

Julian Majdanski

Ritchard Hewitt

Joint Office of Gas Transporters
Ground Floor Red
51 Homer Rd
Solihull
B91 3QJ

Gas Code Development Manager
Commercial
UK Transmission
National Grid

07733 001817
01926 655861
Ritchard.Hewitt@uk.ngrid.com

www.nationalgrid.com

20 September 2005

UNC Modification Proposal 0023
'Re-assessment of User Unsecured Credit Limits'
UNC Modification Proposal 0031
'Re-assessment of User Unsecured Credit Limits'
UNC Modification Proposal 0041
'Re-assessment of User Unsecured Credit Limits'

UNC Modification Proposal 0024
'Independent security provision by an entity with an investment grade rating of 'A' or above'

UNC Modification Proposal 0025
'Notice period for credit limit downgrade and remedies for non compliance'

UNC Modification Proposal 0026
'Application of charges consistent with the late payment of commercial debts (interest) act 1998'

UNC Modification Proposal 0027
'Right of off set under UNC'
UNC Modification Proposal 0034
'Netting off of payment and credits relating to Transportation charges'

UNC Modification Proposal 0032
'Adjustment to the number of days in the V A R calculation to bring the Code Credit Rules into line with the Best Practice Guidelines, Conclusions document Feb 2005'

Dear Julian,

1

Thank you for your invitation seeking representation with respect to the above Modification Proposals.

Transco NTS has submitted a consolidated response to all nine Proposals.

We note that as part of its conclusions document, “Best Practice Guidelines for Gas and Electricity Network Operator Credit Cover’ 58/05 (Best Practices Guidelines), Ofgem have recommended that, provided the Relevant Transporter has carried out its obligations in accordance with the recommended ‘Best Practices Guidelines’, it will be permitted to obtain 100% ‘Pass Through’ of bad debt. We note that ‘Pass Through’ arrangements are yet to be finalised and therefore our response to these Proposals is conditional, and provided on the assumption that 100% ‘Pass Through’ arrangements are finalised prior to implementation of these Proposals.

We therefore provide the following response: -

1. Re-assessment of the User Unsecured Credit Limits

UNC0023 Re-assessment of the User Unsecured Credit Limits

UNC0031 Re-assessment of User Unsecured Credit Limits

UNC0041 Re-assessment of the User Unsecured credit Limits

Maximum Credit Limit set at 2% of RAV – Under prevailing arrangements Code Credit Limits are set at an overall cap of £250 million. All three Proposals seek to amend prevailing arrangements such that the maximum unsecured Code Credit Limit is based on 2% of the relevant Transporter’s Regulatory Asset Value (RAV). We support this aspect of all three Proposals.

As part of its ‘Best Practice Guidelines’ Ofgem recommended that both Gas and Electricity Networks Operators should base their maximum credit limits on 2% of the Network Operator’s RAV. We note that in respect of Transco Plc this percentage represent a significantly greater monetary quantity than that within the electricity industry due to the magnitude of the relevant RAV in the two industries. This therefore implies that any increase in credit exposure, which may result from User default, is likely to be greater within the gas market than within the electricity regime.

Users Unsecured Credit Limit - We recognise that there is a balance to be achieved between facilitating greater competition through extending an unsecured credit allowance to all levels of credit rated Users where appropriate and ensuring that the community is not exposed to unnecessary or disproportionate credit risk resulting from defaulting Users. The following paragraphs consider each of the three above Proposal’s against whether or not this balance has been appropriately achieved: -

UNC0023 – ‘Re-assessment of the User Unsecured Credit Limits’- We offer qualified support for this Modification Proposal. We believe that formalising a consistent approach to the assessment and application of User unsecured Credit Limits across all Transporters will facilitate

2

greater competition between Shippers and between Suppliers, in that such consistency in terms of the application of unsecured credit, may provide Users with a 'level playing field' across all Transportation Networks.

We also consider that UNC0023 may better facilitate the securing of effective competition between Shippers and between Suppliers, in that providing unsecured allowance for BBB- and above rated companies may 'free up' capital which may have otherwise been required for security purposes.

We note that extending Unsecured Credit Allowances to Users with a rating of BBB- and above, only, may be viewed as anti-competitive in that Users with credit rating below BBB- are not extended an allowance and as such there may be a widening gap between the advantages extended to higher credit rated Users and less 'strong companies' or 'speculative grade' Users (as reference in Credit Risk Management Transportation – Rules and Procedures - pg 7 – Box 2) which, in many instances will be smaller Users or new entrants to the gas market. However we believe that providing unsecured credit to Users below BBB- requires careful consideration in terms of appropriately balancing any provision of unsecured credit against increased risk of credit exposure to the Industry. As part of the Ofgem Credit Consultation - Credit Cover Workgroup, we highlighted these concerns. We therefore consider that the balance between these conflicting goals has been appropriately struck in this Proposal.

