

Title: Implementation of Credit Cover Arrangements – Drafting Requirements Document
Produced by: Distribution Commercial Forum Credit Cover Sub Group

1. Introduction

Following an industry wide consultation, the preferred arrangements for the provision of credit cover to UK Network Operators have been outlined by Ofgem. These arrangements take the form of best practice guidelines and are detailed in the document entitled “Best Practice Guidelines for gas and electricity network operator credit cover – Feb 05”.

An industry group, the Credit Cover DCF Sub Group, was set up to agree an amended template Distribution Use of System Agreement (DUoSA), which incorporates the new guidelines. It is intended that this template will form the basis of discussion between suppliers and Network Operators, when negotiating the amendment of bilateral DUoSAs extant between them.

2. Scope

The agreements to be created include:

- a template UK Distribution Use of System Agreement (DUoSA)
- a template Scottish Distribution Use of System Agreement (DUoSA)

Out of Scope are credit cover arrangements for use of system for:

- distributed generation;
- Independent Distribution Network Operators (IDNOs);
- the transmission system
- gas arrangements
- MOP and MAP charges

3. Amendments to the DUoSA

A summary of the arrangements outlined by Ofgem can be found in Appendix 1. Using this summary, the Credit Cover Sub Group has made the following amendments to a standard DUoSA:

Main Body of Agreement

1. DEFINITIONS - Deleted definition of Approved Credit Rating
2. CONDITIONS PRECEDENT –altered clause 2.1.7
- 8A PAYMENT DEFAULT – inclusion of a new section to handle payment default

Schedules

1. COVER – complete re-write of schedule
6. BILLING & PAYMENT DISPUTE – Insertion of new clause 1.2(C)

Where Ofgem’s published guidelines do not provide the details needed for drafting, or where there is ambiguity, the Sub Group have reached agreement on appropriate wording through discussion and through clarification with Ofgem.

4. Drafting Requirements to DUoSA

Wragge and Co are requested to review the amendments made by the Credit Cover Sub Group, to the template DUoSA, in order to ensure consistency across the entirety of the document and consistency of the document with other industry agreements, where appropriate. Wragge and Co are requested to make any amendments necessary to ensure the document remains legally robust following the changes made by the Credit Cover Sub Group.

In particular, Wragge and Co are requested to ensure any clauses relating to payment default (eg clause 8A) are compatible with clause 18, which deals with termination.

Any requests for clarification on drafting should be directed to the DCF Credit Cover Sub Group, via the Chair, Louise Boland on 01865 812 003 or at Louise.Boland@OpusEnergy.com . All other queries should be directed to the Distributors Commercial Operations Group, via Tony McEntee at Tony.McEntee@SPPowerSystems.com.

Appendix 1

The Following table summarises the arrangements outlined by Ofgem, which must be incorporated in the DUoSA.

Ofgem Proposal	Drafting Assessment																
<i>Setting Unsecured Credit Limits</i>																	
<p>Best Counterparty Limit will be set by Regulator, initially at 2% RAV for each NWO. Individual Counterparty Limits are then given a % of the Best Counterparty limit as follows:</p> <p>Rated Companies:</p> <table border="0"> <tr> <td>AAA/AA</td> <td>100%</td> </tr> <tr> <td>A</td> <td>40%</td> </tr> <tr> <td>BBB+</td> <td>20%</td> </tr> <tr> <td>BBB</td> <td>19%</td> </tr> <tr> <td>BBB-</td> <td>18%</td> </tr> <tr> <td>BB+</td> <td>17%</td> </tr> <tr> <td>BB</td> <td>16%</td> </tr> <tr> <td>BB-</td> <td>15%</td> </tr> </table> <p>(Based on the lowest of rating from Moody's KMV and Standard & Poor's. Publicly and/or specially commissioned ratings. Latter must be reviewed annually.)</p> <p>Unrated Companies and Rated <BB-</p> <p>Counterparty chooses assessment based on:</p> <ul style="list-style-type: none"> 0.4% per year of good payment performance, escalating monthly, up to 2% max after 5 years with reduction to 0% for deterioration in performance. Current payment performance to date to be taken into account. <p>Or</p> <p>Scaled access to 20% via score 1-10 (Unrated) or 13.3% via score 1-4 (low Rated) based on independent assessment from an agency chosen by the counterparty out of three industry chosen agencies. Paid for by the NWO annually, by the counterparty mid term. Panel of agencies to be used will change from time to time as agreed by an industry group set up by Ofgem.</p>	AAA/AA	100%	A	40%	BBB+	20%	BBB	19%	BBB-	18%	BB+	17%	BB	16%	BB-	15%	<p>Clauses: Sch 1: 1.1, 2.1, 2.2</p> <p>Mechanism to calculate the amount of credit provided to a Supplier – best incorporated through a re-write of Schedule 1.</p> <p>Variables set by the Regulator or by the Industry (eg name of rating agencies in panel) could be within the Condition 4 Statement or in some external place which is not specific to any NWO.</p>
AAA/AA	100%																
A	40%																
BBB+	20%																
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Distribution Credit Cover Arrangements

