

Modification proposal:	Uniform Network Code (UNC) 301: Removal of the use of specially commissioned ratings for the purposes of obtaining an Unsecured Code Credit Limit (UNC301)		
Decision:	The Authority ¹ directs that this proposal be made ²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	10 November 2010	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

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.

On 19 December 2006 the Authority directed the implementation of UNC modification proposal 107V: 'Specially Commissioned Credit Ratings'. The effect of UNC107V was to allow Users without an existing credit rating allocated by Moody's or Standard & Poor's to receive an amount of unsecured credit equivalent to that which could be obtained by Parties with such a rating. This would be on the basis of a specially commissioned rating from one of those agencies. The costs of the initial and any subsequent assessment would be met by the User, though there was nothing in the proposal to prescribe how often the rating should be reviewed.

Unlike normal credit ratings, the specially commissioned rating would not be continually reviewed by the credit rating agencies in light of changing circumstances, but would simply provide a snapshot at that point in time. The Authority noted in its decision that although the implementation on UNC107V could result in some additional risk associated with an increase in unsecured credit, this would be outweighed by the benefits to competition this availability of credit would bring.

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 which have arisen since 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.

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 modification proposal

The review group initially considered including Specially Commissioned Ratings within the scope of Section V 3.2.5. That section allows the Gas Transporters (GTs) to immediately review and if appropriate reduce a Users access to unsecured credit in the event of a downgrade in the Users published credit rating. However, the group noted that unlike published credit ratings, Specially Commissioned Ratings cannot be monitored and re-assessed without being re-commissioned.

The group considered that the impracticality of active and effective monitoring means that Specially Commissioned Ratings do not reflect the principles of the best practice guidelines. The group therefore recommended that Specially Commissioned Ratings be removed as a credit tool. This proposal seeks to give effect to that recommendation.

The proposer also confirms that to date no User has sought to obtain a Specially Commissioned Rating, citing anticipated costs of up to £100,000 as being a possible reason.

UNC Panel⁴ recommendation

At its meeting of 19 August 2010 the UNC Panel voted unanimously to recommend implementation of this proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 6 October 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:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC⁶; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties⁷.

Reasons for the Authority's decision

There were 11 responses to the Joint Office's consultation. Of these, 10 were in favour and the final respondent offered comments only. Respondents generally referred to the greater risk of bad debt associated with Specially Commissioned Ratings owing to the lack of ongoing monitoring. Several also noted that to date such ratings have not been used, therefore their removal would have no detrimental impact.

The respondent who offered comments stated that they had supported the original introduction of Specially Commissioned Ratings through UNC107V. They considered that the shortcomings of this tool would have existed at the time of UNC107V, but considered it debateable whether they were fully recognised at the time. They therefore felt unable

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>

⁷ The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

to conclude that the removal of Specially Commissioned Ratings would further the relevant objectives, having earlier determined that its introduction would facilitate those same objectives.

As mentioned above, in making our decision to direct the implementation of UNC107V we recognised that there are risks associated with Specially Commissioned Ratings to the extent that they are not proactively monitored. We noted that the UNC107V legal text provided for the ratings to be monitored on a daily basis, but only reassessed annually. At that time we considered that it would be good commercial practice for the GT to instigate a review of any Specially Commissioned Rating in place should it consider the creditworthiness of the Party to be inaccurately reflected in its credit rating. It remained unclear what would trigger such a review, how it would be undertaken and what action the GT could subsequently take in the absence of the rating being revised.

We remain of the view that restrictive credit cover arrangements inhibit competition with its associated benefits for consumers. Credit arrangements must therefore appropriately manage rather than seek the absolute removal of risk. We originally took the view that on balance the availability of unsecured credit based on a Specially Commissioned Rating would outweigh the additional risk such a tool presents compared to a standard credit rating. However, the fact that to date no Users have utilised this option, but instead obtain unsecured credit limits through other more robust tools, would suggest that Specially Commissioned Ratings are not a necessity.

When publishing our guidelines we set out our expectation that they and corresponding code credit rules would be reviewed on a regular basis in order to ensure they remain in keeping with prevailing best practice. We therefore welcome this review having been undertaken. Based on the comments received to UNC301, it is apparent that the provision of a Specially Commissioned Rating that is not sufficiently dynamic to reflect a change in the Users circumstances would not be considered by many to be good practice.

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

The proposer and subsequently the UNC Panel felt that the removal of the option for a Specially Commissioned Rating would make the operation of the UNC, particularly the credit rules, more efficient. They considered that this would further relevant objective (f). To the extent that this is a redundant and impractical option which has little likelihood of take up, we would agree that its removal could be considered efficient administration and therefore that it furthers relevant objective (f).

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority directs modification proposal UNC301: '*Removal of the use of specially commissioned ratings for the purposes of obtaining an Unsecured Code Credit Limit*' be made.

Rachel Fletcher
Partner, Distribution

Signed on behalf of the Authority and authorised for that purpose