



Direct Dial: 020-7901-7355

24 February 2003

The National Grid Company, CUSC Signatories and  
Other Interested Parties

Your Ref: CAP018  
Our Ref: IND/COD/CUSC/CAP018

Dear Colleague,

**Amendment to the Connection and Use of System Code (“CUSC”) - Decision and Notice in relation to Proposed Amendment CAP018: “Credit Cover Requirements for Transmission Use of System Charges”.**

The Gas and Electricity Markets Authority (the “Authority”<sup>1</sup>) has carefully considered the issues raised in the Amendment Report<sup>2</sup> in respect of Proposed Amendment CAP018 “Credit Cover Requirements for Transmission Use of System Charges”.

The National Grid Company plc (“NGC”) has recommended to the Authority that Proposed Amendment CAP018 be approved with an implementation date of 1 April 2003.

Having considered the Amendment Report and NGC’s recommendation and having regard to the Applicable CUSC Objectives<sup>3</sup> and the Authority’s wider statutory duties, the Authority has decided not to direct a modification to the CUSC.

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

<sup>2</sup> CAP018 Amendment Report dated 28 August 2002.

<sup>3</sup> The Applicable CUSC Objectives are contained in Standard Condition C7F of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 as amended (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.

This letter explains the background to Proposed Amendment CAP018 and sets out the Authority's reasons for its decision.

## **Background**

The current arrangements for the provision of Security Cover in respect of TNUoS and BSUoS charges, as set out in Section 3 of the CUSC, provide for the use of Approved Credit Ratings ("ACRs") to determine which Users have to provide Security Cover. Users that do not hold an ACR are required to provide Security Cover for TNUoS and BSUoS charges in the form of one, or a combination, of the following:

- (i) A Qualifying Guarantee from a Company that holds an ACR, usually in the form of a Parent Company Guarantee (PCG);
- (ii) A Letter of Credit (LoC); or
- (iii) Cash to be credited to the Escrow Account

Proposed Amendment CAP018 was raised by NGC on 14 March 2002 and was submitted for consideration at the CUSC Amendments Panel Meeting on 22 March 2002. The Panel determined that the Credit Cover Working Group ("CCWG") should be established to evaluate the Proposed Amendment. The CCWG submitted its report for consideration at the Amendments Panel Meeting on 21 June 2002. The Panel endorsed the report and determined that the Proposed Amendment should proceed to wider industry consultation by NGC. A consultation paper was issued on 11 July 2002 with responses invited by 14 August 2002. A final Amendment Report was submitted to the Authority on 28 August 2002.

## **The Proposed Amendment**

Proposed Amendment CAP018 seeks to modify the requirement for Security Cover in respect of both TNUoS and BSUoS charges set out in Section 3 of the CUSC. Proposed Amendment CAP018 seeks to remove the use of ACRs to determine which Users are required to provide Security Cover for TNUoS and BSUoS charges and to remove PCGs as a means of providing such Security Cover. The Proposed Amendment would require all Users to provide Security Cover for TNUoS and BSUoS charges in the form of a LoC or a cash deposit or a combination of the two.

The Proposer considered that removal of use of ACRs to determine which Users are required to provide Security Cover for TNUoS and BSUoS charges would better facilitate achievement of the Applicable CUSC Objective C7F.1(a) since an ACR does not guarantee payment in the event that a User defaults on the payment of its charges. The Proposer considered that removal of the use of ACRs would also better facilitate achievement of the Applicable CUSC Objective C7F.1(b) since requiring all Users to provide Security Cover would remove the distinction between Users that hold an ACR and those that do not, thereby placing all Users on a "common footing". In addition the Proposer considered that removal of Parent Company Guarantees (PCGs) as a means of providing Security Cover would better facilitate achievement of the Applicable CUSC Objective C7F.1(b) since PCGs introduce a cross-subsidy from a parent company to its subsidiary (the User).

## **Working Group's views**

The Credit Cover Working Group ("CCWG") considered that Proposed Amendment CAP018 would better facilitate achievement of the Applicable CUSC Objective C7F.1(a) since it would guarantee payment in the event that a User defaulted (up to the amount provided as Security Cover). The CCWG considered that the Proposed Amendment would also better facilitate achievement of the Applicable CUSC Objective C7F.1(b) since it would place all Users on a "common footing" in terms of the forms of Security Cover that could be provided.

