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The National Grid Company, BSC Signatories and
Other Interested Parties

29 June 2004

Our Ref: MP No P140

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P140 “Revised Credit Cover methodology for Interconnector BM Units”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P140, “Revised Credit Cover methodology for Interconnector BM Units”.

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

- Proposed Modification P140 should be made;
- the P140 Implementation Date of 23 February 2005 (if an Authority decision is received on or before 29 June 2004) or the 29 June 2005 (if the Authority decision is received after 29 June 2004 but on or before 3 November 2004); and
- the proposed text for modifying the Code, as set out in the Modification Report.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives³ and the Authority’s wider statutory duties,⁴ the

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

² ELEXON document reference P140RR10, Version No. Final/1.0, dated 15 March 2004

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

- a) the efficient discharge by the licensee of the obligations imposed upon it by this licence;
- b) the efficient, economic and co-ordinated operation by the licensee of the licensee’s transmission system;
- c) promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity;
- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements
- e) the undertaking of work by BSCCo (as defined in the BSC) which is:
 - (i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and

Authority has decided to direct a Modification to the BSC in line with the Modification Proposal P140.

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

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

Background

The amount of Credit Cover needed by an Interconnector User for its I-BM Units can vary substantially. The Proposer contended that this variation is not caused by the risk posed by Interconnector Users to the rest of the market, but by the particular methodology used to determine the BM Unit Credit Assessment Import and Export Capabilities (BMCAIC/BMCAEC), which are calculated from the Credit Assessment Load Factor (CALF) and Generation and Demand Capacity (GC^5/DC^6) values effective for the BM Unit. The BMCAIC/BMCAEC forms one layer which contributes to a Party's Credit Assessment Energy Indebtedness (CEI).⁷

The current CALF methodologies seek to make the BMCAIC/BMCAEC values for a BM Unit equivalent to the average load of the BM Unit during a defined period, usually the equivalent season of the preceding year. Thus, the CEI generated for a BM Unit reflects the deviation of its current behaviour from its historical load pattern. These historical volumes may bear little relation to a particular Interconnector BM Unit's current level of trade, or the levels it may exhibit during the forthcoming BSC Season. The Proposer contended that such volumes are actually dependent on the capacity obtained on the interconnector and the price differentials exhibited in the interconnected markets for the period in question. Other BM Unit types are not subject to those factors and were suggested to be more amenable to profiling using historical volumes.

Basing an I-BMU's future trading volumes on historical data can cause large magnitudes of either positive or negative CEI being generated. As a consequence, the assessment of potential liabilities, in terms of future Trading Charges, may be significantly inaccurate for Interconnector Users. The Proposer suggested that this was burdensome for two reasons; firstly as it requires excessively high levels of Credit Cover to be lodged to address periods of peak positive CEI, and secondly as it necessitates frequent monitoring of an Interconnector User's Credit Cover position.

(ii) relevant to the proposed GB wide balancing and settlement code; and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

⁴ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

⁵ The GC is the positive value of QM_{ij} for the BM Unit in the relevant BSC Season, divided by the Settlement Period Duration.

⁶ The DC is the negative value of QM_{ij} for the BM Unit in the relevant BSC Season, divided by the Settlement Period Duration.

⁷ The CEI is the net energy contribution determined to be allocated to a Trading Party for Settlement Periods as defined in Section M1.2.1. CEI is determined according to Section M1.2.2 of the BSC.

In order to rectify this situation, EdF Trading Ltd submitted Modification Proposal P140, "Revised Credit Cover methodology for Interconnector BM Units " on 21 August 2003.

The Modification Proposal

Modification Proposal P140 seeks to modify the CEI calculation such that the calculation of the Credit Cover Percentage (CCP)⁸ would be based upon the Final Physical Notification for each half hour balancing period (FPN_{ij})⁹ rather than CALF and GC¹⁰/DC¹¹. If no FPN data was received from the Transmission Company for the latest Settlement Period at the time of the CCP calculation, the Energy Contract Volume Aggregation Agent (ECVAA) would default to the FPN_{ij} used in the calculation for the preceding Settlement Period. This defaulted data would be replaced by actual data in the next ECVAA calculation after the receipt of such data. P140 does not propose to apply this methodology to other BM Unit types. The justification for the Modification Proposal was that it would better facilitate achievement of Applicable BSC Objectives C3 (3) (c) and (d).

