Modification Proposal P76 - Anomalies Associated with Negative Quantities of Credit Cover

A consultation document developed on behalf of the Credit Modification Group (CMG)

For Attention of:	**BSC Parties and the System Operator**
Date of Issue:	**05 June 2002**
Responses Due:	**17:00 Tuesday 18 June 2002 (To: Modifications@elexon.co.uk)**

1. INTRODUCTION

Modification Proposal P76 Anomalies Associated with Negative Quantities of Credit Cover was raised by BGT on 8 April 2002. The Modification Proposal seeks to address an issue whereby a Party that has insufficient credit to cover their outstanding liabilities may not be flagged as being in Credit Default. This issue arises as a consequence of the link between the Payment Default and Credit Default procedures, as Trading Charges from the Payment Default process are taken into account when calculating the amount of Credit Cover available to each Trading Party.

The Initial Written Assessment (IWA) was produced and presented to the Balancing and Settlement Code Panel at their meeting on 18 April 2002. The IWA recommended that the Modification Proposal be submitted to the Assessment Procedure and that the Credit Modification Group (CMG) undertakes this work. The Panel agreed this recommendation.

An initial assessment of the Modification Proposal identified the following areas of impact:

- The Balancing and Settlement Code:
    - Section M – This section will need to be updated to reflect any amendments to the definitions of Credit Cover Percentage, Credit Cover or Energy Indebtedness.
- BSC Systems and processes:
    - A potential impact on ECVAA Credit Checking systems and processes depending on which solution is agreed upon.
    - A potential impact on FAA Clearing Invoicing and Payment systems and processes depending on which solution is agreed upon.
- Other Systems and Processes
    - Potential impact on Parties ability to balance their Credit Cover and therefore their Energy indebtedness over a Settlement period. It may also impact Parties verification of their own Energy Indebtedness.
- Documents Potentially Impacted
    - The FAA Service Description may need to be changed if they have to notify relevant Parties of a negative Energy Credit Cover.
    - Data Catalogues may have to be updated to reflect that Credit Cover should never have a negative value.

2. MODIFICATION GROUP DISCUSSION

At their meeting on 23 April 2002, the CMG discussed the issues raised in the IWA and a Requirements Specification was written to describe the Modification Proposal and the two other options discussed in the meeting in more detail. These three options are detailed below;

Modification Proposal	The definition of Credit Cover Percentage in section M3.1.1(a) of the BSC be modified to take into account negative credit cover
Alternative Option 1	The definitions of Energy Indebtedness and Credit Cover be amended so that the amount of any unpaid Trading Charges is added to Energy Indebtedness, rather than subtracted from Credit Cover.
Alternative Option 2	The definition of Credit Cover be modified to say that non payments should be deducted from the amount of credit lodged, provided the Credit Cover value is not less than zero.

The Modification Proposal and the two Alternative Options have been assessed by the NETA Central Services Agent and the estimated costing for each are;

Modification Proposal	£ 110k approx.
Alternative Option 1	£ 130k approx.
Alternative Option 2	may have some FAA cost implications but no impact on the Central Services Agent, awaiting assessment from FAA.

An assessment of the materiality of the Modification Proposal and the two Alternative Options has been prepared and this is attached in Annex 1. The risk assessment concluded that it is only if the ECVAA is incorrectly estimating Party's indebtedness that there is any additional risk and that once P2 has been implemented, the benefit of enhancing the credit checking rules to handle negative Credit Cover values will therefore be minimal.

Copies of all papers relating to Modification Proposal P76 and its progression through the Assessment Procedure can be found on the BSC Website (www.elexon.co.uk/ta/modifications/mods_docs.html).

3. CONSULTATION

This consultation seeks respondent's views on the issues raised by the Modification Proposal and in particular, which of the Modification Proposal and the two Alternative options better facilitates the applicable BSC Objectives.

For information the applicable BSC objectives are;

(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.

You are invited to provide a response in respect of the questions on the attached pro-forma.

