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The National Grid Company, BSC Signatories and
Other Interested Parties

30 April 2004

Our Ref: MP No P152

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P152 “Reduction of Credit Cover for a Trading Party in Default which has ceased trading and which has paid all accrued Trading Charges”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P152, “Reduction of Credit Cover for a Trading Party in Default which has ceased trading and which has paid all accrued Trading Charges”.

The BSC Panel (the “Panel”) recommended to the Authority that:

- both the Proposed and Alternative Modification P152 should not be made;
- the P152 Implementation Date (in the event that the Authority determines that either should be made) of 3 November 2004 if an Authority decision is received on or before 16 June 2004, or the 23 February 2005 if the Authority decision is received after 16 June 2004 but on or before 6 October 2004.
- the proposed text for modifying the Code, as set out in the draft Modification Report.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives³ and the Authority’s wider statutory duties,⁴ the

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

² ELEXON document reference P152RR Version No. 1.0, dated 12 March 2004.

³ The 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;
- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements
- e) the undertaking of work by BSCCo (as defined in the BSC) which is:

Authority has decided to direct a Modification to the BSC in line with Alternative Modification P152.

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.

Background

The BSC allows a Trading Party to reduce the amount of its Credit Cover once it has followed a formal process described in Section M. The current rules allow a Trading Party which has ceased trading in normal circumstances to reduce its Credit Cover, whereas a Trading Party in Default for reasons of insolvency under section H of the BSC is prevented from doing so. The Proposer contended that these provisions produced an anomaly which operates inequitably and was not in accordance with the Applicable BSC Objectives.

In order to rectify this situation, Roger Marsh and Michael Horrocks of PricewaterhouseCoopers (acting as administrative receivers of Shotton Combined Heat and Power Limited) submitted Modification Proposal P152, "Reduction of Credit Cover for a Trading Party in Default which has ceased trading and which has paid all accrued Trading Charges" on 1 December 2003.

The Modification Proposal

Modification Proposal P152 seeks to modify the BSC so as to enable a Party that is in Default and which fulfils the following criteria to reduce or reclaim its Credit Cover providing that it has:

- Ceased all forms of trading pursuant to the Code;
- Paid all Trading Charges due on the Settlement Payment Date for the last Settlement Day on which it traded as well as all previously accrued Trading Charges;
- Transferred or de-registered any Relevant BM Units; and
- Had an Energy Indebtedness of zero or less than zero continuously over the previous 30 days.

Under the Modification Proposal, the Party in Default would provide notice to BSCCo of its desire to reduce its Credit Cover. BSCCo would then check whether the Party fulfilled the requisite criteria, and if this was the case the Party could apply to the Panel in order to recover a proportion of its Credit Cover. The amount received would be the amount of Credit Cover in

(i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
(ii) relevant to the proposed GB wide balancing and settlement code;
and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

⁴ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

place minus the average of the positive Reconciliation Charges across the Reconciliation Timetable for which the Party was liable during the previous year of trading.⁵ The Panel would grant the Party recovery unless it believed extenuating circumstances existed. The remainder of the Credit Cover would be returned to the Party at the Final Reconciliation Run (RF).

The justification for the Modification Proposal was that it would better facilitate achievement of the Applicable BSC Objectives C3 (3) (c) and (d).

The Proposer contended that the Proposed Modification better facilitated Applicable BSC Objective (c) for four primary reasons.

- Having to leave funds as security after the cessation of trading and reduction of Energy Indebtedness could constitute a barrier to entry and insolvency practitioners in particular may be disinclined from running generating plants and from trading during receivership because of this.
- Insolvency practitioners and commercial counterparties or creditors may be relying on the funds tied up in Credit Cover.
- Trading Parties in insolvency Default may seek to minimise the Credit Cover posted if it can not be reclaimed upon cessation of trading and for this reason are more likely to go into Credit Default during the time in which they are active in the market.
- The approval of P152 would promote the consistent treatment of Credit Cover calculations between Parties.

