

Modification proposal:	Uniform Network Code (UNC) 375: 'Changes to how Unsecured Credit Limits are determined within UNC TPD Section 3.1.7 (Independent Assessments)' (UNC375)		
Decision:	The Authority ¹ has decided to reject this proposal		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	23 February 2012	Implementation Date:	N/A

Background to the modification proposal

In 2005, following extensive consultation, we published our conclusions on best practice guidelines for gas and electricity network operator credit cover ('the guidelines')². These guidelines aimed to ensure that gas transporters' (GTs') credit cover and payment terms were proportionate, allowing network operators to properly manage, rather than wholly avoid, any exposure to financial risk. The document indicated that appropriate changes would need to be brought forward by parties to industry codes in order to arrive at credit cover arrangements consistent with the best practice guidelines. This included the recommendation that unrated companies should be able to access a line of unsecured credit on the basis of their payment record or on the basis of an independent assessment of their credit worthiness. It was also recommended that companies with an issuer rating of B+ and below should be able to access unsecured credit through similar mechanisms to those applying to unrated companies.

Accordingly, in January 2007 the Authority directed the implementation of Uniform Network Code (UNC) modification proposal 113³. 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 against transportation charges. This would be by one of two means: the first being payment record and the second an independent assessment, for which a scoring table to compare different credit agency applicant ratings was introduced. It was considered that this would help ensure that there is no inappropriate discrimination or barriers to entry in the market.

However, in April 2009, in light of the numerous credit related issues that had arisen since the publication of the guidelines, Review Proposal 252⁴ was raised to allow a review of the UNC credit arrangements for transportation charges and consider whether they remained fit for purpose. The Review Group came forward with 14 recommendations, each of which was raised as an individual modification proposal. In particular, the review group concluded that there was no clear guidance on the application of the scoring mechanism, which could result in GTs using different methodologies for establishing the Independent Assessment Score.

In line with one of the review group's recommendations, UNC304⁵ sought to introduce a clear credit scoring mechanism into the UNC, reflecting the procedure introduced into the

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 Best practice guidelines for gas and electricity network operator credit cover - Conclusions document, available at <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=9791-5805.pdf&refer=Licensing/IndCodes/CreditCover>

³ UNC113 'Availability of Unsecured Credit Based on User Payment Record or Independent Assessment', available at <http://www.gasgovernance.co.uk/0113>

⁴ Review Proposal 252 'Review of Network Operator Credit Arrangements', available at <http://www.gasgovernance.co.uk/0252>

⁵ UNC304 'RG0252 Proposal 7 Introduction of a rating table for independent credit rating agencies for use with Independent Assessment', available at <http://www.gasgovernance.co.uk/0304>

electricity Distribution Connection and Use of System Code (DCUSA) through change proposal 034. It introduced a list of credit scores used by various credit agencies and set them against a scale of unsecured credit limit levels. The unsecured credit limit levels were expressed as a percentage of the Transporter's maximum unsecured credit limit⁶ which was the same approach used in respect of approved, issuer credit ratings. However, UNC304 also provided that the User's unsecured credit limit should default to any credit value recommended within the Independent Assessment if lower than the scale amount referred to above.

Separately, UNC305⁷ amended the UNC such that an unsecured credit limit based on a User's payment history would 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. After that time, the User would be required to utilise other mechanisms such as independent credit assessments. It also capped the unsecured credit limit available under payment history to 0.8% of the relevant GT's Maximum Unsecured Credit Limit. This was intended to strike an appropriate balance between facilitating market entry and mitigating the risks of bad debt costs being passed through to consumers.

The modification proposal

First Utility (FUT) highlighted a materially significant gap between the Unsecured Credit Limit that could be achieved based on the value calculated by applying an Independent Assessment Score to a Transporter's Maximum Unsecured Credit Limit in line with the table contained in UNC TPD 3.1.7 and the Unsecured Credit Limit that would usually result from the Transporter using only the credit value recommended within the assessment report. FUT believed that this undermined the intended purpose of the implementation of UNC304, unfairly discriminating against Users without an approved credit rating and negatively impacting competition.

The original modification raised by FUT proposed to remove the requirement for Transporters to use the lower value (scale score or value recommended in report), instead allowing the User to choose which should be used. The proposer considered that this would assist competition by allowing Users without an approved credit rating to free up working capital, which could then be used to grow their businesses. This proposal was withdrawn by FUT, because the specific reasons for it being raised were addressed through other means. However, the modification was later adopted and revised by Wales and West Utilities (WWU).

WWU believes that, due to the existing "lesser of" rule within UNC TPD V 3.1.7, the application of the Independent Assessment Score to determine a User's Unsecured Credit Limit is unlikely to happen. The workgroup assessment report also notes that the guidelines covered both electricity and gas network operators and that applying the Independent Assessment Scores to a network's maximum Unsecured Credit Limit may be more applicable in the electricity industry due to the number and comparatively similar size of electricity Distribution Network Operators (DNOs)⁸. WWU asserts that merely removing the "lesser of" rule, as set out in the original proposal, could lead to inappropriate Unsecured Credit Limits. Therefore the revised modification proposal instead proposes to remove the Independent Assessment Score option, and for the Unsecured Credit Limit to be based solely on the credit value contained within the Independent Assessment.

