

Modification proposal:	<b>Uniform Network Code (UNC) 726: 'COVID-19 Liquidity relief scheme for Shippers' (UNC726)</b>		
Decision:	The Authority <sup>1</sup> directs this modification be made <sup>2</sup>		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	23 June 2020	Implementation date:	To be confirmed by the Joint Office

## Background

COVID-19 has triggered an unprecedented public health emergency and caused serious challenges for the energy industry to tackle on behalf of the homes and businesses that depend on the sector for gas and electricity. As a consequence of the impacts on the energy supply chain, suppliers (and in turn shippers) may find themselves experiencing cash flow issues, which could have negative impacts on consumers.

On 2 June 2020, we issued an open letter<sup>3</sup> to all energy suppliers, shippers and network operators, both to thank them for their continuing efforts to provide essential services to consumers during this challenging time, and to outline the further support that we expect to be made available to energy suppliers and shippers. In particular, we noted that work had been undertaken by the network companies to develop schemes to enable the temporary relaxation of payment terms for suppliers and shippers.

As noted in our letter, our overarching aims during this crisis are to ensure that energy consumers are offered the support and service they need, to minimise disruption for consumers and other market participants that could arise should companies exit the energy market in a disorderly way over the next few months, and to mitigate the risk to consumers of a material decline in competition arising from the potential exit of otherwise efficient suppliers.

Having reviewed the principles of the proposed schemes, we invited industry parties to consider how best to give effect to them.

## The modification proposal

UNC726 was raised by Wales and West Utilities following the publication of our open letter, with a request that it be given urgent status and follow an expedited timetable. On 3 June 2020, we agreed to that request.<sup>4</sup>

UNC726 proposes to provide relief to shippers by allowing them to defer payment of some gas transportation invoices related to DNO and National Grid NTS charges, issued in July, August, and September 2020. Repayment of any deferred invoices would be required before the end of March 2021, with instalments payable prior to that deadline and deferred amounts being subject to interest equivalent to existing rates for late

<sup>1</sup> References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

<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> See <https://www.ofgem.gov.uk/publications-and-updates/managing-impact-covid-19-energy-market-relaxing-network-charge-payment-terms>

<sup>4</sup> See: <https://www.ofgem.gov.uk/publications-and-updates/unc726-covid-19-liquidity-relief-scheme-shippers-decision-urgency>

payment. Further, there would be certain eligibility criteria for shippers, and caps on relief available to them, so that scheme targets support to those shippers less able to access liquidity support by other means.

In order to ensure the financial stability of each gas network company, there would also be a cap on the amount of each network's charges that may be deferred under the scheme.

### **UNC Panel<sup>5</sup> recommendation**

At its meeting of 18 June 2020, the UNC Panel did not vote with a clear majority to recommend the implementation UNC726. Therefore, UNC Panel did not recommend that UNC726 should be implemented.

### **Our decision**

We have considered the issues raised by the modification proposal and the Final Modification Report (**FMR**) dated 18 June 2020, including the responses to the industry consultation which were attached to the FMR,<sup>6</sup> and concluded that:

- implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC;<sup>7</sup> and
- directing that the modification be made is consistent with our principal objective and statutory duties.<sup>8</sup>

### **Reasons for our decision**

Eighteen responses were submitted to the consultation on UNC726. Of those, nine supported its implementation while six were opposed. The remaining three offered neutral comments.

The majority of respondents, whether for or against the proposal, linked their comments to the impact that they considered UNC726 would have on competition. We agree with those respondents and the UNC Panel that UNC726 should be considered against relevant objective d), although the potential effect of UNC726 on relevant objective c) is also material to this decision. We consider that the impact on other relevant objectives is neutral.

### ***c) the efficient discharge of the licensee's obligations under this licence***

In light of our general aim of preventing detriment to consumers arising from market disruption as set out above and expanded upon in our open letter, we have considered whether a relaxation of payment terms for transportation charges as set out in UNC726 is an effective and appropriate means of achieving that aim. Some respondents queried whether the proposed scheme was consistent with the gas transporter (**GT**) licence,

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<sup>5</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

<sup>6</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.co.uk](http://www.gasgovernance.co.uk)

<sup>7</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, available at: <https://epr.ofgem.gov.uk/Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf>

<sup>8</sup> 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 as amended.

noting variously that the licence does not provide for such a scheme, or that it seems contrary to the GT's obligations to operate in a non-discriminatory manner. We agree that these are important considerations.

