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29 July 2004

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No P147

Dear Colleague,

**Modification to the Balancing and Settlement Code (BSC) - Decision in relation to
Modification Proposal P147: Introduction of a Notified Contract Capacity to limit Party liability
in the event of erroneous contract notifications**

The Gas and Electricity Markets Authority (the Authority)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P147: Introduction of a Notified Contract Capacity to limit Party liability in the event of erroneous contract notifications.

The BSC Panel (the Panel) recommended to the Authority that Proposed Modification P147 should not be made, but in the event that the Authority determines that the Proposed Modification should be made, the Implementation Date should be 23 February 2005 where the Authority's decision is received before or on 28 May 2004. Where the Authority's decision is received after this date but before or on 30 July 2004, the Panel recommended that the Implementation Date should be 29 June 2005.

Having carefully considered the Modification Report and the Panel's recommendation and having had regard to the Applicable BSC Objectives³ and the Authority's wider statutory duties⁴, the Authority has decided not to direct a Modification to the BSC.

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

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

² ELEXON document reference P147MR, Version No. 1.0, dated 16 March 2004.

³ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Company's (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:
 - ii) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
 - iii) 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 Set out in Section 3A of the Electricity Act 1989, as amended by the Utilities Act 2000. Ofgem's statutory duties are wider than the matters 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.

Background

There are strong incentives on participants to balance their individual trading positions and minimise the costs to the System Operator (SO) of balancing the Transmission System (System). Market participants can contract ahead in the forwards, futures and short-term markets to balance their contract position ahead of Gate Closure (one hour before real time). Gate Closure is the last point at which Parties can make contract notifications to, and correct their contract position with, BSC Central Systems. Contract notifications are only registered if they are notified from a participant's system via communications links to the Energy Contract Volume Aggregation Agent (ECVAA) System and acknowledged before Gate Closure.

In each Settlement Period, the metered volumes for each Trading Party are used to determine if the actual volumes taken from, or put onto, the System match their notified contractual volumes. Trading Parties with a position of energy imbalance will be exposed to the relevant Energy Imbalance Prices for the relevant Settlement Period.

Prior to NETA Go-Live⁵ consideration was given by market participants, the Department of Trade and Industry (DTI) and Ofgem as to whether to have a system of dual or single contract notification. The DTI and Ofgem determined that the process for making contract notifications to the ECVAA System would be carried out via single notification. Under the arrangements for single notification the counterparties appoint a single Notification Agent⁶, which can be one of the two Parties or alternatively a third party. The Notification Agent makes a single notification to the ECVAA on behalf of both of the Contract Trading Parties.

On 2 September 2002, Dynegy raised Modification Proposal P98⁷. It was the view of the Proposer that the system of single notification creates a risk of contract positions being notified against Parties without their knowledge, particularly for those Parties that do not operate 24 hours a day, 7 days a week, and that there is unlimited settlement liability associated with this risk. The Proposer therefore considered that, in removing this risk, the Modification Proposal would promote effective competition by encouraging and facilitating trading and reducing barriers to market entry. The Proposer also considered that dual notification would increase liquidity closer to real time in the markets as it provides a more robust trading mechanism.

Proposed Modification P98 sought to modify the BSC so that the voluntary dual notification system would be implemented within the BSC Central Systems alongside the existing single notification system. Under the proposed voluntary dual notification system, both counterparties nominate a Notification Agent. When making a contract notification, the Agent is required to specify the pair of counterparties and the nominated Energy Accounts. Any notification received from the Notification Agent is validated by the ECVAA. If the ECVAA fails any part of the submission validation, or if the submission is to be refused under Credit Default rules, then the contract notifications for the affected Settlement Periods are rejected individually and notified to the counterparties in a Rejection Feedback Report (RFR). Where the submission is accepted, the contract notification volumes are matched and an Acceptance Feedback Report (AFR) is generated, containing the detail of what has been accepted and matched by the ECVAA.

The Authority carefully considered the overall costs and benefits associated with Proposed Modification P98 and, in its decision letter of 18 August 2003, directed that the modification

⁵ NETA Go-Live was the 27 March 2001.

