# Memorandum

**To** The BSC Panel **cc.**

**From** Claire Williams

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**RESPONSE ON ISSUES RELATING TO THE SUPPLIER OF LAST RESORT PROCESS AND THE RECENT DEFAULTS**

## 1. Introduction

1.1 Several questions have arisen as a result of the recent Section H defaults. These questions relate to :-

- the structure of the Code in relation to credit cover.
- can the Issue 22 group consider the wider issues relating to credit cover.
- can the Panel stop a company trading in the imbalance mechanism and thereby increasing its indebtedness position.
- revocation of the supply licence.
- can ELEXON start the statutory demand process earlier.
- status of creditors.
- direct debit payments.
- mismatch between supply licence and Section K of the Code.
- Section H Resolutions – should these be time based or settlement period based.
- suspension of the right to register Metering Systems and BMUs.

## 2. Structure of the Code in Relation to Credit Cover.

2.1 The structure of the Code in relation to credit cover reflects the current balance between the cost to Parties of obtaining credit cover against the risk to Parties of having to share the loss if a Party fails to pay its Code debts for whatever reason (including insolvency). The Code does not require a Party to lodge credit cover which will equally match its liabilities, but rather to lodge proportionate credit cover calculated on the basis of a set formula. The Code also does not give BSCCo the right to tell Parties from time to time what credit cover they must lodge, nor any right to ensure that such cover is lodged before a Party can trade or can trade further. The Code places the onus on a Party to calculate the credit cover which it needs to lodge, and then sets up a system for assessing after the event whether the Party has lodged sufficient credit cover (i.e. the Level 1 and Level 2 credit default process).

2.2 As further protection to the Parties, Section P of the Code states that if a Party is in Level 2 credit default, all ECVNs or MRVNs submitted by the Party which would have the effect of increasing the Party's indebtedness will be treated as refused and ineffective. In addition, being in "long term" Level 1 or Level 2 credit default is a Section H default which can trigger the Section H processes.

2.3 It might be that Parties wish to reconsider the current balance relating to the cost of credit cover/risk of Party failure. An increase in the level of credit cover might have assisted to some extent in a case such as Utility Link. However, unless the credit cover in place equally matches the debt, there will never be complete protection. It should also be noted that the situation could well arise where debt keeps increasing but the Party does not wish to or does not have the ability to lodge more credit cover. This may be the situation where (for example) a company is going bust but is still continuing to trade whether actively or passively (i.e. because its customers continue to draw down electricity). The latter was the situation which occurred in relation to both Utility Link and Zest.

2.4 If Parties were going to consider the credit cover position further, they might also want to consider the ability of Parties to reduce or withdraw credit cover. It was noted in relation to one of the recent defaults that a Party, by using the processes in the Code, was able to reduce its credit cover to zero. Similarly, consideration could be given to having a base credit cover amount for all Parties (perhaps differentially calculated) which must be retained for the entirety of the 14 month settlement period where a Party is still trading. Consideration could also be given to possibly having a different (but still differentially calculated) base credit cover amount where a Party has ceased trading.

2.5 The question then arises as to whether a modification to consider changing the credit cover situation could be a Panel raised "efficiency" modification under Section F2.1.1(d). The answer to this is clearly no. *This is now under consideration by the Issue 22 Standing Modification Group*

## 3. Can the Issue 22 Group Consider the Wider Issues relating to Credit Cover?

3.1 Credit cover can be considered by a standing Modification Group under Section F2.4.23 if its terms of reference from the Panel permit it to consider such matters. If the terms of reference do so permit, the Group may consider any issue put to it by any person or body entitled to propose a modification to the Code.

3.2 Issue 22 is currently being considered by a standing Modification Group. The issue as described includes the wider issues relating to credit cover and indebtedness. Therefore, I would not see any problem in the Issue Group considering matters such as those mentioned above.

## 4. Can the Panel ensure that a Defaulting Party does not Continue to Incur Debt?

4.1 The Panel can only make resolutions if a Section H default arises. This, so far as is relevant for the present discussion, will only happen if the Party is in "long term" credit cover default (something which involves a relatively considerable period of time), a payment default occurs or an insolvency event arises.

4.2 It may on occasion take some time before the Panel becomes aware that a Party is continuing to incur debts which it is unable or unlikely to pay, particularly if the Party does not allow the matter to become easily observable. Once the Panel does become aware of the situation, it can do nothing until a Section H default arises.

