Consultation for Modification Proposal P152: "Reduction of Credit Cover for a Trading Party in Default which has ceased trading and which has paid all accrued Trading Charges"

A consultation document developed on behalf of the P152 Modification Group.

For Attention of: **BSC Parties and all other interested parties.**

Date of Issue: **9 January 2004**

Responses Due: **17:00 on 23 January 2004 (To: Modifications@elexon.co.uk)**

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1. INTRODUCTION

P152 – 'Reduction of Credit Cover for a Trading Party in Default which has ceased trading and which has paid all accrued Trading Charges' (P152) was raised by PricewaterhouseCoopers as receivers of Shotton Combined Heat and Power (CHP) Limited on 1 December 2003. The Initial Written Assessment was presented to the Panel at its meeting on the 11 December 2003 and the Panel recommended that P152 be progressed via a 2 month Assessment Procedure.

At the first Modification Group meeting, the Proposer's representative provided a brief outline of the justification for raising P152.

The Proposer of the Modification Proposal outlined the background leading to the Modification Proposal. Shotton CHP went into receivership in December 2002. It applied to the Panel and began trading again shortly afterwards. Subsequently it ceased trading, (did not intend to accrue any further indebtedness) and sold some of their assets on 6th October 2003. Since Shotton had fulfilled its commitments and met its liabilities to date, it was felt by the Proposer, that it was an appropriate time for it to receive its Credit Cover back.

P152 seeks to enable a Party that is in Default for reasons of insolvency[1] and fulfils several criteria to reduce or reclaim its Credit Cover, as would a Party that has ceased trading under regular circumstances. Currently a Trading Party that is in Default, is prevented from reducing its Credit Cover under section M 2.3, under circumstances where, were it not in Default, it would be allowed to do so. This remains the case if the Defaulting Party has stopped trading, paid all invoices and met other contractual obligations in respect of the Code. A Party in default under H3.1.1(g) will be able, post P127 implementation and subject to meeting the conditions specified, to receive its Credit Cover back in full after the final Reconciliation Run (RF).

The Proposer believes that since Credit Cover is intended to cover Energy Indebtedness, if a Party's Energy Indebtedness is zero or less, the Party should be entitled to consequently reduce its Credit Cover if the Party has no other liabilities under the Code and the other conditions outlined in the Modification Proposal are fulfilled.

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[1] This refers to being in default under Section H3.1.1 (g) only.

The Proposer believes that P152 better facilitates Applicable BSC Objectives (c), promoting effective competition in the generation and supply of electricity and (so far as is consistent therewith) promoting such competition in the sale and purchase of electricity, and (d), efficiency in the implementation and administration of the balancing and settlement arrangements.

The Proposer asserts that Applicable BSC Objective (c) is better facilitated for a number of reasons:

- having to leave funds trapped as security after cessation of trading and reduction of Energy Indebtedness is a barrier to entry. More particularly, insolvency practitioners will be disinclined to run generating plants and trade in receivership for this reason and commercial counterparties or creditors may be relying on the funds that are tied up in default;
- Trading Parties in insolvency Default will minimise the Credit Cover they post if they know they cannot reclaim it upon cessation of trading, thus will be more likely to go into Credit Default; and
- P152 ensures consistent treatment of Credit Cover calculations between Parties defaulting in H3.1.1(g) and non defaulting Parties.

The Proposer also asserts that applicable BSC Objective (d) is better facilitated for a number of reasons, including that it would reduce the risk that Parties will seek return of Credit Cover outside of the BSC e.g. through litigation and this will therefore save BSCCo time and cost in defending the action.

P152 is currently within the Assessment Procedure phase of the Modification process, and an Assessment Report is scheduled to be presented at the February meeting of the Panel. This consultation document describes the discussions of the P152 Modification Group ("the Group") to date, and seeks the views of market participants on the following:

- whether or not P152 would better facilitate achievement of the Applicable BSC Objectives;
- what mechanism should be used to enable Parties to reduce/reclaim their Credit Cover (four alternatives are presented);
- whether there are any substantive issues that need to be brought to the attention of the Group.

