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Dear Chris,

Proposed DN sales - Open letter to Transco regarding credit cover arrangements for gas transportation use of system and connection charges

As you are no doubt aware, credit rules have recently been discussed at both the Development and Implementation Steering Group (DISG) and the Uniform Network Code Development Forum. I am writing to set out Ofgem's current position on how these arrangements should be dealt with for the purposes of drafting the proposed Uniform Network Code (UNC).

In issuing this open letter, it is important to make clear that there can be no expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. This open letter is provided on an informal basis and should not be treated as binding on the Authority. Nothing in this open letter is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statement made in this letter.

Ofgem consultation on best practice guidelines for credit cover

Ofgem has recently consulted on best practice guidelines for gas and electricity network operator credit cover, which we envisage will be incorporated in all the relevant industry codes and agreements¹. If adopted, the revised arrangements are expected to apply to all charges made

¹ Ofgem, *Recommendations for best practice guidelines for gas and electricity network operator credit cover Consultation Document*, September 2004 226/04 (the September 2004 credit cover consultation document).

by gas and electricity network operators², whether commodity, capacity, connection or use of system charges.

The consultation period has now closed. Ofgem is presently considering the responses it has received and intends to publish its final conclusions in late January 2005, with the aim that the revised arrangements will be implemented as speedily as practicable and ideally with effect from April 2005. We recognise that this timetable is ambitious and may not be achieved. Accordingly, there is a risk that complete certainty for Transco, intending DN purchasers and other interested parties will not be provided at a sufficiently early date to enable the appropriate provisions of the UNC to be drafted in accordance with the DN Sales timetable.

Nevertheless, Ofgem considers that development of the key features of the revised credit cover arrangements is sufficiently advanced for it to be practicable for the UNC to be drafted so as to implement them in relation to gas transportation charges. Accordingly, the UNC should include credit cover arrangements that are consistent with the proposals for best practice guidelines set out in the September 2004 credit cover consultation document.

To the extent that Ofgem's final conclusions on network operator credit cover guidelines vary from these proposals, Ofgem will expect modification of the UNC to be made as soon as practicable to bring its provisions into line with the final conclusions.

Summary of proposals

For convenience, we have summarised some of the key features of the proposals in the following paragraphs. For a complete description of the issues interested parties should refer to the full text of the September 2004 credit cover consultation document.

Some of the key features of Ofgem's proposals are as follows:

1. Each network operator should establish and maintain a system of controls for the management of its counter-party credit exposures which enables the network operator to comply with best practice guidelines in force from time to time.
2. Such controls, and the manner in which they are implemented, should not be unduly discriminatory.
3. Subject to compliance with the guidelines, and to satisfactory explanation of any non-compliance, network operators will be entitled to recover, out of future regulated revenues, all or a proportion of any incurred bad debt losses resulting from the insolvency of a counter-party (net of any recoveries) depending on the age of the debt at the date insolvency occurs.
4. The best practice guidelines to be adopted by all network operators should have the following features:
 - a. Each network operator should set a limit on the amount of unsecured credit that may be taken by each of its counter-parties, which should not exceed its maximum credit limit (the limit for a hypothetical riskless counter-party);

² Other than certain holders of electricity transmission licences, to which separate arrangements will apply under the SO/TO Code.