The Proposer also contended that the approval of P152 would better facilitate Applicable BSC Objective (d) by obviating the need for Parties in such circumstances to seek the return of their lodged Credit Cover by means outside the BSC, thus saving BSCCo time and money.

The Panel considered the Initial Written Assessment at its meeting of 11 December 2003 and agreed to submit Modification Proposal P152 to the Assessment Procedure. The Modification Group (the "Group") considered the Modification Proposal at three meetings on 18 December 2003, 5 January 2004 and 28 January 2004. One consultation document and one BSC Central System Agent impact assessment were issued during the Assessment Procedure.

During the three meetings the Group considered in detail the question of whether the Proposed Modification better facilitated Applicable BSC Objectives (c) and (d). In particular the Group considered whether an insolvent Party fulfilling the criteria outlined in P152 constituted a greater risk to the market than a Party that was not insolvent but which had ceased trading. The Group also considered whether there was a need for Modification Proposal P152 following the Authority's approval of Modification Proposal P127 Alternative. The Group further considered the mechanism by which a Party could reclaim its Credit Cover (giving specific attention to the three methods outlined in the Modification Proposal).

In their consideration of Applicable BSC Objective (c) the Group's view was that giving an insolvent Party any of its Credit Cover back before the Final Reconciliation Run was a risk to the market and was not one it considered the industry would be willing to underwrite. These members believed that there was a greater risk that insolvent Parties would be unable to meet any liabilities which they may accrue in the future. In countering this view the Proposer

⁵ Or the period of time the Party had been trading, should this be less than one year.

acknowledged that there was some risk, but considered that not giving a Party any of their Credit Cover back before the Final Reconciliation Run was inequitable and unreasonable.

Some members of the Group acknowledged that it seemed reasonable to return a proportion of the Credit Cover prior to the Final Reconciliation Run, but following consideration of the three mechanisms outlined by the Modification Proposal for the reclamation of a Party's Credit Cover it was felt that it was difficult to determine what this proportion should be, as there did not seem to be a methodology that could accurately reflect a Party's future Trading Charges. The Group therefore considered that some Credit Cover ought to be retained.

The Group commented that the risk of being liable for a bad debt may constitute more of a barrier to entry than the Credit Cover requirements of an insolvent Party. This view diverged from that of the Proposer who considered that retaining funds as security for a significant period of time would act as a material disincentive to continue or restart generation and would therefore enhance the economic argument for plant mothballing.

One member of the Group suggested that following the approval of Modification Proposal P127 Alternative, a Party such as that described in Modification Proposal P152 would be able recover their Credit Cover at the end of the Final Reconciliation Run. This member considered that there was therefore no longer a requirement for Modification Proposal P152, as the defect which it sought to address no longer existed. The Proposer commented that Approved Modification Proposal P127 was not raised to solve the same defect as Modification Proposal P152 and as such it did not consider all relevant issues. The Proposer acknowledged that whilst Approved Modification Proposal P127 met some of the defects outlined in their Proposal, it was not, in their view, as extensive as Modification Proposal P152.

In its consideration of Applicable BSC Objective (d) the Group noted the Proposer's view that Proposed Modification P152 would reduce the risk of Parties seeking the return of Credit Cover through litigation, but considered that the likelihood of a Party instigating legal proceedings had been reduced by Approved Modification Proposal P127. The Group added that if an insolvent Party was to withdraw its funds and then not pay future Trading Charges, other Parties may decide to make claims against this Party outside the BSC and the status of BSCCo would change from being a secured to an unsecured creditor. This, the Group considered, would lower the likelihood of receiving monies due.

The Modification Group members were unanimous in concluding that the Proposed Modification would not better facilitate the achievement of Applicable BSC Objectives (c) and (d).

