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18 March 2004

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No P132

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Notice in relation to Modification Proposal P132: “Redefinition of Credit Cover Requirements to account for Reconciliation Charges”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P132, “Redefinition of Credit Cover Requirements to account for Reconciliation Charges”.

The BSC Panel (the “Panel”) recommended to the Authority that Modification Proposal P132 should not be made and that if the Authority determines that Proposed Modification P132 should be made the Implementation Date should be 22 February 2005 if the Authority determination is received before 23 April 2004. Should an Authority determination be received on or after this date, but prior to 23 October 2004 then the Implementation Date should be 1 November 2005.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives and the Authority’s wider statutory duties,³ the Authority has decided not to direct a Modification to the BSC.

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

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

² ELEXON document reference P132MR, Version No. 1.0, dated 15/10/03

³ Ofgem’s statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

Background

Under the existing arrangements,⁴ a Party may reduce its Credit Cover to the Minimum Eligible Amount. A Minimum Eligible Amount is defined in section M of the BSC as the amount of Credit Cover that would have resulted in a Credit Cover Percentage of not more than 75% during the waiting period (currently 10 days).

A Party's Credit Cover Percentage is the ratio of its Energy Indebtedness to its Energy Credit Cover. Energy Indebtedness is an estimation of the energy traded by the Party over the last 29 Days, whilst a Party's Energy Credit Cover is an amount in MWh arrived at by dividing the amount of a Trading Party's Credit Cover by the Credit Assessment Price applicable at that time. Currently, the calculation of Energy Indebtedness does not factor in any potential changes following Reconciliation Runs and rectification of Trading Disputes or Past Notification Error (PNE) claims. Accordingly, the Minimum Eligible Amount for any Party which has not traded for 29 days will be zero.

The BSC currently stipulates that a Party may not withdraw from the BSC until several criteria have been fulfilled. Amongst these criteria the BSC states that a Party may not withdraw if the Final Reconciliation Settlement Run has not been carried out in relation to the last Settlement Day, or the corresponding Payment Date has not past.

It is possible for example that a Party may cease trading but still be registered under the BSC if these criteria are not fulfilled. Twenty nine days after it ceases trading this Party will be able to reduce its Credit Cover to zero (as its Energy Indebtedness will fall to zero). However, the Party may still be liable to pay Trading Charges associated with Reconciliation Runs and rectification of Trading Disputes or PNE claims for Settlement Days for which it was trading. Following the 29 day period, after the last Settlement Day during which the Party has traded, any Trading Charges not paid by the Party would potentially have to be recovered via legal action.

In order to rectify this perceived anomaly, TXU Direct Sales Limited submitted Modification Proposal P132, "Redefinition of Credit Cover Requirements to account for Reconciliation Charges" on 19 June 2003.

The Modification Proposal

Modification Proposal P132 seeks to modify the BSC so as to redefine Credit Cover requirements to account for Reconciliation Charges, Trading Disputes and Past Notification Error (PNE) claims in order to ensure that credit cover is retained for a withdrawing or withdrawn Party such that potential future settlement liabilities may be met.

The justification for the Modification Proposal was that it would better facilitate achievement of Applicable BSC Objectives⁵ C3 (3) (c) and (d).

⁴ Section M of the BSC

⁵ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Company's ("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;

It was proposed that ensuring withdrawing Parties have an obligation to provide Credit Cover for the full range of potential Trading Charges would reduce the likelihood of those Parties who continue trading having to pick up liabilities of those Parties who have voluntarily ceased trading, thus promoting competition in the generation and supply of electricity. It was further proposed that the recovery of outstanding amounts from Credit Cover would be easier than pursuing Parties through legal routes, thereby improving the administrative efficiency of the Balancing and Settlement arrangements.

The Panel considered the Initial Written Assessment at its meeting of 10 July 2003 and agreed to submit Modification Proposal P132 to the Definition Procedure for 2 months. The Settlement Standing Modification Group (the "Group") considered the Modification Proposal. The Group met twice during the Definition Procedure and a Definition Consultation was issued to the industry on 11 August 2003.

Following industry consultation, the Group defined Modification Proposal P132 as a Proposal which, if approved, would introduce new Credit Cover arrangements that would:

- Not change the existing Credit Cover arrangements for Parties continuing to trade;
- Require a Party wishing to withdraw from the BSC to notify BSCCo on the discontinuation of Trading Activity;
- Require that BSCCo be informed of any Parties making significant reductions in their Credit Cover;
- Require BSCCo to, on notification of a Party's intent to withdraw from the BSC, calculate an amount of Credit Cover to be posted by such withdrawing Party;
- Include in the calculation of the Credit Cover required by a withdrawing Party potential liabilities resulting from future Reconciliation Runs, existing Trading Disputes and PNE claims;
- Require a withdrawing Party to post the amount of Credit Cover calculated by BSCCo; and
- Require this Credit Cover to be retained until all Reconciliation Runs, Trading Disputes and PNE claims included within the calculation of the amount had been processed.

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- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements
- e) the undertaking of work by BSCCo (as defined in the BSC) which is:
- (i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
 - (ii) relevant to the proposed GB wide balancing and settlement code;
- and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

The Group agreed that Modification Proposal P132 would not better facilitate achievement of the Applicable BSC Objectives. The Group agreed that it was not possible to define how potential Reconciliation and Trading Dispute claim liabilities should be estimated. Further, it was the Group's view that the perceived risk associated with the Reconciliation charges of a withdrawing Party was relatively minor.

