# ISG183/04 – FURTHER REVIEW OF BSC CREDIT MODIFICATIONS

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| **Summary** | Following the January 2016 ISG meeting and February 2016 Panel meeting, ELEXON completed a further review of the impact of three Credit Cover related BSC Modifications. It highlights the observed benefits brought by Modification P306 'Expanding the definition of a "Letter of Credit" to include regulated insurance companies', P307 'Amendments to Credit Default arrangements' and P310 'Revised Credit Cover for Exporting Supplier BM Units'. |

## 1. Background

1.1 This review follows the review brought to the ISG in January 2016 (ISG 177/02) and to the Panel in February 2016 (249/15). At its meeting in January the ISG asked ELEXON to bring an additional review of Modifications P307 and P310 a year after implementation. We have reviewed the impact on Parties' Credit Cover and tried to identify changes in behaviour. In addition we have included analysis on Modification P306 which ELEXON implemented in November 2014.

1.2 This paper provides a summary of our analysis and findings. Appendix 1 contains a more detailed assessment of how the modifications have affected the provision of Credit Cover. In addition we have tried where possible, to identify the individual effects of each Modification on the level of Credit Cover across the market.

1.3 As observed in the last review, the overall impact of the three Modifications is positive. Parties have been able to reduce their Credit Cover and have more choice in the products used as Credit Cover due to the Modifications.

**Modification P306**

1.4 At the June 2015 and January 2016 ISG meetings, ELEXON reported minimal impact in Parties' activities following Modification P306, implemented in November 2014. Since then, no financial product equivalent was issued by an insurance company to be held as Credit Cover. However, there are currently two issuing banks that are solely qualified by Fitch Ratings, a scenario introduced by Modification P306. More detail is provided in Section 2 in Appendix 1.

**Modification P307**

1.5 On 25 June 2015, the day of the June 2015 release and the implementation of Modifications P307 and P310, BSC Parties had £347m of Credit Cover lodged with ELEXON. This amount dropped by mid-August and remained between £323m and £330m until mid-December. The amount of Credit Cover increased by approximately £50m prior to the Christmas and New Year bank holidays, however this is not unusual. The industry experiences peak Energy Indebtedness at this time each year due to a greater reliance on estimated data in the Credit Cover Percentage calculation for non-Working Days.

1.6 Since the June 2015 release, seven Parties have directly taken advantage of Modification P307. They had until 14:00 the next Working Day to bring their Credit Cover Percentage to below 90% to avoid Level 2 Credit

 

Default. Before the implementation of Modification P307, those Parties would have been in Credit Default. Indeed, previously the BSC allowed Parties 24 hours before entering Level 2 Credit Default which could have been triggered during the weekend. More detail is included in Section 3 in Appendix 1.

**Modification P310**

1.7 From the amounts of credit withdrawn in July and August 2015, £5.2m can be directly attributed to the implementation of Modification P310 as reported by impacted Parties. As of June 2016, we estimate a further £8m could be withdrawn and we have approached affected Parties to highlight the possibility to withdraw such amounts. More detail is included in Section 4 in Appendix 1.

**Further Credit related Modification**

1.8 In February 2017, approved BSC Modification P326 'Introduction of a non-Working day adjustment to the Credit Cover Percentage calculation' will change the estimation of metered volumes to take into account changes between Working days and non-Working Days. Analysis undertaken during the Modification's development demonstrated that the solution could have resulted in a 5.28% reduction in absolute estimation inaccuracy in 2013 (4,300GWh) and a 2.98% reduction in 2014 (2,400GWh).

## 2. Conclusions

2.1 Overall the three Modifications have had a positive impact on BSC Parties' operation in the BSC. Some reduction in Credit Cover can be directly attributed to Modification P310. Further, since its implementation in June 2015, Modification P307 has allowed seven Parties to avoid consequences of Level 2 Credit Default where they have guaranteed Business Hours to increase Credit Cover and resolve the default. Additionally, Modification P306 has allowed eight Parties' Letters of Credit to remain qualified under the BSC requirements despite changes in credit ratings.

