



Direct Dial: 020-7901 7435

2 October 2002

The National Grid Company, BSC Signatories and  
Other Interested Parties

Our Ref: MP No P76

Dear Colleague,

**Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P76: "Anomalies Associated With Negative Quantities of Credit Cover"**

The Gas and Electricity Markets Authority (the "Authority")<sup>1</sup> has carefully considered the issues raised in the Modification Report<sup>2</sup> in respect of Modification Proposal P76, "Anomalies Associated With Negative Quantities of Credit Cover".

The Balancing and Settlement Code Panel (the "Panel") recommended to the Authority that Alternative Modification Proposal P76 should be made with an Implementation Date of 15 Working Days after the Authority's determination.

The Authority has decided to direct a Modification to the BSC.

This letter explains the background and sets out the Authority's reasons for its decision. In addition, the letter contains a direction to The National Grid Company plc ("NGC") to modify the Balancing and Settlement Code ("BSC") in line with Alternative Modification Proposal P76, as set out in the Modification Report.

This letter constitutes the notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

**Background**

British Gas Trading submitted Modification Proposal P76, "Anomalies Associated With Negative Quantities of Credit Cover", on 8 April 2002. The justification for the Modification Proposal was

---

<sup>1</sup> Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

<sup>2</sup> ELEXON document reference P76RR, Version No. 2, dated 21 August 2002

that it better facilitated achievement of the Applicable BSC Objective<sup>3</sup> C3 (3) (c), “promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) that it promoted competition in the sale and purchase of electricity”.

The Credit Modification Group (the “CMG”) considered the Modification Proposal and two other options over the course of two meetings. A requirements specification<sup>4</sup> was produced and both the Central Services Agent and Funds Administration Agent (the “FAA”) used this to provide detailed level impact assessments. The results of these assessments were used by Parties to respond to a high-level impact assessment and a consultation. A risk assessment<sup>5</sup> was also produced prior to an Assessment Report being issued. The Panel agreed to send the Modification Proposal to the Report Phase at its meeting on 18 July 2002.

### **The Modification Proposal**

A Party is deemed to be in Credit Default if in relation to any Settlement Period its Credit Cover Percentage (“CCP”) as determined by the Energy Contract Volume Aggregation Agent (the “ECVAA”) becomes greater than 80%. The calculation for determining a Trading Party’s CCP is given in Section M, Paragraph 3.1.1 of the BSC, as:

$$\text{CCP} = (100 * \text{Energy Indebtedness}) / (\text{Energy Credit Cover})$$

when Energy Credit Cover (“ECC”) is not equal to zero.

The problem identified by Modification Proposal P76 is that this equation is not sufficiently robust to deal with negative values of ECC. A Trading Party with negative ECC and positive Energy Indebtedness would have a negative CCP and therefore would not be flagged as being in Credit Default. This is despite the fact that it would have debts (i.e., Energy Indebtedness) and inadequate Credit Cover.

Modification Proposal P76 seeks to modify the BSC so as address the anomalies that arise from using negative values of ECC to calculate CCP. The proposer considers that making this Modification would reduce the bad debt risk faced by the industry.

The CMG considered three different means of addressing the problem identified by Modification Proposal P76:

- Amending the equation used to calculate CCP to make it robust enough to deal with negative values of ECC (the original Modification Proposal)
- Amending the definitions of Energy Indebtedness and Credit Cover so that the amount of unpaid Trading Charges is added to Energy Indebtedness, rather than being subtracted from Credit Cover (as currently happens)
- Amending the definition of Credit Cover to prohibit negative values of Credit Cover

---

<sup>3</sup> The Applicable BSC Objectives, as contained in Condition C3 (3) of National Grid Company’s Transmission Licence, are:

- a) the efficient discharge by the licensee of the obligations imposed upon it by this licence;
- b) the efficient, economic and co-ordinated operation by the licensee of the licensee’s transmission system;
- c) promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity;
- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

<sup>4</sup> ELEXON document “Requirements Specification to Support Modification P76”, Version No. 1, dated 16 May 2002

<sup>5</sup> ELEXON document “Modification Proposal P76 Risk Assessment”, Version No. 1, dated 5 June 2002

The risk assessment identified three circumstances where negative ECC could arise. In two of these instances, the current controls were considered to be sufficient. However, if the ECVAAs have incorrectly assessed a Party's Energy Indebtedness, due to inaccurate Trading Charge data, this may result in the Party posting insufficient Credit Cover. Since this was identified as the primary risk, the proposed solutions were evaluated against their ability to restrict the occurrence of such a scenario. It was noted that the implementation of Modification P2<sup>6</sup> on 30 September 2002 should improve the accuracy of estimates of Parties' Energy Indebtedness, thereby reducing the likelihood of Parties being able to post insufficient Credit Cover while remaining undetected by the Credit Default Process.

The conclusion of the risk analysis was *"...that fixing the credit checking process to correctly handle negative values of Credit Cover ... doesn't provide any benefit to BSC Parties, unless the ECVAAs system has under-estimated the Party's indebtedness, and hence allowed them to post insufficient Credit Cover"*. In view of the impending implementation of Modification Proposal P2, the CMG decided that the comparative simplicity of the option to amend the definition of Credit Cover to prohibit negative values of Credit Cover would be just as effective as either of the other two options under review.

