

Modification proposal:	Uniform Network Code (UNC) 307: (UNC307) 'RG252 Proposal 10: Alignment of defaulting User Threshold with Insolvency Act (1986) Threshold'		
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

Currently, Section V4.3.1 of the UNC states that a '**User Default**' occurs where their debt (excluding any amount which is subject to an invoice query) is in excess of **£10,000** and:

- The User has not paid the debt in full by the 5th Business Day after its due date;

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 Gas Transporter (GT) has subsequently given notice to the User requiring payment of the outstanding amount; and
- The User has not paid the amount in full by the 5th Business Day from the date of the notice.

When a User Default occurs, the GT may issue a '**Termination Notice**' to the defaulting User in accordance with Section V4.3.3. The effect of this notice is that the User shall cease to be a User of the GTs Pipeline Systems.

The proposer considers that the figure of £10,000, which was carried over from the previous National Grid Network Code, is no longer appropriate in an environment with multiple GTs, as this has effectively multiplied the amount of debt that a User may accrue before Section V4.3.3 provisions can have effect.

The proposer also contends that the original £10,000 is largely arbitrary, as Review Group 252 was unable to attach any historic significance or prevailing rationale for that figure. The proposer has therefore sought to address the Review Group's view that the figure should be based on some comparable process.

UNC307 seeks to reduce the amount of debt that a User can accrue with any given GT, to prevent the effective figure being potentially several times greater than the original £10,000 threshold. However, in recognition that the £10,000 may itself be an arbitrary figure, rather than simply dividing this by the number of current GTs to which UNC applies (i.e. reduce it to £2000), the proposal seeks to introduce a reference to the Insolvency Act (1986) which currently has a threshold of **£750** before an action can be brought by a creditor. It is envisaged that this would also future proof the UNC, allowing the threshold to rise over time in line with any revisions to the Insolvency Act threshold.

UNC Panel⁴ recommendation

At its meeting of 19 August 2010 the UNC Panel recommended by a majority 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 FMR⁵. The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC⁶.

Reasons for the Authority's decision

There were eleven responses to the Joint Office's consultation. Of these, eight were in support of the proposal, with a further respondent offering qualified support. Three were opposed.

⁴ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁶ 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

One respondent noted that whereas the Insolvency Act refers to a 21 day payment window, under the Code the payment should be made within 15 days and is therefore inconsistent. This point has subsequently been acknowledged by the GTs, though they note that the intent of the proposal was to align the monetary values, not the timescales.

Relevant Objective (a): the efficient and economic operation of pipeline system;

The proposer contends that the implementation of UNC307 would better facilitate this objective by reducing the cost of operating the pipeline system by reducing the risk of exposure to the GT of bad debt. Whilst we would agree that this may be the case insofar as an instance of User Default may be capped at the proposed £750 rather than £10,000, we do not consider this to be material, particularly relative to the GTs regulatory asset value. We also consider that any savings that may be made from limiting a defaulting user's debt may be more than outweighed by the increased administrative costs of issuing an increased number of notices relating to smaller amounts. We do not consider that UNC307 would better facilitate this objective.

Relevant Objective (d): 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;

We note that while the Insolvency Act itself has been periodically amended, the £750 figure remains unaltered since 1986. It is therefore likely that this figure would be substantially increased in a future revision of the Act and there is no way of knowing whether UNC Parties would consider this as yet unknown figure to be any more or less appropriate than the prevailing £10,000.

We welcome the responses submitted by smaller Users on these proposals. One suggested that they understood the rationale for seeking to ensure that there was no inadvertent multiplication of potential exposure resulting from DN network sales. However, they point out that the proposed £750 threshold would be far below the historic level and suggest instead that the original £10,000 be divided by the current number of GTs.

We also note the concerns of one respondent who suggested as the issuance of a Termination Notice will be at a GTs discretion, it is more likely to be used for smaller Users as this would have relatively less consequential impact on other parties. Regardless of whether this is a real or merely perceived risk, it highlights a problem insofar as smaller parties and in particular new entrants experience of the UNC credit arrangements. GTs have an obligation⁷ not to discriminate between Users, and whilst it is appropriate that credit arrangements are risk based, it is important that the credit arrangements work in an equitable fashion and that any difference in treatment can be wholly justified by the relevant differences between Parties and the risks they impose.

Whilst it is appropriate for the GTs to seek to manage and wherever appropriate reduce their level of risk, any proposed revision to the existing arrangements must strike a

⁷ Standard Special Condition A6 of the GT licence requires the licensee to conduct its transportation business in the manner best calculated to secure that neither the licensee nor any gas shipper or gas supplier obtains any unfair commercial advantage including, in particular, any such advantage from a preferential or discriminatory arrangement.

balance between the effective management of risk and the needs of UNC Users. It is therefore welcome that the GTs have sought to identify a relevant external benchmark for the debt threshold which, if unresolved, may trigger a UNC Termination Notice.

However, we are not convinced that £750 is a suitable level of debt on which to justify a User's termination from the UNC, or more generally that the Insolvency Act provides a suitable external comparator. In particular, whereas £750 may be considered a suitable benchmark at which to allow insolvency proceedings to be sought by a creditor, it is merely the start of a process. The debtor will have ample opportunity to clear their debts or come to an arrangement with their creditors in order to avoid subsequent action. The interests of both parties will be protected throughout, not least by the courts. In contrast, termination from the UNC is by definition the culmination of a process which will cause the defaulting party to cease to operate in the capacity of a UNC User. Whilst we have no doubts that this is not a step that the GTs would take lightly and that they would take every reasonable measure to resolve matters with the User in order to avoid this action, the likelihood of this work in itself contributes to our view that £750 does not represent a proportionate level of debt at which to trigger a potential termination from UNC.

Given the above, we are unable to conclude that the implementation of UNC307 would further this relevant objective.

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

We note and agree with those comments which suggest that commencing Termination proceedings for a £750 debt would be administratively inefficient and disproportionate. While this figure may be appropriate for the commencement of insolvency proceedings, it acts as a protection to creditors for which £750 may be a significant debt and cannot readily be written off. It also acts as a safeguard against situations where a debtor cannot or will not pay relatively small debts to a potentially unlimited number of creditors. In the context of UNC, there is already a finite threshold of aggregate debt which a User cannot exceed without triggering remedial action. We consider it likely that the commencement of Termination proceedings would cost substantially in excess of £750 to pursue through to a conclusion. If 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.