Consultation for Modification Proposal P146:

New Participation Category to the BSC – Clearing House

A consultation document developed on behalf of the Settlement Standing Modification Group.

For Attention of: **BSC Parties and all other interested parties**

Date of Issue: **18 December 2003**

Responses Due: **17:00 on Friday 9 January 2004 (to: modifications@elexon.co.uk)**

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1. INTRODUCTION

1.1 Issue/Defect which Proposed Modification seeks to Address

Currently, Parties who operate as Clearing Houses hold Energy Accounts and are therefore obliged to register as Trading Parties under the Balancing and Settlement Code ('the Code'). The Proposer of Modification Proposal P146 ('P146') argues that this failure to recognise a specific role for Clearing Houses in the electricity market represents a defect in the Code. The Proposer states that Clearing Houses operate a different market position to other Trading Parties since they are subject to their own regulatory requirements, do not hold gross positions in power contracts, and do not seek to profit from price changes. It is argued that, by acting as the 'buyer to every seller and the seller to every buyer', Clearing Houses allow Parties to trade at the 'best price' available without concerns over the credit-worthiness of counterparties as each Clearing House takes responsibility for the credit risk and performance of the contracts they clear.

P146 therefore suggests that the Code should seek to facilitate and enhance the role of Clearing Houses since they increase the efficiency and transparency, and therefore the competitiveness, of the sale and purchase of electricity. The Proposer requests that the Code be amended to explicitly recognise the role of Clearing Houses, in order to include additional Code provisions intended to facilitate their activities. Specifically, P146 seeks to mitigate the risk to Clearing Houses of their counterparties entering Credit Default, and to correct a perceived discrimination in Notified Volume Charging.

The three components of the Proposed Modification are outlined in more detail below.

1.2 Proposed Solution

1.2.1 New Category of 'Clearing House'

The Proposed Modification seeks to introduce a new category of 'Clearing House' into Section A of the Code. Within this category Clearing Houses would be able to submit Energy Contract Volume Notifications (ECVNs or 'notifications') in the role of an Energy Contract Volume Notification Agent (ECVNA) as currently, but would not be authorised to act in any other participation capacity. However, those Parties registering as Clearing Houses would receive two unique benefits as described below.

1.2.2 Notification of Potential Credit Defaults from the ECVAA to Clearing Houses

The Proposer argues that the Code's inability to facilitate the operation of Clearing Houses is manifest in the inability of the Energy Contract Volume Aggregation Agent (ECVAA) to supply information to such organisations in the event of the potential Credit Defaults of their members. The Proposed Modification therefore seeks to guarantee delivery of Clearing Houses' contracts through the introduction of an obligation in Section M of the Code for the ECVAA to inform a Clearing House of the potential Credit Default of any Party for whom the Clearing House is authorised to submit ECVNs.

1.2.3 Single Notified Volume Charge for Clearing Houses

P146 states that another area in which the Code fails to recognise the role of Clearing Houses is in the charging schedule applied to notified energy volumes. 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. Clearing Houses act as the central counterparty to all their cleared positions and therefore receive twice the level of charges due to this 'doubling' of ECVN submissions. The Proposed Modification therefore seeks to amend Section D, Annex D-3 of the Code so that those Parties registered within the new capacity of Clearing House would be charged a single notification fee for each cleared position, determined on the basis of positive energy volumes alone.

1.3 Process Followed to Date

P146 was raised by OM London Exchange Ltd on 3 November 2003. An Initial Written Assessment was presented to the BSC Panel at its meeting of 11 November 2003, where the Panel determined that the Modification should be submitted to a three-month Assessment Procedure by the Settlement Standing Modification Group (SSMG) supplemented with expertise from the Governance Standing Modification Group and non-physical traders. To date, the SSMG has met three times to consider P146: on 18 November, 2 December and 16 December 2003.

This document describes the discussions of the SSMG to date and seeks views on:

- Whether the Proposed Modification would better facilitate the achievement of the Applicable BSC Objectives;
- Whether any of the points raised during the SSMG's discussions give rise to any Alternative Modification which, when compared with the Proposed Modification, would better facilitate achievement of the Applicable BSC Objectives in relation to the defect identified by the Proposal; and
- Whether there are any substantive issues not considered by the SSMG which should be brought to the Group's attention for inclusion in its assessment of P146.

2. MODIFICATION GROUP DISCUSSIONS

At its meetings on 18 November, 2 December and 16 December 2003 the SSMG discussed the issues raised by the Proposed Modification. The members of the Group refined the requirements for the proposed solution and gave initial views as to the merits of the Proposed Modification against the Applicable BSC Objectives.

The Group's discussions regarding the requirements, and its initial assessment of the Proposed Modification against the Applicable BSC Objectives, are summarised below. A high-level flow diagram outlining the proposed solution is also attached as Annex 1.

2.1 New Category of 'Clearing House'

2.1.1 SSMG's Clarification of Participation Category

The SSMG noted that the Proposal seeks to introduce a new 'participation category', which is not a Code-defined term. The Group therefore queried whether the Proposer's intention was to create a new participation capacity under Section A, as this would require amendment to the current Code definition of Trading Party in order to exclude Clearing Houses. The Group noted that the Code currently contains approximately 600 references to Trading Party/Parties, and that these would have to be examined during production of legal text in order to identify whether they should also refer to the new participation capacity of Clearing House. The Proposer clarified that the intent of P146 was to amend the current participation

capacities in Section A in order to recognise the role of Clearing Houses as a distinct form of market participation, but that this could be achieved either as a separate participation capacity or as a sub-category of Trading Party. The Group and the Proposer therefore agreed that Clearing Houses should be established as a subset of the current Trading Party capacity since this represented the most practical solution.