4.3 Once a Section H default arises, the Panel can suspend and disapply MVRNS or ECVNs. While this will prevent a generator (and non-physical trader) from trading it will not of itself, as has been stated previously, stop a supplier (actively or passively) trading in the imbalance market and incurring debts for which it may not have credit cover. The administrator or liquidator of a supplier is less likely to allow such a situation to develop due to the personal responsibilities and potential exposure of the administrator or liquidator.

4.4 The Panel does have the right (with the prior approval of the Authority) to require the defaulting Party and the Transmission Company (or Distribution System Operator) to de-energise Plant and Apparatus comprising one or more BMUs for which the Defaulting Party is Lead Party. The Code expressly states in Section H3.2.1(d) that the Lead Party and all other Parties irrevocably and unconditionally consent to such de-energisation.

4.5 In addition, the Code in Section H3.2.5 states that where the Panel has issued an instruction to de-energise, the Transmission Operator (or the Distribution System Operator) shall use all reasonable endeavours to comply or procure compliance as quickly as reasonably practicable with such instruction. The defaulting Party (or failing this) each Trading Party shall, to the extent of their annual funding share, indemnify the Transmission Operator (or Distribution System Operator) against any losses or liabilities which it suffers as a result of obeying the Panel's instruction.

4.6 Assuming that the conditions for de-energisation are present, the Authority has not historically been willing to give its approval to de-energisation, particularly in a situation where this would effectively mean depriving customers of electricity.

4.7 This means that the only practical option which currently seems available to "make" an essentially insolvent company stop trading when it fails or refuses to do so, is the supplier of last resort process. The trigger for the supplier of last resort process is the revocation of the supplier's licence. However, the minimum period before a notice to revoke is effective, unless a specified insolvency event of the type described in the supply licence occurs, is 30 days. If there is such a specified insolvency event, the revocation and supplier of last resort process can take place on 24 hours notice. A Section H default is not of itself a trigger for the revocation of the supply licence, although some of the events which trigger a Section H default may also trigger a trigger a revocation of the supply licence.

4.8 Unfortunately, the specified insolvency events in the standard supply licence which trigger a revocation of the supply licence do not include the Party simply admitting that it is unable to pay its debts as and when they fall due. It would have helped in the recent Zest 4 Electricity Ltd ("Zest") situation if the Authority had been able to trigger the supplier of last resort process earlier by reason of Zest admitting that it could not pay its debts. However, it would not have helped in the Utility Link Limited situation where the company did not make a similar statement. Therefore another trigger for the supplier of last resort process would have been needed for the Utility Link situation (for e.g. non-payment of trading charges for a specified period or non-payment of trading charges over a certain amount). These are matters which may be considered in the Authority's review of the SoLR process and/or standard supply licence conditions.

4.9 Are there any other options whereby a Party could effectively be "made" to stop trading in addition to the de-energisation and supplier of last resort options? Another possibility might be a mode or process (outside of the supplier of last resort process and operated by the Panel as part of the Section H process) whereby a failing supplier's Plant and Apparatus or customers could transferred to another entity. Both would be quite serious concepts as they would involve a compulsory transfer of assets or customers, and would also involve considerations of Parties' rights, liabilities, ability to trade and residual value in assets. *It is open for a BSC Party to raise a Modification Proposal and a guidance note is being prepared on the purpose of credit cover*

4.10 Could a modification proposal to effect a mode or process such as that described in Item 4.9 above be a Panel raised efficiency modification proposal under Section F2.1.1(d). The answer to this is clearly no.

## 5. Licence Revocation

5.1 As referred to above, the current trigger for a 24 hour revocation of the licence is the occurrence of one of the insolvency events falling within Paragraph 1(f) of Schedule 2 to the standard supply licence. These are that :-

- the Party is unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986, but subject to paragraph 2 and 3 of Schedule 2 of the supply licence;
- the Party has a receiver appointed; NB receivers are rarely appointed today due to changes in insolvency law and the availability of other processes.
- an administration order is made under Section 8 of the Insolvency Act 1986; NB section 8 is rarely used today due to changes in insolvency law and the availability of other processes to appoint administrators.
- the Party passes any resolution for winding up (other than a resolution previously approved in writing by the Authority);
- the Party becomes subject to a winding up order;
- the Party enters into voluntary arrangement under Section 1 of the Insolvency Act 1986; or
- the Party enters into any scheme of arrangement (other than for the purposes of amalgamation or reconstruction upon terms previously approved by the Authority).

