August 2002

MODIFICATION REPORT

MODIFICATION PROPOSAL P76 – Anomalies Associated With Negative Quantities of Credit Cover

Prepared by ELEXON on behalf of the Balancing and Settlement Code Panel

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a Authorities

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c References

Ref.	Document	Owner	Issue Date	Version
1.	Assessment Report for P76 'Anomalies Associated with Negative Levels of Credit Cover'	ELEXON	12/07/02	1.0
2.	Initial Assessment of Modification Proposal P76	ELEXON	12/04/02	1.0
3.	Requirements Specification to Support Modification P76	ELEXON	16/05/02	1.0
4.	Modification Proposal P76 Risk Assessment	ELEXON	05/06/02	1.0
5.	Assessment Report for Modification Proposal P2 'Revision of the Methodology for Assessing Credit Indebtedness'	ELEXON	20/07/01	1.0

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1 SUMMARY AND RECOMMENDATIONS

1.1 Recommendation

On the basis of the analysis, consultation and assessment undertaken in respect of this Modification Proposal during the Assessment Procedure, and the resultant findings of this report, the Balancing and Settlement Code Panel ('the Panel') recommends that:

- **Alternative Modification P76 should be made with an Implementation Date of 15 Working Days after the Authority determination; and**
- **Proposed Modification P76 should not be made. In the event that the Authority determines that Proposed Modification P76 should be made, the Implementation Date should be:**
    - **25 February 2003 if a determination is made by the Authority on or prior to 24 October 2002; or**
    - **24 June 2003 if a determination is received after 24 October 2002.**

1.2 Background

Modification Proposal P76 'Anomalies Associated with Negative Quantities of Credit Cover', seeks to address anomalies that arise in the Credit Cover Percentage calculation when unpaid Trading Charges cause a Party's Energy Credit Cover to become negative. It proposes that the definition of Credit Cover Percentage in Section M3.1.1 of the Code be modified to take into account negative Energy Credit Cover and suggests this is achieved by amending the equation used to calculate a Party's Credit Cover Percentage to make it robust to negative values of Energy Credit Cover.

The proposer states that currently a BSC Party with negative Energy Credit Cover can avoid being placed in Credit Default, as the equation for calculating Credit Cover Percentage is not robust to negative values of Energy Credit Cover. The proposer therefore believes that P76 would reduce the bad debt risk faced by the industry and so would better facilitate 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.

The Credit Modification Group (CMG) considered P76 and two other possible options detailed within it. The first option (option 1) was to change the definition of Energy Indebtedness to include the amount of unpaid Trading Charges. The second option (option 2) was to modify the definition of Credit Cover to say that non payments should be deducted from the amount of credit posted, provided the Energy Credit Cover never became less than zero.

The CMG considered the responses received to an industry impact assessment and consultation at a meeting on 20 June 2002 and agreed that out of the Proposed Modification and the two other options considered, the second option (option 2) should be progressed as an Alternative Modification.

The Panel considered the Assessment Report (reference 1) for P76 on 18 July 2002 and agreed to endorse the recommendations of the Assessment Report that the Proposed Modification should be rejected, the Alternative Modification should be made and P76 should progress to the Report Phase, for consideration at the Panel Meeting on 15 August 2002.

1.3 Rationale for Recommendations

The CMG concluded that although the Proposed Modification represents a better technical solution by treating the root cause of the problem, the Alternative Modification should be implemented. The rationale for this decision was that the Alternative Modification will still identify Parties who should be in Credit Default when their Credit Cover Percentage is negative (i.e. they have a positive Energy Indebtedness and a negative Energy Credit Cover) and this will significantly reduce the risk faced by other BSC Parties. The CMG therefore, agreed that the additional cost of implementing the Proposed Modification versus that of the Alternative Modification was not justified. The relative development costs being £110,700 for the Proposed Modification as it involves changes to the NETA Central Service Agents' software, and £2,000 for the Alternative Modification, which only requires documentation changes. The software changes needed for the Proposed Modification would require a 4 month implementation timescale, whilst the Alternative Modification could be implemented within 15 Working days. Since this Modification Proposal seeks to mitigate risk currently faced by BSC Parties, this marked difference in implementation timescales is another reason why the Alternative Modification is favoured.

