

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

Company	Confidential/ Anonymous	1. Distributors: Please provide your view on the existing credit cover arrangements?	Working Group Comments
Electricity North West	Non-confidential	<p>The current arrangements do appear to be appropriate and while it is difficult to cover for every eventuality DCUSA does seem to take a reasonable approach to credit cover.</p> <p>It may be helpful to take the opportunity to make schedule 1 more 'user' friendly. We suggest the following changes:</p> <ul style="list-style-type: none"> • the premise of the concerns raised in respect of banks having a credit rating not less than single A is tucked away in the definitions section of the schedule • it may also be useful to define unsecured and secured credit as these phrases are not used within the schedule • it would seem appropriate to remove the wording highlighted in red in the RFI (extract below) as rather than providing the distributor with the discretion to not insist on a Letter of Credit from a bank that has an A rating, it seems to leave the distributor more vulnerable having taken the decision not to apply the A rating threshold. Therefore, should we be looking to agree a lower acceptable rating (A-?), is there an industry average? <p>Letter of Credit Definition:</p> <p><i>"means an unconditional irrevocable standby letter of credit in such form as the Company may reasonably approve issued for the account of the User in sterling in favour of the Company, allowing for partial drawings and providing for the payment to the Company forthwith on demand by any United Kingdom clearing bank or any other bank which in each case has a long-term debt rating of not less than single A by Standard and Poor's Ratings Group or by Moody's Investors Service. or such other bank as the Company may approve and which shall be available for payment at a branch of the issuing bank".</i></p>	<p>The response suggests the required Credit Rating could be reduced. In addition, the response proposed to take the opportunity to make Schedule 1 more 'user' friendly.</p>
Northern Powergrid	Non-confidential	<p>Overall the current Credit Cover arrangements have worked well considering the length of time they have been in place. However, there are some areas where improvements could be made, such as;</p> <ul style="list-style-type: none"> • Increase the number of banks who are able to provide Letters of Credit by reducing the minimum required credit rating; 	<p>The response proposed to reduce the Credit Rating associated with bank's Letters of Credit. This will act to increase the number of banks that can provide credit cover.</p>

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		<ul style="list-style-type: none"> • Specific training for new Suppliers who trade as NPg are finding Suppliers are not fully understanding of what is required under Schedule 1; <p>Allow new Suppliers one month of Good Payment History (GPH) when they pay their first UoS invoice. This would reduce the initial credit cover requirement whilst allowing them to build up their GPH without the need to pay their invoice immediately or put a cash deposit in place. Alternatively, have a minimum secured collateral amount, e.g. £1,000, to be put in place of prior to the first invoice being issued.</p>	<p>Additionally, there may be some need for training of Suppliers g. It was proposed that to allow one month of GPH for suppliers when they pay their first UoS invoice.</p>
<p>Southern Electric Power Distribution plc and Scottish Hydro Electric Power Distribution plc</p>	<p>Non-confidential</p>	<p>The existing credit arrangements in DCUSA have generally operated well over the years and ensure that there are no material barriers to market entry for new electricity suppliers.</p> <p>The relatively small number of suppliers who require to support their trading through a means of collateral have a choice of options. Where Letters of Credit are used, there currently appears to be a reasonable and diverse range of potential providers (UK and international) who meet the current rating criteria, from our experience as a beneficiary of these.</p> <p>We have not heard at first hand any adverse comments from suppliers (or prospective suppliers) about the DCUSA credit arrangements and would therefore welcome more information on any adverse impacts of the current requirements.</p> <p>One area of the current arrangements where we would recommend review however is the extent of unsecured credit which can be an entitlement under the Payment Record Factor.</p> <p>Currently in relation to our two DNO companies, the monthly credit limits on this basis can be as high as £870k and £412k respectively. As such, failure of a supplier with unsecured credit on this basis could readily leave us with bad debt as high as £2m for a single supplier.</p> <p>Under current arrangements, these levels of credit limit entitlement can apply to suppliers with no rating or very poor ratings (even where agencies effectively warn against extending any unsecured credit).</p> <p>We recognise the importance of a mechanism for new entrants to the supply market to obtain credit cover, but since any bad debt is most likely to be socialised amongst DUoS customers, this should be balanced against our responsibility to protect customers from exposure to an undue level of risk.</p> <p>We therefore feel that there is a case for review of credit entitlements under the Payment Record Factor with a view to placing more moderate limits on companies who have no or poor credit ratings and are therefore reasonably seen as at the highest risk of failure.</p>	<p>The response looks at good payment record being too generous. The response suggests a review of credit entitlements under the PRF with a view to placing more moderate limits on some companies.</p>

