

**Best practice guidelines for gas and
electricity network operator credit cover**

Conclusions document

February 2005 58/05

Summary

Competition in gas and electricity supply is now established and continues to develop. There is, however, the possibility that an energy company using the networks and supplying customers may face financial difficulties, as with any competitive arena. The management of this financial risk by credit cover and payment terms has been the subject of extensive industry debate and consultation.

In February 2003 Ofgem¹ published a conclusions and proposals document² which concluded the high level principles that should be applied and that further detailed work needed to be undertaken on credit cover arrangements for transportation. It also concluded that industry parties were best placed to identify best practice in comparable industries and to develop their own credit cover arrangements accordingly.

In September 2004 Ofgem published a consultation document³ setting out the recommendations of four industry workgroups (the Workgroups) that were formed to identify best practice in comparable industries and to develop best practice guidelines for gas and electricity network operator credit cover arrangements. This also set out Ofgem's views on the mechanism and criteria for the pass through of bad debt for gas and electricity network operators.

This document sets out respondents' views on the September consultation, outlines progress on outstanding issues identified in that document, and includes Ofgem's conclusions. This document establishes the best practice guidelines for gas and electricity network operator credit cover arrangements and the mechanism and criteria for the pass through of bad debt for gas and electricity network operators (NWO).

Going forward, Ofgem expects NWOs and their counterparties to take steps over the coming months to bring their credit arrangements into line with the approach set out in these conclusions. Those steps may take a number of forms, from the raising of modifications to industry codes through to the re-negotiation of bi-lateral agreements and changes in internal working practices. In the interests of transparency, Ofgem would prefer that the key arrangements are set out in the commercial codes where

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this document

² Arrangements for gas and electricity network operator credit cover. Conclusions and proposals document 06/03.

³ Recommendations for best practice guidelines for gas and electricity network operator credit cover. Consultation document 226/04.

appropriate. It should be noted that the conclusions and views set out in this document cannot and do not fetter the Authority's discretion in determining any future dispute, modification or amendment proposal.

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1. Introduction

- 1.1. Ofgem and participants in the gas and electricity markets have a shared concern that the various credit cover arrangements in regulated areas of the industry which are designed to mitigate risk of exposure to bad debt have not been consistent and/or appropriate. This document is the fourth in a series and includes responses to proposals by industry Workgroups and Ofgem. It sets out Ofgem's conclusions on the best practice guidelines for gas and electricity network operator credit cover arrangements and criteria for the pass through of bad debt for gas and electricity network operators.
- 1.2. It should be noted that the conclusions and views contained in this document cannot prejudice current and future decisions by the Authority or be taken to fetter the discretion of the Authority in any way.

Previous work

- 1.3. In March 2002, Ofgem published a document⁴ that opened a consultation process regarding the appropriate arrangements for covering credit risk and mitigating costs to which parties in the gas and electricity markets are exposed, when a gas or electricity supplier or a gas shipper fails.
- 1.4. In February 2003 Ofgem published its Conclusions and Proposals⁵ document, which set out Ofgem's proposals for credit cover arrangements in the regulated areas of the gas and electricity industry. The document also set out principles that Ofgem will have regard to when discharging its functions in relation to credit issues, and which also set down its preferred approach to the management of credit risk going forward. These are as follows:
- Incentives need to be placed upon the Network Operators (NWOs) to manage debt efficiently;

⁴ 'Arrangements for gas and electricity supply and gas shipping credit cover', a consultation document, 24/02.

⁵ 'Arrangements for gas and electricity network operator credit cover – conclusions and proposals', February 2003, 06/03

- The credit arrangements must not be unduly discriminatory, or prevent the promotion of competition;
- The credit arrangements should provide a secure and stable business environment; and
- Ofgem should take measures to protect consumers from loss of supply, in the event of a supplier or shipper's failure to maintain adequate levels of cover or default on payments due.

1.5. Subsequently, in line with general support, Ofgem's proposal was taken forward to form industry-wide Workgroups to establish best commercial practice guidelines with reference to comparable competitive industries, taking into account the nature of gas and electricity transportation and all relevant regulatory and legal issues, in the following areas:

- Identification and assessment of credit exposures;
- Protection of credit exposures;
- Payment and billing and collection procedures; and
- Remedies for payment default.

1.6. Ofgem's September 2004 consultation document⁶ invited comment on the Workgroups' recommendations on best practice guidelines for gas and electricity network operator credit cover arrangements, some dissenting opinions and Ofgem's views.

1.7. The following errata were contained within the Workgroups' recommendations:

- On the *Approach to setting unsecured credit limits*, paragraph 4.7 should have read; 'It was the recommendation of the Workgroups that until such work is completed and conclusions are drawn, **NWOs should have the discretion as to whether** in-house credit scoring should be used'; and

- In respect of *supplemental credit scoring*, paragraph 4.23 should have read; 'The Workgroups did not propose that the 90 per cent weighting should be allocated between individual components of the quantitative assessment; this would be decided according to the judgement of NWO's credit risk managers. Further, it is proposed that in order to set credit limits (within the relevant range) for **rated** companies, the only factor that should be considered is payment history'.

1.8. The September document went on to describe Ofgem's initial views and suggestions on criteria for the future recovery of bad debt by NWOs in the event of a counterparty failure, as set out below:

- Companies must have implemented procedures in line with the best practice guidelines, in order to be eligible for pass through;
- In the event of a default, companies claiming pass through need to provide self-certification of compliance with the best practice guidelines and of the amount of loss incurred, which may be subject to audit by Ofgem;
- Companies demonstrating compliance or able to satisfactorily explain departure from the guidelines will be able to recover all bad debt losses arising in respect of charges not due for payment at the date of the relevant counterparty's insolvency, net of any recoveries;
- Such companies will also be able to recover a proportion (up to 100 per cent) of bad debt losses arising in respect of charges overdue for payment at the date of the relevant counterparty's insolvency, net of any recoveries.

Future mechanisms for change – DN sales

1.9. On 20 January 2005 the Authority gave its conditional consent to the sale of four of NGT's gas distribution networks (DN). These conditions included certain new industry structures being implemented. In particular, the sale will involve the creation of a Uniform Network Code (UNC), underpinned by new gas

⁶ 'Recommendations for best practice guidelines for gas and electricity network operator credit cover' a

transporter (GT) licence conditions, to which each of the distribution network operators will be bound.

- 1.10. This UNC will largely replicate the prevailing transportation arrangements at the time of the sale. In addition, each DN will retain an individual Network Code which is only applicable to the transportation arrangements of that business. These individual Network Codes, referred to as Short Form Codes (SFC), will incorporate by reference the terms of the UNC. Both the UNC and the individual DN SFCs may only be modified following the procedures which must be established under the terms of the GT licence, and with the consent of the Authority.
- 1.11. As stated, Ofgem considers that arrangements for credit cover should be governed by robust and transparent modification procedures. Given the availability of existing code/agreement modification procedures, as required by licence, Ofgem considers that incorporating the credit arrangements into existing code/agreements is the most suitable way of achieving appropriate governance.
- 1.12. Under this approach, Ofgem considers that it would be appropriate for the common high level principles to be contained within the UNC, setting the parameters within which each DN may operate. It will then be for each DN to prescribe the particular credit arrangements that it will operate, taking into account the particular circumstances of that DN. In this way, each DN will retain individual accountability for the operation of its credit arrangements.

Future mechanisms for change – Distribution Connection Use of System Code (DCUSC)

- 1.13. A decision has yet to be made as to whether a DCUSC will eventually embody the distribution credit arrangements, but in any case it is unlikely that codification of the commercial distribution arrangements will take place before the implementation date for revised credit cover arrangements of 01 October 2005. In the meantime, the Credit Sub-group of the Distribution Commercial

Forum which is a self selected group open to all interested parties is currently working on implementing the findings of Ofgem's consultation. The Credit Sub-group of the Distribution Commercial Forum will meet periodically over the following months to develop common credit arrangements intended to be consistent with Ofgem's conclusions and which other interested parties might want to adopt, in the interest of consistency, into their Distribution Use of System Agreements (DUOSAs).

Structure of this document

- 1.14. Chapter 2 outlines the responses to Ofgem's September 2004 consultation document.

Chapter 3 sets out Ofgem's conclusions on best practice guidelines for NWO credit cover.

Chapter 4 presents Ofgem's conclusions on pass through criteria.

Chapter 5 summarises areas identified within this document as requiring further development.

Chapter 6 outlines the next steps required to achieve implementation and maintenance of the best practice guidelines.

Appendix 1 contains the Identification and Assessment of Credit Exposure Workgroup's views on supplemental credit scoring of companies within lower bands.

- 1.15. If you have any queries about this document please contact Nick Simpson (tel: 020 7901 7355).

2. Consultation responses

- 2.1. Summaries of both the Workgroups' and Ofgem's views as presented in the September 2004 consultation are provided below for ease of reference, and therefore should not be taken as a full representation of the issues involved. For full commentary, readers should refer to the consultation itself.

Impact Assessment

- 2.2. The September document set out an Impact Assessment relevant to the consideration of credit cover issues in the regulated areas of the gas and electricity industries. Within this, Ofgem welcomed responses identifying the costs and benefits of putting in place a comprehensive set of guidelines.

Respondents' views

- 2.3. A large number of wide ranging views were expressed on the potential benefits and disadvantages associated with individual elements of the proposed arrangements, which are addressed under the headings below. In addition, it was generally noted that implementation of the proposals would have associated financial costs, with some respondents making recommendations as to where these should rest. A number of the submissions went on to specify anticipated costs to the respective respondents.

Identification and assessment of credit exposure

Maximum credit limits

The Workgroups' recommendation

- 2.4. The Workgroups suggested that each NWO be responsible for calculating its maximum credit limit for any counterparty, providing, on request by Ofgem, all information deemed necessary to describe the methodology employed when determining the maximum credit limit, assessing counterparties and to justify the credit limits set there under.

Ofgem's initial views and suggestions (September 2004)

- 2.5. Ofgem proposed that NWOs should set maximum credit limits based on the impact a loss of the size in question would have on the NWOs financial position. To avoid undue variation between counterparties, this should be based on Regulatory Asset Value (RAV) or turnover. Ofgem proposed that a value 2% of RAV be applied.

