

P308 'Alternative security product for securing credit under the BSC'

This Industry Consultation on Potential Solutions for P308 was issued on Monday 3 August 2015, with responses invited by Monday 24 August 2015.

Phase

Initial Written Assessment

Definition Procedure

Assessment Procedure

Report Phase

Implementation

Consultation Respondents

Respondent	No. of Parties/Non-Parties Represented	Role(s) Represented
EDF Energy	9/0	Generator, Supplier, Non Physical Trader, ECVNA, MVRNA, Supplier Agent
Drax Power Limited	1/0	Generator
Green Energy UK	1/0	Supplier
Haven Power Ltd	1/0	Supplier
RWE npower	1/0	Supplier
ScottishPower Group	5/0	Generator, Supplier, Distributor, Interconnector User, Non Physical Trader, ECVNA, MVRNA, Supplier Agent
SmartestEnergy	1/0	Supplier

Question 1: Do you agree that intervention point 1 should be removed as a possible solution option for P308?

Summary

Yes	No	Neutral/No Comment	Other
7	0	0	0

Responses

Respondent	Response	Rationale
EDF Energy	Yes	<p>“Intervention point 1” is used in the consultation document to indicate a situation where there has not yet been a payment default; merely a level 1 or level 2 credit default. We do agree with the workgroup that the new product or solution, whatever other characteristics it may have, must pay out immediately upon request, in order to allow ELEXON to clear its position for that day following a default. A level 1 (80% of credit cover used up) or level 2 (90% of credit cover used up) credit default is not a payment default, and we agree that it is not an appropriate trigger, or “intervention point”, for irrevocable payout by the insurer on the new product. Insurers need a clear breakpoint to pay out against, which we believe to be a proper BSC Section H financial default. Where the workgroup has referred to the product being able to pay out ‘immediately’ on request, we think up to 3-5 business days for payment is more realistic and still acceptable compromise, and would be more workable for insurers. Any longer than that, though, would be too slow. We would emphasise that although we know it sometimes takes “traditional” insurers time to prove a claim, and therefore the payout takes longer, if they want this new BSC business, they have to come up with a product that suits our needs, i.e. more on demand than conditional. It should not be subject to challenge or arbitration or loss adjustment – but if it takes up to 3-5 business days for an unconditional payment, that is acceptable.</p>
Drax Power Limited	Yes	<p>If this point is of no interest to insurers then we agree that it should be removed as a possible solution. Please see our answer to Q7 for comments regarding the development of an appropriate metric.</p>
Green Energy UK	Yes	<p>We agree with the working groups recommendation as an insurance product is unlikely to be</p>

Respondent	Response	Rationale
		forthcoming.
Haven Power Ltd	Yes	If this intervention point is of no interest to insurers, we agree it should be removed.
RWE npower	Yes	Yes, in view of the specifications of P308, since the default associated with intervention point 1 is of a temporary nature.
ScottishPower Group	Yes	We agree that, as Level 1 defaults are mainly temporary in nature, an insurance solution is not appropriate here.
SmartestEnergy	Yes	-

Question 2: Do you agree that the pre-funding option should not be developed any further by INDECS and removed as a possible solution option for P308?

Summary

Yes	No	Neutral/No Comment	Other
6	0	0	1

Responses

Respondent	Response	Rationale
EDF Energy	Yes	We agree that the solution, whatever it may be, should not increase moral hazard in the system for risk of rogue trading or insolvency – it should not entail cross-subsidy by others of firms with poor credit risks for whatever reasons. The idea that was raised by INDECS and discussed, of all BSC parties paying into a pot over time to a fund that can be used when a party defaults “to avoid a funding call on the other parties”, is not consistent with this principle, and forms no part of the proposal as raised either, as it was posited on being an OPTIONAL ALTERNATIVE to the existing instruments of cash or a letter of credit, but not a REPLACEMENT for those, which would represent a far more radical modification – and is not what was raised.
Drax Power Limited	Yes	INDECS has stressed that the negatives of this will outweigh the positives. We therefore agree that this should be removed as an option.
Green Energy UK	Yes	The level of estimation that would be necessary for a pre-funding option is likely to make the product very unpopular, and therefore we are prepared to agree with the recommendation. However, we do feel that the level of estimation would decrease over time, as trading patterns become more consistent, and pre-funding would negate a significant amount of risk.
Haven Power Ltd	Yes	The number of flaws highlighted for this option, including expense and a reliance on estimation of defaults, rule it out as a potential solution.
RWE npower	Yes	Yes, as the default associated with intervention point 2 is also of a short term nature, as well as the likely cost and difficulty of default estimation involved in this option.

