
Meeting name	BSC Panel
Date of meeting	12 May 2005
Paper Title	ISSUE 16 'CREDIT DEFAULT AND THE DEFAULT PROVISIONS IN SECTION H OF THE BSC'
Purpose of Paper	For Information
Synopsis	This paper seeks to inform the Panel of the discussions which have taken place with respect to Issue 16. The issue seeks to consider whether the current provisions applying to Parties in Credit Default provide industry participants with an appropriate level of protection. The issue has subsequently been raised as Modification Proposal P188 - 'Revision of Credit Default Provisions'.

1. BACKGROUND

- 1.1 Issue 16 - 'Credit Default and the Default Provisions in Section H of the BSC' was submitted on 20 April 2005 by British Gas Trading (the 'Proposer'). A meeting comprising members of the Settlement Standing Modification Group (the 'Group') was held on 26 April 2005 to discuss the issue.
- 1.2 Issue 16 was raised to consider whether the current Code provisions applying in the case of persistent or recurring Level 1 or 2 Credit Default, provide industry participants with an appropriate level of protection. In particular, whether the existing provisions whereby a Party is in Section H default following a defined period of either Level 1 or 2 Credit Default are sufficient.
- 1.3 The issue identified by Issue 16 was raised as Modification Proposal P188 - 'Revision of Credit Default Provisions' on 3 May 2005 by British Gas Trading.

2. DESCRIPTION OF ISSUE

- 2.1 Under the current trading arrangements, payments to and from Parties in respect of Trading Charges arising on any particular Settlement Day are made, on average, 29 calendar days later. Thus, at any given time, Parties may have debts (or be due payments) in respect of Trading Charges incurred, on average, over the previous 29 days. The purpose of Credit Cover is to ensure that, should a Party default on payments, sufficient collateral is available to pay these debts.
- 2.2 Energy Indebtedness is calculated in accordance with Section M 1.2 of the Balancing and Settlement Code (the 'Code') and effectively estimates a Party's liabilities over the 29 day credit window (as an energy volume). Energy Credit Cover is calculated in accordance with Section M 2.4 and effectively represents the level of Credit Cover a Party has in place as an energy volume.
- 2.3 Under Section M of the Code a Trading Party's Credit Cover Percentage (CCP) is calculated via comparison of that Party's Energy Indebtedness and its Energy Credit Cover. A CCP of greater than 100% indicates a Party's estimated liabilities within the 29 credit window are greater than its level of Credit Cover.

- 2.4 Where the CCP of a Party exceeds 80% (Level 1) or 90% (Level 2) for any Settlement Period the Credit Default provisions specified in Section M3 of the Code apply and as a result a Party may be in Level 1 or Level 2 Credit Default¹.
- 2.5 Where a Party is in Level 1 Credit Default a notice to such effect is posted on either the BMRS or the BSCCo Website. The following provisions apply to a Party in Level 2 Credit Default:
- Notice that the Party is in Level 2 Credit Default will be posted on the BMRS or the BSC Website. Notice of a Level 2 Credit Default is also provided directly to all Parties;
 - A Credit Default Refusal Period will apply, during which any Volume Notification submitted that does not decrease the Energy Indebtedness of the Party will be refused in its entirety; and
 - A Credit Default Rejection Period will apply, during this period any Volume Notification data already validated will be treated as rejected if it does not have the effect of decreasing the Party's Energy Indebtedness.
- 2.6 Where a Party is in Level 1 Credit Default for a period of 90 continuous days or any intermittent period of 120 out of 180 days, or in Level 2 Credit Default for a period of 65 continuous days or any intermittent period of 75 out of 120 days, a Default in relation to that Party occurs in accordance with Section H 3.1 of the Code. The Panel has discretion to apply a number of provisions to a Defaulting Party under Section H of the Code including the following (this list is not intended to be exhaustive):
- With prior approval of the Authority, removal of the right of the Party to register further Metering Systems and BM Units;
 - With prior approval of the Authority, specify that the Party's Plant or apparatus is de-energised;
 - Removal of the Party's right to submit Contract Notifications and to reject all previously validated Volume Notifications (whether or not such Notification has the effect of decreasing the Party's Energy Indebtedness); and
 - Expel the Party from the Code.
- 2.7 Issue 16 notes that the current Level 2 Credit Default provisions limit a Party's ability to notify contracts which increase its Energy Indebtedness. However, there is no specific requirement to post additional Credit Cover under Level 2 Credit Default provisions; rather these provisions create an incentive to provide sufficient Credit Cover to avoid the consequence of Level 2 Credit Default. Issue 16 questions whether the incentive provided is the same for generators and Suppliers.
- 2.8 A situation can occur where a Party is in Level 2 Credit Default and its estimated liabilities within the credit window continue to increase with no further action being required under the Code. In the case of a Supplier, Volume Notifications typically decrease the Party's Energy Indebtedness (since the majority of notifications will be to buy energy) and will not be rejected under the Level 2 Credit Default provisions. However, where the Supplier has not purchased sufficient energy its Energy Indebtedness will continue to increase. Therefore, a Party may be in Level 2 Credit Default and operating in accordance with the Code, whilst its estimated liabilities increase to a

