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The National Grid Company, BSC Signatories and
Other Interested Parties

07 September 2005

Our Ref: MP No P188

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and notice in relation to Modification Proposal P188 "Revision to Credit Default provisions"

The Gas and Electricity Markets Authority (the "Authority")[1] has considered the issues raised in the Modification Report[2] in respect of Modification Proposal P188, "Revision to Credit Default provisions".

The BSC Panel (the "Panel") recommended to the Authority that Proposed Modification P188 should be made.

Having considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives[3] and the Authority's wider statutory duties,[4] the Authority has decided to direct a Modification to the BSC in line with Proposed Modification P188.

This letter explains the background and sets out the Authority's reasons for its decision.

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

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[1] Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

[2] ELEXON document reference P188MR, Version No. 1.0, dated 15 August 2005

[3] The relevant Applicable BSC Objectives, as contained in Standard Condition C3 (3) of NGC'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; and
d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements

[4] Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and are detailed in sections 3A to 3C of the Electricity Act 1989.

Background

Under the current trading arrangements, payments to and from Parties in respect of Trading Charges arising on any particular Settlement Day are made, on average, 29 calendar days later. Thus at any given time, Parties may have outstanding debts (or be due payments) accrued over an equivalent timeframe.

BSC provisions seek to estimate the level of these Trading Charges using the Energy Indebtedness calculation. This calculation is itself a composite of two separate estimates of likely imbalance position in MWh: Actual Energy Indebtedness, based on Interim Information Settlement Run data, is used for the majority of the 29 days; and Credit Assessment Energy Indebtedness, based on the difference between a Party's bilateral contract volume and its expected physical position, used for the remainder.

Parties may lodge Credit Cover against their outstanding Trading Charges in the form of cash and/or a Letter of Credit. To allow its comparison with Energy Indebtedness, the Credit Cover they have lodged is converted from a financial amount into an MWh amount by dividing it by the Credit Assessment Price. This MWh amount is known as Energy Credit Cover.

Following Gate Closure for each Settlement Period, the Energy Contract Volume Aggregation Agent (ECVAA) will divide each Party's Energy Indebtedness by its Energy Credit Cover to determine its Credit Cover Percentage (CCP). Where CCP exceeds defined thresholds over defined timescales a Party may trigger the Credit Default provisions.

Level 1 Credit Default is triggered by breaches of 80% CCP. It triggers a 24 hour Query Period during which the Party can avoid sanction if it can decrease its CCP below 80% in any Settlement Period. If it does not, there follows a Level 1 Credit Default Cure Period that lasts until midnight on the next Business Day, during which the Party can avoid sanction if it can decrease its CCP below 75% in any Settlement Period. If a Party does not extricate itself during either window, and there is no material doubt as to the validity of the CCP calculation, the Party will enter Level 1 Credit Default and other Parties will be informed of this fact through notifications on both the Balancing Mechanism Reporting Agent (BMRA) website and through the daily contract notification report issued to all Parties[5].

Level 2 Credit Default is triggered by breaches of 90% CCP. Assuming that there is no material doubt; that the Query Period for Level 1 Credit Default has lapsed; and that a Level 2 Credit Default Cure Period[6] has either not been triggered or lapsed, then the Party will enter Level 2 Credit Default. Like Level 1 Credit Default, this will result in other Parties being warned through notifications on both the BMRA website and through the daily contract notification report. Additionally, rejection and refusal of notified contract volumes may occur. The ECVAA will refuse new, and reject existing, contract volumes relating to the affected Party that are not energy purchases. This pattern will continue until its CCP is brought below 90%.

[5] The ECVAA-I014, 'Notification Report'.

[6] Level 2 Credit Default Cure Periods are only triggered in limited circumstances where a CCP breach in the 90-100% bracket occurs over a weekend or other non working day. Please see M3.3 of the BSC for further details.

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In the event that a Party remains in either Level 1 or Level 2 Credit Default for a sustained period of time[7], it will trigger the Defaulting Party provisions contained within Section H of the BSC. These provisions allow the Panel discretion to take further sanctions against the Party, the more severe of which require Authority approval.