The Settlement Standing Modification Group (the 'Group') met in July 2003 when the subject of the modification was referred to it by the ISG on the grounds that the issue would be better dealt with as a modification to the BSC. The Group agreed that Interconnector Users are different to other Parties because their FPN_{ij} is considered to be their deemed BM Unit Metered Volume (QM_{ij}). It was therefore agreed that there might be merit in a Modification Proposal whereby the FPN_{ij}, for Interconnectors only, is used as the Credit Assessment Credited Energy Volume (CAQCE). The SSMG did not believe this should be extended to other BM Unit types as the linkage between FPN_{ij} and the QM_{ij} was not automatic for other BM Unit types.

FPN_{ij} values are considered to be deemed Metered Volumes for Interconnector BM Units, and would only fail to be met due to instances of technical failures on an Interconnector. The Proposer suggested that such failures were infrequent. The Proposer further contended that the proposals contained in the Modification Proposal would enable the CEI calculation to more accurately reflect the actual behaviour of the Interconnector BM Unit.

The Proposer believed that this methodology would not be discriminatory as all Interconnector BM Units would be treated identically, and the levels of Credit Cover required as a result of this calculation would be more representative of the risk posed to the market.

⁸ A half hourly calculation conducted by the ECVAA after each Gate Closure.

⁹ The value of FPN_{ij} would be calculated from the FPN data received for that BM Unit from the Transmission Company, as per suggested new clause Q 6.1A.1.

¹⁰ The GC is the positive value of QM_{ij} for the BM Unit in the relevant BSC Season, divided by the Settlement Period Duration.

¹¹ The DC is the negative value of QM_{ij} for the BM Unit in the relevant BSC Season, divided by the Settlement Period Duration.

The SSMG concluded that Interconnector Users are disproportionately affected by inaccuracies in the CEI calculation due to a greater likelihood that historical performance measures do not accurately predict contemporary behaviour for this BM Unit type.

The Group considered that P140 may facilitate more effective competition in the market, thus better facilitating achievement of Applicable Objective (c) by:

- reducing the risk to the market of Interconnector Users accumulating unsecured liabilities for Trading Charges;
- reducing barriers to entry for potential Interconnector Users; and
- providing an increase in the accuracy of the calculation of Energy Indebtedness for Interconnector BM Units.

In addition, the SSMG considered that the decrease in BSCCo resources required for handling Interconnector CALF issues, such as seasonal calculation and appeals processes, may better facilitate achievement of Applicable BSC Objective (d) although to a lesser extent.

The Panel considered the Initial Written Assessment at its meeting of 11 September 2003 and agreed to submit Modification Proposal P140 to a three month Assessment Procedure to be carried out by the Group with the Assessment Report to be presented at the Panel meeting on 11 December 2003. At that meeting the Panel requested the Assessment Procedure be extended by a further two months in order that a further consultation might be carried out in support of the cost/benefit analysis, with the Assessment Report to be presented to the Panel meeting on 12 February 2004.

ELEXON published a draft Modification Report on 18 February 2004, which invited respondents' views by 17:00 on 27 February 2004.

Responses to ELEXON Consultation

Nine responses were received. Seven responses (representing 38 Parties) expressed support for the Proposed Modification, one response (representing 3 Parties) opposed the Proposed Modification and the remaining respondent (representing 1 Party) provided a "no comment" response.

Several respondents commented to the effect that the Proposed Modification would provide greater accuracy in the estimation of Energy Indebtedness and the risk posed to the market by a Party. The respondents commented that this would provide more accurate information on which Credit Cover could be calculated. One respondent considered that this would be advantageous to the market as a whole, as well as to individual Interconnector Users.

Some respondents commented that P140 would reduce barriers to market entry by allowing an appropriate level of Credit Cover to be lodged in the future and enabling the release of excess Credit Cover collateral currently posted with ELEXON; better facilitating achievement of Applicable BSC Objective (c).