2.1.2 SSMG's Clarification of 'Clearing House' Definition

The SSMG asked the Proposer to clarify the difference between a 'clearing house' and a 'power exchange', since UKPX (UK Power Exchange, part of OM London Exchange Ltd) provides both clearing and exchange services. The Proposer clarified that a pure exchange function provides a platform for the matching of buyers with sellers, who pay a fee for using the platform. The Proposer stated that this neutral market place represents a 'pre-trade' service whilst an organisation providing a clearing service notifies the actual cleared trade. By acting as the central counterparty to the trade, the clearing organisation absorbs the credit risk for the buyer and seller by making the notifications and thereby guaranteeing the contract. In return, organisations offering clearing services hold collateral (or 'margin') from their members.[1]

The Proposer advised that, in practice, organisations like UKPX might provide both exchange and clearing services – and, indeed, might be required to do so. This is explained in more detail below.

2.1.3 SSMG's Clarification of FSA Regulation

P146 states that parties wishing to register under the Code as Clearing Houses should be licensed and regulated by the Financial Services Authority (FSA), or by their appropriate national regulatory body. The SSMG noted that the FSA does not license parties as such, but grants recognition statuses under the Financial Services and Markets Act 2000 (FSMA). The Group noted that there were two kinds of recognised body under the FSMA that could include clearing activities:

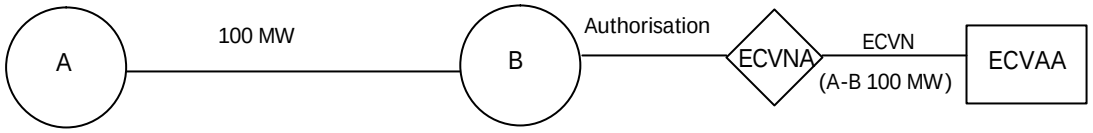
- A Recognised Clearing House (RCH) status – being a party which is prevented from running an exchange and only authorised to provide clearing services. A RCH may provide clearing services to trades matched via an exchange, or to any Party and counterparty wishing to clear their trade.
- A Recognised Investment Exchange (RIE) – being an exchange that also offers clearing services. The FSMA requires that RIEs either offer their own clearing services or use a RCH for that purpose. RIEs operating their own clearing arrangements may also provide a clearing service to other exchanges, or to any Party and counterparty wishing to clear their trade.

The SSMG noted that OM London Exchange is a Recognised Investment Exchange under the FSMA. The Group therefore asked the Proposer to clarify which of kind of recognition status was intended to be used as part of the criteria for registering as a Clearing House under the Code. The Proposer clarified that the new Code category of 'Clearing House' is intended to include RCHs and those RIEs (such as OM London) who provide their own clearing activities. RIEs which use other organisations to provide clearing services would therefore not be included, since these would not be subject to the credit risk of being the central counterparty to trades. The Group noted that this is similar to the admittance criteria for 'Restricted User' in Section V 2.5 of the Network Code under the gas market, which requires such parties to be either a RCH or a RIE which provides its own clearing arrangements.

Figures 1-3 on the following pages outline the differences between bilateral and cleared trades.

[1] Although Clearing Houses mitigate the non-delivery risk involved in a trade, both buyer and seller are still required to lodge Credit Cover under the Code in addition to the margin held by the Clearing House.

Figure 1 – Bilateral Trade



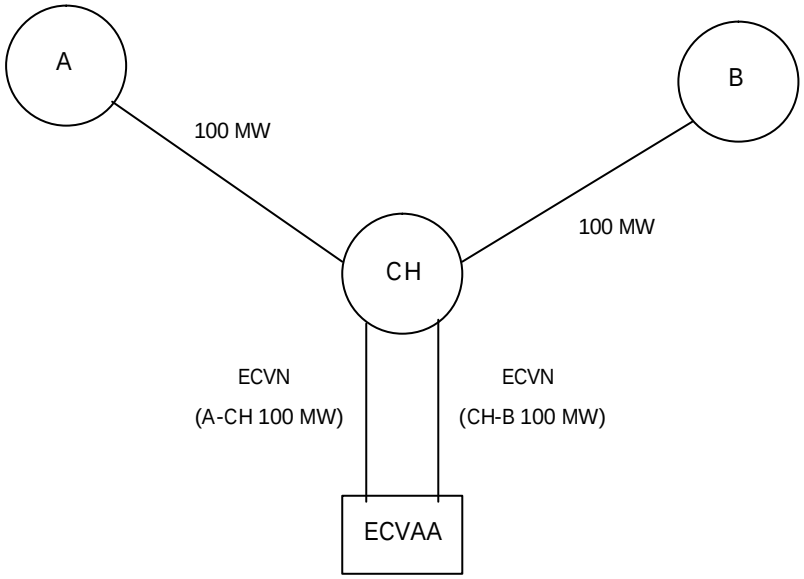
Party A sells 100 MW to Party B.

Party A has a direct credit exposure to Party B, and vice-versa.

ECVNA submits one ECVN to the ECVAA.

2 Notified Volume Charges are incurred – 1 each by Party A and Party B.

Figure 2 – Cleared Trade



Party A and Party B bring their trade to the Clearing House to be cleared.

Clearing House becomes the central counterparty to the trade.

Party A sells 100 MW to Clearing House – Clearing House sells 100 MW to Party B.

Clearing House holds net position of zero.

Clearing House acts as an ECVNA and submits two ECVNs to the ECVAA.