The Proposer of P188 suggests that current Credit Default provisions are insufficient. They note that the current baseline attempts to reduce the CCP position of a Party in Level 2 Credit Default by precluding its ability to sell energy, such that only energy purchases will be accepted by the ECVAA. It is suggested that this despite this, the Party may remain short, as though it may be purchasing energy, the volumes of these purchases may be insufficient. In such a circumstance, they contend that the position of the Party could worsen rather than improve even though Level 2 Credit Default provisions are being applied. The Proposer notes that there is a mechanism to allow a Party in sustained Credit Default to be escalated to Panel as a Defaulting Party, but considers that the minimum lead time of 60 days required for this creates a real and unnecessary risk to the industry that needs to be addressed.

In order to rectify this situation, British Gas Trading submitted Modification Proposal P188, "Revision of Credit Default provisions" on 3 May 2005.

The Modification Proposal

Modification Proposal P188 sought to modify the BSC so that a Party whose CCP exceeds 100% might have a specified number of Working Days from the point this threshold is reached to either lodge additional Credit Cover or trade out its position to below 90% CCP. If it failed to do so, then it would be considered to be a Defaulting Party in accordance with Section H of the BSC.

In addition to this trigger caused by a sustained 100% breach, P188 also proposed a "repeat offender" provision that would be triggered by persistent breaches of the 100% threshold. In the event that a Party's CCP exceeded 100% on a specified number of separate occasions during any rolling six month period it would be considered to be a Defaulting Party. Each of these breaches may or may not have been of sufficient duration to have caused Defaulting Party status in their own right.

As it developed these principles into the Proposed Modification, the Modification Group (the "Group") determined that the number of Working Days allowed to get below 90% CCP should be two, and that the number of breaches in any six month period before escalation to the Panel should be six.

The justification for the Modification Proposal was that it would better facilitate achievement of the Applicable BSC Objective C3 (3) (c) by reducing the potential exposure of Parties to bad debt caused due to a Party failing to pay its Trading Charges whilst having insufficient Credit Cover lodged; and ensuring that all Parties lodge a level of Credit Cover that is proportionate to the activities that they are undertaking.

[7] 90 continuous days or any intermittent period of 120 out of 180 days for Level 1 Credit Default, or 60 continuous days or any intermittent period of 75 out of 120 days for Level 2 Credit Default.

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The Panel considered the Initial Written Assessment at its meeting of 6 May 2005 and agreed to submit Modification Proposal P188 to a two-month Assessment Procedure. The Group met twice to consider the Modification Proposal, and convened one teleconference call to finalise aspects of the technical solution. Impact assessments were sought from Parties, BSC Agents, the Transmission Company and ELEXON, and one industry consultation was undertaken.

The Assessment Report was considered by the Panel at its meeting on 14 July 2005, where a provisional recommendation to approve was passed on the casting vote of the Panel Chairman.

Responses to ELEXON Consultation

ELEXON published a draft Modification Report on 20 July 2005, which invited respondents' views by 29 July 2005. Six responses were received. All six responses (representing 46 Parties and no non-Parties) expressed support for the Proposed Modification.

The respondents' views are summarised in the Modification Report for Modification Proposal P188, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 11 August 2005 to re-consider Proposed Modification P188 in the light of the consultation responses received.

The Panel recommended by a majority that the Authority should approve the Proposed Modification and that, if approved, the Proposed Modification should be implemented on 27 June 2006 if an Authority decision is received on or before 21 December 2005, or 8 November 2006 if received after 21 December 2005 but on or before 3 May 2006.

This recommendation was based on a perception that P188 would better facilitate the achievement of Applicable BSC Objectives (c) and (d).

The majority opinion was that competition would be aided through reducing the potential exposure of Parties to unsecured bad debts, and improving industry consistency by ensuring that all Parties are required to lodge a level of Credit Cover that is proportional to the activities they are undertaking.

The majority additionally considered that P188 may reduce the number of Parties entering Level 1 and 2 Credit Default more generally, thus improving the efficiency of enacting the credit arrangements.

A minority of Panel members acknowledged the existence of a defect in the current baseline but felt that the Proposed Modification was a disproportionate solution that would be detrimental to smaller Parties and constitute a barrier to entry.

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Ofgem's view

Having considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that Proposed Modification P188 will better facilitate achievement of Applicable BSC Objectives (c) and (d).

