14 August, 2003

Query Periods and Default Cure Periods in Relation to Level 2 Credit Default – A Paper to the Settlement Standing Modification Group

Summary

The issue of what happens when a Party's Credit Cover Percentage goes immediately to a level under which Level 2 Credit Default could be called, was raised at the SSMG whilst it was considering Modification Proposals P122 and P123. It is not clear whether there is provision for a Query Period in this circumstance, as there is under Level 1 Credit Default. Additionally, there is no provision for a default cure period for Level 2 Credit Default.

Background

The treatment of Credit Default is outlined in Section M of the BSC. There are two levels of Credit Default.

Level 1 Credit Default

Level 1 Credit Default can be called when a Party's Credit Cover Percentage (CCP) becomes greater than 80 percent (Paragraph M3.2.1). Credit Cover Percentage is the ratio of a Party's Energy Indebtedness to the level of Energy Credit Cover it has lodged, expressed as a percentage (M3.1.1). When this level is exceeded the Energy Contract Volume Aggregation Agent (ECVAA) notifies Elexon and the Party concerned (M3.2.1a).

The Party then has 24 hours, the "Query Period", in which to query the validity of the ECVAA's calculation of CCP (M3.2.1b & 3.2.2). If the CCP is still determined to be higher than 80 percent then the Party has until the end of the next business day to ensure that the CCP is below 75 percent for at least one settlement period (M3.2.5). This period of time is referred to as the "default cure period". If the CCP is not reduced to below 75 percent then the Party will be in Level 1 Credit Default and a notice to this effect is published on the BMRS (M3.2.6).

Level 2 Credit Default

The full situation for Level 2 Credit Default is not entirely clear. If a Party's CCP becomes greater than 90 percent, then M3.3.1 states that Level 2 Credit Default can be called and that this can happen regardless of whether the period concerned falls in a Query Period or default cure period under Level 1 Credit Default.

However, M3.3.1 also states that Level 2 Credit Default cannot be called until an authorisation notice is issued by Elexon. Section M3.4 covers the issuing of the authorisation notice. M3.4.2 states that an authorisation notice is a notice authorising the ECVAA "to take the steps referred to in paragraph 3.2.6(b) and 3.3.1(b)". These two paragraphs refer to the stating on the BMRA or BSC Website that the Party concerned is in Level 1 or Level 2 Credit Default respectively.

If the Party concerned is within a Query Period under Level 1 Default, M3.4.3(a) states that the authorisation notice will not be submitted by Elexon until the end of expiry of the Query Period. However, the BSC is silent on what happens when the Party goes straight into Level 2 Default, which would imply that there is not a Query Period in this instance.

If Level 2 Credit Default is called, M3.3.3 outlines that, under Section P, Energy Contract Volume Notifications and Metered Volume Reallocation Notifications will be refused and rejected if they increase the Party's indebtedness. However, M3.3.4 states that "For the purposes of M3.3.3, a relevant Query Period is the Query Period in relation to any Settlement Period, not later than Settlement Period J, for which the Trading Party had given a default query notice." which would suggest that there is a Query Period in this instance after all. That said, M3.3.3 does not even refer to a Query Period.

Issues

1. It is uncertain whether there is a Query Period for Parties whose CCPs go straight above 90%. Therefore, these Parties are treated differently from those who first go into a Level 1 Query Period. Should they be treated differently?

2. There is no provision for a default cure period for Level 2 Credit Default. This means that a Party whose CCP goes above 90% during a non-business day may not be able to raise additional credit cover to avoid going formally into default, it can only trade to do so (assuming it has a 24 hour trading function). This may lead to a Party trading unnecessarily to get out of default when it could easily post more credit cover the next business day. Should this be the case?

Clearly, a balance needs to be struck between protecting market participants fom defaulting parties whilst ensuring that Parties who wish to lodge extra credit to rectify Level 2 Defaulting positions, can do so within realistic timescales. There may be a number of things which could be considered to ensure that Level 2 Query Periods and default cure periods have tighter constraints than Level 1 equivalents. For instance, there could be a provision to refuse and reject notifications which increased the indebtedness until the CCP is reduced to the appropriate level or make the default period tighter for Level 2, say by giving Parties until midday on the next business day.

The SSMG is invited to consider the above issues with a view to whether a modification to the BSC is required.