Please send your responses entitled '**P76 Assessment Consultation 1**', by **17:00 Tuesday 18 June 2002** to Modifications@elexon.co.uk

Any queries on the content of the consultation pro-forma should be addressed to Joanne Ellis (020 7380 4316) email address joanne.ellis@elexon.co.uk or Nigel Williams (020 7380 4370) email address nigel.williams@elexon.co.uk.

ANNEX 1: P76 RISK ASSESSMENT

1. Introduction

At the Credit Modification Group (CMG) meeting on 23 April, the Modification Proposal and two Alternative options were identified for addressing anomalies in the calculation of Credit Cover Percentage (CCP) arising from negative values of Credit Cover. These are detailed below:

Modification Proposal	Changing the CCP equation itself, to make it robust to negative values of Credit Cover.
Alternative Option 1	Changing the definitions of Credit Cover and Energy Indebtedness to add unpaid Trading Charges to the Energy Indebtedness value, rather than subtracting them from the Credit Cover value as currently.
Alternative Option 2	Changing the definition of Credit Cover to disallow negative values of Credit Cover.

This paper attempts to provide a quantitative assessment of the materiality of negative Credit Cover, in order to assist the Modification Group in deciding which of these options is most appropriate.

2. Summary of Findings

The key finding of this paper can be summarised as follows:

Provided that the ECVAA system is correctly assessing Parties' indebtedness, the extra sophistication of the Modification Proposal or Alternative Option 1 will not have any impact at all on the credit risk faced by BSC Parties.

Once Modification Proposal P2 becomes effective, ECVAA will have access to Trading Charge data from the Interim Information run, and should therefore be able to assess indebtedness with a high level of accuracy. For this reason, it is recommended that Alternative Option 2 (the lowest cost option) is the most appropriate method of dealing with the issues raised by P76.

3. Background to P76

Modification Proposal P76 identifies a possible weakness in the interface from the Payment Default process to the Credit Default process. It is important to understand that these are two distinct processes, serving two different purposes:

- The Payment Default process is designed to ensure that Parties pay their Trading Charges, once the Payment Date is reached. Any Party who fails to do so will be in Default of the BSC at the end of the third Business Day after failing to pay. At this point the Panel has a number of sanctions available, including preventing the Party from continuing to trade.
- The Credit Default process is designed to ensure that Parties have sufficient Credit Cover in place to cover their settlement liabilities for the 29 days for which the Payment Date has not yet been reached.

The only link between the two is that the BSC definition of Credit Cover (in section M2.1.3) takes into account unpaid Trading Charges, by deducting them from the Party's Credit Cover. The issue raised by P76 is that the Credit Default process is not robust to negative values of Credit Cover, and will therefore give nonsensical answers if a Party runs up unpaid Trading Charges that exceed the total amount of cash and Letters of Credit (LoC) posted.

4. How Do Negative Values of Credit Cover Arise?

Analysis of the conditions under which Credit Cover becomes negative suggests that this can only happen under the following circumstances:

- If the Party is already in Credit Default (in which case the credit checking process can't deliver any further protection to Parties).
- If the Party has unpaid Trading Charges, but these are offset by money owed to the Party for Settlement Days that haven't yet reached the Payment Date. (In this case, the unpaid money will be recovered via the set-off rules in Section N2.6 of the BSC).
- If the ECVAA system has incorrectly assessed the indebtedness of the Party, allowing them to post insufficient Credit Cover. The current rules for assessing indebtedness are known to be poor, which means this situation could well arise. However, once Modification Proposal P2 has been implemented

(in September 2002), ECVAA will have access to Trading Charge data from the Interim Information run, and this situation is therefore unlikely to arise.