Where a company does fail, it is important that this does not cause a "domino effect" leading to supply disruption. The rate at which Trading Charges can build up is significantly faster than the rate at which transportation and connection debt can build up, and a major Supplier collapsing could accrue balancing costs at a rate of millions of pounds per day.

Under the BSC, exposure to this potentially volatile debt is centrally managed on behalf of other market participants. It is therefore important that there are appropriate safeguards to allow exposure to potential bad debt to be managed quickly and effectively. It is in the interest of facilitating competition that such costs are not unfairly smeared across all participants.

Ofgem notes that the current rules mean that a Supplier may continue to trade in Credit Default for an extended period of time. In addition, because energy purchases may not be sufficient to cover physical position, it is possible for a Supplier's Energy Indebtedness position to actually deteriorate even whilst in authorised Level 2 Credit Default.

The materiality of this defect is currently uncapped. Whilst modelling conducted within the Assessment Procedure suggested that the materiality of many 100% CCP breaches has been small, the presence of one actual exposure in excess of £0.5m in the year modelled demonstrates that there is a very real risk of significant bad debt arising through the current arrangements. Were these liabilities to crystallise as bad debt because of non-payment, they would be smeared across other Parties through the funding share mechanism. Ofgem considers that the current ability for a Party to trade freely whilst exposing other Parties to potential bad debt for its activities presents a risk of distorting competition through the smearing of costs. Implementation of P188 would minimize this risk and will therefore better facilitate the achievement of Applicable BSC Objective (c).

Ofgem notes that an argument has been put forward that P188 would discriminate against smaller Parties and constitute a barrier to entry. Ofgem do not accept that this argument has sufficient weight as it implies that smaller Parties should be able to expose the market to potential bad debt with impunity. Ofgem additionally observes that P188 does not alter any aspect of the cash-out or Energy Indebtedness calculations and therefore its introduction will not have any impact on the amount of estimated Trading Charges attributable to a Party at any given time.

Several Group attendees and Panel members expressed a preference for a materiality threshold to be applied before a Party is escalated to Panel under P188. The concern that such a threshold should be applied appears driven by a wish both to avoid inefficiencies from Panel needing to actively manage the resolution of small financial exposures, and to avoid the risk that Panel could take punitive sanction against a Party over a trivial sum of money.

Ofgem recognises these concerns, and considers that both affected Parties and the Panel may be able to take practical steps to mitigate against them. Whilst Section H describes the sanctions that Panel may take in response to a Defaulting Party, it should be noted that these sanctions are

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discretionary. Panel has the ability to vary its response in accordance with the severity of an incident, and it is within the Panel's gift to take no action at all if it so chooses. Parties concerned about the prospect of being escalated to Panel over a nominal unsecured debt may choose to lodge additional Credit Cover or trade out of their position. In the event of escalation, Parties may attend Panel to put forward any mitigating circumstances.

Ofgem observes that the Energy Indebtedness calculation provides an estimate of outstanding Trading Charges, rather than a definitive figure. Panel will need to bear this in mind when determining what action to take against a Defaulting Party.

Since NETA go-live, approximately one Party per week[8] has triggered the Credit Default processes. Each such incident necessitates resolution activity by ELEXON, the BSC Agents, and the affected Party. Allowing 100% CCP breaches to be treated much more rapidly as instances of Section H Default should significantly increase the deterrent effect of Credit Default provisions. Ofgem therefore agrees with the majority Panel and unanimous Group view that P188 may reduce the number of Parties entering Level 1 and Level 2 Credit Default.

As a consequence, whilst acknowledging that P188 introduces some new procedures to manage 100% CCP breaches, Ofgem considers that on balance it should promote efficiency in the implementation and administration of the settlement arrangements, therefore better facilitating Applicable BSC Objective (d).

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

Yours sincerely,

Nick Simpson
Director, Modifications
Signed on behalf of the Authority and authorised for that purpose by the Authority

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[8] At the time of the June 2005 Panel meeting there had been 206 separate breaches of the Credit Default trigger thresholds. Source: http://www.elexon.co.uk/documents/BSC_Panel_and_Panel_Committees/BSC_Panel_Meetings_Documents/Panel_Minutes_93_(Final).pdf