Respondents' views

- 2.6. There were thirteen responses on this issue, of which eight were opposed to Ofgem's proposed use of RAV in determining NWOs' maximum credit limits, and four were supportive.
- 2.7. Those respondents who did not support the use of the RAV methodology put forward a number of concerns, including that Ofgem's proposals would result in overly generous unsecured credit limits being made available to counterparties, particularly those in lower bands or without credit ratings. It was suggested that this might undermine smaller NWOs which are unable to spread risk through economies of scale. One respondent believed that the proposal would result in total reliance on pass through and that, although not ideal, existing arrangements provide better protection.
- 2.8. Three respondents stated that maximum unsecured credit limits should be based on counterparty creditworthiness, rather than a NWO's ability to sustain loss. Of these, two expressed support for the Workgroups' proposal, with one stating that this offers a compromise between acceptable risk to NWOs and allowing unrated counterparties unsecured credit. Alternate proposals put forward by respondents included the use of Approved Credit Ratings (ACRs) and payment records, and also the use of 45 days trading in conjunction with the application of credit scoring.
- 2.9. In offering support for the use of RAV in setting NWOs' maximum unsecured credit limits, respondents agreed the need for the application of non-discriminatory and transparent methodology. Whilst agreeing in principle that the use of the formula would provide consistency and transparency, one of the

respondents expressed concern about how often the maximum unsecured credit limit would change. In addition, two respondents (who offered support for the principle) requested Ofgem provide detailed analysis for all potential values, including that supporting the application of 2%.

Approach to setting unsecured credit limits

The Workgroups' recommendation

- 2.10. The Workgroups recommended that credit limits be based on the outcome of credit scoring, including recognition of acceptable credit ratings (issued by Moody's, Standard and Poor's, or Fitch). Both publicly available and specially commissioned ratings would be acceptable, although in the latter case these would have to be reviewed at least annually. It was recommended that until further evaluation of third party credit scoring products is completed and conclusions are drawn, NWOs should have the discretion as to whether in-house credit scoring techniques should be used.

Ofgem's initial views and suggestions (September 2004)

- 2.11. Ofgem proposed that individual counterparty limits should be set using credit ratings (or for unrated counterparties, another transparent and objective methodology). Although the basis of scaling was for further consideration, Ofgem considered it should be less steeply progressive than the Workgroups' recommendations proposed. Ofgem suggested that the same basic weightings as are to be applied under the Basel II rules for determining bank capital adequacy.

Respondents' views

- 2.12. Fourteen respondents commented. A high level of support was offered in general for the use of credit ratings in determining unsecured credit limits, although one respondent suggested that there should be a mechanism to scale back credit limits on evidence of company deterioration, given that credit ratings are often slow to react.
- 2.13. Four respondents offered support for the Workgroups' proposed use of credit ratings and credit scoring. Of these, one commented that the use of ACRs would

be objective and cost less to police and that there is no need to introduce granularity to accommodate counterparties that are unable to acquire an investment grade credit rating. One, whilst agreeing that only ratings issued by Moody's, Standard and Poor's and Fitch should be accepted, believed that these should be publicly available ratings only, as specially commissioned ratings cannot be tracked. In addition, one stated that strict guidelines should be established if NWOs are expected to accept a lower standard of credit.

- 2.14. A number of respondents proposed differing levels of unsecured credit that should be extended to counterparties. One suggested that parties with an investment grade rating should not be required to provide collateral unless there is evidence of likely default, whilst a second supported companies with a credit rating of A- or above being exempt, on the basis that there is no evidence that these present a significant risk to NWOs. A further respondent expressed preference for retaining arrangements closer to the status quo for rated entities, believing that they provide better protection than those proposed by Ofgem. In contrast, one respondent proposed that credit limits should be set on the basis of the risk posed to the NWO if the counterparty fails.
- 2.15. Whilst supporting the need for a more granular approach to credit cover, one respondent considered that both Ofgem's and the Workgroups' proposals fail to reflect the range of credit ratings in the market and are too steeply progressive, with the difference between successive bands maximum credit limit too great.
- 2.16. In regard to the proposed application of Basel II principles, a common concern of the above respondents was the amount of credit that would be extended to weaker ratings and/or small suppliers, which they considered would not be justified on commercial grounds. It was highlighted that this would significantly increase NWO exposure to companies that are more likely to default. It was also commented that it would be inappropriate to place low investment grade ratings with unrated companies and that this could encourage weaker companies to exit ratings registers in order to gain more unsecured credit.

- 2.17. In addition to general support offered by a respondent for Ofgem's proposal, a further respondent suggested that whilst this provides a useful framework it is not convinced that the values derived need to be followed.

Reaction to rating downgrades

Workgroups' recommendation

- 2.18. The Workgroups proposed that upon any change in credit rating or significant market event, a NWO should revise the unsecured credit limit made available to the counterparty on one working days notice, with the change being effected immediately.

Ofgem's initial views and suggestions (September 2004)

- 2.19. Ofgem supported the proposal.

Respondents' views

- 2.20. Two respondents expressed support for the ability of NWOs to revise unsecured credit limits where credit ratings are downgraded, with both proposing that NWOs should be able to do this immediately. One went on to state that NWOs should have the ability to require alternative security where necessary within one working day.

Further assessment of companies within lower bands

Ofgem's initial views and suggestions (September 2004)

- 2.21. Ofgem suggested that NWOs may wish to make further assessment of companies to differentiate creditworthiness within the lower two bands and welcomed more work on this aspect in order to provide more consistency across NWOs.

Respondents' views

- 2.22. Twelve respondents commented on this proposal. Whilst a high level of support was offered for the assessment of companies in the lower bands, opinions

differed on how this should be carried out. Of those who supported additional assessment, there was general support for the use of payment history, ranging from this being the only relevant assessment tool, to its combined application with investment grade and in-house ratings.

- 2.23. Two respondents supported assessment being carried out by NWOs, with one believing that NWOs should be afforded discretion in determining permissible credit, whilst the second proposed that they should operate within a high level framework. An additional five respondents expressed preference for the use of external agents, particularly credit rating agencies, to determine appropriate levels of credit cover. Of these, one indicated the potential use of quarterly reporting to a third party for the whole industry, and one other proposed that counterparties that are unable to obtain a credit rating from a third party should be required to provide full credit cover.
- 2.24. Concerns expressed related to the introduction of uncertainty to companies in the lower bands and the costs associated with carrying out such assessments. A number of respondents highlighted the need for clear, unambiguous and detailed guidance or framework to be applied, and the need for associated costs to be recoverable.

Aggregated credit position / use of group ratings

Ofgem's initial views and suggestions (September 2004)

- 2.25. Ofgem indicated in the paper that where counterparties wish to aggregate their credit position or use group ratings, Ofgem considers this is appropriate, providing the arrangements are robust and unconditional.

Respondents' views

- 2.26. There were three responses on the aggregation of credit positions by corporate groups, with one suggesting that the resulting credit limit should be shared equally between each of the subsidiary businesses. The second noted the need to avoid loopholes enabling companies to be created such that multiple offerings must be offered to members of a group without cover being required. The third

believed that aggregation should occur in all instances where suppliers operate under more than one id.

Unrated companies

A Workgroup member's recommendation

- 2.27. A proposal offered by a member of the Workgroups applied a combination of payment record of a company and evidence that it is prepared to submit to the NWO on its financial health. Payment performance would set an increasing allowance, climbing at 2 per cent per year to a maximum of 10 per cent after five years of perfect payment record, with any underperformance returning the company to the 0 per cent position. To obtain a further allowance of 10 per cent, bringing the total possible allowance to 20 per cent, equivalent to the top of the band in which unrated companies are placed on the Basel II scale, the company would have to provide suitable financial information to satisfy objective tests that the NWO would apply.

Ofgem's initial views and suggestions (September 2004)

- 2.28. Ofgem indicated that it favoured the above approach.

Respondents' views

- 2.29. Thirteen respondents offered comments on how unrated counterparties should be treated. Three respondents expressed support for the proposal, but made comments including that the return to 0% in the event of payment performance failures should be subject to a materiality threshold and a disputes process. It was also suggested that there should be a threshold for low value underperformance, thereby allowing very small invoices to be rolled into the next payment. In respect of the provision of suitable financial information, in commenting that published accounts may be unreliable, one respondent proposed that a combination of billing, cash collection and payment history records should be used.
- 2.30. Whilst supporting unrated companies having access to unsecured credit, a number of respondents proposed alternative methods of how appropriate limits

should be calculated. As discussed above, although support was offered for the use of credit scoring, a number of respondents believed that this should be carried out by parties other than NWOs, with one stating that where a counterparty is unable to procure a third party rating then the NWO should be able to require full security.

- 2.31. In contrast, one response supported credit scoring being carried out by NWOs, but considered that it would be inappropriate to have a prescribed approach, preferring that the unsecured credit limit should be determined by the NWO (within a high level framework agreed by Ofgem) with an appeal route to Ofgem. Other methods endorsed by respondents, one of whom explicitly opposed the use of credit scoring, included the use of payment history (over varying periods of time).
- 2.32. Four respondents also proposed that differing levels of unsecured credit should apply to unrated counterparties, with one considering that no credit cover should be required under a *de minimis* trading level. Three believed that unrated counterparties should be afforded less unsecured credit than proposed, or have a higher level of Value at Risk applied.
- 2.33. Two respondents expressed opposition to the proposal, one considering that this would lead to a lack of consistency and transparency. The second stated that this goes beyond creating a competitive environment and increases the level of risk borne by NWOs.
- 2.34. In addition to the above, one respondent considered that Ofgem should undertake more viability checks on new entrants prior to market entry.

Value at Risk (VAR)

The Workgroups' recommendation

- 2.35. The Workgroups proposed that credit limits be applied to the VAR from trading with a counterparty, based on the assumption that default will happen on the 'worst possible' day, ie when exposure is at its greatest, and that nil recovery from liquidation is achieved. VAR in respect of system charges was defined as:

$\text{VAR} = \text{Exposure} - \text{Amounts owed to counterparty}$

Where:

Exposure comprised billed and unbilled receivables for goods and services already provided (ie the credit cycle, which is currently a maximum of 67 days for electricity and 63 days for gas); and

Amounts owed to counterparty (a) include billed and unbilled goods and services received by the NWO and (b) can be legally offset under the relevant contracts (ie enforceable in the event of administration or liquidation).

Ofgem's initial views and suggestions (September 2004)

- 2.36. Ofgem suggested that the VAR for UoS charges should be measured as the value of billed but unpaid charges, augmented by an amount equal to charges for a further 15 days' usage (based on the same daily rate implicit in billed charges), as this would provide a rough proxy for the time-weighted average of such charges arising within a billing cycle.

