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Direct Dial: 020-7901-7355

1 June 2006

National Grid Electricity Transmission Company (NGET),
CUSC Signatories and Other Interested Parties

Our Ref: IND/COD/CUSC/CAP019

Dear Colleague,

Amendment to the Connection and Use of System Code ("CUSC") - Decision and Direction in relation to Proposed Amendment CAP119: "Clarification and Correction to the table of Users' Credit Allowances".

The Gas and Electricity Markets Authority (the "Authority"¹) has considered the issues raised in the Amendment Report² in respect of Proposed Amendment CAP119 "Clarification and Correction to the table of Users Credit Allowances".

The CUSC Amendments Panel (the Panel) recommended to the Authority that CAP119 original Amendment Proposal should be approved and implemented, with an implementation date as suggested by NGET of ten business days after the Authority's decision.

Having considered the Amendment Report and the CUSC Amendment Panel's recommendation, as well as having regard to the Applicable CUSC Objectives³ and Ofgem's wider statutory duties,⁴ the Authority has decided to direct a modification to the CUSC in line with the original Amendment Proposal for CAP119

¹ Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

² CAP119 Amendment Report dated 25 April 2005.

³ The Applicable CUSC Objectives are contained in Standard Condition C10 of the licence to transmit electricity treated as granted to NGET under Section 6 of the Electricity Act 1989 (the "Transmission Licence") and are:
(a) the efficient discharge by the licensee of the obligations imposed upon it under the Act and by this licence;
and
(b) facilitating effective competition in the generation and supply of electricity, and (so far as consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity.

⁴ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and are explained in sections 3A – 3D of the Electricity Act 1989.

This letter explains the background to CAP119, and sets out the Authority's reasons for its decision. This letter constitutes notice by the Authority under section 49A of the Electricity Act 1989.

Background

CAP089/090/091 introduced into the CUSC a table defining the credit allowances that would be available to Users with Approved Credit Ratings (ACR). At the top end of the rating scale, Users with ACR's ranging from AAA to AA- are able to obtain the maximum amount of unsecured credit available. Users with ACR's ranging from A+ to A- are only able to obtain 40% of this maximum. The table however does not list all the related ratings but instead groups them together, potentially providing some scope for ambiguity as to the level of credit available. The table also incorrectly references some of the Fitch ratings, referring to short term Fitch ratings, instead of long term Fitch ratings.

CAP119 was raised by NGET and submitted to the CUSC Amendments Panel at their meeting on 27 January 2006. At the meeting the Panel determined that CAP119 should proceed to wider consultation by NGET. A consultation paper was issued on 2 February 2006 with responses invited by 16 February 2006. A Consultation Alternative Amendment was submitted and a Consultation Alternative Amendment Consultation was issued on 21 February 2006, with responses invited by 7 March 2006. The CUSC Amendment Panel Recommendation Vote for CAP119 was conducted at the Panel meeting on 31 March 2006. The final Amendment Report was submitted to the Authority on 25 April 2006.

The Proposed Amendment

The original Amendment Proposal would amend the table such that instead of displaying the ratings grouped together at the top end of the ratings scale they would be explicitly listed displaying the full range with the corresponding percentage of credit available, as a percentage of the maximum amount of credit available, for that range. It would also correct the references to the incorrect Fitch ratings.

The Proposer considers this would increase the transparency and clarity of the table allowing anyone referencing the table to more easily understand the level of credit they would be entitled to and in so doing better facilitate Applicable CUSC Objective (b).

Respondents' views

NGET issued a consultation paper on 2 February 2006 inviting responses from CUSC Parties and interested parties.

NGET received 2 responses to the consultation in respect of CAP119, of which 1 expressed support for the original Amendment Proposal and 1 proposed a Consultation Alternative Amendment (CAA). The respondent in support agreed the original Amendment Proposal would expand and clarify the table. The CAA raised by the other respondent is discussed further below.

The respondents' views are summarised and contained in the Amendment Report in respect of CAP119.