2. MODIFICATION GROUP DISCUSSION

As part of the Assessment Procedure, the Group has met on two occasions to date - 18 December 2003 and 5 January 2004. At these meetings, the Group has identified four options for the mechanism that should be used to enable Parties to reduce/reclaim its Credit Cover. Three of these were outlined in the Modification Proposal itself, namely, reclaiming all Credit Cover after 29 days as a withdrawing Party is able to do, reclaiming a different amount at each Reconciliation run up until the final Run whether it be RF or DF - the so-called sliding scale multi-step - and referral to the Panel to make the decision as to whether to allow the Party to reduce their Credit Cover. The Group also came up with a variation on the sliding scale multi step which was to receive a certain amount back at Initial Settlement with the remainder being reclaimed after RF or DF as applicable. The perceived advantages and disadvantages of each of these options are summarised in this document. Discussion of

these options identified three key characteristics which the Group believed the solution ought to embody – simplicity, low cost and as low risk as possible to industry. The other sections summarise the Group's position on other key issues.

2.1 Process common to all mechanisms

A Party that is in Default under H3.1.1(g) and wanted to reclaim its Credit Cover would apply to BSCCo.

BSCCo would check to see if they had fulfilled the following criteria:

- ceased all forms of trading pursuant to the BSC;
- paid all Trading Charges due on the Settlement Payment Date for the last Settlement Day on which it traded as well as all previously accrued Trading Charges;
- transferred or de-registered any relevant BM Units; and
- had an Energy Indebtedness of zero or less than zero continuously over the previous 30 days

If a Party fulfilled these criteria BSCCo would authorise it to use the selected mechanism to reduce/reclaim its Credit Cover. There are four options for the mechanism used. These will be described below and consulted upon.

1) **zero –** Party could apply to have its MEA (Minimum Eligible Amount) calculated by ECVAA - this would be zero and it could then request back 100% of its Credit Cover.

2a) **Sliding Scale – multi step –** Party could apply to receive certain set percentages of its Credit Cover back at different points in the reconciliation timetable.

2b) **Sliding Scale – two step -** Party could apply to receive a certain set percentage of its Credit Cover back after the thirty days and the remainder back after the Dispute Final Run.

3) **Panel decision –** Party could apply to the Panel to decide whether it is able to reduce or reclaim its Credit Cover. The decision would be at the Panel's discretion.

2.2 Zero

This option would mean that a Party that was in H3.1.1(g) Default and had fulfilled the criteria listed in the Modification Proposal could apply to have its MEA (Minimum Eligible Amount) calculated by ECVAA - this would be zero and it could then request and get back 100% of its Credit Cover.

Pros	Cons
• Simple • Low Cost – fits with current system • Consistent treatment of party defaulting under criteria proposed and non defaulting Parties – not discriminatory	• Higher risk – Parties would not leave any security to cover potential future reconciliation charges (this is the same for non-defaulting Parties withdrawing from the Code)

2.3 Sliding Scale – multi step

This option would mean that a Party that was in H3.1.1(g) Default and had fulfilled the criteria listed in the Modification Proposal would be able to request a certain amount of its Credit Cover back after each Reconciliation Run.

Pros	Cons
• Lower risk – option to freeze and retain credit cover of parties if circumstances change • Model more representative of risk profile of defaulting Party (to industry)	• Arbitrary and difficult to quantify • Increased risk relative to baseline • Increased complexity/cost • Inconsistent treatment • Setting an exact percentage retained for each Reconciliation Run implies too high a level of accuracy in the calculation required • Different from other credit arrangements

2.4 Sliding Scale – two step

This option would mean that a Party that was in H3.1.1(g) Default and had fulfilled the criteria listed in the Modification Proposal would get a percentage of its Credit Cover back after 30 days and then the remaining sum at DF (Dispute Final Run).

Pros	Cons
• Lower risk – option to freeze and retain credit cover of parties if circumstances change • Model more representative of risk profile of defaulting Party (to industry) • Simple • Fewer percentages set so doesn't imply too high a degree of accuracy (unlike multi-step)	• Arbitrary and difficult to quantify • Increased risk relative to baseline • Inconsistent treatment • different from other credit arrangements

2.5 Panel decision

This option would mean that a Party that was in H3.1.1(g) Default and had fulfilled the criteria listed in the Modification Proposal would be able to ask the Panel whether it is able to reduce or reclaim its Credit Cover. The decision would be at the Panel's discretion.