Having recommended the Alternative Modification, the CMG and the Panel agreed that the Alternative Modification better facilitated the Applicable BSC Objectives as set out in Condition C3.3 (c) of the Transmission Licence, as follows:

(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.

The rationale behind this decision was that Parties with unsecured liabilities, who were avoiding being placed under Credit Default, were putting an additional credit risk on the other Trading Parties. Currently the 'loophole' identified in the Credit Cover Percentage equation could allow a Party with negative Credit Cover to insist that they are kept out of Credit Default, even if their Credit Cover was inadequate. Being exposed to this extra credit risk will discourage smaller Companies from becoming BSC Trading Parties. This would not promote competition in the trading of electricity and hence by removing this risk, it would better facilitate BSC Objective (c).

2 INTRODUCTION

This Report has been prepared by ELEXON Ltd., on behalf of the Panel, in accordance with the terms of the Balancing and Settlement Code ('the Code'). The Code is the legal document containing the rules of the balancing mechanism and imbalance settlement process and related governance provisions. ELEXON is the company that performs the role and functions of the BSCCo, as defined in the Code.

This Modification Report is addressed and furnished to the Gas and Electricity Markets Authority ('the Authority') and none of the facts, opinions or statements contained herein may be relied upon by any other person.

An electronic copy of this document can be found on the ELEXON website, at www.elexon.co.uk.

3 HISTORY OF MODIFICATION PROPOSAL

P76 was raised by British Gas Trading on 8 April 2002 and an Initial Written Assessment, reference 2, was considered by the Panel at their meeting of 18 April 2002. The Panel agreed that P76 should proceed with a three month Assessment Procedure, culminating in the presentation of an Assessment Report to their meeting of 18 July 2002.

The Assessment Procedure was undertaken by the CMG, who met twice to assess P76. At its meeting on 23 April 2002 the CMG considered P76 and the two other options described within the proposal and agreed that a requirements specification (reference 3) was needed in order to allow assessment of the best solution. This was then used by the NETA Central Services Agent and the Funds Administration Agent (FAA) to provide a detailed level impact assessment (DLIA) for the Proposed Modification and the two other options. Also at the first meeting, a risk assessment (reference 4) was requested to identify the likelihood of negative Energy Credit Cover occurring and to assist the Credit Modification Group in assessing P76 and the other options. The results of the risk assessment and the DLIA were used by Parties to respond to the high level impact assessment (HLIA) and consultation questions.

At their second meeting of 20 June 2002, the CMG reviewed the HLIA and the consultation responses and agreed that of the two other options, option 2 should be progressed as an Alternative Modification.

The Panel, at their meeting of 18 July 2002, agreed to endorse the recommendations of the CMG contained within the Assessment Report, that the Alternative Modification should be made. The Panel agreed to send P76 to the Report Phase, with a draft Modification Report to be presented to the Panel meeting on 15 August 2002.

A draft Modification Report for P76 was issued for consultation to BSC Parties on 26 July 2002. 8 responses (37 Parties) were received with 7 of the responses (36 Parties) supporting P76 and the remaining response registering 'no comment'. On the basis of the support for P76 the Panel recommends to the Authority that the Alternative Modification as set out in this report be made.

4 DESCRIPTION OF MODIFICATION PROPOSAL

P76 was raised to address anomalies associated with negative quantities of Energy Credit Cover. As well as the Proposed Modification, two other options were contained within the Modification Proposal.

