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08 September 2003

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No P123

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Direction in relation to Modification Proposal P123: “Assessment of Credit Cover following a change in a Party's Portfolio”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P123, “Assessment of Credit Cover following a change in a Party's Portfolio”.

The BSC Panel (the “Panel”) recommended to the Authority that the Proposed Modification P123 should be made. The Panel recommended that the Implementation Date of Proposed Modification P123 should be 27 February 2004 (for the Spring 2004 BSC Season) should the Authority determination be received on or before 17 November 2003. Should an Authority determination be received after this date, but prior to 12 January 2004 then the Implementation Date should be 31 May 2004 (for the summer 2004 BSC Season).

Having carefully considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives and the Authority's wider statutory duties³, the Authority has decided to direct a Modification to the BSC in line with the Modification Proposal P123.

This letter explains the background and sets out the Authority's reasons for its decision. In addition, the letter contains a direction to The National Grid Company plc (“NGC”) to modify the BSC in line with Modification Proposal P123, as set out in the Modification Report.

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

² ELEXON document reference P123RR, Version No. 1.0, dated 15 August 2003.

³ 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.

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

Background

Following the Spring and Autumn contract rounds or at other times when there may be a significant portfolio change, there can be a consequential significant change in the meter systems of Suppliers with a BMU registered in SVA, above all among suppliers with portfolios that are in the Industrial and Commercial sector. As a result, it was asserted that assessment of Credit Cover requirements can be skewed against a Party that undergoes such a change to their portfolio.

Energy Indebtedness is a megawatt-hour figure, which is translated into a percentage known as the Credit Cover Percentage. A calculation for Credit Cover Percentage is directly proportional to a Party's Energy Indebtedness. Energy Indebtedness is calculated from the approximated expected imbalance of the Party and an approximation of the Energy Imbalance Charges for that imbalance. The calculation is cumulative over 29 days and comprises two parts, Credited Energy Indebtedness and Actual Energy Indebtedness.

Credited Energy Indebtedness is calculated from the Balancing Mechanism (BM) Unit Credit Assessment Import or Export Capability which is based on Generation Capacity (GC) or Demand Capacity multiplied by the Credit Assessment Load Factor (CALF). This is used to calculate the average potential metered volume of the BM Unit. This is used for days for which there is no actual data available as the Interim Information Settlement Run⁴ data is not available. This is in general the first 9 days.

Actual Energy Indebtedness is calculated from the actual trading data available for the remaining 20 days of the calculation. Metered data for Supplier Volume Allocation⁵ BM Units is not available at the Interim Information Settlement Run stage and will not be available until the Initial Settlement Run.

The Initial Settlement Run is generally 15 Settlement Days after the Interim Information Settlement Run and therefore if there has been a change in load for that Party, it will not be reflected in the calculation. Also on days where Initial Settlement Run data is not available the metered volumes are calculated by using data from an "equivalent day" which is the most recent Settlement Day, which is the same day of the week for which the Initial Settlement Run data is available.

⁴ A Settlement Run is a determination of amounts in respect of Trading Charges in relation to a Settlement Day (i.e. the period from 00.00 hours to 24.00 hours on each day) to be paid by Trading Parties and NGC or amounts to be paid to them. The BSC requires that the Settlement Administration Agent (SAA) be responsible for determining Trading Charges and intermediate calculations. The SAA is required to carry out an Interim Information Settlement Run, an Initial Settlement Run, four timetabled Reconciliation Settlement Runs for each Settlement Day as well as any Ad Hoc Settlement Runs required by the BSC Panel.

⁵ The Trading Party responsible for all Exports and Imports of electricity is responsible for ensuring that there is adequate metering and for registering the necessary Metering Systems in either the Central Metering Registration System or in one of the Supplier Metering Registration Systems provided by the Licensed Distribution System Operators. The BM Unit Metered volume will then be calculated in either Central Volume Allocation or in Supplier Volume Allocation.

It was asserted that two issues emerge in the event of a portfolio change and in general during periods of lowered demand. The first relates to the way a seasonal average CALF is currently used which, it is said, creates an unrealistically high Energy Indebtedness, and consequently a high Credit Cover Percentage value for the days where settlement data is not used. The second issue is the use of the 'same day of the week', the equivalent day, at the point of the Interim Information Settlement Run to estimate supplier data. This circumstance may result in a requirement for the Party to lodge an unrepresentatively high level of Credit Cover after a portfolio change to avoid entry into Credit Default.

It was further asserted that the current definition and application of material doubt under the BSC, means that Parties who have entered Credit Default as a consequence of the asserted anomaly in the Energy Indebtedness calculation, face a level of uncertainty as to the mechanism and methodology used by BSCCo in the determination of material doubt, as well as the length of time that BSCCo may take to determine whether material doubt should be applied. Therefore because BSC Parties cannot be certain that material doubt will be granted and in what time frames, this may mean that Parties are required to try to obtain Credit Cover as a matter of urgency pending confirmation of the BSCCo determination on material doubt (as there may be insufficient time to obtain and lodge additional Credit Cover following the BSCCo determination).

It was stated that the problem Modification Proposal P123 seeks to address is caused by the current rules and not by the trading practices of a particular BSC Party.

In order to rectify this situation, BizzEnergy Limited submitted Modification Proposal P123, "Assessment of Credit Cover following a change in a Party's Portfolio" on 26 March 2003.

The Modification Proposal

Modification Proposal P123 seeks to introduce the ability for Lead Party's to be able to reduce the magnitude of Demand Capacity for any Supplier Base and Additional BM Units for periods during a BSC year where demand differs as a consequence of portfolio change. Parties will only be able to have two mid-season decreases to DC per BSC Season per Supplier BM Unit. If any more than two are received the CRA will reject them, noting that this requires amendment to the CRA validation rules.

