CUSC Modification Workgroup Consultation

At what stage is this document in the process?

01	Proposal Form
02	Workgroup Consultation
03	Workgroup Report
04	Code Administrator Consultation
05	Draft CUSC Modification Report
06	Final CUSC Modification Report

CMP311:

Mod Title: Reassessment of CUSC credit requirements for Suppliers, specifically for "User Allowed Credit" as defined in Section 3, Part III section 3.27 of the CUSC

Purpose of Modification: To reassess User Allowed Credit" as defined in Section 3, Part III section 3.27 of the CUSC due to the large scale of liabilities this creates

This document contains the discussion of the Workgroup which formed in April 2019 to develop and assess the proposal. Any interested party is able to make a response in line with the guidance set out in Section 2 of this document.

Published on: 1 October 2019

Length of Consultation: 20 Working days

Responses by: 29 October 2019

Summary: Looking for an overview of the modification? A two-page summary can be located on page 3 and is also published on the National Grid ESO website

High Impact: Suppliers

Medium Impact: National Grid Electricity System Operator (NGESO)

Contents

Timetable

The Code Administrator recommends the following timetable:	
Initial consideration by Workgroup	9 April 2019
Workgroup Consultation issued to the Industry	01 October 2019
Workgroup Consultation closes	29 October 2019
Post Workgroup Consultation discussions	October-December 2019
Modification concluded by Workgroup	January 2020
Workgroup Report presented to Panel	January 2020
Code Administration Consultation Report issued to the Industry	February 2020
Draft Final Modification Report presented to Panel	March 2020
Modification Panel recommendation	March 2020
Final Modification Report issued the Authority	April 2020
Decision implemented in CUSC	TBC – please see implementation section

Any questions?

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1 CMP311 High level summary & signposting

What is going to change if this modification is approved?
The unsecured credit that a Supplier can receive from the Electricity System Operator will change. Appendix 1 of the code currently stipulates that Suppliers can gain unsecured credit through; • Approved Credit Rating (from S&P, Moody's or equivalent of BB-, Ba3 respectively or above) • Independent Credit Assessment (from an Approved Agency) (what is this? Please see the Workgroup discussions section for an overview) • Payment Record Sum (paying and paying on time) This change would mean that Suppliers could no longer be able to use their good payment record to build up an unsecured allowance as the Payment Record Sum facility would be removed. This would leave Suppliers with two routes to unsecured credit through the Independent Credit Assessment or Approved Credit Rating.
Why does the Proposer think this needs to happen?
• The number of suppliers is increasing and these may have business models that carry a substantial amount of financial risk, this has led to the ESO re-assessing its credit requirements. • There is the potential that if nothing is done that there may be an increase in costs to future consumers if the ESO is unable to recover the unpaid invoices. • As of April 1st, 2019, the ESO is a separate entity from the Transmission Owner business. Carrying large unsecured amounts of credit risk may cause the ESO additional financial costs which may need to be recovered from consumers. • The ESO cashflow is affected as Transmission Owners must still be paid on time. There is a real cost to the ESO here from drawing on this capital of fees paid to investors.
Who is going to be affected?
• All current and future Suppliers
When is this going to happen?
• The Workgroup are currently discussing this and welcome your views, the current thinking is start of the Financial Year occurring 12 months after an Ofgem decision

Workgroup views

Workgroup members met six times ahead of this Consultation being issued to discuss the issue raised by the Proposer and to consider potential solutions to address it.

Some Workgroup members believe there is no issue to resolve as the ESO can recover the costs through the existing mechanisms even though this can take a period of time. Without further information the Workgroup were not able to determine if the proposal would deliver reduced costs to consumer or better facilitate effective competition. Concern was expressed that this proposal could further exacerbate Supplier failures.

The Workgroup reviewed Ofgem's Best Practice Guidance documents (please see Annex 2) and following this the Proposer reviewed their original proposal (as was submitted to the CUSC Panel) and now only seeks to remove the Payment Record Sum.

Workgroup members were also mindful of the impacts this removal would cause for new and existing Suppliers and would like to understand what impact this would have on your business to assist in formulating other solutions to the issue.

Two other potential solutions were discussed within the Workgroup; these are that the Payment Record Sum would not be removed but would;

1. *Be permitted for only the initial 2 or 3 years of a New Supplier's lifetime (at the current rate of 0.4% per annum).*
2. *As "1" but if a Supplier is left with no unsecured credit allowance they can request to use a credit limit from an Approved Agency as substitute (if such a limit exists).*

The Workgroup are seeking views on these potential solutions – please see the related question on the response proforma.

Where can I get more information and how do I feed into the process?

We are seeking your view on how this will impact you, you can send us your views on the consultation response proforma or please get in touch by emailing us at cusc.team@nationalgrideso.com.

We will also be holding a webinar to discuss this proposal on 21 October 2019 at 11am please email us if you wish to join.

The sections within this document do the following;

Original Proposal

What was originally submitted to the CUSC Panel for their review. Please note that the Proposer originally sought to remove all unsecured credit for Suppliers but following feedback from the Workgroup is now seeking to just remove the Payment Record Sum as outlined above.

Proposer solution
This outlines what is potentially going to change in the Code (CUSC)
Workgroup discussions
This section outlines the discussions that were held in the Workgroup
Annex 2
This provides a summary of the key documentation that the Workgroup reviewed
Annex 3
This shows the slides presented by the Proposer at Workgroup meetings

2 This Workgroup consultation: How to respond

The CMP311 Workgroup is seeking the views of CUSC Parties and other interested parties in relation to the issues noted in this document and specifically in response to the questions highlighted in the report and summarised below:

Standard Workgroup Consultation questions:

Q1: Do you believe that CMP311 Original proposal (revised since originally proposed to just remove the Payment Record Sum) better facilitates the Applicable CUSC Objectives than current arrangements?

Q2: Do you support the proposed implementation approach, both in terms of allowing at least 12 months to make arrangements and the Workgroup suggestion to commence in April with the Financial Year?

Q3: Do you have any other comments?

Q4: Do you wish to raise a Workgroup Consultation Alternative request for the Workgroup to consider?

Specific CMP311 Workgroup Consultations Questions:

Q5: What impact do you think this modification would have on suppliers entering the market?

Q6: What impact do you think this modification would have on existing suppliers and what would be the cost to your business?

Q7: Two potential solutions other than that Proposed have been discussed by the Workgroup, what are your views on these?

Q8: What impact do you believe this modification would have on the Consumer?

Please send your response using the response proforma which can be found on the National Grid website via the following link:

https://www.nationalgrideso.com/codes/connection-and-use-system-code-cusc

In accordance with Section 8 of the CUSC, CUSC Parties, BSC Parties, the Citizens Advice and the Citizens Advice Scotland may also raise a Workgroup Consultation Alternative Request. If you wish to raise such a request, please use the relevant form available at the weblink below:

http://www.nationalgrid.com/uk/Electricity/Codes/systemcode/amendments/forms_guidance/

Views are invited upon the proposals outlined in this report, which should be received by **5pm** on **29 October 2019.**

Your formal responses may be emailed to: cusc.team@nationalgrideso.com

If you wish to submit a confidential response, please note that information provided in response to this consultation will be published on National Grid's website unless the response is clearly marked "Private & Confidential", we will contact you to establish the extent of the confidentiality. A response market "Private & Confidential" will be disclosed to the Authority in full but, unless agreed otherwise, will not be shared with the CUSC Modifications Panel or the industry and may therefore not influence the debate to the same extent as a non-confidential response.