Respondents' views

- 2.37. There were fifteen responses on this issue, which provided evenly divided views. Five respondents offered support for Ofgem's proposal, commenting that it appears reasonable and has the advantage of simplicity. Of these, one suggested that the seasonal nature of demand should be taken into account and a second recommended that special consideration is needed in respect of TNUoS. In addition to the above, one offered support for the principle, but indicated concern that the proposed arrangements appear complex and difficult to administer.
- 2.38. Eight respondents agreed with the Workgroups' view that VAR should be the full amount over the credit cycle. Of these, two suggested that Ofgem's proposal would not be consistent with commercial best practice, with one stating that 30 to 45 days would only be adequate if failure occurred immediately after the bill is paid. In endorsing the Workgroups' view, respondents commented that

defaults usually occur at the end of the payment cycle, with previous failures being close to 65 days.

- 2.39. Whilst preferring the Workgroups' proposal, two of the above respondents indicated that acceptance of Ofgem's recommendation would be dependent on clarity and certainty of the ability to recover bad debt via pass through. Whilst stating that there is a case for a higher figure than is presently applies, a further respondent went on to propose graduation of VAR. This would require a minimum of 60 days for unrated companies, 45 days for CCC rated counterparties, 30 days for BBB/BB/B ratings and high and medium investment grade rated companies being exempt from the need to provide any credit cover.
- 2.40. Whilst not specifically commenting on the appropriate level of VAR, one respondent stated that the methodology for assessing daily cover requirements needs to reflect data quality issues and have appropriate material doubt provisions within it. It was suggested that an improvement would be to have VAR assessment made quarterly and hence minimise the effects of rogue data. The respondent went on to propose that TNUoS charging methodology should follow the principle of average delivered unpaid and that supplier credits with NGC for TRIAD charges should be recognised in any VAR calculation.

Protection of credit exposures

The tools available

The Workgroups' recommendation

- 2.41. The Workgroups proposed a number of tools that should be available to counterparties to allow them to cover their exposure. It would be for each counterparty to determine which, how many, and in what percentage they are used, placing the makeup of the 'basket' within the control of the counterparty. It was also proposed that the NWO will rate these tools according to the effectiveness with which risk is transferred and the conditionality of the instrument. The Workgroups indicated that the way in which these tools are rated must be bound by objective criteria.

Ofgem's initial views and suggestions (September 2004)

- 2.42. Ofgem proposed that following the calculation of its unsecured credit limit counterparties should have an initial period of one month in which to provide credit cover to secure any additional credit exposure.

Ofgem indicated that the range of credit cover tools proposed by the Workgroups was largely consistent with its principles enunciated in its February 2003 document and also supported the ability for parties to determine which, and to what extent, the various tools should be used. Ofgem agreed that NWOs should have the ability to rate the credit cover tools, in accordance with genuinely clear, objective and appropriate criteria, judged against the effectiveness with which the risk is transferred and the conditionality of the instrument. With this in mind, Ofgem anticipated the development and maintenance of a full set of criteria to be applied by NWOs when rating credit cover tools.

Respondents' views

- 2.43. There were eleven responses on this issue. Five respondents expressed full support for the proposals, with an additional one offering general support for the portfolio concept, but indicating that it would always wish to discuss the appropriate choice of credit cover tools with individual counterparties. Three responses also supported the inclusion of Parent Company Guarantees (PCGs), provided that they are sufficiently robust, as an acceptable form of credit cover and a further response expressed specific support for prepayment (partial) being allowed rather than posting credit.
- 2.44. Whilst agreeing with some aspects, three respondents' views diverged from the proposals. One listed those tools which it considered did not offer adequate protection and therefore should not be accepted, namely; advance payment, bi-lateral or mutual insurance (until more development activity has occurred), and ESCROW accounts. The remaining two believed that only tools offering full face value should be accepted. The above respondents also listed a number of conditions that they considered all tools should be subject to, which (for the

most part) were broadly similar to those proposed by the Workgroups for application in respect of independent security.

- 2.45. In addition to the above, two respondents offered general support for the development of a set of criteria to be applied in the assessment of the value of credit cover tools by NWOs. One of these went on to state that absent such standardisation, until the terms of a credit option have been agreed, counterparties should be required to provide cash or Letters of Credit (LoCs).

Mutualisation

The Workgroups' recommendation

- 2.46. The Workgroups indicated that whilst they believed that there is potential for a mutual insurance offering to be added to the 'basket', more preparatory work is required. They recommended that Ofgem consider the issues and identify economic benefits that are likely to result, potentially via a feasibility study.

Ofgem's initial views and suggestions (September 2004)

- 2.47. Ofgem indicated that if the above approach were sufficiently supported, it would be willing to facilitate further work by industry parties.

Respondents' views

- 2.48. All six respondents who commented expressed support for further analysis to be undertaken, with a number offering their assistance. Two respondents believed that mutualisation has a role to play in the provision of credit cover, with one stating that it has the potential to offer the most effective and cost-efficient mechanism for managing credit exposure. Another respondent was concerned that there would be difficulties in practical application. Views were split on the form a mutual fund should take, between the need for a single or two-tier pool, although one respondent believed that the key issue would be to ensure that any premiums paid by participants reflect the level of risk they impose on the industry.

Management of a counterparty approaching its upper limit of security

The Workgroups' recommendation

2.49. The Workgroups' proposed that:

- Ofgem should create licence obligations to require system users to have Use of System Agreements in place and to require 'good behaviour', which would hold a licensee in breach of its licence should it contravene security cover provisions;
- NWOs should closely monitor their counterparty's indebtedness, with it being prudent for them to issue a warning when a counterparty approaches 95 per cent of its credit limit;
- only at 100 per cent should rapid measures be introduced; and
- If a counterparty experiences an increased/decreased level of trade with the NWO, a reassessment of its credit may be necessary.

Ofgem's initial views and suggestions (September 2004)

2.50. Ofgem did not consider the proposed reliance on a regulatory body to enforce contractual terms constituted best commercial practice. It also did not believe that the proposed licence amendments would provide NWOs with any additional ability to enforce their credit cover terms, but might actually serve to reduce their incentives to do so. Furthermore, in addition to issues regarding the ability to introduce the suggested licence obligations, Ofgem considered that licence enforcement would, in most cases, be both a disproportionate and impractical remedy and would be inconsistent with credit cover principles.

Ofgem agreed that NWOs should take limited action prior to a breach of security cover, but concurred that calls for additional security may not necessarily be appropriate. Ofgem also stated that such action should not include disconnection of existing customers or inhibiting registration of new customers. Ofgem agreed that NWOs should closely monitor counterparty indebtedness, but considered that the issue of warning notices should be

standard practice, possibly at an earlier point in time, for example when a counterparty reaches 90 per cent of its credit limit. Finally, Ofgem agreed that should a counterparty experience a material change in its level of trade, a reassessment of required credit cover may be necessary.

Respondents' views

- 2.51. There were eight responses on this subject, of which one expressed agreement that the regulator should not be used to enforce contractual terms. Three commented on monitoring of counterparty indebtedness, with two supporting NWOs carrying out frequent monitoring, one of which suggested that the resulting information should be made available online. A further respondent, who believed that daily calculations may be unnecessary, stated that the mechanism for calculation must be straightforward and transparent. Two respondents highlighted that such activity will increase NWO costs, with one agreeing that it should be undertaken on condition that it is part of an acceptable package.
- 2.52. While one response indicated that parties should only have to secure to the level of their liability, a second suggested that the level of cover should be set for a regulated period and should incorporate any expected growth within this period. Two further responses believed that NWOs should not wait until exposures exceed the available credit, with one supporting the use of cash calling arrangements where a counterparty reaches 85 per cent of its credit limit (reducing exposure to 70 per cent) and the other proposing 90 per cent (with exposure reduced to 80 per cent). One of these also backed NWOs having the ability to suspend registrations at 85 per cent.
- 2.53. Four responses also made reference to the appropriate trigger for the issue of initial warning notices, all of which agreed they should be issued before counterparties reach 95 per cent of their credit limits. Of these, two expressed support for these to be issued at 90 per cent, one proposed 80 per cent, and one preferred a 70 per cent trigger as currently applied by Transco.

Payment and billing terms

Availability of data for billing processes

The Workgroups' recommendation

- 2.54. The Workgroups' concluded that the likely costs of improvements to the availability and quality of data would not be justified by the likely benefits.

Ofgem's initial views and suggestions (September 2004)

- 2.55. Ofgem agreed that compulsory changes to existing arrangements are not required.

Respondents' views

- 2.56. Of the six respondents who expressed a view, five welcomed the recommendation. The sixth disagreed that the prospective benefits are unlikely to justify the anticipated financial costs, believing that there are many strong reasons for improvements in this area.

Billing frequency

The Workgroups' recommendation

- 2.57. The Workgroups concluded that existing billing frequencies should be retained.

Ofgem's initial views and suggestions (September 2004)

- 2.58. Ofgem agreed that revisions should not be required to existing billing frequencies.

Respondents' views

- 2.59. Ten of the eleven respondents agreed that changes should not be required to billing frequencies, although one believed that NWOs should not be prevented from making changes where systems allow. The respondent also suggested that Ofgem might consider whether there are incentives that it can offer to support such behaviour. An additional respondent noted a concern that the credit

proposals are predicted against a payment timetable and that a NWO may be tempted to accelerate their billing calendar once the proposals have been implemented in order to reduce their VAR.

Payment terms

The Workgroups' recommendation

- 2.60. The Workgroups considered that a move to e-billing would be helpful, and concluded that existing payment terms should continue, but all payments should be via electronic or cleared funds.

Ofgem's initial views and suggestions (September 2004)

- 2.61. Ofgem considered that the Workgroups' recommendations were broadly consistent with its principles, but noted as and when market developments provide opportunity, the potential benefits of harmonisation of industry payment terms should be considered. Ofgem also considered that NWOs should have rights of set off under codes.

Respondents' views

- 2.62. Five responses agreed that there should be no change to existing payment terms and three expressed support for payments being made via electronic or cleared funds. In addition to electronic funds transfer, one also supported all parties using e-billing and proposed that the ability to handle these should form part of the entry requirements for all new entrants.
- 2.63. A further respondent acknowledged that moves toward e-billing for validation and payment of invoices would make the process more efficient, but noted that it is unclear how and by whom the associated costs would be funded. One other, who generally supported e-billing (on the assumption that there would be tight security controls and fall-back provisions in the event of system failure), expected to see more information on the structure of the proposal and cost analysis.

