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Direct Dial: 020-7901-7491

7 December 2005

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

Our Ref: IND/COD/CUSC/CAP099

Dear Colleague,

Amendment to the Connection and Use of System Code (“CUSC”) - Decision and Notice in relation to Proposed Amendment CAP099: “Incorporation of additional credit management tools within the CUSC in line with current best practice”.

The Gas and Electricity Markets Authority (the “Authority”¹) has considered the issues raised in the Amendment Report² in respect of Proposed Amendment CAP099 “Incorporation of additional credit management tools within the CUSC in line with current best practice”.

National Grid Electricity Transmission Company plc (“NGET”) recommended to the Authority that the Working Group Alternative Amendment for CAP099 should be approved with an Implementation Date of 10 Business days after the Authority’s decision. National Grid recommended that Proposed Amendment CAP099 should not be approved, but recommended that should the Authority approve the Proposed Amendment, an Implementation Date of 10 Business Days after the Authority’s decision would be appropriate.

Having considered the Amendment Report and NGET’s recommendation and 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 Proposed Amendment CAP099.

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

² CAP099 Amendment Report dated 11 November 2005.

³ The Applicable CUSC Objectives are contained in Standard Condition C10 of the licence to transmit electricity treated as granted to NGC 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 include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

A separate letter contains the direction to NGET to modify the CUSC in accordance with Proposed Amendment CAP099 as set out in the Amendment Report.

This letter explains the background to CAP099, 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 in relation to the direction.

Background

In February 2005 Ofgem issued its [Best practice guidelines for gas and electricity network operator credit cover](#) (the guidelines). Amongst other things the guidelines dealt with the tools which could be used by Users to cover credit exposure. Ofgem's conclusions as to which credit cover tools should be available to parties was almost entirely based on the consensus on this issue that had been developed amongst industry during the development work which preceded the publication of the guidelines. In addition to proposing a range of tools the workgroup also agreed that the way in which credit cover tools are rated must be bound by objective criteria capable of rating the face value of a tool in a consistent manner.⁵ The solution developed provided for an end to aspire to (namely that a tool providing cash on demand should be rated at full value, whilst a tool that has conditionality but provides cash in a timely fashion could be rated at up to full value, and that where the tool is an insurance product the insurer should be of a good rating in order for the tool to be rated at full value). It did not seek to provide the criteria upon which this assessment should be based. This approach was later followed by Ofgem in the guidelines. In that paper Ofgem recognised appropriate changes would need to be brought forward by parties to industry codes and agreements in order to give effect to the proposed arrangements for credit cover.

A number of amendments were raised to the CUSC, some of which are still being considered. For the purposes of information these amendments include (to date) CAP088, 089,090, 091, and 099, details of these amendments can be found in the [CUSC amendments area of the National Grid website](#).⁶ Ofgem has made its decision in relation to CAP099 solely on the basis of whether or not CAP099 better facilitates the Applicable CUSC Objectives and Ofgem's own statutory duties.

The CUSC currently includes provisions allowing entities to provide security for Use of System charges through letters of credit, cash held in escrow, and guarantees from parent companies. The best practice guidelines envisaged a wider range of tools and in an order address this perceived defect CAP099 was raised by BizzEnergy.

The Proposed Amendment was considered by the CUSC Amendments Panel (the Panel) at its meeting of 29 July 2005. At the meeting the Panel determined that a Working Group should be

⁵ [Recommendations for best practice guidelines for gas and electricity network operator credit cover](#) Consultation Document (September 2004 226/04) Paragraph 4.38.

⁶ CAP089-091 were amalgamated by the CUSC Amendments Panel.

established to consider the Proposed Amendment. The Group developed both the original proposal and a Working Group Alternative Amendment (WGAA). The Working Group submitted its report for consideration at the Panel Meeting on 23 September 2005. At the meeting the Panel determined that CAP099 should proceed to wider consultation by NGET. A consultation paper was issued on 28 September 2005 with responses invited by 28 October 2005. Five responses were received. The final Amendment Report was submitted to the Authority on 11 November 2005.

The Proposed Amendment

CAP099 sought to widen the range of tools available to CUSC Parties which need to post collateral. These included:

- ◆ a performance bond (provided by an insurer),
- ◆ bilateral insurance,
- ◆ independent security (provided by an entity other than a bank, an insurer or a parent company),
- ◆ prepayment / advance payment.

