Stage 03: Attachment A: Detailed Assessment for P249

What stage is this document in the process?

01 Initial Written Assessment

02 Definition Procedure

03 Assessment Procedure

04 Report Phase

P249: Revision of Banking Arrangements under the BSC

Contents

About this document:

This is Attachment A to the Assessment Report.

This attachment provides additional details of the Modification Group's discussions, a summary of the impacts and consultation responses, and the process which the Group has followed in assessing P249.

Panel 166/07

P249
Detailed Assessment

5 March 2010

Version 1.0

1 Terms of Reference

The P249 Modification Group consists of members of the Governance Standing Modification Group (GSMG), supplemented with industry representatives with established financial or funds administration experience.

The table below summarises the:

- Areas which the Group has considered as part of the P249 Terms of Reference, as set by the Panel and shown in Table 1 below; and
- The Group's conclusions in each area.

Table 1 – Terms of Reference

P249 Terms of Reference		
Ref		Group's conclusion
1	The effect of the Modification on Applicable BSC Objective (d) and any other relevant BSC Objective(s).	The Proposed Modification better facilitates Applicable BSC Objective (d), compared to the current baseline, and has no impact on any other Applicable BSC Objectives.
2	Whether an Alternative Modification is required.	No Alternative Modification is required.
3	The most effective implementation approach for the Modification, including whether the necessary Code Subsidiary Document changes are drafted in the Assessment Procedure or during implementation.	The Group would suggest that the Proposed Modification be implemented 5 working days following the return of an Authority decision to approve, and that the Code Subsidiary Document changes are drafted in the Assessment Procedure and issued for industry consultation in the Report Phase.

Group's views on the implications on financial risk

A number of respondents to the Assessment Consultation noted that there were impacts arising from P249 on the nature and magnitude of the financial risks associated with Reserve Account monies.

After discussion, the Modification Group agreed that diversifying risk on monies held in the Reserve Account would result in a smaller amount of money being lost in the event of a single bank failure. This would be achieved by providing for the reduction of the total proportion of the Reserve Account balance held in a single bank account with a single financial institution (the BSC Banker). As a consequence, the overall risk to Parties' ability to operate in the market could be seen as being lessened.

A Group member speculated that if the failure of a financial institution following the implementation of P249 resulted in the loss of 25% of Parties' credit cover, Parties would be likely to be able to continue to operate, in the short term, with 75% of their original credit cover. Prior to the implementation of P249, any failure of the single BSC Banker would result in the loss of 100% of Reserve Account funds, and hence 100% of Parties' credit cover.

The Group noted that under P249 a marginally greater risk would exist for a proportion of monies lodged to be lost as the total balance was spread across multiple financial institutions.

The Group agreed that the issue of liability to recover funds, and return them to Parties who had originally lodged cash cover, in the event of the BSC Banker or another financial institution failing should be considered a separate matter, outside the scope of P249. ELEXON noted that the Code was currently silent or unclear on who would bear the liability for a loss of Reserve Account funds in the event of a failure of a financial institution. The Group suggested that this issue of liability could be considered by a BSC Issue Group, with a particular view as to whether such provisions would need to be clearly incorporated into the Code. This course of action would be dependent on a BSC Party raising an Issue.

Group's views on the analysis of risk and return

The Group – among whose members were a number of Treasury or Funds Administration personnel from Parties – considered sufficient analysis to have been completed on the balance of risk and reward in the context of P249. The Group cited the point that the financial institutions into which investments would be made would be restricted to UK banks and building societies, as opposed to other financial instruments including institutions based overseas, as an appropriate risk mitigation factor.

Group's views on the impact on the Applicable BSC Objectives

The Group concluded unanimously that the Proposed Modification **better facilitated Applicable BSC Objective (d) (efficiency)**, as they considered the diversification of investments of Reserve Account monies to lessen the overall impact of the risk of financial loss with the failure of a single financial institution. The Group considered the diversification of this risk to constitute a greater overall benefit for BSC Parties lodging cash cover than the possibility of increased financial returns from the investing of these monies in institutions with competitive rates of interest.