Remedies for default

Credit cover

The Workgroups' recommendation

- 2.64. Where a party has been requested to vary the level of lodged credit either through indebtedness being in excess of 100 per cent of credit cover or through a reassessment of cover required:
- NWOs should test each party's indebtedness every day. If in excess of 100 per cent of credit cover (unsecured credit and security posted), the party should be cash-called one business day after surpassing 100 per cent of credit cover, with payment due two business days later;
 - A cash-call would bring indebtedness down to 80 per cent;
 - If no payment is received, Ofgem should be informed;
 - Where reassessment of cover leads to a request for increased cover to be posted, the counterparty should have one month to respond;
 - If such requests are not complied with then the party's ability to register new customers should be suspended; and
 - Where parties fail to comply with credit requests under the Connection Use of System Code (CUSC), Ofgem must take licence enforcement action. Following failure of the processes outlined above, Ofgem should issue enforcement notices, which, if unobserved, should be followed up by fines and licence revocation.

Ofgem's initial views and suggestions (September 2004)

- 2.65. Whilst agreeing some of the Workgroups' proposals, Ofgem considered that where reassessment of a party's credit scoring or credit rating has led to a revision in its unsecured credit limit and consequently to the need for increased security to be posted, the notice period should be two business days. Where

there is a reassessment of the forecast indebtedness, one month should be allowed.

In cases of default, in addition to the suspension of customer registrations, Ofgem proposed NWOs should also have the ability to publish details of defaulting parties, and considered such sanctions suitable for industry standardisation. However, Ofgem's involvement should be limited to the receipt of reports of incidences of default.

Subject to the above, NWOs should use all means generally available to them at law to enforce their rights and remedies in order to mitigate losses arising from default. However, disconnection, de-energisation or isolation of consumers should only be considered after all other routes have been investigated and a reasonable period of notice has been given to the consumer to enable them to switch to another supplier.

Respondents' views

- 2.66. One respondent was in general agreement with the proposals in terms of what distributors can do, whilst another was concerned that they would incentivise NWOs to be totally risk averse as there would no longer be scope for the application of commercial judgement.
- 2.67. In respect of cash-calling, two respondents expressed opposition, stating that it would result in over collateralisation. One of these proposed that a cure period be established to deal with minor breaches, with lower thresholds only applying to more serious breaches. The second considered that continual breaches should be penalised via the default process. An additional respondent agreed it would be reasonable to require defaults to be remedied quickly, and believed that defaulting parties should be required to provide cover which is fully realisable in circumstances of default.
- 2.68. Three respondents agreed that a rapid response should be required to requests for increased credit cover following reassessment of unsecured credit limits, varying between support for Ofgem's proposal, to endorsing immediate lodging of additional security. One respondent also considered that five working days

would be appropriate in instances where there is a reassessment of forecast indebtedness.

- 2.69. Four responses offered support for the suspension of registrations where parties fail to comply with requests, although one believed that this should be subject to a *de minimis* threshold, materiality and dispute process. A fifth noted that this only slows the escalation of bad debt exposure and, whilst agreeing that they should only be exercised once all other routes have been exhausted, believed that options of disconnection or de-energisation should remain for counterparties who do not directly supply consumers.
- 2.70. Three respondents welcomed the ability of NWOs to publish details of defaulting parties, although one considered that this should also be subject to a *de minimis* threshold, materiality and dispute process and another did not consider it to be a practical enforcement tool. A further two respondents were opposed, believing that there are more appropriate remedies and that it may be counterproductive. In addition, one respondent supported the application of administration charges against defaulting counterparties.
- 2.71. Three respondents indicated that Ofgem should take an active role in enforcement, with emphasis placed on the need for the Supplier of Last Resort (SoLR) process to be invoked promptly.

Payment default

The Workgroups' recommendation

- 2.72. In addition to proposing that NWOs might wish to selectively contact counterparties prior to invoice due dates in order to prompt payment, the Workgroups devised follow-up guideline sanctions on an ascending scale of severity. These ranged from the application of administrative fees and high interest rates for late payment (with NWOs having discretion to waive these provided there is no undue discrimination), through to formal requests for position statements and ending with the ability to suspend all registrations and the commencement of the SoLR process. The Workgroups recommended no

changes to existing disputes processes, but suggested that the rules be applied promptly, with support from Ofgem where required.

Whilst supporting codification of the recommendations, the Workgroups proposed that companies be able to introduce other steps. It was also felt that companies should be able to diverge from the guidelines, although they should be prepared to both explain and justify these actions.

The Workgroups agreed that Ofgem should be actively involved, in supporting NWOs and taking enforcement action. In addition, it was proposed that Ofgem consider introducing a short-term licence requirement to facilitate implementation of the guidelines.

Ofgem's initial views and suggestions (September 2004)

- 2.73. Ofgem agreed that remedies for payment default should be transparent to all parties, rule-based and properly codified and therefore considered that revised procedures should be incorporated into industry codes and agreements.

Ofgem agreed with the suggested application of high interest charges (although it was indicated that these should not be excessive) and appropriate administrative charges, from due date + 1. However, Ofgem did not agree that NWOs should have discretion to waive the application of interest. It was considered that the remedies should be all those available generally at law, together with a right to suspend registration of (inward) transfers.

Ofgem also indicated that consideration needs to be given to whether, and if so by what means, this or an equivalent remedy should be available to electricity transmission licensees and to Transco (in respect of NTS charges).

Respondents' views

- 2.74. Sixteen respondents offered a wide range of views on the proposals. Two offered general support; with one considering that 'won't pay' parties would receive unambiguous signals of the measures that would follow. The second believed that the proposals would make meaningful remedies available if

implemented as suggested, but commented that Ofgem commitment to the whole package appears unclear.

- 2.75. Four respondents expressed concerns, including that the proposed timescales are unrealistic and rigid, lacking scope for commercial judgement to be applied and that there should be a materiality consideration in following up failure to pay. Respondents believed that this could lead to problems, such as insufficient opportunity for communication, increased unsecured credit exposures, and encouraging NWOs to prematurely escalate debt recovery (thereby increasing market volatility). A further one indicated that the guidelines need to explicitly show the further follow up and legal action that NWOs would be expected to take in pursuing debt.
- 2.76. Specific comments on the proposed remedies included support from one respondent for engaging with companies prior to invoices becoming overdue, indicating that this has been extremely successful.
- 2.77. Six respondents commented on the proposed interest and administration charges, five of which supported their application, although one preferred the use of tiered interest rates. The sixth stated that use of 8 per cent interest would be unwarranted and would create a disincentive on NWOs to produce simple and regular invoices. Although the respondent supported the principle of tiered interest rates, it recognised that these would be likely to be overly complex. An additional respondent proposed that the cost of court actions should also be recoverable from the defaulting party as an excluded charge.
- 2.78. Three respondents commented on the ability of NWOs to waive interest charges, two of which offered support, with one believing that this should be available in circumstances where their recovery would be uneconomic or unreasonable.
- 2.79. Five responses supported NWOs having the facility to suspend registrations, although one considered that this must be subject to a *de minimis* threshold, materiality and a formalised dispute process.
- 2.80. One respondent sought clarification on when within the proposed guidelines Ofgem would view it as acceptable for NWOs to issue statutory demands. A

further two opposed their inclusion in best practice, indicating that they are a final solution designed as a means to enforce insolvency rather than a collection tool. One of these expected a reasonable increase in its cost base to account for associated costs if this process were to become commonplace.

- 2.81. In addition to belief that it would be challenging to commence SoLR within the proposed timescales, it was noted that, despite being a viable tool to ensure compliance, its use would severely damage any chance of recovery from the counterparty.
- 2.82. Two offered support for the guidelines being codified, with one also suggesting that an obligation should also be placed on NWOs to make their charges as transparent and easy to validate as possible. In addition to a respondent who indicated that it has arrangements in place that would supplement the guidelines, one offered support for NWOs having the ability to diverge from them, provided that arrangements are equivalent and codified.
- 2.83. In relation to Ofgem involvement, two responses focused on the importance of application of the SoLR process, with one stating that the package will otherwise lack force.

DN sales

Ofgem's initial views and suggestions (September 2004)

- 2.84. Ofgem recognised that, dependent on the grant of the necessary consent by the Authority, the Health and Safety Executive and the Secretary of State for Trade and Industry, the sale of one or more of Transco plc's local gas DNs would result in fundamental changes to the structure of the gas industry. However, Ofgem envisaged that the arrangements developed to facilitate such a sale would be reflective of best practice guidelines and underlying general principles for credit cover arrangements.

Respondent's views

- 2.85. Three respondents offered comments, including that this would represent a major change to the gas industry, with issues arising that were not addressed by

the consultation. Accordingly, it was suggested that the gas market should be considered independently from the electricity market. Mixed views were also offered on the arrangements, including those for terminations, that should be adopted for DN sales and their consistency with Ofgem's principles.

Implementation

The Workgroups' recommendation

- 2.86. The Workgroups recognised that implementation of the guidelines would require modifications to relevant licences and codes. As part of this process, it was proposed that Ofgem should consider making it a short-term licence requirement that all parties ensure that they are compliant with the new guidelines on day one, provided that there is sufficient lead time, as required.

Ofgem's initial views and suggestions (September 2004)

- 2.87. Whilst Ofgem agreed that changes are likely to be needed to industry codes and agreements, it proposed that arrangements consistent with best practice and Ofgem's underlying credit cover principles should be implemented by April 2005.

Respondents' views

- 2.88. There was general recognition among respondents that the proposed timetable is challenging. There was also support for use of code and agreement modification procedures to progress implementation of the best practice guidelines, although one respondent did express preference for credit arrangements to remain outside of codes.
- 2.89. Two respondents expressed concern that the period between publication of this document and the proposed implementation date is relatively short. It was commented that the timetable is ambitious, given that it falls in a period when industry resources will already be stretched and there is also still much to be agreed. With this point in mind, one requested the opportunity to comment on the final recommendations prior to implementation.

- 2.90. In recognising the above constraints, the need for (as far as possible) unambiguous final arrangements, a strict timetable for implementation and issue resolution, cooperation of industry parties and Ofgem involvement, were noted in order for April 2005 to be met. It was suggested by one respondent that the Distribution Commercial Forum could be used as a vehicle for co-ordinating necessary changes to the DUoSA. In the event that April 2005 is not met, one respondent requested clarity on interim arrangements.
- 2.91. Four respondents proposed differing timetables, including the need for reasonable lead times before any new arrangements become effective, and for modifications to be made to the UNC once it has come into effect. Two of these proposed alternate implementation dates of October 2005 (at the earliest) and April 2006.

Bad debt pass through criteria

Ofgem's initial views and suggestions (September 2004)

- 2.92. Ofgem indicated that in order to claim pass through NWOs must have implemented procedures in line with the best practice guidelines and provide self-certification of compliance with them and of the amount of loss incurred, which Ofgem may audit. Companies demonstrating compliance with or able satisfactorily to explain departure from the guidelines would be able to recover all bad debt losses arising in respect of charges not due for payment at the date of the relevant counterparty's insolvency, net of any recoveries.

