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The National Grid Company, BSC Signatories and
Other Interested Parties

17 August 2004

Our Ref: MP No P146

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P146 “New Participation Category to the BSC – Clearing House”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P146, “New Participation Category to the BSC – Clearing House”.

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

- Proposed Modification P146 should not be made;
- Alternative Modification P146 should be made;
- The Implementation Date for the Proposed Modification P146 (in the event that the Authority determines that the Proposed Modification should be made) should be 23 February 2005 if an Authority decision is received on or before 22 June 2004, or 29 June 2005 if an Authority decision is received after 22 June 2004 but on or before 28 October 2004;
- The Implementation Date for the Alternative Modification P146 should be 3 November 2004 if an Authority decision is received on or before 27 July 2004, or 23 February 2005 if an Authority decision is received after 27 July 2004 but on or before 16 November 2004.

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 P146RR, Version No. Final/1.0, dated 15 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:
 - (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.

Authority has decided not to direct a Modification to the BSC in line with the Proposed Modification P146 and also not to direct a Modification to the BSC in line with the Alternative Modification Proposal P146.

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

Presently organisations which operate as Clearing Houses in the electricity market are required to register as Trading Parties under the BSC as they hold Energy Accounts in order to act as the central counterparty and to notify trades between their members. It was argued by the Proposer that this requirement represents a defect in the BSC which manifests itself in a failure to recognise that Clearing Houses occupy a different market position to other BSC Trading Parties. It was argued that Clearing Houses do not seek a profit from price changes, are subject to their own regulatory obligations and do not hold power contracts. It was further argued that membership of a Clearing House allows BSC Parties to trade at the best price available without concerns over the credit-worthiness of their counterparties, since each Clearing House takes responsibility for the credit risk and performance of the contracts they clear.

It was suggested that the BSC should seek to recognise, facilitate and enhance the role of Clearing Houses since such organisations increase efficiency and transparency in the sale and purchase of electricity.

In order to rectify this situation, OM London Exchange Ltd submitted Modification Proposal P146, "New Participation Category to the BSC – Clearing House" on 3 November 2003.

The Modification Proposal

Modification Proposal P146 seeks to modify the BSC so as to create a new participation category of 'Clearing House' into Section A of the BSC. It also seeks to mitigate the risk to Clearing Houses of their counterparties entering Credit Default, and correct a perceived discrimination in the Notified Volume Charges applied to Clearing Houses. The justification for the Modification Proposal was that it would better facilitate achievement of Applicable BSC Objective C3 (3) (c).

It was submitted that the introduction of the new category of "Clearing House" would enable Clearing Houses to submit Energy Contract Volume Notifications (ECVNs) for their cleared trades in the role of an Energy Contract Volume Notification Agent (ECVNA), but would not authorise them to act in any other participation capacity.

The Proposal advocates that Parties registering as Clearing Houses would, by way of a BSC Obligation in Section M of the BSC, be warned of any breaches by its members of their Credit Cover Percentage by the Energy Contract Volume Aggregation Agent (ECVAA). This is important under the Proposal since the ECVAA is currently unable to supply information to organisations such as Clearing Houses in the event of the potential Credit Defaults of their members. It is argued that by acting as the central counterparty to their members' trades and guaranteeing delivery, the Clearing House bears the non-delivery risk normally involved in a bilateral trade between Parties. The argument follows that, since clearing facilitates competition by removing this exposure for Parties, the BSC should act to protect Clearing Houses from such risks in return. This can be aided by the ECVAA warning the Clearing House of any of their members about to

be in breach of their Credit Cover Percentage. Modification Proposal P146 seeks to mitigate the potential imbalance risk to a Clearing House of any of its members becoming unable to deliver part of a cleared trade due to having been placed in Credit Default under the Code and thereby having triggered notification rejections.

Although Clearing Houses would continue to notify the volume twice as the central counterparty, Modification Proposal P146 also seeks to allow those Parties registered within the new capacity of Clearing House to be charged once only per traded volume. The Proposer argues that the Notified Volume Charge, which is currently applied to all Trading Parties by total notified energy volume, discriminates against Clearing Houses. By acting as the central notifying counterparty to all their cleared positions Clearing Houses submit two notifications for the actual volume traded. An amendment to Section D of the BSC would mean that Clearing Houses are charged once only per traded volume.

The Panel considered the Initial Written Assessment at its meeting of 11 November 2003 and agreed to submit Modification Proposal P146 to the Assessment Procedure. The Settlement Standing Modification Group (the "Group") aided by the Governance Standing Modification Group and some non-physical traders considered the Modification Proposal during the Assessment Procedure.

The Group met four times during the Assessment Procedure: on 18 November 2003, 2 December 2003, 16 December 2003 and 13 January 2004. An Assessment Consultation was issued and impact assessments commissioned from the BSC Agent, BSC Parties, Party Agents, Core Industry Document Owners and BSCCo.

