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04 February 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No: P11

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Notice in relation to Modification Proposal P11: “Revision of Minimum Credit Cover Requirements”.

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in Modification Proposal P11 “Revision of Minimum Credit Cover Requirements”.

The Balancing and Settlement Code Panel (the “Panel”) recommended to the Authority that

- (i) Modification Proposal P11 be rejected; and
- (ii) The Alternative modification as developed by the Modification Group and defined in the Assessment Report also be rejected.

The Authority has decided not to direct a Modification to the BSC.

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

Background to the proposal

Modification Proposal P11 was raised on 09 May 2001 by the European Power Source Company (UK) Limited and subsequently clarified in the P11 Definition Report.

On 31 May 2001, the BSC Panel considered an Initial Written Assessment of the Proposal and submitted the Proposal to the Definition Procedure. The Credit Modification Group submitted a Definition Report to the BSC Panel on 26 July and the Proposal was then submitted to the Assessment Procedure, with the Assessment Report being considered by the Panel on 15 November 2001. During the Assessment Stage the Modification Group developed an Alternative Modification Proposal.

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

The Assessment Report recommended that Modification Proposal P11 be rejected but did not include a recommendation on the Alternative Modification Proposal as the Modification Group could not reach consensus.

The Panel considered the various arguments in the Assessment Report, concluding that neither Modification Proposal P11 nor the Alternative would better facilitate the BSC Objectives.

The Modification Proposal

Modification Proposal P11 seeks to revise the minimum Credit Cover requirements, in order to increase the likelihood that any Party defaulting on their Trading Charges would have sufficient Credit Cover in place and hence reduce the risk of financial loss to other Trading Parties.

Trading Parties would be required to maintain a minimum level of Energy Credit Cover (ECC)² (which would be determined by ELEXON or an appropriate third party) in order to be able to transact.

Under the current credit arrangements, Trading Parties are expected to project their expected consumption and production volumes and post sufficient collateral with ELEXON to cover their projected Energy Indebtedness level. Such collateral then translates directly into the amount of ECC posted by that Trading Party.

During the Assessment Procedure, the Modification Group developed an Alternative Modification, which differed from the original Modification Proposal in a number of ways. Firstly, unlike the original Modification Proposal, the Alternative did not have a fixed £50k minimum on the minimum level of Credit Cover calculated by each party.

Secondly, it was proposed that the minimum level of the Credit Cover should be the highest value of cumulative 29-day indebtedness over the year, not the 95th percentile value. Finally, the Alternative calculates the minimum required level of Credit Cover using Trading Charge data from the Settlement Administration Agent (SAA) system, rather than the indebtedness estimates used by ECVAA in credit-checking.

ELEXON published a Draft Modification Report on 22 November 2001.

Respondents' views

In total, ELEXON received 7 responses to the consultation on the draft Modification Report for Modification Proposal P11, representing the views of 34 BSC Parties. Of the responses,

² ECC is defined as the Credit Cover divided by the CAP determined by the Panel.

CAP is the price that the BSC Panel determines, after consultation with Trading Parties, as the price appropriate to use to determine the equivalent financial amount of a Trading Party's Energy Indebtedness (EI).

Energy Indebtedness is the algebraic sum of the Credit Assessment Energy Indebtedness of that Party in relation to that Settlement Period and all prior Settlement Periods falling within the Period of 29 Settlement Days expiring on (and including) the Settlement Day which includes the Settlement Period [Section M:1.1.1(a)].

5 representing the views of 26 Parties supported the Panel's decision to recommend to the Authority that the Modification should not be made.

Of the respondents who supported the Proposal, one respondent agreed that it was inappropriate to use historical indebtedness data as a measure of likely future indebtedness and suggested that Modification Proposal P11 would constitute a barrier to entry.

Two responses, representing the views of 8 Parties disagreed with the decision. Of the responses disagreeing with the Panel decision, one respondent stated that it was imperative that Parties who are operating in the industry should have adequate protection from entrants who do not have robust processes in place to ensure that they are effectively mitigating their own risk.

One Party drew attention to the recent default of the Enron Group. ELEXON has investigated whether Modification Proposal P11 or the Alternative Modification would have obliged Enron Capital and Trade Resources Ltd (ECTRL) or Enron Gas and Petrochemicals Trading Ltd (EGPTL) to post more Credit Cover. It was concluded that neither the Modification nor its Alternative would have done so, as both of these Parties at the time of Default had a level of Credit Cover that was significantly higher than their historical levels of indebtedness.

Panel's Recommendation

The Panel met on 13 December 2001 and considered Modification Proposal P11 and the Alternative, the Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should reject both the Proposed Modification and the Alternative.

Ofgem's view

Ofgem considers, having regard to its statutory duties, that Modification Proposal P11 and the Alternative do not better facilitate the relevant objectives of the BSC.

Ofgem agrees with the Panel's argument that neither the Modification Proposal nor its Alternative would better facilitate achievement of the relevant BSC objectives because the £50,000 minimum Credit Cover would be applied to all Trading Parties in an arbitrary fashion and because mainly estimated data would be used to calculate historical indebtedness.

Excessive use of estimated data is not an efficient means of calculating historical indebtedness and it could lead to the imposition of arbitrary costs on Trading Parties and so reduce efficiency and distort competition. This would not better facilitate the achievement of the BSC Objective Condition C3:3 (b) and the BSC Objective Condition C3:3 (c).

Ofgem agrees with the Panel's views that many of the shortcomings relating to the use of estimated data would be mitigated when Modification P2 comes into effect on 30 September 2002. However, Modification Proposal P11 or its Alternative would not be an appropriate interim solution to this issue.

The Panel's view, which is supported by Ofgem, is that under the Alternative Modification, the additional Credit Cover requirements would, therefore, be less arbitrary than under the original Modification Proposal.

However, that benefit is likely to be outweighed by the fact that implementation of the Proposal would have the effect of imposing additional and disproportionate Credit Cover costs on Trading Parties. This may also constitute a barrier to entry. Ofgem would consider the imposition of such costs inappropriate and hence the Alternative Modification would fail to facilitate the achievement of the BSC Objectives in conditions C3(3)(c) and C3(3)(d) of the Transmission Licence.

Ofgem agrees with the Panel's recommendation that the Authority should reject The Proposed Modification and its Alternative.

The Authority's decision

The Authority agrees with the Panel's recommendation that the Modification Proposal P11 and its Alternative should be rejected.

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.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,



David Edward
Head of Electricity Code Development

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