As noted by some respondents, whilst shippers and suppliers can be part of the same company, they are often distinct entities. Suppliers are not in their own right signatories to the UNC or direct recipients of the transportation services that it governs. They are therefore not directly liable for the transportation charges for which UNC726 seeks to modify the payment terms. However, the network charges which feed through to suppliers do make up a significant proportion of the costs that suppliers and ultimately consumers face, making up around 25% of the typical gas bill.<sup>9</sup>

The transportation arrangements established by the GTs and set out in the UNC must be consistent with the licensees' duties under the Gas Act 1986, section 9 of which includes the duty to facilitate competition in the supply of gas. This is also reflected in the relevant objectives of the UNC, in particular relevant objective d) as set out below. We are therefore comfortable that a proposal intended to support the supply market is appropriately within scope of the UNC objectives, albeit we acknowledge that the structure of the gas market means that this support is indirectly, rather than directly, targeted. Some respondents were concerned as to whether any additional liquidity offered through UNC726 would be passed through to suppliers and consumers. As the commercial relationships between suppliers, shippers and consumers is not for the GTs to determine, we consider this further under relevant objective d) below.

#### *Recovery of bad debt, and treatment of interest*

Some respondents raised concerns over the treatment of any bad debt that may accrue if a shipper defers payment of network charges but fails before paying the deferred charges, and over the treatment of interest payments. One respondent suggested that the interest rate applied to any deferred payment would be punitively high and contradict the intent of the scheme to support suppliers experiencing liquidity issues.

We consider UNC726 is consistent with the basis on which GTs' costs are recovered. All charges would continue to be levied on a cost-reflective basis, UNC726 simply extends the deadline for payment of some of those charges. To the extent that the GTs may incur any additional cost of capital in extending those payment terms, we consider that it is reasonable for the GTs to recover that cost through charges for interest. Whilst the applicable interest rate<sup>10</sup> is higher than the GTs' cost of capital, it is in line with the rates that would ordinarily be applied to late payments, as defined in the UNC. We consider that this is appropriate, both in terms of consistency of treatment and to ensure that the support offered through the scheme is targeted at those who need it, and only to the extent they need it, rather than utilised simply as a cheaper source of credit than may be available elsewhere.

Some respondents queried how this interest would be treated for price control purposes. As noted in our open letter, any interest accrued by the GTs net of their cost of capital would be used to offset any bad debt that may accrue as a result of scheme participants' failure to repay deferred charges plus interest, once all avenues to recover the money have been exhausted. In the event that there is no such bad debt, the interest charged would be treated as revenue and offset against other transportation charges.

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<sup>9</sup> See: <https://www.ofgem.gov.uk/publications-and-updates/infographic-bills-prices-and-profits>

<sup>10</sup> The FMR confirms that the interest rate will be 8.1% from 1 July 2020

In our open letter, we suggested that the bad debt would be recovered within the year 2021/22. In practice, the treatment of these monies, including the pursuance through debt recovery and, if necessary, liquidation process and/or the consequential adjustment of transportation charges, is largely at the discretion of the GTs and may extend late into 2021/22 or beyond. In particular, the GTs will not be in a position to confirm whether any debt is outstanding ahead of their 2021/22 charges taking effect. However, an option we are looking at is to modify the licence to allow GTs to make an estimation or provision for bad debts as part of their revenue, in advance of setting charges. This would be adjusted as and when the full impact of any bad debt is known. Given the limited scale of the liquidity scheme as compared to overall transportation charges, it is unlikely that bad debt arising from the scheme would of itself warrant any *ad hoc* revision to charges.

We agree with respondents who suggested that, in the interest of transparency, the GTs should publish (in anonymised form) the level of take-up of the scheme and of any outstanding balance upon its closure. However, given the points on timing above, shippers should not assume that those values provide a reliable indication of their own potential exposure. With particular reference to the default tariff cap, we would expect that bad debt arising from the failure to repay deferred charges plus interest would be reflected in the allowance for network costs in line with the usual default tariff review process.

#### *Discrimination*

UNC726 is targeted at those shippers who do not have an investment grade credit rating, on the basis that such companies would find it more difficult and expensive to secure alternative sources of liquidity. This is intended to maximise the effectiveness of the scheme, and ensure that the financial resilience of the GTs is protected. However, some respondents considered that in targeting the scheme in this way, to the exclusion of those shippers who do have an investment credit grade rating, UNC726 may be discriminatory or otherwise have a distortive effect on competition. While we consider the potential impacts of UNC726 on competition below, the potential for discrimination is relevant to our consideration of whether its implementation would further relevant objective c). In particular, the GTs are obliged<sup>11</sup> to ensure that no shipper or supplier receives any unfair commercial advantage from a preferential or discriminatory arrangement relating to the manner in which the licensee conducts its transportation business.

