Guide to Credit Allowances

Introduction

Every supplier has an allowance of unsecured credit which is dependent on a number of areas. This document will explain what factors are used in calculating the credit allowances and what impact these allowances have on the counterparty.

This document is for information only and does not form part of the CUSC documentation. If there are any inconsistencies between this guide and the CUSC documentation, the terms of the CUSC documentation shall prevail.

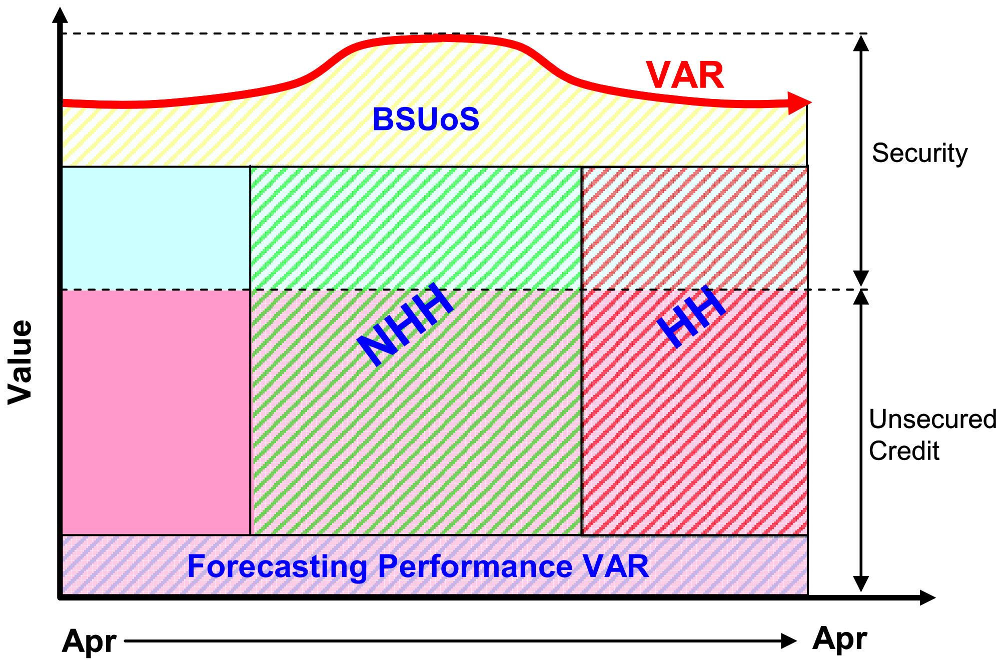
What are credit limits and what are they used for?

Each supplier will have a value at risk (VAR) associated with it, which varies depending on the size of the supplier's liabilities (see Guide to VAR for more info on this). To minimise the risk to consumers each supplier has to ensure that their VAR is covered by a combination of unsecured credit and (if necessary) additional security.

Unsecured credit is offered to each supplier up to a defined limit. The limit is that supplier's credit allowance. This allowance could potentially be zero as this document will explain.

Figure 1 illustrates a typical annual make up and how credit allowance and security provide the cover.

Figure 1



The diagram is not to any particular scale and the values are illustrative only. It should be noted that whilst a supplier's credit allowance can be zero, it can also be sufficient enough not to warrant any additional security.

How are credit limits calculated?

The maximum credit limit for any supplier is 2% of National Grid's revenue asset value (RAV). Each supplier's credit allowance will therefore be between 0% and 2% of the RAV. The relevant percentage is dependent on the suppliers credit rating.

The RAV for 2013/14 is £10,108m which results in a maximum credit limit of £202.2m.

There are two types of credit rating used:

- Approved Credit Ratings (also known as Investment grade ratings) which are provided by either Standard & Poors (S&P) or Moodys KMV rating agencies.

- Independent Ratings which are provided by agencies such as Dunn & Bradstreet (D&B), Graydons and Experian. These are used when the supplier doesn't have a rating with S&P or Moodys.

Companies with an Approved Credit Rating

The supplier is given a rating by the agency and their credit limit is then calculated as a percentage of the maximum credit limit for a single counterparty.

Table 1 below details the percentage of the maximum credit limit that each credit rating is awarded and the relevant monetary value using the 2011/12 RAV.

