

Modification proposal:	<b>Balancing and Settlement Code (BSC) P307: 'Amendments to Credit Default arrangements'</b>		
Decision:	The Authority <sup>1</sup> directs that this modification be made <sup>2</sup>		
Target audience:	National Grid Transmission Plc (NGET), Parties to the BSC, the BSC Panel and other interested parties		
Date of publication:	29 January 2015	Implementation date:	25 June 2015

## Background

Under the current BSC arrangements each Party is required to lodge Credit Cover with Elexon to cover the risk of default. The Credit Default process begins when a Party's Credit Cover Percentage (CCP) (the ratio of its Energy Indebtedness<sup>3</sup> compared to the level of Credit Cover lodged) exceeds 80%, at which point it receives a default notice by phone and email, and a 24 hour Query Period commences to allow the Party to investigate.

The next steps depend on the Party's CCP at the end of the Query Period. If the CCP is above 80%, and the party fails to reduce its CCP in accordance with the process and timescales set out in the BSC, it will enter either Level 1 or Level 2 Default. In some circumstances when the CCP exceeds 90%, the Party will automatically enter Level 2 Default.

The consequences of entering Level 1 or Level 2 Credit Default are significant for affected Parties. In the latter case, it can involve the refusal or rejection of further contract notifications, which increases Energy Indebtedness, until the credit default is remedied.

### Worked example

Where the Query Period commences after 17:00 on a Friday and any time through to Sunday morning, there can be a scenario where there are very few or no Working Hours in which the Party can lodge further Credit Cover. The Party would therefore have no option other than to buy energy during the Query Period and notify energy contracts to reduce its CCP. This action can incur significant costs to the Party.

If the Party is unable to trade out its position over the weekend, and in the absence of being able to secure a line of credit over the weekend, then depending on at what time the Query Period commences, the Party can find itself in Credit Default on the Monday morning.

In addition to the impact of this issue on specific parties, the level of credit held across the energy industry, even by those parties with appropriate arrangements to avoid this problem, is viewed by many as being exceptionally high and above and beyond the actual risk that market participants are likely to incur. The holding of excess credit cover to avoid a credit default scenario where there are few or no Business Hours to remedy default, given the consequences of this, is seen as an excessive cost burden, and was the original rationale for proposing this mod.

<sup>1</sup> References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

<sup>3</sup> Trading Parties typically settle their Trading Charges (monies owed by or to them) 29 calendar days after the relevant trading day (Settlement Day). Energy Indebtedness refers to any accumulated debt over the 29 day period.

## The modification proposal

P307 was raised by E.ON UK in June 2014. It proposes to amend the Query Period to be a minimum of 24 hours which must include a minimum of five consecutive Business Hours<sup>4</sup> during a single Working Day. The proposed extension to the Query Period should allow Parties sufficient time to lodge more credit or trade out its position upon breaching the 80% threshold.

In the proposer's view, the extended Query Period proposed by P307 would allow Parties to carry out the necessary internal procedures for authorisation, payment processes and bank transfers to increase the level of Credit Cover following a credit threshold breach.

By extending the Query Period, a Level 2 Cure Period<sup>5</sup> could never be applied. A Level 2 Cure Period could only be granted if the participant had had less than two Business Hours within the Query Period. Under the proposed solution, the participant would always have at least five Business Hours in the Query Period to remedy a credit default. Therefore, the Level 2 Cure Period would be removed from the process.

All other aspects of the current Credit Default process would remain unchanged.

The Workgroup that assessed P307 considered an alternative, wider-ranging modification solution involving a single trigger CCP for credit default and a revised extended Query Period. Although this was considered by the Workgroup to be a potentially more robust long-term solution to the identified defect, the Workgroup members considered that it would be better to implement the proposed solution as a first step towards wider reforms. It was agreed that they would, however, continue to consider the alternative solution at a later date. The Workgroup therefore elected not to raise the alternative solution that they had identified at this time.

The Workgroup unanimously considered that P307 would better facilitate Applicable BSC Objective (c) as:

- reducing the levels of excess Credit Cover that participants would need to lodge, and the costs associated with doing so, would better facilitate competition; and
- P307 proposes a more pragmatic approach than the current process for smaller Parties in responding to a Credit Default event, as the current process is not the most optimal.