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		The existing arrangements have allowed supply competition to flourish without barriers from distributor credit. It is clear though that the well-managed companies who have developed in recent years had no need for excessive levels of credit provision through the Payment Record Factor, as they achieved credit ratings in line with their growing business strength. As such, we do not feel that careful revision of some aspects of the Payment Record Factor provisions need have any material impact on the development and growth of sustainable new suppliers.	
UK Power Networks	Non-confidential	The existing arrangements are broadly fit for purpose.	Noted.
Western Power Distribution	Non-confidential	<p>We think that the current unsecured credit cover is too generous and puts Distributors at an unnecessary level of risk.</p> <p>Although we agree with the principle of unsecured credit cover enabling market entry for small suppliers we think that there should be a ceiling on the amount of cover this provides. For example a supplier with the full 5 years good payment history would qualify for nearly £900k credit cover in one of our distribution areas. We think that a supplier needing this amount of cover has reached a point where they are in a position where they are able to pay the market rate for a suitable secured credit cover and that this type of credit cover should have an upper limit to reflect this.</p> <p>Similarly we think that the amount of credit cover allowed for any given credit rating should be re-visited as it gives, what we think is, a disproportionate amount of cover when compared to the agency's recommendation.</p> <p>Even in the light of the proposed licence modification by ENW we think that this risk should be carefully managed in order to avoid passing extra costs on to customers in future years.</p>	Concerns with the amount of unsecured credit and good payment history amounts.
<p>The SIG note - A couple of opportunities to reduce the credit ratings in order to give diversity of choice. Some respondents suggest this is a good opportunity to look at unsecured credit and good payment history arrangements.</p>			

Company	Confidential/ Anonymous	2. Distributors: Letters of Credit are a secured means of providing credit cover. Do you have any comments on the balance between unsecured and secured credit cover in DCUSA?	Working Group Comments
Electricity North West	Non-confidential	It is difficult to get a reasonable balance between unsecured and secured credit and it is difficult to apply a common threshold or a fixed ratio for unsecured / secured credit. Alternatively it may be more	Response suggests a reasonable balance

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		appropriate to move to only secured credit. This will reduce the complexity for the provision of credit cover, make the requirements clearer and reduce the overall administrative costs across parties.	between secured and unsecured credit. Suggests potentially moving towards only secured credit.
Northern Powergrid	Non-confidential	In terms of managing risk we as the DNO would want 100% secured. However, if this cannot be achieved then the weighting should be more secured in place over unsecured, as if a Supplier goes into Administration then the cash is readily available and can then be immediately off-set against their current debt rather than having to wait and use Ofgem's debt recovery mechanism. NPG's preference would be for Suppliers to have a minimum amount of secured collateral in place, such as £1,000 or a minimum % of the Value At Risk whichever is the larger?	Response looks at the value at risk prior to new suppliers entering. Suggests suppliers have a minimum amount of secured collateral in place.
Southern Electric Power Distribution plc and Scottish Hydro Electric Power Distribution plc	Non-confidential	Please see comments above in relation to the Payment Record Factor. This is our main area of concern in respect of the balance between unsecured and secured credit.	Noted
UK Power Networks	Non-confidential	While it is preferable that there is more secured cover, we believe the current mechanism strikes a reasonable balance.	Noted.
Western Power Distribution	Non-confidential	Currently we have between 6 and 12 times as much unsecured credit cover (Credit Rating and Good Payment) as secured cover (Cash, PCG and LoC) and although not all of the unsecured credit cover is used it represents a significant risk to Distributors. WPD would prefer that a greater proportion of secured credit to reduce our risk or the likelihood of passing additional costs to customers in future years particularly in the light of GB Energy Supply recently going into administration.	Respondent would prefer a greater proportion of secured credit.
The SIG note - Some respondents considered that the level of unsecured credit is too great and should be reviewed. Others considered the level to be suitable.			