Some Group members expressed concern that any benefit from this risk diversification might be outweighed by increased operational costs that might be incurred by ELEXON in administering the revised investment processes following the implementation of P249. ELEXON assured the Group that, based on a scenario of directing 2 financial transfers per week for a term of 7 days, with a total of 8 transfers per month, the maximum effort required to complete this work was 2 man days per month, which could be covered by existing resource. The FAA already has a process in place to monitor various financial institutions' credit ratings on a daily basis, in order to control Letters of Credit lodged, and ELEXON would intend to act on the basis of such information following the implementation of P249. ELEXON further confirmed that the services of a stockbroker to provide investment advice would be free of charge to ELEXON, with any fees covered by the recipient financial institutions. ELEXON noted that no ongoing operational Service Provider costs would be incurred and that, as P249 had no impact on the BSC Central Systems, a minimal Service Provider implementation cost (£1,300) would be necessary for the development of a new spreadsheet for the calculation of interest returns to Parties.

The Group discussed the impact of the Proposed Modification on Applicable BSC Objective (c) (competition). Some Group members were of the opinion that P249 offered those Parties with the means to deposit larger amounts of cash cover something of a competitive advantage as they would incur comparatively greater financial returns (i.e. promote their ability to compete in the market). Conversely, Group members observed that Parties with cash cover lodged may be 'losing out' by not receiving market rate levels of interest on this money under current provisions. The Group concluded unanimously, however, that so minimal was this impact on the overall competitiveness of the generation and supply markets that P249 could be judged to have **no impact on Applicable BSC Objective (c)**.

The Group agreed, unanimously, that the Proposed Modification had **no impact on Applicable BSC Objectives (a)** (the effective discharge by the Transmission Company of its obligations) or **(b)** (efficiency in the operation of the transmission system).

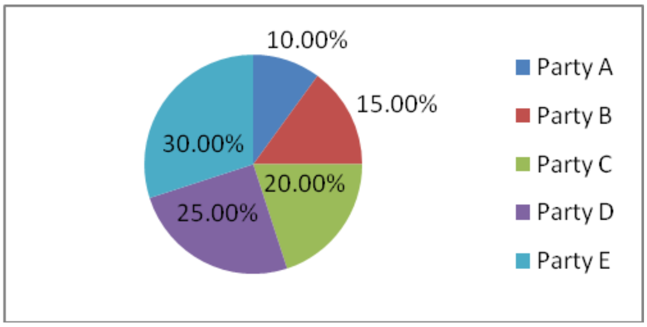
Group's views on interest calculation

The Group requested clarification on what process or methodology ELEXON intended to follow to confirm the calculation and payment of interest returns on cash cover lodged in the Reserve Account and Investment Accounts to Parties. ELEXON explained that all monies deposited in the Reserve Account, whether invested in Investment Accounts or not, would be treated as a single pool. Returns from Investment Accounts would be pooled and apportioned to Parties, at quarterly intervals, in proportion to the amount of monies attributable to the relevant Party from time to time.

SIMPLIFIED EXAMPLE:

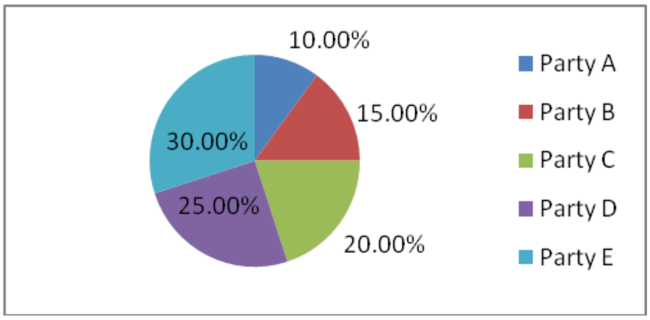
£100m exists in the Reserve Account.

A first investment is placed for 10% of the overall funds - £10m.