5.2 It should be noted in relation to bullet point 1 above, that section 123 of the Insolvency Act indicates that a company shall be deemed unable to pay its debts if a statutory demand for a sum exceeding £750 has been served on the company and the company fails to pay the amount within 3 weeks or give security or compound it to the reasonable satisfaction of the creditor. Section 123 also provides that a company shall be deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the companywide assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

5.3 However, it should also be noted that paragraphs 2 and 3 of the standard supply licence restrict the operation of section 123 for the purposes of the revocation of a supply licence. They do this by stating that section 123 only has effect if the statutory demand is for over £100K and also does not operate where statutory demand is being contested in good faith by the licensee "with recourse to all appropriate measures and procedures".

5.4 The only possibilities at the present time for ELEXON to itself trigger one of the grounds for revocation set out in the current standard supply licence is by bullet point 1 (statutory demand), seeking to wind the company up (bullet point 5) or (in certain circumstances) applying for an administration order (bullet point 3). There are issues in activating all these triggers, and none of them are without cost, delay and some administrative burden.

5.5 It should also be noted that it would be useful if the standard supply licence was updated in relation to the "insolvency" event triggers to reflect more modern practices. NB Section H should also be updated in this regard, albeit the Section H triggers are wider than the supplier licence triggers. This would be a housekeeping modification. *On hold until the Supply Licence Review is completed.*

## 6. Can ELEXON Start the Statutory Demand Process Earlier?

6.1 The Code could be modified to clearly give ELEXON the right to serve a statutory demand without awaiting the approval of the Panel (or a consultation by the Panel with industry). If ELEXON more clearly had this power, it would be unlikely to exercise it if a Party simply failed to pay on the due date. ELEXON would be likely to only exercise the power in circumstances where the Party repeatedly failed to pay its debts or its financial position looked precarious and the Party did not have sufficient credit cover to meets its debts.

6.2 However, while it would be useful to have confirmation in the Code that ELEXON has the right to start the statutory demand process earlier, the service of a statutory demand will not necessarily assist in triggering a revocation of the supply licence. The statutory demand gives ELEXON the right to present a petition to wind up the company at the expiration of 3 weeks from the date of the demand. During this 3 week period the company could still be trading and incurring significant debt. Further, if the company contested the statutory demand, the situation might drag on for some time and the Authority would be unable to revoke the licence. *ELEXON is considering whether it is necessary to raise a CP to amend the invoice. It is also open to Parties to raise a standing issue/Modification Proposal to remove the necessity for a industry consultation.*

## 7. Status of Creditors

7.1 A debtor who is still technically solvent and trying to trade will generally first pay the creditors with the most bargaining power. In other words, it will pay (whether in whole or in part) the creditors it most needs in order to be able to continue to trade. This (for e.g.) might be its bank who is providing an overdraft facility, a supplier upon whom it is dependant or its employees. On some occasions a creditor (usually a bank) may also have a special arrangement whereby it is able to have first call on any monies coming into a debtor.

7.2 Once a debtor becomes insolvent, the situation becomes somewhat different. The assets of the insolvent debtor are divided in accordance with law. There are complex legal rules relating to this. In a very broad brush way one could describe the division as follows. Creditors who have security over a fixed asset are paid (in the ranking order of their security) out of the fixed assets. The remaining assets will be used as follows - the fees of the liquidator or administrator are paid first, then employees wages are paid (including their pension contributions), unsecured creditors (including HM Revenue & Customs) will be paid out of a specific pot, then the floating charge creditors will be paid and then the unsecured creditors will come back in and take payment out of what is remaining. If any monies are left over after paying the creditors, the monies will be divided among the shareholders.

7.3 It is often also the case that certain payments made in the time period leading up to the insolvency can be re-opened. If it is discovered that any wrongful "preferential payments" have been made for which proper value was not received (for instance wrongful payments to shareholders or directors), these payments might have to be repaid to the debtor company for division among the creditors.

7.4 ELEXON and ELEXON Clear are unsecured creditors. The debts owed to them do not have any special status.

7.5 The question then arises as to how the position of ELEXON and ELEXON Clear could be better protected, and what this would entail. There are several methods of "protecting" ELEXON and ELEXON Clear which would not involve taking security over the assets of the Parties. Some examples are set out below, and Parties considering the matter might be able to think of other methods as well. The desirability and cost/benefit of some of these methods may be subject to some debate. The examples are :-

- the credit cover situation could be reconsidered.
- insurance cover could also be considered. Insurance, if available, might be expensive and subject to conditions (such as being only available in relation to Parties which have particular credit ratings).

