Draft Modification Report
Re-assessment of User Unsecured Credit Limits
Modification Reference Number 0041
Version 1.0

This Draft Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 9.6.

1. The Modification Proposal

This Proposal seeks to implement some of the recommendations identified within Ofgem's conclusion document "***Best Practice Guidelines for Gas and Electricity Network Operator Credit Cover***" ***58/05.*** This concluded the high-level principles that should be applied and outlined further work needed in respect of credit cover arrangements for transportation.

This Proposal seeks to implement elements of recommendations detailed within paragraphs 3.4 to 3.9 of the conclusion document.

UNC Section V3.1 details the Code Credit Limits to which Transporters and Users are obliged to adhere. A Code Credit Limit is the amount representing a Users maximum permitted Relevant Code Indebtedness being the aggregate amount, other than Energy Balancing Charges, for which a User is liable to a Transporter. The overall cap for Unsecured credit exposure to any company or group of related companies is currently set at £250million.

It is proposed that a Relevant Transporter sets a maximum unsecured credit limit based on 2% of its Regulatory Asset Value. Whilst this would not constrain Relevant Transporters, those who seek other levels of risk may not obtain full pass through in the event of a failure and/or may be subject to objections and disputes from counterparties.

In respect of an individual User's Unsecured Credit limit, this is currently assessed by the Transporter based on an Investment Grade Rating provided by an approved rating agency being either *Moody's Investors Service* or *Standards & Poor's*. Ofgem's paper concluded that individual counterparty credit limits and those that use Parent Company Guarantees or aggregates of both, should be set using credit ratings (provided by the aforementioned rating agencies) applied under the 'Basel 2' rules for determining bank capital adequacy. These currently are in the ratio of 1 : 2.5,1 : 5,1: 7.5, for *Standards & Poor's* AAA/AA, A, BBB and below BBB- (or Moody's Investors Service equivalent). Therefore using ‘Basel 2’ exclusively would imply maximum credit allowances of, 100 percent for AAA/AA, 40 percent for A, 20 percent for BBB/BB/Unrated and $13^{1/3}$ percent for below BB-, of the NWO's maximum credit limit for a single counterparty.

The proposer believes that although ‘Basel 2’ is useful as an approximation to unsecured credit levels, it is not appropriate to be used as the sole basis for its determination. Transco is unable to choose its counterparties (unlike banks which predominately use ‘Basel 2’) and the credit limits should be adjusted to reflect this.

Total proposes that these suggested maximum credit limits should be detailed to take account of historically observed default rates across the rating spectrum. In order to capture the significant differences in credit worthiness for companies in the BBB band we propose a further sub-division with the unsecured credit limits as follows:

***Standard & Poor's* Credit rating**	**Credit allowance as % of maximum credit limit**
AAA/AA	100
A	40
BBB+	20
BBB/Unrated	18
BBB-	15
<BB	10

The step changes between these bands are based on information complied by Moody's on historic default rates for the period 1983-2004:

Credit rating	**Percentage Chance of Default within 5 years (%)**
BBB+	1.46
BBB/Unrated	2.11
BBB-	3.60
BB+	6.76
BB	8.82
BB-	19.14

As is demonstrated by the above information, there is a significant increase in a default by companies rated BBB- or below compared to BBB/BBB+ companies.

Any change in unsecured credit ratings must balance the level of unsecured exposure to the market, against the cost to Users of securing credit. The possible chance of default indicated by Moody's research point to a significant risk to the market from <BBB- companies. On this basis we have proposed the step changes above.

2. Extent to which implementation of the proposed modification would better facilitate the relevant objectives

The proposer believes that the measures identified within this Modification Proposal further the GT Licence 'code relevant objective' of facilitating the efficient and economic operation by the licensee of its pipe-line system by ensuring that robust procedures and best practice measures are in place to reduce the impact on the industry of User failure.

In respect of similar Modification Proposals 0023 and 0031, the Distribution Workstream concluded that implementing consistent credit processes which move towards recognised best practice would help ensure that there is no inappropriate discrimination, and no inappropriate barrier to entry, thereby facilitating the securing of effective competition between Relevant Shippers

3. The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation

No such implications on security of supply or operation of the Total System have been identified. Incorporating elements of the existing Code Credit Rules within the UNC may help to reduce the impacts of industry fragmentation.

4. The implications for Transporters and each Transporter of implementing the Modification Proposal , including

a) implications for operation of the System:

No implications for operation of the system have been identified.

b) development and capital cost and operating cost implications:

The Transporters have suggested that some additional monitoring costs have the potential to be incurred relative to the existing position and that proposed under Modification Proposal 0023, reflecting the additional risk of default through increased unsecured credit limits. A one off development cost would also be incurred to establish a process for assessing the unsecured credit limits associated with BB+ to BB- rated Users.

