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11 June 2002

The National Grid Company, BSC Signatories and  
Other Interested Parties

Our Ref: MP No P39

Dear Colleague,

**Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P39: "Improvements in the Administration of the Payment Default Process"**

The Gas and Electricity Markets Authority (the "Authority")<sup>1</sup> has carefully considered the issues raised in the Modification Report<sup>2</sup> in respect of Modification Proposal P39, "Improvements in the Administration of the Payment Default Process"

The Balancing and Settlement Code Panel (the "Panel") recommended to the Authority that the Proposed Modification be approved, with an Implementation Date of 12 August 2002 and that it should apply to all payments processed from that date, including payments relating to Settlement Days prior to the Implementation Date.

The Authority has decided to direct a Modification to the BSC.

This letter explains the background and sets out the Authority's reasons for its decision. In addition, the letter contains a direction to The National Grid Company plc ("NGC") to modify the Balancing and Settlement Code ("BSC") in line with Modification Proposal P39, as set out in the Modification Report.

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

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<sup>1</sup> Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

<sup>2</sup> ELEXON Document Reference MR039, Version No 1, dated 19 March 2002

## Background

The BSC Panel raised Modification Proposal P39, on the recommendation of ELEXON, on 20 September 2001. It was raised in accordance with Section F2.1.1 (d) of the BSC, as ELEXON considered that the proposal would better facilitate achievement of the objective in Condition C3 (3) (d) of the National Grid Transmission Licence<sup>3</sup>, i.e. promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

The Panel agreed that Modification Proposal P39 should be submitted to the Definition Phase. A Definition Report was prepared by a Modification Group formed from members of the Imbalance Settlement Group (ISG), and presented to the Panel at the meeting on 18 October 2001. The Panel endorsed the Modification Group's recommendation to progress the proposal to the Assessment Phase and following an extension to the assessment phase, the Assessment Report was submitted to the Panel meeting on 14 February 2002.

The Panel endorsed the recommendations of the Modification Group and agreed that a draft Modification Report be prepared and consulted upon.

## The Modification Proposal

The original Modification Proposal P39 sought to revise the payment procedure (Section N8 of the BSC) and the payment default procedure (Section N9 of the BSC) to remove inconsistencies between the BSC and the banking procedures. The proposal suggested four main areas of change, as follows:

- ***Payment Timescales***
- ***Payment Default Thresholds***
- ***Letters of Credit***
- ***Payment transfers***

Each of these areas is discussed in turn.

- ***Payment Timescales***

The Modification Proposal stated that the timescales relating to the transfer of funds (Section N8.2) should be modified to take into account the delay that can arise from the processing of these funds by the relevant banks. The timescales within the BSC relating to the transfer of funds state that Parties should ensure payment is credited to the Collection Account by 12:00 on the relevant Payment Date. The Funds Administration Agent (FAA) should determine whether the required amounts have been credited to the Collection Account by 13:00 and ensure that these are then remitted to the Clearing Account by 13:30.

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<sup>3</sup> The Applicable BSC Objectives, as contained in Condition C3 (3) of National Grid Company'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.

- ***Payment Default Thresholds***

The second proposed change relates to the introduction of payment default thresholds. The proposal states that Default thresholds should be introduced, whereby insignificant default amounts are treated differently to significant amounts e.g. amounts under £1,000 are not escalated to the Panel within the same timescales as defaults of £1,000,000. At present all defaults are progressed in the same way, regardless of the size of the default.

- ***Letters of Credit***

The Modification Proposal also raised an issue that funds are not available immediately when a Letter of Credit is called and that the payment default procedure should take this into account. The proposal stated that the BSC should include provisions for Letters of Credit to be called upon on the Payment Date (if payment hasn't been received) so that the funds are available as soon as possible.

- ***Payment transfers***

The final area of change raised in the Modification Proposal relates to the use of banks with no UK offices. It stated that an explicit clause should be added to the BSC, highlighting that BSC Parties should use a UK bank, or they will be liable for the charge that is applied to the transfer of money to/from a foreign bank.