Please note an automatic confidentiality disclaimer generated by your IT System will not in itself, mean that your response is treated as if it had been marked "Private and Confidential"

3 Workgroup Terms of Reference and acronyms

This document includes the discussion of the Workgroup, which formed in April 2019 to develop and assess the proposal and provides you with an overview of the potential change.

The CUSC Panel detailed in the Terms of Reference the scope of work for the CMP311 Workgroup and the specific areas that the Workgroup should consider. The table below details these specific areas and where the Workgroup have covered them or will cover post Workgroup Consultation.

The full Terms of Reference can be found in Annex 1.

Table 1: CMP311 Terms of Reference

Specific Area	Location in the report
a) Consider if a variation to the Users Allowed Credit Components may be appropriate	Section 6

b) Consider the interaction with the Targeted Charging Review	Section 6
c) Impact on Suppliers, as well as Consumers	Section 6
d) Analyse recent Supplier of Last Resort incidents – credit rating and payment history	Section 6
e) Ensuring the views of smaller suppliers are represented	Section 6
f) Review of original User Allowed Credit decisions	Section 6

Definition Table

Defined Term and Acronym	Definition
Balancing Services Use of System (**BSUoS**)	The BSUoS charge recovers the cost of day-to-day operation of the transmission system. Generators and suppliers are liable for these charges, which are calculated daily as a flat tariff for all users.
Connection and Use of System Code (**CUSC**)	The CUSC is the contractual framework for connection to, and use of, the National Electricity Transmission System.
National Grid Electricity System Operator (**NGESO** or **the ESO**)	NGESO operates the National Electricity Transmission System in England, Scotland and Wales.
National Grid Electricity Transmission (**NGET**)	NGET owns and operates the regulated electricity transmission network in England and Wales.
Parent Company Guarantee (**PCG**)	A parent company guarantee is a guarantee given by one contracting party's ultimate or intermediate holding company in favour of the other contracting party (the child company) to secure the performance of that party's (the child company's) obligations under the contract.

Supplier of Last Resort (**SoLR**)	An energy supplier who must supply a given classification or sub-classification of customers who may not be able to acquire energy from any other provider.
Targeted Charging Review (**TCR**)	An Ofgem review under the Serious Code Review to consider the current framework for residual network charges that could lead to inefficient use of network and potential adverse impacts for consumers.
Transmission Network Use of System (**TNUoS**)	TNUoS charges recover the cost of installing and maintaining the transmission system in England, Wales, Scotland and Offshore.
Workgroup Alternative CUSC Modification (**WACM**)	An alternative proposed solution raised by a party other than the Proposer.

4 Original Proposal

Section 2 (Original Proposal) and Section 3 (Proposer's solution) are sourced directly from the Proposer and any statements or assertions have not been altered or substantiated/supported or refuted by the Workgroup. Section 6 of the Workgroup Consultation contains the discussion by the Workgroup on the Proposal and the potential solution.

Defect

User Allowed Credit, as defined in Section 3, Part III section 3.27 of the CUSC, allows all suppliers to have up to £6 million credit with NGESO. This figure is calculated as a % of NGET revenue and updated annually in April (a Supplier can earn a "payment record sum" which currently is equal to approx. £100K a month for a maximum of 60 months). The credit is in place to support financial cover for TNUoS and BSUoS liabilities. This amount of unsecured credit has grown exponentially as more Suppliers have entered the market increasing risk to the ESO and potentially increasing costs on future consumers as a result of supplier failure.

What

NGESO propose to remove the User Allowed Credit in Section 3, Part III (Credit Arrangements), specifically section 3.27 and update other relevant sections in the CUSC that refer to it.

This currently allows all Suppliers to gain unsecured credit cover (to a max value £6 million) from the ESO against a calculation made in Appendix 1 of section 3. The 3 areas of cover that will be removed by this change are:

- Payment record sum

- Independent credit assessment
- Approved credit rating.

This change will affect all parties (new suppliers and existing). NGESO suggest an implementation date of April 2020, which will allow existing credit arrangements with suppliers to come to natural conclusion and allow time for alternatives to be found.

After considering feedback from the workgroup discussions NGESO propose to remove just the Payment Record Sum from User Allowed Credit in Section 3, Part III (Credit Arrangements)

This will still affect all parties (new suppliers and existing) but maintains suppliers access to the other forms of unsecured credit available. NGESO suggest changing the implementation date to 12 months after Ofgem approval, which will allow a more realistic opportunity for those suppliers losing use of Payment Record Sum s to find alternative credit arrangements.

Why

Since Part III of the CUSC was written there has been a large increase in the number of suppliers, currently totalling approximately 70 in 2019. This growth in suppliers, often with business models that carry a substantial amount of financial risk, has led to the ESO re-assessing its credit requirements. If nothing is done, then there may be an increase in costs to future consumers if the ESO is unable to recover the unpaid TNUoS and BSUoS invoices because of Supplier failure from administrators.

Additionally, as of April 1st, 2019, the ESO will be a separate entity from the TO business. Carrying large unsecured amounts of credit risk may cause the ESO additional financial costs which would need to be recovered from consumers. Establishing more appropriate credit arrangements for all Suppliers would in turn reduce the potential exposure that the ESO carries and ensure that consumers in future are protected from other Supplier failures.

To highlight the reasons laid out above, NGESO have included relevant figures from 2018/19

- 9 x suppliers have ceased trading in Financial Year 2018/19
- As of 14/02/19 a total of 48 suppliers are under-forecasting their demands for the charging year, which totals £102m, increasing the potential risk exposure of the ESO.
    - As of 02/19 the ESO unsecured risk within this total is £55m

NGESO will not be changing the way suppliers proof of Security Cover is provided, e.g. letter of credit, qualifying guarantee, cash for credit, bilateral insurance policy, insurance performance bond, independent security arrangement.

The Proposer presented to the Workgroup their view on the defect at their last meeting ahead of this Consultation being issued. The slides can be located in Annex 3. These slides summarise the Proposers view on the issue and why they have raised the modification.

How

As discussed above NGESO intend to remove the facility for User Allowed Credit from the CUSC. NGESO do not intend to replace it with something else, but to ensure that all references to it are removed and updated.

Updating this proposal, the focus for this proposed solution is on Payment Record Sum (PRS) only. This has been the area identified as having the most significant risk of bearing the cost of supplier failures, especially for new suppliers.

This currently equates to approx. £708m unsecured credit, of which £187m is currently utilised, as of August 2019.

This will ensure this burden is reduced and to manage this risk for consumers and NGESO.

CUSC Objectives: Proposer initial view

This section contains the Proposer's view of the relevant applicable CUSC objectives.

Impact of the modification on the Applicable CUSC Objectives (Standard):	
Relevant Objective	Identified impact
(a) The efficient discharge by the Licensee of the obligations imposed on it by the Act and the Transmission Licence;	Positive - Proactively managing costs that would be borne by future consumers in the event of a supplier default
(b) Facilitating effective competition in the generation and supply of electricity, and (so far as consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity;	Positive – This will remove a real financial risk from NGESO, and a potential cost to consumers. It will support new suppliers into the industry who can become long term market participants and understand the responsibility they need to have to manage their own risks. They will therefore be more financially secure when entering the market. Suppliers would therefore be more likely to endure in the market place, which brings benefits to competition for consumers who would be less likely to be affected by new suppliers becoming insolvent.