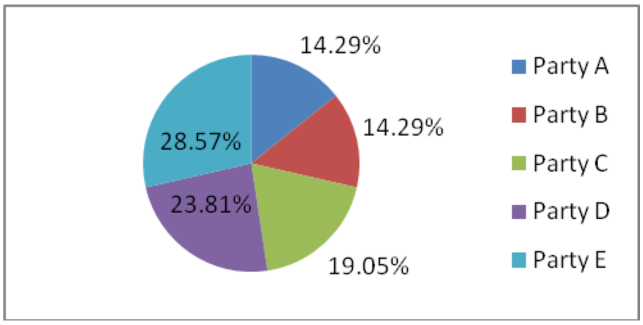
Party	Total Cash Lodged (£)	% Overall Total	% of Investment	Investment (£)
A	10,000,000	10.00%	10	1,000,000
B	15,000,000	15.00%	10	1,500,000
C	20,000,000	20.00%	10	2,000,000
D	25,000,000	25.00%	10	2,500,000
E	30,000,000	30.00%	10	3,000,000

A second investment is placed for 20% of the overall funds held in the Reserve and Investment Accounts - £20m.



Party	Total Cash Lodged (£)	% Overall Total	% of Investment	Investment (£)
A	10,000,000	10.00%	20	2,000,000
B	15,000,000	15.00%	20	3,000,000
C	20,000,000	20.00%	20	4,000,000
D	25,000,000	25.00%	20	5,000,000
E	30,000,000	30.00%	20	6,000,000

Should Party A subsequently increase their cash deposit by £5m, the next investment will be based on a total of £105m held in Reserve and Investment Accounts, with Party A having lodged £15m. Individual Party shares for a 10% investment will change, correspondingly, to:



Party	Total Cash Lodged (£)	% Overall Total	% of Investment	% of Investment (£)
A	15,000,000	14.29%	10	1,500,000
B	15,000,000	14.29%	10	1,500,000
C	20,000,000	19.05%	10	2,000,000
D	25,000,000	23.81%	10	2,500,000
E	30,000,000	28.57%	10	3,000,000

Party A will receive interest, quarterly, on their share of each investment.

- First investment: 10% of the share of interest received
- Second investment: 10% share of the interest received
- Third investment: 14.29% share of the interest received

Assuming an interest rate of 0.52%, on a 30 day deposit Party A would receive:

Investment	Amt Invested	Total Interest Earned	Party A Share	Party A Share
1	£10,000,000	£4273.97	10%	£427.40
2	£20,000,000	£8547.95	10%	£854.79
3	£10,500,000	£4487.67	14.29%	£641.29

Group's comments on the P249 Proposed Legal Text

The Group provided comments on the P249 Proposed Legal Text, following which ELEXON have produced a further draft of the text. The Group felt that the provision for a revised ELEXON Treasury Policy to become effective within 10 working days of the Board issuing a decision to approve was inadequate for Parties to take appropriate action. ELEXON agreed to amend the legal text to specify that the revised Treasury Policy would become effective within 15 working days of a communication being issued to the industry to that effect, following the issuing of a Board decision to approve.

Modification Group's comments on the ELEXON Treasury Policy

The P249 Modification Group thought it appropriate that, following the implementation of P249, investment decisions should be made in line with a Treasury Policy under the ownership of the ELEXON Board. The Group felt that the ELEXON Board members were well qualified to make such decisions on the basis of advice from ELEXON's Chief Financial Officer. The Group had reviewed the Treasury Policy as currently approved by the ELEXON Board.

ELEXON will present the Group's comments to the ELEXON Board for consideration when reviewing the Treasury Policy. Were P249 to be approved by the Authority, ELEXON would seek to expedite this review.

Control

An Assessment Consultation respondent's suggestion that control over the Treasury Policy should come under the control of the BSC Panel, with a process in place for consultation with Parties in the event of any review, was judged by the Group to be unviable. It was felt that ELEXON would need the flexibility to make speedy strategic decisions on its investment policies; should such policies need to be issued for industry consultation, establishing a consensus would be difficult and timescales would be extended prohibitively. The Group were keen for ELEXON to communicate closely with Parties in the event of a review of the Treasury Policy in order to gauge their risk appetite, but the Group agreed that the control process for this Policy should be managed by the ELEXON Board. The Group noted that Parties could make a view on the Treasury Policy when electing how to lodge credit; if they did not agree with its provisions the option would remain for them to lodge a Letter of Credit.

The Group suggested that the Policy be reviewed at least annually by the ELEXON Board, with changes drafted by ELEXON Finance accordingly and submitted for approval by the Board. ELEXON stated that it was proposed that the Policy be reviewed every 6 months. The Group also thought it appropriate that ELEXON communicate changes to the Policy to Parties upon approval by the Board, with any changes taking effect 15 working days following such approval.