The Modification Group discussed each of the above areas at the meetings on 2 and 30 October 2001. Legal text for P39 was issued for industry consultation as part of the Assessment Procedure. Following the consultation, further legal and financial issues emerged. The Modification Group met again on 22 January 2002 specifically to discuss these legal and financial concerns. At this meeting the Modification Group drew conclusions on the above four areas as follows:

- ***Payment Timescales***

The Modification Group agreed that a single payment deadline of 16:00 hours should be specified in the BSC as this is the latest time that payment can be made to the Collection Banks to allow for transfers to be made to the BSC Bank on the same day. It would be the responsibility of the relevant Party to ensure that payment is received by this time. The Modification Group noted that whilst a later time could be specified for the BSC Bank, introducing two separate deadlines would not aid clarity and therefore, the deadline should be the same for all Parties.

- ***Payment Default Thresholds***

The initial work undertaken by the Modification Group had focused on establishing a series of payment default thresholds with associated maximum timescales that would be used to determine when actions must be taken. Additionally, it was agreed that discretion would be given to ELEXON to initiate earlier action.

The legal advice indicated a concern that conferring upon ELEXON the discretion to enable them to shorten the periods used for the payment default thresholds could leave ELEXON open to legal challenge and that the relevant amounts and periods used for the payment default thresholds should be detailed in the BSC. This latter point was considered undesirable by the

Modification Group and industry responses. In addition to the legal advice, a potential issue relating to VAT was identified. It was observed that prior to any changes to the BSC being made, confirmation would be needed that the current agreement with Customs & Excise would remain unaffected.

Accordingly, the Modification Group agreed that allowing ELEXON to exercise discretion in this regard would not be prudent and that payment default thresholds should not be included in this modification because without the discretionary element, the incentives to prompt payment would be reduced. It was agreed that ELEXON should instead ensure that Parties are making payments on time and that all late payments are treated in accordance with the BSC, as currently drafted (i.e. all payment defaults being progressed in the same way regardless of the size of the default). The Modification Group believed that this may increase the administration costs in the short term, however it was envisaged that this approach would lead to a reduction in late payment and therefore save money in the long term. Furthermore, it was felt that striving for compliance would better protect the collective interests of Parties in the event of a Party going into default.

- ***Letters of Credit***

It was agreed that if the total outstanding amount being used within the Borrowing Account becomes greater than £4m (the total borrowing facility in accordance with Section N4.9.1 of the BSC), then the FAA would call on all relevant Letters of Credit immediately, starting with the Letter of Credit for the party with the largest default. Extra interest charges would be incurred for an unauthorised overdraft and these would be charged to the relevant parties.

The original Modification Proposal raised the issue of the time taken to process Letters of Credit. It stated that the BSC should include provisions for Letters of Credit to be called on the Payment Date<sup>4</sup> (if payment has not been received) so that the funds are available on the Business Day after the date payment is due. The group noted that in practice, funds might not be received for up to a week after the Letter of Credit is called.

The Modification Group agreed that the current provision for a Party initially entering default should be retained. However, the Modification Group agreed that Sections N9.2.1 and N9.2.2 should be modified to allow Letters of Credit to be called on the affected date<sup>5</sup> once a party is already in default (in accordance with Section H of the BSC). This proposal would minimise the use of the borrowing facility when a Party stops paying, but continues to accumulate, trading charges.

- ***Payment transfers***

The Modification Group initially suggested that an explicit statement should be added to the BSC stating that the ELEXON and their agents will not pay any additional bank charges for payment transfers. Subsequent discussions with ELEXON's legal advisors revealed that it was not necessary to include an explicit statement regarding foreign transfer charges in the BSC as this is covered by the existing requirement to make payment in full to the BSC Clearer (Section N6.7.1 of the BSC).

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<sup>4</sup> The date on which payment is due

<sup>5</sup> Such date in respect of the Settlement Day to which it relates.