(c) Compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or the Agency *; and	None
(d) Promoting efficiency in the implementation and administration of the CUSC arrangements.	Positive – by removing payment history cover this will reduce the monitoring on specific supplier's requirements to secure cover. This will reduce an administrative burden on the NGESO.
*Objective (c) refers specifically to European Regulation 2009/714/EC. Reference to the Agency is to the Agency for the Cooperation of Energy Regulators (ACER).	

This modification shows a proactive approach to managing costs that would be borne by consumers. It removes a real financial risk from NGESO, a cost that would ultimately be on consumers. It will support new suppliers into the industry who can become long term market participants, as they will need to be more financially secure to enter the market. It is more efficient as it removes Payment History cover which reduces the monitoring on specific supplier's requirements to secure cover. This will reduce the administrative burden on the NGESO.

Implementation

The Proposer originally proposed that Implementation be as soon as possible, on the 1 April 2020. The proposer has now reviewed following workgroup feedback and has updated to 12 months following Ofgem approval. Following discussions at the Workgroup meetings the Workgroup are currently considering the most appropriate date for implementation. Please note the Workgroup Consultation question on this on your response proforma.

5 Proposer's Solution

Section 5 (Proposer's solution) is sourced directly from the Proposer and any statements or assertions have not been altered or substantiated/supported or refuted by the Workgroup. Section 6 of the Workgroup Consultation contains the discussion by the Workgroup on the Proposal and the potential solution.

The Proposer originally outlined the sections below that would need to be reviewed as part of the legal text changes to the CUSC as a result of this modification, these are listed below;

The specific relevant areas are, but not restricted to:

- 3.22.2(a) - change
- 3.22.3 - change
- 3.23 - change

- 3.23.1 – Remove
- 3.23.11(f) - change
- 3.27 – Remove the whole section
- Appendix 1 Credit Arrangements – remove the whole section

Also, in section 11 definitions: User Allowed Credit and any others contain that phrase.

With the updated proposal following Workgroup discussions, the relevant areas are to review, but not restricted to:

- CUSC Section 3 part III
- All terms in User Allowed Credit relating to "Payment Record Sum"

The legal text will be drafted following the conclusion of the Workgroup process and finalisation of the solution, at this stage the Proposer and Workgroup are seeking views on the removal of the Payment Record Sum.

Does this modification impact a Significant Code Review (SCR) or other significant industry change projects, if so, how?

N/A.

Consumer Impacts

This change proposal should result in beneficial impacts for consumers as the costs of Supplier failure will be covered by appropriate credit facilities as opposed to recovery from consumers in the future.

6 Workgroup Discussions

The Workgroup convened six times between April 2019 and September 2019 to discuss the proposal, detail the scope of the proposed defect, devise potential solutions and assess the proposal in terms of the Applicable CUSC Objectives. The Workgroup will in due course conclude these tasks after this consultation (taking account of responses to this consultation).

The Workgroup discussed a number of the key attributes under CMP311 and these discussions are described below.

Representation

The Workgroup discussed whether the Workgroup had an appropriate representation of suppliers affected by the modification. The Code Administrator and Workgroup sought further membership and are now content that there is appropriate representation on the Workgroup of those who will be affected.

Background information/reference documentation

The Workgroup discussed the fact that there were a number of key Ofgem documents and background information that would be important to review ahead of considering the proposed defect that the Proposer has identified.

The three Ofgem documents detail how Ofgem came to its decisions and guidance on best practice on credit arrangements (written in 2005 and confirmed by Ofgem as still valid at the fourth WG meeting). They lay out guidance, some of which has been codified in the CUSC, which Ofgem expect Networks to follow for credit arrangements. Further, they specify the reasoning behind the decisions made and also describe how Ofgem will allow full recovery of losses (including costs) if this guidance is followed. Of particular note they also specify that any changes in arrangements should be consistent with the principles set out in the Best Practice Guidelines.

Further relevant documents and some key extracts and a two-page summary pulled together by a Workgroup member can be located in Annex 2.

What is the issue?

The Proposer stated that User Allowed Credit, as defined in Section 3, Part III section 3.27 of the CUSC, allows each supplier to have up to £6 million credit with the ESO, which can be built up over a period of 60 months. The Proposer informed the Workgroup that during 2018/19, 10 Suppliers have ceased trading, with consumers undergoing SoLR process. The unpaid use of system liabilities is currently recovered through all parties. The Proposer stated that the financial risk posed by unsecured credit arrangements before re-billing are significant.

A Workgroup member queried the percentage of the credit allowance used by the companies that ceased trading. The Proposer stated that six of the companies that ceased trading left debt, which totalled around £1.5 million. At a later meeting, it was confirmed that all ten of the failed companies had been using the Payment Record Allowances.

A Workgroup member stated that the issues with under forecasting and bringing forward any credit penalties would help to resolve some of the issues. The Proposer agreed that forecasting is a factor and initially said this may be considered within this modification but might be better addressed in a separate modification. The Proposer confirmed in the first and second meetings that the intention is to look at alternative credit arrangements to address the removal of the payment record sum, independent credit assessments and approved credit ratings as options for unsecured credit.

A Workgroup member expressed that those parties that are financially robust are currently paying for those that are less financially robust and queried the fairness of the current system. It was noted that this had to be balanced with enabling smaller suppliers to compete and enter the market.

The Workgroup noted that the removal of all unsecured credit options without appropriate alternative options may have unintended consequences e.g. additional work for the ESO in the event that all suppliers were required to collateralise everything. A Workgroup member stated that any alternative solution needs to be proportionate.

The Workgroup agreed that it would be useful to analyse how the exposure is made up across the three areas of payment record sum, independent credit assessments and approved credit ratings. In addition, the Workgroup agreed that it would be essential to understand the exact amount of credit that would need to be covered by the industry based on the previous year.

The Proposer expressed that care needs to be taken that a particular type of credit is removed and then the issue is moved to one of the other two types of User Allowed Credit available. The Workgroup discussed the implications of removing unsecured credit for smaller suppliers and agreed that they may be disadvantaged in comparison to larger suppliers. A Workgroup member highlighted that whilst smaller suppliers ~~w~~ould be impacted to the most extreme extent (in that this requirement could cause them to fail), all suppliers including the larger ones would be affected too as they would not be able to adapt quickly as budgets are set and alternative credit would need to be found.

The Workgroup discussed the payment record option of unsecured credit. A Workgroup member stated that in the event that you lose your payment record, you can build this again over a five-year period. This will involve regular financial monitoring and the credit can go up and down depending upon the supplier and how they are financially performing and meeting its liabilities. A Workgroup member stated that care needed to be taken to ensure that the incentive of being fiscally responsible is not removed by eliminating payment record and not replacing it with an equivalent option. However, in the third meeting it was discussed that NGESO do not always immediately remove payment record allowances if payments are late/not made, the aim being to try and support suppliers firstly, for example with a payment plan. The majority of the workgroup felt the incentive to be fiscally responsible is not currently in place. Overall the Workgroup did not seem to be convinced that a defect had been evidenced by the end of the second meeting and the Proposer agreed to provide more information

A Workgroup member stated that credit reference agencies are essentially making an assessment of the company ceasing trading. Another Workgroup member stated that the ESO is managing credit risk on behalf of the industry and suppliers.

The Workgroup discussed that credit in the sector is being discussed in the round, outside of this modification. In particular, the Workgroup discussed whether Ofgem has a view of credit options and what is suitable to offer. The Workgroup discussed the publications that they had been able to locate including the Ofgem Credit Cover document. Some extracts from these have been included in Annex 2. Ofgem have since said their Best Practice Guidelines still stand.