It was therefore the Group's conclusion that Modification Proposal P132 did not warrant further assessment and should be sent to the Report Phase with a recommendation to reject. The Panel supported the Group's rationale and agreed to send Modification Proposal P132 to the Report Phase.

ELEXON published a draft Modification Report on 22 September 2003, which invited respondents' views by 29 September 2003.

Respondents' views

ELEXON received 3 responses to the consultation on Modification Proposal P132. 2 responses (representing 20 Parties) expressed support for the Proposed Modification, no responses opposed the Proposed Modification, whilst 1 (representing 1 Party) provided a "no comment" response.

All respondents, who expressed a view, supported the Panel's views on Modification Proposal P132 and the provisional recommendation to the Authority contained in the draft Modification Report that the Proposed Modification should not be made. One respondent, whilst indicating support of the principle behind the Modification Proposal, supported the Group's view that Modification Proposal P132 was not practical. One respondent stated that, as it is not possible to assess accurately the level of Credit Cover required by a withdrawing Party, requiring such a Party to hold Credit Cover would effectively be covering the risk associated with the inability to forecast accurately the extent of any liabilities. As such, the respondent believed that Modification Proposal P132 would present a barrier to exiting the market. Furthermore, the respondent indicated that the current arrangements, whereby remaining Parties underwrite the risk associated with withdrawing Parties, was considered more appropriate than Modification Proposal P132.

The respondents' views are summarised in the Modification Report for Modification Proposal P132, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 9 October 2003 and considered the draft Modification Report, and the responses received to the consultation on that report.

The Panel recommended that the Authority should reject the Proposed Modification but that, if approved, the Proposed Modification should be implemented on 22 February 2005 if the Authority determination is received before 23 April 2004. Should an Authority determination be received on or after this date, but prior to 23 October 2004 then the Implementation Date should be 1 November 2005.

The Panel agreed with the Group's view that implementing Modification Proposal P132 would introduce Credit Cover requirements which are less appropriate than the current arrangements

and that this would have a negative overall effect on competition within the market. As such, the Panel agreed that, overall, Modification Proposal P132 would not better facilitate achievement of the Applicable BSC Objectives and that, in particular, there would be a negative effect on Applicable BSC Objective (c).

The Panel supported the Group's conclusion that it was not possible to define how potential Reconciliation and Trading Dispute claim liabilities should be estimated and, as such, no legal text would be commissioned for Modification Proposal P132. However, the Panel recognised the BSC requirement to provide a proposed Implementation Date in all Modification Reports and supported the proposed Implementation Date recommended by the Group.

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 Modification Proposal P132 would not better facilitate achievement of the Applicable BSC Objectives.

It is Ofgem's view that since it has not been possible to define how potential Reconciliation and Trading Dispute claim liabilities should be estimated the Proposed Modification does not better facilitate achievement of Applicable BSC Objectives (c) and (d). In particular requiring the industry to incur further costs in order to introduce new Credit Cover arrangements would not provide a more accurate estimation of potential liabilities but would discourage competition.

Full assessment of Modification Proposal P132 would only have been possible once the changes to the methodology for calculating the Minimum Eligible Amount were fully defined. As the initial submission did not elucidate the form these changes might take it was necessary for the Group to define this aspect of the Modification Proposal.

The methodology developed by the Group would require a Party wishing to withdraw from the Code to notify BSCCo of its intention to do so upon the cessation of its trading activity. BSCCo would then calculate the Credit Cover required to cover potential liabilities arising from Reconciliation Charges, Trading Disputes and Past Notification Error claims. The withdrawing Party would then post Credit Cover as calculated by BSCCo and this Credit Cover would be maintained until all Reconciliation Runs, Trading Disputes and PNE claims included within the calculation had been processed.

It is Ofgem's view having agreed with the analysis of the Group that there would be particular difficulty in trying to account for Reconciliation in Credit Cover arrangements. The Group's analysis has indicated that there was potential for Reconciliation Trading Charges to constitute a significant amount during the extended timescales for withdrawal from the BSC. However, it also indicated that it is not possible to predict whether these Trading Charges would result in a net payment to the Party, or whether there would be a payment made by the Party (as the net Trading Charges can be either positive or negative).

Ofgem notes that this Modification Proposal has presented interesting questions relating to the definition of Modification Proposals as a whole. In circumstances where the Panel sends Modification Proposal to the Definition Procedure of the modification process it is the

Modification Group's responsibility to define the Proposal in sufficient detail to enable the Panel to determine their position on the next step for the Proposal. It is Ofgem's view that in circumstances where the Modification Group decides that they cannot define a Proposal and the Proposer nonetheless feels that the Proposal has not been given sufficient consideration, the Proposer has the option of defining the proposal as best he or she can and presenting it to the Modification Group at a subsequent meeting.

The Authority's decision

The Authority has therefore decided not to direct that the Proposed Modification P132, as set out in the Modification Report, should be made and implemented.

Having regard to the above, the Authority, in accordance with Section F1.1.4 of the BSC, hereby notifies NGC that it does not intend to direct NGC to modify the BSC as set out in the Modification Report.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

Nick Simpson
Director, Modifications

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