Such companies would also be able to recover a proportion of bad debt losses arising in respect of charges overdue for payment at the date of the relevant counterparty's insolvency, net of any recoveries (which would be offset proportionately against all outstanding balances), depending on the age of the outstanding receivable. The amount recoverable would be equal to the value of outstanding balances subject to bona fide dispute (plus or minus the value of any reconciliation adjustments subsequently made), together with a proportion of the value of all undisputed balances (up to a maximum of 100 per cent) that varies inversely with the age of the balance. The overall recoverable amount would be reduced for any other recoveries.

Respondent's views

- 2.93. Twelve respondents commented on the proposed criteria. Two offered general support for the establishment of clear criteria for the recovery of bad debt, although, in addition to suggesting that the mechanism for making a claim should be formalised in NWOs' licences, one held some concerns.
- 2.94. Four responses commented on self-certification by NWOs, with one offering full support and two providing conditional acceptance. The final one suggested that neither this, nor audit by Ofgem, would be entirely consistent with the principle of NWOs being able to recover 100 per cent of bad debt so long as they can show that they have followed the best practice guidelines. However, one did accept such audit, with another two requesting details of what processes will be used to examine the debt recovery procedures employed.
- 2.95. Three respondents welcomed NWOs being able to recover incurred bad debt losses arising in respect of charges not due for payment at the date of insolvency. However, although one was supportive, ten respondents expressed concern over the proposed proportion of recovery of losses arising in respect of charges overdue for payment at the date of insolvency. In addition to the need for additional clarity on a number of points, the key concern articulated by these respondents was that the sliding scale of recovery commences too quickly after an invoice becomes overdue and does not take into account the timescales involved in proving insolvency, and that it is also too steep.
- 2.96. It was commonly felt that the proposal would be penal in effect, giving NWOs minimal chance of achieving 100 per cent pass through of bad debt, which would neither incentivise them to manage debt efficiently, nor provide a secure and stable business environment. However, the notion of scaling was not rejected, and responses proposed a number of alternatives as to when it should commence, including the issuance of a statutory demand, once the best practice guidelines have been exhausted, on completion of insolvency proceedings, and once all possible means to recover outstanding debt have been explored.
- 2.97. Whilst offering the above alternatives, the majority of the above stated that where a NWO has followed the best practice guidelines (or is able satisfactorily

to explain departures from them) it should be entitled to full recovery of bad debt.

Timing of pass through

Ofgem's initial views and suggestions (September 2004)

- 2.98. Ofgem proposed that any required price control adjustment be made at the start of the following price control period. Such an adjustment would include an allowance for the cost of funding the loss pending recovery.

Respondents' views

- 2.99. Eight respondents remarked on the timing of pass through of bad debt, with one requesting details of at which point, after the appointment of an administrator, Ofgem will advise the NWO of the percentage of bad debt to be recovered.
- 2.100. Five respondents endorsed early recovery, either in the formula year following that in which the debt is incurred, or within the price control period, believing that this would be consistent with the low risk business nature of a NWO business. This approach was also encouraged in view of the fact that price control reviews involve the bundling of many issues and it would be difficult to distinguish bad debt recovery from others. One of the above suggested that where recovery is delayed, there should be a cap on the amount that NWOs are expected to fund in the interim and they should have the opportunity to seek a mid period adjustment should the cap be exceeded.
- 2.101. The remaining three respondents agreed with pass-through occurring at the beginning of the next price control, although one highlighted the need for interim measures in the event that a major supplier failed and another sought clarification on the treatment of bad debts arising late in a price control review period. In addition, the need for bad debt items to be ring-fenced from other pass through items was indicated.
- 2.102. Four respondents welcomed the inclusion of an allowance to NWOs for the cost of funding loss pending recovery. However, a fifth proposed that such costs

should fall on NWOs, as this would act as an additional incentive to ensure that security is in place and the credit procedures are followed.

3. Ofgem's conclusions on best practice guidelines for NWO credit cover

- 3.1. In reaching the conclusions set out in the following chapters Ofgem has taken into account all submissions received including those on the costs and benefits associated with implementation of best practice guidelines. Detailed reasoning behind Ofgem's initial views in September 2004 is contained in that document and is not all repeated here in the interests of conciseness.
- 3.2. The guidelines developed by the industry Workgroups have broadly followed the high level principles established by Ofgem in February 2003. Following consultation Ofgem has modified the guidelines in places by the minimum necessary to accommodate some differing views, to bring them in line with Ofgem's view of best practice and to provide guidance that is sufficiently detailed for parties to evaluate the whole package of credit arrangements. For clarity Ofgem is setting out all the critical best practice guidelines here.
- 3.3. In order to ensure transparency, these guidelines would benefit from being properly codified within industry codes and agreements.

Identification and assessment of credit exposure

Approach to setting unsecured credit limits

- 3.4. Following consideration of the responses, Ofgem has concluded that the general approach outlined in the September document is appropriate. Unsecured credit limits should be set as a proportion of each NWO's maximum credit limit. The maximum credit limit should be based on 2 per cent of the NWO's RAV. Whilst this would not constrain NWOs, those who seek other levels of risk may not obtain full pass through in the event of a failure and/or may be subject to objections and disputes from counterparties.
- 3.5. Ofgem acknowledges that there have been respondents that do not support the use of weightings based on the 'Basel II' rules for determining bank capital adequacy and that other rating methods could produce different results.

However, Ofgem has not perceived any industry consensus on an alternative method.

- 3.6. Ofgem therefore concludes that individual counterparty credit limits should be set using credit ratings (and, for unrated counterparties and counterparties with credit ratings below BB-, the methodology set out below at 3.12 to 3.29) using the same basic weightings as are to be applied under the 'Basel II' rules for determining bank capital adequacy. These are in the ratio of 1 : 2.5 : 5 : 7.5, for respectively, AAA/AA, A, BBB/BB/Unrated, and below BB-. These would imply maximum credit allowances of, respectively, 100 per cent, 40 per cent, 20 per cent and 13-1/3 per cent of the NWO's maximum credit limit for a single counterparty.
- 3.7. For the third band, Ofgem considers the above allowance should be further subdivided, such that the following are applied to rated entities:

| Credit rating | Credit allowance as % of maximum credit limit |
|---------------|---|
| AAA/AA | 100 |
| A | 40 |
| BBB+ | 20 |
| BBB | 19 |
| BBB- | 18 |
| BB+ | 17 |
| BB | 16 |
| BB- | 15 |

- 3.8. For the purposes of these guidelines, only credit ratings issued by two agencies – Moody's KMV and Standard & Poor's – should be accepted. Both publicly and specially commissioned ratings should be accepted, although in the latter case provided these are reviewed at least annually. Where credit ratings produced by the various agencies differ, NWOs should apply the lowest assigned rating in determining the credit limit for the entity concerned.
- 3.9. Counterparties may aggregate their credit positions or use group ratings (for instance through PCGs), providing the arrangements are robust and unconditional. The limit will be applied to the contracting party or, subject to the conditions listed below, an affiliated credit support provider:

- The credit support provider must offer a guarantee which is legally enforceable in Great Britain (GB). The counterparty may be required to provide reasonable counsel's opinion of enforceability, particularly if the guarantors are not GB based;
 - The guarantor entity will be subject to the same credit scoring process as the buyer, and must also be willing to provide information to facilitate the completion of this process; and
 - The country of residence of the guarantor must have a sovereign credit rating of at least A awarded by Moody's KMV or Standard and Poor's. If the rating agencies differ, the lower rating will apply.
- 3.10. Where a counterparty benefits from a suitable PCG, the unsecured credit limit assigned to that counterparty should be based on the credit strength of the guarantor. Thus for example, a BB counterparty guaranteed by an A rated parent would get an unsecured limit equal to 40 per cent of the relevant NWO's maximum credit limit.

Reaction to downgrades

- 3.11. Upon any change in credit rating or significant market event, a NWO should revise the unsecured credit limit made available to the counterparty on one working days notice, with the change being effected immediately following the expiry of that notice.

Unrated companies

- 3.12. The mechanism for establishing a consistent approach for determining the creditworthiness of smaller entities has been the subject of much debate. Ofgem has carefully considered the responses and the issues associated with this aspect of the credit arrangements and takes the view that an unrated company does not necessarily pose a high risk of default. As has been stated before, a rated entity could well be more likely to fail than a well run and collateralised smaller company that is unrated. For this reason Ofgem has sought to balance the

likelihood and potential cost to consumers of the failure of unrated companies with the need for each unrated company to provide security.

- 3.13. In the September consultation document Ofgem stated that it favoured an approach where a fraction (one tenth) of the maximum credit limit of the network was used to calculate an allowance based on the payment performance of the counterparty. Ofgem invited detailed comments.
- 3.14. As discussed in the September document, the payment record of a company is not a strong positive indicator of its health. However it is a strong negative indicator, inasmuch as a company with problems paying its bills on time is likely to be financially weak and possibly in some difficulty. An added advantage of linking unsecured credit allowances to payment history is that the facility is removed immediately upon non-payment, whereas an annual assessment may be less current.
- 3.15. Concern was expressed by a number of respondents who felt that the proposal would lead to higher than warranted exposures for NWOs due to the allowance being based on the NWO's maximum credit limit rather than an assessment of the ability of the counterparty to pay. Ofgem has considered the detail of these arguments and accepts that the proposed fraction (one tenth) of the maximum credit limit placed too much emphasis on the payment record of the counterparty.
- 3.16. Nevertheless, Ofgem has concluded that an unsecured credit allowance for unrated counterparties could be determined using the payment record of the company providing that these allowances were reasonable.
- 3.17. Ofgem considers that where a counterparty opts to obtain a credit allowance based on its payment record it should be accorded an increasing allowance, climbing at 0.4 per cent per year (escalating on an evenly graduated basis each month within year) of the NWO's maximum credit limit to a maximum of 2 per cent after five years of perfect payment history. In this respect, payment performance prior to implementation of these arrangements should be taken into account by NWOs. Any underperformance, for whatever reason, would return

the company to 0 per cent position. It would be for the counterparty to take whatever steps necessary to protect a payment record.

- 3.18. For instance, under this arrangement after one year of perfect payment record, a counterparty to a network with a RAV of £1bn would have access to £80,000 of unsecured credit. After five years of perfect payment record the counterparty would be accorded £400,000 of unsecured credit from that network.
- 3.19. Ofgem has carefully considered the responses on this issue and has sought to balance views. On the one hand it can be argued that separating the payment record from the general assessment of creditworthiness focuses on a single and imperfect measure of creditworthiness. On the other hand the clarity of focussing on payment history gives a very sharp and hence beneficial incentive on unrated companies who opt for this method, to pay their bills on time.
- 3.20. Ofgem consider that this latter argument not only has merit but also can be expected to provide real benefits in terms of lower costs for NWOs both in chasing late payments and identifying financial difficulties at an early stage.