⁶ Set at 2% of the Transporter's Regulatory Asset Value (RAV)

⁷ UNC305 ' RG0252 Proposal 8 Unsecured Credit Limit allocated through payment history', available at <http://www.gasgovernance.co.uk/0305>

⁸ Northern Gas Networks provided analysis to the 30 June meeting of Workgroup 0375 showing how the application of the table within UNC TPD V 3.1.7 would apply to electricity DNOs. They considered that as the RAVs for DNOs are more proportional to each other there is a much greater likelihood of the Independent Assessment Score being used to produce a "lesser of" value. See: www.gasgovernance.co.uk/0375/300611

WWU believes this proposal will better facilitate Relevant Objective (f), 'Promotion of efficiency in the implementation and administration of the Code' by giving clarity to how an Independent Assessment would result in the determination of a User's Unsecured Credit Limit. This would be achieved by removing a complicated process from the UNC that is not appropriate and has never been used to determine a User's Unsecured Credit Limit.

UNC Panel⁹ recommendation

At its meeting on 19 January 2012, the 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 19 January 2012. 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 FMR¹⁰.

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC¹¹.

Reasons for the Authority's decision

We have assessed the proposed modification against the UNC Relevant Objectives. We consider this proposal will not further objective (d) or (f) and is neutral with regard to the other Relevant Objectives.

Relevant Objective (d) '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.

The rationale behind introducing various options for establishing the credit limit of smaller players without an approved credit rating was to strike an appropriate balance between facilitating market entry and mitigating the risks of bad debt costs being passed through to consumers. Whilst the options currently available are not functioning in the way initially envisaged, in that the Independent Assessment scale score is invariably higher and therefore never used to determine the Unsecured Credit Limit, we have a concern that removing this option could be detrimental to competition.

We are concerned that smaller parties, particularly new entrants, in some circumstances may not be receiving the appropriate credit assessment value. For example, recent research shows that where each credit information provider employs its own methodology for calculating a credit score or limit, significant variations in certain company ratings can occur¹². Therefore, if the credit rating were based solely on these figures, smaller parties without an approved credit rating may not be receiving the appropriate level of credit.

⁹ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

¹⁰ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

¹¹ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: <http://epr.ofgem.gov.uk/index.php?pk=folder590301>

¹² See 'Credit Rating Agencies Research Findings', Shelly Stock Hutter LLP, Autumn 2011

We consider that whilst independent credit assessments are a useful tool in determining a User's Unsecured Credit Limit, they are not intended to be a substitute for or supersede a creditors own judgement and discretion. We recognise that an independent assessment score, when linked to a GT's RAV, may give an inappropriate figure, exponentially higher than the assessment value contained within the same report. However, it is also important to consider the nature of the GT, being a low risk natural monopoly which the User has no option but to deal with. Associating the independent assessment score with a reference point of the relevant GT's RAV was intended to reflect the GT's ability to carry risk without threatening its own position.

It is clear from the analysis provided to the 0375 workgroup that an Unsecured Credit Limit based on the Independent Assessment Score alone would be disproportionate. We therefore consider that there is a defect within the UNC to the extent that the reference table within Section V 3.1.7 is not working as intended. We also agree with WWU and those respondents who suggested that it would be inappropriate to simply remove the rule stipulating that the "lesser of" the assessment value and the result of the assessment score be used. However, the varied proposal goes much further by seeking to remove the use of an Independent Assessment Score entirely.

We consider that the implementation of UNC375 would make the UNC credit arrangements overly reliant upon Independent Assessment values, and given our concern with the accuracy of those values and their applicability to a network monopoly service, this could be detrimental to smaller parties and new entrants who use such assessments in obtaining an Unsecured Credit Limit. UNC375 may therefore be detrimental to competition.

Relevant Objective (f) Promotion of efficiency in the implementation and administration of the code

The proposer and some of the respondents consider that amending UNC TPD Sections V 3.1.1, V 3.1.7 and V 3.1.8 will remove uncertainty regarding the issue of the Unsecured Credit Limit for those Users who do not have an approved credit rating by ensuring that it is based solely on the value contained within their Independent Assessment(s).

Whilst we recognise that the "lesser of" rule effectively means that the option of determining a User's Unsecured Credit Limit based on an Independent Assessment Score, rather than value, is not used in practice, we do not consider that its removal would be in line with the credit best practice guidelines, which themselves sought to create a greater degree of consistency with the credit arrangements across relevant industry codes. We therefore do not consider that it would promote efficiency in the implementation and administration of the code.

We welcome the analysis that was provided to the UNC375 workgroup in the preparation of its report. This has highlighted an issue with UNC Section V 3.1.7 that should be reviewed to consider if changes need to be brought forward to enable GTs to efficiently manage, but not necessarily wholly avoid, an appropriate level of credit risk. However, for the reasons set out above, we do not consider that UNC375 is an appropriate solution.

Andrew Burgess
Associate Partner, Transmission and Distribution Policy

Signed on behalf of the Authority and authorised for that purpose.