



Direct Dial: 020-7901-7355

28 January 2003

The National Grid Company, CUSC Signatories and
Other Interested Parties

Your Ref: CAP024
Our Ref: IND/COD/CUSC/CAP024

Dear Colleague,

Amendment to the Connection and Use of System Code ("CUSC") - Decision and Notice in relation to Proposed Amendment CAP024: "Modification of Defined Term 'NGC Credit Rating'".

The Gas and Electricity Markets Authority (the "Authority"¹) has carefully considered the issues raised in the Amendment Report² in respect of Proposed Amendment CAP024 "Modification of Defined Term 'NGC Credit Rating'".

The National Grid Company plc ("NGC") recommended to the Authority that Proposed Amendment CAP024 be rejected.

The Authority has decided to direct a modification to the CUSC.

This letter explains the background to Proposed Amendment CAP024, as set out in the Amendment Report, and sets out the Authority's reasons for its decision. In addition, this letter contains a direction to NGC to modify the CUSC in respect of Proposed Amendment CAP024.

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

² CAP024 Amendment Report dated 18 October 2002.

This letter constitutes the notice by the Authority under Section 49A of the Electricity Act 1989 in relation to the direction.

Background

Currently under the CUSC the arrangements for the provision of Security Cover in respect of Termination Amounts (in relation to NGC Connection Assets Commissioned after the Transfer Date) and Final Sums (in relation to a Construction Agreement between NGC and a User) provide for the use of an NGC Credit Rating to determine which Users have to provide Security Cover. The NGC Credit Rating is defined in section 11 of the CUSC as a credit rating for long-term debt (or equivalent) of A- or A3 as set by Standard & Poor's and Moody's respectively.

The Proposer considered that the NGC Credit Rating is not consistent with the credit rating that Licensed Distributors are required to maintain under the Distribution Licence. Licensed Distributors are required by Standard Condition 46 of the Electricity Distribution Licence to use all reasonable endeavours to ensure that they maintain an investment grade issuer credit rating (i.e. an issuer rating of not less than BBB- as set by Standard & Poor's or a corporate rating of not less than Baa3 as set by Moody's) or an equivalent rating from any other reputable credit rating agency which the Authority considers to have comparable standing. The Proposer considered that since both the NGC Credit Rating and the credit rating specified in the Distribution Licence are intended to minimise the same risk it is neither appropriate nor efficient for the two credit ratings to be different.

Proposed Amendment CAP024 was raised by Aquila Networks plc on 2 August 2002 and was submitted for consideration at the CUSC Amendments Panel Meeting on 16 August 2002. At the meeting the Amendments Panel determined that the Proposed Amendment should proceed to wider consultation by NGC. A consultation paper was issued on 4 September 2002 with responses invited by 4 October 2002. The final Amendment Report was submitted to the Authority on 18 October 2002.

The Proposed Amendment

Proposed Amendment CAP024 seeks to amend the definition of NGC Credit Rating in section 11 of the CUSC. The effect of this amendment would be that, in instances where a Licensed User is required by its Licence to maintain a credit rating, the NGC Credit Rating would be the credit rating defined in that Licence. Were the Proposed Amendment to be approved and implemented, a Licensed Distributor maintaining an investment grade issuer credit rating of not less than BBB- or Baa3, as specified in its Distribution Licence, would automatically qualify for an NGC Credit Rating.

The Proposer stated that, where a User is a Licensed monopoly and the grantor of that Licence is obliged by statute to ensure that the User is able to finance the activities which are the subject of obligations imposed by or under that statute, it is reasonable to assume that a User compliant with any Licence obligations imposed by the grantor of the Licence for this purpose should not

be subject to any further obligations in respect of credit. The Proposer considered that requiring such a User to maintain a higher credit rating than that required by its Licence imposes unnecessary costs on the industry and leads to inefficiencies in the promotion of effective competition in supply as well as reducing the effectiveness of competition in the sale, distribution and purchase of electricity. It was therefore the view of the Proposer that the Proposed Amendment would better facilitate achievement of the Applicable CUSC Objectives³.

Respondents' views

NGC issued a consultation paper on 4 September 2002 inviting views from CUSC Parties and interested parties by 4 October 2002.

NGC received seven responses to the consultation on Proposed Amendment CAP024, of which four respondents expressed support for the Proposed Amendment and three did not express support for the Proposed Amendment.

One respondent that did not support the Proposed Amendment considered that the current definition of the NGC Credit Rating should be maintained since it provides a reasonable balance between the need to protect the industry from non-payment and the overall cost to the industry of providing appropriate Security Cover. The respondent also commented that if there is an inconsistency between the current definition of the NGC Credit Rating and the credit rating that Licensed Distributors are required to maintain under the Distribution Licence then the Distribution Licence should be amended accordingly.