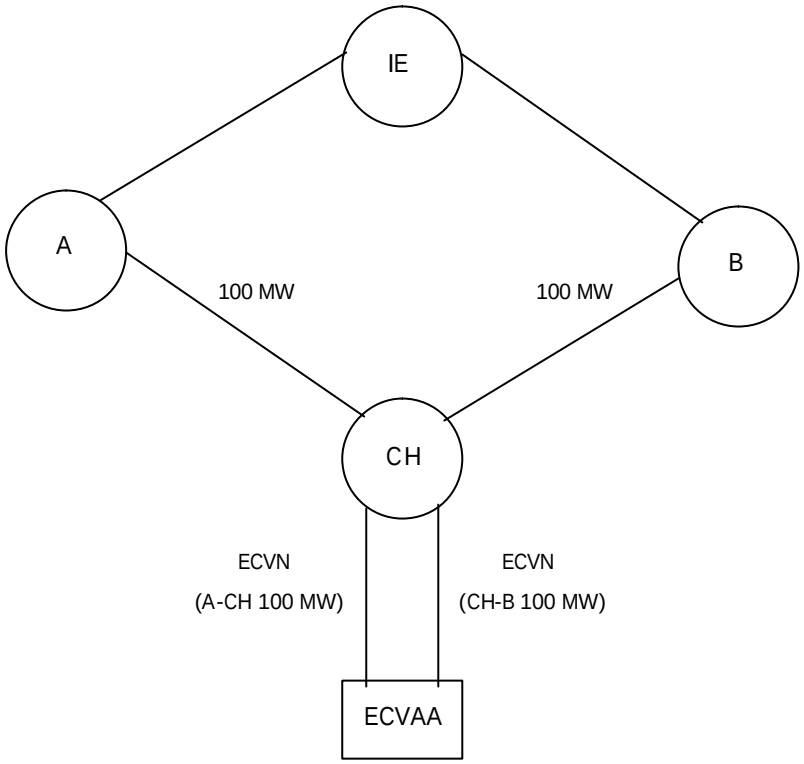
4 Notified Volume Charges are incurred – 1 each by Party A and Party B, and 2 by the Clearing House.

Party A has no credit exposure to Party B, and vice-versa.

Clearing House has direct credit exposure to both Party A and Party B.

Party A and Party B lodge margin with Clearing House.

Figure 3 – Matched and Cleared Trade



Investment Exchange matches Party A (wishing to sell) with Party B (seeking to buy).

Party A and Party B pay a fee to the exchange for the matching service.

Either: Exchange brings trade to the Clearing House to be cleared, or

Exchange and Clearing House are the same organisation.

Clearing House becomes the central counterparty to the trade.

Party A sells 100 MW to Clearing House – Clearing House sells 100 MW to Party B.

Clearing House holds net position of zero.

Clearing House acts as an ECVNA and submits two ECVNs to the ECVAA.

4 Notified Volume Charges are incurred – 1 each by Party A and Party B, and 2 by the Clearing House.

Party A has no credit exposure to Party B, and vice-versa.

Exchange has no credit exposure to Party A and Party B, unless it is also the Clearing House.

Clearing House has direct credit exposure to both Party A and Party B.

Party A and Party B lodge margin with Clearing House.

The SSMG questioned P146's reference to recognition by overseas bodies, and expressed concern that overseas regulatory requirements might be different to, or inconsistent with, those of the FSA. The Group noted, however, that overseas investment exchanges or clearing houses wishing to undertake regulated activities in the UK are required to achieve the status of Recognised Overseas Investment Exchange (ROIE) or Recognised Overseas Clearing House (ROCH) under the FSMA. The Group therefore agreed that overseas parties should be required to be a ROCH or an ROIE undertaking clearing activities in order to register under the new Code participation category of Clearing House.

The Group noted that OM London Exchange Ltd (a RIE) and The London Clearing House (a RCH) are currently the only BSC Parties who are also recognised bodies under the FSMA. However, the Group noted that other parties wishing to register under the Code could apply to be a RCH/ROCH or RIE/ROIE, and that there are currently around 18 organisations recognised as RCHs and RIEs/ROIEs who do not participate in the electricity market.[2]

The SSMG also considered whether it would be appropriate to include organisations which are not recognised bodies like RCHs and RIEs, but which are subject to more general regulation under the FSMA and which may provide clearing services. All firms engaged in 'regulated activities' within the UK are required to be either authorised by the FSA, exempt from authorisation, or authorised by an equivalent regulator in the European Economic Area. Regulated activities include most financial products or services and examples include mortgages, life insurance, unit trusts and shares. As at 28 July 2003, around 10,000 firms were regulated by the FSA – including 7,500 investment firms, over 660 banks, around 70 building societies, almost 1,000 insurance companies and around 700 credit unions.[3] BSC Trading Parties or their subsidiaries may also be regulated by the FSA where the agreements traded by such Parties under the Code fall within the area of investment activities.

The Group noted that the Automated Power Exchange (APX) Ltd represented an example of an authorised firm which also currently undertakes clearing activities within the electricity market as a Trading Party. APX acts in the role of an 'arranger', defined within the FSA Handbook's Glossary as 'a person who is arranging (bringing about) deals in investments, making arrangements with a view to transactions in investments or agreeing to carry on any of those regulated activities'.[4] Although arrangers are subject to rules concerning the neutrality of their matching service, they are not required to comply with the more detailed criteria for RCHs and RIEs. The key difference between the recognition requirements of RCHs and RIEs (as recognised bodies) and the rules for authorised firms is the requirement to ensure the regulation of their markets and clearing services to appropriate standards – including regulation of members' conduct through contracts.

Table 1 provides more detail regarding the differences between recognised bodies and authorised firms.

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[2] There are currently no organisations recognised as ROCHs. See http://www.fsa.gov.uk/register-res/html/prof_exchanges_fram.html.

[3] Figures obtained from the FSA website Media Centre at http://www.fsa.gov.uk/media_centre/historical_timeline.html.

[4] See http://www.fsa.gov.uk/handbook/hbk_glossary.pdf. The Group also noted that the FSA currently plans to introduce a new authorised role of 'alternative trading system' in April 2004, and that APX would qualify to act in this role. The draft FSA requirements for the role of an ATS require the provision of satisfactory clearing and settlement arrangements, as well as monitoring and regulating client compliance with trading rules. The category is currently intended to create a new kind of authorised firm which matches buyers and sellers but is not a RIE. The SSMG agreed that it was not possible to assess the merits of including ATSs as Clearing Houses under the Code, since the category and its requirements remain subject to change, and that only current authorised firms should be considered.

Table 1 – Requirements for recognised bodies and authorised firms under the FSMA

	Recognised Body	Authorised Firm
Regulation	Required to regulate conduct of own members, subject to FSA oversight. Rules must be subject to government scrutiny. Must fund necessary resource to regulate its members' trading activities. Required to share regulatory information with other recognised bodies and the FSA. In undertaking regulatory role, has statutory immunity from legal action by members for any losses.	Subject to FSA regulation regarding general business conduct and disclosure rules. No requirement to monitor client trading activities. No specific rules regarding information sharing, but must co-operate with the FSA.
Capital adequacy	Required to have sufficient resources for performance of its functions.	Required to have capital to cover risks associated with its business.
Trade performance	Required to guarantee performance of trades. Required to have rules to deal with member default.	No requirement to guarantee trades, but general obligations regarding business conduct and counterparty risks. Required to hold capital against the risk of member default, but no requirement for default rules.