NGESO revised solution following feedback from the Workgroup

The ESO, as Proposer stated that they had decided to revise their solution following the feedback provided and outlined by the Workgroup to them. This revised solution is as follows, the presentation outlined in the Workgroup meeting can be located in Annex 3

- focus on Payment Record Sum (PRS) only. This has been the area identified as having the most significant risk of bearing the cost of supplier failures, especially for new suppliers.
    - This currently equates to approx. £708m unsecured credit, of which £187m is currently utilised, as of August2019This will ensure this burden is reduced and to manage this risk for consumers and NGESO.

Workgroup feedback on revised solution

Workgroup members had a number of comments on the revised solution and the other elements revealed by NGESO. The Workgroup summarised their view of what the Proposal is seeking to do as the following;

If Ofgem's guidance is followed unsecured good payment allowances are removed once a Supplier is late to make payment and the Network can recover up to 100% of any losses. This Proposal seeks to codify the Networks' actual practice of continuing to work with Suppliers to achieve payments over the longer term and proposes removal of good payment allowances from all Suppliers in order to reduce the Networks' subsequent larger exposure, for which they have established no recovery mechanism.

The Workgroup also expressed their view on what the Proposer had presented; a summary of the discussions can be found below;

Invoice arrears

The Proposer stated that there could be instances where a supplier could be in arrears by two to three invoices by the time they cease trading (which could leave debts between £5-20m for a small to medium supplier), resulting in the ESO having a to manage the consequential cashflow issue. They stated that historically this was not an issue but with the new funding model following legal separation as an asset less business, managing the cashflow consequence is not something that the ESO can do moving forward. A WG member asked how this debt could accrue on an unsecured credit allowance given it was supposed to be reduced or removed at non-payment. The NGESO explained that they seek to work with Suppliers who are having difficulties.

Workgroup members outlined that this is a common issue across the NWOs, not just NGESO; they noted that there is an understandable reluctance to be the cause of, or trigger for, a supplier exiting the market. NWOs are not removing unsecured credit allowances immediately upon non-payment but rather, as acknowledged in the Workgroup meeting, are exhausting some or all reasonable means for resolution first. However, NGESO is not opposed to performing this role as it has asked for the BPG route to be formally adopted and included in the licence to give certainty for all parties on how the debt should be treated. Thus the Workgroup again reasoned that the defect was not in credit arrangements but in how they were currently being applied.

Ofgem guidance

A Workgroup member noted that Ofgem considers it to be in the nature of competitive markets that some businesses will fail. The Workgroup noted that Ofgem have incentivised the NGESO to keep costs no higher than necessary to consumers by allowing pass through only where the NWO has complied with the Best Practice Guidelines (BPG). Fundamental to the BPG is that the unsecured credit allowance facility is linked to payment history and removed immediately upon non-payment. Ofgem say the clarity of focussing on payment history gives a very sharp incentive on companies to pay their bills on time, providing lower costs for NWOs both in chasing late payments and identifying financial difficulties at an early stage.

New ESO funding model since legal separation

The Proposer talked through the fact that since becoming a legally separate company that cashflow is one of the concerns for the ESO.

A Workgroup member asked and the Proposer agreed that the BPG does specify that the cost of funding a loss (pending recovery) is included in the recovery mechanism The Proposer explained that the NGESO has reduced assets and a maximum profit of 30million.The Proposer also explained that they have a small asset base (currently 200m RAV) yet transacts significant revenues on behalf of the industry (£4bn –of which TNUoS £2.7bn).

Workgroup members noted the points raised by the ESO and that the NGESO is moving from a RAV based business model to an as-yet uncertain incentive/penalty performance and margin based model.

NGESO credit rating and cashflow

NGESO's credit rating of Baa1 until March 2021 arises directly from this current business model and NGESO's continued close integration within the wider NG group. Two thirds of the TNUoS revenue collected by NGESO goes to NGET, NGET receives the majority of its TO revenue from NGESO.

Workgroup members noted that NGESO's asset base of £200m RAV as shown on the Proposer's slides is accompanied by revenue transactions on behalf of industry (£4bn, of which TNUoS £2.7bn). They stated that although the BPG indicates that unsecured allowances should relate to RAV or turnover, a NWO with a lower risk appetite can reduce these as long as they do not seek to recover all losses via Ofgem's recovery mechanism. In addition they noted however that this transparent recovery process is fundamental to NGESO's current rating.

Supplier credit requirements from the revised proposal

The Proposer stated the following;

• Suppliers obtain credit for trading and energy balancing, so do have other options

•LoC would ask industry to obtain approx. £143m at cost to industry of approx. £3m (2%) p.a.

•Any exposure to customer credit risk therefore creates volatility to its cashflows and underlying profits of the business.

•These exposures are significant in relation to its size and ability to bear the downside consequences putting pressure on its credit rating.

Workgroup members noted that it is by no means certain that every smaller supplier will be able to avail of an appreciable credit line. They stated that banking relationships take time to develop and there is less liquidity in recent years across the credit industry as a whole.

A Workgroup member explained that for those smaller suppliers *able* to obtain credit, actual costs are unknown but the annual cost could be as high as 8%, it was noted that the range would likely be between 2% and 8%.

The current level of utilised Payment Record Sum is £186.8m. With the normal 85% margin this would be an aggregate Letter of Credit Requirement of £220m. At 3%pa this would cost £6.6m annually, at 4% this would cost £8.8m. It has been highlighted at each meeting that these potential costs far outstrip the £1.5m potential loss NGESO are exposed to but that if the Independent Allowances are available to most Suppliers, then this collateral cost does not fully materialise. The Proposer agreed to ask in-house if this evaluation could be made. The majority of the workgroup had a concern about those companies who will not be able to avail of an Independent Assessment based allowance – this impact at least must be identified as early as possible.

A Workgroup member highlighted that NGESO itself has an internal Revolving Credit Facility such that not only will its costs be substantially less but, further, its own rating as explained by Moody's is partly based on its ability to cope with a number of years of cashflow or under recovery issues in their view.

A Workgroup member further explained that, in their view, the constraints upon NGESO's credit rating *have* been recognised and can be summarised as arising from risk to future revenue from the developing new regulatory framework of disallowance mechanism and financial incentives and the risk to current and future temporary cashflows.

They also noted that the latter although mitigated by the credit facility can be significant in comparison to its RAV, especially if demand under forecasting occurs. It was discussed in earlier Workgroup meetings how a reduction in the forecast error threshold would directly address the exposure of NGESO to under forecast volumes caught within the timing mismatch between NGESO's outgoing payments to TO's and its income from Generators and Suppliers. A Workgroup member stated that they are disappointed that NGESO appear not to be pursuing such a reduction at this time.

Independent Credit Assessment – what is it?

A User can elect to use their credit rating (at one of the independent credit assessment agencies; D&B, Experian or Graydons) in lieu of placing collateral <u>or</u> using their PHA. NG would check independently and allocate the appropriate unsecured credit limit, which would be used to 'offset' their Use of System liabilities.

Unrecovered monies

The Proposer highlighted that;

•The ESO have the ability to appeal to Ofgem to allow for the resocialisation of any unrecovered monies this is not certain and can take a number of years to complete. In the meantime, the ESO bears the impact of this (finding the cash to pay the Transmission Owners and the cost for borrowing this money). The Proposer agreed when it was raised by a Workgroup member that all costs of funding the loss pending recovery are included.