During the course of its deliberations the Group noted that the Modification Proposal made specific reference to a "Trading Party". The Group noted that the term "Trading Party" described a number of different types of industry Parties including generators, Interconnector Users and Suppliers. The Group noted that generators and Interconnector Users often have smaller and more predictable variation in Reconciliation payments than other categories of Trading Parties. Therefore the Group felt that it would be easier to predict Reconciliation Charges for generators and Interconnector Users up to the Final Reconciliation Run. It would also allow for the use of a sliding scale type mechanism for the reclamation of Credit Cover limiting the risk of high Reconciliation payments falling due. One member of the Group found this suggestion problematic as it does not cater for potential charges arising from Disputes that would cause

greater variety in a generator's Reconciliation payments. The Group however considered that including only generators and Interconnector Users with no Supply interests in the Alternative solution would enable a less arbitrary sliding scale to be used and would diminish the risk to the market of reducing Credit Cover.

The Group then considered how to define the types of Trading Party that would be encompassed by the Alternative Modification Proposal. They noted that there are many vertically integrated Parties and these Parties put up a single sum to serve as Credit Cover for a range of activities, hence singling out different types of activities for which Credit Cover can be returned is complicated and perhaps impractical. The Group concluded that it would have to include only pure generators or Interconnector Users with no supply side to their business.

The Alternative Modification developed by the Group is as follows:

A pure generator or Interconnector User (i.e. a Party that has no Supply business at all); which has no Metered Volume Reallocation Notifications (MVRNs) with a Supplier; which is in Default solely by virtue of Section H 3.1.1 (g); and which wishes to reduce the amount of its Credit Cover may send notice to this effect to BSCCo. BSCCo would then check to ensure that the Party in question has:

- Ceased all forms of trading pursuant to the Code;
- Paid all Trading Charges due on the Settlement Payment Date for the last Settlement Day on which it traded as well as all previously accrued Trading Charges;
- Paid all BSCCo Charges up to the date of application to BSCCo;
- Transferred or de-registered any Relevant BM Units; and
- Had an Energy Indebtedness of zero or less than zero continuously over the previous 30 days

Once the Party has fulfilled these criteria they will be able to apply to the Panel in order to recover a proportion of their Credit Cover. The amount received would be the amount of Credit Cover in place minus the average of the positive Reconciliation Charges across the Reconciliation Timetable for which the Party was liable during the previous year of trading.⁶ The Panel would grant the Party recovery unless it believed that extenuating circumstances existed. The remainder of the Credit Cover would be returned to the Party at the Final Reconciliation Run.

In their final deliberations the Group considered that the Alternative Modification Proposal better facilitated the Applicable BSC Objectives when compared to the Proposed Modification but not when compared to the current baseline.

⁶ Or the period of time the Party had been trading, should this be less than one year.

Responses to ELEXON Consultation

ELEXON published a draft Modification Report on 27 February 2004, which invited respondents' views by 26 February 2004. 8 responses were received. 5 responses (representing 26 Parties) expressed support for the Panel's recommendation that Proposed Modification P152 should not be made, 2 responses (representing 1 Party and 1 non-Party) opposed the Panel's recommendation that Proposed Modification P152 should not be made and the remaining 1 (representing 1 Party) provided a "no comment" response.

The respondents' views are summarised in the Modification Report for Modification Proposal P152, which also includes the complete text of all respondents' replies.

The majority of respondents agreed with the views of the Panel in the draft Modification Report and its recommendation to the Authority that Modification Proposal P152 should not be made. These respondents considered that Modification Proposal P152 would expose Parties to unnecessary risk. In their view the Defaulting Party can currently be sure that it will receive its security cover in full after the Final Reconciliation Run as long as it does not Default on payments due under the BSC. In contrast, if the Credit Cover was returned, Parties would have no certainty that payments due, could or would be paid.

One respondent observed that at the time of raising Modification Proposal P152 there was a defect in the BSC that prevented a Party in Default from reclaiming their Credit Cover, but that the approval of Modification Proposal P127 Alternative alleviates the defect, by allowing a Party in Default to have any unused Credit Cover returned to it after the current 14-month reconciliation period without unduly increasing the risk of Parties being exposed to a bad debt.