The majority of the SSMG considered that, since the FSA definition of 'arranger' does not specifically reference clearing activities, no justification could be made for the inclusion of arrangers to the exclusion of other authorised firms. Some Group members therefore suggested that the Code category of Clearing House should be expanded to include any authorised firms providing a de-facto clearing service within the UK electricity market. However, one member stated that – although the definition of 'arranger' does not reference clearing activities – arrangers are not authorised to deal, or profit from trades. This member considered that there would be no reason for an arranger to register as a BSC Party unless they were undertaking a clearing service, since providing a matching service to buyers and sellers could be operated outside of the Code. An arranger which also acted as an ECVNA would be required to register as a Party Agent but would not need to be a BSC Party. This member therefore argued that arrangers could be included as Clearing Houses under the Code without also including other authorised firms. However, it was noted that to date the SSMG has been unable to locate the FSA's requirement that arrangers should not seek to profit from trades or price movements.

2.1.4 SSMG's Discussion of Appropriate Entry Criteria for Clearing Houses

The SSMG therefore developed a series of options for the entry criteria which could be applied to the new Clearing House sub-category of Trading Party, and these options are outlined below. In all cases, Clearing House Parties would continue to hold the same obligations and rights as Trading Parties – subject to the additional specified criteria.

Option 1 – RCH/RIE plus Code Criteria

- The party must be either a RCH/ROCH or a RIE/ROIE providing its own clearing arrangements;
- The party shall not seek to trade or hold gross positions in electricity contracts, but shall seek to hold a net position at all times;
- The party may not hold Balancing Mechanism Units (BM Units); and

- The party must operate independently from any party trading or holding gross positions under the Code, or which holds BM Units.

Option 2 – Recognised Body or Authorised Firm plus Code Criteria

- The party must be either a recognised body under the FSMA or an authorised firm regulated by the FSA;
- The party must provide a central counterparty clearing service in order to guarantee the performance of its cleared contracts;
- The party shall not seek to trade or hold gross positions in electricity contracts, but shall seek to hold a net position at all times;
- The party may not hold BM Units; and
- The party must operate independently from any party trading or holding gross positions under the Code, or which holds BM Units.

Option 3 – Code Criteria Only

- The party must provide a central counterparty clearing service in order to guarantee the performance of its cleared contracts;
- The party shall not seek to trade or hold gross positions in electricity contracts, but shall seek to hold a net position at all times;
- The party may not hold BM Units; and
- The party must operate independently from any party trading or holding gross positions under the Code, or which holds BM Units.

Option 4 – RCH/RIE Only

- The party must be either a RCH/ROCH or a RIE/ROIE providing its own clearing arrangements. No other criteria would be applied.

Option 5 – Recognised Body or Authorised Firm Only

- The party must be either a recognised body under the FSMA or an authorised firm regulated by the FSA. No other criteria would be applied.

The Group noted that Option 3 would require an Alternative Modification since this removes the Proposal's original requirement for FSA regulation.

The SSMG agreed that Options 4 and 5 might not be desirable, since the broad requirements of the FSA were not industry-specific. The Group agreed that parties wishing to register as Clearing Houses under P146 should be required to comply with other BSC-specific criteria in order to ensure their appropriateness to carry out the new market role under the Code. Specifically, the Group agreed that these criteria should seek to prevent BSC Parties acting as both a Clearing House and another kind of physical or non-physical trader. This requirement would prevent other Trading Parties or their subsidiaries registering as Clearing Houses in order to receive the benefits of P146.

The Group's discussions therefore focused predominantly on Options 1-3.

Some members of the SSMG argued that Option 1 would be discriminatory towards parties such as APX, who provide a clearing service but are not a RCH or RIE. These members therefore supported Option 2, since this could include all organisations undertaking clearing activities within the wholesale electricity market. In contrast, other members considered that the FSA's recognition requirements for RCHs and RIEs provide an existing means of reassurance regarding such organisations' fitness for purpose, capital adequacy, market neutrality and commercial confidentiality. These members therefore did not support the

addition of the less stringent rules for authorised firms under Option 2. It was noted that (in addition to APX) other authorised firms might currently provide clearing services as Trading Parties, and some members queried the administrative and charging implications if many Parties registered as Clearing Houses under the Code (see below).

Some members of the Group did not support Options 1 or 2 since they would set a precedent by including external legislation and regulation as a Code qualification criteria. Currently, where the Code requires types of pre-registration status, these take the form of licences granted by Ofgem. Under Options 1 and 2, however, the form of pre-qualification would be a recognised or regulated status outside the regulation of Ofgem and the Code. The Group noted that this contained a risk of the relevant legislation, definitions and requirements changing at a future point, at which they could become inappropriate for the role of Clearing Houses under the Code. Whilst the Group noted that Section V 2.5 of the Network Code referenced the FSMA as part of its 'Restricted User' provisions for RCHs and RIEs, it considered that the intent of these provisions were different to that of P146 since such status confers exemptions from aspects of physical trading that are not relevant for these bodies.[5] In return for exemption from such obligations, Restricted Users waive all Trading Party rights other than the right to make nominations – and this therefore contrasts with P146, where Clearing Houses would not only continue to hold the rights and obligations of Trading Parties (subject to their registration criteria) but would also receive additional benefits.