On balance we therefore offer qualified support for this Proposal, in preference to Modification Proposal UNC0031 and UNC0041, as we believe that the changes proposed demonstrate further improvements to our GT Licence Relevant Objectives over and above those set out in UNC0031 and UNC0041.

UNC0031 – 'Re-assessment of User Unsecured Credit Limits', We consider that this Proposal may promote greater competition between Shippers and between Suppliers when compared with prevailing Transportation credit arrangements. As with Modification Proposal 0023, we believe that formalising a consistent approach to the assessment and application of User unsecured Credit Limits across all Transporters may facilitate greater competition between Shippers and between Suppliers, in that such consistency in terms of the application of unsecured credit, may provide Users with a 'level playing field' across all Transportation Networks.

However, we have concerns regarding the percentages proposed in respect of the Unsecured Credit Allowance for Users with a rating of BB+ or below. We consider that, given the percentage of RAV through which the maximum credit limit is based, this Proposal might extend a disproportionately large amount of Unsecured Credit Allowance to Users with a rating below BB+, which may in turn result in Transco NTS less efficiently discharging our obligations to provide unsecured credit to Users whilst appropriately managing industry risks of exposure to User default. However, we also believe that the provisions of such Unsecured Credit Allowances to BB+ or below rated Users may, in the short-term 'free up' capital through which greater competition may be encouraged, and, this must be balanced against the risk that providing such levels of unsecured credit to 'weaker companies/speculative grade Users' (as referenced in Credit Risk Management Transportation – Rules and Procedures - pg 7 – Box 2) might increase

the level of unsecured exposure to the market, at a cost to the Community and ultimately End Users in the longer-term.

On a fine balance we offer qualified support for this Proposal as given the above it better facilitates the relevant objectives. However, we would support UNC0023 in preference.

UNC0041 – ‘Re-assessment of User Unsecured credit Limits’: - We note that UNC Modification Proposal 0041 is a variation on the Ofgem ‘Best Practices Guidelines’ recommendations and as with UNC0031, seeks to extend an Unsecured Credit Limit percentage to Users which have a rating below BB+. We agree with the proposer that extending Unsecured Credit must be balanced against the level of unsecured exposure to the market. We consider that this Proposal attempts to quantify the likelihood of the risk, from default, and apply an appropriate unsecured credit percentage in respect of this likelihood. We believe that such considerations go some way to mitigate potential exposure to default to the industry, whilst extending Unsecured Credit to lower rated companies. We agree with the proposer that this Proposal may facilitate greater competition where appropriate to do so. As the Proposal seeks to mitigate the exposure to default risk in proportion to the User’s credit rating, we consider this Proposal, in comparison to 0031 would strike an appropriate balance and would further the relevant objectives to a greater degree than UNC0031.

We note that as part of the Proposal the proposer has included a table detailing ‘Standard and Poor’s Credit Rating and the proposed credit allowance as a maximum credit limit, we also note that the table provides a percentage for triple B or ‘Unrated’ Users. This has also been reflected in the legal text attached to the DMR. We therefore ask that the SME please confirm that the proposer did not intend to include ‘Unrated’ within this table.

2. UNC0024 – ‘Independent security provision by an entity with an investment grade rating of ‘A’ or above’

We support this Proposal. The Proposal reflects the recommendations of Ofgem’s ‘Best Practices Guidelines’. We are satisfied that the Proposal, if implemented, would better facilitate competition between Shippers and between Suppliers. Provided that independent security from a credit worthy entity has met the criteria set out in paragraph 3.40 of the Ofgem ‘Best Practices Guidelines’, we believe that through credit support from an independent ‘A’ rated entity, the Transporter may extend unsecured credit to any additional Users whilst ensuring that risk from credit exposure to the industry is mitigated.

3. UNC0025 - Notice period for credit limit downgrade and remedies for non-compliance

We support this Proposal. The down grading notice is currently carried out over a 30-day notice period. We agree that the down grading notice could be achieved within a 2-day period.

We consider that such measures introduce robust procedures and best practice measures that may minimise the impact that User failure may have on the industry. We consider that this Proposal, if implemented, may facilitate greater competition between Users as a result of

providing greater confidence within the industry in respect of risk mitigation from exposure to Shipper default.

4. UNC0026 - Application of charges consistent with the late payment of commercial debts (interest) act 1998

We support this Modification Proposal. The Proposal reflects the recommendations of Ofgem's 'Best Practices Guidelines'. We consider that an interest rate at 8% above base is set at a sufficient level to incentivise Users not to delay payments.