Any combination of these tools (in addition to the tools already available under the CUSC) could be used in order to secure the amount required.

It was the suggestion of the Proposer that CAP099 would enable NGET to better facilitate competition in the generation and supply of electricity by allowing a range of credit management tools to be utilised by Users. The proposer believed that precluding the use of such tools would restrict the options of Users and constitute a barrier to market entry.

During the development of CAP099 NGET suggested that the tools which the Amendment sought to introduce should be accepted at full value if the following conditions were met:

- ◆ the credit support is from an entity with a credit rating of not less than A-,
- ◆ the credit support is legally enforceable in the UK,
- ◆ 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.

Where these proposals were not met in full the tools may still be accepted at a discounted value. It was suggested by the proposer that this was in line with the best practice guidelines and would introduce greater creativity and flexibility into the CUSC credit practices. NGET suggested that the credit tools already present in the CUSC would continue to be assessed according to the current CUSC requirements for those tools: that they should be from a creditworthy entity, that National Grid should have the ability to call down upon the tool and to be able to do so in a timely manner, and that such tools should cover the security requirement.

The group noted that it may not be possible for NGET and the counterparty to agree the value of a particular tool in all eventualities. It was highlighted that the credit cover guidelines state that

in the event a counterparty disagrees with the rating given by the network operator to a proposed credit cover tool, such disputes should be referred to an industry group for determination. The Group considered that it would be outside the scope of CAP099, and possibly outside the scope of the CUSC, to create a cross-governance dispute resolution body by hardwiring provisions into the CUSC. As a result it was decided that the dispute would be referred to an independent expert who would determine the value of the tool. In the event the parties were unable to agree the appointment of such an expert, the appointment would be made by the Director General of the Institute of Credit Management. The Group felt that if an industry wide expert group were created at some point in the future the current drafting of the document could encapsulate such a group.

Concerns were also raised to the effect that any discussions between NGET and a counterparty (and potentially any subsequent decision by an Independent Expert) as to the appropriate value of the tool(s) would lack transparency. The Group concluded that it would be beneficial if either guidelines or records of resolutions made by the Independent Expert could be made available.

During the development of CAP099 a number of issues were raised in relation to bilateral insurance. During its discussions the Group clarified that an insurance company offering bilateral insurance would normally only pay out only in the event of the insolvency of the counterparty. Meanwhile, NGET expressed concern that an insurer would not pay out the full amount of credit exposure arising as a result of the insolvency of a counterparty, and that any recovery would be very slow. NGET was also concerned that a higher burden of proof could be placed on the network operator if evidence was required that a debt was due and that all reasonable efforts had been made to obtain payment of the debt. Other members of the Group considered this latter point little more than a formality.

Other comments were also made as to the relative immaturity of bilateral insurance as a product and the likelihood of its uptake in the market. It was agreed that this did not mean the provision of bilateral insurance was impossible. It was agreed that parties wanting to use such tools should be able to encourage future innovation and that the drafting of the CUSC should be such as to allow this.

One member of the Group considered that the Original Proposal better facilitated the Applicable CUSC Objectives, three members were unsure, whilst two considered that it definitely did not.

Working Group Alternative Amendment (WGAA)

Some Group members held reservations about the original proposal. The substantive concerns centred around:

- ◆ the use of bilateral insurance which some thought was risky, inefficient and under-developed,
- ◆ the provision of performance bonds and independent security by entities with a low degree of creditworthiness, and

- ◆ the non-transparent nature of the bilateral negotiation process in relation to the value of credit tools worth less than 100% of face value between NGET and counterparties.

In order to address these concerns a WGAA was proposed by NGET. This proposed the addition of Performance Bonds and Independent Security to the CUSC as acceptable methods of providing credit cover, but only where these tools could fulfil the conditions described on page three of this letter. The application of such a solution would not require the existence of a negotiation or dispute resolution process as there would be no dispute as to the value of the Performance Bond or Independent Security; it would either be worth 100% of face value or be invalid for the purposes of the CUSC. This solution would also mean that bi-lateral insurance would not be an option available to CUSC Parties. It was agreed that Prepayment / Advance payment would be catered for under the WGAA.