¹ NB: In accordance with Section M3.2 of the Code, a Party is not in Level 1 or Level 2 Credit Default until expiry of the relevant Query Period, the Level 1 or Level 2 Credit Default Cure Period and an Authorisation has been put in place by BSCCo. This paper seeks to consider the provisions applying to Parties in Level 1 or Level 2 Credit Default rather than the process which determines whether or not a Credit Default occurs.

level exceeding its Credit Cover. As such, Issue 16 questions whether the current Credit Default provisions are sufficient to mitigate the risk of bad debt in all scenarios.

- 2.9 Issue 16 notes that the time for which a Party can be in Level 1 or 2 Credit Default prior to being in Section H Default exceeds the times taken for liabilities within the 29 day credit window to materialise and questions whether this is appropriate.

3. GROUP DISCUSSION OF PERCEIVED DEFECT

- 3.1 The Group agreed that Issue 16 highlighted a defect in the current Credit Default arrangements. The Group acknowledged that there are limitations on the accuracy to which a Party's liabilities can be estimated within the 29 day Credit Cover window. However, the Group agreed that it was important that the Credit Default provisions provided sufficient incentives for a Party to ensure its level of Credit Cover is appropriate. It was noted by the Group that this may not be the case under the current baseline, since a Party in Level 2 Credit Default can potentially accrue significant unsecured liabilities whilst continuing to operate in accordance with the Code. The Group also noted advice from ELEXON's operational department that, despite the application of the current Credit Default provisions, the CCP of a number of Parties has continued to increase to above 100%. It was noted by the Group that this may indicate some Parties are taking advantage of the perceived defect.
- 3.2 A view was expressed that any solution should distinguish between Parties who have a level of Credit Cover in place which exceeds their estimated liabilities (CCP less than 100%) and those that have a level of Credit Cover which is less than their estimated liabilities (CCP greater than 100%). The Group noted it may be difficult to justify applying some of the provisions of Section H of the Code to a Party which has a level of Credit Cover greater than its estimated liabilities. Other members of the Group were of the view that applying the provisions prior to a Party's CCP exceeding 100% protects against inaccuracy in the estimated liabilities i.e. that applying stringent provision where CCP is below 100% protects against the situation where a Party's liabilities have been underestimated.
- 3.3 The Group agreed any further provisions introduced should only apply where a Party is considered to pose a risk to the industry. For example a Party with a CCP of 200% for a relatively short period of time may be considered a higher risk to the industry than a Party with a CCP of 91% over an extended period of time. It was noted that a Party's liabilities can increase significantly in a short space of time, for example it is feasible for CCP to increase from 0 to over 100% within a single Settlement Period. Therefore, the Group agreed a Party's estimated liabilities should be the primary driver for applying any further provisions introduced, with the timescales involved being a secondary consideration.
- 3.4 The Group agreed that the current Credit Default provisions do not provide consistent incentives on industry participants to lodge an appropriate level of Credit Cover. The Group agreed that the current provisions are effective in the case of generation, since the restriction on the ability to submit Volume Notifications which increase Energy Indebtedness (i.e. to sell energy) limits the ability to accrue further liabilities and introduces a significant incentive to avoid Level 2 Credit Default. In the case of a Supplier the situation is more complex, since a limitation on the ability to submit Volume Notifications which increase Energy Indebtedness does not limit the ability to accrue further liabilities or to continue trading. In addition, one member of the Group noted that some Parties may be considered to trade on reputation to a greater extent and therefore the