Ofgem Proposal	Drafting Assessment
<p>Parental Company Guarantees (PCGs)</p> <ul style="list-style-type: none"> • PCGs can be offered from a Credit Support Provider (CSP) where legally enforceable in GB. (CSP may be required to provide reasonable counsel's opinion of enforceability in GB). • The same rules as above section will apply to the CSP • A group can aggregate credit positions using PCGs to one CSP <p>Where PCGs have been used, the Individual Counterparty Limit will be based on the CSP's rating.</p>	<p>The VAR for the CSP will relate to indebtedness arising from its own operations and from those of all parties connected via PCGs. Hence the daily calculation of the Indebtedness Ratio for the CSP will need to be based on an aggregate of VAR for all counterparties supported regardless of company structure.</p> <p>Where counterparties are not supported with a PCG, the assignment of Individual Counterparty Limit and daily calculation of the Indebtedness Ratio for the counterparty will be based on the company as a standalone organisation.</p>
<i>VAR and Cover Required</i>	
<p>Use of System</p> <p>VAR = 'Billed but Unpaid' plus 15 days Value (15 days Value calculated at the average daily rate of 'billed but unpaid')</p> <p>Collateral Required = VAR less Individual Counterparty Limit</p> <p>Counterparties are given 1 month's notice to increase collateral where:</p> <ul style="list-style-type: none"> • There has been a reassessment of forecast indebtedness for the next period, or • Counterparty experiences material change in level of trade, or • NWO improves charge forecast 	<p>Clauses: Sch 1: 1.1, 2.1, 2.2, 2.3</p> <p>Mechanism needed to calculate the forecast VAR for next period for a Supplier and the consequent level of Collateral Required – best incorporated through a re-write of Schedule 1.</p> <p><i>(Proposals unclear on mechanism of forecasting cover and length of period between each assessment)</i></p>

Ofgem Proposal	Drafting Assessment
<i>Protection of Credit Exposure</i>	
<p>Choose from basket of tools to cover:</p> <ul style="list-style-type: none"> • approved LC or equivalent bank guarantee from a bank with a long term debt rating of not less than A by Moody's KMV or Standard & Poor's • Cash deposit (should receive Base Rate) • Prepayment before delivery or Advanced Payment of invoice • Approved Escrow account • Performance bond provided by an insurance company not a bank • bilateral insurance • Independent security from an unrelated entity (To be 100% it must be credit support from an entity with a long term debt rating of A or better by Standard & Poor's or Moody's KMV, be legally enforceable in the UK (and may require reasonably acceptable counsel's opinion) from a country with sovereign credit rating of A or better for non local currency obligations and no material conditions preventing exercise of the security) • Any other tools approved by Industry Group set up by Ofgem from time to time (eg mutualisation if further work carried out) <p>NWO to rate tools from 0% to 100% effective. Dispute where counterparty disagrees with effectiveness rating to be referred to an industry group set up by Ofgem for determination.</p>	<p>Clauses: Sch 1: 1.1, 1.2, 1.3, 1.4</p> <p>Most new tools to be included in Schedule 1 with any detailed specifications required.</p> <p>Industry Group needed to develop industry standard model forms for each tool which could be included as appendices to Schedule 1 and to rate the effectiveness of standard tools and to handle disputes over non-standard tools.</p>
<i>Limits of Security</i>	
<p>NWO monitors Indebtedness daily Warning when Indebtedness Ratio is 85%</p> <p>Indebtedness = VAR = undisputed 'Billed but Unpaid' + 15 Days Value Credit Limit = Collateral Provided + Individual Counterparty Limit Indebtedness Ratio = Indebtedness / Credit Limit</p>	<p>Clauses: Sch 1: 2.4</p> <p>Mechanism for daily calculation of Indebtedness and warning mechanism best included in Schedule 1.</p> <p>Indebtedness Ratio (%) = $\frac{(\text{'Billed but Unpaid' + 15 Days Value})}{(\text{Collateral Provided + Individual Counterparty Limit})}$</p>