During its evaluation, the majority of the Group concluded that the Modification Proposal P146 would not better facilitate achievement of the Applicable BSC Objectives, since its provisions for Clearing Houses to receive warning of members' potential Credit Defaults would have a negative impact on competition. It was the Group's view that it would be inappropriate to introduce a Code obligation for the ECVA to provide Clearing Houses with advance Credit Default information. The Group believed that this would create a conflict of interest between the Clearing House and the BSC and was a matter to be pursued by the Clearing House outside the BSC through its own contracts with members. The Group also added that although Parties might not have out of hours resources, they would have the full 24 hour Query Period in which to notify the Clearing House of their breach if their Clearing House contract stipulated a requirement to do so. It should be noted that the Proposer did not agree with the Group's majority view reiterating their view in the Modification Proposal that it better facilitated achievement of Applicable BSC Objective (c).

The Group then considered developing an Alternative Modification Proposal. The Group considered an Alternative Modification Proposal which removed the Credit Default provisions of the Proposed Modification whilst retaining its participation category and charging aspects.

Following its consideration of the Alternative Modification Proposal the majority of the Group concluded that Alternative Modification Proposal P146 would, as compared with the current BSC arrangements and against the Proposed Modification, better facilitate the achievement of the Applicable BSC Objective (c). In support of this conclusion, the majority stated the following:

- Clearing Houses facilitate competition. The current application of Notified Volume Charges represented a cross-subsidy which discriminates against Clearing Houses and acted as a barrier to their operations;

- Halving Notified Volume Charges for Clearing Houses would therefore correct this discrimination and provide a 'level playing field' between Clearing Houses and other Trading Parties;
- The incremental cost of processing Clearing Houses' 'extra' ECVNs was not material, and that if charges were halved for Clearing Houses BSCCo would continue to receive three out of four of the Notified Volume Charges currently incurred by a cleared trade;
- An increased number of Clearing Houses, or increased trade for existing Clearing Houses, would not lead to BSCCo 'losing' any Notified Volume Charges resulting from Parties' switching from bilateral to cleared trades but would in effect gain an 'extra' charge since the Clearing House and both its counterparties would continue to pay one charge each;
- There is potential for the cost-saving to Clearing Houses resulting from halved Notified Volume Charges to be passed on to their members, and that this would facilitate use of Clearing Houses and thereby competition through a mutually-beneficial arrangement between the interests of the Code and of Clearing Houses; and
- The fact that the fees charged to Clearing House members lay outside the Code could not be used as an argument against Modification Proposal P146.

A minority of the Group felt that Alternative Modification Proposal P146 would not better facilitate the achievement of the Applicable BSC Objectives in relation to the defect identified by the Modification Proposal as compared to the current BSC arrangements and the Proposed Modification. The minority felt that Alternative Modification Proposal P146 would have a negative impact on Applicable BSC Objective (c). In support of their conclusion, the minority stated the following.

- That any cost-savings from Clearing Houses from halved Notified Volume Charges would be recovered via Parties' Main Funding Shares and that this would effectively create a cross-subsidy for Clearing Houses.
- That the current arrangements – whereby those Parties wishing to gain the benefit of using a Clearing House cover the cost resulting from the additional notified volume – is more appropriate than P146's proposal to recover the additional volume cost from all Parties.
- That the cost of a Clearing House ECVN is no different from that of an ECVN submitted by any other Party and that both the Proposed and Alternative Modifications would therefore create a conflict between the intentions of the Codes's charging schedule and the commercial interests of the Clearing Houses
- That the benefit to Clearing Houses of the Proposed and Alternative modifications would be achieved at the expense of other BSC Parties.

Responses to ELEXON Consultation

ELEXON published a draft Modification Report on 20 February 2004, which invited respondents' views by 27 February 2004. Eight responses were received. With regards the Proposed Modification, six respondents representing 37 Parties) agreed with the Panel's provisional recommendation that it should not be made. However one response (representing 1 Party) supported the Proposed Modification. The remaining one respondent (representing 1 Party) provided a "no comment" response. With regard to the Alternative Modification Proposal four respondents (representing 19 Parties) agreed with the Panel's provisional recommendation that it should be made. However three respondents (representing 20 Parties) did not consider that the Alternative Modification Proposal better facilitated the Code objectives and as, as stated above, the remaining one respondent (representing 1 Party) provided a no comment response.

Of the parties that did not consider that the Proposed Modification better facilitated achievement of the Code objectives, one respondent stated that they did not support information on Credit Cover being provided to a subset of BSC Parties prior to being made available to all BSC Parties. This Party noted that Clearing Houses do not seek to profit from price movements however in their view, Clearing Houses are still commercial entities and will endeavour to trade out their position to manage their liability. This would allow them to make decisions based upon preferential information, which would give Clearing Houses a commercial advantage that is not available to the remainder of the market.

Another respondent who did not support the Proposed Modification believed the absence of the Credit Default warning provisions would remove the concerns that parties have on the Proposed Modification. This respondent added that whilst they could not see how reducing the notification charges helped the liquidity of the market unless there is corresponding reduction in clearing costs to members. The respondent believed that due to the relative small charges involved, if there was a potential that the cost of such service could be reduced, the Alternative Modification could better facilitate achievement of Applicable BSC Objective (c).

