

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

P306 proposes to increase the range of financial institutions capable of providing security that Parties can use to meet Credit Cover requirements by including forms of security equivalent to a Letter of Credit.

This Modification also seeks to add Fitch Ratings to the list of approved rating agencies to further expand the pool of financial institutions able to provide security under the BSC.



The BSC Panel initially recommends **approval** of P306

This Modification is expected to impact:

- ELEXON
- BSC Parties

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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Any questions?

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About This Document

This is the P306 Draft Modification Report, which ELEXON will present to the Panel at its meeting on 9 October 2014. It includes the responses received to the Report Phase Consultation on the Panel's initial recommendations. The Panel will consider all responses, and will agree a final decision on whether the change should be made.

There are four parts to this document:

- This is the main document. It provides details of the solution, impacts, costs, benefits, drawbacks and proposed implementation approach. It also summarises the Workgroup's key views on the areas set by the Panel in its Terms of Reference, and contains details of the Workgroup's membership and full Terms of Reference.
- Attachment A contains the draft redlined changes to the BSC for P306.
- Attachment B contains the full responses received to the Workgroup's Assessment Procedure Consultation.
- Attachment C contains the full responses received to the Panel's Report Phase Consultation.

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Why Change?

The credit ratings of several licensed banks have been downgraded over 2012/13. This has 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 unlikely to incentivise banks and similar entities to maintain or reduce charges for providing security.

Solution

This Modification aims to give individual BSC Parties additional options in which to provide Credit Cover under the BSC by including products provided by regulated insurance companies (e.g. performance bonds) that are equivalent, for BSC purposes, to a 'Letter of Credit' (usually provided by a bank). P306 also seeks to include Fitch Ratings as an approved rating agency under the definition of a 'Letter of Credit'.

Impacts & Costs

There are no direct impacts on BSC Parties anticipated as P306 aims to provide Parties with additional options for lodging Credit Cover under the BSC but does not mandate action by Parties.

Implementation

The Panel recommends an Implementation Date for P306 of:

- **10 Working Days** after the Self-Governance Appeal Window Closes.

Recommendation

The Panel initially **unanimously** believes that P306 does better facilitate Objectives (c) and (d) and should therefore be **approved**.

2 Why Change?

What is Credit Cover?

Under the BSC, payments to and from BSC Parties for Trading Charges arising on a particular Settlement Day are made, on average, 29 calendar days following that Settlement Day. This means that at any given time Parties may have debts (or be due payments) in respect of Trading Charges incurred.

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 Credit Cover they will enter into Credit Default.

The BSC currently requires Parties to lodge Credit Cover against its Energy Indebtedness, as detailed in [BSC Section M 1.2.1](#). This provision allows for cover to be in the form of either a 'Letter of Credit' or cash.

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 M-1, M-2, M-3](#) 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 Inc. ('Moody's') and Standard & Poor's Corporation ('Standard & Poor's') downgraded their credit rating of several licensed banks. This reduced 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 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

E.ON raised [P306 'Expanding the Definition of a 'Letter of Credit' to include regulated insurance companies'](#) on 4 June 2014.

This Modification aims to give individual BSC Parties additional options for providing Credit Cover under the BSC by including products provided by regulated insurance companies (e.g. performance bonds) which are similar to a 'Letter of Credit' (usually provided by a bank).

Inclusion of 'Approved Insurance Product' as a security option

The Proposer and Workgroup have agreed that the BSC should be amended to include the following additional security option:

- **'Approved Insurance Products'** that are effectively equivalent to a 'Letter of Credit' under the BSC and that must:
 - be provided by a regulated insurance company or bank² with not less than a **single 'A' credit rating** (or an equivalent rating to a single 'A') from a suitable rating agency, i.e. a rating equivalent to that required of a bank to be able to provide a 'Letter of Credit'; and
 - be provided with a guarantee that funds will be released within **Three Working Days** of a claim being presented.

Inclusion of Fitch Ratings under the definition of a 'Letter of Credit' and 'Approved Insurance Product'

The P306 Proposer and Workgroup have also agreed that the BSC definition of a 'Letter of Credit' should be amended to:

- Include [Fitch Ratings](#) ('Fitch') as an approved rating agency under the Credit Cover provisions alongside Standard & Poor's and Moody's. Therefore, the approved rating agencies under the definition of a 'Letter of Credit' would be Standard & Poor's, Moody's and Fitch.
 - banks rated by Fitch will need to meet the equivalent rating requirements under the BSC (i.e. the rating required for Standard & Poor's or Moody's rated banks).