• NGESO believe something has to change with unsecured credit, it is not a sound business model for NGESO who now have no asset base and a capped profit of 30m.

•NGESO recognised Ofgem best practice is still current, but NGESO is an asset less business now so our business model is significantly different to when this was written. A Workgroup member re-stated that Ofgem say they will only allow loss recovery <u>if</u> their Best Practice Guidelines are followed.

A Workgroup member stated that in their view NGESO's investment grade rating is directly linked to the reliability and transparency of these recoveries, alongside a portfolio of largely resilient counterparties and predictable underlying cashflows. They further stated that this rating is an important source of confidence and reassurance for NGESO's counterparties when agreeing longer-term contracts for the availability of balancing services at lower-cost than would otherwise be the case. The BPG specifies that compliant NWOs can seek 100% recovery including the cost of funding the loss pending recovery and may consider earlier modifications where delay would cause material adverse effect.

A Workgroup member highlighted that within its response to Ofgem's RIIO-2 Sector Specific Methodology Consultation NGESO has said it does not consider itself a business that simply passes through costs; rather where best placed, NGESO "should manage risk and costs on behalf of industry and consumers".

NGESO acknowledged this point in their presentation, but stated that nothing in our RIIO-2 proposal has been confirmed or is guaranteed to happen

The member stated that in their view that NGESO has welcomed Ofgem's recognition that different business risks exist, supports the principle that reasonably incurred costs should attract a margin and proposes that for the role of Revenue Collection Agent on behalf of the industry, an appropriate margin on the amounts transacted should be agreed to reflect the cashflow risk involved.

The Consumer impact

Following the revised proposed solution being presented by the Proposer, the Workgroup questioned what the impact could be on the Consumer of this and whether it would be positive or negative. The Proposer noted that that the Consumer pays for supplier failures when bad debt is collected through future TNUoS.

Is there a defect/issue or big enough case for change from today?

A number of Workgroup members stated that, after reading the Ofgem guidance provided to the group and listening to the Proposer's case for change, in their view a defect has not been identified and there is no issue to be resolved.

They stated that, in their view, a conversation between Ofgem and the Proposer on their concerns about pass through and the NWO's role in SOLR process would be a more suitable way of tackling the issues identified than a CUSC code change.

The Proposer stated that they would like to continue with the modification and ensure it is submitted to Ofgem for a decision.

Potential alternative solutions

A Workgroup member was requested in the second meeting to "float" some alternative proposals in the third meeting. The Workgroup member did so in the understanding that in their opinion the defect was yet to be proved. At the point in time they were formulated removal of all forms of unsecured credit was the still the only proposal in existence.-They outlined the following two alternatives (to original) potential proposals as follow;

Potential alternative A

- Triple A to BB- table --- no change
- Independent assessment table --- no change
- Payment history --- reduce from 60 months to 24 months (from 2% to 0.8%) (36 months is also possible, pending views of industry)

Targets the risk identified by NGESO of suppliers using payment history alone. After 24/36 months a supplier would need to graduate to more robust arrangements befitting of their growth and time in industry – independent assessment

Potential alternative B

- Triple A to BB- table --- no change
- Independent assessment table --- no change
- Payment history --- reduce from 60 months to 24 months (from 2% to 0.8%) (or to 36). Suppliers receiving zero allowances from the independent assessment table can use an independent agency's recommended credit limit.

Targets the risk identified by NGESO of suppliers using Payment History alone and after 24/36 months a supplier graduates to independent credit assessment. If, in doing so, a supplier loses all unsecured allowances as their Credit Assessment Score is zero, but they have a suggested Credit Limit this can be used instead for as long as they can't reach the allowance threshold. Such a credit limit is not the maximum value a Supplier is considered good for, rather it is the suggested exposure that an average creditor can carry. For a Network, as a larger entity, these limits could provide reasonable cover against Suppliers that are currently less credit worthy than the Credit Assessment Score recognises.

If you have any view on these proposed solutions please note the question on your response proforma on them, we welcome your views ahead of deciding on whether to develop these further and submit them as solutions to Ofgem for decision.

Annex 1: Terms of Reference

Workgroup Terms of Reference and Membership

TERMS OF REFERENCE FOR CMP311 WORKGROUP

CMP311 modification has been raised to reassess User Allowed Credit" as defined in Section 3, Part III section 3.27 of the CUSC due to the large scale of liabilities this creates.

Responsibilities

1. The Workgroup is responsible for assisting the CUSC Modifications Panel in the evaluation of CUSC Modification Proposal **CMP311**

2. The proposal must be evaluated to consider whether it better facilitates achievement of the Applicable CUSC Objectives. These can be summarised as follows:

   a) The efficient discharge by the Licensee of the obligations imposed on it by the Act and the Transmission Licence;
   b) Facilitating effective competition in the generation and supply of electricity, and (so far as consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity;
   c) Compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or the Agency *; and
   d) Promoting efficiency in the implementation and administration of the CUSC arrangements.

3. It should be noted that additional provisions apply where it is proposed to modify the CUSC Modification provisions, and generally reference should be made to the Transmission Licence for the full definition of the term.

Scope of work

4. The Workgroup must consider the issues raised by the Modification Proposal and consider if the proposal identified better facilitates achievement of the Applicable CUSC Objectives.

5. In addition to the overriding requirement of paragraph 4, the Workgroup shall consider and report on the following specific issues:

   a) Consider if a variation to the Users Allowed Credit Components may be appropriate
   b) Consider the interaction with the TCR
   c) Impact on Suppliers, as well as Consumers
   d) Analyse recent SOLR incidents – credit rating and payment history

e) Ensuring the views of smaller suppliers are represented
f) Review of original User Allowed Credit decisions

6. The Workgroup is responsible for the formulation and evaluation of any Workgroup Alternative CUSC Modifications (WACMs) arising from Group discussions which would, as compared with the Modification Proposal or the current version of the CUSC, better facilitate achieving the Applicable CUSC Objectives in relation to the issue or defect identified.

7. The Workgroup should become conversant with the definition of Workgroup Alternative CUSC Modification which appears in Section 11 (Interpretation and Definitions) of the CUSC. The definition entitles the Group and/or an individual member of the Workgroup to put forward a WACM if the member(s) genuinely believes the WACM would better facilitate the achievement of the Applicable CUSC Objectives, as compared with the Modification Proposal or the current version of the CUSC. The extent of the support for the Modification Proposal or any WACM arising from the Workgroup's discussions should be clearly described in the final Workgroup Report to the CUSC Modifications Panel.

8. Workgroup members should be mindful of efficiency and propose the fewest number of WACMs possible.

9. All proposed WACMs should include the Proposer(s)'s details within the final Workgroup report, for the avoidance of doubt this includes WACMs which are proposed by the entire Workgroup or subset of members.

10. There is an obligation on the Workgroup to undertake a period of Consultation in accordance with CUSC 8.20. The Workgroup Consultation period shall be for a period of **15 working days** as determined by the Modifications Panel.

11. Following the Consultation period the Workgroup is required to consider all responses including any WG Consultation Alternative Requests. In undertaking an assessment of any WG Consultation Alternative Request, the Workgroup should consider whether it better facilitates the Applicable CUSC Objectives than the current version of the CUSC.

    As appropriate, the Workgroup will be required to undertake any further analysis and update the original Modification Proposal and/or WACMs. All responses including any WG Consultation Alternative Requests shall be included within the final report including a summary of the Workgroup's deliberations and conclusions. The report should make it clear where and why the Workgroup chairman has exercised his right under the CUSC to progress a WG Consultation Alternative Request or a WACM against the majority views of Workgroup members. It should also be explicitly stated where, under these circumstances, the Workgroup chairman is employed by the same organisation who submitted the WG Consultation Alternative Request.