In the absence of an explicit statement being inserted into the BSC, the Modification Group agreed that ELEXON would issue a statement to ensure that all Parties are aware of the obligation to make full payment and that the ELEXON are not liable for foreign transfer charges. It was also suggested that this should be added to Balancing and Settlement Code Procedure (BSCP) 301. These actions will be undertaken outside the modification process.

Following the Modification Group meeting on the 22 January 2002, the legal text was revised and issued for further industry consultation. The Modification Group felt that these changes did not represent the introduction of an alternative modification, rather that they are an evolution of the original proposal based on the assessment that has been undertaken. The Final Modification Report states that this view is supported by legal advice.

The Modification Group agreed that in the light of the above, Modification Proposal P39 would better facilitate achievement of the applicable BSC Objective in Condition C3 (3) (d) of the Transmission Licence. ELEXON published a draft Modification Report on 25 February 2002 that invited respondents' views by 4 March 2002.

### **Respondents' views**

In total, ELEXON received eleven responses (representing 30 Parties and 1 Party Agent) to the consultation on Modification Proposal P39. Of the responses, nine (representing 29 Parties) expressed support for the recommendation of the draft Modification Report to approve the Proposed Modification. One response (representing 1 Party Agent) stated that there was no impact and the remaining respondent (representing 1 Party) stated that they had no comment. No responses objected to the recommendation in the draft Modification Report. The consultation responses raised no new issues.

The respondents' views are summarised in the Final Modification Report for Modification Proposal P39 dated 19 March 2002.

### **Panel's recommendation**

The Panel met on 14 March 2002 and considered the Modification Proposal P39, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Proposed Modification with a proposed "Calendar Day" implementation effective from 12 August 2002. It was noted in the Modification Report that the proposed implementation date applied to all payments processed from that date, including payments relating to Settlement Days prior to the implementation date.

### **Ofgem's view**

Ofgem considers, having had regard to its statutory duties, that Modification Proposal P39 will better facilitate achievement of the Applicable BSC Objective C3 (3) (d), since the Proposal will promote efficiency in the implementation and administration of the balancing and settlement arrangements.

The net effect of the introduction of these changes would be that:

- Payment timescales within the BSC will be realigned with current commercial practice, in allowing for the limitation of current bank transfer processes
- FAA's will be able to call on Letters of Credit of defaulting Parties on the day payment is due

On the first of these issues, Ofgem considers that the BSC should reflect actual practice in all operational matters. Where there is an inconsistency, efforts should be made to realign the BSC and practice in the most efficient manner. In this instance, the criteria specified in the BSC are not capable of being fulfilled in practice, so the BSC should be amended to reflect the current constraints of the banking system. The Modification Proposal outlines an efficient and pragmatic solution to these constraints.

As regards the calling of Letters of Credit, it is important that in the event of default, the Parties responsible should be held to account as soon as possible in order to mitigate the risk to other BSC Parties. Changing the current situation, so that Letters of Credit can be called in order to have funds available as soon as possible, fulfils this aim. It also allows for the more efficient running of the BSC's overdraft facility, thereby reducing overall banking charges.

Ofgem accepts the arguments relating to the problems with introducing payment default thresholds and the fact that specific clauses relating to bank account charges are not deemed as necessary. It agrees that ELEXON should enforce compliance with the requirements of the BSC on late payments to incentivise all Parties to minimise their costs and protect the collective interests of all BSC parties in the event of a Party defaulting.

Ofgem considers that publishing its decision now will give Parties ample time to take account of the effects that this Modification Proposal will have on trades prior to the implementation date of 12 August 2002.

### **The Authority's decision**

The Authority has therefore decided to direct that the Proposed Modification P39, as set out in the Modification Report, should be made and implemented.

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

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

The Modification is to take effect from 12 August 2002.

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

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

Yours sincerely,

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

**Nick Simpson**

**Director, Industry Codes Development**

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