The SSMG also considered that, although the FSA's actions over breaches of the FSMA could include penalties and de-recognition, neither Ofgem nor BSCCo would have jurisdiction to require the FSA to take such action. BSCCo's vires would be limited to its current actions over breaches of the Code (as outlined in Section H), by which it could ultimately prevent a Clearing House from trading through expulsion from the Code. Those members of the SSMG who did not support Options 1 or 2 therefore argued that it was more appropriate to define Clearing Houses purely within the Code. However, the Group noted BSCCo's concern that it could not confidently regulate the criteria proposed for Clearing Houses. Since BSCCo does not hold detailed information regarding Parties' ownership structure it would therefore not be able to ensure Clearing Houses' independence from other Trading Parties. A requirement to monitor Clearing Houses to ensure that such Parties always held a net position would also create a significant administrative burden for BSCCo and could require a new technical assurance process. Some members therefore noted that, aside from proof of recognised or regulated status under the FSA, regulation of the Code criteria for Clearing Houses might be reliant upon self-certification by the party concerned. This would take the form of a signed undertaking by each registering Clearing House to comply with the criteria, and to notify BSCCo if at any time it became unable to do so. These members argued that Options 2 and 3 would create the risk of a large number of existing organisations meeting the requirement to be an authorised firm, with BSCCo being largely reliant on their self-certification if such parties applied to be Clearing Houses. These members considered that this was highly inadvisable given the benefits P146 would grant to the new category. Other members of the SSMG argued that, for all three options, BSCCo should be required to put in place processes to monitor Clearing Houses' compliance with the criteria. However, the Group did not reach agreement regarding how a Clearing House's ownership would be monitored, the process to be followed if a gross position was held by a Clearing Party, or how the holding of a gross position could be established as accidental or intentional with regard to the criteria.

The SSMG was therefore unable to agree which criteria should be applied to Clearing Houses under the Code, and requested that BSCCo consult with parties regarding the suggested options.

The SSMG also noted BSCCo's advice that the primary function of the current Code participation capacities is to reflect the different activities that each kind of Party carries out under the Code, in order that the necessary registration requirements and system qualifications can be appropriately identified. Rights, obligations, accruals and liabilities then flow from the activities that each capacity of Party undertakes.

[5] The sections of the Network Code from which Restricted Users are exempt are Section L Maintenance and Operational Planning', Section O 'System Planning' and Section Q 'Emergencies'.

However, the Proposer of P146 suggests that the Code currently acts as a disincentive to provide clearing services in the electricity market. If the distinctiveness of Clearing Houses results from activities or a status outside the Code, P146 might therefore set a precedent of rights and obligations resulting directly from a Code capacity. The Group noted that it could be possible to achieve the benefits of P146, without changes to the current participation capacities, by adding a definition of a Clearing House elsewhere in the Code. However, the Group noted that this was outside the scope of P146.

Respondents' views are sought regarding the potential registration criteria for Clearing Houses under P146, as outlined in Options 1-5.

2.2 Notification of Potential Credit Defaults from the ECVAA to Clearing Houses

2.2.1 SSMG's Clarification of Timings

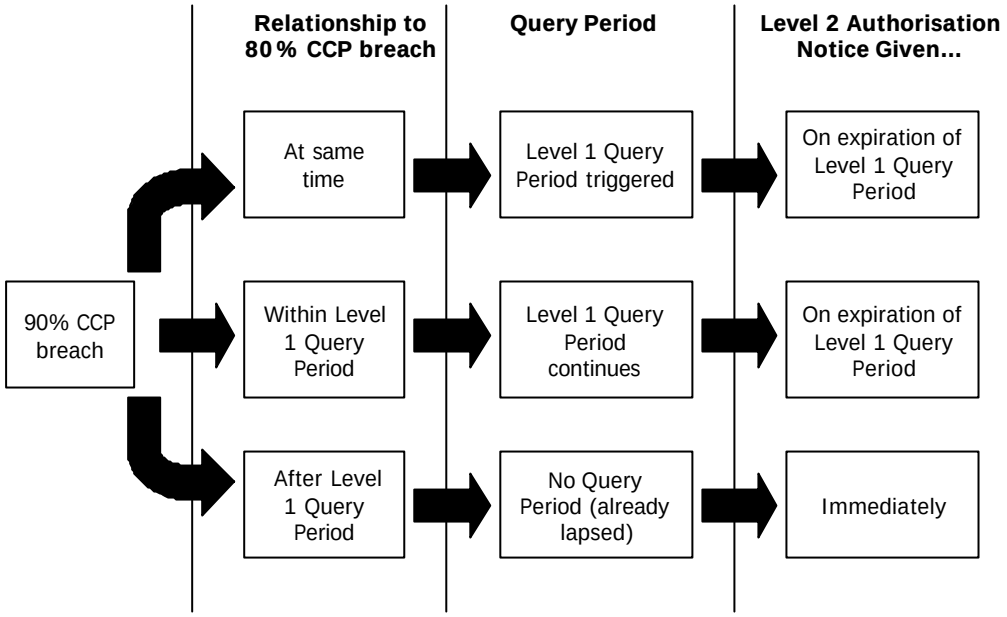
The SSMG asked the Proposer to clarify the timings of the proposed notification from the ECVAA to Clearing Houses regarding their members' breach of Credit Cover Percentage. The Proposer clarified that notification should be provided by email at the end of the Query Period, providing that the Party was still in breach of the Credit Cover Percentage limits defined in the Code. The Proposer also clarified that the intention of P146 was for a Clearing House to receive notice of such breaches for all Parties for whom the Clearing House was authorised to submit ECVNs, regardless of whether ECVNs had actually been submitted at the time of the breach.

The Group noted that a Party whose Credit Cover Percentage was greater than 80% but less than 90% at the end of the Query Period would not at that stage have entered Level 1 Credit Default, since a Level 1 authorisation notice would not be published until the end of the following default cure period. The Proposer confirmed that the intention of P146 is for Clearing Houses to receive notice of the potential Credit Defaults of their members before confirmation of the Default is made available to all Parties via the Balancing Mechanism Reporting Service (BMRS). Where a member resolved its potential Default during the Query Period, the Clearing House would not be informed. However, where a member resolved its potential Default during a Level 1 default cure period, Clearing Houses would receive information not made available to other Parties.