However, a majority of the CCWG highlighted what it considered to be a weakness with the Proposed Amendment. The CCWG considered that the Proposed Amendment would increase costs to the industry that would ultimately be borne by the end consumer. It was noted by the CCWG that the amount of Security Cover for TNUoS and BSUoS charges currently in the form of ACRs/PCGs was approximately £90 million. It was also noted that a LoC for an "investment grade" company (a company currently holding an ACR) would typically be available at a cost of between 0.2% and 0.5% of the Security Amount. The CCWG estimated that the Proposed Amendment would be likely to result in increased costs to industry in the range of £180,000 to £450,000 per annum, assuming LoCs were the preferred form of Security Cover. The CCWG considered that the provision of cash deposits as Security Cover would be more costly than LoCs since consideration would need to be given to the opportunity cost associated with depositing cash into the Escrow Account.

The CCWG considered whether an Alternative Amendment to the Proposed Amendment would better facilitate achievement of the Applicable CUSC Objectives. The CCWG concentrated on alternatives that would remove altogether the requirement to provide Security Cover for TNUoS and BSUoS charges. For instance the CCWG considered the recovery of bad debt directly via the Price Control framework or via an insurance based arrangement (either with the premium paid by NGC and recovered via the Price Control mechanism or arranged directly by the User). The CCWG concluded that, whilst such alternatives may provide greater value for electricity consumers, they could not be implemented through a modification to the CUSC since they would require modifications to be made to the Transmission Licence, Price Control mechanism and/or the Charging Methodology Statements.

## **Respondents' views**

NGC issued a consultation paper on 11 July 2002 inviting views from CUSC Parties and interested parties by 14 August 2002.

NGC received ten responses to the consultation in respect of Proposed Amendment CAP018, of which one respondent supported the Proposed Amendment and nine respondents did not support the Proposed Amendment. Of the ten respondents, five favoured retaining the current arrangements for using ACRs to determine which Users are required to provide Security Cover for TNUoS and BSUoS charges, seven respondents considered that the Proposed Amendment would not better facilitate achievement of the Applicable CUSC Objectives and three respondents considered that recovery of bad debt directly via the Price Control framework would be a more appropriate mechanism for managing bad debt.

One respondent considered that the use of ACRs was still appropriate in circumstances where the rating of the User was “significant”. One respondent in favour of the continued use of ACRs commented that since the failure of Enron credit ratings agencies are more attuned to the need to respond quickly to a company’s financial position. In addition two respondents considered that the fact that a User holds an ACR or is able to provide a PCG represents a legitimate competitive advantage and that removal of this advantage would unfairly discriminate against such Users. In contrast, one respondent concluded that the use of ACRs to determine which Users provide Security Cover is anti-competitive since it imposes greater costs on Users that do not hold an ACR than Users that do.

Four respondents considered that the Proposed Amendment would not better facilitate achievement of the Applicable CUSC Objectives since it would increase costs to the industry that would ultimately be borne by the end consumer. One respondent noted that widespread use of LoCs could concentrate industry risk upon particular areas of the banking industry, which could lead to doubts about the quality of Security Cover provided. Another respondent considered that such a concentration could increase the cost of LoCs to 2% of the Security Amount as compared with the 0.2% to 0.5% assumed by NGC. This respondent also noted that provision of LoCs could increase the cost to Users of borrowing in the future. In the view of one respondent the economic cost (including the opportunity cost) to the industry of providing cash deposits as Security Cover could be as high as £9 million.

One respondent expressed concern that the Proposed Amendment could result in a disproportionate amount of Security Cover being provided across the industry and therefore that, were the Proposed Amendment were to be implemented, a review of the mechanism for determining the amount of Security Cover should be undertaken.

Copies of all written responses to the consultation are contained in the Amendment Report in respect of Proposed Amendment CAP018. A summary of respondents’ views prepared by NGC is also contained in the Amendment Report.