Three respondents that supported the Proposed Amendment considered that NGC should conduct a review of credit arrangements in respect of Connection Assets but that this should not delay the approval and implementation of the Proposed Amendment.

Two respondents that supported the Proposed Amendment stated that Licensed Distributors are required by the Licence to use all reasonable endeavours to ensure that an investment grade issuer credit rating is maintained at all times and considered that this was the acceptable standard of credit worthiness imposed by the Authority. These respondents considered, therefore, that requiring a higher and more costly standard than that "deemed appropriate by the Authority" could not be justified.

One respondent considered that the likelihood of a termination occurring at an NGC / Licensed Distributor Connection Site in the event of the financial failure of a Licensed Distributor was

³ 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.

“almost non-existent”. Two respondents considered that even in the event of the financial failure of a Licensed Distributor the Authority would not expect any customer to be disconnected and therefore the respondents could not envisage a “situation where the lights were permitted to go out”. It was the view of these respondents that the most likely outcome of such an event would be that the Licensed Distributor would carry on business under new management and that there would be no Termination Amounts due.

One respondent that did not support the Proposed Amendment considered that it was discriminatory since a credit rating pertaining to an activity, irrespective of whether that activity was licensed, could have no bearing on the relevant credit rating required for CUSC activities. This respondent considered that, were the Proposed Amendment to be approved and implemented, in order to avoid discrimination the CUSC would require a further amendment to reduce the credit rating requirement for all CUSC Parties.

Two respondents that supported the Proposed Amendment considered that that the current arrangements for the provision of Security Cover in respect of Termination Amounts and Final Sums impose a higher credit rating requirement on Licensed Distributors than that required by the Distribution Licence. It was the view of these respondents that these arrangements are discriminatory and that the Proposed Amendment would remedy this.

The respondents’ views are summarised and contained in the Amendment Report in respect of Proposed Amendment CAP024.

Amendments Panel Members’ views

One Amendments Panel Member expressed a view during the consultation in respect of Proposed Amendment CAP024. The Panel Member supported the Proposed Amendment since they considered that the assignment of a credit rating is a judgement of risk and therefore that requiring a credit rating in excess of that already required by a User’s Licence creates an anomaly and imposes unnecessary cost upon the User. The Panel Member considered that amending the CUSC so that, in instances where a Licensed User is required by its Licence to maintain a credit rating, the User would automatically qualify for an NGC Credit Rating, as put forward by the Proposed Amendment, would better facilitate achievement of the Applicable CUSC Objective C7F.1(a).

NGC’s recommendation

NGC recommended that the Authority should not approve Proposed Amendment CAP024.

NGC agreed that there is a limited risk of the financial failure of the twelve Licensed Distributors that were formed as a consequence of the separation of the Public Electricity Supply (PES) companies in England & Wales, but considered this risk to be finite. NGC’s opinion was that it faced real exposures from a failing DNO. For example, until a replacement DNO was identified, unpaid Connection Charges could arise and a replacement DNO might not accept the liabilities

of its predecessor. It was the view of NGC that although a credit rating of BBB- or Baa3 is consistent with the requirement placed on a Licensed Distributor in the Distribution Licence, this rating represents the lowest investment grade credit rating available and may be too low for such a User to put in place either a Letter of Credit or cash as Security Cover should its credit rating fall below that required by the Distribution Licence. NGC considered that, should the Proposed Amendment be approved and implemented, a Licensed Distributor that was about to have its credit rating downgraded to below BBB- or Baa3 would most likely be unable to provide alternative arrangements for Security Cover.

NGC raised the issue that amending the CUSC so that, in instances where a Licensed User is required by its Licence to maintain a credit rating, the User would automatically qualify for an NGC Credit Rating, as put forward by the Proposed Amendment, may apply to private distribution network operators as well as to the twelve former-PES Licensed Distributors. NGC considered that the risk of the financial failure of private distribution network operators is higher than that of the twelve former-PES Licensed Distributors since the private distribution network operators are generally dependent on a large primary customer. NGC considered that this was an unintended consequence of the Proposed Amendment and that, if this was the case, the legal text submitted in order to give effect to the Proposed Amendment should be more tightly worded.

On the subject of discrimination it was the view of NGC that the current arrangements for the provision of Security Cover in respect of Termination Amounts and Final Sums are not discriminatory. NGC considered that the credit rating requirement specified in the Distribution Licence exists so that the Authority can be sure that the Licence holder is sufficiently financially sound that it will have the necessary financial resources available to properly and efficiently carry on its distribution business. NGC considered that its Security Cover requirements are not related to these Licence requirements since they are established to protect NGC against the risk of financial default of a User.