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

Company	Confidential/ Anonymous	3. Distributors: How can we improve the provisions for Letters of Credit under DCUSA?	Working Group Comments
Electricity North West	Non-confidential	A common 'boiler plate' template for a Letter of Credit would be useful as it has the potential to reduce administration costs; we do see Solicitors having different views on how such letters should be drafted, which can take up a lot of time and cause delays. A common template would reduce administrative costs and if a change was needed then a change could be agreed between the parties through the change control process.	Suggest that a common template for a Letter of Credit would be useful.
Northern Powergrid	Non-confidential	The provisions can be improved by simply reducing the minimum long-term debt rating of the bank from not less than a single 'A' to say a 'BB-'. This is so that the minimum rating is in line with the minimum rating required for a 3 rd party Qualifying Guarantee.	The respondent suggested reducing the minimum long-term debt rating of the bank from not less than a single 'A' to say a 'BB-'.
Southern Electric Power Distribution plc and Scottish Hydro Electric Power Distribution plc	Non-confidential	From our perspective the existing provisions in DCUSA in relation to Letters of Credit are fit for purpose, however we will endeavour to work with other DCUSA parties on improvement if the RFI identifies a need for this.	Current process is fit for purpose.
UK Power Networks	Non-confidential	We have not encountered any concerns from suppliers dealing with us in the provision of LoCs.	Current process is fit for purpose.
Western Power Distribution	Non-confidential	We think that the clause enabling Distributors to insist on a bank providing a LoC to have a credit rating of 'A' or above should be reduced to 'A-' and the amount of LoC provided by banks aggregated across all suppliers that use that bank with the limit to the total of LoCs of a bank determined by substituting the bank's credit rating into Paragraph 2.3 in the same way as a Parent Company Guarantee.	Suggests a bank providing a LoC to have a credit rating of 'A' or above should be reduced to 'A

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		<p>This solution would meet the issue of the banks having lower credit ratings and concomitant restriction of the LoC market for suppliers whilst still managing the risk to DNOs which in the event of a failure would be eventually be picked up by the customers.</p> <p>On a matter of housekeeping we also think that this restriction should be moved from the Definitions section in to the main body of Schedule 1.</p>	
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The SIG note - Some respondents thought the existing process was fit for purpose. Others suggest that the credit ratings for banks providing Letters of Credit should be reduced.

Company	Confidential/ Anonymous	4. Distributors: How many Letters of Credit for Suppliers do you currently have?	Working Group Comments
Electricity North West	Non-confidential	<p>We have ten Letters of Credit in place and haven't seen any evidence to suggest there is an issue with them being provided. In recent years there has been a move away from cash deposits to Letters of Credit.</p> <p>If the credit rating of not less than single A was reduced to facilitate supply competition for Letters of Credit it may encourage smaller suppliers to go down the route of providing Letters of Credit.</p>	10
Northern Powergrid	Non-confidential	NPg currently have open 13 LoCs used by 3 different Supplier groups across both NPg's licence distribution areas.	13
Southern Electric Power Distribution plc and Scottish Hydro Electric Power Distribution plc	Non-confidential	12	12
UK Power Networks	Non-confidential	24	24

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

Western Power Distribution	Non-confidential	35 across 4 Distribution areas	35
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The SIG note - The total number of Letters of Credit for Suppliers that DNOs had and calculated the average per DNO licence area. Due to a response being confidential the total and average are not included here.