The Group noted that a Party whose Credit Cover Percentage was greater than 90% at the end of the Query Period would be subject to a Level 2 Credit Default authorisation and would therefore enter Level 2 Credit Default since there is currently no Level 2 cure period. The Group also noted that the length or occurrence of a Query Period in the event of a 90% breach would depend upon whether a Level 1 Query Period had already begun, had ended, or had not begun.

Figure 4 outlines the Level 2 process in more detail.

Figure 4 – Timetable of Level 2 Credit Default Provisions



The Proposer confirmed that Clearing Houses would therefore not receive earlier notification of Level 2 Credit Defaults where a Party breached 80% and 90% of its Credit Cover Percentage simultaneously, or where a Party breached 90% during a Level 1 Query Period, since notice of the Level 2 Default would be published on the BMRS at the end of the Query Period. However, where a Party breached 90% following a Level 1 Query Period the Clearing House would have received notification of its 80% breach at the end of the Query Period, and would therefore have had the opportunity to contact the Party concerned to ascertain the situation. The Group also noted that, if approved, P142 'Minor Refinement to Allow a Level 2 Default Cure Period in Defined Circumstances' ('P142') would introduce a default cure period for Level 2 Credit Default. If both P142 and P146 were implemented, Clearing Houses would therefore receive early notification of potential Level 2 Defaults. The Group noted that the solutions to P142 and P146 were, however, independent of each other.

The SSMG considered that Clearing Houses should only receive notifications where there was no potential for material doubt. The Group noted that the ECVAA is not currently required to hold information about material doubt, since this process is managed by BSCCo, and that introduction of a process for the ECVAA to check this information would involve cost and effort for both organisations (and could be impractical where breaches occur outside of working hours). BSCCo advised that the process through which it is contacted by the ECVAA outside working hours is intended as a 'crisis' provision for use at the time of Credit Cover breaches. Additional use of this process by the ECVAA to check material doubt at the end of a Query Period would therefore incur extra costs and would represent a departure from the original rationale for the service. The Group noted that, upon receiving a notice of a breach of Credit Cover, Clearing Houses could check the existence or outcome of a material doubt query with the Party concerned. However, the SSMG agreed that it would be desirable to include a process for the ECVAA to check material doubt. The Group noted that this process had not been included within BSCCo's and the BSC Agent's impact assessments, and revised costs are therefore currently being sought (see Section 3).

2.2.2 SSMG's Clarification of Information to be Provided

The SSMG therefore clarified that an email notification should be sent to Clearing Houses by the ECVAA at the end of a Query Period, providing that either:

- Material doubt had not been queried, and the Party's Credit Cover Percentage remained above 75%; or
- Material doubt had been queried and declined, and the Party's Credit Cover Percentage remained above 80%.[6]

Where material doubt had been queried and upheld, or was still being investigated at the end of the Query Period, email notification would not be provided.

The SSMG agreed that the email notification should provide Clearing Houses with the following information:

- Name of the Party in breach for whom the Clearing House is authorised to submit ECVNs; and
- Notification that the Party concerned was still in breach of its Credit Cover Percentage at the end of a Query Period.

The Group agreed that the exact percentage of the Party's breach would not be notified.

2.2.3 SSMG's Discussion of Appropriateness of Early Credit Default Information for Clearing Houses

The members of the SSMG (with the exception of the Proposer) considered that, since all Parties are subject to risks over the credit-worthiness of counterparties, Code provisions to mitigate such risks for Clearing Houses only would provide such organisations with a commercial advantage. These Group members argued that, by seeking to provide Clearing Houses with notification of potential Level 1 Credit Defaults, P146 was inconsistent with the rationale behind the default cure period since this is intended to provide Parties with a last opportunity to resolve their breach of Credit Cover Percentage before entering Credit Default (and thereby triggering the associated consequences). These members highlighted that providing information regarding a Party's potential Credit Default to any organisations other than the ECVAA and BSCCo could adversely impact that Party's reputation.

The Proposer stated that the intention of P146 is to provide Clearing Houses with an opportunity to contact the Party in breach in order to help resolve their potential Credit Default, and that P146 would therefore facilitate competition. The Proposer argued that Clearing Houses would only seek to trade away from the Party as a last resort. However, the other Group members noted that the Party concerned would have been notified by the ECVAA and contacted by BSCCo when it breached its Credit Cover Percentage, and therefore queried the benefit of Clearing Houses being able to discuss the situation with the Party at the end of the Query Period. Although the Proposer stated that P146 would enable Clearing Houses to offer a market route by which their members could resolve their breach, the Group considered that a Clearing House would gain an advantage in offering the Party an opportunity to trade out of its difficulties through the Clearing House. The Group also noted the risk that the advice given to the Party by BSCCo and by the Clearing House could be inconsistent, or given to different individuals within that Party. The SSMG agreed that the Clearing House's priority would be to its own operations, and that P146 might worsen a Party's potential Default if the Clearing House chose to trade away from a Party which might have been able to resolve its breach during the cure period. It was also noted that the FSMA, whilst placing confidentiality undertakings upon RCHs and RIEs with regard to their members' information, does not impose such requirements upon authorised firms. Some members of the Group argued that confidentiality of Credit Default information under P146 could be ensured via a Code obligation; however, the Group did not agree a process by which this could be enforced. Members of the SSMG also expressed concern that providing information regarding a potential Credit Default could lead a RCH or a RIE to put a Party in default under its own rulebook, and noted that the FSMA requires such organisations to share information regarding their own defaults with other recognised bodies and the FSA.

[6] 75% represents the level at which a Party could proceed to the default cure period following a Level 1 Query Period. However, where material doubt has been raised and declined the level is 80%.