The proposer of the WGAA considered that the original amendment would not better facilitate the Applicable CUSC Objectives as it would be inefficient. It was also suggested that the original proposal could increase the risk of industry being exposed to the costs of user insolvency as a result of accepting security which is inherently more risky, and introduce an uncodified bilateral negotiation process, both of which, in its opinion, would hinder competition. Whilst this was the case the Proposer of the Working Group Alternative Amendment considered the solution would better facilitate competition in the supply and generation of electricity by allowing a wider range of efficient credit management tools to be utilised in a transparent manner, against clear criteria.

Three members of the Group considered the WGAA better facilitated the Applicable CUSC Objectives when compared to the current baseline of the CUSC, two were unsure and one considered that it did not. The Group members considered that the WGAA better facilitated the Applicable CUSC Objectives when compared to the original proposal by a margin of five to one.

Respondents' views

NGET issued a consultation paper on 28 September 2005 inviting responses from CUSC Parties and interested parties.

NGET received 5 responses to the consultation in respect of Proposed Amendment CAP099, none of which expressed support for the original proposal, 4 of which expressed support for the WGAA, and 1 of which was unsupportive of both the original proposal and the WGAA.

All of the respondents to the consultation were concerned that the implementation of the original amendment, specifically the introduction of bilateral insurance could be detrimental to the CUSC. A number of respondents were concerned that the original proposal would introduce a greater level of risk to CUSC Parties than that posed by the current arrangements and stressed that whilst it would benefit competition in the generation and supply of electricity to widen the range of tools through which a party could lodge collateral, this should not be done at the expense of the level of protection to CUSC signatories and that the new arrangements should be as robust as the previous arrangements.

Another issue of concern was the provision of credit by an issuer with a credit rating of less than A-, or the provision of credit by an issuer which failed to fulfil one of the other criteria used to help determine when security provided under the tools introduced by CAP099 may be valued at 100% of face value. In particular, a number of respondents were concerned by what they perceived to be a lack of transparency associated with the process of negotiation which was proposed should take place between NGET and Users in order to determine the value which should be assigned to a particular tool in the event that a dispute as to the value of the tool put forward arose.

The full text of the respondents' views are appended to the Amendment Report for CAP099.

Amendments Panel Members' views

No responses to the CAP099 consultation document were received from Panel Members in their capacity as Panel Members. The Amendments Panel had previously indicated that although the drafting of the Amendment did not seek to create a cross governance expert group to deal with disputes as to the value of a particular form of security, the Panel Members who spoke on this issue considered that the drafting appeared sensible on the grounds that the appointment of an Independent Expert enables CAP099 to work, but that if an expert group were developed in the future this could be used in the context of the CUSC.

NGET's recommendation

National Grid Electricity Transmission Company plc ("NGET") recommended to the Authority that the Working Group Alternative Amendment for CAP099 should be approved with an Implementation Date of 10 Business days after the Authority's decision. National Grid recommended that the Original Proposal for CAP099 should not be approved, but recommended that should the Authority approve the Original Amendment, an Implementation Date of 10 Business Days after the Authority's decision would be appropriate.

Ofgem's view

Having considered the Amendment Report, Ofgem considers that both the original proposal for CAP099 and the WGAA would better facilitate the achievement of the Applicable CUSC Objectives and Ofgem's statutory duties when compared to the current baseline of the CUSC. Enabling Users to put in place the relevant amounts of collateral through a range of tools which have been developed by the industry is likely to better facilitate the promotion of competition in the generation and supply of electricity.

The original proposal suggested that certain criteria (such as those described on page three of this letter) should be used to determine whether the tools introduced by CAP099 should be rated at full value or not. Ofgem notes that although the guidelines intended the application of these criteria in the context of Independent Security alone, CAP099 was developed on the basis of NGET's suggestion that these criteria would form a good basis for determining whether or not the other tools introduced by CAP099 would be fit for purpose. Whilst these principles may be

