

Stage 01: Initial Written Assessment

P306 'Expanding the Definition of a 'Letter of Credit' to include regulated insurance companies'

P306 proposes changes to expand the definition of a Letter of Credit to include other financial institutions, increasing the range of providers capable of meeting the BSC requirements.



ELEXON recommends P306 is progressed to the Assessment Procedure for an assessment by a Workgroup

This Modification is expected to impact:

- BSC Parties
- ELEXON

What stage is this document in the process?

01 Initial Written Assessment

02 Definition Procedure

03 Assessment Procedure

04 Report Phase

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About This Document

This document is an Initial Written Assessment (IWA), which ELEXON will present to the Panel on 12 June 2014. The Panel will consider the recommendations and agree how to progress P306.



Any questions?

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1 Why Change?

What is Credit Cover?

Credit Cover is cash, Letter of Credit or a combination of both provided by a BSC Party to cover Trading Charges.

Under the BSC arrangements, payments by Trading Parties for Trading Charges arising on any particular Settlement Day are typically made 29 calendar days later. Thus, at any given time, Parties may have debts (or be due payments) for Trading Charges incurred over the previous 29 days.

The purpose of Credit Cover is to ensure that, should a Party default, sufficient collateral is available to pay these debts. If a Party does not have sufficient funds they can enter into Credit Default.

What is a Letter of Credit?

In the case of the BSC a Letter of Credit means an unconditional, irrevocable standby letter of credit in the form set out in BSC Section M Annexes M1, M2, M3 or as such other form as approved by the BSC Panel.

Under the BSC, banks that are able to supply Letters of Credit are defined as being one of the following:

- Any United Kingdom clearing bank(s); or
- Any other bank(s) which has (have) a long term debt rating of not less than a single rating of A¹ by [Standard & Poor's Corporation](#) or by [Moody's Investors Services Inc.](#); or
- Any other bank(s) as the Panel may approve.

What is the Issue?

During 2012 and 2013 Moody's Investors Services (also referred to as Moody's) and Standard & Poor's Corporation downgraded several licensed banks. This resulted in a reduction in the number of financial institutions with the required credit rating of A or above needed to provide security on behalf of Parties under the BSC.

A smaller pool of prospective security providers, and the potential for further downgrading, is unlikely to incentivise banks and similar entities to maintain or reduce charges for providing security. The Proposer considers the view that smaller companies may find it cheaper to lodge cash than negotiate a Letter of Credit with banks.

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¹ An 'A' rating means a "Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances".

Proposed solution

This Modification proposes that the definition of a Letter of Credit under the BSC is expanded to include regulated insurance companies that can provide “like for like” products to that of a bank (e.g. performance bonds). Regulated insurance companies are normally members of the [International Credit Insurance & Surety Association](#)² (ICISA) and capable of providing security of a similar level and form as that provided by a bank. This would provide individual BSC Parties with additional options in which to provide Credit Cover under the BSC.

The Proposer believes that the following changes to the BSC will need to be considered as part of this Modification’s Assessment:

- introduce a third option under Section M2.1.1 such as “c) a performance bond valid for an initial of not less than three months” and also defining the term “performance bond” under Section X Annex X-1; or
- expanding the definition of the term “letter of credit” by including a performance bond issued by a regulated insurance company. This could be done by replacing the term “letter of credit” used in Section X Annex X-1 with “letter of credit/guarantee” to avoid any confusion. A new Section M Annex M-4 will need to be inserted into Section M with an acceptable form of the wording applicable to the letter of guarantee.

However, the Proposer leaves such changes open to the Workgroup to determine the most appropriate definition to implement their proposed solution.

Applicable BSC Objectives

The Proposer believes that P306 will better facilitate:

- **Applicable BSC Objective (c)** as it seeks to increase the range of providers capable of meeting the BSC requirements relating to the provision of security available to BSC Parties, thereby improving competition and reducing costs incurred by BSC Parties.

Related industry changes

CMP228

The Connection and Use of Systems Code (CUSC) definition of “Qualified Bank” requires the entity providing a Performance Bond or Letter of Credit to a company to meet the general description of being a ‘bank’, which might imply that the entity is expected to hold a UK banking licence. CUSC Modification Proposal (CMP) [228 ‘Definition of ‘Qualified Bank’](#) was raised to make changes to the definition of ‘Qualified Bank’ to include ‘trade credit insurance company’, thereby increasing the number of prospective providers of security available to users.