## 3. Next steps

3.1 We will continue monitoring the effect of the three Modifications, particularly P307 and P310, on Parties' credit situations. We will continue to educate Parties that could better understand the rules and use this to manage their Credit Cover efficiently for their business.

3.2 We will update the BSC Panel with a summary of our findings at its next meeting, on 11 August 2016. We welcome comments from the ISG on our analysis of the benefits of these three Modifications and will include these comments in our report to the Panel.

## 4. Recommendations

4.1 We invite you to:

a) **NOTE** the update given on the impact of Modifications P306, P307 and P310; and

b) **PROVIDE** comments on this analysis to be shared with the BSC Panel at its meeting on 11 August 2016.

## Appendices

Appendix 1 – Individual Modifications analysis

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## Appendix 1 – Individual Modifications analysis

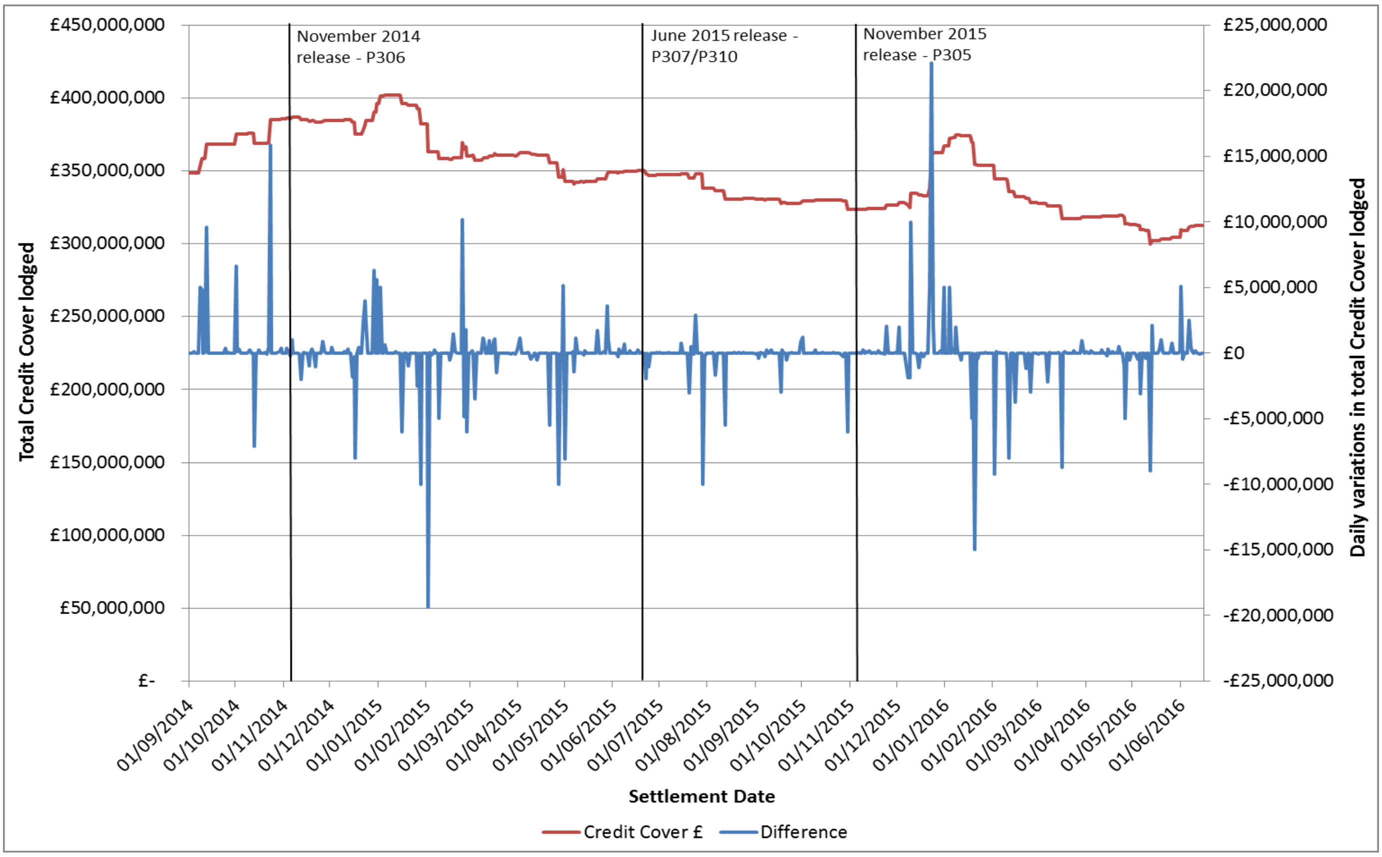
## 1. Overall analysis

1.1 **Graph 1** displays the total amount of Credit Cover lodged by Parties since 1 November 2014 and the daily variations. The implementation of Modification P306 did not have an immediate effect on the amount of cash Credit Cover lodged but we observe a trend of decreasing Credit Cover from January 2015. This trend accelerated following the June 2015 release and the implementation of Modifications P307 and P310. Following the November 2015 release and the implementation of Modification P305 – Electricity Balancing Significant Code Review Developments, we have seen market prices fall which has led to decreases in the Credit Assessment Price (CAP), reducing the Credit requirement of many Parties. Additionally, average Imbalance Prices also went down since November 2015, potentially reducing the need for Credit Cover. In December 2015 levels of Credit Cover started to increase to cover the Christmas period, similar to behaviour seen in previous years.

1.2 Historically, Parties have tended to increase Credit Cover towards the Christmas period to avoid the risk of Level 2 Credit Default at a time when workers are more likely to take annual leave and when there are fewer non-working days than usual. It could be the case that Parties have not amended operational procedures to use the Business Hours available to resolve a default notice. However, feedback from one Party suggests that the timescales for signing off and providing additional Credit Cover still make it difficult to meet the 14:00 deadline.