Respondent	Response	Rationale
ScottishPower Group	Yes	We agree that pre funding gives rise to several uncertainties and should not be developed.
SmartestEnergy	Yes and No	We agree that the pre-funding solution should not be developed any further by INDECS as they are looking at solutions which can be presented to insurers. This does not automatically mean, however, that the pre-funding option should not be explored further. We feel that it needs to be explored part of P308 so that the solution can be compared with other options. It would be interesting to note how much money would accumulate say, if for this segment of risk, all parties paid in the equivalent of the cost of capital i.e. there would be no additional cost if Parties could reduce their capital. Obviously, the issue of allowing opting-out would need to be considered.

Question 3: Do you agree that the post-funding option should not be developed any further by INDECS and removed as a possible solution option for P308?

Summary

Yes	No	Neutral/No Comment	Other
6	0	0	1

Responses

Respondent	Response	Rationale
EDF Energy	Yes	We agree that the solution, whatever it may be, should not increase moral hazard in the system for risk of rogue trading or insolvency – it should not entail cross-subsidy by others of firms with poor credit risks for whatever reasons. The idea that was raised by INDECS and discussed, of all BSC parties paying AFTER A DEFAULT to cover the shortfall of funds held by ELEXON when a party defaults, is not consistent with this principle, and forms no part of the proposal as raised either. Ultimately what happens currently if there is an unsecured loss is that, as ELEXON has no balance sheet, all other parties do pay to cover the unsecured loss left by the defaulter if inadequate security had been lodged (so that the arrangements had not worked as intended), but this is a highly undesirable last resort and is exactly what good credit arrangements are aimed at avoiding.
Drax Power Limited	Yes	Drax agrees with the Workgroup's opinion that ELEXON is better placed to manage this intervention point.
Green Energy UK	Yes	We agree that post-funding has the same issues as prefunding, with the added issue of the ELEXON vires.
Haven Power Ltd	Yes	The Workgroup agreed that the post-funding option would not be appropriate, and this intervention point is better managed by ELEXON.
RWE npower	Yes	Yes, as the default associated with intervention point 2 is of a temporary nature.
ScottishPower Group	Yes	We agree with the workgroups deliberations on this.
SmartestEnergy	Yes and No	Again, we agree that the post-funding solution should not be developed any further by INDECS as they are looking at solutions which can be

Respondent	Response	Rationale
		<p>presented to insurers. This does not automatically mean, however, that the post-funding option should not be explored further. If it is explored further it does need to be done as part of P308 so that the boundary between temporary and permanent default may be determined.</p>

Question 4: Do you agree that intervention point 3 should be developed further as part of P308?

Summary

Yes	No	Neutral/No Comment	Other
7	0	0	0

Responses

Respondent	Response	Rationale
EDF Energy	Yes	“Intervention point 3” is the name the workgroup has given to “permanent payment default” by a BSC Party, presumably events of default under BSC sections H3.1.1(b) or (g), and it does seem the right trigger for this mod, and so is the trigger or intervention point, of the three given, that seems to have the greatest potential merit. (As distinct from temporary payment default for Intervention point 2). There has been a suggestion that the P308 solution might not cover the smallest losses – but if it is to work, absent a letter of credit or insurance equivalent (as per BSC P306) or cash deposit from the defaulter, then the solution must cover these losses, and the largest losses if secured under this scheme, to avoid the moral hazard of other parties doing so (perhaps there could be a compromise around very small, de minimis, losses, though).
Drax Power Limited	Yes	The P308 assessment procedure shows this intervention point would most likely be developed into a possible solution. We agree with INDECS and the Workgroup that this should be developed further as part of P308.
Green Energy UK	Yes	We feel that it is correct for the working group to develop intervention point 3 further, however we are sceptical about the outcome. In the event of a ‘catastrophic loss’ sizable enough to force one of the major players into financial difficulties we are told that the insurance is unlikely to provide any relief from the cash constraints that all parties will be facing in the short term, and government will step in. We are also told that ‘attritional losses’ will not be covered by the insurance product, and therefore we are unsure what the advantage would be to an actual default.
Haven Power Ltd	Yes	Based on INDECS’ assessment of the potential