4.1 Proposed Modification

P76 proposes a change to the equation for calculating a Party's Credit Cover Percentage outlined in section M3.1.1 of the Code, to make it robust to negative values of Energy Credit Cover. The CMG agreed that this could be achieved by modifying the equation so that if Energy Indebtedness is greater than Energy Credit Cover, negative values of Energy Credit Cover return a positive value of Credit Cover Percentage, which is always in excess of 100% and would therefore trigger the Credit Default process. These changes would not affect positive values of Energy Credit Cover, which will return the same value of Credit Cover Percentage as in the original equation.

4.2 Option 1

The first alternative option detailed in the Modification Proposal and considered by the CMG involved amending the definitions of Energy Indebtedness and Credit Cover, so that the amount of any unpaid Trading Charges is added to Energy Indebtedness, rather than subtracted from Energy Credit Cover.

This option was not progressed, but is included for completeness.

4.3 Option 2 (Alternative Modification)

The second option detailed in the Modification Proposal and considered by the CMG states that the definition of Credit Cover should be modified to eliminate negative values of Energy Credit Cover. This is achieved by changing the definition of Credit Cover to state that non-payments should be deducted from the amount of credit posted, with any ensuing negative values of Energy Credit Cover being set to and treated as being equal to zero.

This option was progressed as an Alternative Modification.

5 RATIONALE FOR PANEL RECOMMENDATIONS

The Panel agreed with the views of the CMG as set out in the Assessment Report (reference 1) and summarised below:

The Group's rationale for believing that a change to the Code was required (be it the Proposed Modification or an appropriate Alternative Modification) is that currently the 'loophole' in the Credit Cover Percentage equation could allow a Party with negative Energy Credit Cover to insist that they are taken out of Credit Default, even if their Credit Cover was inadequate. The resultant credit risk to other BSC Parties represents a potential barrier to effective competition, and closing the 'loophole' would therefore better facilitate the Applicable BSC Objectives.

The CMG concluded that although the Proposed Modification represents a better technical solution by treating the root cause of the problem, the Alternative Modification should be implemented. The rationale for this decision was that the Alternative Modification will still identify Parties who should be in Credit Default when their Credit Cover Percentage is negative (i.e. they have a positive Energy Indebtedness and a negative Energy Credit Cover) and this will significantly reduce the risk faced by other BSC Parties. In addition, the likelihood of a Party having a negative value of Energy Credit Cover will be significantly decreased once Modification Proposal P2[1] (reference 5) is implemented, as identified in the risk assessment (reference 4). The CMG therefore, agreed that the additional cost of implementing the Proposed Modification versus that of the Alternative Modification was not justified. The relative development costs being £110,700 for the Proposed Modification, as it would involve changes to the NETA Central Service Agents' software, and £2,000 for the Alternative Modification, which only requires documentation changes. The software changes needed for the Proposed Modification would require a 4 month implementation timescale, whilst the Alternative Modification could be implemented within 15 Working days. Since this Modification Proposal seeks to mitigate risk currently faced by BSC Parties, this marked difference in implementation timescales further supports the recommendation to approve the Alternative Modification.

Seven of the eight responses to the draft Modification Report consultation responses supported the recommendations of the Panel, with the other response registering 'no comment', and no new arguments were made against these recommendations.

6 LEGAL TEXT TO GIVE EFFECT TO THE PROPOSED MODIFICATION

P76 requires minor changes to Section M of the Code. The changes to the legal text of the Code are based on version 4.0 of Section M. If the baseline of the Code changes prior to implementation of P76, or if other Modification Proposals are to be implemented at the same time as P76, the legal text may need to be amended to realign to the new baseline.

A summary of the changes is given below and a detailed red-lined version is contained within Annex 2.

[1] Modification Proposal P2 'Revision of the methodology for assessing Credit Indebtedness' is due to be implemented on 30 September 2002.

6.1 Proposed Modification

Paragraph 3.1.1 of Section M would be amended to make the Credit Cover Percentage Calculation more robust to negative values of Energy Credit Cover.