In addition, one Respondent also considered that P140 would reduce the scale of the bad debt smeared across BSC Parties in the event of a default¹² and the likelihood that such a default would occur. The respondent considered that this would address the potential which currently exists for market distortion, thereby better facilitating achievement of Applicable BSC Objective (c).

The respondent opposing the Modification commented that P140 would improve the accuracy of indebtedness monitoring for Interconnector Users by reducing the extent of under and over estimation. However, the respondent considered that as the current method sometimes overestimates indebtedness the proposal would not always provide a reduction in the risk to the market of Interconnector Users accumulating unsecured liabilities for Trading Charges, as the current credit requirements may sometimes be reduced. The respondent also considered that as the current method is reported to frequently underestimate indebtedness, it could not be said that the Modification Proposal would always produce an incentive to entry for potential Interconnector Users, as the credit requirements may sometimes be increased.

The respondent further commented that in its view, the cost of implementing the Modification Proposal was such as to make the overall benefit doubtful due to the high costs of implementation and as a result, the monetary benefit of eliminating the over-provision of Credit Cover may not be sufficient to justify the costs involved. In order to minimise these costs the respondent considered that, should Proposed Modification be approved, P140 should be implemented in a release containing other system modifications which would share the fixed costs of that release.

The final point made by the opposing respondent was that for the level of cost suggested it would expect the Modification to benefit a wider range of participants. It stated that the credit indebtedness calculation is approximate for all parties, and probably results in under or over provision in many cases. The respondent suggested that improving the approximation solely for interconnectors could be considered not to meet BSC Objective (c), because it discriminates in favour of interconnectors.

The respondents' views are summarised in the Modification Report for Modification Proposal P140, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 11 March 2004 and considered the Modification Proposal, the draft Modification Report, 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 23 February 2005 if an Authority decision should be received on or before 29 June 2004, or 29 June 2005 if the Authority decision should be received after 29 June 2004 but on or before 3 November 2004.

¹² This is done in accordance with Party's Default Shares.

Responses to Ofgem GB Consultation

On 5 December 2003 Ofgem undertook to invite responses on additional implications that a Proposed Modification may have, were it to be applied on a GB wide basis, as opposed to being limited to England and Wales. In order to discharge this undertaking Ofgem published a GB Consultation Paper on 20 February 2004 which invited respondents' views by 5pm on Monday 22 March 2004. Two responses were received.

One respondent considered that the GB application of P140 needs to take account of the proposed trading arrangements on the Moyle Interconnector connecting Scotland with Northern Ireland which upon the introduction of BETTA will become an Interconnector in the context of the GB BSC. It was the respondent's opinion that the BSC appears to treat the Moyle Interconnector as any other Interconnector, but as the rules of operation of the Moyle Interconnector in the context of BETTA have not been made transparent, consideration may need to be given to its particular set up and operational needs.

The second respondent reiterated its response to the ELEXON consultation to the effect that the cost of the proposed modification had not been clearly demonstrated to outweigh the benefits, and that the modification will provide an improved BSC Credit Indebtedness calculation for only a small sub-set of BSC Parties and that for the expenditure proposed, it would expect an improvement benefiting a wider range of parties. The respondent commented that these concerns are relevant in the context of BETTA as the benefits of improved calculations for the Scottish Interconnector will disappear when BETTA is introduced, reducing the benefits of the proposal but leaving in place a large proportion of the costs involved.

The Consultation Paper, the responses to it and other related documents can be found on the *BETTA GB Consultation* section of the Ofgem website.¹³

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 P140 will better facilitate the achievement of Applicable BSC Objectives (c) and (d).

The inaccuracies which can arise from using CALF and GC/DC values to approximate a BM Unit's BMCAIC/BMCAEC are more likely to occur for Interconnector Users when compared to some other types of market participants whose electricity flows are subject to the CEI calculation, as an Interconnector BM Unit is generally less amenable to the use of historical data to predict its future level of trade when compared to other BM Unit types. The use of these historical volumes can result in a significant divergence between the assessment of an Interconnector User's potential liabilities, (and thus the level of Credit Cover which it is required to lodge), when compared with the actual risk posed by the Interconnector User to the rest of the market. Ofgem considers that the provisions P140 seeks to introduce will increase the

¹³ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

accuracy in the calculation of energy indebtedness for Interconnector BM Units, better facilitating the achievement of Applicable BSC Objective (c).