Three other factors were considered by the CMG in coming to this decision:

- In practice, the FAA currently sets negative values of Credit Cover to zero when considering a Party's credit position. Accordingly, there is an inconsistency between operational practice and the Code, in an area where the Code has been highlighted as deficient. Without the implementation of a change to the Code, a Party could demand that the negative value of CCP is used to determine their credit status, thereby avoiding being placed in Credit Default.
- There were substantial differences in the costs of implementing the various options – the original Modification Proposal was estimated at £110,700, the option of amending the definitions of both Energy Indebtedness and Credit Cover was estimated at £160,000, while the option of prohibiting negative values of Credit Cover was estimated at £2,050.
- The changes proposed to the CCP calculation bring the possibility of a Party being put directly into Level 2 Credit Default, rather than the usual instance where a Party would firstly go into Level 1 Credit Default. This means that a Party might need to arrange extra Credit Cover outside of normal working hours in order to prevent trading restrictions being placed on them. An analysis of the effects of the original Modification Proposal and those of the option of prohibiting negative values of Credit Cover indicated that the latter option would not cause any increase in the number of Parties that could be put directly into Level 2 Credit Default. However, there is a risk that the original Modification Proposal may cause such an increase, especially in instances where a party is maintaining its Energy Indebtedness at zero.

The CMG decided to recommend that the original Modification Proposal should be rejected in view of the conclusions from the risk analysis and in view of the implementation costs. The option of amending the definitions of Energy Indebtedness and Credit Cover was also rejected for the same reasons. The CMG proposed that the option of prohibiting negative values of Credit Cover should be progressed as an Alternative Modification Proposal, with the suggestion that this Alternative be recommended to the Panel for implementation.

---

<sup>6</sup> Modification Proposal P2, "Revision of the Methodology for Assessing Credit Indebtedness", approved by the Authority on 15 October 2001

ELEXON published a draft Modification Report on 26 July 2002, which invited respondents' views by 2 August 2002.

### **Respondents' views**

ELEXON received eight responses to the consultation on Modification Proposal P76. Seven responses (representing 37 Parties) expressed support for the Alternative Modification and the remaining respondent (representing 1 Party) replied with 'no comment'.

The respondents' views are summarised in the Modification Report for Modification Proposal P76, which also includes the complete text of all respondents' replies.

### **Panel's recommendation**

The Panel met on 15 August 2002 and considered the Modification Proposal P76, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Alternative Modification Proposal and that, if approved, the Alternative Modification Proposal should be made with an Implementation Date of 15 Working Days after the Authority's determination. Moreover, the Panel recommended that the Proposed Modification P76 should not be made, but in the event that the Authority determined that Proposed Modification P76 should be made, the Implementation Date should be:

- 25 February 2003 if a determination is made by the Authority on or prior to 24 October 2002
- 24 June 2003 if a determination is made by the Authority after 24 October 2002

### **Ofgem's view**

Ofgem considers, having had regard to its statutory duties, that the Alternative Modification Proposal P76 will better facilitate achievement of the Applicable BSC Objectives. The original Modification Proposal has highlighted that the equation for the calculation of CCP is not robust enough to deal with negative values of ECC. This could allow a Party with insufficient Credit Cover to continue trading, which places an unnecessary financial risk on all other BSC Parties. The alleviation of this risk creates a more equitable and stable trading environment for all Parties and so is consistent with the objective of promoting effective competition in the generation and supply of electricity.

The risk analysis conducted by ELEXON has illustrated that following the implementation of Modification Proposal P2, the original Modification Proposal does not provide any greater reduction in risk to BSC Parties than the Alternative Modification Proposal. Additional factors favour the adoption of the Alternative Modification Proposal in preference to the original:

- The Alternative Modification Proposal requires minor changes to documentation, while the original requires system changes and significant testing
- The implementation cost of the Alternative Modification Proposal is £2,050 while the original would cost £110,700 plus annual maintenance costs
- The implementation of the original Modification Proposal could lead to an increase in the likelihood of a Party being put straight into Level 2 Credit Default due to small changes in absolute credit level, which would create unwarranted trading difficulties for that Party

- The implementation of the Alternative Modification Proposal codifies an existing operational practice, so the disruption to the trading environment should be minimal

Accordingly, Ofgem believes that the Alternative Modification Proposal, as compared with the original Modification Proposal, will better facilitate achievement of the Applicable BSC Objectives.

Ofgem agrees with the Panel's recommendation that the Alternative Modification Proposal P76 should be made and implemented.

### **The Authority's decision**

The Authority has therefore decided to direct that the Alternative Modification Proposal P76, as set out in the Modification Report for Modification Proposal P76, should be made and implemented.

### **Direction under Condition C3 (5) (a) of NGC's Transmission Licence**

Having regard to the above, the Authority, in accordance with Condition C3 (5) (a) of the licence to transmit electricity granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the BSC as set out in the Alternative Modification Proposal contained in the Modification Report.

The Implementation Date of Alternative Modification Proposal P76 is 15 Working Days from the date of this decision letter.

In accordance with Condition C3 (5) (b) of NGC's Transmission Licence, NGC shall modify the BSC in accordance with this direction of the Authority.

If you have any questions, please contact me on the above number.

Yours sincerely,



**David Edward**

**Head of Electricity Codes Development**

Signed on behalf of the Authority and authorised for that purpose by the Authority