

Modification proposal:	Uniform Network Code (UNC) 303: (UNC303) 'RG252 Proposal 6: Obligation for Users to maintain a Code Credit Limit and at a reasonable level'		
Decision:	The Authority ¹ rejects this proposal ²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	28 September 2010	Implementation Date:	Not applicable

Background to the modification proposal

As with any competitive market, there is a possibility that an energy company using the gas and electricity networks to supply their customers may face financial difficulties at some point in its life. Given that those networks are natural monopolies their operators are required to offer access on equitable terms, while Users are not able to go elsewhere if they do not like those terms.

A balance therefore needs to be struck, to ensure that network operators are able to properly manage the financial risk that network Users may impose, while maintaining credit cover and payment terms which do not unduly restrict access to and use of those networks. With this in mind, in 2005 Ofgem published its best practice guidelines for gas and electricity network operator credit cover ('the guidelines')³.

The aim of the guidelines was to ensure that network operators' credit cover and payment terms were proportionate, allowing network operators to properly manage, rather than wholly avoid, any exposure to financial risk. The guidelines also set out our views and criteria for the pass through of any bad debt. This could be summarised as requiring a demonstration of adherence to best practice, as may be set out in the guidelines or elsewhere. In recognition that best practice is constantly evolving, we suggested that the guidelines should remain under periodic review.

Review Proposal 252 was raised in April 2009. Its aim was to review the UNC credit arrangements for transportation charges and consider whether they remained fit for purpose in light of the many credit issues since the publication of the guidelines. Examples of such issues are the collapse of financial institutions such as Lehman Brothers and the wider 'credit crunch'. The Review Group came forward with 14 recommendations, each of which has now been raised as an individual modification proposal.

The modification proposal

For the purposes of the UNC, Users are assigned a Code Credit Limit (CCL). The CCL will be the sum of the User Unsecured Credit Limit and any security the User may have provided. The User is expected to ensure that their CCL remains at least equal to their Value at Risk (VAR).

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 This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=9791-5805.pdf&refer=Licensing/IndCodes/CreditCover>

The VAR is a dynamic value and is at any point in time the sum of the aggregate amount invoiced to the User (excluding Energy Balancing Charges) which are unpaid, and the average daily amount invoiced to that User (again, excluding Energy Balancing Charges) over the previous calendar month multiplied by 20.

Where a User's VAR exceeds 80% of its CCL the GT will notify them that they are approaching their CCL. If the User's VAR subsequently exceeds 100% of their CCL, the GT will issue a Notice giving the User two Business Days to provide an amount of additional Surety or Security specified in the Notice, in order to reduce VAR below their CCL. As long as the User satisfies the requirements of each Notice no further action is required under UNC and there is no proscription on the number of notices that may be received.

UNC303 seeks to ensure that Users maintain their CCL at a reasonable level; sufficient to avoid repeated issuance of Notices. The level of CCL will be considered to have fallen to an unreasonable level (or as the case may be not increased to a reasonable level) if the User receives two or more Notices that its VAR has exceeded 100% of the Users CCL within two consecutive calendar months.

Under UNC303, if the User does receive two or more Notices the Gas Transporter (GT) may apply portfolio sanctions until such time as the User has raised their CCL to a level at least equal to the largest VAR value quoted in the Notices. The portfolio sanctions available to the GT⁴ are a refusal to accept any or all of the following:

- An application for System Capacity or increased System Capacity;
- A System Capacity Trade; and
- A Supply Point Nomination or Supply Point Confirmation.

These sanctions are intended to limit the User's potential liabilities.

The Proposer considers that UNC303 is likely to further relevant objective (d) by ensuring that the appropriate credit limit is afforded to Users based on their ability to pay.

UNC Panel⁵ recommendation

At its meeting of 19 August 2010 the UNC Panel recommended by unanimous vote that the proposal be implemented.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 23 August 2010. 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 FMR⁶. The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC⁷.

⁴ as allowed for under Section 3.5.3 of the UNC

⁵ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

⁶ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁷ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547

Reasons for the Authority's decision

We consider that UNC303 should be assessed against relevant objectives d) and f) only. The other UNC objectives are not pertinent to this proposal.

