

Modification proposal:	Uniform Network Code (UNC) 305: Unsecured Credit Limit allocated through payment history (UNC305)		
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:	5 November 2010	Implementation Date:	To be confirmed by the Joint Office

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.

On 26 January 2007 the Authority directed that UNC modification proposal 113 (UNC113) be implemented. The effect of UNC113 was to ensure that a User without a credit rating allocated by Moody's or Standard & Poor's, or with a public credit rating allocated by those agencies but below the current prescribed minimum, should be able to obtain a level of unsecured credit.

UNC113 stipulated that a User which settles all of its Transportation invoices by the due date on an ongoing basis would obtain an unsecured credit level of 0.4% per 12 month period (escalating on an evenly graduated basis each month) up to a maximum of 2% of the Transporter's maximum credit limit (obtained after 60 months unblemished payment record). However, any failure to pay a transportation invoice by the due date would return the User to 0% unsecured credit.

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

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>

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

UNC305 has three key elements.

Firstly, it seeks to amend Sections V3.1.5 to V3.1.6 of the UNC such that an unsecured credit provision based on a User's payment history will only be available as an option for the first two years after the User's accession to the UNC, rather than for an unlimited period as currently. After that time, the User will be required to utilise other mechanisms recognised under Section V, such as independent credit assessments.

Secondly, in recognition that some late payments may be a result of administrative errors rather than the User being in financial difficulty, UNC305 seeks to provide more flexibility during the period in which the facility can be used. Whereas the first instance of a late payment may currently result in the User's Unsecured Credit Limit being set to zero, UNC305 would defer such action to the second missed payment in a rolling 12 month period, as long as payment is received up to and including 2 days after the payment due date. However, the User's Unsecured Credit Limit will not be increased the following month, as it would have been if the payment had been received on time. Interest may also be charged on the late payment.

Lastly, in line with the intent to reduce the availability of unsecured credit to the first two years, UNC305 would cap the unsecured credit to 0.8% of the relevant gas transporter ('GT')'s Maximum Unsecured Credit Limit. Currently, a User's unsecured credit limit may gradually increase by 0.4% per year, to a maximum of 2% over the course of five years.

The Proposer considers that UNC305 strikes an appropriate balance between facilitating market entry and mitigating the risks new entrants impose upon existing players⁴, thereby better facilitating relevant objective (d), as set out in Standard Special Condition A11 (1) of the Gas Transporters Licence⁵.

UNC Panel⁶ recommendation

At its meeting of 19 August 2010 the UNC Panel voted by a majority 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 1 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 FMR⁷. The Authority has concluded that:

⁴ The pass through of a bad by a network operator could increase future charges to other Users

⁵ For detailed views from the Proposer and Respondents, see: www.gasgovernance.com

⁶ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

⁷ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC⁸; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties⁹.

Reasons for the Authority's decision

There were 12 responses to the Joint Office's consultation. Of these, 9 were in favour and 3 opposed to its implementation. We agree with the proposer and the UNC panel that this proposal should be assessed against relevant objective (d).

Relevant objective (d): the securing of effective competition between relevant shippers and suppliers;

Notwithstanding our decision to accept UNC113 in 2007, at the time we noted that the modification seemed to offer no discretion on the part of GTs in the event that a User unwittingly misses a payment. It was considered that in the event of such a default the GT would be required under the terms of the UNC to reduce a User's payment history and therefore access to unsecured credit back to zero. Although we stated that the requirement for parties to make timely payments is a critical aspect of arrangements, it was also important that this requirement should not override the exercise of sensible commercial practice. For example, discretion could be exercised where the GT took the view that late payment of a trivial invoice or owing to a demonstrable administrative error, and not lead to the withdrawal of unsecured credit. We considered that to the extent UNC113 did not allow such discretion it may negatively impact upon relevant objective (d).

UNC305 addresses this concern by providing that the first instance of a missed payment will not result in the User's access to unsecured credit being reset to zero. However, any subsequent default in a rolling 12 month period may result in that sanction being applied. It is reasonable to expect Users to take steps to prevent any reoccurrence of an administrative error. Several respondents, including one of those opposed to the proposal overall, supported this concept of a soft landing for administrative errors.

We are mindful of the views of the respondent who suggested that the removal of access to unsecured credit after a two year period may adversely impact them, potentially restricting their growth if they are required to post cash as security. As stated in the background, credit arrangements must strike an appropriate balance between properly managing risk and not making terms unduly restrictive. However, we consider that this proposal merely removes one means of determining an appropriate level of unsecured credit and only after the User has had a reasonable period to establish themselves in the market, rather than removing access to unsecured credit entirely.

We do not consider the requirement to obtain an independent credit assessment to be unduly onerous, particularly as the relevant GT will be required to pay 80% of the costs in accordance with UNC Section 3.1.8. In obtaining such a rating, the User will then be able to access a greater amount of unsecured credit, up to 20% of each GT's Maximum Unsecured Credit Limit rather than the 2% currently available without such a rating. We also agree with those respondents who suggested that the payment of transportation

⁸ 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

⁹ 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.

invoices may not of itself be a good indicator of a User's financial health, particularly as the GTs may in effect be a priority creditor owing to the range of sanctions available to them and the User's dependence on those services.

We note that one of the respondents opposed to the implementation of this proposal, itself a relatively small party, argued that the use of payment history increased the risk of default, the costs of which will ultimately be borne by other players. They therefore favoured the removal of unsecured credit based on payment history entirely.

The same respondent also suggested that if this option were to be retained, it should be available to all market participants, as the two year limit is arbitrary and effectively discriminates between new and established participants. We currently have no view on whether two years is the most appropriate threshold for the option of unsecured credit based on payment history alone, but consider that this could be evaluated as part of any future review of the UNC credit arrangements. However, we do consider that it is appropriate for the UNC arrangements to make reasonable accommodation for the differing circumstances of parties. In particular, while there is little or no trading history on which a credit assessment could be performed, it is appropriate the new entrants can gradually build up their access to unsecured credit based on an early indicator of their behaviour and good faith.

For the reasons set out above, we consider that UNC305 better facilitates relevant objective (d) than the current baseline.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC305: 'Unsecured Credit Limit allocated through payment history' be made.

Rachel Fletcher
Partner, Distribution

Signed on behalf of the Authority and authorised for that purpose