The Proposer and Workgroup also agreed that Fitch should be included as an approved rating agency under the definition of an 'Approved Insurance Product'. Any financial institutions rated by Fitch looking to provide an 'Approved Insurance Product' must meet the equivalent rating requirements under the BSC.

² Products such as performance bonds or surety bonds, which may be accepted as an 'Approved Insurance Product', can be issued by both insurance companies and banks.

Clarification changes

In addition to the above changes the Proposer and Workgroup agreed that some clarification changes to the definition of a 'Letter of Credit' should be made as follows:

- Minimise repetitive use of the word 'banks' which makes the definition more difficult to read and potentially more difficult to understand, as shown below:
 - “. . . any United Kingdom clearing bank ~~(s) or banks~~ or any other bank~~(s) or banks~~ which has (have) a long term debt rating of. . .”
- Make it clear that variations on a 'single A' rating (which is the credit rating required by banks to provide a 'Letter of Credit') will be accepted, for example 'A-' or 'A+'.

Full details of the Workgroup's discussions in developing this solution can be found in Section 6, including details of possible alternative changes considered by the Workgroup but not ultimately taken forward.

Legal text for P306 solution

Further information on the P306 solution can be found in the draft Legal Text in Attachment A.

Interactions with other 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.

On 28 February 2014 the CUSC Panel approved CMP228 as Self-Governance. CMP228 has since been implemented on 7 July 2014. There is no link between P306 and CMP228, but the two proposals have similar objectives and solutions.

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 independent solutions:

- [P307 'Amendments to Credit Default arrangements'](#) proposes to amend the timings, triggers and thresholds in relation to Credit Default, in particular expanding the duration of the Query Period and amending the triggers and thresholds for entering Credit Default, specifically with respect to the Cure Periods and the 80%, 90% and 100% thresholds.

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- [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. The three Workgroups will be mindful of the progression of the other Modifications as they each develop their solutions.

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Estimated central implementation costs of P306

The estimated ELEXON effort to implement P306 will be minimal, equating to £240 (or one ELEXON man day). ELEXON will update the relevant documents impacted by the solution and oversee its implementation.

Potential industry costs of P306

The P306 Workgroup has not identified any direct impacts on BSC Parties or Party Agents due to the implementation of this Modification. All respondents to the P306 Assessment Consultation indicated that there would be no costs incurred in implementing P306.

P306 Impacts

Impact on BSC Parties and Party Agents

There are no direct impacts on participants anticipated due to the implementation of this Modification. Though, participants will have additional options in which to provide Credit Cover under the BSC.

Impact on Transmission Company

No impact on the Transmission Company associated with the implementation of P306.

Impact on BSCCo

Area of ELEXON	Potential Impact
Release Management	ELEXON will be required to implement this Modification.

Impact on BSC Systems and processes

There are no impacts on BSC Systems to implement the P306 solution. However, if 'Approved Insurance Products' are used as Credit Cover security we would manage this and develop any required admin processes as part of business as usual work.

Impact on Code

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

Recommended Implementation Date

The Panel recommends an Implementation Date for P306 of:

- **10 Working Days** after the Self-Governance Appeal Window closes.

All of the respondents to the Assessment Consultation agreed with an implementation lead time of 10 Working Days.

The Workgroup did not identify any direct impacts on BSC Parties as P306 will increase the options available for Parties to lodge Credit Cover but will not introduce any obligations on Parties. Therefore, the Workgroup recommended to the Panel that P306 be treated as a Self-Governance Modification Proposal.

The Panel considered the Workgroup's request at its meeting on 11 September 2014 and unanimously agreed that P306 should be treated as a Self-Governance Modification.

If this Modification is approved by the BSC Panel at its meeting in October it will be subject to a 15 Working Day appeal window, which would close on 31 October 2014. If an appeal is received, the implementation of the Modification will be suspended and the appeal tabled at the next available Panel meeting. In the case of this Modification this would be on 13 November 2014. If no appeals are received, the Panel will be advised and the Modification will be implemented on 14 November 2014 (10 Working days after the appeal window closes).



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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What are the current processes for claiming funds under the BSC?

The Workgroup considered the current default and claiming processes under the BSC. In summary these processes, including associated timescales, are as follows:

- Default Process
 - 3 Working Days after Default: If funds have not been paid an advice notice is issued to the Party in question by ELEXON giving a due date for payment;
 - Due Date + 1 Working Day: If payment is not received within 1 Working Day of the payment due date ELEXON will contact the Party in question; and
 - Due Date + 3 Working Days: If payment is not received within 3 Working Days of the payment due date ELEXON will make a claim on the Party's Credit Cover.
- Claim on a 'Letter of Credit' (approximately 1 Working Day to complete claiming process)
 - Funds Administration Agent (FAA) produces claim documents;
 - claiming documents are then couriered between ELEXON, Barclays Bank and the bank that issued the 'Letter of Credit';
 - funds received by ELEXON; and
 - Credit Cover for Party in question is reduced by ELEXON to reflect the receipt of funds.
- Claim on cash (approximately 1 Working Day to complete claiming process)
 - FAA Transfer funds from reserve account;
 - Funds received by ELEXON; and
 - Credit Cover for Party in question is reduced by ELEXON to reflect the receipt of funds.