6.2 Alternative Modification

Paragraph 2.1.3 of Section M would be amended to include the condition that if a Party's unpaid Trading Charges exceeds its level of Credit Cover Posted, then the Party's Credit Cover will be set to zero rather than a negative amount.

7 ASSESSMENT

This section of the report summarises the assessment carried out by the CMG during the Assessment Procedure. Full details are contained in the P76 Assessment Report (reference 1), which may be found on the ELEXON website at www.elexon.co.uk.

The additional specific Terms of Reference set by the Panel for the CMG when progressing P76 were:

- An assessment of the three solutions suggested in the Modification Proposal;
- The potential impact on the Energy Contract Volume Aggregation Agent (ECVAA) and the Funds Administration Agent (FAA); and
- The potential impact on Parties' systems and processes.

7.1 Assessment of the Solutions Suggested in the Modification Proposal

7.1.1 Proposed Modification

The view of the CMG at the first meeting was that the Proposed Modification would be the preferred option, pending the impact assessments and consultation responses.

The risk assessment, commissioned by the CMG and carried out by ELEXON found that implementing P76 would have no effect on the credit risk faced by BSC Parties unless the ECVAA system is incorrectly calculating a Party's indebtedness, due to inaccurate Trading Charge data. After the implementation of P2, when ECVAA will have access to Trading Charge data from the Interim Information Settlement Run, it is expected that ECVAA will be able to more accurately assess a Party's indebtedness.

At the second CMG Meeting of 20 June 2002, it was decided that the extra sophistication of the Proposed Modification, compared to option 2 was not required. As the associated BSC Agent costs of the Proposed Modification were high (£100,700) and the risk currently faced by BSC Parties is low, an Alternative Modification would be recommended.

7.1.2 Alternative Modification

One of the alternative options discussed by the CMG, which later became the Alternative Modification, involved modifying the definition of Energy Credit Cover to eliminate negative values. This is achieved by changing the definition of Energy Credit Cover to state that non-payments should be deducted from the amount of credit lodged, with any ensuing negative values of Energy Credit Cover being set to and treated as being equal to zero.

The FAA currently follows the procedure described above, i.e. setting negative Energy Credit Cover to zero, but the CMG agreed that a Modification to the Code is required to remove an inconsistency between the wording in the Code and the actions currently being undertaken by the FAA. In following the Code in its present form, a Party could insist that the actual negative value of Energy Credit Cover be used instead of taking the value as zero. Due to the weakness of the Credit Cover Percentage calculation in dealing with negative values of Energy Credit Cover, this could lead to a Party being removed from Credit Default, despite the fact that they do not have enough Credit Cover posted to cover their Trading liabilities.

At its second meeting, the CMG agreed that this alternative option sufficiently dealt with the perceived problems with negative Energy Credit Cover and due to its low BSC Agent implementation cost (£2,000) it would be progressed as an Alternative Modification.

7.2 The Potential Impact on the ECVAA and FAA

To assess the potential impact on ECVAA and FAA, a DLIA was requested and the results are summarised below. Full details of the results of the DLIA are contained within the Assessment Report (reference 1).

Implementation of the Proposed Modification would cause no change to FAA systems or processes. However, minor changes will be required to the FAA documentation should the Alternative Modification be approved. The FAA has estimated that these changes will take 2 man-days and cost approximately £2000.

Implementation of the Proposed Modification will require changes to the ECVAA systems and documents to include the amended Credit Cover calculation. It is estimated that the development of this change will take 9 weeks and cost approximately £110,700 (ex VAT). If the Alternative Modification is approved no change to the ECVAA systems and processes would be required, as changes to the FAA systems would prevent negative values of Energy Credit Cover being supplied to ECVAA.

7.3 The Potential Impact on Parties Systems and Processes

A HLIA was issued to assess the potential impact that the implementation of the Proposed Modification or an Alternative Modification would have on Party Systems and processes. Seven responses were received from industry participants. Five of these responses stated that there was no impact for implementation of the Proposed Modification or the Alternative Modification. Two Parties stated that there was minimal impact on their systems and processes.