#### **Amendments Panel Members’ views**

No formal responses were submitted by Amendments Panel Members to the consultation on Proposed Amendment CAP0018.

#### **NGC’s recommendation**

NGC recommended to the Authority that Proposed Amendment CAP018 be approved with an implementation date of 1 April 2003.

It was the view of NGC that restricting the types of Security Cover available for TNUoS and BSUoS charges to LoCs and cash deposited in the Escrow Account would increase the likelihood of NGC being able to recover its liabilities since these types of Security Cover represent the “best form of credit protection available”. NGC therefore considered that Proposed Amendment CAP018 would better facilitate achievement of the Applicable CUSC Objective C7F.1(a).

NGC considered that removal of the use of ACRs would also better facilitate achievement of the Applicable CUSC Objective C7F.1(b) since requiring all Users to provide Security Cover would remove the distinction between Users that hold an ACR and those that do not, thereby placing all Users on a “common footing”.

In addition, NGC considered that removal of PCGs as a means of providing Security Cover would better facilitate achievement of the Applicable CUSC Objective C7F.1(b) since PCGs introduce a cross-subsidy from a parent company to its subsidiary (the User).

NGC’s recommendation and views are contained in the Amendment Report in respect of Proposed Amendment CAP018.

### **Ofgem’s view**

Having carefully considered the Amendment Report, NGC’s recommendation and the representations of the Proposer, Ofgem considers, having had regard to the Applicable CUSC Objectives and its statutory duties, that Proposed Amendment CAP018, as set out in the Amendment Report, would not better facilitate achievement of the Applicable CUSC Objectives.

It is Ofgem’s view that the arrangements for the provision of credit cover in the electricity industry should follow best commercial practice in comparable competitive industries, taking into account the particular nature of the electricity industry. Ofgem considers that such arrangements should strike a balance between the cost of financial failure within the industry and the cost of mitigating the risk of financial failure.

It is Ofgem’s view that in competitive industries the nature of the competitive process should result in economically efficient arrangements for the provision of credit cover. Ofgem notes that in competitive industries the requirement for credit cover and the types of credit cover permitted vary by industry and from counter-party to counter-party. Counter-parties do not exclusively insist on a LoC or cash up-front as a condition of contract, but rather an appropriate assessment of credit risk is taken and terms and conditions set accordingly. Ofgem does not consider the variation of credit terms by network operators between its counter-parties to be unduly discriminatory provided that any variation can be objectively justified.

Ofgem acknowledges that Proposed Amendment CAP018, in restricting the types of Security Cover permitted for TNUoS and BSUoS charges to LoCs and cash deposited in the Escrow Account, would guarantee payment to NGC in the event that a User defaulted (up to the amount provided as Security Cover). However, Ofgem considers that the financial benefit to NGC associated with this certainty would be outweighed by the significant economic cost to the industry, which may ultimately be borne by the end consumer. It is therefore Ofgem’s view that Proposed Amendment CAP018 would not better facilitate achievement of the Applicable CUSC Objective C7F.1(b).

Ofgem acknowledges that there are instances where it is appropriate to restrict the types of Security Cover permitted to LoCs and cash deposits, for instance where there is a combination of exposure to risk being managed on behalf of others, a potentially volatile debt and where the scale of potential debt is directly linked to the creditworthiness of the counter-party. Under the

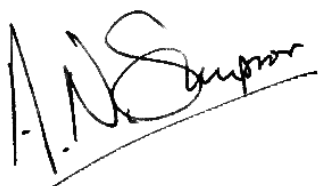
Balancing and Settlement Code (BSC), Trading Parties are restricted to LoCs and cash deposits for credit cover in respect of electricity balancing debt. Ofgem considers that the economic cost of such arrangements is justifiable in this instance since the rate at which electricity balancing debt can build up is significantly faster than the rate at which use of system debt can build up.

### **The Authority's Decision**

The Authority has therefore decided not to direct that Proposed Amendment CAP018, as set out in the Amendment Report, should be made and implemented.

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 'A. N. Simpson', written over a horizontal line.

**Nick Simpson**

**Director of Industry Code Development**

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