The claim documents produced by the FAA for claiming on a 'Letter of Credit' require original signatures by the appropriate individuals, as noted above. The Workgroup considered that it would be easier to email documents for electronic confirmation and send the signed copy in the post shortly after. A Workgroup member commented that it is normal practice for banks to accept documents electronically. However, ELEXON's bank (Barclays) will only accept the original documents because of the risk of people converting PDFs or using Photoshop to recreate these documents.

What will be the process for making a claim on an insurance product?

Under the P306 solution a claim on a security bond would be made by ELEXON, not the associated Party. It is anticipated that there would be a list attached to the insurance product specifying the people with the authority to make a claim for funds to be released. The Workgroup noted that both a bond issued by an insurance company and a 'Letter of Credit' issued by a bank can be considered 'guarantees of payment'.

The Workgroup considered that services similar to the kind of security proposed by P306 exist. For example, a company may take out non-payment insurance in case a contractor does not pay their bill and leaves the company unable to pay off debts. However, a 'Letter of Credit' is a demand instrument (i.e. once all signatures are laid in front of a bank they must pay) meaning there may be some risk of insurance companies not being able to pay out funds as fast as a bank; this led the Workgroup to consider a three Working Day timescale for the pay out of insurance products, as detailed below.

What risks are associated with longer timescales for the release of claimed funds?

The claiming process for both cash and a 'Letter of Credit' are time sensitive and the longer it takes to obtain the required funds the more risk there is of the relevant Party continuing to default. A Workgroup member noted that arguably, as long as ELEXON are satisfied that a form of security is valid it should not matter whether it is from a Bank (a Letter of Credit) or a regulated insurance company (for example, in the form of a bond). The member suggested that the underlying issue is around Parties providing bridging funds to make sure that, while money is being released, the Party in question does not continue to default.

If a Party defaults and is unable to cover the debt in time (i.e. it has insufficient Credit Cover), funding shares are taken from all other BSC Parties in proportion to their market share. However, these shares are returned to Parties if the required funds are received from the defaulting Party.

ELEXON does have an overdraft provision of £1 million (M), which could in principle, be used to provide bridge funding for defaults up to £1M. However, there will be interest and charges associated with utilising this overdraft.

A Workgroup member noted that if the overdraft provision was used for bridge funding and a default amount exceeds the full overdraft facility there are no further fall back funds. This means that the only recourse would be to seek funding shares from other Parties. Therefore, there would be a risk of relying on ELEXON's overdraft limit if there are long timescales associated with releasing funds claimed on an insurance product. The Workgroup considered that ELEXON's overdraft facility would not be an effective means of providing bridge funding to facilitate default claims.

The Workgroup believe that it is likely to usually take longer than three Working Days to receive funds following a claim to an insurance company, based on existing insurance products. The Group discussed whether this risk would mean that consideration should be given to putting a cap on the amount of credit that could be lodged in a bond or other insurance product. Meaning that up to a certain limit it would be acceptable for claims to take longer than three Working Days because the provision of bridge funding would not be too onerous. However, a member argued that this would not be beneficial to competition as larger players may not be able to lodge a significant amount of Credit Cover through an

insurance company if such a limit is imposed. The member added that smaller players might be able to cover all or most of their liability using such cover, depending on the limit that is set. However, larger players are more likely to be able to afford a 'Letter of Credit'.

The Workgroup therefore considered whether a timescale restriction might be a more appropriate approach to managing the risk. For example, specifying that a Party can only lodge credit in the form of security from a regulated insurance company if the funds will be released within three Working Days of a claim being made. This approach will leave the product type used open to the industry, i.e. a Party could use a product of its choice as long as Elexon and the FAA are satisfied that the funds will definitely be released and in the required timescales to limit the risk of continued default. The Workgroup agreed that this approach is preferable.

A Workgroup member questioned whether insurance companies will be able to tailor their products to meet a three Working Day timescale. Another member noted that large utility companies have been approached in the past by insurance companies with which they already have a relationship. The insurance companies have enquired whether these large utility companies would be willing to use some of their other products to lodge credit. Therefore, the member believed that it is possible to tailor products to a companies' individual needs (for example, a required timescale obligation) given such products would be corporate products. There may be a premium price associated with tailoring such a product but it would be up to the Party to determine whether or not that price would be competitive with the price of taking out a 'Letter of Credit' or lodging cash.

