

ISG177/02 - REVIEW OF BSC CREDIT MODIFICATIONS

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Owner/author Elliott Hall and Thomas Routier

Purpose of paper Information

Classification Public

Summary This paper reviews the impact of three Credit Cover related BSC Modifications implemented via the November 2014 and June 2015 releases. It highlights the 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'. Following the January ISG meeting, ELEXON will present the findings of this analysis to the BSC Panel at its next meeting, 11 February 2016.

1. Executive Summary

- 1.1 The changes from each of the three Modifications are to distinct areas of the credit arrangements. We can observe their benefits independently. However, numerous factors will determine the overall level of Credit Cover across the market.
- 1.2 The overall impact of the three Modifications is positive. Impacted Parties have been able to reduce their Credit Cover due to the Modifications.
- 1.3 At the June 2015 ISG meeting, ELEXON reported minimal impact in Parties' behaviours 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. Further, no Letter of Credit issued by an institution is solely approved by Fitch Ratings.
- 1.4 On 25 June 2015, the day of the June 2015 release, the total amount of Credit Cover held was £347m. This amount dropped by mid-August and remained between £323m and £330m until mid-December. The amount of Credit Cover increased prior to the Christmas and New Year bank holidays. We experience peak Energy Indebtedness at this time due to the estimated part of the Credit Cover Percentage calculation extending.
- 1.5 From the amounts withdrawn in July and August 2015, £5.2m can be directly attributed to the implementation of Modification P310 as reported by impacted Parties. We estimate a further £7.6m could be withdrawn.
- 1.6 Since the June 2015 release, two Parties have directly taken advantage of Modification P307. They have had until 14:00 the next Working Day to bring their Credit Cover Percentage to below 90% to avoid Level 2 Credit Default. Previously, the BSC allowed Parties 24 hours before entering Level 2 Credit Default which could have been triggered during the weekend.

The Credit Default Process

- 1.7 The Credit Default Process is triggered when a Party's indebtedness exceeds 80% of its Credit Cover. A Level 1 Credit Default notice is then sent out to the Party and a 24 hour 'Query Period' starts. During that Query period, if the Party's indebtedness increases above 90% or 100%, the Party receives a Level 2 Credit Default notice. If at the end of the Query Period the Party's position is still above 90%, ELEXON will set the Credit Default Assessment Flag (CDAF), leading to refusal and rejection of the Party's contract that would increase

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its indebtedness further. If the Party's position is between 80% and 90% at the end of the Query Period, it is allowed a 'Level 1 Credit Default Cure Period'. This runs until 24:00 the next Business Day. The Party must decrease its percentage below 75% to exit the process. Note that, since the implementation of Modification P307, the Query Period includes at least five consecutive Business Hours, hence it can extend until 14:00 on the next Business Day if the breach occurs on a weekend.

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 unlikely to incentivise banks and similar entities to maintain or reduce charges for providing security.
- 2.2 To support 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. This intended to further expand the pool of financial institutions able to provide security under the BSC.
- 2.3 The BSC Panel approved P306 as a Self-Governance Modification and ELEXON implemented P306 on 14 November 2014. ELEXON presented a preliminary analysis of the impact of P306 to the ISG at its June 2015 meeting.
- 2.4 To date, no Approved Insurance Product issued by a regulated insurance company has been used as Credit Cover. Additionally, there is currently no Letter of Credit solely valid due to Fitch Ratings held as collateral.
- 2.5 Table 1 below shows the breakdown of new Letters of Credit issued since April 2015 and the rating agencies that allow them to be qualified. All new Letters of Credit received since April 2015 were approved by Moody's Investors Services Inc., allowing them to be valid whether or not they were approved by Fitch Ratings.
- 2.6 However, it is possible that Standard & Poor's Corporation and Moody's downgrade an issuer below the BSC acceptable level (a single A if appended by a '+' or '-' according to [BSC Section X-1](#)), leaving Fitch Ratings as the sole rating for the product to be accepted as Credit Cover.
- 2.7 To conclude, the benefits brought by this Modification have not been fully realised to date.

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Table 1: Letters of Credit held per month

Month Issued	No. of cancelled LC's in this month	No. of New LC's received in Month	No. of LC received in month that qualify by Moody's	No. of LC received in month that qualify by S&P	No. of LC received in month that qualify by Fitch	No. of Insurance Products received in month	Total No. Lodged
Apr-15	2	0	0	0	0	0	82
May-15	4	0	0	0	0	0	78
Jun-15	0	1	1	1	0	0	79
Jul-15	1	1	1	0	0	0	79
Aug-15	0	3	3	2	1	0	82
Sep-15	0	2	2	1	1	0	84
Oct-15	0	1	1	0	0	0	85
Nov-15	1	0	0	0	0	0	84
Dec-15	0	2	2	2	2	0	86

3. Modification P307 - Amendments to Credit Default arrangements

- 3.1 There can be scenarios where the Query Period has no Business Hours included to allow the Party to lodge further Credit Cover. As a result, where a Level 2 Default and Query Period occurred outside of Business Hours the Party had to trade to remedy its position. A Party can incur significant costs through this route in order to avoid the consequences of default. Where there were no Business Hours in this event the Party would not have the option of increasing its Credit Cover until the next Business Day, when banks open. 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 issue, Modification P307 changed the way the Query Period was applied. The Query Period was originally 24 hours, changing 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.
- 3.3 Between the implementation of Modification P307 on 25 June 2015 and 7 January 2016, there were 28 Level 1 default notices (80%) to 20 individual Parties.