Independent assessments

- 3.21. Ofgem has previously stated that an unrated company could potentially be as creditworthy as a rated company in the lower two bands and therefore from a consistency point of view, should be able to achieve an unsecured allowance of 20% of the NWO's maximum credit limit.
- 3.22. Ofgem has further concluded that where an unrated counterparty seeks to increase its unsecured credit allowance it can do so by submitting to independent assessment of its creditworthiness. This assessment would replace the allowance for payment record because an assessment could include this measure and there is therefore a potential issue with double-counting.
- 3.23. As discussed in chapter 5, an independent assessment for these purposes could be one given by one of a panel of three assessment agencies selected by the NWO. An annual assessment could be paid for by the NWO if requested by the counterparty. Any intermediate assessment could be paid for by the party that requests it.

3.24. The assessment could take the form of a score of 0 to 10 where nought indicates that the company is not suitable for any allowance of unsecured credit. A company rated at 10 could be eligible for up to 20% of the NWO's maximum credit limit. Scores in between could result in allowances which matched the steps of rated companies indicated in the table below. In making this assessment, the agency methodology could consider how the size of the counterparty's portfolio limits its ability to avail itself of the full allowance. As a result the party's equivalence to rated companies could be equitable whilst taking into account the 'absolute' value of 'what a party is good for'.

| Credit rating | Credit assessment score | Credit allowance as % of maximum credit limit |
|---------------|-------------------------|---|
| AAA/AA | n/a | 100 |
| A | n/a | 40 |
| BBB+ | 10 | 20 |
| BBB | 9 | 19 |
| BBB- | 8 | 18 |
| BB+ | 7 | 17 |
| BB | 6 | 16 |
| BB- | 5 | 15 |
| <BB- | 4 | 13-1/3 |
| | 3 | 10 |
| | 2 | 6-2/3 |
| | 1 | 3-1/3 |
| | 0 | 0 |

Companies within the lower band

3.25. In respect of companies with credit ratings of B+ and below, Ofgem considers that arrangements akin to those for unrated counterparties should apply, in that an unsecured credit limit should be determined either using the payment record of a company or via independent assessment of creditworthiness.

3.26. Therefore, where a counterparty opts to obtain a credit allowance based on its payment record the arrangements outlined above at 3.17 should apply.

Independent assessments

3.27. Consistent with the individual counterparty credit limits set out at 3.6, parties in the lower band should be able to achieve an unsecured allowance of up to 13-1/3 per cent of the NWO's maximum credit limit for a single counterparty. Therefore, a counterparty may seek to increase its unsecured credit allowance

through independent assessment of its creditworthiness, which would replace any allowance for payment record.

- 3.28. Such an assessment could follow the suggested arrangements for unrated companies, with possible scores of between 0 and 4 resulting in allowances indicated in the table above.

Transitional issues

- 3.29. Ofgem noted from the responses to the September document that there may be transitional issues for businesses that have to make additional collateral available. Ofgem therefore consider that following implementation of any new arrangements that require additional collateral from counterparties, that requirement should be evenly increased over the year following the implementation date so that full compliance is achieved by the anniversary of implementation.

Value at risk

- 3.30. Unsecured credit should be extended to each counterparty up to the applicable allowance from time to time. The amount of credit deemed to be taken at any time is the VAR from trading with a counterparty. In relation to each counterparty, the VAR for Use of System (UoS) charges at any time shall be the amount in money which is equal to the sum of:
- (a) the aggregate value of all charges which at that time have been billed to such counterparty (but not necessarily due) but remain unpaid; and
 - (b) a deemed amount equal to the aggregate value of all UoS charges that would be incurred in fifteen day period at the same average daily rate implicit in billed charges under (a).

This additional amount provides a proxy for UoS charges that are accrued but unbilled at any point in time, broadly in line with the time-weighted average of such charges arising in each monthly billing period.

- 3.31. VAR for exposures arising under long-term connection and capacity contracts should be based on payments billed but unpaid plus the difference (if any) between the recoverable value of the reversionary interest held by the NWO in the contracted capacity, and the contract value.
- 3.32. For gas entry, this will be guided by market resale values. Where the market price cannot be agreed between the NWO and the counterparty, an independent assessment should be undertaken with the cost shared equally between the parties.
- 3.33. In respect of NGC post-vesting connections, DNO generation connections and Transco exit capacity and connections, NWOs should make reasonable VAR calculations, based on a dynamic assessment of VAR given demands for new connections and/or their assessment of the likelihood of being able to re-use assets and/or of their recoverable value, provided these are based on reasonable central assumptions backed by an objective assessment of all relevant evidence.

Protection of credit exposure

- 3.34. Following the implementation of a counterparty's new unsecured credit allowance under these new arrangements, the party should have a reasonable period in which to provide credit cover to secure credit exposure. As a result of careful consideration of responses to the September consultation, Ofgem have concluded that for a period of one year following implementation, the credit allowance should be adjusted so that any additional collateral requirements are evenly increased until full compliance is achieved on the anniversary of implementation.

The tools available

- 3.35. The following tools should be available to counterparties to allow them to cover any exposure beyond their unsecured credit limit. It will be for each counterparty to determine which, how many, and in what percentage they are used, placing the makeup of the 'basket' within the control of the counterparty.
- 3.36. Any of the following tools (or any combination of them) will be acceptable:

- An approved LoC 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/prepayment (payment made before the delivery of the service);
- Advance payment (payment made after the delivery of a service but before contract settlement);
- An approved ESCROW account;
- A performance bond (provided by an insurance company, not a bank);
- Bi-lateral insurance; and
- Independent security.

3.37. Where used, monies deposited to provide credit cover should appreciate at a rate equivalent to the prevalent Base Rate.

3.38. The NWO will rate the chosen tools according to the effectiveness with which risk is transferred and the conditionality of the instrument. The criteria to be applied by NWOs when doing so must be clear, objective and appropriate. These should include:

- A tool providing cash on demand should be rated at full value (100 per cent);
- A tool that has conditionality but is certain to provide cash in a timely fashion could be rated at up to full value; and
- Where the tool is an insurance product, the insurer should be of a good rating and the terms unconditional in all material matters in order for the tool to be rated at full value.

3.39. *Independent security* covers security from unrelated entities (ie a credit support provider outside the ownership structure of the buyer and which has no formal or informal control of security provider by buyer, its parent company or its affiliated companies).

- 3.40. Independent security valued at 100 per cent of face value may be accepted subject to the following conditions:
- Credit support must be from an entity with a long term debt rating of not less than A by Standard & Poor's or Moody's KMV;
 - Credit support shall be legally enforceable in the UK. This may require the entity to provide reasonably acceptable counsel's opinion;
 - The country of residence of the support provider must have a sovereign credit rating of A or better for non local currency obligations; and
 - There are no material conditions preventing exercise of the security.
- 3.41. Ofgem recognises that the development of a pro-forma, where possible, could reduce the need for assessments, save that for variations on the terms of the pro-forma which would need to be reviewed on a case-by-case basis. Such work could be undertaken by an industry development group.
- 3.42. However, whilst it is desirable to avoid variation across NWOs, it is recognised that in some instances the terms of prospective tools (eg insurance) are likely to vary between providers and their associated values will therefore need to be assessed on an individual basis and may lead to a disputed view. Therefore, in circumstances where a counterparty disagrees with the rating given to a proposed credit cover tool, a route of appeal should be available. This is discussed further in chapter 5.
- 3.43. Subject to the above, in circumstances where a tool is rated at less than 100 per cent, the counterparty would secure residual exposure by an alternate instrument.

Mutualisation

- 3.44. Whilst mutualisation has the potential to be added to the list of credit cover tools, this remains subject to the outcome of further development work. In this respect, Ofgem remains willing to facilitate further work by industry parties.

Management of a counterparty approaching its upper limit of security

- 3.45. NWOs should closely monitor counterparty indebtedness and take appropriate remedial action in respect of those who approach their upper limit of security.
- 3.46. Given that these parties would not be in default, such action should be restricted to the automatic issue of warning notices to counterparties when they reach 85 per cent of their credit limits. For the purposes of clarification, such action should not include calls for additional security (cash calling arrangements), or the disconnection of existing customers and/or inhibiting registration of new customers.
- 3.47. Where a counterparty experiences a material change in its level of trade, a reassessment of required credit cover may be necessary. Where this has occurred as a result of an improved charge forecast by the NWO, counterparties should have one month's notice of any need to increase collateral.

Payment and billing terms

- 3.48. Compulsory changes to existing arrangements for the availability of data billing processes and billing frequencies are not required.
- 3.49. In respect of payment terms, moves should be made toward any reasonable improvements in efficiency including payments that are made via electronic or cleared funds. It would be appropriate for NWOs to make reasonable charges for non compliant payment methods. In addition, NWOs should have rights of set off under codes. Furthermore, whilst changes other than those detailed above are not required, as and when market developments provide opportunity, the potential benefits of harmonisation of industry payment terms should be considered.

Remedies for default

Credit cover

- 3.50. The following remedies should apply:

- NWOs should assess counterparties' VAR every day;
- If a party presents aggregate VAR in excess of 100 per cent of the sum of its unsecured credit limit and the agreed value of any security posted, they should on the following business day be given notice requiring the provision of additional security in any of the acceptable forms (see paragraph 3.36 above). Such additional security shall be provided within two business days following the date of the notice. The counterparty must notify the NWO of any dispute concerning the amount of additional security notified within 24 hours of the notice;
- The amount of additional security required should be sufficient to bring unsecured VAR down to 80 per cent of the counterparty's credit allowance (the allowance shall remain at 80% of the normal value for one year); and
- Ofgem should be informed if the additional cover is not received.

3.51. In circumstances where the reassessment of a party's credit scoring or credit rating has led to a revision in its unsecured credit limit and consequently to the need for increased security to be posted, the applicable notice period for the provision of such additional security should be two business days. As mentioned above, where there is a reassessment of the forecast indebtedness, one month should be allowed.