The Workgroup considered that as long as a product can be presented to ELEXON and the FAA in which funds can be collected in line with the current timescales (i.e. the three Working Days it takes to process the release of funds) they cannot see a problem with allowing the industry to use such products under the BSC.

The Workgroup agreed that the solution should include a time limit for the release of funds and that three Working Days would be appropriate. Though, the Workgroup wishes to obtain industry views on this to ensure its members make a fully informed decision on P306. Therefore, the Workgroup sought views to know whether industry participants agree that a 3 Working Day time limit for the release of funds would be pragmatic or whether a longer time scale is preferred. This would mean giving a longer period for the payment of claims but the industry may need to accept that that bridging funds might be required while claims are made. Such bridging funds would be delivered via levying funding shares on market participants.

'What 'Letter of Credit' requirements must apply equivalently to Approved Insurance Products'?

The Workgroup considered the types of 'Letters of Credit' that can be obtained from a bank and whether or not an insurance company can provide the same things. A bank can provide a number of different types, including a Standby Letter of Credit, but insurance companies cannot provide any kind of 'Letter of Credit'.

Insurance companies can provide bonds which are in line with a guarantee of credit, and when looking to issue a bond will assess the credit rating of the company requesting it. They will not issue a bond to a company that would be an unacceptable risk to them. It was noted that there may be a level of risk with using bonds as these can sometimes require proof of funds to be provided by the company taking the bond out. Also, based on ELEXON's research, performance bonds are usually used if one cannot deliver a product

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rather than to lodge credit. Credit cover may therefore be an unusual application of bonds, but under the P306 it would be up to insurance companies and Parties to see if they can develop viable products that would meet the credit requirements of the BSC.

Are there any other options for expanding the pool of banks that can provide a 'Letter of Credit' under the BSC?

ELEXON advised the Workgroup that banks that are able to supply 'Letters of Credit' under the BSC 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 'A' by Standard & Poor's Corporation or by Moody's Investors Services Inc.; or
- Any other bank(s) as the Panel may approve.

ELEXON noted that the pool of banks could be expanded in two ways.

Adding Fitch as approved rating agency

The first way to expand the pool would be by adding Fitch Ratings as an approved rating agency. Currently a bank needs the appropriate credit rating under Standard & Poor's and Moody's. However, if the definition was expanded to include banks with appropriate credit ratings by Standard & Poor's, Moody's and Fitch, the pool of banks the industry could use would expand from 60 to 81 (if the appropriate rating was kept at 'not less than a single rating of A').

A Workgroup member noted that, in the past, Fitch was associated more with sovereign ratings. However, Fitch has grown into more of a corporate rating agency and would therefore be an appropriate rating agency to add to the current list. ELEXON added that Fitch is already an approved rating agency under the Treasury Report but not for the purposes of providing a 'Letter of Credit' under the BSC. Another member advised the Workgroup that, in the past, the Panel has approved 'Letters of Credit' from Fitch rated banks on a case by case basis.

The Workgroup agreed that it would be pragmatic to add Fitch Ratings as an approved rating agency for the purposes of providing 'Letters of Credit' under the BSC. The Proposer also agreed with this view.

Lowering the required credit rating for banks providing 'Letters of Credit'

The Workgroup also considered the option of lowering the required credit rating for banks providing 'Letters of Credit'. The Workgroup considered that if this rating requirement was lowered it should be lowered to the next step down from the current single 'A' rating, as detailed below.

The Workgroup therefore consulted upon reducing the credit rating required for banks to be able to provide a 'Letter of Credit' under the BSC as follows:

- reduce the credit rating required under the definition of a 'Letter of Credit' from a single 'A' rating to:

- ['BBB' by Standard and Poor's](#);
- ['Baa' by Moody's](#); and
- ['BBB' by Fitch](#).

A Workgroup member noted that there may be some risk involved with lowering the required credit rating. The Workgroup agreed to ask the industry in the P306 consultation whether they would prefer to lower the rating and/or add Fitch Ratings to expand the pool of banks able to provide a 'Letter of Credit' under the BSC.

ELEXON received nine responses to the P306 Assessment Consultation. Of those nine respondents five indicated that they did agree with lowering the credit rating required to expand the pool of banks able to provide a 'Letter of Credit'. Of the nine respondents four were not in support of lowering the credit rating due to the potential risk to industry participants. Some respondents believed that lowering the credit rating to either a BBB or Baa was not appropriate and that a move to a rating of A- would be better. Under the current arrangements variations on a 'single A' rating (which is the credit rating required by banks to provide a 'Letter of Credit') will be accepted, for example 'A-' or 'A+'.