As regulated monopoly businesses, the GTs do not have sole discretion over whom to do business with or on what terms. It is therefore appropriate that their credit arrangements are applied consistently and on a non-discriminatory basis, as facilitated by them being codified as part of the UNC. Nevertheless, it would undermine the efficiency and effectiveness of those credit arrangements if they treated all parties as being the same, rather than tailoring the applicable terms and conditions in accordance with relevant factors, primarily around the relative risk of the GT being able to recover the value of any credit they extend to parties. In particular, the UNC credit rules already apply different conditions to shippers on the basis of whether or not they have an investment grade credit rating, and to the relevant value that the GT is willing to place at risk based on differing grades. Fundamentally, that is the purpose of such ratings.

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<sup>11</sup> Standard Special Condition A6: Conduct of Transportation Business

We therefore do not consider that the implementation of UNC726 would give rise to an unfair commercial advantage for eligible shippers and their suppliers by differentiating between companies which are and are not investment grade rated. On the contrary, while under normal market conditions, a company's investment grade credit rating would simply provide greater access to capital markets and bank lending, the government's financial support for businesses during the COVID-19 pandemic means that companies with an investment grade credit rating have an additional source of funding that is not available to other shippers.

We are sympathetic to the argument made by some respondents that the cash flow challenges presented by the COVID-19 pandemic are not unique to parties without an investment grade credit rating but we are satisfied that shippers with an investment grade credit rating are better able to access other sources of funding, including through the capital markets and the government's financial support for businesses. According to our assessments, investment grade credit rated corporate groups that own gas shippers operating in UK market have continued to raise finance by issuing bonds during the pandemic.

Further and as noted above, we are mindful that the GTs' own headroom to offer additional liquidity is both finite and time-bound. Given the greater difficulties that a party without an investment grade credit rating would have in securing alternative sources of finance, as compared to one which has such a rating, we consider that the targeting of scarce available support on this category of shipper is objectively justified and is unlikely to result in eligible shippers receiving an unfair commercial advantage.

Some respondents queried whether the scheme would be open to those shippers who currently pay their transportation charges through a pre-payment arrangement. By definition, the shippers who currently pre-pay their transportation charges would not be subject to the proposed extension of payment due dates for invoices to be paid in arrears. However, if any such shipper would otherwise meet the qualifying criteria for the scheme and wanted to change their payment terms, we would expect the GTs to treat them on an equal basis.

Given the above, we consider that the implementation of UNC726 would be consistent with relevant objective c).

***d) the securing of effective competition between relevant shippers and between relevant suppliers;***

Following the government's decision to issue stay-at-home advice, resulting in much of the UK workforce either working from home or being furloughed, energy suppliers agreed with the Department for Business, Energy and Industrial Strategy a package of support for domestic customers who may be financially impacted by the COVID-19 pandemic.<sup>12</sup> This agreement framed the energy suppliers' approach to bills, payment and supporting prepayment customers to stay on supply, including the suspension of much debt collection activity.

Meanwhile, energy suppliers catering for non-domestic customers have also seen increased instances of late or non-payment, and a significant reduction in energy consumption. We expect non-domestic suppliers to be reasonable in considering what

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<sup>12</sup> See:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/873960/Supplier\\_Agreement\\_19.3.2020.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873960/Supplier_Agreement_19.3.2020.pdf)

support they can offer their customers. We are mindful of the financial pressures that many small businesses are under and we expect suppliers to treat small business customers fairly to support them in managing their energy needs and recovering once the lock down is lifted and economic activity resumes.

We have seen evidence that these factors, together with other cost pressures in the energy supply chain arising as a result of COVID-19, create cash flow challenges for suppliers and, in turn, shippers. We consider that the implementation of UNC726 would, for the duration of any deferral, provide support to suppliers with temporary cash flow issues, and give suppliers and shippers time to take further action to reduce the risk of companies exiting the market in a disorderly manner. UNC726 would thus help reduce the risks that we see could arise from multiple suppliers exiting the market in a short space of time, and the consequent negative impacts on competition in the short-term, including undermining competition through poor customer service and a chilling effect on switching, as well as in the longer-term, including less vigorous price competition and potential loss of consumer confidence.