Whilst recognising that the Modification Proposal intended to change the BSC to facilitate the implementation of an investment regime in line with this Policy, the Group suggested a number of changes to the policy for inclusion in a subsequent review and update to the Policy. The Group recognised that any decision on whether to progress such a review remained with the ELEXON Board.

Selection Criteria

The Group felt that further clarification was needed as to what constituted a UK financial institution (Section 3, "Selection Criteria"). ELEXON informed the Group that this was intended to mean a bank or building society incorporated in the UK, with a head office in the UK and authorised and regulated by the Financial Services Authority (FSA). The Group agreed that this was a sensible policy as ELEXON Finance or any broker it employed would be likely to have greater knowledge of the overall financial security of financial institutions based in the UK. The Group suggested that text be added to the Policy to explain this.

What does the Treasury Policy cover?

The Treasury Policy sets out appropriate parameters for ELEXON's banking arrangements to deliver a reasonable rate of return on cash balances and being able to meet the organisation's financial obligations.

It covers the core objectives of security, liquidity and yield. It is governed by the ELEXON Board of Directors who are responsible for approving any changes.

The Group noted certain Assessment Consultation responses calling for greater investment diversification, and suggested that the Treasury Policy be amended to allow investments in up to five financial institutions other than the BSC Banker, as opposed to the two institutions as specified in the Policy at present. ELEXON thought it appropriate that these be chosen from a list, approved by the Board, of up to ten financial institutions with whom deposits could be made during any period. The Group believed that providing the flexibility to spread investments across a larger number of financial institutions would diversify, and hence lessen, overall financial risk.

There was some discussion among Group members regarding comments in Assessment Consultation responses suggesting that credit ratings were an unreliable criterion on which to select financial institutions for investment purposes. Group members did not feel that any better alternative criteria existed, and concluded that the proposed geographical restriction on investments (UK financial institutions only) provided additional assurance that monies would be invested securely. Some Group members suggested that, from a further risk diversification standpoint, limits be set as to the proportions of the total Reserve Account balance, as well as the gross monetary value of investments, that could be invested in a single financial institution based on its credit rating. The Group also suggested that it would be sensible to employ more flexible criteria in the Treasury Policy, to prevent the Policy by being subject to frequent change.

ELEXON considered that a fixed limit on the amount deposited with each financial institution, rather than a maximum percentage, could also give clarity to the amounts that can be deposited with any one financial institution, with the possibility of setting limits based on bank ratings. This would make the investments easier to manage, reducing the administration work involved, and eliminating any risk of breaching the terms of the Policy should the volume of funds in the Reserve Account decrease.

Reserve Account Liquidity

The Group sought reassurance that sufficient liquidity would be maintained in the Reserve Account to enable access to cash cover monies within current timescales. ELEXON agreed to seek to amend the Treasury Policy to clarify this matter. The following example illustrates how this might be managed under a revised Treasury Policy.

EXAMPLE:

The Treasury Policy would clarify that, at all times, Barclays would retain in the Reserve Account, an amount that exceeds the greater of:

- 30% of the total funds deposited in the Reserve Account; or
- the single largest cash deposit by a Party plus 5% of the total Cash Cover lodged by all Parties.

For example, consider the scenario whereby a total of £129 million is deposited in the Reserve Account and where the largest single deposit by a Party is £30 million:

- Using the single largest cash deposit criteria, the funds that would be retained in the Reserve Account would be £30 million (single cash deposit) plus £6.45 million (5% of the total £129 million).
- The resultant £36.45 million would however only form 28% of the total Reserve Account pool.
- In this instance we would retain 30% of the total deposit (£38.7 million) in the Reserve Account.

In all events, ELEXON would also ensure that any monies placed on term deposit could be called back on request. Such requests might result in ELEXON incurring penalties; ELEXON would direct investments in such a way to ensure that these penalties would not exceed any returns on the principal amount.

3 Summary of Assessment Consultation Responses

"Would you like the ELEXON Treasury Policy to be made available to BSC Parties on request?"

Respondents unanimously believed that it would be appropriate for ELEXON to make its Treasury Policy, as approved by the ELEXON Board, available to Parties on request. The views given matched those of the Group as detailed in Section 3 of the main Assessment Report.