One member stated that the number of occasions under P146 where Clearing Houses would receive notifications of members' potential Credit Defaults would be too few to justify the cost to industry of implementing the Modification. The Group noted that Clearing Houses hold margin from their members to cover the value of their trades, and therefore asked the Proposer to clarify why Clearing Houses require such Credit Default information. The Proposer stated that the margin held does not cover the risk of the Clearing House being exposed to imbalance charges if a counterparty enters Credit Default. The Group queried whether there is an existing Code obligation for Parties to notify their counterparties of their breach of Credit Cover and, if so, why this is not sufficient for Clearing Houses. BSCCo confirmed that Parties in breach were informally advised to notify their counterparties if there was a risk to their trades, but that this was not a formal obligation as it could not necessarily be enforced. The Group noted that such an obligation could be sought by the Clearing House through its bilateral agreements with members, and therefore asked the Proposer to clarify it was necessary to obtain this information from the ECVAA through the Code. The Proposer stated that breaches could occur outside working hours and that the Party concerned might not be resourced to provide prompt notification to the Clearing House. However, the other members of the SSMG agreed that it was not appropriate to introduce a Code obligation for the ECVAA to provide Clearing Houses with such information, and that this was a matter to be pursued by the Clearing House outside the Code through its own contracts with members.

Respondents' views are sought as to whether, under P146, it would be appropriate to introduce early notification to Clearing Houses of a member's breach of the Credit Cover Percentage limits defined in the Code.

2.3 Single Notified Volume Charge for Clearing Houses

2.3.1 SSMG's Discussion of Materiality and Appropriateness of Proposed Changes

The SSMG noted that, if P146 were approved, parties registered as Clearing Houses under the Code would pay Notified Volume Charges for positive volumes only. The Group noted that this would in effect mean that such Parties would be subject to half their current charges (since Clearing Houses seek to hold net positions). The SSMG asked BSCCo, with the consent of the Proposer, to investigate the materiality of this reduction for OM London Exchange.

BSCCo therefore undertook an analysis of OM London's historic payments of Notified Volume Charging. Using the average monthly amount invoiced to OM London during April–November 2003, BSCCo calculated an annualised cost-saving of £18,000 had P146's proposed charging structure been applied.

The SSMG noted that BSCCo's charges to Parties are used to recoup the cost of its operations, and that for any shortfall figure resulting from reduced Notified Volumes Charges for Clearing Houses an equal figure would therefore be recouped through Trading Parties' Main Funding Shares.

The Group noted that halving the Notified Volume Charges for Clearing Houses would not take account of any instances where the Clearing House did not manage to hold a net position and was left in imbalance. The Group noted the suggestion that a more accurate charging structure might be to sum positive volumes and negative volumes separately, and charge a Clearing House for the largest volume when it was in imbalance. However, the Group noted that this process would incur Central Systems costs and that the Proposed Modification seeks to invoice Clearing Houses for positive volumes only. The Group agreed that a solution which halved the charges would be similar in accuracy to one which charged only for positive volumes, and that halving the charges represented the most cost-effective solution since it could be implemented by BSCCo without a Central Systems change. The Group noted that Clearing Houses would continue to be subject to imbalance charges if they failed to hold a net position, and that their registration criteria would require them to seek to do so at all times.

The view of the SSMG was split regarding the merits of halving charges for Clearing Houses. Some members argued that the current application of Notified Volume Charges discriminates against Clearing Houses since, by acting as the central counterparty, such organisations are charged twice for the volume traded. For example, where a Clearing House notified a trade of 100 MW from Party A to Party B with itself as the central counterparty the Clearing House would be charged for the total notified energy volume of 200 MW. These members considered that Clearing Houses facilitate competition and that the current charging system acts as a barrier to their operations. It was therefore argued that P146 would provide a 'level playing field' between Clearing Houses and other Trading Parties. These members also considered that the incremental processing cost of Clearing Houses' 'extra' ECVNs was small, and noted that if charges for Clearing Houses were halved BSCCo would continue to receive three out of four of the current charges (one from the Clearing House, and one from each counterparty – see Figure 2).

Other members of the SSMG expressed the counter-view that Clearing Houses make a commercial decision to act as a central counterparty to trades. These members argued that Clearing Houses are not currently discriminated against, since they recover their costs through their own fees charged to members. The Proposer stated that a high proportion of Clearing House members' charges existed to cover Notified Volume Charges, and that if Notified Volume Charges were halved for Clearing Houses the fees to members could therefore be reduced. The Proposer argued that this would remove an existing barrier to Parties using Clearing Houses, and that use of Clearing Houses should be facilitated by the Code since such organisations aid market competition. However, it was noted that P146 does not contain reference to Clearing Houses passing on any cost-savings resulting from the Modification to their members, and that this could not be guaranteed. The majority of the Group therefore agreed that cost-savings for Clearing House members could not be used as an argument in favour of P146, whilst one member stated that this also could not be used as an argument against P146 since the fees charged to Clearing House members lie outside the Code.

Some members also argued that, as any cost-saving for Clearing Houses would be recovered via Parties' Main Funding Shares, P146 would effectively create a cross-subsidy for Clearing Houses. These members considered 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. The Group noted that, since they are not physical traders, Clearing Houses do not pay Main Funding Shares. However, one member argued that the current arrangements themselves represent a cross-subsidy which discriminates against Clearing Houses.

The SSMG noted that Notified Volume Charges were intended at NETA Go-Live to be broadly reflective of the cost incurred by the ECVAA in processing each ECVN. Although some members considered that the incremental cost of Clearing Houses' 'extra' ECVNs is not material, other members argued that each notification incurs a cost and questioned whether the cost of a Clearing House ECVN is different to those of other Parties. The Group noted BSCCo's cost-saving analysis for OM London Exchange and that – should more Parties register as Clearing Houses under the Code, or if the volume of trades cleared by such organisations increased – P146 could require a greater figure to be recovered via Parties' Main Funding Shares.

The SSMG noted that, if the current Notified Volume Charge of £0.0025/MWh was not felt to be reflective of the ECVAA's costs in processing ECVNs, Annex D-3 of the Code provides the Panel with the authority to change this figure. Although the Group agreed that this was outside the scope of P146, it was noted that the current industry consultation regarding BSCCo's draft Business Strategy for 2004-2007 and Annual Budget provides a potential forum for comments regarding charging figures and cost-recovery.[7]

[7] BSCCo's draft Business Strategy for 2004-2007 can be viewed at http://www.elexon.co.uk/elexon/about_elexon/bus_plan.html. The deadline for responses is 13 January 2004.