7.6 The suggestion has also been made that ELEXON and ELEXON Clear could take some sort of security over the assets of Parties. There are many different types of security which may be taken – for instance, mortgages, debentures, charges (including fixed and floating charges). Industry would have view on whether and what form of security might be the most appropriate. The matter would probably cause much debate (particularly as it would be a restriction on Parties commercial activities and use of their assets, including for the purpose of funding their commercial activities). I would also suggest that specialist legal advice would be necessary in relation to the concept of the most appropriate (and least cost and administratively burdensome) form of security. If some form of security was considered by the industry to be appropriate, the necessary process would need to be inserted into the Code. This would not be an efficiency modification.

7.7 I should mention that it may well be the case that many industry Parties will already have granted securities of over at least some of their assets, and may not be permitted to grant further security. It might also be the case that ELEXON (if it did manage to obtain some security) would still find itself ranking behind other secured creditors. *Under consideration by the Issue 22 Group.*

## 8. Direct Debit Payments

8.1 When a Party fails to pay its trading charges on the due date a notice will be sent to the Party under Section H3.1.1 (a) requiring payment of the outstanding amount. This will be sent on the day after the due date. If the Party does not pay the outstanding amount in full by the third Business Day after the date of its receipt of the notice, the Party will be in Section H default.

8.2 Where a Party pays its debts by direct debit (as opposed to, for example, by BACs) it is possible, because of the very nature of the process and rules relating to direct debits, that the Funds Administration Agent ("FAA") may not know for certain that payment has not been received until some time after the due date. The reason for this is because, when a direct debit is in place, the FAA will instruct the Party's bank to deduct the relevant amount from the Party's bank account for payment on the due date. The bank will automatically pay the relevant monies on the specified date and the monies will "appear" in the FAA's bank account. However, under the rules applying to direct debits, the payment is a "contingent" payment and may be withdrawn by the bank if the Party does not have sufficient funds in its account to honour the direct debit instruction. This is treated as a rejection by the bank of the direct debit instruction. If there is a rejection, this rejection will generally not occur until approximately 2 Business Days after the due date, but may take up to 5 Business Days.

8.3 The FAA accordingly may not become aware that the Party has not paid on the due date for a period of up to 5 Business Days after the due date. A Party paying by direct debit whose direct debit is rejected will therefore potentially have the benefit of extra time before ELEXON becomes aware that the Party may be in financial difficulty, and/or ELEXON and the Panel become aware that a Section H default has occurred.

8.4 Even if a Party is not in serious financial difficulty, it will essentially be able to have a minimum of between 1 and 5 Business Days more time to remedy its non-payment than Parties who pay by other means. The fact that the Party would (presumably) not be sure of whether the period will be 1 Business Day or 5 Business Days, would probably reduce the possibly of a Party considering it worthwhile to rely on the potential direct debit delay in order to manipulate the date of payment of its debts.

8.5 The situation which is of potentially more concern is therefore the situation where the Party is in clear financial difficulty, but it is unclear (because the Party has paid by a direct debit but such direct debit may yet be rejected) whether the Party has or has not paid on the due date.

8.6 Direct debit is often considered to be a modern and convenient method of payment with advantages which outweigh its disadvantages. If this should be considered not to be the case for the purposes of the Code, Parties could be informed that such a form of payment is not acceptable. *Up to a Party to raise a Standing Issue*

## 9. Mismatch Between the Supply Licence and Section K of the Code

9.1 It has been suggested that there is a mismatch between the supply licence and Section K due to the fact that the supply licence operates in terms of suppliers and the Code operates in terms of Supplier IDs. This is not accurate. The Code actually does operate in terms of suppliers (particularly Section K which does not recognise or refer to a concept of a Supplier ID). The concept of a Supplier ID, is in the main, merely a convenient way for the systems to recognise which supplier is being dealt with. It is a shorthand way of referring to a supplier in the same way as the concept of a Party ID is a shorthand way of referring to a Party.

9.2 The real issue is that while the failing supplier provisions in Section K work well enough in the straightforward situation (situation 1) where the failing supplier supplies its "own" customers (i.e. the customer's MPANs are registered to the failing Supplier) by use of its own Plant and Apparatus (or BMUs). However, it does not work well where the failing supplier has customers, but no BMUs and uses another supplier to supply its customers (situation 2). In situation 2 the customer's MPANs are not registered to the failing supplier, but to another supplier.