applicable to some of the forms of credit cover which CAP099 seeks to introduce, Ofgem is not convinced they constitute a complete method of assessing the face value of the tool(s) in question. In this regard Ofgem shares the strongly held reservations expressed by industry parties that the process used to define the value of the tool could lack transparency, thus having a negative effect on the better achievement of Applicable CUSC Objective (b). The criteria applied when rating tools according to the effectiveness with which risk is transferred and the conditionality of the instrument should be clear, objective and appropriate. Indeed, it has been Ofgem's expectation that a full set of criteria for the rating of credit tools would be developed and maintained by the various network operators. Ofgem is also concerned that a consultation respondent has highlighted a perceived risk that the operation of these provisions could result in claims that NGET had acted in an unduly discriminatory manner when discharging its duties under the CUSC. Accordingly, it is Ofgem's view that it may be appropriate for further work to be undertaken to more clearly define the criteria used to assess how effectively risk is transferred and the conditionality of Performance Bonds, Bilateral Insurance, Prepayment/Advance Payment and possibly also Independent Security. Ofgem recognises that it may not be possible to define this process in an exacting formula. Notwithstanding this, it may be that the development of a series of principles for each tool would form an appropriate basis upon which transparent, and consistent discussions between NGET and Users could take place.

Ofgem recognises that parties have raised concerns about a number of the credit tools suggested in the original amendment, but which are not part of the WGAA. In relation to the application of bilateral insurance, Ofgem is aware that a number of insurance products are available, some of which will pay out only in the case of supplier insolvency, and others which would pay out on the basis of other failures to pay. Ofgem noted in paragraph 3.38 of the conclusions that in the case of insurance products, the insurer should be of a good rating and the terms of the policy should be unconditional in all material matters in order for the tool to be rated at full value. It may be that an insurance product which only pays out in the event of supplier insolvency contains an element of conditionality in relation to the material matter of providing credit cover for use of system charges under the CUSC. Ofgem suggests that if attempts are made to define a set of objective criteria for the rating of credit tools that it may be appropriate for this issue to be taken into account. In the same vein it may also be appropriate for the industry to consider what a 'good rating' means in the context of the CUSC, and how the criteria for the rating of bilateral insurance products would delineate the treatment of different ratings within that definition.

Ofgem also recognises that NGET may need to provide evidence to an insurer that the debt was due and efforts to obtain payment of the debt had been made. Insurance products which contain terms placing a high burden on NGET (in terms of the provision of evidence to facilitate the processing of a claim) may be thought to an element of conditionality which other policies might not, and for a lower face value to be ascribed to the product as a result. Ofgem recognises that due to the nature of bilateral insurance as a maturing product it will be important for NGET to work closely with companies seeking to use bilateral insurance as a means of providing credit cover and to keep under review the legal drafting in the CUSC. Similarly, industry may take the view that policies which would be more likely to only pay out a proportion of the full amount would contain an element of conditionality.

The original proposal for CAP099 developed a solution for the resolution of disputes relating to the rating of credit cover tools under which such matters would be determined by an Independent Expert instead of an industry group. The perceived transparency of these arrangements have been criticised by industry members in a similar manner to the criticism directed toward the lack of transparency in the initial discussions between NGET and Users when determining the face value of a particular form of security. It is Ofgem's view that a cross code or cross governance industry group is not required, simply for an industry group to be established. As such Ofgem considers it would have been possible for the original proposal to have referred such disputes to a subcommittee of the Panel with a duty to report its decisions on an anonymous basis. Whilst the proposed solution takes a different approach to that envisaged in the conclusions, Ofgem considers it may not necessarily act to the detriment of competition in the generation and supply of electricity if the records of the determinations are made available in a manner which provides a suitable level of transparency.


Ofgem is concerned that, as recognised by NGET and other companies which participated in the Working Group for CAP099, the solution developed may not provide adequate criteria to enable ratings to be provided in a consistent and transparent manner. Notwithstanding this, the Amendment Proposal introduces a wider range of tools than the WGAA, resulting in a significant positive impact on competition in the generation and supply of electricity. Ofgem recognises that the impact of the deficiencies described above on the CAP099 means that the Amendment Proposal only marginally better facilitates the achievement of effective competition in the generation and supply of electricity as compared to the WGAA. Ofgem is also mindful that neither the provisions of the guidelines, nor the intention of the industry, have been transposed into the CUSC as effectively as might have been the case.

The Authority's Decision

The Authority has therefore decided to direct that the Amendment Proposal for CAP099, as set out in the Amendment Report, should be made and implemented. An attached letter contains this direction.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

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

Nick Simpson
Director, Modifications

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