NGC noted that although the current arrangements for the provision of Security Cover in respect of Termination Amounts and Final Sums impose costs on CUSC Parties, in NGC's view they provide a reasonable balance between the need to protect the industry from non-payment and the overall cost to the industry of providing the appropriate Security Cover.

NGC considered that a Licence obligation to maintain a certain credit rating is not a guarantee that the User's rating will not fall below that required by the Licence in the short term and that a credit rating does not guarantee that a User will be able to meet its payment obligations.

It was the view of NGC that the status quo be maintained until a review of credit in respect of NGC Connection Assets could be undertaken. Although Ofgem's consultation on Arrangements for Gas and Electricity Supply and Gas Shipping Credit Cover did not deal specifically with connection charges, it might provide indications of possible approaches to security. The issue of DNOs of last resort would also need to be examined.

It was therefore the view of NGC that the Proposed Amendment would not better facilitate achievement of the Applicable CUSC Objectives.

Ofgem's view

Ofgem has considered the credit arrangements between NGC and the Distribution Network Operators (DNO) as specified in the CUSC. Ofgem notes that all the DNOs have financial ring fencing arrangements in place. Ofgem considers that it would better facilitate achievement of the Applicable CUSC Objective C7 F.1(b) if the current arrangements involved a less mechanical assessment of the credit worthiness of DNOs under the CUSC. Ofgem considers that the credit worthiness of the DNOs under the CUSC should reflect the on-going regulatory financial ring fencing that the DNOs have to operate within.

One such ring-fencing provision is set out in Standard Condition 46 of the Electricity Distribution Licence, which places an obligation on the licence holder to use all reasonable endeavours to ensure that it maintains at all times an investment grade issuer credit rating (i.e. an issuer rating of not less than BBB- as set by Standard & Poor's or a corporate rating of not less than or Baa3 as set by Moody's) or an equivalent rating from any other reputable credit rating agency which the Authority considers to have comparable standing. It is Ofgem's view that such ring fencing requirements were introduced to ensure that distribution licence holders are able to finance the activities which are the subject of obligations imposed by the Electricity Act 1989 as amended, including the duty to develop and maintain an efficient, co-ordinated and economical system of electricity distribution (as set out in section 9.1(a) of the Electricity Act 1989 as amended).

It is Ofgem's view that the arrangements for the provision of Security Cover in respect of BSUoS, TNUoS and TNUoS Demand Reconciliation Charges (section 3.21 of the CUSC) already require NGC to differentiate between Parties on the basis of the credit worthiness of each Party. Ofgem considers that since the criteria for differentiating between Parties in this regard are objective, proportionate and transparent, it is entirely justifiable that NGC should be allowed to make a distinction between Parties that qualify for an Approved Credit Rating and those that do not. Ofgem considers that Proposed Amendment CAP024 acknowledges the financially ring fenced status of the DNOs and proposes an appropriate mechanism for the assessment of credit worthiness that would differentiate between CUSC Parties in a way that is efficient and cost effective without being unduly discriminatory. Ofgem therefore considers, having had regard to its statutory duties, that Proposed Amendment CAP024, as set out in the Amendment Report, would better facilitate achievement of the Applicable CUSC Objective C7F.1 (b) for 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.

In proposing that where a Licensed User is required by its Licence to maintain a credit rating then such a User would automatically qualify for an NGC Credit Rating, Ofgem acknowledges that Proposed Amendment CAP024 would apply to any User whose Licence required a credit rating to be maintained and not just the twelve former-PES Licensed Distributors. Ofgem also

notes that should the Licensing arrangements for private distribution network operators place a requirement on such Users to maintain a credit rating then these Users would automatically qualify for an NGC Credit Rating. Ofgem would like to note that, in reaching its decision as to the appropriate Licensing arrangements for private distribution network operators, it will have regard to the effects of Proposed Amendment CAP024 on the provision of Security Cover by private distribution network operators should such Users be required by their Licence to maintain a credit rating.

The Authority's Decision

The Authority has therefore decided to direct that Proposed Amendment CAP024, as set out in the Amendment Report, should be made and implemented.

Direction under Condition C7F.7(a) of NGC's Transmission Licence

Having regard to the above, the Authority, in accordance with Condition C7F.7(a) of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the CUSC in respect of Proposed Amendment CAP024 as set out in the Amendment Report.

The modification is to be implemented and take effect from 30 days after the Authority's decision.

In accordance with Condition C7F.7(b) of NGC's Transmission Licence, NGC 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 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