"Would the Proposed Modification impact your organisation?"

Of the eight Assessment Consultation responses, six affirmed that the Proposed Modification would impact respondents' organisations' processes, but not systems. See Section 2 of the Detailed Assessment for further discussions on the impact of P249 on BSC Parties.

"Do you support the implementation option as described in the Assessment Consultation document?"

Of the eight Assessment Consultation responses, six stated support for the proposed implementation approach. No respondents suggested an alternative to this approach. The two respondents who stated a negative response voiced their opposition to the implementation of P249 itself.

"Would the Proposed Modification P249 help to facilitate the Applicable BSC Objectives?"

Of the eight Assessment Consultation responses, four indicated that P249 would help to facilitate BSC Objective (d). Three suggested that P249 would not better achieve the applicable Objectives, and one was neutral. The Group's discussions of the impact on P249 on the Applicable BSC Objectives can be found in Section 2 of the Detailed Assessment.

"Are there alternative solutions that the Modification Group has not identified that they should consider?"

Of the eight Assessment Consultation responses, three suggested potential alternative solutions for P249 which the Group considered but decided not to progress. These potential alternatives concerned principally the contents of the ELEXON Treasury Policy, for which the Group's discussions are detailed in Section 2 of the Detailed Assessment.

"Do you have any further comments on P249?"

Five of the eight organisations which responded to the Assessment Consultation provided further comments on P249. The Group received these comments with interest, and details of the discussions can be found in Section 2.

4 Transmission Company Analysis

National Grid returned its Transmission Company Analysis for P249 along with the industry Assessment Consultation responses.

National Grid did not identify any impacts to its ability to discharge its obligations under the Transmission Licence, nor to its systems. National Grid also identified no risks to security of supply arising from P249.

5 Impacts on Participants, Systems, Processes & Documents

No responses to the P249 Assessment Consultation reported any impact on BSC Party or Party Agent systems arising from the Proposed Modification. The only salient impacts identified were for organisations to incorporate the new ELEXON Treasury Policy into their decision making processes.

Responses to the Assessment Consultation did indicate that participants held some concerns about the exposure of cash cover they would be lodging in the Reserve Account to a different financial risk environment. See Section 2 of the Detailed Assessment for the Group's discussions on the implications of P249 on financial risk.

6 Timetable and Responsibilities

Table 2 – P249 Progression Timetable

P249 Progression Timetable	
Date	Activity
10/12/09	Modification Proposal P249 raised and Initial Written Assessment (IWA) presented to the Panel
13/01/10	First Assessment Procedure Modification Group meeting held
25/01/10	Assessment Consultation and request for Transmission Company Analysis issued
08/02/10	Assessment Consultation responses and Transmission Company Analysis returned
10/02/10	Second Assessment Procedure Modification Group meeting held
11/03/10	Assessment Report presented to the BSC Panel

Table 3 – P249 Estimated Progression and Implementation Costs

Estimated progression and implementation costs based on current timetable	
Progression	
Meeting costs (including Modification Group member expenses)	£1,000
Non-ELEXON legal and expert costs	£3,000
Service Provider impact assessment costs (including implementation)	£3,000
ELEXON resource	21 man days, equating to £7,000
Implementation	
Service Provider implementation costs	£1,300
ELEXON resource	11.5 man days, equating to £2,760

Table 4 – P249 Modification Group attendance

Member	Organisation	13/01/10	10/02/10
Adam Richardson	ELEXON (Chairman)	Y	Y
Dickon Prior	ELEXON (Lead Analyst)	Y	Y
Alan Church	ConocoPhillips (U.K.) Ltd.	Y	Y
Andrew Colley	Scottish and Southern Energy plc.	Y	N
Gary Henderson	SAIC Ltd.	Y	Y
Daniel Nanson	Centrica plc.	Y	Y
Esther Sutton	E.ON UK Ltd.	Y	Y
Janice Tanner	Thames Power Services Ltd.	Y	Y
Attendee	Organisation	13/01/10	10/02/10
Darren Draper	ELEXON (Technical Support)	Y	Y

Steve Francis	ELEXON (Technical Support)	Y	Y
Natalie Pike	ELEXON (Lawyer)	Y	Y
Nigel Smith	ELEXON (Executive)	N	Y