Respondent	Response	Rationale
		solutions, intervention point 3 would appear to be the best option to explore further.
RWE npower	Yes	Yes, we would be interested in further investigation of possible solutions at this intervention point, in particular an associated cost-benefit analysis of each.
ScottishPower Group	Yes	The workgroup should continue to develop a solution to Section H default, as this seems to best fit the insurance model. An irrevocable failure can be risk assessed and priced appropriately. The current arrangements are not entirely financially robust to the loss of a major Party and this should be addressed as swiftly as possible.
SmartestEnergy	Yes	However, we wonder whether the temporary funding by Parties negates the whole purpose of the insurance. If the loss is "catastrophic" Parties would need to stump up significant amounts of money anyway. The fact that it would be paid back is largely irrelevant; it could cause cash flow issues for some parties.

Question 5: Do you agree that INDECS should consider the Commercial Insurance Market and Capital Markets further but discount the other insurance options?

Summary

Yes	No	Neutral/No Comment	Other
7	0	0	0

Responses

Respondent	Response	Rationale
EDF Energy	Yes	<p>INDECS advised the workgroup that the capital markets have developed securitised bonds for particular catastrophe scenarios, and are marketing these to cover a defined menu of selected major natural catastrophes, for example hurricanes in the United States. INDECS further advised the workgroup that capital markets are often more expensive than insurance solutions and so may not represent an optimal solution. However, INDECS offered to make some discreet enquiries as to whether there is an appetite in these markets for risk financing if a large VI utility or Supplier defaulted, e.g. at times when prices trend to VOLL, as Exelon had suggested that worst-case unsecured losses could top £100m, perhaps exceeding what the commercial insurance market would be willing to cover (it might want a cap). The Workgroup agreed that INDECS should carry out this investigation – it might lead to a hybrid solution as optimal. It is indeed quite feasible, it seems to us, that insurers will not agree to an unlimited payout or, if they do, it won't be economic to agree, so a hybrid solution could involve insurers for the first £xxxxx, then a capital markets payment as the economic solution above this. This does then have the feature of more complexity.</p> <p>A mutual insurance company owned by the ESI is rightly ruled out as it merely amounts to self-insurance and brings back the "moral hazard"; there is no true transfer of risk with this option. We also agree with the conclusion that the ESI cannot rely on a government bailout in the event of a failure of a BSC Party.</p>
Drax Power Limited	Yes	<p>Noting the lack of claims experience within the commercial insurance market and generally more expensive insurance solutions in the capital markets, we agree that these options should be</p>

Respondent	Response	Rationale
		considered further. We agree with INDECS and the Workgroup that the other options are much less credible than those available in the capital and commercial insurance markets.
Green Energy UK	Yes	We feel that these are the most appropriate Markets to consider.
Haven Power Ltd	Yes	Based on INDECS' commentary, Commercial Insurance Markets and Capital Markets are the most appropriate insurance options.
RWE npower	Yes	Yes, as these are seen as the only viable and cost effective options.
ScottishPower Group	Yes	We believe that to be the most cost effective way forward.
SmartestEnergy	Yes	However, as stated above, due to the fact that Parties would need to stump up money anyway, we believe the pre-funding and mutual insurance company options should be considered further.

Question 6: Are there any other options you believe should be considered?