The Workgroup also unanimously considered that P307 would better facilitate Applicable BSC Objective (d) as:

- allowing more time to manage a Credit Default and the removal of the Level 2 Cure Period would better facilitate efficiency in the BSC arrangements; and
- the P307 solution would help to reduce some of the complexity in the Credit Default processes.

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<sup>4</sup> 'Business Hours' is defined in the BSC as the period from 09:00 to 17:00 on a Working Day.

<sup>5</sup> A Cure Period (Level 1 or Level 2) is the amount of time given to the BSC Party to bring its CCP below 75% and exit the Credit Default process.

## **BSC Panel<sup>6</sup> recommendation**

At the BSC Panel meeting on 11 December 2014, the BSC Panel unanimously agreed that P307 would better facilitate the BSC Applicable Objectives. It recommended approval of P307 and the proposed P307 implementation date. The full views of the Panel are set out in the FMR.

In the Panel's initial discussions, one Panel Member requested that Elexon<sup>7</sup> monitor the effect of the extended Query Period as part of their usual monitoring of Parties' credit positions and processes. This was to enable an assessment of the impacts it has on BSC Trading Parties' behaviour.

## **Our decision**

We have considered the issues raised by the modification proposal and the FMR dated 11 December 2014. We have considered and taken into account the responses to the industry consultations which are attached to the FMR.<sup>8</sup> We have concluded that:

- implementation of the modification proposal will better facilitate the achievement of the applicable objectives of the BSC;<sup>9</sup> and
- directing that the modification be made is consistent with the Authority's principal objective and statutory duties.<sup>10</sup>

## **Reasons for our decision**

We consider this modification proposal will better facilitate BSC Applicable Objectives (c) and (d) and has a neutral impact on the other applicable objectives.

***(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'***

We note that the current level of Credit Cover that Parties must post is considered by some to be excessive. We agree that a reduction in the overall levels of credit cover posted by industry participants would be beneficial to competition and help meet this BSC objective.

This modification should help ensure that all BSC parties can deal with the credit and collateral arrangements on a more efficient and equitable basis. Reducing the likelihood of Credit Default is beneficial both for the affected Party and the corresponding Party(ies) to its trades. By removing a barrier to entry and expansion, this should help promote greater competition in the electricity market. In particular, it should also benefit smaller players who do not have 24 hour trading desks by providing more opportunities to manage their CCP in a simpler and more cost-effective manner.

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6 The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC and Standard Special Licence Condition C3 of the Electricity Transmission Licence available at: [www.epr.ofgem.gov.uk](http://www.epr.ofgem.gov.uk)

7 Elexon is the Balancing and Settlement Code Company (BSCCo) which administers the BSC.

8 BSC modification proposals, modification reports and representations can be viewed on the Elexon website at [www.elexon.co.uk](http://www.elexon.co.uk)

9 As set out in Standard Condition C3(3) of National Grid Electricity Transmission's (NGET's) Transmission Licence: <https://epr.ofgem.gov.uk>

10 The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

We agree with the respondent who considered the effect of the extended Query Period on parties' positions and processes should be monitored, and we expect industry to consider this in its further work in this area.

As noted by the Panel in the FMR, this modification is considered to be a first step to resolving issues relating to credit default arrangements before a more wide-ranging examination of the credit and collateral arrangements under the BSC can be completed.<sup>11</sup>

***(d) 'promoting efficiency in the implementation and administration of the balancing and settlement arrangements'***

We agree that the effect of allowing more time for a party to manage its CCP within the Query Period is a more efficient arrangement than at present as it allows BSC Parties to better manage their own position to avoid entering default as a result of the current Credit Default procedures. The consequent removal of the Level 2 Cure Period should also reduce the complexity of the process.

However we note again that there are likely further steps to be taken in this regard to further improve the wider efficiency of the balancing and settlement arrangements. We welcome the ongoing work on this issue and encourage the industry to continue to consider whether further changes to the BSC credit arrangements may be appropriate.

**Decision notice**

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority hereby directs that modification proposal BSC P307 '*Amendments to Credit Default arrangements*' be made.

**Emma Kelso**  
**Partner, Markets**

Signed on behalf of the Authority and authorised for that purpose

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<sup>11</sup> [P306 'Expanding the definition of a 'Letter of Credit' to include regulated insurance companies'](#) and [P308 'Alternative security product for securing credit under the BSC'](#)