Table 1

Credit Rating		Use of System	
S&P	Moodys	Credit allowance as percentage of maximum credit limit	2013/14 Monetary Equivalent (£million)
AAA, AA+, AA, AA-	Aaa, Aa1, Aa2, Aa3	100	202
A+, A, A-	A1, A2, A3	40	81
BBB+	Baa1	20	40
BBB	Baa2	19	38
BBB-	Baa3	18	36
BB+	Ba1	17	34
BB	Ba2	16	32
BB-	Ba3	15	30

If the credit ratings differ between the two agencies then normally the lowest rating will apply in determining the credit limit.

Example 1

Company A wishes to get a credit limit with National Grid. Company A is awarded a credit rating of BBB+ from Standard & Poor's and A3 from Moody's KMV. National Grids RAV is £10,108m.

The calculation applied to establish Company A's credit limit is as follows:

% Credit Allowance x 2% of RAV

0.20 x (0.02 x 7,640,100,000)

= £40,432,000

The % credit allowance is 20% as the lower credit rating of BBB+ is applied.

Company A is therefore awarded an unsecured credit amount of £40.4m (the above table can also be used to as a quick guide).

Unrated Companies

Where a supplier is not listed with S&P or Moodys there is still a possibility that they can have unsecured credit. An assessment would be carried out by National Grid and would use reports from an Independent Ratings Agency such as D&B, Graydons or Experian. Any calculation would take into account the credit score and the recommended maximum level of credit provided by the agencies.

Payment History

If a supplier does not have an Approved Credit Rating or an Independent Rating then unsecured credit is not automatically offered.

There is however, one other mechanism by which a supplier can get unsecured credit. CUSC allows unsecured credit to be offered up to a limit that is calculated using the supplier's payment history record.

Initially an unrated supplier would have to provide 100% security.

To get credit through the payment history method the supplier is required to have a perfect payment record. To get this the supplier has to pay all invoices by the due date (this includes TNUoS, BSUoS and Hydro Benefit invoices). For every month that all invoices are paid on time the suppliers unsecured credit limit will automatically increase.

The rate of increase is 0.4% of the maximum credit limit (2% of National Grid's RAV) per year up to a maximum of 2% of the maximum credit limit after five years of perfect payment history. As the increase is applied monthly the effective increase rate is 0.033% of the maximum credit limit per month. In monetary terms this equates to a £66,726 increase to the suppliers credit limit every month up to a total maximum limit of £4,003,560 after five years.

However, if a supplier makes a late payment then their current level of credit would immediately be reduced by 50%. If that supplier is late with a second payment within twelve months of the first late payment then the credit allowance is reduced to zero.

The suppliers credit level would start increasing again from the month after the missed payment (providing all invoices were paid on time). If the reduction in credit limit results in a shortfall in security then alternative security will have to be posted until the payment history credit limit has increased back to the required level (see Guide to Security for further details).

It is worth noting that National Grid's RAV is recalculated each year. Whilst the percentage increases will remain constant the monetary equivalent will change each year and the maximum credit limit will also change each year.

Example 2

Company B is unrated but has been paying all invoices on time for exactly two years.

Their credit limit would be calculated as follows:

> No of years perfect payment history x (0.4% x (maximum credit limit))
>
> Which equates to:
>
> 2 x (0.004 x 202,200,000)
>
> This equals £1,617,600.

Providing the payment record remained perfect this would increase by £66,726 each month for the next three years giving a credit allowance of £4,003,560 after five years. This can then not increase any further but can decrease should a payment be missed.

Example 3

Company B from the above example is used as a starting point for this example.

Company B now has five years perfect payment history and therefore a credit allowance of £4,003,560. If they miss a payment the credit allowance gets reduced immediately to £2,001,780. Providing they don't miss any more payments in the next twelve months then their credit limit will have increased to £2,802,492 thirteen months after the missed payment date (as they don't start accruing again until the month after the missed payment). After another twelve months the credit limit would be £3,603,204 and then after six additional months it would reach £4,003,560. Again it can not go above this value.

Whilst a supplier is building up a payment history it will be very likely that some other form of security will need to be in place. As the payment history allowance gains value the security required will be reviewed and adjusted if necessary.

Credit Limit Reviews

As credit limits are reviewed constantly should a supplier's credit rating decrease then the credit limit will be adjusted accordingly. If the credit limit has reduced below what is accepted then alternative security will have to be provided immediately.

If a credit rating increases then it is the responsibility of the counterparty to provide details to National Grid who will then review the credit allowance.

See Also

Guide to VAR

Guide to Security Cover