The additional liquidity provided by this scheme will not remove the risk of supplier failure entirely, nor will it avoid any single supplier failure *per se*. The scheme does not provide a longer-term alternative source of liquidity for struggling suppliers, but does make it more likely that any exits from the market can be handled in an orderly fashion, and without risking wider impacts on other market participants, while the economic effects of the pandemic are being felt throughout the industry.

We expect this scheme to provide industry with a degree of breathing space – both to enable otherwise viable firms to manage their cash flow in a way that allows them to remain in the market, and for suppliers more generally to stabilise their financial positions and their operational capacity, allowing them to acquire other energy suppliers through commercial transactions or act as a supplier of last resort should the need arise.

#### *"Trickle down" to suppliers and consumers*

Some respondents and several members of the UNC Panel noted that the modification relates specifically to shippers and questioned whether and how relief would be passed down to suppliers and consumers who are facing challenges arising from the COVID-19 pandemic. We acknowledge the limitations of the scheme in this respect, but consider that we must work within the framework as it currently exists.

The pass through of any additional liquidity provided by UNC726 to suppliers, and indeed consumers, will be largely subject to the commercial structures and contractual terms and conditions in place. Where the supplier and shipper are part of the same corporate group, the supplier may benefit more directly from the scheme. To the extent that third party shippers make use of this scheme to defer payment of certain network charges, it would be reasonable to expect that such shippers may take the commercial decision to offer corresponding flexibility to their contracted suppliers. We would similarly expect that consumers who are subject to the direct pass through of transportation charges would benefit from this scheme. Whilst, as noted, this will be subject to each shipper's assessment of their own commercial position, at the very least UNC726 give them greater scope to offer such flexibility. Further, as the shipper is ultimately liable to pay network charges, we would consider it reasonable for the shipper to be the beneficiary of this scheme where a supplier has defaulted on payments to the shipper.

#### *Mutualisation of bad debt*

Several respondents noted the risk of bad debt left behind by failed shippers/suppliers being mutualised across remaining shippers/suppliers, which they felt would distort competition. We acknowledge this risk but consider that the modification seeks to minimise the scale of potential bad debt arising by targeting proportionate, capped and time-limited support for parties who cannot access government schemes. Supplier or shipper failure, in itself, during current market conditions, would be likely to give rise to significant costs being mutualised. We consider the benefits of UNC726 outweigh the risk posed by potential mutualisation of scheme-related bad debt.

We also note that UNC726 contains mechanisms to discourage network charges from being deferred unnecessarily and so reducing the risk of bad debt being passed through to other market participants. For instance, deferred payments will attract interest charges in line with those of other late payments, dis-incentivising shippers from making use of the option to defer other than as a last resort.

Further, the interest payments will, net of cost of capital, be treated as price controlled revenue and therefore offset any bad debt that may accrue from other shippers, minimising the impact on the shipper community as a whole. Finally, the caps and requirement to pay 25% of monthly charges limit how much bad debt any one shipper could accrue. The impact on the GTs will be neutral overall, as any revenues initially unrecovered due to bad debt that are not offset by any interest payable under the scheme, will be passed through to shippers in the following financial year.

Some respondents queried how any bad debt passed through to suppliers would be treated under the default tariff cap. Where this relates to bad debt arising from non-payment by the suppliers' own customers, as noted in our open letter, the default tariff cap allows headroom to take into account unexpected costs like a short-term increase in bad debt. If there is a material change in suppliers' costs as a result of COVID-19 impacts, including bad debt costs, we will consider how to reflect these in the default tariff cap methodology whilst protecting existing and future domestic default tariff customers. In the case of any bad debt arising from UNC726 that may need to be mutualised, notwithstanding the measures referred to above, these would be passed through as part of network costs, as set out on page 4 above.

We consider that, on balance, the implementation of UNC726 would be likely to maintain higher levels of competition between gas suppliers and between shippers than might otherwise be the case. Given the above, we consider that the implementation of UNC726 would better facilitate relevant objective d).

### **Assessment against Authority's principal objective and statutory duties**

In considering whether directing the implementation of UNC726 would be consistent with our principal objective and statutory duties to protect the interests of consumers, we have focused on three specific areas.

The first area is whether this arrangement would be consistent with our general response to the COVID-19 challenge, with particular focus on supporting vulnerable consumers, and maintaining secure, reliable and safe supplies of energy. In summary, we consider that the modification should mitigate the risks of consumers, including those in vulnerable circumstances, not receiving the support and service they need, and minimise disruption for consumers and other market participants that could arise should companies exit the energy market in a disorderly way over the next few months.