3.52. Where a counterparty does not comply with a request to provide, or increase the level of, security, and is therefore in default, the following should apply:

| Number of days after default | Action suggested |
|------------------------------|---|
| Day 0 | Due date |
| Day + 1 | Interest and administration fee trigger |
| Day + 1 | NWO to issue a formal notice of default as to statement of position and how default is to be remedied |
| Day + 3 | Formal supplier response is required |
| Day + 5 | Ability to suspend registrations of (inward) transfers |

The notice of default should be issued to the notified contract manager of the counterparty's staff. This notice of default and associated response should be copied to Ofgem

- 3.53. In all instances interest and administration fees should be charged, in line with the above timetable. As discussed in the September document, these should not be extreme or excessive. In this regard, the application of charges consistent with the Late Payment of Commercial Debts (Interest) Act 1998 would appear reasonable.
- 3.54. In addition to the above, NWOs should use all means generally available to them at law to enforce their rights and remedies in order to mitigate losses arising from shipper or supplier default. NWOs should incentivise counterparties to meet their obligations in a timely fashion and if necessary should serve Statutory Demands. Where counterparties are unable to comply it is likely to result in trade sales or the application of the SoLR process.
- 3.55. The disconnection, de-energisation or isolation of consumers should consequently only be considered after all other routes have been investigated and a reasonable period of notice has been given to the affected consumers to enable them to switch to another supplier.

Payment default

- 3.56. NWOs may choose to selectively initiate contact with counterparties at due date less 3 in order to prompt payment.
- 3.57. Where a company fails to make payment on the invoice due date NWOs should apply all remedies generally available at law. In all other respects, payment default should be dealt with in a similar fashion to the arrangements for default in posting credit cover, as set out in paragraphs 3.52 to 3.55 above.

4. Ofgem's conclusions on pass through criteria

Amount of recovery

The following criteria will apply where NWOs seek pass through of bad debt:

- 4.1. Companies must have implemented credit control, billing and collection procedures in line with these best practice guidelines, in order to be eligible for pass through;
- 4.2. In the event of a default, companies claiming pass through need to provide self-certification of compliance with the best practice guidelines and the amount of loss incurred, which may be subject to audit by Ofgem;
- 4.3. Companies demonstrating compliance with or able to satisfactorily to explain departure from the guidelines will be able to recover all bad debt losses arising in respect of charges not due for payment at the date of the relevant counterparty's insolvency, net of any dividends or recoveries⁷;
- 4.4. Such companies will also be able to recover a proportion of bad debt losses arising in respect of charges overdue for payment at the date of the relevant counterparty's insolvency⁸, net of any dividends or recoveries (which would be offset proportionately against all outstanding balances), depending on the age of the outstanding receivable. Ofgem has noted comments from a number of respondents regarding the opportunity to recover 100 per cent of bad debt whilst employing reasonable procedures. Ofgem has concluded that the amount

⁷ For the purposes of this document, recoveries means the aggregate amount in cash or in kind, net of any costs of enforcement or recovery incurred, received from:

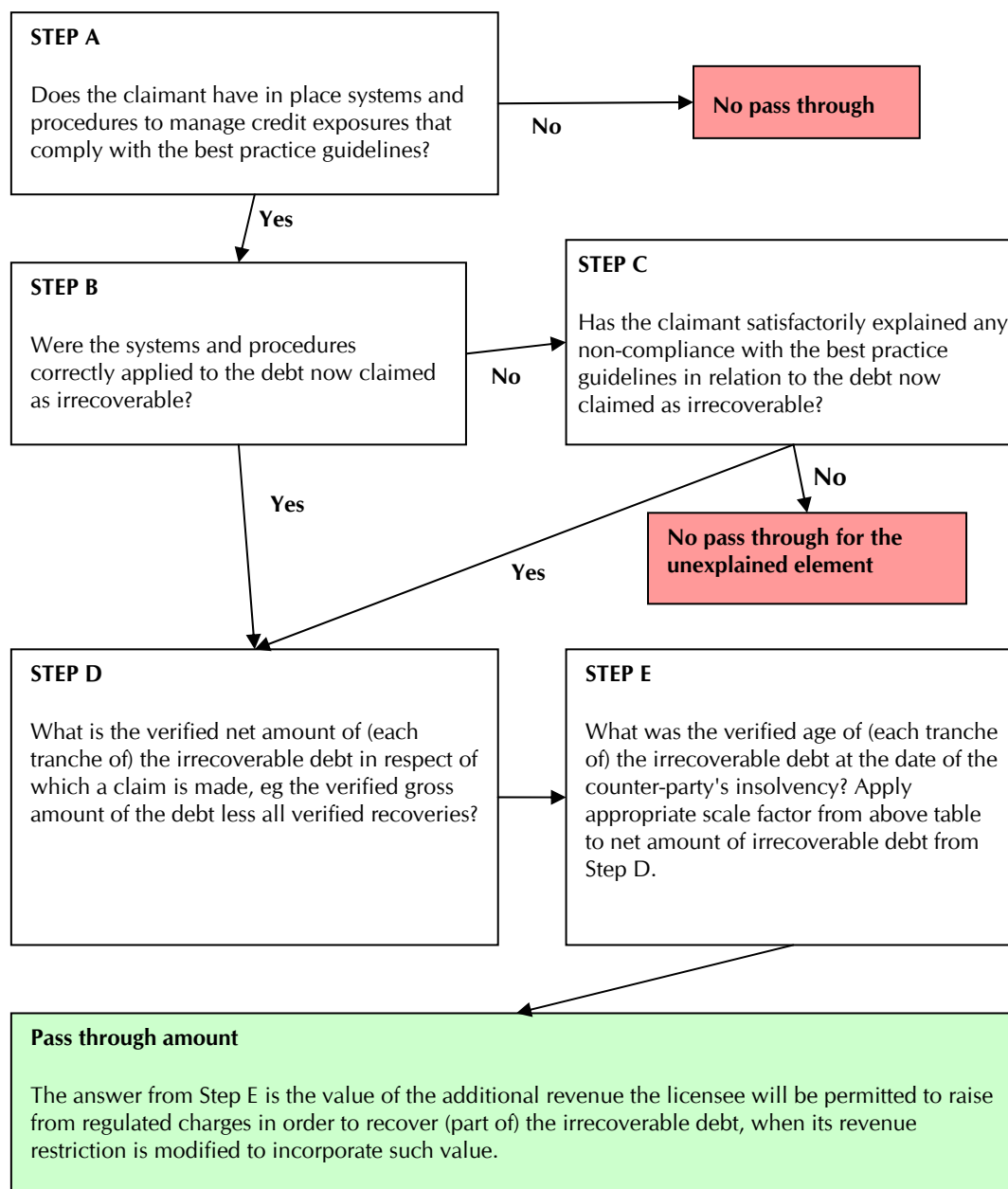
- The realisations of any security or other collateral;
- The enforcement of any lien, set off or other quasi-security interest;
- Distributions or other payments from the counterparty's insolvency whether out of administration, liquidation, company voluntary arrangements or other scheme or compromise with all or part of the company's creditors;
- Any other payment and discharge in part of any amounts outstanding or to become due from the counterparty to the company including but not limited to any payments received by way of prepayment, rescheduling or compromise;
- Any amounts received from any third party whatsoever whether under any guarantee, indemnity, insurance, other assurance or otherwise in respect of the counterparty's debt; and
- Any bad debt relief or other tax credit or relief arising from the company's failure to pay.

recoverable would be equal to the value of outstanding balances subject to bona fide dispute (plus or minus the value of any reconciliation adjustments subsequently made) together with a proportion of the value of all undisputed balances (up to a maximum of 100 per cent) that varies inversely with the age of the balance, as set out below. The overall recoverable amount would be reduced for any other recoveries.

| No. of business days past due | Percentage of face value recoverable |
|-------------------------------|--------------------------------------|
| 0 – 30 | 100 |
| 31 – 35 | 90 |
| 36 – 40 | 80 |
| 41 – 45 | 70 |
| 46 – 50 | 60 |
| 51 – 55 | 50 |
| 56 – 60 | 35 |
| 61 – 65 | 20 |
| > 65 | 5 |

⁸ For the purposes of these criteria the timing and definition of insolvency is as per the Insolvency Act 1986.

4.5. In summary, the practical application of the above process would be:



Timing of recovery

4.6. Following the application of the above process, Ofgem will advise affected NWOs of the percentage of recovery.

- 4.7. All sums to be recovered will be 'logged up' and dealt with at the subsequent price control review⁹. In addition, the adjustment will have an allowance for the cost of funding the loss pending recovery. However, where a delay in recovery would have a material adverse effect on the financial position of a NWO, Ofgem may consider earlier licence modifications.

⁹ Whilst Ofgem is unable to guarantee the approach that will be taken at a price control review (particularly where it is set by the Competition Commission in the event of an appeal); in the distribution review, recovery of costs incurred in the last review period (predominantly bad debt) was clearly visible as a separate item in the financial model and published as a separate line in 'DPCR3 costs' in the final proposals.

5. Further work

Supplemental credit scoring of companies within lower bands

Following publication of the September 2004 document, the Identification and Assessment of Credit Exposure Workgroup undertook a review of potential arrangements for supplemental credit scoring of companies within lower bands. The resulting options and accompanying views of the Workgroup are set out in appendix 1.

- 5.1. After lengthy debate by the Credit Cover Steering Group, and based on NWOs' preference for the use of external credit scoring agencies, it was agreed that consideration should be given to the following arrangements:
- a. NWOs would agree (as an industry standard) a shortlist of three credit rating agencies that would be used to obtain credit ratings (which will specify a score from 0 to 10) for non-rated companies;
 - b. The counterparty would select one agency from that shortlist, from which the NWO would obtain the rating;
 - c. The NWO will pay for the rating annually;
 - d. The counterparty may request and pay for additional ratings to be undertaken (in which case the lowest rating would be used);
 - e. Both the NWO and the counterparty agree to be bound by the result; and
 - f. An industry-wide forum would periodically assess the quality of such ratings, eg every six months or annually. Feedback, including minority views, would be provided to the rating agencies

Ofgem's view

- 5.2. Ofgem supports the use of a panel of three agencies for the provision of credit ratings, but notes that over time there may be a preference for the use of a single

rating agency. Ofgem would not be opposed in principle to such an arrangement once the elapse of a trial period enables the evaluation of results.

- 5.3. Whilst recognising the intent to produce a bespoke solution, Ofgem believes that prescribing the methodology for agencies to use would not be beneficial. Nevertheless, agencies should be aware of the special characteristics of the energy market and make their judgements accordingly. They should be as consistent as practicable with the use of public ratings in the arrangements.
- 5.4. Ofgem notes the existence of third party credit products, as endorsed by some industry participants, which could be used to generate credit limits. Where they consider them to be sufficiently reliable and accurate, NWOs may wish to consider the use of such products as a substitute for one of the panel agencies.
- 5.5. In order to conclude this work the following will need to be undertaken:
- NWOs need to agree (as an industry standard) the shortlist of credit rating agencies to be used at stage a; and
 - The basis of the industry wide forum for, and the methodology of, review of the quality of ratings.