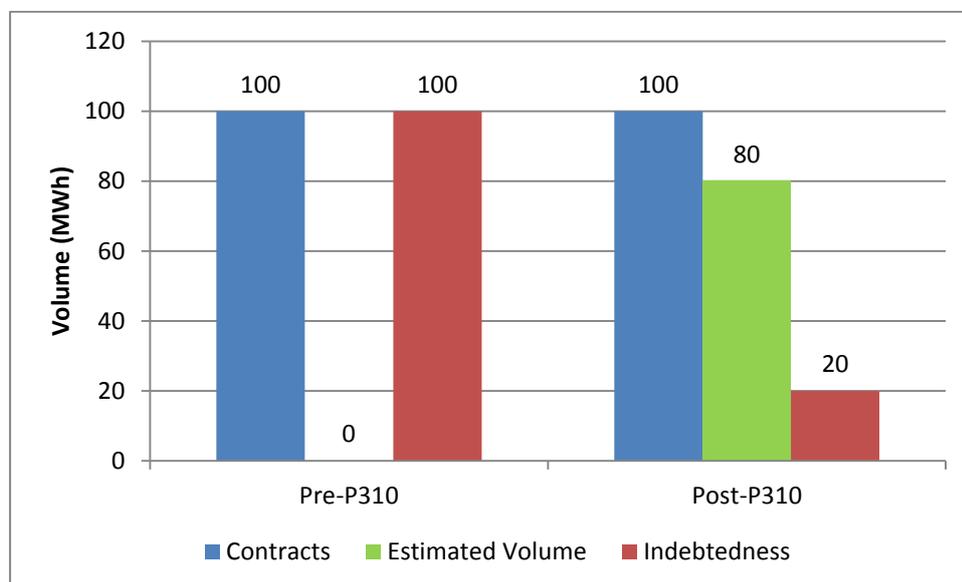
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- 3.4 From those 28 notices, ELEXON issued nine on a non-Working Day and had the Query Period running until 14:00 the next Working Day to reduce the Credit Cover Percentage. Seven of these breaches were resolved before the Credit Cover Percentage went above 100%.
- 3.5 Two Parties would have entered Level 2 Credit Default if the rules had not been changed by Modification P307. The Parties' Credit Cover Percentage went above 100% during the first 24 hours but, since this period did not include at least five consecutive Business Hours, there were no negative consequences and they could resolve their situation on time by the next Business Day.
- 3.6 This Modification gave Parties more flexibility to act when breaches occur on weekends. 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.

4. Modification P310 - Revised Credit Cover for Exporting Supplier BM Units

- 4.1 [Modification P310](#) allowed metered volume for generating Supplier BM Units with no consumption (e.g. embedded generation) to be estimated more accurately. Prior to P310, when estimated metered volumes for Supplier BM Units with export activity only were compared to Energy Contracts, affected Parties had artificially high imbalance estimates. The resulting high indebtedness required them to lodge excessive Credit Cover. This was because the calculation did not estimate the BM Units metered volume as generation, and considered it as zero demand volume.
- 4.2 Graph 2 below illustrates how modification P310 reduces Indebtedness (red), by introducing a more accurate estimation of metered volume (green), where previously this was estimated as zero. This Indebtedness can be calculated as Contracts (blue) less Estimated Volume.

Graph 2: Illustration of the effect of Modification P310 on affected Parties' Indebtedness



- 4.3 Modification P310 addressed this issue by improving the estimation of metered volume for these BM Units. It has corrected the high indebtedness and reduced the Credit Cover requirement. This Modification only affects Supplier BM Units with a GC > 0 and a DC of 0.