1.3 Following the Christmas peak in Credit Cover, Parties withdrew large amounts from mid-January 2016 to mid-May 2016, to below £300m. This may be due to several factors including the fall in wholesale electricity prices which impacts Trading Charges, a longer market-wide imbalance position and the decrease of the Credit Assessment Price (CAP) over the same period.

**Graph 1:** Total amount of Credit Cover lodged and daily variations




## 2. Modification P306 – 'Expanding the definition of a "Letter of Credit" to include regulated insurance companies'

2.1 The credit ratings of several licensed banks were downgraded over 2012/2013. This resulted in reduced numbers of financial institutions with an adequate credit rating to provide security to BSC Parties. A smaller pool of prospective security providers, and the potential for further downgrading, is likely to increase costs of Credit.

2.2 To address this issue, Modification P306 introduced an option for BSC Parties to use an Approved Insurance Product from a regulated insurance company as a form of security equivalent to a Letter of Credit. This Modification also added Fitch Ratings to the list of approved rating agencies. P306 therefore expanded the options for lodging credit and the pool of financial institutions able to provide security under the BSC.

2.3 ELEXON implemented Modification P306 on 14 November 2014. ELEXON presented a preliminary analysis of the impact of P306 to the ISG at its June 2015 meeting and included an update in the January 2016 paper.

2.4 To date, no Party has used an Approved Insurance Product issued by a regulated insurance company as Credit Cover.

2.5 Only two new Letters of Credit were received since January 2016. They were issued by a provider approved by all three rating agencies, meaning they would have been valid whether or not they were approved by Fitch Ratings.

2.6 However, two issuing banks have seen their rating downgraded by Standard & Poor's Corporation and Moody's below the BSC acceptable level (a single A which can be appended by a '+' or '–' for Standard & Poor's and Fitch Ratings or by a 1, 2 or 3 for Moody's, according to BSC Section X-1), leaving Fitch Ratings as the sole ratings agency for their products to be accepted as Credit Cover. Consequently, eight BSC Parties, which have their Letters of Credit issued by one of the two banks, did not have to provide an alternative form of Credit Cover as their credit ratings were still acceptable according to Fitch Ratings assessment.