The Workgroup considered all of the Assessment Consultation responses and agreed that, due to respondent's views and the potential risk to the industry, it would not look to reduce the required credit rating under the P306 solution.

All of the responses to the Assessment Consultation can be found in Attachment B.

How would adding Fitch Ratings or reducing the required credit rating expand the pool of banks able to provide security to BSC Parties?

Banks are not always rated by all rating agencies. It is also possible that one bank may receive different ratings between agencies. Under the current arrangements, a bank is able to provide security to Parties if one rating it has received by an approved rating agency meets the requirements under the BSC. This is true even when the bank has received a rating from another agency that is below the required credit rating level.

Expanding the number of approved rating agencies under the BSC will increase the number of banks which BSC Parties can use to lodge Credit Cover. By adding Fitch as an approved rating agency under the definition of a 'Letter of Credit', the pool of qualified 'A' rated banks will expand from 60 to 81.

If the required credit rating were to be reduced without expanding the number of approved rating agencies from a single rating of 'A' to 'BBB' for Standard and Poor's and 'Baa' for Moody's, the pool of qualified banks will expand from 60 to 73.

If both of the above changes are made to the definition of a 'Letter of Credit' (i.e. adding Fitch as an approved rating agency and reducing the required credit rating) the pool of qualified banks will expand from 60 to 101.

Minimum Rating	Fitch Ratings Excluded	Fitch Ratings included
Single A	60 qualified banks <i>(current baseline)</i>	81 qualified banks
BBB or Baa <i>(depending on the rating agency)</i>	73 qualified banks	101 qualified banks

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It is worth noting that Fitch is already an approved rating agency under the [Treasury Policy](#)³. However, they are not referenced in relation to Credit Cover under the BSC. It is worth noting that they have been approved for Credit Cover purposes on individual cases in the past by the Panel.

What changes are required to the BSC?

The FAA checks all 'Letters of Credit' submitted, and BSC Section M lays out the format options that the industry can use when submitting a 'Letter of Credit'. The Workgroup considered whether a new format would be required or if the existing three could be suitably amended.

A Workgroup member stated that it is important to make sure that insurance products used are presented in a uniform format. The member did not believe there was a need for a separate letter format to be created. ELEXON advised the Workgroup that it would look into which would be more appropriate, depending on the current letter formats in the Code. ELEXON advised the Workgroup that as 'Approved Insurance Products' come in we will ensure they meet all the relevant requirements and guarantees on a case by case basis until we are comfortable with the products being submitted.

Along with other changes to the BSC to implement P306, ELEXON would add a new Annex M-4 to BSC Section M. This annex lists the requirements that an insurance product (issued by a regulated insurance company) must fulfil in order for it to be considered by ELEXON and the FAA as an approved form of Credit Cover. Further information can be found in the draft redlining in **Attachment B**.

A Workgroup member noted that banks are quite strictly regulated which is why there is the ability under the BSC to have 'Letter of Credit' formats. The member asked whether or not insurance companies are as strictly regulated. ELEXON advised the Workgroup that there are two regulators that oversee the insurance industry:

- The Financial Conduct Authority (FCA) regulates the financial services industry in the UK. Their aim is to protect consumers, ensure the industry remains stable and promote healthy competition between financial services providers; and
- The Prudential Regulation Authority (PRA) is a part of the Bank of England and is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm.

The Rules and guidelines that insurance companies need to follow can be found in the [Insurance: Conduct of Business Sourcebook](#) (ICOBS). Firms that breach these rules can be fined and also have their licence revoked.

The Workgroup considered whether it would be necessary for companies providing security to Parties via insurance products to be investigated to confirm their ability to provide credit. The Workgroup concluded that if an insurance company had an acceptable credit rating there is no need for further investigation into its ability to provide a 'Letter of Credit' equivalent product, similar to the credit rating requirement for banks under the

³ The Treasury Policy sets out the appropriate parameters as deemed fit by the Board for ELEXON's banking arrangements, in order to minimise counterparty risk, while delivering a reasonable rate of return on the ELEXON Group cash balances and being able to meet the organisation's financial obligations.

current Letter of Credit arrangements. The Workgroup agreed that an equivalent credit rating level to that imposed upon banks providing a Letter of Credit should apply to an organization that is not a bank providing a 'Letter of Credit' equivalent product.

Are any clarification changes required to the 'Letter of Credit' definition?