⁶ Reference to 'Notification Agents' includes both Energy Contract Volume Notification Agents (ECVNAs) and Metered Volume Reallocation Notification Agents (MVRNAs).

⁷ BSC Modification Proposal P98: Dual Notification of Contract Positions.

should be made and implemented on the basis that it would better facilitate achievement of the Applicable BSC Objectives.

On 19 November 2003, Npower Ltd (the Proposer) proposed Modification Proposal P147: Introduction of a Notified Contract Capacity to limit Party liability in the event of erroneous contract notifications.

The Proposer considered that few, if any, current BSC Parties would be willing to utilise the voluntary dual notification system introduced by Approved Modification P98. The Proposer also considered that new entrants would utilise the same notification system as incumbent parties in order to trade efficiently.

It was the view of the Proposer that by replacing the voluntary dual notification system (which, at the time of Proposed Modification P147 being proposed, was in the process of being implemented following approval of Approved Modification P98) with a voluntary limit on settlement liability, Proposed Modification P147 would limit the risks associated with erroneous notification of Party contract positions. The Proposer considered this would thereby replicate the benefits of Approved Modification P98, in that it would promote effective competition in the generation and supply of electricity, but with a marked reduction in costs as compared with Approved Modification P98. The Proposer therefore considered that Proposed Modification P147 would better facilitate achievement of Applicable BSC Objectives (c) and (d).

Modification Proposal

Proposed Modification P147 seeks to introduce a new parameter into the BSC, the Notified Energy Contract Capacity (NECC). The NECC would allow a Party to specify an upper limit on its contracts notified to an Energy Account for each Settlement Period. The cap is intended to provide a limit to a Party's imbalance liability, and limit any exposure to erroneous or malicious contract notifications. The NECC parameter would be notified seasonally by each BSC Party for each account in a similar manner to the notification of Generation Capacity (GC) and Demand Capacity (DC) parameters and would limit the volume of Energy Contract Volumes notified to that Party's Energy Account within a Settlement Period to +/- NECC.

The Proposed Modification also seeks to implement a warning mechanism that would alert Parties when their notified contract volumes approach a certain percentage (for example 80 per cent and/or 90 per cent) of the NECC parameter. Parties would be able to revise the NECC in circumstances where a breach may be imminent.

On submission of the Proposed Modification, the Proposer requested that Proposed Modification P147 be treated as an Urgent Modification Proposal⁸ and this recommendation was supported by the BSC Panel. On 21 November 2003, the Authority rejected the request for Urgency as it did not consider that Proposed Modification P147 exhibited any of the requisite characteristics for urgency to be granted. Therefore Proposed Modification P147 was required to be assessed via the normal Modification Procedures.

The Panel submitted Proposed Modification P147 to a two month Assessment Procedure undertaken by the Settlement Standing Modification Group (SSMG) and directed that the SSMG should not assess Proposed Modification P147 as a replacement for Approved Modification P98. The SSMG therefore assessed Proposed Modification P147 as a proposal which, if approved, would be implemented alongside Approved Modification P98.

⁸ Section F2.9 of the BSC sets out the processes relating to Urgent Modification Proposals.

Settlement Standing Modification Group (SSMG) considerations

The SSMG considered Proposed Modification P147 over the course of three meetings.⁹

While the SSMG expressed sympathy with the issue that Proposed Modification P147 was seeking to address during these meetings, i.e. mitigating the risk associated with the potential exposure to unlimited liability as a result of erroneous or malicious notifications, the SSMG unanimously concluded that the Proposed Modification would not better facilitate achievement of the Applicable BSC Objectives and therefore should not be made.

Mechanism for Proposed Modification P147

The SSMG identified a number of complex issues that they could not resolve. Many of these issues related specifically to the flexibility and usability of the proposed mechanism; i.e. whether, in practice, the mechanism would effectively address the perceived defect and therefore better facilitate achievement of the Applicable BSC Objectives as proposed. The substantive points raised in relation to this issue are set out below.