Pros	Cons
• Examine on case by case basis • Fits with other Panel obligations e.g. decision on treatment of Defaulting Parties • Low cost	• subjective • different from other credit arrangements • introduces uncertainty and potentially inconsistent treatment

2.6 Applicable BSC Objectives

The Group considered which of the Applicable BSC Objectives P152 affected and how. The Group considered Applicable BSC Objective (c). One member of the Group considered that there was no case to be made for enhancing Applicable BSC Objective (c) in the case of new entrants to the market. However, for existing market participants who have gone into insolvency, the insolvency practitioners (in the case of a generator for example) have a decision to make as to whether they consider that it is worthwhile for the company to continue or recommence trading or whether to mothball the plant. They would consider several factors which would include saleability of the plant, as well as the exit route. Having what could be a considerable amount in terms of Credit Cover trapped for 14 months would affect this decision since stakeholders might not be prepared to wait this extended time to be repaid and it would extend the time that the receivers themselves (and hence the cost associated with them) would be involved with the company – in this case the plant might be withdrawn from the market hence affecting competition. One member of the Group pointed out that this would only be completely solved by using the mechanism suggested by option 1, since with the other options, at least some Credit Cover is retained up to either RF or DF, however, it might make a difference to the stakeholders to receive part of their stake back earlier.

The Group also considered Applicable BSC Objective (d). The Group believed that since the approval of P127 there is less force for arguments in favour of (d), since originally the Group had thought that Parties seeking monies by means outside the Code would cost BSCCo time and money in defending the action. One member of the Group commented that the tight timescale meant that the Requirement Specification had to be sent out alongside the Consultation document. This meant that it was not possible to send the costs of the options to industry participants and hence it was difficult to come to an informed decision on Applicable BSC Objective (d).

2.7 End point – RF or DF?

The Group considered whether it was suitable for Parties to get the remainder of their money back for options 2a and 2b at RF or DF. One member of the Group pointed out that P127 Alternative Modification that was recommended by the Panel, if implemented, would enable Parties to get their money back fully at RF (see Section 2.7 below). It was also commented that the P127 Modification Group had considered the matter of an appropriate end point and had decided that RF should be used and the risk of contingent liabilities was acceptable. Several Group members stated that they were uncomfortable with this and given the number of Post Final Settlement Runs that are occurring, it was necessary to keep cover for monies that might be owing at Dispute Final Runs. If DF were considered an appropriate end point then some deliberation would have to occur as to how to change the new baseline under P127. A potential problem of having DF as an end point was noted. P127 allows all Credit Cover back to insolvent Parties after RF, if P152 were to have an end point of DF, this would mean that all Parties who fulfilled the criteria of P152 would only be able to receive their Credit Cover back at DF whilst other Parties who were in insolvency default would receive their Credit Cover back at RF.

It was pointed out that having an end point at DF would mean that Parties would not receive their Credit Cover back until after 28 months (the timeframe for DF Runs see Section U of the Code), even if no DF Run took place, since they would have to wait for 28 months to be sure no DF was going to occur.

The Group agreed to ask consultation respondents whether they considered an end point of RF or DF was preferable

2.8 Catering for Trading Disputes and Extra Settlement Determinations (ESD)

The Group discussed whether the amount that would be retained as Credit Cover would cater for monies that may be owed subsequent to ESDs etc or whether this was not possible. The Group decided that due to the fact that ESDs were unpredictable they could not be included, however, they considered that perhaps only returning the full amount of Credit Cover at DF would be better than doing so earlier at RF.

Potential Trading Disputes leading to ESDs would not be taken into account in the retention of Credit Cover

2.9 P127

The Proposer considered that although P127 did improve the situation, in that an insolvent Party will be able to reclaim its Credit Cover at RF (subject to fulfilling other conditions), it did not provide Parties in H3.1.1(g) with equitable treatment with respect to non-defaulting Parties withdrawing from the Code or who otherwise cease trading. Since the P152 criteria mean a Party must have ceased trading, paid all Trading Charges to date and have had an Energy Indebtedness of zero or less for 30 days then it seemed appropriate to the Proposer for them to be able to reclaim Credit Cover prior to RF. Several members of the Group said that they considered it inappropriate for P127 to allow Parties to claim all their Credit Cover back at RF and were this to go through they would seek to change this either with P152 or via another Modification proposal.