2.7 To conclude, although no one has yet used an Approved Insurance Product, several Parties have been able to benefit from the additional approved rating agency introduced by this Modification.

## 3. Modification P307 – 'Amendments to Credit Default arrangements'

3.1 When a Party triggers the Credit Default process due to a Credit Cover Percentage (CCP) of 80% or greater, a Query Period of 24 hours commences to allow for initial investigation and resolution of the issue. There can be scenarios where the Query Period includes no Business Hours in which the Party can lodge further Credit Cover. To avoid a default situation where a Level 2 Default notice and Query Period occurred outside of Business Hours, Parties used to have a restricted number of options: purchasing additional energy volume or, where the need for additional credit could be forecast, lodging excess Credit in advance to mitigate the risk. These pre-Modification P307 provisions adversely incentivised Parties to lodge higher amounts of Credit Cover to avoid the risk of entering Credit Default, particularly in the event where there are no Business Hours to resolve the issue.

3.2 To solve this type of situation, Modification P307 changed the way the Query Period was applied. The Query Period was changed from simply 24 hours to a period of at least 24 hours which must include a minimum of five consecutive Business Hours. This change means that Parties that breach over the weekend have more opportunity of increasing their Credit Cover to resolve a Credit breach. Without this option, a Credit Cover Percentage exceeding 100% could result in Level 2 Credit Default during a weekend. This would result in Energy Contract refusal and rejection. This Modification gave Parties more flexibility to act when breaches occur on weekends and Bank Holidays. It has potentially allowed them to lodge less Credit Cover knowing they have until 14:00 the next Business Day to resolve the situation in case of a Level 1 default notice.

3.3 Since our last review of the Credit Mods in January 2016, 23 Level 1 default notices (80%) were sent to 13 individual Parties.

3.4 From those 23 notices, ELEXON issued 16 on a non-Working Day and had the Query Period running until 14:00 the next Working Day to reduce the Credit Cover Percentage. 11 of these breaches were resolved before the Credit Cover Percentage went above 100%.

3.5 Five Parties would have entered Level 2 Credit Default if Modification P307 had not changed the rules. Whilst the Parties' Credit Cover Percentage went above 100% during the first 24 hours, they could resolve their situation within the first five hours of the next Business Day and therefore the Parties avoided Level 2 Credit Default and its negative consequences. The higher number of Parties that have benefitted from P307 compared to our first 6 months review (only two Parties), is due to the number of Bank Holidays in April and May that increased the chances of Parties triggering Level 1 default during a non-working day.

3.6 Since the implementation of Modification P307 last June, there were 51 Level 1 default notices (i.e. a CCP >80%) sent to 29 individual Parties. Seven Parties took directly advantage of Modification P307 since its implementation.

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## 4. Modification P310 – 'Revised Credit Cover for Exporting Supplier BM Units'

4.1 Modification P310 introduced a method that allowed ELEXON to more accurately estimate metered volumes for net exporting Supplier BM Units (e.g. embedded generation). Prior to P310, the method for estimating net exporting Supplier BM Units indebtedness resulted in high estimates of indebtedness which required Parties to lodge excessive Credit Cover. This was because the calculation did not estimate the BM Unit Metered Volume as generation, but zero demand volume instead. This Modification only affects Supplier BM Units with a Generation Capacity of greater than zero and a Demand Capacity of zero

4.2 Since 1 January 2016 and our report to the ISG in January 2016, the same 11 Parties remain affected by the changes introduced by P310. Of these 11 Parties, two withdrew Credit Cover totalling £1.6m and five did not change their Credit Cover. Three Parties could have withdrawn a total of £8m since the 1 March 2016 without triggering the Credit Default processes. ELEXON have again contacted one Party that make up £7m of this total and they have confirmed no intention to reduce this amount. Due to the fact that the new review period (1 January 2016 to June 2016) does not span the June 2015 implementation date of P310, we cannot attribute the reduction in Credit Cover to benefits realised under this Modification.