The respondent who supported the Proposed Modification stated that in their view the proposal would (as compared with the Alternative Modification Proposal) better facilitate achievement of Applicable BSC Objective (c).

Of the Parties who expressed their support for the Alternative Modification Proposal one respondent believed that halving Notified Volume Charges for Clearing Houses would only help the liquidity of the market if there was to be a corresponding reduction in Clearing Houses' own charges to members. However, this respondent considered that if the Alternative Modification could potentially result in a reduction in such charges, then the Alternative could better facilitate competition.

The Proposer expressed support for the Alternative Modification Proposal in the absence of legal text for the Proposed Modification, although they also believed that the Proposed Modification would better facilitate achievement of Applicable Objective (c).

Of those respondents who did not consider that the Alternative Modification Proposal better facilitated the Code objectives one respondent agreed with the arguments against the Alternative Modification, which were expressed by the minority of the Group during its discussions, and therefore considered that the Alternative should not be made. Another respondent did not agree that Clearing Houses are currently discriminated against through Notified Volume Charges. This respondent considered that the Alternative Modification would introduce a cross-subsidy for Clearing Houses, and it was noted that corresponding cost-reductions for Clearing House members could not be guaranteed. One respondent was not convinced that the Alternative Modification Proposal would achieve increased use of Clearing Houses. This respondent stating that cost-savings for members could not be guaranteed and that there were other financial obligations involved in using a Clearing House.

The respondents' views are summarised in the Modification Report for Modification Proposal P146, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 11 March 2004 and considered Modification Proposal P146, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended to the Authority that:

- Proposed Modification P146 should not be made;
- Alternative Modification P146 should be made;
- The Implementation Date for the Proposed Modification P146 (in the event that the Authority determines that the Proposed Modification should be made) should be 23 February 2005 if an Authority decision is received on or before 22 June 2004, or 29 June 2005 if an Authority decision is received after 22 June 2004 but on or before 28 October 2004;
- The Implementation Date for the Alternative Modification P146 should be 3 November 2004 if an Authority decision is received on or before 27 July 2004, or 23 February 2005 if an Authority decision is received after 27 July 2004 but on or before 16 November 2004.

The majority of Panel Members agreed that the Alternative Modification would remove a current discrimination in the Notified Volume Charge applied to Clearing Houses. This, in their view, may result in corresponding cost-savings for members and would therefore better facilitate achievement of Applicable BSC Objective C 3 (3) c) by promoting competition.

Responses to Ofgem GB Consultation

On 5 December 2003 Ofgem undertook to invite responses on additional implications that a Proposed Modification 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 regarding Modification Proposal P146 on 5 March 2004 which invited respondents' views by 2 April 2004. Ofgem received no responses to the Consultation Paper.

The Consultation Paper and other related documents can be found on the *BETTA GB Consultation* section of the Ofgem website.⁵

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 neither Proposed Modification P146 nor the Alternative Modification Proposal will better facilitate achievement of Applicable BSC Objective (c).

It is Ofgem's view that the main perceived benefit propounded for the Proposed Modification is that advance notifications of Credit Default by Clearing House members should be provided to Clearing Houses by the ECVAAs because this advance notice will enable the Clearing House to assist their members to rectify their credit situation. It is Ofgem's view that it would not be appropriate to introduce a Code obligation for the ECVAAs to provide Clearing Houses with advance Credit Default information. Ofgem notes that the Group, the Panel and the majority of consultation respondents have expressed concerns about this aspect of the proposal. These concerns are primarily on the grounds that the Clearing House would gain a commercial advantage where it offered its members an opportunity to trade out its potential default with the Clearing House. Ofgem agrees with this observation. It is also Ofgem's view that such advance notifications could create an inappropriate conflict of interests between the Clearing House and the BSCCo and would therefore be inappropriate.

Regarding the Alternative Modification Proposal, it is Ofgem's view that the main advocated benefit relates to the perceived inequity of the charging arrangements relating to traded volumes and Clearing Houses. The view in favour of the Alternative Modification Proposal is that Clearing Houses facilitate competition and that the current application of Notified Volume

⁵ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

Charges represents a cross-subsidy which discriminates against Clearing Houses and acts as a barrier to their operations. It is argued that the halving of Notified Volume Charges for Clearing Houses would therefore correct this discrimination and provide a 'level playing field' between Clearing Houses and other Trading Parties.

It is Ofgem's view that, consistent with the relevant objective of facilitating competition (by preventing cross subsidies), it is important that Electricity Balancing costs are targeted on those participants that cause them. In this case the Notified Volume Charges should reflect the cost of the service. Clearing Houses do not pay Main Funding Shares and furthermore it should be recognised that Clearing Houses make commercial decisions and recover their costs through their own charges to members which lie outside the BSC. It is Ofgem's view that amending the rules so as to halve the Notified Volume Charges for Clearing Houses would create a cross subsidy and would be contrary to the facilitation of competition.

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 of Industry Code Development

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