We note that of the eleven responses to the Joint Office's consultation, ten were in support of its implementation. A common theme in responses from those in support, including a smaller and relative new entrant to the market, was that it is appropriate for the GTs to be able to trigger sanctions in order to ensure that parties maintain an appropriate CCL. There were few other substantive comments.

Relevant Objective (d): so far as is consistent with subparagraphs (a) to (c) the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;

While we would agree that it is important for a User to maintain an appropriate CCL, we note that there are already sanctions under Section V of the UNC if a User fails to maintain their CCL at VAR or above. These include those sanctions set out above. Currently, the sanctions also include an ability for the GT to deem the value of any Surety or Security provided by the User to be 80% of its face value⁸. Ultimately, failure to lodge sufficient security may result in the User being terminated from the UNC⁹. UNC303 does not add to those sanctions, but may allow them to be utilised for a new reason, namely a User triggering two or more Notices in a two calendar month period. The effect is not simply to ensure that further Security or Surety would be lodged as required, but to discourage Users from managing their credit position in such a way that the Notices mentioned above would be regularly triggered. In effect this may require Users not simply to maintain their CCL at a level approximate to their VAR, but to provide for an additional buffer to negate the likelihood of a Notice being triggered.

As noted above, the purpose of the credit best practice is to provide a greater level of assurance to GTs that if they adopt best practice they will be able to recover any residual bad debt. We also consider that any measures they put in place to manage risk should be proportionate to the monies involved. In the absence of any further evidence of the frequency and materiality of the Notices, it seems likely that this proposal would have a disproportionate impact upon those smaller players who are reliant upon cash as a form of security rather than have ready (and affordable) access to Guarantees or Letters of Credit. Such players are also likely to be continuously at the margin of their allowed CCL, to make best use of scarce capital.

Therefore, while we accept that any instance of VAR exceeding CCL imposes a risk on the GTs we consider that there are already sufficient sanctions, particularly the ability to terminate the User from the UNC, to ensure that the User remedies the situation in a timely manner. Further, if that risk does subsequently manifest into a bad debt, to the extent that the GTs can demonstrate that they have adhered to the code rules and best practice more generally, they are protected insofar as they can apply for a price control pass through of that debt, allowing them to recover it through future charges. For

⁸ This provision which allows the GT to deem Security and Surety provided by the User to be 80% of its face value is proposed to be removed as part of UNC298.

⁹ Section V 3.3.3

instance in electricity Distribution Price Control Review 5 we admitted total bad debt costs of £6.4m because best practice and prevailing code requirements had been adhered to.

We consider that any proposal which imposes additional credit requirements must strike a balance between the effective management of risk, and the needs of Users, particularly smaller parties for whom relatively small differences in the availability of credit may be vital. For the reasons set out above, we consider that this proposal will have a disproportionate and detrimental impact upon new entrants who may be genuinely small parties rather than a subsidiary of a larger entity. To the extent that this proposal would constitute a barrier to entry and/or a subsequent constraint on their growth, we consider that it would be detrimental to securing effective competition between suppliers.

Relevant Objective (f): the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;

The one respondent who was opposed to UNC303 raised some specific concerns regarding timing. They suggested that not all GTs accept Guarantees to be effective until they have been signed by the respective board, which in some cases could take longer to arrange than the timescales allowed for in this proposal, meaning that sanctions could be applied despite the User having taken steps to increase their CCL. This point has, however, been addressed by some of the GT respondents, confirming that they do indeed recognise and accept Deeds of Amendment to Guarantees as an interim form of Surety. While nothing in this particular proposal sought to confirm or expand the credit tools available to Users, we consider that it would be helpful if the UNC were clearer in this respect and the policy with respect to Deeds of Amendment confirmed as common to all GTs.

We recognise that there is an administrative burden and associated cost to the GTs in having to issue regular Notices that a User's CCL has exceeded 100% of their VAR. If this proposal were to be implemented the number of these Notices might be expected to drop, which could be considered an administrative efficiency and therefore marginally furthering this objective. If, however, this proposal were to lead to a proliferation of potentially premature actions based on such a small debt, we consider that it would be detrimental to the efficient administration of the UNC credit arrangements.

Rachel Fletcher
Partner, Distribution

Signed on behalf of the Authority and authorised for that purpose