

Modification proposal:	<b>Uniform Network Code (UNC) 302: (UNC302) 'Definition of Regulatory Asset Value (RAV) when calculating Maximum Unsecured Credit'</b>		
Decision:	The Authority <sup>1</sup> directs that this proposal be made <sup>2</sup>		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	14 January 2011	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')<sup>3</sup>. 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.

In order to achieve an appropriate balance between facilitating competition through the availability of credit, including unsecured credit, and not placing the Gas Transporter (GT) itself in financial jeopardy in the event of Users defaulting, the guidelines provide an objective methodology for the amount of credit that should be made available.

The GT determines and assigns to each User a Code Credit Limit (CCL), which may comprise of an unsecured element calculated in accordance Section V3.1.3 of the UNC and an element reflecting any additional security or surety provided by the User. The GT keeps each User informed of its CCL, with the Unsecured Credit Limit extended to any individual User being calculated by the GT in accordance with Section V3.1.3 and V3.1.4, taking into account factors such as approved credit ratings, as appropriate.

The Unsecured Credit Limit is limited to a maximum 2% of the GT's Regulatory Asset Value (RAV). The RAV of a GT is currently defined under the UNC as being the value of its regulated assets as published from time to time by the Authority. However, to date, whilst RAV figures have been published as part of the final proposals for relevant price controls (typically every five years), Ofgem has only published indicative updates for intervening years on an intermittent basis.

To the extent that the RAV figure is not regularly updated, the maximum Unsecured Credit Limit made available to Users may become fixed at a historic level and fall below that which the GT should reasonably offer, being up to 2% of the actual RAV.

Review Proposal 252 was raised in April 2009. Its aim was to review the Uniform Network Code (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'.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

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

The Review Group came forward with 14 recommendations, each of which has now been raised as an individual modification proposal. One of its recommendations was to make available a revised RAV figure on an annual basis.

### **The modification proposal**

UNC302 seeks to revise the definition of the RAV, retaining reference to the figure that may be published by the Authority at the start of the relevant price control period, but thereafter being a figure updated to current year prices and published by the GT.

The proposer considers that UNC302 would facilitate effective competition between relevant shippers by ensuring that the appropriate maximum unsecured credit limit is afforded to Users based on the most up to date RAV position of the GT concerned. They also considered that a uniform approach to the use of the most relevant RAV would provide each GT with a comparable level of risk.

### **UNC Panel<sup>3</sup> recommendation**

At its meeting of 19 August 2010 the UNC Modification Panel voted unanimously to recommend that this 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 21 December 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 FMR<sup>4</sup>. The Authority has concluded that:

1. implementation of the modification proposal will for the time being better facilitate the achievement of the relevant objectives of the UNC; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties<sup>5</sup>.

It should be noted, however, that under the new RIIO (Revenue = Incentives + Innovation + Outputs) model for networks regulation Ofgem will in future regularly publish annual updates to the indicative RAV for each GT. As these figures become available we would expect GTs to use them for the purposes of Section V 3.1.1 as modified.

Once regular RAV figure publications by Ofgem are established it may also be appropriate for Section V 3.1.1 to be further modified to make direct reference to them.

### **Reasons for the Authority's decision**

Of the twelve responses to the Joint Office's consultation, all were in support of its implementation<sup>6</sup>. Like the UNC Panel, we have considered UNC302 against relevant objectives d) only, as it has no discernible impact upon the other relevant objectives.

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<sup>6</sup> The FMR records SSE as offering comments only, though its response letter dated 20 July 2010 agrees with the proposer that the modification would further the relevant objectives as detailed in the proposal. It raises no concerns.

***Relevant Objective (d): so far as is consistent with subparagraphs (a) to (c) the securing of effective competition between relevant shippers and between relevant suppliers;***

The majority of respondents did not provide substantive comments on this proposal, though there was a common theme that its implementation would improve clarity on the application of unsecured credit and a greater degree of consistency between GTs.

One of the respondents, while supporting the proposal, requested further details on how much notice would be provided to UNC Users of the change in RAV. They noted the possibility that the Retail Price Index could actually be negative, contributing to a downward revision to the RAV. If this were to happen, the availability of unsecured credit may reduce, with Users being required to lodge additional credit cover. They also requested further clarity on the methodology that the GTs would adopt in revising the RAV. Another respondent, a GT, also suggested that it would be desirable for the GTs to adopt a consistent approach to adjusting RAV.

Whilst noting these comments we consider that they are issues that can be addressed without needing to be prescribed as part of this proposal because:

- (i) indicative RAV figures provided by GTs should be ascertained in accordance with the requirements of the Price Control Review Information condition in their licenses, and
- (ii) indicative RAV figures provided by GTs will reflect additions for allowed expenditure during each year as well as deductions for depreciation and the application of a price indexation factor.

With respect to the appropriate notice period, we note that Sections V 3.2.4 and V3.2.11 of the UNC require that Users be given no less than 30 days/one calendar month notice of a change in their Code Credit Limit<sup>7</sup>. We anticipate that any revision in RAV, particularly a downward revision which further limits the availability of unsecured credit, would be treated similarly.

**Decision notice**

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC302: '*Definition of Regulatory Asset Value (RAV) when calculating Maximum Unsecured Credit*' be made.

**Rachel Fletcher**  
**Partner, Distribution**

Signed on behalf of the Authority and authorised for that purpose

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