

Direct Dial: 020-7901- 7435

16 October 2001

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref : MP No: P2

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Direction in relation to Modification Proposal P2: “Revision of the Methodology for Assessing Credit Indebtedness”.

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in Modification Proposal P2 “Revision of the Methodology for Assessing Credit Indebtedness”.

The Balancing and Settlement Code Panel (the “Panel”) recommended to the Authority that the Proposed Modification set out in Section 7 of the P2 Modification report dated 3 September 2001 be approved, with an Implementation Date of 30 September 2002.

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

This letter explains the background to the Modification Proposal 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”) as set out in Modification Proposal P2.

Background to the proposal

Modification Proposal P2 was submitted by British Gas Trading Ltd. on 27 March 2001, and proposes that the calculation of indebtedness for credit-checking purposes should be enhanced to use actual prices and metered volumes. The proposal states that this would

¹ Ofgem is the office of the Authority. The terms “Ofgem” and the “Authority” are used interchangeably in this letter.

protect Parties from the expense of having to post inappropriate levels of credit cover, and also the risk of a defaulting Party having unsecured settlement liabilities.

The BSC Panel meeting on 5 April 2001 agreed that Modification Proposal P2 should be submitted to the Definition Procedure (as defined in section F2.5 of the BSC). This Definition Procedure was carried out by the Credit Modification Group, who concluded that Trading Parties are being exposed to significant risks and costs as a result of inaccuracies in the current credit-checking methodology.

The BSC Panel meeting on 31 May 2001 agreed the Definition Report prepared by the Modification Group, and agreed that Modification Proposal P2 should be submitted to the Assessment Procedure (as defined in section F2.6 of the BSC). In the course of the Assessment Procedure, the Modification Group issued for consultation and assessment a detailed description of two possible Modification Proposals:

- Modification Proposal P2, as proposed by British Gas Trading; and
- An Alternative Modification Proposal (developed by the Modification Group) which sought further to increase the accuracy of the credit-checking process by using a more accurate method of estimating indebtedness in the period prior to actual data becoming available.

Having reviewed the responses to this consultation, and assessed the costs and benefits of each Modification Proposal, the Modification Group concluded that Modification Proposal P2 would better facilitate the achievement of the Applicable BSC Objectives. Details of the analysis undertaken can be found in the Assessment Report.

The BSC Panel meeting on 26 July 2001 considered the Assessment Report prepared by the Credit Modification Group, and endorsed their recommendation that the draft Modification Report should recommend acceptance of Modification Proposal P2. The draft Modification Report was then issued for consultation. The BSC Panel meeting on 23 August 2001 considered the consultation responses confirmed that the Final Modification Report should recommend acceptance of Modification Proposal P2 and agreed the legal text required to give effect to the Modification.

The Modification Proposal

Modification Proposal P2 seeks to modify the BSC so as to improve the accuracy of the credit-checking process by using actual prices and metered volumes once they become available with Credit Assessment Price (CAP) continuing to be used in the meantime. CAP is the amount in £/MWh that the BSC Panel determines, after consultation with Trading Parties, as the price, which it would be appropriate to use to determine the equivalent financial amount of Trading Parties Energy indebtedness.

This proposal was further clarified during the P2 Definition Procedure, and at the Modification Group meeting on 20 June as follows:

- In order to ensure accurate calculation of indebtedness, credit-checking should take into account not just Energy Imbalance charges, but also all the other Trading Charges calculated by the Settlement Administration Agent (SAA) system i.e. Residual Cashflow Reallocation Cashflow, BM Unit Cashflow, Non-Delivery Charges and Information Imbalances. The Settlement Administration Agent is the BSC Agent who deals with settlement matters under section T of the BSC.

It was considered undesirable to build a new system to calculate all of these Trading Charges. It was therefore proposed to use the SAA Interim Information run for this purpose i.e. indebtedness will be based on Trading Charges calculated by SAA for that portion of the 29-day credit period for which an Interim Information run has been performed. For the remainder of the 29-day credit period, indebtedness would be estimated on the basis of CAP and Credit Assessment Load Factor (CALF) as it is currently. The BSC Panel establishes principles or guidance as to how CALF values are assigned to BM Units. Elexon determines CALF values in accordance with the principles established by the BSC Panel, although a Trading Party may request the Panel to re-determine CALF values for one or more of its BM Units.

Using Trading Charges calculated by SAA ensures that indebtedness is calculated using actual price data and actual metered volumes for each Central Volume Allocation Balancing Mechanism Unit (CVA BM Unit). CVA is the determination of quantities of Active Energy to be taken into account for the purposes of settlement in respect of BM Units. BM Units that are CVA, therefore, have their Active Energy determined this way for settlement purposes.