- b. Each network operator's maximum credit limit should be set by reference to its ability to sustain loss;
- c. To avoid undue variation between network operators, each network operator's maximum credit limit should therefore be set at a standard proportion of an appropriate measure of the value of its regulated business from time to time. Ofgem has proposed this should be 2% of RAV, corresponding in the typical case to some 10% of annual regulated revenues;
- d. Each counter-party's unsecured credit limit should be scaled to the network operator's maximum credit limit, by reference to the relative creditworthiness of the counter-party
- e. To avoid over complication, and to reduce the scope for undue discrimination, Ofgem proposes that the scale used for this purpose be based on the weightings adopted under the 'Basel II' guidelines for assessing bank capital adequacy. These are based on default probabilities.
- f. The 'Basel II' weightings are in the ratio 1 : 2.5 : 5 : 7.5 for assets rated, respectively, AAA/AA, A, BBB/BB/Unrated, and below BB. Transposing these weightings yields counter-party credit limits of, respectively, 100%, 40%, 20% or 13-1/3% of the network operator's maximum credit limit, according to the band in which each counter-party's credit rating falls.
- g. Ofgem recognises that these bandings fail to distinguish adequately between differing degrees of creditworthiness among unrated counter-parties, and those that fall in the lowest band (which could include those already in default). Accordingly, it is proposed that supplementary credit-scoring methods be used to assign credit limits to counter-parties within these bands. Thus, for example, an unrated counter-party might have a limit of between 0% and 20% of the network operator's maximum limit, based on the score assigned to it by these methods. Similarly, a counter-party rated below BB might on the same basis have a limit between 0% and 13.33% of the network operator's maximum. Further work is being undertaken to determine appropriate credit scoring procedures for this purpose.
- h. Each counter-party should be allowed to take unsecured credit up to its limit. For this purpose, the amount of credit taken (value at risk) in respect of use of system charges should be determined by reference to all amounts billed but unpaid, augmented by an amount equivalent to a further fifteen days' usage (based on the same daily rate implicit in billed amounts), to reflect the network operator's exposure in respect of accrued but unbilled charges.
- i. Standard measures of value at risk should be used for charges arising under long-term capacity and connection agreements, which take account of the probability of recovery in the event of default. Wherever practicable, market values should be used for this purpose. A default method needs to be established where there is no market price discovery. This is the subject of further work in progress.

- j. Amounts of credit taken by a counter-party in excess of its limit should be secured by any one of a variety of acceptable means³. Network operators should monitor credit taken daily, and enforce the requirement for security, where applicable, promptly and diligently. Default in providing any security required is to be treated in broadly similar fashion to default in payment of invoices.
- k. Network operators should act promptly and firmly to enforce remedies for default. Ofgem expects network operators to avail themselves of all remedies open to them at law, with the single exception that Ofgem considers de-energisation or disconnection of consumers should be undertaken only in the last resort and only after sufficient notice has been given to all affected consumers to enable them to switch supplier. The guidelines will contain standard provisions for implementation of default remedies.

Application of these proposals in the context of DN Sales

Ofgem considers that arrangements which implement these proposals are likely to afford adequate protection to all network operators, regardless of any other factor that might differentiate them, and therefore sees no reason to approve special arrangements for DN Sales purposes.

Ofgem accepts that counter-parties facing liquidity constraints might manage their payments in such a way as to take proportionately more credit from one network operator than from another, according to the judgement they make about the speed and efficacy with each network operator will respond to default. It is possible, though by no means certain, that incentives faced by shippers under the revised gas industry arrangements proposed for DN Sales will operate in such a way as to result in systematic bias between network operators in this respect. If this proves to be the case, some network operators may need to incur proportionately greater cost than others to implement compliant credit and collection procedures.

As a general matter, Ofgem's methods take account of special factors affecting particular networks when making comparisons for the purposes of setting operating cost allowances in price control reviews. In principle, therefore, if a network operator is able, at any review, to demonstrate that its credit and collection costs are higher than those of the frontier company because of special factors, and do not reflect inefficiency, due allowance will be made for this in judging relative efficiency. Nevertheless, the onus will be on the network operator to show that its costs are no more than an efficient company would need to incur in the same circumstances. This applies equally to operators whose costs benefit from any systematic bias.

Ofgem expects that this position will be reflected in the business rules put forward to the UNC Development Forum. If any contentious issues arise, they should be referred to the DISG.

³ A complete list is set out in the September 2004 credit cover consultation document. The amount of cover provided by different forms of security will be based on a standardised assessment. This is the subject of further work in progress.

If you or any interested party have any queries or comments, please do not hesitate to contact Jessica Hunt on 0207 901 7431.

Yours sincerely,

Sonia Brown
Director, DN Sales