Modification Proposal P123 also proposes to amend the process whereby material doubt is applied to credit default situations so as to shorten the length of time between the Credit Default notices being issued by the Energy Contract Volume Aggregation Agent (ECVAA) and being either Authorised or cancelled by BSCCo, in order to provide BSC Parties with more certainty around the application of material doubt by BSCCo. The Panel will be obliged to establish and maintain a material doubt guideline that BSCCo will use when determining and applying material doubt to achieve this.

The justification for the Modification Proposal was that it would better facilitate achievement of the Applicable BSC Objectives⁶ C3 (3) (c) and (d).

⁶ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of NGC's Transmission Licence, are:

The Panel considered the Initial Written Assessment at its meeting of 10 April 2003, and agreed to submit Modification Proposal P123 to the Assessment Procedure. The Settlement Standing Modification Group (the "Group") considered the Modification Proposal during four meetings, on 15 and 28 April 2003, 27 May 2003 and 24 June 2003. At these meetings the group reviewed a High Level Impact Assessment issued to the BSC Central Service Agent and ELEXON as well as an Assessment Consultation. The Assessment Consultation included the results of the High Level Impact Assessment of the potential solutions.

The Group agreed that if approved Modification Proposal P123 would improve competition by removing barriers to entry for certain industrial and commercial Suppliers, allowing them to maintain a more appropriate level of Credit Cover. This would reduce their costs, thereby encouraging niche competitors and lowering the cost of market entry for new suppliers. The Group also agreed that to a lesser extent, Modification Proposal P123 would promote efficiency in the implementation and administration of the balancing and settlement arrangements because the amendments to the Credit Default process identified by the Modification Proposal may have the effect of improving efficiency in the Credit Cover and Credit Default arrangements, thus improving efficiency in BSCCo's handling of Credit Default.

ELEXON published a draft Modification Report on 17 July 2003, which invited respondents' views by 1 August 2003.

Respondents' views

ELEXON received seven responses to the consultation on Modification Proposal P123. Five responses (representing 26 Parties) expressed support for the Proposed Modification, one response (representing 4 Party) opposed the Proposed Modification and the remaining one response (representing 1 Party) provided a "no comment" response. The majority of responses also agreed that the legal drafting provided to give effect to the Proposed Modification addressed the defect identified by the Modification Proposal.

The one response that did not express support for the Modification Proposal stated that it did not better facilitate achievement of the Applicable BSC Objectives. This respondent gave no further explanation of their view.

The respondents' views are summarised in the Modification Report for Modification Proposal P123, which also includes the complete text of all respondents' replies.

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- 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.

Panel's recommendation

The Panel met on 14 August 2003 and considered the Modification Proposal P123, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Proposed Modification and that, if approved, the Proposed Modification should be implemented on 27 February 2004 (for the Spring 2004 BSC Season), should the Authority determination be received on or before 17 November 2003. Should an Authority determination be received after this date, but prior to 12 January 2004 then the Implementation Date should be 31 May 2004 (for the Summer 2004 BSC Season).

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 Proposed Modification P123 will better facilitate achievement of the Applicable BSC Objectives.

It is Ofgem's view that Modification Proposal P123 will better facilitate achievement of the Applicable BSC Objective (c) improving competition by removing barriers to entry for certain industrial and commercial Suppliers. This would reduce their costs, thereby encouraging niche competitors and lowering the cost of market entry for new suppliers. It is Ofgem's view that Modification Proposal P123 better facilitates achievement of Applicable BSC Objective 3(d) by amending to the Credit Default process so as to improve efficiency in the Credit Cover and Credit Default arrangements. This in turn will help to improve efficiency in BSCCo's handling of Credit Default situations.

Modification Proposal P123 will enable Parties to have two mid-season decreases to DC per BSC Season per Supplier BM Unit. If any more than two are received the Central Registration Agent (CRA) will reject them, noting that this requires amendment to the CRA validation rules. Ofgem notes that the current obligation in the Code, to increase the magnitude of DC if the Party is aware that the maximum expected metered volume of a BM Unit increases by 1% or 0.5MW will remain and will not be changed. Ofgem also notes that the process for establishing material doubt will also remain unchanged. Parties will be required to provide sufficient evidence to demonstrate to BSCCo that their case is valid, in order for BSCCo to reach a view on material doubt and carry out any necessary calculations prior to any notice being issued, so that a final determination can be reached as soon as possible after the receipt of a Credit Default notice.

Ofgem agrees permitting two mid-season decreases to DC per BSC Season per Supplier BM Unit is the most pragmatic solution and that it is consistent with the present arrangements for an increase in DC within season, which does not require an associated change in CALF. On the issue of material doubt, Ofgem's welcomes the introduction of more formal guidelines on the type of calculations that BSCCo should be using for verifying material doubt. This will provide further clarity to the process for determining material doubt and will make the process more transparent. It will further allow BSCCo more flexibility to deal with circumstances as they arise.

The Authority has therefore decided to direct that the Proposed Modification P123, as set out in the Modification Report, should be made and implemented.

Direction under Condition C3 (5) (a) of NGC's Transmission Licence

Having regard to the above, the Authority, in accordance with Condition C3 (5) (a) of the licence to transmit electricity granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the BSC as set out in the Modification Report.

The Implementation Date for Modification Proposal P123 is 27 February 2004

In accordance with Condition C3 (5) (b) of NGC's Transmission Licence, NGC shall modify the BSC in accordance with this direction of the Authority.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'D. Edward', written in a cursive style.

David Edward
Head of Electricity Code Development

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