Company	Confidential/ Anonymous	5. Suppliers: How often do you come across issues with credit cover arrangements?	Working Group Comments
E.ON	Non-confidential	We regularly encounter issues with credit cover arrangements particularly regarding the interpretation of cover arrangements. We have therefore found ourselves in a position where DNO's interpret the schedules differently and we have to have different variations of cover arrangements. We have also encountered issues over the past year of a DNO revising their interpretation of the arrangements and requiring us to provide different cover arrangements to those that were previously acceptable	Respondent regularly encounters issues with credit cover arrangements particularly regarding the interpretation of cover arrangements.
	Anonymous	Often. As a Supplier we have to provide Credit Cover to a number of counter-parties.	Often

The SIG note - Respondents said they had issues but to various extents. There are issues but it appears to be around the interpretation of the arrangements

Company	Confidential/ Anonymous	6. Suppliers: Are you satisfied with the current credit cover options available?	Working Group Comments
E.ON	Non-confidential	We believe there is scope in reviewing the arrangements – since schedule 1 cover was implemented there have been significant changes in the financial world and we see we see value in confirming whether the current arrangements are still fit for purpose	Given significant changes in financial world there is scope in reviewing arrangements
EDF Energy Customers plc	Non-confidential	The forms of credit cover available seem wide-ranging enough when considering the flexibility contained in Paragraph 1.1(d) of Schedule 1. We are not clear, however, why an 'on demand' performance bond from a surety / financial institution that met the required minimum rating and	CAFs should be reviewed. Noted difference in drops

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		<p>minimum term for such instrument could be assigned anything less than 100% effective. If it was a conditional bond then we can understand that it would not be as effective as a letter of credit but if it is 'on demand' then it should be 100% effective.</p> <p>We also feel that the unsecured credit allowance factors (CAFs) could benefit from being reviewed. Just as banks now tend to be rated lower than they were before the financial crisis, the same is true of many corporate entities (and indeed sovereigns). Whilst we are not advocating increasing the CAFs materially - because distributors take a direct risk to suppliers, whereas it is a contingent risk to letter of credit issuers - we are not sure that a drop of 60% in CAF between the rating categories of AA and AA-, a drop of 20% between A- and BBB+ and then further drops of 1% per single rating decrease thereafter is reflective of the risk.</p>	between different levels of credit rating.
	Anonymous	It is important that credit cover can be provided in different forms and not rely on cash being the only form of credit cover.	Noted
<p>The SIG note - Responses noted that there is scope to review the existing arrangements.</p>			

Company	Confidential/ Anonymous	7. Suppliers: Do you see value in amending the credit rating value in Schedule 1 to obtain a Letter of Credit?	Working Group Comments
E.ON	Non-confidential	Yes - increasing the percentages will reduce the burden on suppliers	Yes – E.ON representative to seek clarity around the response.
EDF Energy Customers plc	Non-confidential	<p>Yes. Market practice in many areas has moved away from requiring a financial institution issuing a letter of credit or bond to have a minimum credit rating of A/A2 and is now, in many cases, set around a minimum of A-/A3. Where we accept letters of credit / bonds in certain areas of our own business, we have also reduced our minimum rating requirement from A/A2 to A-/A3 in recent years and we feel that is a more reasonable standard for both bilateral and industry arrangements.</p> <p>In terms of the reference to 'value' in the question, we believe that reducing the minimum rating requirement will allow suppliers to widen their pool of potential issuers and this should help keep issuance fees down and that, in turn, reduces the cost of running a supply business and ultimately reduces costs to consumers. Letter of credit issuance fees are not a major cost for suppliers but they are now increasing, particularly when taking into consideration the raft of industry arrangements that</p>	Yes, in order to allow suppliers to widen their pool of potential providers. Suggested some potential solutions.