² The ICISA provides a forum for the continuous exchange of ideas and information, in order to support improving and developing the specialised services its members give the business world. This includes the exchange of views and experience about trading conditions and developments in particular industrial and trade sectors as well as markets, the exchange of information about credit risks and co-operation through reinsurance arrangements.



What are the Applicable BSC Objectives?

(a) The efficient discharge by the Transmission Company of the obligations imposed upon it by the Transmission Licence

(b) The efficient, economic and co-ordinated operation of the National Electricity 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 of the balancing and settlement arrangements

(e) Compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or the Agency [for the Co-operation of Energy Regulators]

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On 28 February 2014 the CUSC Panel approved CMP228 as Self-Governance. The objection window for this change will close on 20 June 2014. If no objections are received CMP228 will be implemented on 7 July 2014.

Interactions with P307 and P308

This Modification has been raised alongside two other Modifications relating to the credit arrangements. However, while these Modifications are all looking at the credit arrangements, each is looking at a different aspect of the process and proposing mutually independent solutions. To summarise, these three proposals are:

- [P306 'Expanding the definition of a 'Letter of Credit' to include regulated insurance companies'](#) (this proposal) proposes to allow individual Parties to obtain a Letter of Credit from a regulated insurance company that is capable of providing security of a similar level and form as that provided by a bank.
- [P307 'Amendments to Credit Default arrangements'](#) proposes to amend the timings, triggers and thresholds in relation to Credit Default, including adjusting the thresholds for entering Credit Default, extending the duration of the Query Period and reviewing the processes around the Cure Periods.
- [P308 'Alternative security product for securing credit under the BSC'](#) proposes to introduce a centrally provided alternative security product as an alternative method for securing credit under the BSC, which Parties could use in place of the existing requirements to provide Credit Cover individually.

All three Modifications can be progressed and implemented independently of each other; P306 could be implemented both with and without P307 or P308, and the solution it proposes would not impact the solutions proposed by the others. Nevertheless, all three Workgroups should be mindful of the other proposed solutions when developing its solution.

3 Areas to Consider

In this section we highlight areas which we believe the Panel should consider when making its decision on how to progress this Modification Proposal, and which a Workgroup should consider as part of its assessment of P306. We recommend that the areas below form the basis of a Workgroup's Terms of Reference, supplemented with any further areas specified by the Panel.

Definition of Letter of Credit

P306 proposes that the definition of a Letter of Credit under the BSC is expanded to include regulated insurance companies that can provide "like for like" products to that of a bank (e.g. performance bonds). The Proposer believes that there are a few different ways this change can be reflected in the BSC, as detailed in Section 2. Therefore, the Proposer considers that it is important for the P306 Workgroup to consider all the potential ways forward and determine the most appropriate definition of Letter of Credit.

Are changes needed to the credit ratings required under the BSC?

During 2012 and 2013 Moody's and Standard & Poor's downgraded several licensed banks, reducing the number of financial institutions with an adequate credit rating to provide security on behalf of Parties under the BSC. A smaller pool of prospective security providers, and the potential for further downgrading, is unlikely to incentivise banks and similar entities to maintain or reduce charges for providing security.

The Proposer considers that the pool of prospective providers should be expanded to include regulated insurance companies which will provide more options to individual Parties, facilitating competition. However, we believe it is important for the Workgroup to consider if changes are needed to the current credit level requirements under the BSC to further expand this pool of prospective providers.

Self-Governance

P306 is intended to increase the range of providers capable of meeting the BSC requirements relating to the provision of security. The Proposer believes that this Modification will not result in a reduction in the level of security currently provided by BSC Parties to the BSC Clearer³. Thus, the Proposer considers this change unlikely to have a material effect on any of the areas listed under the Self-Governance Criteria, and has therefore requested that P306 be progressed as a Self-Governance Modification.



What is the Self-Governance Criteria?

A Modification that, if implemented:

- (a) is unlikely to have a material effect on:
 - (i) existing or future electricity consumers; and
 - (ii) competition in the generation, distribution, or supply of electricity or any commercial activities connected with the generation, distribution, or supply of electricity; and
 - (iii) the operation of the national electricity transmission system; and
 - (iv) matters relating to sustainable development, safety or security of supply, or the management of market or network emergencies; and
 - (v) the Code's governance procedures or modification procedures; and

(b) is unlikely to discriminate between different classes of Parties.