- The majority of the SSMG considered that while a maximum limit or cap on the aggregated contract volume (i.e. the NECC) would protect against notifications that increase (in absolute terms) the net contract volume above that defined limit, an equally damaging erroneous or malicious notification that decreases (in absolute terms) the aggregate contract volume for a Party's imbalance position, is not identified nor prevented under this mechanism.
- The majority of the SSMG also considered that in the absence of an extremely dynamic amendment process, the presence of a cap on the upper contract volume (in absolute terms) could present a risk of rejecting a legitimately large trade.
- The majority of the SSMG considered that the calculation of the aggregated volume would become problematic and complex for Parties that use a combination of single and dual notification, as there would be an issue regarding the volumes that are used in the aggregation for dual notifiers.
- The majority of the SSMG also considered that the aggregated volume would become complex for Parties that, in addition to any single notifications, had a number of dual notifications in various states of matching. The SSMC considered that if the ECVAAs only looked at matched volumes for BSC Parties, a potential problem could arise where a Settlement Period is pending matching. The SSMG also considered problems could arise if the ECVAAs only looked at the volumes notified by the BSC Party (and Energy Account), as this could cause potential problems where an erroneous volume is pending matching, or where no volume is notified.
- The majority of the SSMG could not resolve the issue of how far ahead the contract volumes needed to be checked and therefore aggregated when performing the aggregation on receipt of a notification. The Proposed Modification was intended to allow sufficient time for Parties to react to rejections or warnings. However, when specifying an effective time period for Parties to react, the SSMG considered that the

⁹ These meetings were held on 18 December 2003, 13 January 2004 and 3 February 2004.

Proposed Modification would not allow sufficient time for non 24-7 Parties to react to rejections or warnings, as any rectification required outside of business hours could not be identified or achieved.

Given these issues surrounding the mechanism for Proposed Modification P147, the SSMG unanimously decided that Proposed Modification P147 could not feasibly deliver the proposed benefits of removing the risk of unlimited liability and thereby encouraging new entrants. The SSMG therefore considered that Proposed Modification P147 would not better facilitate achievement of Applicable BSC Objective (c) - the promotion of effective competition in the generation and supply of electricity.

The associated development and implementation costs of Proposed Modification P147

The SSMG considered that the BSC Central Service Agent development and implementation costs associated with Proposed Modification P147 were of such a significant magnitude that, even were the £1.5 million hardware costs to be removed, the costs of implementing the Proposed Modification would outweigh the benefits, especially given the limitations of the mechanism.

The SSMG therefore agreed that P147 would not better facilitate achievement of the Applicable BSC Objective (d) – the promotion of efficiency in the administration of the balancing and settlement arrangements.

SSMG recommendations

The SSMG unanimously agreed to recommend to the Panel that Proposed Modification P147 should not be made. The SSMG, including the Proposer, were of the view that the Proposed Modification would not better facilitate achievement of the Applicable BSC Objectives as they considered the proposed mechanism to be unworkable in practice and also raised concerns about the magnitude of the development and implementation costs associated with the Proposed Modification. Furthermore, the SSMG noted that only two responses were made in respect of the Party impact assessment, and proposed that this could be interpreted as indicating the potential for a low up take of the Proposed Modification, which would further limit its proposed benefits.

Respondents' views

In total Elexon received seven responses to the consultation on Proposed Modification P147. Six respondents did not support the Proposed Modification, and one respondent provided a no comment response.

The majority of respondents considered that Proposed Modification P147 should not be made. These respondents considered that the Proposed Modification was unworkable in practice and would not prevent an occurrence of the defect identified in the proposal. The majority of these respondents considered that the changes required to make Proposed Modification P147 workable would introduce unsustainable complexity. A number of respondents also considered that Proposed Modification P147 should not be made because of the magnitude of the development and implementation costs that would be incurred in addition to the implementation costs of Proposed Modification P98.

One respondent considered that the Proposed Modification could potentially limit Party liability to malicious or erroneous notifications and was of the view that the proposal should have been

considered promptly as a potential means of avoiding the costs of a dual notification system for the implementation of Approved Modification P98. However this respondent considered that the costs of implementing Proposed Modification P147 would outweigh the benefits, and therefore that the Proposed Modification should not be made.