9.3 In situation 1, the supplier of last resort process set out in Section K can operate to effectively "transfer" the customers of the failing supplier by means of transferring (for Code purposes) the failing supplier's BMUs to a new supplier. As the new supplier is considered (for Code purposes) to be responsible for the BMUs. It is therefore also responsible for the on-going trading charges relating to the supply of the customers through those BMUs.

9.4 In situation 2, the failing supplier does not have any BMUs. There is therefore nothing which can (for Code purposes) be transferred under Section K to a new supplier, and thus the customers cannot be effectively transferred.

9.5 It would require a modification to the Code to give ELEXON the ability to also effectively transfer the customers of a failing supplier as well as to transfer the BMUs of a failing supplier. This could not be an efficiency modification. *Up to a Party to raise a Standing Issue*

## 10. Section H Resolutions – Should these be Time Based or Settlement Period Based

10.1 It has been suggested that the fact that some resolutions under Section H are referred to in terms of settlement periods and others in terms of time means that it is not always clear at what point resolutions become effective. It should be noted that the resolutions expressed in terms of settlement period are standard resolutions 2 and 3 which relate to the suspension and disapplication of MVRNs and ECVNs. It could therefore be said that it makes sense for them to be expressed in terms of settlement periods.

10.2 However, I can well see that persons who do not work regularly with settlement periods will not immediately be able to understand the timing intended by the resolutions. I think that the matter can be dealt with very simply by a minor alteration to the phrasing of standard resolutions 2 and 3. For example, the resolutions could be changed to something along the lines of - "suspend/disapply from settlement period [x] on [day][month][year] (being [x a.m/p.m.] on [day][month][year]).". *It's ELEXON's responsibility to ensure that the meaning of the resolutions is clear.*

## 11. Suspension of the Right to Register Metering System and BMUs.

11.1 If there is a Section H default the Panel may under Section H3.2.2(e), if it has the approval of the Authority, suspend the right of the defaulting Party to register further Metering Systems and BMUs.

11.2 A question has arisen which relates to how much practical effect a resolution of the Panel to suspend the right of a Party to register further Metering Systems can have. The background to this issue is that the Code in Section K requires a Party to install Metering Equipment and to register the Metering Systems which result from the installation of such Metering Equipment. Section K also requires the Party to register BMUs comprising the relevant Plant and Apparatus involved in the Export and Import of electricity. If the Party fails to do so it will be in breach of the Code.

11.3 Metering Systems must be registered in either CMRS ("the Central Meter Registration Service") or in SMRS ("the Supplier Meter Registration Service"). Registration in CMRS is via the Central Registration Agent ("CRA"), who is a BSC Agent under the Code. Applications for the registration of BMUs also go through the CRA. As the CRA is a BSC Agent, it is considered that there is adequate ability to ensure that if the Panel makes a resolution under Section H to suspend a Party's right to register further BMUs and to register those Metering Systems which are registered in CMRS, such a resolution can be carried out and have practical effect.

11.4 However, the SMRS is a service provided by Licensed Distribution System Operators ("LDSOs") for the registration of Metering Systems on the Boundary Points with Distribution Systems in accordance with Master Registration Agreement ("the MRA"). Registration in SMRS is undertaken by the Supplier Meter Registration Agent ("SMRA"). The SMRA is defined under the Code as being an LDSO acting in its capacity as the provider of an SMRS.

11.5 As I understand it, the MRA also contains rights and obligations requiring the relevant Parties to register "Metering Points" (which are essentially identical to Metering Systems under the Code). The MRA essentially provides that the provider of the Metering Points Administration Service ("MPAS") under the MRA is obliged to register the Metering Points where the appropriate application is made and where there is nothing in the MRA to prevent this.

11.6 As a result of this there is some concern that while the Panel has the right to make a resolution suspending the right of a Party to register in SMRS, such a resolution may be of no practical effect as there is nothing which would entitle the MPAS provider under the MRA to have regard to it.

11.7 Discussions have taken place between ELEXON and the administrator of the MRA. The suggestion has been made that the MRA be amended to require the MPAS provider not to register further Metering Points where the Panel has passed a Section H resolution. Discussions on the matter are proceeding satisfactorily to date.

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