CODE MODIFICATION PROPOSAL No. 0041

"Re-assessment of User Unsecured Credit Limits"
Version 1.0

Date: 01/08/2005

Proposed Implementation Date: 01/10/2005

Urgency: Non-Urgent

Proposer's preferred route through modification procedures and if applicable, justification for Urgency

(see the criteria at http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2752_Urgency_Criteria.pdf)

An outline of this modification has already been highlighted to the Distribution Workstream at its meeting of the 28th July 2005. Because of this and its similarity to modifications 0023 and modification 0034 we believe it is sufficiently well developed to proceed direct to consultation.

Nature and Purpose of Proposal (including consequence of non implementation)

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 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.

Though ‘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.

Basis upon which the Proposer considers that it will better facilitate the achievement of the Relevant Objectives, specified in Standard Special Condition A11.1 & 2 of the Gas Transporters Licence

Total 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.

Any further information (Optional), likely impact on systems, processes or procedures, Proposer's view on implementation timescales and suggested text

Total believes that minimal changes would be required in respect of operational processes and procedures and therefore this Modification could be implemented with immediate effect if appropriate direction is received from the Authority.

Code Concerned, sections and paragraphs

Uniform Network Code Section V3.1

Proposer's Representative

Gareth Evans (Total Gas and Power Limited)

Proposer

Steve Ladle (Total Gas and Power Limited)

Signature

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