Summary

Yes	No	Neutral/No Comment	Other
3	4	0	0

Responses

Respondent	Response	Rationale
EDF Energy	Yes	We believe that annual pricing of the sort of product that might be developed, rather than seasonal pricing, may, depending on INDECS' advice, be more realistic. This is because most insurance products that we see are for a year; this does mean that the insurance cover needs to be non-cancellable for that whole year.
Drax Power Limited	No	-
Green Energy UK	Yes	We agree that the credit requirements under the BSC are stringent; however we feel that P308 has the potential to create adverse unintended consequences. Our view is that a half-way house solution could be possible by reducing the timescales over which parties pay for their Trading Charges. Currently the BSC stipulates that these charges are paid 29 days after the settlement period they occurred in, by reducing this period (for example to 14 days) it would reduce the levels of debt, and therefore the credit requirements imposed on to the parties could be reduced. This solution would achieve the same goal as P308 without the need for a centrally funded credit underwriter.
Haven Power Ltd	No	It is clear that the current credit cover arrangements are far from ideal, resulting in significant sums of excess money needing to be lodged. We are not currently aware of any alternative options.
RWE npower	No	-
ScottishPower Group	No	-
SmartestEnergy	Yes	The way in which LoC/cash is provided to and withdrawn from ELEXON is very clunky and not reciprocal; when ELEXON request collateral, Parties have to pay the next day. When Parties ask for a

Respondent	Response	Rationale
		<p>return of collateral, ELEXON require them to send a "request for calculation" which takes 10 days. After receiving the results Parties can ask for collateral. More importantly, though, is the "name and shame" process that ELEXON has when an entity's collateral is over 80% of ELEXON exposure; nobody want to be in this situation so everybody massively over-collateralizes. Costs to participants could be reduced significantly by easing the transfer of LoC/cash between participants and ELEXON so that the collateral transfer emulates a typical OTC margining agreement.</p>

Question 7: Do you have any further comments on the potential solutions?

Summary

Yes	No
5	2

Responses

Respondent	Response	Comments
EDF Energy	Yes	The workgroup's progress has been slow. We do prefer the original form of the modification which was clear that P308 was to allow, if passed, an alternative security product for securing credit under the BSC that could allow BSC parties to opt to draw on a new means of securing their potential BSC credit liabilities. The new product was clearly envisaged as an alternative to the existing instruments of cash or letter of credit (and now insurance equivalents), which would remain available. There was talk at the workgroup of deviating from this approach; we don't think that is a good idea.
Drax Power Limited	Yes	Drax agrees that the development of an appropriate metric (mentioned under intervention point 1) should be given further consideration to control trading activity in the same way as the existing CCP calculation. Further, Drax agrees that the consideration of an insurance product here should not be developed.
Green Energy UK	Yes	<p>In the view of Green Energy the solution proposed in P308 is inherently risky, and therefore we do not feel that it should be implemented in its current guise. We agree that the current credit arrangements are a burden for new entrants and growing suppliers, however, it does mean that suppliers finances have to be robust, secure and sensibly managed.</p> <p>Currently there are many players in the market who buy a supply company 'off the shelf' and do not go through any financial vetting which would be appropriate to be supplier in this market. It is not appropriate to grant these suppliers access to a central pool of funds to cover their risk. We also work in a market where many growing suppliers use customer money to fund their business and therefore lack the cash reserves to be taking a</p>

Respondent	Response	Comments
		<p>prudent approach to risk. We therefore believe that holding parties financially responsible for the actions of another party, however partial, is unacceptable.</p> <p>It is the responsibility of the BSC to ensure proper financial scrutiny of both new and existing parties is carried out, and to guarantee the industry is not absolving high risk parties from gambling with the other parties' money.</p>
Haven Power Ltd	No	-
RWE npower	Yes	We are keen to see the detail of how the cost of potential solutions would be passed on to parties (i.e. the charging mechanism of socialising the costs), as well as how this compares to the existing cost of credit cover.
ScottishPower Group	Yes	<p>Whilst we support efforts to make the process as cost effective as possible, we do not believe that generally the level of credit lodged is immoderate. The cover is there to prevent significant loss due to a low probability event. However we do agree that the cost of this cover is excessive and an ideal scenario would be to allow alternatives to LOC or cash (e.g. a performance bond) which one would hope could lead to more competitive pricing and reduced costs.</p>
SmartestEnergy	No	-