Distribution Credit Cover Arrangements

Ofgem Proposal	Drafting Assessment
<i>Remedy for Default of Cover</i>	
<p>Where Indebtedness Ratio >100% of Credit Limit:- If due to change in VAR: Notice at D+1, Payment by D+3 or in default If due to change in Credit Limit: Notice at D+1, Payment by D+3 or in default</p> <p>Disputes must be notified to NWO within 1 Working Day.</p> <p>Supplier must then reduce Indebtedness Ratio to 80% and keep at 80% for the period of one year.</p> <p>NWO must notify Ofgem if additional cover is not received.</p>	<p>Clauses: Main Body Cl 18</p> <p>All sections relating to Breach of Cover to be taken out of the Termination Clause 18 and included in new Clause within main body of DUOSA which will cover the new default requirements</p>
<p>If default:</p> <ul style="list-style-type: none"> D+0 – Collateral Due Date D+1 – Penalty Interest and Admin Fee D+1 – NWO issues formal notice of default and requests statement of position and how default is to be remedied (to Contract Manager & copied to Ofgem) D+3 – Formal Supplier Response required D+5 – Suspend registrations <p>After this period, NWO has the right to apply for SoLR and all other remedies generally available at law. Interest charges should be consistent with Late Payment of Commercial Debts (Interest) Act 1998</p>	<p>Clauses: Main Body Cl 18</p> <p>Action taken on Termination to be included in new default clause or in termination clause as appropriate.</p> <p>Penalty Interest and Admin Fee to be listed in Condition 4 Statement. Penalty Interest = r+[8]% Fee: £40 if >£400, £70 if >1000, £100 if >£1000</p>
<i>Payment and Billing Terms</i>	
<p>Payment should be via electronic or cleared funds, or NWO can make a reasonable charge for non standard payment methods</p> <p>NWO should have rights of set off.</p>	<p>Clauses: Main Body Cl 7 & 8</p> <p>Wording change needed to incorporate this.</p>

Distribution Credit Cover Arrangements

Ofgem Proposal	Drafting Assessment
<p><i>Payment Default</i></p> <p>D+0 – Invoice Due Date D+1 – Penalty Interest and Admin Fee D+1 – NWO issues formal notice of default and requests statement of position and how default is to be remedied (to Contract Manager & copied to Ofgem) D+3 – Formal Supplier Response required D+5 – Suspend registrations</p> <p>After this period, NWO has the right to apply for SoLR and all other remedies generally available at law.</p>	<p>Clauses: Main Body Cl 7 & 8</p> <p>New Payment Default rules either to be included in Cls 7 & 9 or in new Default clause which suits drafting best.</p> <p style="padding-left: 40px;">Penalty Interest = r+[8]% Fee: £40 if >£400, £70 if >1000, £100 if >£1000</p> <p>MRA Change to MRA may be needed for clarification since MRA currently refers to conditions in DUOSA</p> <p>Mechanism must differentiate uplift on interest rate as penalty rate for late payment but not rate for reconciliations.</p>

Notes

1. New arrangements to be codified by industry by 1 Oct 05.
2. Pass-through on failures on interim period before implementation on 1 Oct 05 will depend on steps taken to progress implementation.
3. Any additional collateral required by counterparties under the new arrangements should be provided evenly over a period of 1 year from implementation ie 1st Oct 06.
4. Best Practice Guidelines to be reviewed annually by a body set up by Ofgem similar to the Credit Cover Steering Group.