We consider that such measures introduce robust procedures and best practice measures that may minimise the impact that User failure may have on the industry. We consider that this Proposal, if implemented, may facilitate greater competition between Users, and a result of providing greater confidence within the industry in respect of mitigation from exposure to credit risk.

5. Right to Offset

UNC0027 Right of off set under UNC

UNC0034 Netting off of payment and credits relating to Transportation charges

UNC0027 - 'Right of off set under UNC'

We support this Modification Proposal. We consider that the Proposal may promote competition among Users by simplifying and improving arrangements for payment of Transportation charges and by keeping banking charges to a minimum.

UNC0034 – 'Netting off of payment and credits relating to Transportation charges'

We support this Modification Proposal. We agree with the views expressed by the proposer that the Proposal may facilitate the continuation of a practice that streamlines administrative operation and reduces costs, which may ultimately be borne by consumers.

We consider that the Proposal may promote competition among Users by simplifying and improving arrangements for payment of Transportation charges and by keeping banking charges to a minimum.

6. UNC0032 – 'Adjustment to the number of days in the V A R calculation to bring the Code Credit Rules into line with the Best Practice Guidelines, Conclusions document Feb 2005'

We do not support this Modification Proposal.

We do not believe that this Proposal reflects the objective it seeks to achieve. We consider that there is an issue regarding whether or not the Proposal is in-line with the intent of Ofgem's 'Best Practices Guidelines' recommendations. In terms of the calculation of accrued debt, Ofgem

recommended that: *“This additional amount provides a proxy for UoS charges that are accrued but unbilled at **any point in time**, broadly in line with the **time-weighted average** of such charges arising in each monthly billing period.”* This is not consistent with the Proposal, which does not seek to change the method of calculating the Value at Risk (VaR) but merely reduce the number of days peak trading upon which the VaR is derived and apply the same methodology to existing Users and new Users.

Under prevailing arrangements when assessing the level of credit appropriate for a new User requires Transco is required to estimate the User’s likely **peak** indebtedness. From this information Transco predicts the scale of charges for 63 days **peak** trading which represents 31 days service, 20 days invoicing period and 12 days payment period.

The Proposal seeks to amend the number of days peak trading, to calculate **peak** indebtedness, to 46 days.

We observe that although this Proposal seeks to change the VaR calculation to bring it in line with the Ofgem ‘Best Practice Guidelines’, a clarifactory statement from Ofgem (issued 24 May 2005) demonstrates that this is not the case. During the July 05 Distribution Workstream, Ofgem were requested to provide a note of clarification regarding its recommendations associated to when and upon what data the VaR should be calculated. For the avoidance of doubt Ofgem stated: -

“Ofgem wishes to clarify that the VaR at any time shall be calculated as the sum of all invoices outstanding and unpaid (whether or not due for payment) plus a further sum equivalent to fifteen day usage charges at the same average daily rate implicit in the invoice amounts.”

Ofgem did not recommend that the VaR be calculated utilising a suggested number of days peak trading, therefore we consider that this Proposal is not in-line with the Ofgem recommendations stated.

Notwithstanding considerations as to whether the Proposal would achieve its stated objective, we do not believe that the proposed change better facilitates the relevant objectives for the following reasons: -

- We do not believe that this Proposal strikes an appropriate balance between applying security provisions which are sufficient to mitigate the financial risks inherent in the billing cycle and the occasions on which cash calls and sanctions for exceeding credit usage are required.
- We consider that the current method of assessing credit requirements for existing Users should be retained, as this is calculated using actual historic indebtedness levels as opposed to an assessment.
- This Proposal seeks to reduce the number of days on which the Code Credit Limit for Use of System Charges are calculated to 46 days peak trading activity. This proposes that less credit cover will be available to the Transporter, which implies an increased likelihood of Users exceeding the 70% and 85% credit usage and in some cases exceeding 100% of credit usage. We note that the Proposal

introduces an increased likelihood of cash call notifications increasing the potential for applying sanctions and for User terminations.

- We are concerned that any increases in instances where Users may come close to, or exceed their credit usage percentages, requires an increase in monitoring and administration, which we do not believe to be economic or efficient.
- We are concerned that less credit cover will be available for the Relevant Transporter to call on in a default situation and notes that historically, User failures have occurred when indebtedness is at its highest.
- We note that, on the assumption that 'Pass Through' is agreed; any potential User failure may adversely impact other Users. We consider that this would be detrimental to any improvements in respect of facilitating greater competition between Shippers and between Suppliers.

Please let me know if you, or the SME assigned to this Proposal, require any further information to enable preparation of the Final Modification Report.

Yours sincerely

Simon Griew