Users have requested that Transporters quantify and provide evidence of the potential cost increase as part of the consultation process for Modification Proposal 0031 and could therefore be applied to this proposal.

c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:

No cost recovery mechanism is proposed.

d) analysis of the consequences (if any) this proposal would have on price regulation:

No such consequences are anticipated.

5. The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal

No such consequence is anticipated.

6. The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users

No systems impacts are anticipated by either Transporters or Users.

7. The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk

Transco Distribution believes the level of credit cover to be provided to Transco by some Users would reduce, thereby potentially reducing Users' costs. Other Relevant Transporters have identified that additional credit cover may be called for, potentially increasing costs for some Users.

With an increased risk of default with unsecured sums due, additional costs could be passed through to Users.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party

No significant implications have been identified.

9. Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal

No such consequences are anticipated.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages

- Increased alignment of the UNC with best practice as identified in Ofgem's conclusions document.
- Ensures credit cover continues to be sought on a non-discriminatory basis.
- Ensures there continue to be no inappropriate barriers to entry as a result of credit requirements.
- Reduced credit cover requirements could reduce costs for some Users.

Disadvantages

- Does not fully implement the best practice approach identified in Ofgem's conclusions document.
- May create inconsistency between the UNC and each set of Code Credit Rules.
- Potential for increased default costs

11. Summary of representations received (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Representations are now invited.

12. The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation

Implementation is not required to enable each Transporter to facilitate compliance with safety or other legislation.

13. The extent to which implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence

Implementation is not required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence.

14. Programme for works required as a consequence of implementing the Modification Proposal

The Proposer believes that minimal changes would be required in respect of operational processes and procedures in the event that this Modification Proposal is implemented.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

The proposer believes that this Modification could be implemented with immediate effect if appropriate direction is received from the Authority.

16. Implications of implementing this Modification Proposal upon existing Code Standards of Service

No implications of implementing this Modification Proposal upon existing Code Standards of Service have been identified.

17. Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel

18. Legal Text

UNIFORM NETWORK CODE - TRANSPORTATION PRINCIPAL DOCUMENT

SECTION V - GENERAL

Amend paragraph 3.1.1 as follows:

"3.1.1 For the purposes of the Code:

(a) the **"Regulatory Asset Value"** is the value of the relevant Transporter's regulated assets as published from time to time by the Authority.

(b) An "**Approved Credit Rating**" is a published and monitored long term issuer rating (not including private ratings) of not less than Ba3 by Moody's Investors Service or equivalent rating by Standard and Poor's.

(c) The "**Unsecured Credit Limit**" is that proportion of the Maximum Unsecured Credit Limit extended to a User by the Transporter as calculated in accordance with the table set out in paragraph 3.1.6.

The Transporter will~~, in accordance with the Code Credit Rules,~~ determine and assign to each User a Code Credit Limit, which may comprise of an Unsecured Credit Limit calculated in accordance with paragraph 3.1.6 and/or security or surety provided in accordance with paragraph 3.4. ~~and will~~ The Transporter shall keep each User informed of its Code Credit Limit (as revised in accordance with the Code) for the time being. The Transporter shall limit the Unsecured Credit Limit to any User and related company to a maximum of two percent (2%) of the Regulatory Asset Value (The "**Maximum Unsecured Credit Limit**")."

Amend paragraph 3.1.2 (a) as follows:

"(a) the principles on which the Transporter will assess ~~and from time to time revise (in accordance with paragraph 3.2.2) its assessment of the credit-worthiness of Users (and persons providing surety for Users)~~ and establish Code Credit Limits;"

Add new paragraph 3.1.6 as follows:

"3.1.6 Where a User has an Approved Credit Rating, such User's Unsecured Credit Limit at any time shall be calculated as that percentage (%) of the Maximum Unsecured Credit Limit by reference to the User's Approved Credit Rating as follows:"

Approved Credit Rating		***User's % of Maximum Unsecured Credit Limit***
Standard and Poor's	**Moody's Investors Service**	
AAA/AA	Aaa/Aa	100
A	A	40
BBB+	Baa1	20
BBB/Unrated	Baa2	18
BBB-	Baa3	15
<BB+	Ba1	10

Subject Matter Expert sign off:

I confirm that I have prepared this modification report in accordance with the Modification Rules.

Signature:

Date :

Signed for and on behalf of Relevant Gas Transporters:

Tim Davis
Chief Executive, Joint Office of Gas Transporters

Signature:

Date :