incentive to avoid Level 1 or 2 Credit Default (and associated public notification of Credit Default) may be more significant for these Parties.

- 3.5 The Group agreed that the discretionary provisions available to the Panel under Section H provide sufficient protection to industry participants once such provisions are triggered. It was noted that the flexibility of this process allows the Panel to take actions appropriate to the particular circumstance of Default and the Party involved. The Group recognised that any change to the provisions available to the Panel following Section H Default would need a wider assessment taking into account the other circumstances under which these provisions apply and would need to be progressed separately.
- 3.6 The Group agreed the high level objectives that any solution to the perceived defect could be considered against:
- The solution should place appropriate incentives on Parties to post a level of Credit Cover which is sufficient to meet their estimated liabilities;
 - The driver for further action should be based on the risk a Party poses to the market; and
 - The solution needs to strike a balance between ensuring appropriate action can be taken when a Party poses a genuine risk without introducing overly onerous provisions impacting Parties which do not pose a risk.

4. GROUP DISCUSSION OF POTENTIAL SOLUTIONS

- 4.1 The Group discussed the potential solutions to the perceived defect outlined in Issue 16.

Solution 1: Reduce Existing Timescales

- 4.2 One potential solution identified was to reduce the number of days for which a Party can be in Level 1 or 2 Credit Default prior to being in Default under Section H.
- 4.3 The Group noted that under this solution a Party could be in Default under Section H of the Code despite having a level of Credit Cover greater than its estimated liabilities. It was recognised that it may be difficult to justify introducing more stringent provisions applying in this situation. It was also noted that a Party's liabilities can increase significantly over a relatively short space of time. As such, it may not be appropriate for a Party to be in Level 2 Credit Default for 5 Working Days before further provisions became applicable (since over this time a Party may accrue further liabilities). It was also considered that this solution may not introduce sufficient incentives on Parties to post an appropriate level of Credit Cover when in Level 2 Credit default.

Solution 2: Link Level 1 Credit Default and Section H Default

- 4.4 Under this approach a Party would be in Default under Section H once it had been in Level 1 Credit Default for 5 Working Days. Therefore, a Party in Level 1 Credit Default would be in Default under Section H of the Code if its CCP was not below 75% for one Settlement Period in the 5 Working Days after entering Level 1 Credit Default.
- 4.5 The Group noted that this solution raised similar issues to the first solution and that this approach would not provide the optimal solution to the perceived defect. In particular it was considered applying Section H Default provisions to Parties with a CCP of 80% may be considered overly onerous.