However, it was noted that this does not address the problem of metered volumes for Supplier BM Units (which aren't available until the Initial Settlement run). It was proposed to solve this issue by enhancing the SAA software to estimate metered volumes for Supplier BM Units in the Interim Information run. This would be done by apportioning the Grid Supply Point (GSP) Group. A GSP is a systems connection point at which the Transmission System is connected to a Distribution System.

ELEXON published a Draft Modification Report on 30 July 2001, which invited respondents' views by 17 August 2001. It was noted that the review of the P2 legal drafting by ELEXON's legal advisers would not be completed by the deadline for circulating papers to Panel Members

(i.e. noon on Friday 17 August). It was, therefore, proposed that any changes to the legal drafting would be circulated to Panel Members at a later date (prior to the meeting on 23 August).

Respondents' views

In total, ELEXON received 9 responses to the consultation on Modification Proposal P2. Of the responses, all expressed support for the proposed modification and the remaining one of the representations expressed disappointment that the Alternative Modification Proposal had not been accepted.

The respondents' views are comprehensively summarised in the Modification Report for Modification Proposal P2 dated 17 August 2001.

Panel's Recommendation

The Panel met on 23 August 2001 and considered the Modification Proposal P2, the Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Proposed Modification and that, if approved, the Proposed Modification should be implemented on 30 September 2002.

Ofgem's view

Ofgem considers, having had regard to its statutory duties, that Modification Proposal P2 will better facilitate the achievement of the relevant objectives of the BSC, since the current methodology for assessing credit indebtedness is over-estimating the indebtedness of certain Parties, potentially obliging them to post unwarrantedly high levels of credit cover.

Presently, Parties may be having to provide up to £170 million of unwarranted credit cover, at an estimated cost per annum of £1.7 million. Conversely, the current methodology for assessing credit indebtedness is under-estimating the indebtedness of certain Parties by some £30 million in total. This potentially allows these Parties to post a level of credit cover that would be insufficient to cover their settlement liabilities in the event of default, with Parties in aggregate bearing the resultant risk. The magnitude of this risk depends upon how Parties are likely to behave prior to going into default, and is therefore hard to quantify precisely.

However, the analysis did identify scenarios under which weaknesses in the current methodology allow a Trading Party to incur very large unsecured debts without the problem being detected by the credit-checking process. Although the probability of such a scenario occurring cannot be determined with any accuracy, it does appear that Trading Parties are currently exposed to significant risks as a result of the current methodology for assessing credit indebtedness.

Analysis suggests that Modification Proposal P2 would decrease the cost of unwarranted credit from £1.7 million to £0.3 million per annum, as well as reducing considerably the risk of

a Party going into default with insufficient credit cover to pay their settlement liabilities. These benefits appear to outweigh the costs of implementing the Modification.

Implementation of Modification Proposal P2 would therefore remove a significant and material inefficiency in the operation of the balancing and settlement arrangements. This will in turn better facilitate achievement of the BSC Objective in condition C3.3 (d) of the Transmission Licence i.e. promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

Ofgem agrees that the unnecessary costs and risks imposed on Trading Parties by the current methodology for assessing credit indebtedness may also act as a deterrent to participation in the electricity market, particularly for those organisations with limited ability to raise additional funds. Implementation of Modification Proposal P2 would therefore also facilitate achievement of the BSC Objective in condition C3.3 (c) of the Transmission License (i.e. promoting effective competition in the generation and supply of electricity).

It is understood that Modification Proposal P2 does not entirely remove the inaccuracies in the credit-checking methodology and consideration has been given to the implementation of an Alternative Modification Proposal that reduced still further the unnecessary costs and risks arising from participation in the balancing and settlement arrangements. However having had regard to this, the view of the Modification Group and their recommendations on such an Alternative Modification Proposal, Ofgem agrees that it would not further facilitate the Applicable BSC Objectives. It is felt that the additional cost savings achievable through the Alternative Modification approach are relatively minor. As such they do not justify the additional cost of implementation.

Ofgem agrees with the Panel's recommendation that the Proposed Modification P2 set out in Section 7 of the P2 Modification report dated 3 September 2001 be approved, with an Implementation Date of 30 September 2002.

The Authority's decision

The Authority has, therefore, decided to direct that Modification Proposal P2 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 Modification Proposal P2.

The implementation date of the Modification will be 30 September 2002.

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 queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

David Edward

Head of Electricity Code Development

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