notes that the proposed definition of independent security encompasses low risk forms of credit cover tools. Coupled with robust and unconditional arrangements, Ofgem agrees that these should effectively mitigate risk to the shipping community (and consequently consumers) of exposure, in the event of User default. Ofgem therefore considers that the proposal would allow Users to operate in a more transparent and secure environment, thereby better facilitating the achievement of competition between relevant shippers.

On the question of whether the independent security providers should have an AAA or AA rating, Ofgem takes the view that it is unlikely that an independent security provider would experience financial stress at the same time as the company it was guaranteeing. Therefore there is no need for the minimum rating to be so high.

As noted by one respondent, the conclusions document contained a broader range of acceptable credit cover tools, intended to enable counterparties to provide cover in the manner best suited to their business. It is therefore open to signatories to the UNC, who wish to make use of alternate credit cover tools, to raise further modification proposals. Moreover, these provisions form a part of an overall set of arrangements which are intended to strike an appropriate balance between providing protection against the risk of exposure in the event of default, and the costs of mitigating that risk. As above, it is open to all signatories to bring forward proposals in order to achieve this end.