Those respondents that disagreed with the views of the Panel and the recommendation to the Authority that Modification Proposal P152 should not be made included the Proposer who stated that the Credit Cover which it currently has in place is manifestly disproportionate to the potential liability that could arise from any future Reconciliation Runs. The Proposer stated that the amount of Credit Cover retained after trading has ceased is based entirely on the amount that was put in place for the purposes of trading, regardless of potential liability. They further stated that they feel the current rules are arbitrary in that they require the same Credit Cover to be retained irrespective of whether it is ten times or one thousand times more than the future liability. The Proposer supported the Alternative Modification on the grounds that it allowed Credit Cover to be reduced to a level that can be calculated objectively and was equitable to all Parties involved.

The Proposer further asserted that although it agreed that Approved Modification P127 provided a mechanism for the return of Credit Cover to an insolvent Trading Party at the Final Reconciliation Run, it believed the Alternative Modification P152 better facilitates Applicable BSC Objectives (c) and (d). Reaffirming its assertion during the Assessment Phase, the Proposer stated that in its opinion, the current situation remains a barrier to entry. The Proposer accepted that a market entrant is unlikely to be deterred from entry. However it noted that, in the specific case of an insolvency practitioner, the fact that funds will remain lodged as security subsequent to it ceasing trading is a material disincentive to continuing or restarting generation (to trade in receivership) and increases the likelihood that such a generator will be mothballed. The Proposer also maintained the view that the current situation may encourage a Trading Party to seek the return of the excess Credit Cover outside the BSC. This would have material time and

cost implications for the BSC and also for BSCCo. The Alternative Modification Proposal would, in its opinion, significantly reduce the likelihood of Parties seeking their remedies for the return of its Credit Cover.

Panel's recommendation

The Panel met on 11 March 2004 and considered the Modification Proposal, the views of the Modification Group, the draft Modification Report, and the consultation responses received.

The Panel unanimously confirmed its previous recommendations to the Authority in the draft Modification Report that both the Proposed and the Alternative Modification P152 should not be made. However, the Panel recommended that in the event the Authority should determine that either Proposed or Alternative Modification P152 should be made, the Implementation Date should be 3 November 2004 if an Authority decision is received on or before 16 June 2004, or 23 February 2005 if the Authority decision is received after 16 June 2004 but on or before 6 October 2004.

Responses to Ofgem GB Consultation

On 5 December 2003 Ofgem undertook to invite responses on additional implications that the Modification Proposal may have, were it to be applied on a GB wide basis, as opposed to being limited to England and Wales. In order to discharge this undertaking Ofgem published a GB Consultation Paper on 20 February 2004 which invited respondents' views by 22 March 2004. One response was received. This response opposed the Proposed Modification stating that it would represent too much risk for the remaining participants in the Great Britain market because in the respondent's view a defaulting Party should have Credit Cover lodged to cover any reconciliation charges that may arise from the Disputes Final Settlement Run.

The Consultation Paper, the responses to it and other related documents can be found on the *BETTA GB Consultation* section of the Ofgem website.⁷

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that Alternative Modification Proposal P152 will better facilitate the achievement of the Applicable BSC Objectives.

The Credit Cover provisions of the BSC seek to ensure that sufficient financial certainty is provided to market participants, promoting a secure trading environment and contributing to market liquidity. Ofgem considers that by effectively balancing the need to remove potential barriers to market entry and allow an appropriate means through which a Party in Default can recover its Credit Cover under the BSC against the need to ensure that sufficient Credit Cover is in place following the cessation of trading to manage industry risk, that P152 better facilitates Applicable Objectives (c) and (d).