Rating of credit cover tools

- 5.6. In circumstances where a counterparty disagrees with the rating given by a NWO to a proposed credit cover tool, Ofgem agrees that such disputes should be referred to an industry group for determination of the effectiveness with which risk is transferred and the conditionality of the instrument, and therefore its associated value.
- 5.7. In order to conclude this work, the basis of the industry group for, and the methodology of, determination of disputes will need to be undertaken. In addition, such a group could potentially undertake the development, where possible, of pro-forma for credit cover tools, as suggested at 3.41.

6. Next steps

Implementation

- 6.1. In order to achieve full implementation of the arrangements set out in this document residual work identified in previous chapters will need to be concluded. However, Ofgem considers that the substantive elements of the revised arrangements have now been determined.
- 6.2. As indicated in chapter 4, in order to be eligible for pass through NWOs must have implemented credit control, billing and collection procedures in line with the best practice guidelines. In the event of a default, companies claiming pass through need to provide self-certification of compliance with the best practice guidelines and be able to demonstrate compliance with or be able to satisfactorily explain departure from the guidelines.
- 6.3. Revised arrangements are expected to apply to all charges made by gas and electricity NWOs (other than certain holders of electricity transmission licences, to which separate arrangements will apply under the SO/TO Code), whether commodity, capacity, connection or use of system charges. Therefore appropriate changes will need to be brought forward by parties to industry codes and agreements, in order to give effect to these arrangements.
- 6.4. Ofgem considers that an open and transparent modification process for all industry codes and agreements is essential to ensure that proposed changes can be fully debated by industry parties. On this basis, arrangements for credit cover should fall under normal code/agreement modification procedures.
- 6.5. As the timing and progression of changes will to an extent be dictated by the codes and/or agreements involved, Ofgem recognises the need to allow a period in which to phase in new systems/processes to accommodate the new arrangements. With the above in mind, Ofgem expects at the latest, the necessary arrangements, with key elements codified, to become effective by 1 October 2005.

- 6.6. The Authority will decide on code modifications (and determinations) that come before it, each on their own merits and having regard to the relevant criteria. Accordingly, nothing in this document can prejudice current and future decisions by the Authority or be taken to fetter the discretion of the Authority in any way.
- 6.7. In the event that a company fails during this interim period, prior to full implementation of arrangements consistent with the best practice guidelines, and as a result there is an application for pass-through, Ofgem will consider the extent to which the affected party is conforming to the guidelines and implementation timetable at that time. In addition, Ofgem will consider what steps the relevant NWO has taken to progress matters.
- 6.8. Following the expiry of the interim period, on 30 September 2005, NWOs that have not implemented suitable arrangements and who are unable to explain satisfactorily that failure would be ineligible for pass through.
- 6.9. Additional recovery will not be available in respect of costs of implementation of these arrangements. However, on an ongoing basis, as a general matter, Ofgem's methods take account of special factors affecting networks when making comparisons for the purposes of setting operating cost allowances in price control reviews. In principle, therefore, if a NWO is able, at any review, to demonstrate that its credit 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 NWO to show that its costs are no more than an efficient company would need to incur in the same circumstances. This applied equally to operators whose costs benefit from systematic bias.

Maintenance of the best practice guidelines

- 6.10. Whilst it will remain open for parties to raise change proposals to relevant codes and/or agreements at any time, subsequent to their implementation, Ofgem suggests that the best practice guidelines be reviewed on an annual basis. This should be carried out in such a way as to ensure that the guidelines remain appropriate and consistent with best practice in comparable industries (taking

into account the nature of gas and electricity transportation and all relevant regulatory and legal issues).

- 6.11. Ofgem considers that high level review could be carried out by a body analogous to the existing Credit Cover Steering Group, with workgroups being constituted, as required, to consider more detailed issues. Absent preference being expressed for alternative arrangements, Ofgem will issue invitations in line with the above, on an annual basis.

DN sales

- 6.12. As set out in chapter 1, the Authority has given its conditional consent to the sale of four of NGT's gas distribution networks. The facilitation of the sale will involve, amongst other things, the creation of a UNC, which will set out the common transportation arrangements of each DN.
- 6.13. Ofgem considers that it would be appropriate for the common high level credit principles to be contained within the UNC, setting the parameters within which each DN may operate. The specific terms that each DN operates may then be set out in each SFC, thereby ensuring a degree of commonality whilst retaining the DNs ability to vary conditions according to its particular circumstances, subject to the approval of the Authority.
- 6.14. One of the principles behind the development of the UNC has been to change only that which is necessary to give effect to DN sales, whilst protecting the interests of the consumer. In this context, Ofgem considers that the UNC should include such credit provisions as are required to reflect a multi-DN situation, and to ensure that those provisions are capable of being modified in order to achieve best practice.
- 6.15. Notwithstanding the timetable associated with the sale of four of NGT's DNs and the above deadline of 01 October 05, Ofgem considers that each NWO, including the new DN owners, should endeavour to implement arrangements consistent with the best practice guidelines at the soonest practicable opportunity. It is recognised that in the interim period, credit provisions may be

reflected in a combination of Network Code (UNC and SFC) and non-Network Code documentation.

DCUSC

- 6.16. The credit sub-group of the Distribution Commercial Forum will meet periodically over the following months to develop common credit arrangements intended to be consistent with this conclusions document and which other interested parties might want to adopt in the interest of consistency.

Appendix 1 The Identification and Assessment of Credit Exposure Workgroup's views on supplemental credit scoring of companies within lower bands

The following options and accompanying views were put forward by the Workgroup in respect of non-investment grade rated companies.

Option A(1)

- 1.1 NWOs agree (as an industry standard) a shortlist of three rating agencies that would be used to obtain credit ratings for non-rated companies.
- 1.2 NWO obtains ratings from either one or all three (in which case uses the lowest).
- 1.3 Both parties (NWO & shipper/supplier) agree to be bound by the result.
- 1.4 An industry-wide forum would periodically assess the quality of such ratings, eg every six months or annually. Feedback, including minority views, to be provided to rating agencies.

Option A(2)

- 1.5 As option A(1) except at 1.3, ie shipper/supplier has opportunity to “appeal” the rating by submitting additional information to the rating agency, with both parties being bound by the subsequent result.

Option B

- 1.6 As Option A except that shippers/suppliers would shortlist the three agencies and the NWO would decide which one it wanted to obtain the rating from, assuming it wasn't all three.

Option C

- 1.7 Industry agrees on the key performance measures that indicate a (growing) company's financial viability, eg (a) billing performance: is the company billing the same volume (adjusted for losses) to customers as it is buying; (b) cash collection efficiency: is the company collecting cash at the same rate as it is billing.
- 1.8 Industry (with Ofgem) agrees a pro forma checklist summarising these indicators and weighting them as appropriate.
- 1.9 Shipper/supplier procures independent review of its performance on a bi-monthly basis. The independent view could be from a rating agency, accountant, auditor or other qualified professional who completes and signs off the form.
- 1.10 Cost is borne by the shipper/supplier, not the NWO.
- 1.11 The checklist is audited twice a year by a qualified auditor, once for the statutory audit and on one other occasion during the year.
- 1.12 An unsatisfactory audit would result in an appropriate adjustment to the credit line (strong incentive to behave).
- 1.13 Unsecured credit is advanced to the non-rated company based on the parameters in the completed checklist.
- 1.14 Notwithstanding the above, failure to maintain up to date payments automatically trigger a reduction in or withdrawal of unsecured credit facilities.
- 1.15 A sliding scale of performance against the checklist to credit granted would be agreed with Ofgem for all in this category (scale to be determined)
- 1.16 Provided the audits were complied with and appropriate action taken, NWO would receive the same bad debt recovery as for the failure of suppliers in other categories.

| | Favourable comments | Adverse comments |
|-----------|---|--|
| A1 | <ul style="list-style-type: none"> NWOs take on the credit risk & so should select the agencies and which of the ratings to accept. Not normal commercial practice for customer to decide by whom it is rated & which rating should apply Similar approach is used when obtaining approved credit ratings Normal practice is to use the lowest of any ratings obtained Use just one agency per assessment, otherwise too costly & bureaucratic and “competitive pressure” could influence judgment Sufficient objectivity in rating process for both parties to be bound by outcome; therefore, no appeals process unless manifest error Rating agencies will not disclose their methodology, so rating should stand as appeals mechanism is likely to require rework by the NWO Annual review of quality of ratings should be sufficient & would allow checking of a sample of ratings against audited accounts | <ul style="list-style-type: none"> If multiple ratings obtained, use average rather than lowest Shipper/supplier, not the NWO, should choose rating agency from the panel of three approved by NWO. The above two counter-proposals would remove the possibility of NWOs searching for credit ratings until a “sufficiently” low one is obtained (so as to avoid providing any significant level of credit). Option C suggested, not as representing commercial best practice, but as an energy sector specific approach |
| A2 | <ul style="list-style-type: none"> As above Allow appeals provided paid for by appellant Acceptable <i>provided</i> shipper/supplier chooses the rating provider from the approved panel Favoured as would allow shipper/supplier to provide additional information, if required, to the rating provider | <ul style="list-style-type: none"> Rating agencies unlikely to consider additional financial information unless audited |
| B | | <ul style="list-style-type: none"> NWOs take on the credit risk and so should select the agencies and which of the ratings to accept Disagree as NWOs have expert knowledge of systems available and can also negotiate rates based on usage |

| | | |
|---|--|---|
| C | <ul style="list-style-type: none"> • Provides more “real time” indication of financial health of new market entrants than standard rating methodologies that rely on historic audited accounts, information contained in which can be up to 12-18 months out of date • Costs borne by supplier/shipper, forcing them to assess the to value of providing information vs the costs of simply providing security • Internal company information acceptable for rating purposes provided independently verified by external auditors | <ul style="list-style-type: none"> • NWO is being asked to support an entity that is either so new or so weak that trained financial professional not prepared to give rating; therefore, not supported (particularly in light of unacceptable pass through arrangements) • If entity cannot satisfy basic rating criteria, should they be allowed to operate in the market? • Non-starter as smaller new companies inherently carry more risk. • Introduces need for more credit resources: costs may be significantly higher than rating agencies. Most commercial companies would not extend unsecured credit until sound payments history established & audited accounts available. • Addresses only a niche of small suppliers, eg non-rated companies are not necessarily growth companies |
|---|--|---|