12. The Workgroup is to submit its final report to the Modifications Panel Secretary for the January 2020 Panel meeting for circulation to Panel Members. The final report conclusions will be presented to the CUSC Modifications Panel meeting in January 2020.

Membership

13. It is recommended that the Workgroup has the following members:

Role	Name	Representing (User nominated)
Chair	Shazia Akhtar	Code Administrator
Technical Secretary	Emma Hart	Code Administrator
Proposer	Simon Sheridan	National Grid Electricity System Operator
Workgroup Member	Karl Mayron	Haven Power
Workgroup Member	Robert Longden	Cornwall Energy
Workgroup Member	James Kerr	Citizens Advice
Workgroup Member	Gareth Evans	Waters Wye
Workgroup Member	David Holland	Scottish Power
Workgroup Member	Amit Gudka	Bulb Energy
Workgroup Member	Claire Towler	SSE Energy Supply Ltd (representing interconnectors)
Workgroup Member	Chris Welby	Bristol Energy
Workgroup Member	Simon Bateman	Engie
Workgroup Member	Dr Sharon McCahey	SSE Electricity Limited (representing suppliers)
Workgroup Member	Lee Stone	EON
Workgroup Member	Richard Jerreat	EDF
Workgroup Member	Chris Greer	Green Energy
Observer	Caroline Pitt	Squeaky Energy

NB: A Workgroup must comprise at least 5 members (who may be Panel Members). The roles identified with an asterisk in the table above contribute toward the required quorum, determined in accordance with paragraph 14 below.

14. The chairman of the Workgroup and the Modifications Panel Chairman must agree a number that will be quorum for each Workgroup meeting. The agreed figure for CMP311 is that at least 5 Workgroup members must participate in a meeting for quorum to be met.

15. A vote is to take place by all eligible Workgroup members on the Modification Proposal and each WACM. The vote shall be decided by simple majority of those present at the meeting at which the vote takes place (whether in person or by teleconference). The Workgroup chairman shall not have a vote, casting or otherwise]. There may be up to three rounds of voting, as follows:

- Vote 1: whether each proposal better facilitates the Applicable CUSC Objectives;
- Vote 2: where one or more WACMs exist, whether each WACM better facilitates the Applicable CUSC Objectives than the original Modification Proposal;

- Vote 3: which option is considered to BEST facilitate achievement of the Applicable CUSC Objectives. For the avoidance of doubt, this vote should include the existing CUSC baseline as an option.

The results from the vote and the reasons for such voting shall be recorded in the Workgroup report in as much detail as practicable.

16. It is expected that Workgroup members would only abstain from voting under limited circumstances, for example where a member feels that a proposal has been insufficiently developed. Where a member has such concerns, they should raise these with the Workgroup chairman at the earliest possible opportunity and certainly before the Workgroup vote takes place. Where abstention occurs, the reason should be recorded in the Workgroup report.

17. Workgroup members or their appointed alternate are required to attend a minimum of 50% of the Workgroup meetings to be eligible to participate in the Workgroup vote.

18. The Technical Secretary shall keep an Attendance Record for the Workgroup meetings and circulate the Attendance Record with the Action Notes after each meeting. This will be attached to the final Workgroup report.

19. The Workgroup membership can be amended from time to time by the CUSC Modifications Panel.

Annex 2: Reference document summary extracts

1. Arrangements for gas and electricity network operator credit cover Conclusions and proposals February 2003, Ofgem 06/03

Objectives

2.17. In the context of credit arrangements, Ofgem having regard to its statutory duties, considers that the management and control of credit risk should as far as possible emulate best commercial practice in comparable competitive industries, taking into account the nature of gas and electricity supply. In this way Ofgem considers that the costs of mitigating exposure to failure relative to the costs of impact of failure can be efficiently balanced. In addition, recognising that some businesses will fail, Ofgem regards the maintenance of a stable business environment as an important element in both reducing ongoing costs and costs arising from individual company failures. Overall, the costs of mitigating credit risk in the regulated framework should not be any greater than is necessary.

2. Recommendations for best practice guidelines for gas and electricity network operator credit cover Consultation Document September 2004, Ofgem 226/04

• Incentives need to be placed on Network Operators ('NWO') to manage debt efficiently;

• Credit arrangements must not be unduly discriminatory, nor prevent the promotion of competition;

• Credit arrangements should provide a secure and stable business environment; and

• Ofgem should take measures to protect consumers from loss of supply in the event of a supplier's or shipper's failure to maintain adequate levels of cover or default on payments due.

3. Recommendations for best practice guidelines for gas and electricity network operator credit cover – Consultation document Sep 2004

Ofgem suggestion

6.8. NWOs should set maximum credit limits based on the impact a loss of the size in question would have on the NWO's financial position. To avoid undue variation between companies (e.g. from differing capital structures), this should be based on RAV or turnover. Ofgem…is currently of the view that it should be set at 2 per cent of RAV which has the effect of decreasing the level of overall unsecured credit.

6.9. Using a fixed benchmark for setting maximum credit limits should not impact on the differing risk appetites of NWOs as these arrangements are concerned with reflecting competitive best practice with a view to the pass through criteria. NWOs who have a higher risk appetite would be unfettered. Those who seek less risk may not obtain full pass through in the event of a failure and also may be subject to objections and disputes from counterparties.

6.11 One possibility, which has the merit of simplicity, would be to adopt the same basic weightings as are to be applied under the 'Basel II' rules for determining bank capital adequacy. These are in the ratio 1 : 2.5 : 5 : 7.5 , for, respectively, AAA/AA, A, BBB/BB/Unrated, and below BB. These would imply maximum limits of, respectively, 100 per cent, 40 per cent, 20 per cent and 13-1/3 per cent of the NWO's maximum credit limit for a single counterparty.

4. Best Practice guidelines for gas and electricity network operator credit cover Conclusions document, Feb 2005, Ofgem 58/05

3.12. The mechanism for establishing a consistent approach for determining the creditworthiness of smaller entities has been the subject of much debate. Ofgem has carefully considered the responses and the issues associated with this aspect of the credit arrangements and takes the view that an unrated company does not necessarily pose a high risk of default. As has been stated before, a rated entity could well be more likely to fail than a well-run and collateralised smaller company that is unrated. For this reason Ofgem has sought to balance the likelihood and potential cost to consumers of the failure of unrated companies with the need for each unrated company to provide security.

3.14. As discussed in the September document, the payment record of a company is not a strong positive indicator of its health. However, it is a strong negative indicator, since a company with problems paying its bills on time is likely to be financially weak and possibly in some difficulty. An added advantage of linking unsecured credit allowances to payment history is that the facility is removed immediately upon non-payment, whereas an annual assessment may be less current.

4. Ofgem's conclusions on pass through criteria

The following criteria will apply where NWOs seek pass through of bad debt:
4.1. Companies must have implemented credit control, billing and collection procedures in line with these best practice guidelines, in order to be eligible for pass through;
4.3. Companies demonstrating compliance with or able to satisfactorily to explain departure from the guidelines will be able to recover all bad debt losses arising in respect of charges not due for payment at the date of the relevant counterparty's insolvency, net of any dividends or recoveries7;
4.7. All sums to be recovered will be 'logged up' and dealt with at the subsequent price control review. In addition, the adjustment will have an allowance for the cost of funding the loss pending recovery. However, where a delay in recovery would have a material adverse effect on the financial position of a NWO, Ofgem may consider earlier licence modifications.