P127 has been approved by the Authority and hence Insolvent Parties can now claim their Credit Cover back at RF

2.10 How 2a and 2b would work

Several members of the Group were sceptical that a set of meaningful percentages or methods to work out the sliding scale could be found and that taking arbitrary numbers was invalid. It was pointed out that if it was felt that giving all Credit Cover back at SF was too risky but waiting until RF was too harsh and/or inequitable then even if the numbers were not fully robust it was valid as an option.
The Group considered how to set the percentages or levels for these two options.

2a – Several of the Group envisaged that the sliding scale would reflect the increasing accuracy of Settlement. It was thought that one could set the Credit Cover to reflect the likely charges a Party will receive at reconciliation runs. However the Dispute Final Run could cause reconciliation charges to be of greater magnitude than they were in the RF run which would make the calculations more difficult as it is unrealistic to ask someone for more Credit Cover. The Group discussed several types of calculations that they could perform to calculate a suitable and not too arbitrary sliding scale.

They were unable to agree on a methodology and decided to leave it open to consultation respondents to discard the option for this reason or suggest a suitable methodology.

2b – The Group considered how to set the percentage. One member of the Group suggested it should be reflective of the risk that the industry would be willing to take on a Party that may not pay its Trading Charges in full. The Group considered that the Pooling and

Settlement Arrangements utilised or had set a percentage in a similar way to this and that it should consider how the percentage was set for that.

P&SA Security Cover Suggestions

It was suggested that in order for both Initial Settlement and subsequent Reconciliation payments to be made, the Security Cover that is to be retained on the resignation of a Pool Member, be split into two parts. The first would be held for 28 days and would cover Initial Settlement liabilities and the second would be held for 14 months to cover any adverse Reconciliation adjustments

For Reconciliation adjustments, a lower amount of Security Cover is required.

The amount of Security Cover retained for the period associated with Reconciliation Runs should be set to 20% of the amount kept for initial settlement.

This amount would be kept for 14 months following the Initial Settlement Run while the resigning Supplier's reconciliation obligations still exist.

"The suggested value of 20% chosen for Reconciliation is taken from the Supplier Continuity Project Initiation Document (Appendix A.2.3.2, paragraph 4), and is deemed an appropriate value to cater for possible Reconciliation adjustments. The 20% was originally only to be applied to the NHH proportion of initial settlement. It is suggested, however, that it now be applied to the full initial settlement value for ease of administration."

A majority of the Group considered that the value of 20% was a number that was specific to the Pool, a fundamentally different set of trading arrangements, and was not a useful number.

P&SA retained 20% of Credit Cover for possible Reconciliation adjustments. Consultation respondents who prefer this sliding scale – two step mechanism are asked to consider whether this is appropriate.

2.11 Panel discretion

The Group considered option 3. One member of the Group suggested that this was a good option as it allowed each Party to be treated according to its individual circumstance. It was thought that this may be a different solution to the Supplier vs. non Supplier issue that is discussed below in Section 2.14. One member of the Group was very uncomfortable with leaving matters such as these to the Panel's discretion. This Group member was of the opinion that the Panel would not be keen on making subjective decisions like this and that a mechanistic approach was preferable. It was pointed out that the Panel use their discretion as to whether defaulting Parties are able to continue or begin to trade – hence are used to make judgements in this arena. This is a different situation as in the latter case the Panel can have the added confidence that there is a mechanistic approach that supports the decision i.e. Credit Cover lodged by the Party according to the formula set out in the Code. In the situation of P152 the decision is less certain, since the Panel would have no backstop to rely upon.

The Group noted the positive and negative aspects of referring such decisions on reduction of Credit Cover to the Panel.

2.12 Nature/risk of Insolvency Default - Equitable treatment of Parties in H3.1.1(g)

The Group considered that the materiality of risk was difficult to define.