Panel's recommendation

At its meeting of 11 March 2004, the Panel considered the consultation responses, and noted that the respondents to the consultation on the draft Modification Report unanimously supported the provisional recommendations of the Panel that Proposed Modification P147 should not be made. The Panel, having considered and taken into due account the contents of the draft Modification Report, unanimously confirmed its provisional recommendations, namely that Proposed Modification P147 would not better facilitate achievement of the Applicable BSC Objectives and therefore should not be made.

The Panel was of the view that, as a consequence of the 'unworkability' and complexity of the proposed mechanism, the Proposed Modification would not fully mitigate the risk of erroneous or malicious notifications, and therefore would not deliver the benefits associated with the risk mitigation. Furthermore, the Panel considered that the costs associated with the development and implementation of the Proposed Modification are material and outweigh the limited benefits delivered by the Proposed Modification.

Ofgem's GB Consultation

On 25 February 2004, Ofgem issued a GB consultation in respect of Proposed Modification P147 inviting responses that identify additional implications for GB, by 12 March 2004. No responses were received to this consultation.

Ofgem views

Having carefully considered the Modification Report, the respondents' views and the Panel's recommendation, Ofgem, having regard to the Applicable BSC Objectives, agrees with the majority of respondents, the SSMG and the Panel, that Proposed Modification P147 would not better facilitate achievement of the Applicable BSC Objectives. In addition, Ofgem considers that this decision is consistent with its wider statutory duties.

Applicable BSC Objective (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

Ofgem is of the view that there are certain aspects of the Proposed Modification that could, to a limited extent, reduce the risk that Parties may face in relation to unlimited settlement liability as a result of erroneous or malicious notifications. For example, the checking of contract volumes against the NECC limit, as put forward by the Proposed Modification, would provide 24-7 Parties sufficient time to react to rejections or warnings in the event that Party's notified contract volumes exceed this limit. However, Ofgem agrees with the majority of the SSMG and the Panel that there are a number of practical problems with the proposed mechanism that could be likely to lead to the Proposed Modification operating to the detriment of the efficient functioning of the market. For instance, Ofgem agrees with the majority of the SSMG that the calculation of the aggregated volume could be problematic for Parties that use a combination of single and dual notification and for contract notifications in various states of matching and that this could lead to confusion in the market. On balance, therefore, Ofgem agrees with the SSMG and the Panel

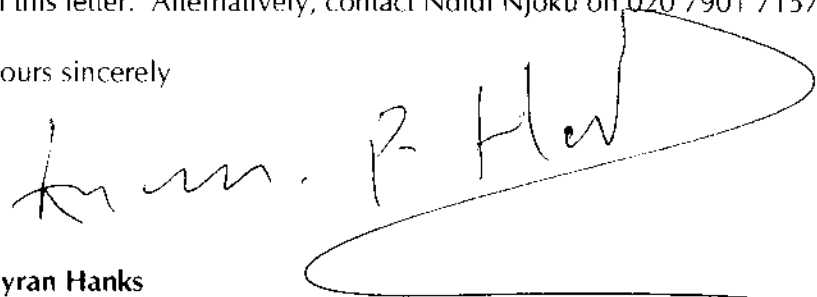
that the Proposed Modification would not better facilitate achievement of Applicable BSC Objective (c).

Applicable BSC Objective (d) – promoting efficiency in the implementation and administration of the balancing and settlement arrangements

Ofgem agrees with the SSMG that the costs of implementing Proposed Modification P147 would outweigh the benefits, especially given the limitations of the proposed mechanism. Furthermore, Ofgem considers that it would not be efficient to develop a further mechanism which seeks to remove the risk of unlimited settlement liability due to erroneous or malicious notifications when the dual contract notification mechanism put forward by Approved Modification P98 already provides an option for market participants to mitigate this risk. Therefore Ofgem agrees with the SSMG and the Panel that the Proposed Modification would not better facilitate achievement of Applicable BSC Objective (d)

Please contact me on the above number if you have any queries in relation to the issues raised in this letter. Alternatively, contact Ndidi Njoku on 020 7901 7157.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Kyran Hanks', written over a large, sweeping horizontal line that extends across the page.

Kyran Hanks
Director, Wholesale Markets