Other publications were also submitted at this second meeting as evidence that the Best Practice Guidelines were still being used and held up as best practice. Note, this was before Ofgem attended the fourth meeting and confirmed all Guidance still stands as best practice.

5. UNC Review Group 0252 October 2009

Part of Review 0252, National Grid's Strawman keeps use of 2% RAV, and introduces concept of "lower of"

6. CMA Energy Market Investigation Extracts 2015

Details Smaller Supplier views on credit accessibility

Observations of investigation:

- paying a premium to avoid posting collateral
- difficult to get meaningful credit facilities with banks
- credit liquidity is an issue, credit availability is an issue as well
- credit difficulties a barrier to entry

7. Ofgem decisions UNC 302

2011 Ofgem approves continued use of 2% of RAV but updated each year to keep from falling much below what should reasonably be offered.

8. Ofwat Change Proposal Ref CPW019

Relevant quote – “Once a retailer has been operating for 3 years or more…it should have sufficient trading history to enable it to obtain a credit score or rating”

9. Ofwat Change Proposal Ref CPW018

Decision on accepting CPW018 : 2017/18 Ofwat support use of PCGs as they “help increase efficiency + competition…otherwise…leads to increased costs”. Allows 6 months post implementation to be arranged as securing new credit arrangements is long and complex, and this is just for the use of PCGs, not externally arranged Letters of Credit.

10. BEIS SECMP0016 Decision

BEIS in 2017 aligned the SEC with the Ofgem best practice. They consider it better facilitates competition & outweighs additional exposure to bad debt in the event of default.

Following Ofgem's confirmation in CMP311 Workgroup Meeting 3 (17th June 2019) that the Credit Cover Best Practice Guidelines (BPG) (1) remain valid and applicable, the following extracts have been consolidated from the BPG to summarise of how Best Practice credit cover arrangements should operate and how potential changes to current arrangements should be evaluated. Additional text from supporting Ofgem documents has been included where indicated.

Ofgem's objectives include protecting consumers from the costs of inefficient security against potential or actual failure whilst protecting industry participants and their consumers from the costs of another party's failure.

Network Operators (NWOs) are incentivised to manage debt efficiently; credit arrangements must not be unduly discriminatory, nor stifle competition and should provide a secure and stable business environment. Exclusive use of cash and LoCs is not appropriate credit cover for transportation and should conform to best commercial practice in comparable competitive industries.

From Ofgem's earliest proposals (2) it has been recognised that it is in the nature of competitive markets that some participant businesses will fail. **T**he management of credit should achieve an appropriate balance between participants protecting themselves from the effects of company failures and keeping the costs of that protection to the minimum. Ofgem considers that the costs of mitigating exposure to failure relative to the costs of impact of failure can be efficiently balanced. In addition, recognising that some businesses will fail, Ofgem regards the maintenance of a stable business environment as an important element in both reducing ongoing costs and costs arising from individual company failures. Overall, the costs of mitigating credit risk in the regulated framework should not be any greater than is necessary. The arrangements should not themselves exacerbate or otherwise increase the threat to continuity and security of supply from financial failure. Therefore, they should be designed to moderate the impact of financial failure and should not increase the risk that it will occur.

Ofgem concludes in the BPG that unsecured credit limits should be set as a proportion of each NWO's maximum credit limit and that this should be based on 2 per cent of the NWO's RAV. Those seeking other levels of risk may not obtain full pass through in the event of a failure. Ofgem explain (3) that the limits are based on the impact a loss would have on the NWO's financial position and are RAV or turnover based to avoid undue variation between companies (eg from differing capital structures). These arrangements are concerned with reflecting competitive best practice with a view to the pass through criteria. NWOs who have a higher risk appetite would be unfettered. Those who seek less risk may not obtain full pass through in the event of a failure.

Individual counterparty credit limits should be set using credit ratings and adopt the same basic weightings as are to be applied under the 'Basel II' rules for determining bank capital adequacy. These would imply maximum credit allowances of, respectively, 100 per cent, 40 per cent, 20 per cent and 13-1/3 per cent of the NWO's maximum credit limit for a single counterparty. Ofgem expand on this (2) that although arbitrary, the overall shape of these weightings is broadly consistent with implicit default probabilities.

Ofgem concludes in the BPG that an unsecured credit allowance for unrated counterparties can be determined using the payment record of the company providing that these allowances are reasonable. Any underperformance, for whatever reason, would return the company to 0 per cent position. It is for the counterparty to take whatever steps necessary to protect a payment record. A company with problems paying its bills on time is likely to be financially weak and possibly in some difficulty. An added advantage of linking unsecured credit allowances to payment history is that the facility is removed immediately upon non-payment, whereas an annual assessment may be less current. The clarity of focussing on payment history gives a very sharp and hence beneficial incentive on unrated companies who opt for this method, to pay their bills on time. Ofgem expects this to provide real benefits in terms of lower costs for NWOs both in chasing late payments and identifying financial difficulties at an early stage.

Ofgem concludes that NWOs must have implemented credit control, billing and collection procedures in line with these best practice guidelines, in order to be eligible for pass through. Companies demonstrating compliance with (or accepted variance from) the guidelines will be able to recover all bad debt losses arising in respect of charges not due for payment at the date of the relevant counterparty's insolvency, net of any dividends or recoveries;

Such companies will also be able to recover a proportion of bad debt losses arising in respect of charges overdue for payment at the date of the relevant counterparty's insolvency, net of any dividends or recoveries (which would be offset proportionately against all outstanding balances), depending on the age of the outstanding receivable. Ofgem has noted comments from a number of respondents regarding the opportunity to recover 100 per cent of bad debt whilst employing reasonable procedures. Ofgem has concluded that the amount recoverable would be equal to the value of outstanding balances subject to bona fide dispute (plus or minus the value of any reconciliation adjustments subsequently made) together with a proportion of the value of all undisputed balances (up to a maximum of 100 per cent) that varies inversely with the age of the balance, as set out below. The overall recoverable amount would be reduced for any other recoveries. The adjustment will have an allowance for the cost of funding the loss pending recovery. However, where a delay in recovery would have a material adverse effect on the financial position of a NWO, Ofgem may consider earlier licence modifications.

Ofgem explained in 2003 (2) Paragraph 6 that it is important that NWOs are appropriately incentivised to deliver effective credit cover management, both to keep costs no higher than necessary and to ensure they are appropriately focused on the companies presenting risk and on mitigating that risk. The incentives that act on NWOs arise from their exposure to any bad debt not being 'passed through' to consumers by means of a price control review. Ofgem's position is only to pass through incurred bad debt losses (or a proportion) where (and to the extent that) it can be shown that the NWO has complied with the principles set out in the BPG.

When considering if changes to the existing credit arrangements will further facilitate competition by lowering barriers to entry but without simultaneously undermining confidence in the efficient operation of the gas and electricity markets (3), issues to take account of include:

- The rules for dealing with bad debt should not distort competition;
- The effect on other parties of exposure to a failed party's bad debt; and
- The effect of a requirement to provide credit cover against the risk of default.