⁷ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

It was suggested by both members of the Group and by way of industry consultation that although there was a defect in the BSC at the time that Modification Proposal P152 was raised, this defect had been addressed by Approved Modification Proposal P127 Alternative. Ofgem considers that although Modification Proposal P127 Alternative provides a mechanism for the return of Credit Cover to an insolvent Trading Party at RF, it does not wholly address the issues raised by Modification Proposal P152. In addition, it can be argued that there is a disincentive for any insolvency practitioner to consider running generation subsequent to default or resuming generation in order to trade in receivership, by requiring that substantial funds remain lodged as security after the Party has ceased trading. This could have the effect of reducing plant margin and increasing the likelihood of mothballing. Because there is a greater likelihood of generation being run by insolvency practitioners during the disposal process, it is Ofgem's view that Modification Proposal P152 will promote competition and better facilitate Applicable BSC Objective (c) as well as improving security of supply.

Ofgem considers that Alternative Modification Proposal P152 also reduces the risk that Parties will seek the return of their Credit Cover through litigation, over and above the reduction of this risk which was facilitated by Approved Modification Proposal P127. Ofgem considers that the current drafting of the BSC could lead an insolvency practitioner to claim any significant frozen Credit Cover. Ofgem considers that by obviating this risk Alternative Modification Proposal P152 will promote efficiency in the implementation and administration of the balancing and settlement arrangements, thus better facilitating Applicable BSC Objective (d).

During the assessment of Modification Proposal P152 it was suggested that the benefit of returning any proportion of a defaulting party's Credit Cover prior to RF was outweighed by the risk posed to the market should it have to bear the bad debt which may arise as a result of implementing Alternative Modification Proposal P152. Ofgem considers that requiring the same amount of Credit Cover to remain in place irrespective of a defaulting Party's future level of liability may produce a disproportionate result. Ofgem considers that any credit requirements should reflect reasonable estimates of cover against risk of default and should certainly not be disproportionate for any particular class of Party. By providing an objective measure by which an appropriate level of credit cover can be calculated, Alternative Modification Proposal P152 provides a suitable balance between protecting the market from default risk and ensuring that obligations placed upon an individual Party are not disproportionately onerous.

Receivers dealing with a Party in Default often wish to sell on that asset as a going concern and if this is the case will seek to continue to trade whilst the asset is in receivership. It is Ofgem's view that requiring a Party's Credit Cover for the 14-month prior to RF period may present serious difficulties for receivers seeking to preserve value in a business, by not incentivising them to continue trading. Forcing funds to remain lodged as security for a significant period of time acts as a material disincentive for receivers wishing to continue or restart generation. In such circumstances, the inability of a Party in Default to recover any of its Credit Cover when the requirements of Alternative Modification Proposal P152 have been met could constitute a barrier to entry. It is Ofgem's view that the approval of Alternative Modification Proposal P152 will remove this barrier and thus better facilitate Applicable BSC Objective (c).

Alternative Modification Proposal P152 uses a sliding scale to determine the level of Credit Cover which a Defaulting Party should be required to have in place. The Modification Group considered that it would be complicated, and perhaps impractical, to apply this sliding scale objectively to some categories of Party and concluded that it would have to limit the categories

to which its provisions would apply to generators and Interconnector Users with no Supply interests. Despite this limitation, Ofgem considers that this proposal better facilitates the relevant objectives on the grounds that the Parties which are most exposed to the defect are those within the limitation.

In considering a Modification Proposal, Ofgem must have regard not only to the Applicable BSC Objectives, but also to its wider statutory duties. s.3A (1) of the Electricity Act 1989 the principal objective of Ofgem is to "...protect the interests of consumers.... by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity". Under 2.3A (2)(a) the Act provides that those functions must be carried out in a manner "...best calculated to further the principal objective, having regard to (a) the need to ensure that all reasonable demands for electricity are met". Ofgem considers that encouraging insolvent Parties to maintain and generate electricity, whilst the assets are being sold, is likely to have a positive effect on security of supply by helping to ensure that sufficient generation capacity can be called upon to service all reasonable demands for electricity, thus protecting the interests of consumers.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

Nick Simpson
Director, Modifications

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