Consultation Alternative Amendments

A CAA was submitted by Scottish and Southern Energy (SSE). In line with the original Amendment Proposal, the CAA proposed to display the full range of credit ratings and the corresponding levels of credit available for the range. The CAA in addition proposes an alteration to the percentage of credit available to parties with an ACR in the range of A+ to A-, suggesting party's with ratings of A+, A and A- receive a credit allowances of 80%, 60% and 40% respectively against the 40% that the whole of this range currently attracts.

Consultation Alternative Amendment consultation

NGET issued a CAA consultation on 21 February inviting responses from CUSC Parties and interested parties.

NGET received 1 response to this consultation, from the proposer of the CAA, expressing support for it. The respondent did not consider the level of risk at AA- was so substantially different to A+ as between 100% and 40%.

CUSC Amendment Panel's recommendation

The CUSC Amendments Panel voted to recommend that original Amendment Proposal CAP119 should be approved with an implementation date of 10 business days after an Authority decision.

Ofgem's view

Ofgem considers, having regard to its statutory duties and the Applicable CUSC Objectives, that original Amendment Proposal CAP119 would better facilitate the achievement of the Applicable CUSC Objectives.

Ofgem agrees that expanding the table introduced by CAP89/90/91 to display the complete range of credit ratings and the corresponding levels of credit available to a range would increase transparency and clarity. This in turn would facilitate Applicable CUSC Objective (b) by allowing current parties and potential new entrants to more easily understand the level of credit they would be entitled to commensurate to their credit rating. Further, correcting the incorrect references to the Fitch ratings would add to this clarity.

Ofgem is unable to see the justification for the additional change proposed by the Consultation Alternative Amendment. Ofgem considered this issue recently under CAP089/090/091 and concluded then that;

" credit allowances based on the Basel II rules for determining bank capital adequacy are the most appropriate approach to adopt and would provide a reasonable reflection of the risk posed by a User. They also provide a clear indication of the credit allowances available and the justification behind them. The introduction of a transparent and easily referenced scale which helps set the level of unsecured credit a User holding a particular rating can be given according to the risk that User poses to NGET, would better facilitate the achievement of the Applicable Objectives."

The Basel II weightings were considered appropriate because they broadly reflect the proportionate change in default probability experienced as a rating transitions from one grade to the next. They were designed to categorise differential risks similar to those examined in detail by Ofgem and the industry over two years when considering network operator credit cover. The risk weightings are predicated on the assumption that credit ratings reflect all relevant risk factors, including the inherent probability of default and the prospects for recovery in the event of default.

Ofgem considers the Basel II weightings to be independent and authoritative. They divide the risk curve into a reasonable number of very clearly bounded bands so as to provide a degree of granularity, while avoiding excessive complexity.

The principles underlying Basel II are fundamental and accordingly the weightings may be applied equally in the context of credit risk mitigation for commercial business as well as in relation to bank capital adequacy. Although the Basel II weightings are not immune from criticism, Ofgem considers that they nevertheless provide a pragmatic approach which would not be significantly improved by increased granularity.

For these reasons Ofgem considers that the Consultation Alternative Amendment would not better facilitate the Applicable CUSC Objectives.

The Authority's Direction

The Authority has decided to direct that original Amendment Proposal CAP119, as set out in the Amendment Report, should be made and implemented.

Having regard to the above, the Authority, in accordance with Condition C10.7(a) of the licence to transmit electricity granted to NGET under Section 6 of the Electricity Act 1989 (the "Transmission Licence"), hereby directs NGET to modify the CUSC in accordance with original Amendment Proposal as set out in the Amendment Report.

The modification is to be implemented and take effect 10 business days after the Authority's decision.

In accordance with Condition C10.7(c) of NGET's Transmission Licence, NGET shall modify the CUSC in accordance with this direction of the Authority.

If you have any queries in relation to the issues raised in this letter, please feel free to contact Dipen Gadhia on the 020 7901 7168.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

Nick Simpson

Director, Industry Codes and Licensing

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