7.4 Other Issues

Following the second CMG meeting, a concern was expressed that implementation of the Proposed Modification or the Alternative Modification would lead to a significant increase in the risk of a BSC Party simultaneously triggering the Level 1 and Level 2 Credit Default processes. This situation would occur if a Party's Credit Cover Percentage increases from below 80% to above 90% in the space of one Settlement Period. The problem with simultaneously triggering the Level 1 and Level 2 Credit Default processes is that the Party is given just 24 hours to resolve the situation. This may lead to a Party having to try to arrange extra Credit Cover outside normal working hours, in order to prevent trading restrictions being placed upon them.

It was concluded that there would be no change in the number of Parties simultaneously triggering the two Credit Default processes if the Alternative Modification is implemented, as the changes proposed under the Alternative Modification reflect current operating practise. However, as unlike the Alternative Modification, the Proposed Modification would see Parties with negative or zero Energy Indebtedness being placed into Credit Default where they have unsecured liabilities, there is a possibility of an increase if the Proposed Modification is implemented. A full description of the assessment of this issue is contained within the Assessment Report (reference 1).

8 SUMMARY OF REPRESENTATIONS

The draft Modification Report was sent out for consultation to BSC Parties on the 26 July 2002, with responses due back by the close of business on 2 August. Eight responses were received, representing a total of 37 Parties. These responses are contained in Annex 1 and summarised below:

Seven of the responses representing 36 Parties supported the Panel's recommendation that the Proposed Modification should be rejected and the Alternative Modification should be made. The remaining response representing 1 Party registered 'no comment' in relation to the Panel's recommendation on P76.

The responses to the consultation contained no new substantive arguments. There was one issue raised regarding the clarity of the proposed legal text for the Proposed Modification. ELEXON reviewed this issue and didn't consider it to be substantive and this point was conveyed to the Panel.

ANNEX 1 – REPRESENTATIONS

Responses from P76 Draft Report Consultation
Consultation issued 26 July 2002

Representations were received from the following parties:

No	Company	File Number	No. Parties Represented	Support for Alternative Modification?
1.	TXU Energy	P76_MR_001	21	Yes
2.	British Gas Trading	P76_MR_002	1	Yes
3.	Aquila Networks	P76_MR_003	1	No Comment
4.	LE Group	P76_MR_004	1	Yes
5.	SEEBOARD	P76_MR_005	1	Yes
6.	Scottish Power	P76_MR_006	5	Yes
7.	Scottish and Southern	P76_MR_007	4	Yes
8.	British Energy (late response)	P76_MR_008	3	Yes

P76_MR_001 – TXU Energy

Thank you for the opportunity to comment on Modification Proposal P76 (Anomalies Associated with Negative Levels of Credit Cover). This response is on behalf of all TXU Europe companies (21 BSC Parties).
TXU supports the recommendation that the Alternative Proposal be implemented. It is important that the current loophole is closed in order to protect the industry from bad debt risk. The Alternative Proposal provides a quick, cheap and efficient solution to the problem.

Yours faithfully

Nicola Roberts
Market Development Analyst
TXU Europe Energy Trading Ltd

P76_MR_002 – British Gas Trading

Thank you for the opportunity of responding to this consultation. British Gas Trading Ltd (BGT) support the Panel's view that the alternative modification proposal should be implemented in preference to that originally proposed by ourselves in April of this year.

Although the Modification Group identified a more technically accurate solution to this defect the Alternative proposal recommended in the final report is the least cost way of meeting the intent of the original proposal. As such BGT believe it better facilitates the Applicable BSC Objectives by closing a loophole in the current Credit Cover Percentage equation and thus reducing the resultant credit risk faced by all BSC participants. Specifically we believe that this Alternative proposal furthers the promotion of competition in the generation and supply of electricity by removing what could constitute a barrier to entry to new entrants.