Ofgem further considers that P140 should mitigate the risk that an Interconnector User could expose the market to substantial unsecured liabilities for Trading Charges. Analysis performed by the Group indicated that at peak times the Energy Indebtedness of the interconnector community has been underestimated by nearly £58 million. If an Interconnector User defaulted on its Trading Charges whilst having insufficient Credit Cover lodged, the outstanding amounts would be recovered by the FAA from all other Trading Parties on the basis of their default shares. Ofgem considers that by reducing the likelihood of such a series of events, P140 better facilitates achievement of Applicable BSC Objective (c).

Ofgem notes the response made to industry consultation to the effect that as the current method sometimes overestimates indebtedness P140 will not always provide a reduction in the risk posed to the market by Interconnector Users as the Credit Cover requirements may sometimes be reduced, and that as the current method sometimes underestimates indebtedness P140 may not always provide an incentive to entry for potential Interconnector Users, as the credit requirements may sometimes be increased. Ofgem agrees that P140 will not always reduce the risk to the market posed by Interconnector Users, but considers that the provision of a more appropriate level of security will remove needless oversecuritisation and promote effective competition in the generation and supply of electricity. Ofgem does not agree that P140 will sometimes fail to provide an incentive to entry by increasing credit requirements where it is appropriate to do so. Equity and transparency are key factors in promoting a level playing field and as such P140 will produce an incentive to entry for Interconnector Users by allowing potential entrants to be more certain of the amount of credit cover which needs to be in place at a given time. Ofgem further considers that the current calculation can create acute short term spikes in positive CEI for Interconnector Users and that this may result in an over provision of Credit Cover for this BM Unit type and disincentivise new market entrants. By improving the circumstances of market entry Ofgem considers that P140 has the potential to better facilitate competition in the generation and supply of electricity and Applicable Objective (c).

Another suggestion made during industry consultation was that the Proposed Modification benefited a limited class of Party. Ofgem considers that the effects of the inaccuracies in the CEI calculation in general apply more to Interconnector Users, as compared to the effect of those inaccuracies on other classes of Party. The inaccuracies in the calculation have the effect of requiring Interconnector Users to post unrepresentative levels of Credit Cover, placing upon them an unnecessarily onerous requirement to monitor their Energy Indebtedness, and requiring them to bear the associated costs these activities may entail. Any Modification proposal in this area relevant to other Parties more broadly would be considered on its merits.

Ofgem recognises that Proposed Modification P140 involves significant cost relative to the money which is likely to be saved as a result of its implementation. Whilst this is the case, Ofgem considers that P140 will benefit the market by providing more accurate provisions for credit cover for Interconnector Users and that this will lead to more effective market security. As such, Ofgem supports the implementation of P140 despite the costs it entails, but welcomes ELEXON's confirmation that the suggested implementation dates are aligned with scheduled CVA Releases so as to minimise those costs.

A comment made in response to Ofgem's GB consultation on P140 suggested that after the implementation of BETTA (under which the England – Scotland Interconnector will be subsumed into the GB market) less benefit will be gained from the provisions which P140 seeks to introduce, whilst the cost of implementation will remain the same. Ofgem agrees that this is the case but considers that post the implementation of BETTA P140 will continue to benefit market security and as such Ofgem does not regard the costs involved in P140 as prohibitive. Furthermore, after BETTA Go-Live the Moyle Interconnector, which extends between Northern Ireland and Scotland, will be relevant for the purposes of the GB BSC and as such similar benefits to those currently seen in relation to the England-Scotland Interconnector will be realised in the context of Moyle, offsetting those that will be lost upon the implementation of BETTA.

Ofgem further considers that Proposed Modification P140 may also better facilitate achievement of Applicable Objective (d) as a result of the reduction in effort required by BSCCo to handle Interconnector CALF issues such as seasonal calculations and appeals processes.

As a result of the date of this decision the Implementation Date for P140 shall be 23 February 2005.

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

Yours sincerely,

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

John Neilson

Managing Director, Corporate Affairs

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