References

(1) *Best practice guidelines for gas and electricity network operator credit cover. Conclusions document*. February 2005 58/05
(2) *Arrangements for gas and electricity network operator credit cover. Conclusions and Proposals.* February 2003 06/03
(3) *Recommendations for best practice guidelines for gas and electricity network operator credit cover. Consultation Document*. September 2004 226/04

Annex 3: Proposer presentation Workgroup 2 & 3 and 6

CMP311 WG2
NGESO Actions

23rd May 2019

nationalgridSO

Feedback for discussion 1

- **The 10 suppliers that went under and/or left a debt**
  - What was each suppliers total User Allowed Credit in place with NGESO?
    - Varied from a few months up to 60 months PHA (i.e. £200k to £6m)
  - How was this split across the 3 types of User Allowed credit?
    - No split, some cash deposits ranging from 0 to £823k
- **For all suppliers**
  - What is the total User Allowed Credit we currently offer?
    - £1,543.9m
  - How is this split for each of the 3 types of User Allowed Credit?
    - PHA: £742m, Credit Rating: £760m, Independent Credit Assessment: £41.9m
- **How often do NGESO currently review Suppliers independent credit assessments?**
  - On request and then monitored monthly

- **What is the RAV for this year?**
  - Forecast NGET RAV £14,696.05m
- **What is the total credit VAR that would need to be found by industry if we removed User allowed Credit?**
  - Currently £399.3m

nationalgridSO

Feedback for discussion 2

- **Would Parent Company Guarantee work if the "child company" doesn't have any credit?**
  - Yes, assuming the Parent Company provides a PCG and it has the required credit rating (Moody's, S&P, Fitch)
- **Do NGESO put a financial limit on level of PCG accepted?**
  - Yes; 2% of RAV

- **Could an unintended consequence of removing User Allowed Credit be there is no motivation for anyone to pay on time or try and improve their credit rating?**
  - The CUSC (Section 6) defines the payment terms for Use of System charges. Late payment would place the User in breach of the CUSC (and in breach of its licence)
- **How many suppliers have reached the full available £6million credit limit on payment record sum**
  - Approx 30%

- **If NGESO are in credit from supplier payments before the Triad period and the supplier goes bust, do NGESO payback credit to administrators?**
  - NGESO would assess total TNUoS liabilities (HH and NHH). An over-payment by a failed supplier would be paid to the administrator.

CMP311 WG3 NGESO proposal update

Simon Sheridan

17th June 2019

nationalgridSO

Proposal – the why

- **Failing suppliers x 10 in FY 18/19 = £1.5m for ESO to recover…..this time**

- Consumers can pick up the bill twice
- Bad for consumer confidence to continue to shop for the best deals, so affects competition

- What if a bigger supplier went into administration?
  - e.g. Even a more established smaller supplier with 2 or 3 invoices in arrears, could leave approx. £5-20m owing

- 2 year funding gap for ESO waiting for cost recovery in K factor (recovery in future TNUoS)
  - Cashflow cost put onto consumers
- Ofgem have indicated there may be tougher scrutiny of future claims

- Suppliers obtain credit for trading and energy balancing, so do have other options
- LoC would ask industry to obtain approx. £143m at cost to industry of approx. £3m (2%) p.a.

Proposal – the why 2

- **NGESO has reduced assets and max profit up to £30m**
  - The ESO has a small asset base (currently £200m RAV) yet transacts significant revenues on behalf of the industry (£4bn – of which TNUoS £2.7bn).
  - Any exposure to customer credit risk therefore creates volatility to its cashflows and underlying profits of the business.
  - These exposures are significant in relation to its size and ability to bear the downside consequences putting pressure on its credit rating.
  - The ESO have the ability to appeal to Ofgem to allow for the resocialisation of any unrecovered monies this is not certain and can take a number of years to complete. In the mean time the ESO bears the impact of this.
  - Would you continue to take on this level of unsecured credit risk?
  - Something has to change with unsecured credit, it is not a sound business model for NGESO
  - Ofgem best practice understood, but NGESO is an asset less business now so our business model is different to when this was written

CMP311 Solution changes

1. **Focus on removing Payment Record Sum (PRS) only**
    - Reminder split for each of the 3 types of User Allowed Credit
        - PRS: £742m, Credit Rating: £760m, Independent Credit Assessment: £41.9m

Current PRH calculations:

- *NGET RAV = £14,696m*
- *Maximum Unsecured Credit Cover is 2% of NGET RAV = £293.921m*
- *PRS 2% of Maximum Unsecured Credit Cover = £5.878m (£98k each month of good payment)*
- *So £98K credit available every month to every supplier built up over 5 years =* ***£6m approx.***
- *PRS remains at 2% of Maximum Unsecured Credit Cover after 5 years*

2. Implementation date 12 months after Ofgem approval

Questions?

CMP311: Reassessment of CUSC credit requirements for Suppliers

NGESO proposers views and background to the modification

Simon Sheridan 3rd September 2019

nationalgridESO

Background

- User allowed credit is a free facility offered by NGESO to all electricity suppliers (approx. 115).
- 1 of the 3 areas of credit available is Payment History allowance (PHA)
  - This is a credit facility that builds up monthly over 5 years up to approx. £6m per supplier.
  - This credit remains in place after the 5-year period

- There is currently £708m available credit with PHA and £187m is being utilised by suppliers.
- This credit facility was set up (driven by Ofgem best practice guidance set in 2005) when there were many fewer suppliers and NGESO was part of NGET and owner of billions of pounds worth of assets.

- PHA is now inappropriately large for NGESO business and allows suppliers to get into difficulty before we have time to act.
  - Note: Removing PHA after payment default does happen in line with CUSC but for suppliers is often ineffective

- **NGESO view: This PHA model is no longer fit for purpose for NGESO as a now asset less business with a max of 30m profit attainable per annum, rather than a network owner with billions of pounds worth of assets to secure PHA against**
  - Who would offer this level of credit where an organisation extends credit well beyond its own OTE/asset base?

Consumer and NGESO impact

- In 2018/19 10 x suppliers went into administration leaving £1.5m to be recovered, there is no guarantee for this to be recovered by NGESO via future TNUoS. Ofgem decide.
- If this money is recovered by future TNUOS (2 years later) consumers will be paying double for this money and interest accrued.
- NGESO can attempt to recover the bad debt direct from the administrator, but historically we have ended up having to recover via an Ofgem decision to allow in future TNUoS

- NGESO cashflow is affected as TOs still must be paid in this time.
  - There is a real cost to NGESO here from drawing on this capital or fees paid to investors.
- NGESO has a licence requirement to keep a bbb rating, these bad debts could affect that

- With NGESO as an asset less business and Supplier failures increasing, the risk to NGESO and cost to consumers has increased and could increase in the future
  - For example, an existing small/medium size supplier who misses 2-3 invoices and leaves it as a bad debt could owe NGESO between £5-20m
  - A market where suppliers are continuing to fail leaves consumers paying for the failures
  - It also could discourage new suppliers to the market if consumers become more cautious and less likely to shop around for the best deals.

Wider industry issue

- Other network codes and operators do not offer this level of credit.
    - The UNC (Gas code) only offers 2 years of PHA credit and removes the facility after this time.

- Credit changes have been proposed in DCUSA, BSC
    - DCUSA – DCP349 mirrors UNC

- A Supplier Licence Review is happening which is also looking to address supplier failure

- The best practice guidance written by Ofgem in 2005 has been confirmed as current by Ofgem, but NGESO believe that our new business model is no longer aligned with it.
    - The document was written nearly 15 years ago and with network owners with assets in mind.
    - Best practice can be reviewed in the event of a significant or material change in the industry
        - legal separation is a significant change

Questions?

Annex 4: Legal Text

This will be finalised following the Proposer finalising their solution.