One member of the Group commented that it is difficult to seek monies from a Party if they have withdrawn from the Code, and hence there is no legal entity remaining. It was pointed out that there was already a risk of the non-recovery of contingent liabilities (charges at DF) for Parties who withdraw from the Code, cease trading in England and Wales and move their operations abroad, and that this risk has been accepted as part of the current baseline of the Code. This was acknowledged during the Modification Process of P127. The Group discussed whether parties in insolvency Default ought to be treated in the same way as those who were withdrawing from the Code – do defaulting parties pose an extra risk to industry and if so does this mean they should be treated differently? Several members of the Group highlighted that Parties withdraw in a controlled manner and there is a higher probability that there will be someone to pay future reconciliation charges than there is for a company in receivership. For example, a large Supplier going out of business might pose a problem in this regard. The receiver also does not have personal liability for the charges.

One member of the Group noted that in the pros listed regarding option 1 – zero, the fact that this option was non discriminatory was considered a positive aspect. This member pointed out that this was not necessarily positive and that some would consider that Parties in any type of default ought to be treated in a different manner to non defaulting Parties.

Note: One member of the Group was concerned that solvent Parties can withdraw from the Code and receive back all their Credit Cover and considered that this may be a defect within the current baseline.

Overall the Group did not initially consider that a Party in insolvency default should be treated identically to one that is withdrawing from the Code.

2.13 Limiting to Certain subsections of H3.1.1(g)

Section H3.1.1(g) contains several subsections which refer to different ways a Party can be in such Default. The Modification Proposal refers in general to H3.1.1(g) however the defect mentions simply Defaulting Parties. It was deliberated upon whether it might be appropriate to limit P152 to certain subsections within H3.1.1(g) or not. It was considered that this was not appropriate as there was no subsection that posed less/more risk to industry than others and more than one might be applicable to a particular company. Also noted was the fact that having debts does not necessarily mean that amounts due under the Code would not be paid.

The Group decided that limiting to certain subsections of H3.1.1(g) was inappropriate.

2.14 Potential Alternative: Treatment of Suppliers vs. non Supplier

The Group considered that it might be appropriate to limit P152 to non Suppliers for a number of reasons.

Suppliers have greater and more unpredictable variation in Reconciliation payments than generators or Interconnector users. So for the latter two categories of market participants it will be easier to predict Reconciliation charges up to RF and hence use a sliding scale mechanism for reclaiming Credit Cover. One of the reasons the Group had difficulty choosing a mechanism was because members felt that the percentages in the sliding scale mechanism would be arbitrarily defined and hence would not be valid. It also felt that neither option 1 nor the status quo were fully desirable solutions. Excluding Suppliers from the P152 solution would enable a more valid sliding scale to be used and hence was a potentially attractive option for the Group.

The Group considered how it would develop an Alternative Modification entailing limiting P152 to non Suppliers. In this way analysis on the Trading Charges owed at each Reconciliation Run could be worked out (average, best or worst case scenarios) and the subsequent percentages could be set for a sliding scale mechanism such as Option 2a. However, the Group then considered which Parties would be included in P152 and which would be excluded. One member of the Group suggested that it was perhaps discriminatory but noted that there was a precedent set with the treatment of Parties by P80 "Deemed Bid-Offer Acceptance for Transmission System Faults" for example.

The Group then considered how to define those who would be included in the Modification. There are many vertically integrated Parties and these Parties put up a single sum to serve as Credit Cover for a range of activities, hence singling out different types of activities for which Credit Cover can be returned is complicated and perhaps impractical. The Group thus concluded that given this problem and the limited time available to it, it would not develop an Alternative Modification.

The Group decided not to develop an Alternative Modification.

3. CONSULTATION

Respondents are invited to respond to the questions contained in the attached pro-forma. For reference, the Applicable BSC Objectives are as follows:

(a) The efficient discharge by the Transmission Company of the obligations imposed under the Transmission Licence;

(b) The efficient, economic and co-ordinated operation by the Transmission Company of the Transmission System;

(c) Promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity;

(d) Promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

(e) without prejudice to the foregoing objectives and subject to paragraph 3A, the undertaking of work by BSCCo (as defined in the BSC) which is:

(i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and

(ii) relevant to the proposed GB wide balancing and settlement code;

and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

You are invited to respond to the questions in the attached pro-forma.

Please send your responses entitled 'P152 Assessment Consultation' by 17:00 on 23 January 2004 to the following email address: Modifications@elexon.co.uk

Any queries on the content of the consultation pro-forma should be addressed to Dena Harris (020 7380 4364) email address Dena.Harris@elexon.co.uk