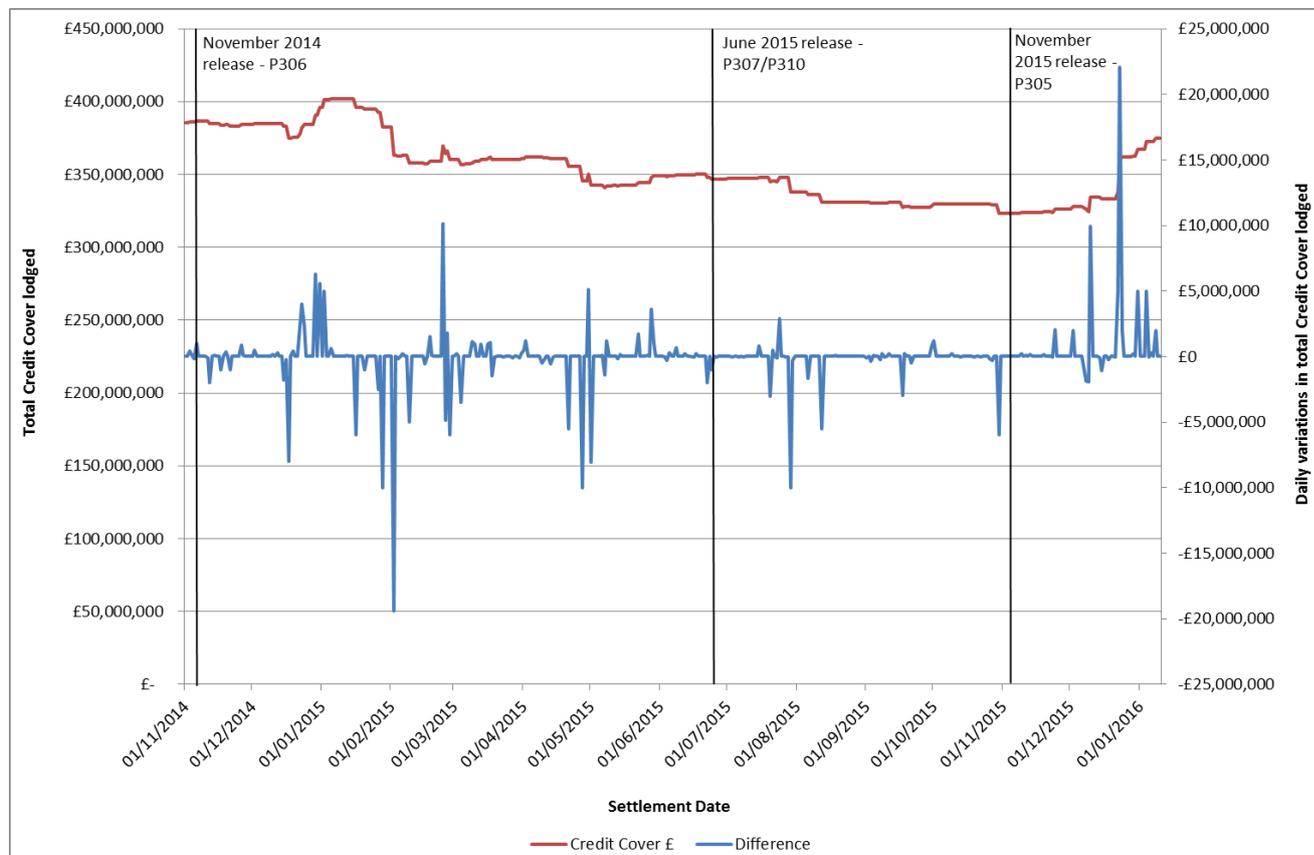
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- 4.4 Between 25 June 2015 and 31 December 2015, 11 Parties were affected by the changes introduced by P310. Of these 11 Parties, three withdrew Credit Cover totalling £5.4m. Seven did not change their Credit Cover and one lodged Credit Cover for the first time. Two of the Parties that withdrew Credit Cover confirmed that they did this due to the reduction in Indebtedness resulting from the P310 implementation.
- 4.5 Eight of 11 Parties did not increase their lodged amount; however five of these saw their Indebtedness fall after the P310 implementation and could have withdrawn Credit Cover. We estimate that these Parties could have withdrawn a further £7.6m.

5. Conclusions

- 5.1 Overall two of the Modifications have had a positive impact on BSC Parties operation in the BSC. Some reduction in Credit Cover can be directly attributed to P310. Further P307 has allowed two Parties to avoid consequences of Level 2 Credit Default where they have guaranteed Business Hours to increase Credit Cover and resolve the default.
- 5.2 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 Credit Cover lodged but a visible decreasing trend in Credit Cover can be observed 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 we have seen a decrease in the average prices, reducing the Credit Cover required. In December it has started to increase to cover the Christmas period similar to behaviour seen in previous years.

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



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- 5.3 Historically, Parties have tended to increase Credit Cover towards the Christmas period to avoid the risk of Level 2 Credit Default. It could be the case that Parties have not amended operational procedures to use the Business Hours available to resolve a default notice.
- 5.4 We will continue monitoring the effect of the three Modifications, particularly P307 and P310 on Parties' indebtedness. We will continue to educate Parties that could better understand the rules and use this to reduce their Credit Cover. We will provide a further review of Modifications P307 and P310 to the ISG in July 2016.
- 5.5 We welcome comments from the ISG on the analysis of the benefits of these three Modifications. We will update the BSC Panel with a summary of the findings at its next meeting, 11 February 2016.

6. Recommendations

- 6.1 We invite you to:
- a) **NOTE** the update given on the impact of Modification P306;
 - b) **NOTE** our plan to complete a further review of Modifications P307 and P310 in July 2016; and
 - c) **PROVIDE** comments on this analysis to be shared with the BSC Panel at its meeting on 11 February 2016.

Attachments

Attachment A – ISG170/01 – Impacts of P306 'Expanding the definition of a 'Letter of Credit' to include regulated insurance companies'

For more information, please contact:

Thomas Routier, Market Analyst

Thomas.routier@elexon.co.uk

020 7380 4378