Yours faithfully

Danielle Lane
Transportation Analyst

P76_MR_003 – Aquila Networks

Please find that Aquila Networks response to P76 Consultation on draft Modification Report is 'No Comment'.

regards
Rachael Gardener

Deregulation Control Group &
Distribution Support Office
AQUILA NETWORKS

P76_MR_004 – LE Group

LE Group support the ELEXON recommendation that the alternative modification (option 2) be implemented. We agree that it fulfils BSC applicable objective (c), as by closing the existing loophole in the credit cover calculation the risk of bad debt is further decreased, which otherwise might be anti-competitive to other market participants.

P76_MR_005 – SEEBOARD

With reference to above mentioned proposal and draft modification report dated 25th July. We agree with recommendation that alternate modification, based on option 2, should be made and with implementation date detailed. From this report it is clear that this version could be rejected by the Authority and original proposal implemented instead. Our rejection of this original proposal, as a costly method for closing a potential loophole, still remains and as such we would not support original modification being made.

Dave Morton
SEEBOARD Energy Limited

P76_MR_006 – Scottish Power

We refer to our previous comments in respect of this proposal and would wish to reiterate our support for P76 Alternative Option 2, which we believe, is the most cost effective and, along with the implementation of P2 in September 2002, will be the most appropriate solution.
We have considered the legal drafting to give effect to P76 Alternative and agree that it is appropriate.
I trust that you will find these comments helpful. Nonetheless, should you require further clarification of any of the above, please do not hesitate to contact me.

Yours Sincerely,

Man Kwong Liu
Calanais Ltd.
For and on behalf of: - *Scottish Power UK Plc.; Scottish Power Energy Trading Ltd.; Scottish Power Generation Ltd.; Scottish Power Energy Retail Ltd.; SP Transmission Ltd.*

P76_MR_007 – Scottish and Southern Energy

This response is sent on behalf of Scottish and Southern Energy, Southern
Electric, Keadby Generation Ltd. and SSE Energy Supply Ltd.

Further to your note of 26th July 2002, and the associated Modification Report for P76, we agree with the proposed BSC Panel recommendation to the Authority that:-

a) the Original Modification Proposal P76 should not be made; and

b) the Alternative Modification Proposal P76 should be made.

If the Original or the Alternative Modification Proposal P76 is approved, we agree with the proposed BSC Panel recommendation on the timing for the Implementation Date, as outlined in Section 1.1 of the Modification Report.

Regards

Garth Graham
Scottish & Southern Energy plc

P76_MR_008 – British Energy

British Energy supports the intent of this modification to address an anomaly in the present BSC whereby a party's due but unpaid trading charges can cause its Energy Credit Cover as defined to become negative, which in turn can prevent it being placed in Credit Default even though it's true indebtedness exceeds it's lodged credit.

The modified credit cover percentage formula in the legal drafting for the original proposal requires clarification, in particular the use of brackets and signs. Without this clarification, we cannot be sure that it achieves the desired objective. Assuming it does, it is probably not as good a solution as "option 1" described in the report, and we note that the implementation costs are relatively high.
"Option 1" described in the draft modification report, to redefine credit cover and indebtedness such that due but unpaid trading charges are added to "indebtedness" instead of being subtracted from "credit cover" appears to be a conceptually pure solution, but we acknowledge that the implementation costs are a concern.
The alternative proposal, "Option 2" to prevent "credit cover" becoming negative at source at the FAA, is not as pure solution as "Option 1" but does nevertheless better meet the BSC objectives of promoting efficiency and competition by better facilitating a reduction in potential exposure of BSC parties to bad debt, at minimum implementation cost, and we support a recommendation to implement this alternative proposal.

Martin Mate
for
British Energy Power & Energy Trading Ltd
British Energy Generation Ltd
Eggborough Power Ltd

ANNEX 2 – LEGAL TEXT

See attached document (P76RR Legal Text Final v1).