During the Workgroup's assessment of P306, ELEXON recommended some clarification changes to the 'Letter of Credit' definition. For example, minimising repetitive use of the word 'banks' which makes the definition more difficult to read and potentially more difficult to understand, as shown below:

- “. . . any United Kingdom clearing bank ~~(s) or banks~~ or any other bank~~(s) or banks~~ which has (have) a long term debt rating of. . .”

ELEXON also recommended adding further clarification around the credit rating required for banks to provide a 'Letter of Credit' under the BSC. Some respondents to the P306 Assessment Consultation misinterpreted the requirements laid out in the current definition. At Present, in order for a bank to be able to provide a 'Letter of Credit' the bank must hold a credit rating of "not less than a single A". However, variations on this "single A" will be accepted (for example, 'A-' or 'A+'), but it appears from consultation responses that this is not clear at present. Therefore, some respondents saw any potential drop in credit rating to be more significant than intended (e.g. one respondent suggested reducing the credit rating only to a rating of 'A-', which is already acceptable).

Taking the above into consideration, the Proposer and the Workgroup agreed with the suggested clarification changes to the current definition of a 'Letter of Credit'. Full details of all the proposed amendments to the BSC can be found in Attachment B.

Should P306 be progressed as a Self-Governance Modification?

The Workgroup considered whether P306 should be progressed as a Self-Governance Modification Proposal. The Workgroup noted that the majority of respondents to the Assessment Consultation indicated that there would be no direct impact on their organization to implement P306. Those respondents who did indicate an impact only referenced positive impacts, which would be positive (e.g. more flexibility in Credit Cover arrangements, additional Credit Cover products available and improved competitive rates).

Ofgem noted at the final Workgroup meeting that there are no anticipated adverse impacts to consumers, competition or BSC Parties. Ofgem indicated that, taking the Modification and Assessment Consultation respondent's views into account, it believes P306 does satisfy the Self-Governance criteria. The Workgroup and Proposer agreed with this view and therefore recommend that P306 is progressed as a Self-Governance Modification Proposal



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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Workgroup's final views on the Applicable BSC Objectives

The Workgroup unanimously believes that P306 does better facilitate Applicable BSC Objectives (c) and (d), for the reasons given below. Therefore, the Workgroup **unanimously** recommends that P306 should be **approved**.

The following table contains the Proposer and the Workgroup's views against each of the Applicable BSC Objectives:

Does P306 better facilitate the Applicable BSC Objectives?		
Obj	Proposer's Views	Other Workgroup Members' Views ⁴
(a)	• Neutral – No impact.	• Neutral – No impact.
(b)	• Neutral – No impact.	• Neutral – No impact.
(c)	• Yes – The proposed solution will promote effective competition by offering greater flexibility and additional options for BSC Parties to lodge Credit Cover under the BSC. This will enable them to provide collateral on their liabilities and lower the barriers for entering the market.	• Yes (unanimous) – Agree with Proposer.
(d)	• Yes – The proposed solution will marginally improve efficiency as adding additional options for lodging Credit Cover should result in less instances of default, despite a slight rise in administration work.	• Yes (unanimous) – Agree with Proposer.
(e)	• Neutral – No impact.	• Neutral – No impact.
(f)	• Neutral – No impact.	• Neutral – No impact.

Assessment Consultation respondents views on the Applicable BSC Objectives

ELEXON received nine responses to the Assessment Consultation, of which eight agreed that P306 **does** better facilitate the Applicable BSC Objectives for the following reasons:

- **Applicable BSC Objective (c):** as P306 will offer greater flexibility and additional options for providing Credit Cover. This Modification will also increase competition across banks that can provide a 'Letter of Credit' to BSC Parties.
- **Applicable BSC Objective (d):** will improve efficiency as adding additional options for lodging Credit Cover should result in fewer instances of default.

One respondent did not agree that P306 would better facilitate the objectives if the solution put forward included a reduction in the required credit rating. The Workgroup did consider lowering the required credit rating but ultimately agreed not to take this change forward.

⁴ Shows the different views expressed by the other Workgroup members – not all members necessarily agree with all of these views.

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]

(f) Implementing and administrating the arrangements for the operation of contracts for difference and arrangements that facilitate the operation of a capacity market pursuant to EMR legislation

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Panel's initial discussions

A Panel Member asked whether ELEXON has processes in place to monitor any 'Approved Insurance Products' that may be provided by a BSC Party for Credit Cover. ELEXON advised that its Finance Department has processes in place and will closely monitor any 'Approved Insurance Product' submitted by a Party for Credit Cover purposes (as per the P306 Solution). Such processes are similar to those taken when the use of a 'Letter of Credit' was introduced under the BSC.