The second area is what effect this scheme would have on competition between suppliers and between shippers, both in the short and longer-term. As explained above, we consider that UNC726 would make an important contribution to mitigating risks we see in this area, and would likely maintain a higher level of competition than otherwise be the case.

The third area relates to our duties to licence holders to secure that they can finance their licensed activities. The financial headroom that GTs have available to offer shippers deferral of network charges is limited. The scheme seeks to maximise the effect of this available liquidity by targeting it at those shippers without an investment grade credit rating. While we acknowledge that such shippers would ordinarily be regarded as being at most risk of default, by placing an appropriate cap on the amount of additional liquidity that each shipper may access, combined with the application of interest rates equivalent to other forms of late payment, and the continuing application of credit management practices, the UNC726 scheme should minimise the risk of bad debt accruing. Further, to the extent that GTs have managed their credit exposure efficiently, we would expect to allow the pass through of any bad debt in due course, protecting GTs from financial instability without imposing an avoidable or excessive burden on shippers and suppliers (who would ultimately bear the cost of any bad debt, were it to arise from this scheme). We are therefore satisfied that the implementation of this scheme would be consistent with our duty to secure that licence holders are able to finance their licensable activities.

UNC726 seeks to address the unprecedented challenges faced by the GB energy industry as the nation deals with the COVID-19 pandemic. This is a distinct and time-bound issue that warrants a different approach than may be appropriate in other times. We consider that directing that UNC726 be implemented is consistent with our principal objective of protecting the interests of existing and future consumers.

#### *Impact assessment*

In its letter dated 3 June 2020, the Authority decided that UNC726 should be given urgent status and follow expedited modification procedures.

In the reasons given for that decision, we noted that “[w]e are satisfied that the progression of this modification proposal and the need for an appropriate response to COVID-19 is “a current issue that if not urgently addressed may cause a significant commercial impact on parties, consumers, or other stakeholders(s)”.

Section 5A of the Utilities Act 2000 imposes a duty on the Authority (its **Section 5A duty**) to undertake an impact assessment in certain circumstances. In particular, the Section 5A duty applies where it appears to the Authority that a proposal is important. A proposal is important for these purposes if its implementation would be likely to, among other things, “have a significant impact on persons engaged in the shipping, transportation or supply of gas conveyed through pipes or in the generation, transmission, distribution or supply of electricity” or “have a significant impact on persons engaged in commercial activities connected with [such activities].” Where this applies, the Authority is obliged to carry out an impact assessment and will generally follow its applicable guidance.<sup>13</sup> The Section 5A duty is, however, subject to exceptions.

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<sup>13</sup> That guidance is available at the following webpage: <https://www.ofgem.gov.uk/publications-and-updates/impact-assessment-guidance>.

In particular, the Authority is not required to conduct an impact assessment if it appears to the Authority that the urgency of the matter makes it impracticable or inappropriate for it to do so.

The Authority has concluded that this exception applies here. As explained above, we are aware of various factors arising from the COVID-19 pandemic placing strains on the liquidity of GB energy suppliers. In the current context of the market being less able to deal satisfactorily with multiple supplier failures in a short space of time, we consider the risk of multiple disorderly supplier and shipper exits with the ensuing disruption for consumers and other market participants warrants our decision to want to implement UNC726 as soon as possible. We also note that the Final Modification Report states that an Authority decision is required by the 23 June in order for the modification to be implemented as planned, providing the scheme from invoices issued in July.

Accordingly, the Authority considers it is impracticable or inappropriate to comply with the Section 5A duty. In any event, we have:

- Considered the need for this scheme in light of what we know about the financial resilience of suppliers and shippers,
- Considered our ability to ensure consumer protection under the status quo versus with the implementation of UNC726,
- Considered the impacts on other market participants and processes, including the risk of wider market impacts associated with supplier and shipper failures, under the status quo versus with the implementation of UNC726,
- Assessed the size of any potential bad debt that would be left behind by suppliers and shippers if they took advantage of the scheme without repaying deferred charges and interest, and
- Considered the impacts on competition between suppliers and between shippers under the status quo versus with the implementation of UNC726.

### **Decision notice**

In accordance with Standard Special Condition A11 of the Gas Transporters licence, the Authority hereby directs that modification proposal UNC726: *'COVID-19 Liquidity relief scheme for Shippers'* be made.

**Neil Barnes**

**Deputy Director, Consumers and Markets**

Signed on behalf of the Authority and authorised for that purpose