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		require credit cover, including the Supplier Obligation for Capacity Market and Contracts for Difference.	
	Anonymous	I would like to see a wide spectrum of financial service providers being able to provide Letters of Credit. Without this, there is a danger that the cost of providing letters of credit will increase and this increased costs will be passed onto customers resulting in higher electricity bills.	Yes

The SIG note - Support for amending the credit rating value.

Company	Confidential/ Anonymous	8. Suppliers: Would having a lower credit rating increase completions with banks who currently do not meet the standard set out in the DCUSA?	Working Group Comments
E.ON	Non-confidential	E.ON are currently using institutions who do not meet the requirement but are in line with 'other bank as the Company may approve' statement. Our preference would be to strengthen the use of discretion by DNO and make clearer the limits to be applied to these institutions.	Support for use of discretion by using other banks than those in the UK.
EDF Energy Customers plc	Non-confidential	Yes. In our opinion, reducing the minimum rating requirement for letter of credit issuers by one notch to A-/A3 would increase completions with banks who do not currently meet the A/A2 standard but would also not unduly increase risk to distributors.	Yes, reducing would increase completions
	Anonymous		

The SIG note - General support at looking at this area and lowering the required credit rating

Company	Confidential/ Anonymous	9. Suppliers: Would you prefer a new option of credit cover over unsecured credit cover?	Working Group Comments
E.ON	Non-confidential	Our preference is for increased usage of unsecured credit support to reduce the burden on suppliers. Any options to reduce the costs of fulfilling obligations are welcome	Increased usage of unsecured credit suggested

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

EDF Energy Customers plc	Non-confidential	As per our response to question 6, we feel that the unsecured credit allowance factors (CAFs) could benefit from being reviewed, with a view to increasing them in certain cases. We acknowledge, however, that material increases should be avoided as that would increase the risk to distributors.	Noted
	Anonymous	I would be happy to explore any new credit cover options, as long as there is flexibility as to what form of credit cover is provided.	Open to exploring more credit options

The SIG note - Respondents are open to exploring more credit options

Company	Confidential/ Anonymous	10. What would be the best solution for this issue? Please provide your rationale.	Working Group Comments
E.ON	Non-confidential	The unsecured credit support calculation could be amended to factor it up by say 50% or 100%. I.e. $CA = RAV \times 2\% \times CAF \times [1.5 \text{ or } 2.0]$ – CHECK!!	Suggestion by respondent
EDF Energy Customers plc	Non-confidential	The minimum rating requirement for letters of credit and performance bonds should be reduced by one notch from A/A2 to A-/A3; we feel that would be in keeping with how market practice has changed over time. We also believe that the timescale to provide credit cover is too short and that it should be increased from 2 working days to 5 working days in Paragraph 3.2 of Schedule 1. In the event that distributors also feel that the 2 working day period to return collateral is too short, then we suggest extending the 2 working day period in Paragraphs 3.8 and 6.1 of Schedule 1 to 5 working days as well. Issuing a completely new letter of credit in 2 working days is not possible and even providing cash in that timescale can be a challenge if the values are relatively large and director sign-off is required (which tends to restrict signatory availability).	Summary of previous responses. Reduction of minimum requirement And Change the timescale in which to provide credit cover from 2 days to 5 days