A Panel Member asked that ELEXON perform a regular review of any 'Approved Insurance Product' and update the Panel, if necessary, should any issues arise. It was also suggested that ELEXON update the Panel if no 'Approved Insurance Product' is put forward after a year of P306 being implemented.

ELEXON agreed to update the Panel should any unexpected issues arise from the use of 'Approved Insurance Products' and if, after a year following implementation, any such products have been put forward.

Panel's views against the Applicable BSC Objectives

Having considered the Modification and the Workgroup's views on P306 the Panel initially **unanimously** recommends that P306 is **approved** as a Self-Governance Modification Proposal.

The Panel expressed the following views against the Applicable BSC Objectives:

Applicable BSC Objective (c)

The Panel **unanimously** agreed that P306 **would** better facilitate the achievement of Objective (c) for the reasons given by the Workgroup, as it:

- will promote effective competition by offering greater flexibility and additional options to lodge Credit Cover; and
- will enable Parties to provide collateral on their liabilities and lower the barriers for entering the market.

Applicable BSC Objective (d)

The Panel **unanimously** agreed that P306 **would** better facilitate the achievement of Applicable BSC Objective (d) as it:

- will marginally improve efficiency, as adding additional options for lodging Credit Cover should result in less instances of default, despite a slight rise in administration work

Panel's views on the draft legal text changes

The Panel **unanimously** agrees with the Workgroup's view that the proposed changes to the BSC in Attachment A deliver the intention of P306.

A Panel Member observed that there were brackets "[]" left in Section M Annex M-4 1.1.1 and requested that these be removed from the legal text changes. ELEXON confirmed that it will amend this.

You can find the revised draft legal text changes in Attachment A.

Panel's views on the proposed Implementation date

The Panel unanimously agree with the Implementation Date proposed by the Workgroup, as detailed in Section 5.

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9 Report Phase Consultation Responses

This section summarises the responses to the Panel's Report Phase Consultation on its initial recommendations. You can find the full responses in Attachment C.

Summary of P306 Report Phase Consultation Responses				
Question	Yes	No	Neutral/ No Comment	Other
Do you agree with the Panel's initial view that P306 should be treated as a Self-Governance Modification?	5	0	0	0
Do you agree with the Panel's initial unanimous recommendation that P306 should be approved?	5	0	0	0
Do you agree with the Panel that the redlined changes to the BSC deliver the intention of P306?	5	0	0	0
Do you agree with the Panel's recommended Implementation Date?	5	0	0	0
Do you have any further comments on P306?	0	5	0	0

Should P306 be treated as a Self-Governance Modification?

ELEXON received 5 responses to the P306 Report Phase Consultation. All respondents agreed with the Panel's view that P306 should be treated as a Self-Governance Modification Proposal.

All Respondents provided similar rationale in that P306 will have no adverse impacts on consumers, competition or BSC Parties. It was also noted that P306 will not change the current processes other than widening the pool of security providers.

Should P306 be approved?

All 5 respondents agreed with the Panel's initial view that P306 should be approved as it will offer greater flexibility and additional options for Parties to lodge Credit Cover under the BSC. It will also improve efficiency as adding additional options for Credit Cover should result in fewer instances of default and lower cost to the industry.

It was also noted that P306 will promote competition between existing and new providers of security and has the potential to ease participation in the wholesale electricity market.

Proposed legal text

All 5 respondents agreed that the proposed legal text changes deliver the intention of P306.

Consideration of 'A-' as a 'single A' rating

One respondent noted that ELEXON has not, in their view, been operating correctly under the BSC. The BSC requires a 'single A' rating or better for a given bank to be allowed to

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provide a 'Letter of Credit' and the respondent believed that ELEXON's acceptance of ratings of 'A-' without obtaining Panel approval does not properly reflect the 'single A' requirement. The respondent believed that ELEXON's interpretation of a 'single A' rating including 'A-' has caused some confusion for some Parties. The respondent noted that they do not wish to see deviations from the BSC and it is important that the BSC is administered correctly and strictly to a common understanding. Although they were concerned with the current 'single A' interpretation, the respondent did indicate support for accepting a rating of an 'A-' and, setting aside their concerns relating to existing processes, that they agreed that the legal text delivers the intention of P306.

No other respondents raised any issues with the present interpretation that 'A-' is considered a 'single A' rating for the purposes of the BSC provisions.