Annex 2 to this document contains a worked example illustrating the reasons for this. However, in summary, the argument is as follows:

- As described in section 3 above, a Party who doesn't pay Trading Charges will go into Default (as defined in Section H) at the end of the third Business Day, at which point the Panel has the option to prevent further trades. A Party therefore has a limited window of time in which to incur unpaid Trading Charges. If they stop paying on day D, this window might run from approximately day D to day D+5 (depending on where the weekend falls), and therefore include the Initial Settlement runs for Settlement Days D-28 to D-23.
- It follows from this that the Party's Credit Cover can only become negative if the actual Trading Charges for the D-28 to D-23 window exceed the total amount of cash and LoC posted. However, the ECVAA system is designed to place people in Credit Default if their liabilities exceed the credit cover posted, and therefore this situation could only arise in the following circumstances:
  i) If the Party has indeed been placed in Credit Default;
  ii) If the total indebtedness over the period from Settlement Days D-28 to D is less than the indebtedness from D-28 to D-23, because the debts are offset by money owed to the Party for later Settlement Days; or
  iii) If the ECVAA system has incorrectly assessed the Party's indebtedness.

It follows from this that fixing the credit checking process to correctly handle negative values of Credit Cover (i.e. the Modification Proposal or Alternative Option 1 as opposed to Alternative Option 2) doesn't provide any benefit to BSC Parties, unless the ECVAA system has under-estimated the Party's indebtedness, and hence allowed them to post insufficient Credit Cover.

ANNEX 2 – EXAMPLE OF NEGATIVE CREDIT COVER

The following example is intended to illustrate the discussion of negative Credit Cover in section 4 of the paper.

Suppose that a Party stops paying their Trading Charges on 1 May, racking up £8,000,000 in unpaid Trading Charges before the Panel takes action to stop them trading:

Payment Date	Settlement Date	Unpaid Trading Charge
01/05/2002	01/04/2002	£1m
01/05/2002	02/04/2002	£1m
02/05/2002	03/04/2002	£1m
02/05/2002	04/04/2002	£1m
03/05/2002	05/04/2002	£1m
03/05/2002	06/04/2002	£1m
07/05/2002	07/04/2002	£1m
07/05/2002	08/04/2002	£1m

The question raised by Modification Proposal P76 is whether changing the credit checking process to handle negative values of Credit Cover could have allowed ECVAA to detect the problem, and prevent the Party from trading earlier. The answer to this depends upon their credit position when payment of Trading Charges ceases. There would appear to be a number of possible cases:

- Case 1 – The ECVAA system knew about the £8m debt for Settlement Days 1 to 8 April, and ensured that the Party put up at least this much Credit Cover. In this case the unpaid Trading Charges won't lead to negative Credit Cover, and so the issues raised by P76 don't apply.
- Case 2 – The ECVAA system knew about the £8m debt for Settlement Days 1 to 8 April, but the Party didn't put up the required Credit Cover. In this case they would already be in Credit Default prior to 1 May, and improvements to the credit checking process wouldn't provide any additional benefit.
- Case 3 – The ECVAA system didn't know about their £8m debt for Settlement Days 1 to 8 April, and therefore allowed them to reach 1 May with insufficient Credit Cover. In this case negative Credit Cover is a real possibility, and improving the credit checking process to handle this could provide real benefits. However, this situation will be much less likely to arise once Modification Proposal P2 becomes effective, because the ECVAA system will then have access to data from the Interim Information SAA run. Only if this data was grossly inaccurate for Settlement Days 1 to 8 April would a risk of negative Credit Cover arise.
- Case 4 – The ECVAA system knew about the £8m debt for Settlement Days 1 to 8 April, but didn't require Credit Cover to be posted, because the debts were offset by money owed to the Party on other Settlement Days in the period between 9 April and 1 May. In this case the money owed for 9 April to 1 May can be used to recover the unpaid Trading Charges (in accordance with the set-off rules in Section N2.6 of the BSC). The only problem would be if ECVAA's estimate of indebtedness for 9 April to 1 May is incorrect, and the Party isn't really owed money. As discussed under case 3 above, this situation is unlikely to arise once Modification Proposal P2 has been implemented.