Solution 3: Introduce Credit Cover Requirements for Reoccurring Breaches

- 4.6 Under the third solution a Party continuously or intermittently in Level 1 Credit Default for 4 days during a rolling 29 day period would be required to lodge additional Credit Cover. The level of additional Credit Cover required would be such that, were the Party's CCP recalculated with this Credit Cover in place for the entire 29 day period, its CCP would have been below a defined level for the entire period (the amount of additional Credit Cover required would be calculated by BSCCo and notified to the Party). The Party would then be required to maintain this level of Credit Cover for a minimum period. This process would also be supported by a new credit committee which would hear appeals from the affected Party in relation to the level of Credit Cover required. The Proposer indicated that this solution is consistent with the approach utilised in the gas market. However, it was recognised that different timescales would be required due to the respective duration of the Settlement Periods in gas and electricity.
- 4.7 It was recognised that this solution introduces a requirement to post an appropriate level of Credit Cover that is desirable in any solution to the perceived defect. However, it was noted that there may be concerns over applying these provisions to Parties that have sufficient Credit Cover in place to meet their estimated liabilities (i.e. CCP less than 100%). It was also noted that the process represented a significant change to the existing Default provisions.
- 4.8 The Group agreed that, by distinguishing between repeated Credit Defaults, this solution provides a benefit not present in other solutions. The group agreed that there would be benefit in considering incorporating this element within any solution progressed.
- 4.9 The Group considered whether there would be any benefit provided by the introduction of a Credit Cover committee to provide independent determinations in relation to the Credit Cover process. The Group agreed that many of the benefits of such a committee are already provided by process such as the Credit Default Cure period, the Material Doubt provisions and the ability of the Panel to apply discretion in the application of the Section H Default provisions. However, it was noted that this approach could potentially be incorporated in any solution progressed and may benefit from further consideration.

Solution 4: Introduce a Third Level of Credit Default

- 4.10 The fourth potential option identified in Issue 16 is to introduce an additional set of provisions that are implemented when a Party's CCP exceeds 100%. Under this approach a Party would be required to ensure its CCP reduced to a defined threshold within 1 Working Day of breaching 100% (this could be achieved either by posting additional Credit Cover or via trading activity). If the Party's indebtedness remained above 100% for 1 Working Day the Party would be in Default under Section H of the Code.
- 4.11 It was noted by the Group that this solution provided the desired incentive on Parties to post an appropriate level of Credit Cover and that these incentives would be consistent across Parties. In addition, the Group acknowledged that this approach provided a distinction between Parties with a level of Credit Cover in excess of their estimated liabilities and those without. It was also recognised that the use of CCP as the trigger would ensure Parties are treated in accordance with the estimated level of liabilities.

- 4.12 The Group noted that this solution would effectively require the introduction of a third level of Credit Default. Provision would have to be created for an appropriate query and cure period for any new Credit Default provisions. It was also noted that the interaction with the existing Credit Default Levels would require further consideration.
- 4.13 The Group considered whether the existing Level 2 Credit Default provision should be removed if new Credit Default provisions were introduced. The Group agreed that the majority of Parties manage their credit positions in order to avoid the existing Credit Default provisions. The removal of existing Credit Default provisions would therefore impact on the operational processes of most Parties. However, introduction of an additional level of Credit Default would represent a minimal change for most Parties if applied at a higher CCP level than the existing provisions.
- 4.14 The Group indicated a preference for this solution and the Proposer indicated an intention to raise this approach via a Modification Proposal. It was also noted that it may be feasible to include elements of the other solutions identified within this approach (in particular to distinguish Parties repeatedly in Credit Default).

5. GROUP CONCLUSIONS

5.1 The Group concluded that:

- **Issue 16 highlights a genuine defect in the current Credit Default arrangements;**
- **Of the solutions identified, an approach which introduced new provisions applying to Parties with a Credit Cover Percentage of over 100% provided the most appropriate incentives on Parties; and**
- **Further development of the full process would be required during the assessment of any Modification Proposal raised in this area.**

ELEXON Change Delivery

Tom Bowcutt

References

- 1) Issue 16 'Credit Default and the Default provisions in Section H of the BSC Review of Trading Query Deadlines':
<http://www.elexon.co.uk/changeimplementation/ModificationProcess/groups/issues/issues.aspx?issueID=18>

ANNEX 1: GROUP DETAILS

Member	Organisation
Sarah Parsons (Chair)	ELEXON
Mark Manley (Proposer)	BGT
Man Kwong Liu	SAIC
Steve Drummond	EDF Trading
Neil Smith	E.ON UK
Andrew Colley	Scottish and Southern
Carl Wilkes	Npower

Attendee	Organisation
Darren Bourke (Operations)	ELEXON
Dipen Gadhia	Ofgem