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

	Anonymous	If there is a concern about counter-parties have too many lines of credit on financial parties with lower credit ratings, there could be introduced a cap on the value of letters of credit being place by say BBB banks and a higher cap for higher rated banks etc. Overall I would want to keep a range of options open to the industry rather than restrict numbers of banks.	Introduce a cap on the value of letters of credit being place by say BBB banks and a higher cap for higher rated banks
Electricity North West	Non-confidential	There is the potential to review wholesale the approach to credit cover. It appears the current approach is cumbersome and complex creating additional costs across the parties that apply and follow the method. It may be the best solution is only to accept secured credit, whilst at the same time reducing slightly the acceptable credit rating to A- thereby increasing the competition for the provision of collateral.	Current approach is cumbersome. Good opportunity to review.
Northern Powergrid	Non-confidential	NPG's view is the best and most simplistic solution would be to reduce the minimum requirement for Banks to have long-term debt rating of not less than 'A' by Standard and Poor's Ratings Group reduced to not less than 'BB-'. In addition to this, NPg do not think that the value of the Letters of Credit should be capped in the same way that Qualifying Guarantees are, as the risk is with the Bank rather than the Supplier. Therefore it should be for the Bank to determine a suitable level of cover they wish to put in place for each individual Supplier. Should the Bank go into administration then (as per Schedule 1) the Supplier would have 2 working days to provide the additional cover that is required. Looking at this timescale NPg feel this could be relaxed slightly to 5wd to allow time to complete.	Simplest solution would be to reduce the minimum requirement. Change the timescale in which to provide credit cover from 2 days to 5 days
Southern Electric Power Distribution plc and Scottish Hydro Electric Power Distribution plc	Non-confidential	Based on our experience to date, we have not seen evidence that this issue is causing problems for the market. We would welcome the opportunity for review of evidence via the DCUSA SIG and to work with other parties on development of an appropriate solution	Welcome the opportunity to review but does not believe that there is an issue.
UK Power Networks	Non-confidential	While our experience does not indicate a pressing need for change, if there is a need for change, a pragmatic solution may be to link the provider of the LoC to the table in Clause 2.4 and to consider the aggregate value of LoCs from the same provider against this. The following changes to Schedule 1 could be considered to effect this; Amend 1.1 (a) as follows;	Provides suggested text. It is noted that this is largely formalising what has been talked about.

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

a Letter of Credit or equivalent bank guarantee (available for an initial period of not less than six months) **in accordance with Paragraphs 2.22 to 2.23**

Add new paragraphs;

Letter Of Credit as Collateral

2.22 Where the User wishes to deliver Collateral to the Company in the form of a Letter of Credit or equivalent bank guarantee, the Company shall not be obliged to accept such a Letter of Credit or guarantee if the aggregate value of all such Letters of Credit or guarantees so offered by the issuing bank would exceed the value of "LC" given by the following formula;

$$LC = RAV \times 2\% \times LCF$$

where: LCF is the Letter of Credit Factor (which is to be expressed as a percentage determined pursuant to Paragraph 2.23)

2.23 Where the bank has a Credit Rating from an Approved Credit Referencing Agency that is Baa3/BBB- or above, LCF shall be determined according to the following table.

Credit Rating		LCF (%)
Moody's	Standard and Poor's	
Aaa to Aa2	AAA to AA	100
Aa3 to A3	AA- to A-	40
Baa1	BBB+	20
Baa2	BBB	19
Baa3	BBB-	18

Includes sliding scale and introduces and aggregate value of LoCs

Some SIG members agreed this is a good option to progress.

DIF 51 'LETTERS OF CREDIT AND BANK CREDIT RATINGS' - COLLATED RFI RESPONSES

		<p>Amend the definition of Letter of Credit as follows;</p> <p>means an unconditional irrevocable standby letter of credit in such form as the Company may reasonably approve issued for the account of the User in sterling in favour of the Company, allowing for partial drawings and providing for the payment to the Company forthwith on demand by any United Kingdom clearing bank or any other bank which in each case has a long-term debt rating of not less than single A BBB- by Standard and Poor's Ratings Group or by Moody's Investors Service, or such other bank as the Company may approve and which shall be available for payment at a branch of the issuing bank</p>	
Western Power Distribution	Non-confidential	See Q3	Noted
<p>The SIG note - Some respondents were happy with current arrangements whereas others wanted a review of arrangements. Some gave suggestions towards potential solutions e.g. a reduction from A to various other ratings (A- or BBB for e.g.). Working Day issue from 2 to 5 was suggested.</p>			