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³ The BSC Clearer means Elexon Clear Limited (or any successor to that company in the capacity of the BSC Clearer).

Areas to consider

The table below summarises the areas we believe a Modification Workgroup should consider as part of its assessment of P306:

Areas to Consider
What is the most appropriate definition for a Letter of Credit under the BSC?
Should regulated insurance companies be allowed to provide a Letter of Credit?
Are changes required to the credit ratings required to provide a Letter of Credit?
Does P306 meet the Self-Governance Criteria?
What is the most appropriate implementation approach?
What changes are needed to BSC documents, systems and processes to support P306 and what are the related costs and lead times?
Are there any Alternative Modifications?
Does P306 better facilitate the Applicable BSC Objectives than the current baseline?

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4 Proposed Progression

Next steps

We believe that P306 should go into an Assessment Procedure so that a Workgroup can consider the areas outlined in Section 3.

Workgroup membership

We recommend that the Workgroup membership should be formed of experts on the credit processes and any other relevant experts and interested parties.

Timetable

The Proposer does not anticipate any material impacts on participants due to the implementation of P306. However, given the number of changes being raised in the industry we want to ensure that there is enough time for individuals to get involved in the P306 Modification process. Therefore, we are recommending a three month Assessment procedure with the Assessment Report being presented to the Panel at its meeting on 11 September 2014.

We believe that the Workgroup will need to undertake the activities shown in the table below, which includes a 15 Working Day Assessment Consultation. The timetable below allows for this and for the Workgroup to fully consider the areas highlighted in the Terms of Reference.

Proposed Progression Timetable for P306	
Event	Date
Present Initial Written Assessment to Panel	12 Jun 14
Workgroup Meeting	W/B 07 Jul 14
Assessment Procedure Consultation	25 Jul 14 – 15 Aug 14
Workgroup Meeting	W/B 18 Aug 14
Present Assessment Report to Panel	11 Sep 14
Report Phase Consultation	12 Sep 14 – 26 Sep 14
Present Draft Modification Report to Panel	09 Oct 14
Issue Final Modification Report to Authority	10 Oct 14

5 Likely Impacts

Impact on BSC Parties and Party Agents

We do not anticipate any direct impacts on participants due to the implementation of this Modification. Though, participants will have an additional method for providing a Letter of Credit under the P306 solution.

Impact on Transmission Company

We do not anticipate there to be an impact on the Transmission Company due to the implementation of P306.

Impact on BSCCo

Area of ELEXON	Potential Impact
Finance	ELEXON will be required to manage a further type of Letter of Credit.

Impact on BSC Systems and processes

It is not anticipated that system changes will be required due to the implementation of P306. Though, as the solution develops this will be confirmed as part of the Modification's Assessment.

Impact on Code

Code Section	Potential Impact
Section M	Changes may be required to implement this Modification.
Section X Annex X-1	

6 Recommendations

We invite the Panel to:

- **AGREE** that P306 progresses to the Assessment Procedure;
- **AGREE** the proposed Assessment Procedure timetable;
- **AGREE** the proposed membership for the P306 Workgroup; and
- **AGREE** the Workgroup's Terms of Reference.

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Appendix 1: Glossary & References

Glossary of defined terms

Acronyms and other defined terms used in this document are listed in the table below.

Glossary of Defined Terms	
Acronym	Definition
CMP	CUSC Modification Proposal
CUSC	Connection Use of Systems Code
ICISA	International Credit Insurance & Surety Association
IWA	Initial Written Assessment

External links

A summary of all hyperlinks used in this document are listed in the table below.

All external documents and URL links listed are correct as of the date of this document.

External Links		
Page(s)	Description	URL
3	BSC Sections page of BSC website	http://www.elexon.co.uk/bsc-related-documents/balancing-settlement-code/bsc-sections/
3	Standard and Poor's Corporation website	http://www.standardandpoors.com/en_EU/web/guest/home
3	Moody's Investors Services In. website	https://www.moodys.com/
4	ICISA website	http://www.icisa.org/
4	CMP228 page of National Grid's website	http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP228/
5	P306 webpage	http://www.elexon.co.uk/mod-proposal/p306/
5	P307 webpage	http://www.elexon.co.uk/mod-proposal/p307/
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