Respondents' views are sought as to whether it would be appropriate to halve the Notified Volume Charges applied to Clearing Houses under P146. Views are also sought as to whether P146 would result in increased use of Clearing Houses under the Code, as argued by the Proposer.

3. IMPACT ASSESSMENT RESULTS

The SSMG noted that the Detailed Level Impact Assessment by Parties and Party Agents had not identified any impact from P146 on external systems or processes.

The SSMG noted the following impacts of P146 upon BSCCo's systems, processes and documentation:

- Updates would be required to BSCP65 'Registration of Parties and Exit Procedures' to include the new category of Clearing House and associated registration process. Thirteen weeks' lead time would be required, in order to allow for industry review and committee approval of the relevant changes.
- The introduction of the new Trading Party subset of Clearing House would impact BSCCo systems, processes and documentation relating to Market Entry and Exit. It is estimated that implementation of these changes would require 14 man days' effort and require one month's lead time.
- P146's Credit Default provisions have a potential impact upon the Material Doubt Guideline currently being developed for Approved Modifications P122 and P123.
- Amendments would be require to BSCCo's systems, documentation and processes relating to Credit Default. It is estimated that implementation of these changes would require 8 man days' effort and two weeks' lead time.
- BSCCo's Finance Department would be required to put in place a new process to charge Clearing Houses for halved notified volumes. This would incur a minor impact.
- BSCCo's CVA Programme would require a total resource of 339 man days' effort to implement P146 as a stand-alone change.

The Group noted that BSCCo's impact assessment had been undertaken in respect of Option 1's criteria for the new category of Clearing House, and had not included the process by which the ECVAA would contact BSCCo to check material doubt. The Group therefore requested that BSCCo obtain revised assessments to include the other potential criteria options and material doubt process, and these are currently being sought. The Group noted that any variation in impact for BSCCo resulting from the different criteria options would be minimal, providing that self-certification was used to ensure compliance with the criteria. The Group noted that use of monitoring and enforcement by BSCCo would give rise to a significant operational impact – especially if the criteria included authorised firms, or were purely Code-specific.

The SSMG noted the following implementation options outlined in the BSC Agent impact assessment:

- Automated solution to match defaulting Parties with Clearing House authorisations and generate an email notification - £66,446 change-specific cost, and £334,548 total release cost as a stand-alone change; and
- Semi-manual solution to match defaulting Parties with Clearing House authorisations and send email notification - £20,217 change-specific cost, and £277,237 total release cost as a stand-alone change.

The Group noted the BSC Agent's concerns that the semi-manual solution represents a complex process which could require implementation by out-of-hours helpdesk staff and therefore contained a risk of non-notification or miss-notification. However, the SSMG agreed that this should be progressed as the most cost-effective solution.

The Group noted that the BSC Agent's impact assessment did not include the process by which the ECVAA would check for material doubt, and therefore actioned BSCCo to clarify the incremental cost of including this process. This clarification is currently being sought.

The SSMG noted that the semi-manual solution would still require some CRA and/or ECVAA system development to create a script or report by which Clearing House authorisations could be matched with a defaulting Party. The Group also noted potential impacts on the following documentation:

- IDD Part 1;
- CRA Manual System Specification;
- CRA Operational Services Manual;
- CRA Local Working Instructions;
- ECVAA User Requirements Specification;
- ECVAA System Specification;
- ECVAA Design Specification;
- Communications Requirements Document; and
- Reporting Catalogue.

4. SSMG'S INITIAL VIEW OF P146 AGAINST APPLICABLE BSC OBJECTIVES

In summary, the initial majority view of the SSMG is that the Proposed Modification would not better facilitate the Applicable BSC Objectives. With the exception of the Proposer, the Group believe that early notification of Credit Default information to Clearing Houses would be detrimental to competition and would therefore have a negative impact on Objective (c). Although some members of the Group believe that halving Notified Volume Charges for Clearing Houses would remove an existing discrimination against such parties, and thereby better facilitate Objective (c), the majority of the SSMG members believe this benefit to be outweighed by the negative impact of P146's Credit Default provisions.

With the exception of the Proposer, the SSMG agreed that the inability for the ECVAA to notify Clearing Houses of the potential Credit Defaults of their members did not represent a defect in the Code since this issue should be pursued by Clearing Houses via their own contracts. The Group therefore agreed that maintaining the current Code provisions regarding Credit Default would better facilitate the Applicable Objectives compared with the Proposed Modification. Some SSMG members suggested that an Alternative Modification consisting of the participation category and charging aspects of P146 only (i.e. with the Credit Default provisions removed) might better facilitate the Applicable BSC Objectives. The Group therefore requested that BSCCo consult with interested parties regarding this potential Alternative.

Respondents' views are therefore sought as to whether the Proposed Modification would better facilitate the Applicable BSC Objectives. In addition, respondents are asked to comment on whether a potential Alternative Modification consisting of the new participation category and charging aspects only would better facilitate the Applicable Objectives with regard to the issue or defect identified by P146.

5. CONSULTATION

This consultation seeks respondent's views on the issues raised by P146 and, in particular, whether the Proposed Modification would better facilitate achievement of the Applicable BSC Objectives.

For information the Applicable BSC Objectives are;

(a) The efficient discharge by the Transmission Company of the obligations imposed under the Transmission Licence;

(b) The efficient, economic and co-ordinated operation by the Transmission Company of the 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) without prejudice to the foregoing objectives and subject to paragraph 3A, 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.

You are invited to provide a response to the questions contained in the attached pro-forma.

Please send responses, entitled 'P146 Assessment Consultation', by 17:00 on Friday 9 January 2004 to the following email address: modifications@elexon.co.uk.

Any queries on the content of the consultation pro-forma should be addressed to Kathryn Coffin (020 7380 4030) email address kathryn.coffin@elexon.co.uk, or Roger Salomone (020 7380 4369) email address roger.salomone@elexon.co.uk.

ANNEX 1 – OVERVIEW OF PROPOSED SOLUTION

This diagram represents the high-level solution required to support P146, as agreed by the SSMG at its meetings of 18 November, 2 December and 16 December 2003.

Figure 5 – Overview of Proposed Solution