Responses to the P306 Assessment Procedure consultation did reveal confusion among Parties with respect to the application of the 'single A' requirement, with some not aware that ELEXON would consider an 'A-' rating acceptable at present. The Workgroup recognised this and decided to resolve the existing ambiguity by adding a sentence in the legal text to make it explicit that a 'single A' rating may be appended with '+' or '-' (or '1', '2' or '3' for Moody's). The Workgroup considered this to be clarification of the acceptable rating, not an amendment. Though the driver for this clarification was in line with the concerns subsequently set out by the Report Phase consultation respondent, i.e. that there is a clear common understanding of the BSC requirements.

Proposed Implementation Date

All 5 of the respondents agree with the proposed Implementation Date of:

- **10 Working Days** after the Self-Governance appeal window closes.

Respondents indicated that a 10 Working Day lead time would be sufficient and acceptable.

10 Recommendations

We invite the Panel to:

- **AGREE** that P306:
 - **DOES** better facilitate Applicable BSC Objective (c); and
 - **DOES** better facilitate Applicable BSC Objective (d);
- **DETERMINE** (in the absence of any Authority direction) that P306 is a Self-Governance Modification Proposal;
- **APPROVE** P306;
- **APPROVE** an Implementation Date of:
 - **10 Working Days** after the Self-Governance Appeal window Closes;
- **APPROVE** the draft legal text;
- Either:
 - **APPROVE** the P306 Modification Report; or
 - **INSTRUCT** the Modification Secretary to make changes to the report as the Panel may specify.

Workgroup's Terms of Reference

Specific areas set by the BSC Panel in the P306 Terms of Reference
What is the most appropriate definition for a 'Letter of Credit' under the BSC?
Should regulated insurance companies be able to provide a 'Letter of Credit'?
Are changes needed to the credit ratings required to provide a 'Letter of Credit'?
What influence does the Panel's ability to consider 'Letters of Credit' on a case by case basis have on the P306 solution?
What unintended consequences could arise from the changes proposed by P306 and how can such risks be managed?
What amendments would need to be made to the credit monitoring processes to account for the changes proposed by P306?
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 P206 and what are the related costs and lead times?
Are there any alternative Modifications?
Does P306 better facilitate the Applicable BSC Objective better than the current baseline?

Workgroup membership and attendance

P306 Workgroup Attendance			
Name	Organisation	17 Jul 14	26 Aug 14
Members			
Dean Riddell	ELEXON (<i>Chair</i>)	✓	✓
Talia Addy	ELEXON (<i>Lead Analyst</i>)	✓	✓
Leonida Bandura	P306 (<i>Proposer</i>)	✓	☎
Andrew Colley	SSE	✓	✓
Karl Maryon	Haven Power	✓	✓
Gary Henderson	IBM	✗	✓
Dimutho Wijetunga	Npower	☎	✗
Lisa Waters	Waters & Wye Associates	✓	✗
Tryfon Tzelis	E.ON	✓	✗
Attendees			
Beth Connew	ELEXON (<i>Design Authority</i>)	✓	✓
Tina Wirth	ELEXON (<i>Lead Lawyer</i>)	✓	✓
Darren Draper	ELEXON (<i>finance</i>)	✓	✓
Kyle Martin	Energy UK	✓	✓
David Munday	Npower	✗	☎

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Appendix 2: Estimated Progression Effort

The following tables contain the estimated effort in progressing P306:

Assessment Effort	
Participant	Effort (man days)
ELEXON	30
Workgroup members	20
Total	50

Consultation Response Effort	
Consultation	No. of responses
Assessment Procedure Consultation	9
Report Phase Consultation	5
Total	14

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Appendix 3: 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
FAA	Funds Administration Agent
FCA	Financial Conduct Authority
PRA	Prudential Regulation Authority
ICOB	Insurance: Conduct of Business Sourcebook.

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	Description	URL
4	BSC Sections website	http://www.elexon.co.uk/bsc-related-documents/balancing-settlement-code/bsc-sections/
4	Standard & Poor's website	http://www.standardandpoors.com/en_EU/web/guest/home
4	Moody's website	https://www.moodys.com/
5	P306 page of ELEXON website	http://www.elexon.co.uk/mod-proposal/p306/
5	Fitch Ratings website	https://www.fitchratings.com/web/en/dynamic/fitch-home.jsp
5	Standard & Poor's credit ratings	http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us
6	Moody's credit ratings	https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004
6	Fitch credit ratings	https://www.fitchratings.com/jsp/general/RatingsDefinitions.faces?context=5&detail=507&context_In=5&detail_In=500
6	CMP228 website	http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP228/
7	P307 page of ELEXON Website	http://www.elexon.co.uk/mod-proposal/p307/
7	P308 page of ELEXON Website	http://www.elexon.co.uk/mod-proposal/p308/
14	ICOB	http://fshandbook.info/FS/html/FCA/ICOB

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