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**MODIFICATION REPORT
MODIFICATION PROPOSAL P11 –
REVISION OF MINIMUM CREDIT
COVER REQUIREMENTS**

Prepared by ELEXON on behalf of the Balancing
and Settlement Code Panel

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1 SUMMARY AND RECOMMENDATIONS

1.1 Recommendation

On the basis of the analysis, consultation and assessment undertaken in respect of this Modification Proposal during the Assessment Phase, and the resultant findings of this report, the BSC Panel recommends that:

- **Modification Proposal P11 be rejected; and**
- **The Alternative Modification, as developed by the Modification Group and defined in the Assessment Report, also be rejected.**

1.2 Background

Modification Proposal P11 was submitted on 9th May 2001 by The European Power Source Company (UK) Limited. The proposal 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. The Proposer has argued that this reduction in the risks faced by Trading Parties would promote effective competition in the generation and supply of electricity, and promote efficiency in the implementation and administration of the balancing and settlement arrangements.

On 31st 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 26th July, and the Proposal was then submitted to the Assessment Procedure, with the Assessment Report being considered by the Panel on 15th November.

The Assessment Report recommended rejection of Modification Proposal P11, but did not include a recommendation on the Alternative Modification Proposal, as the Modification Group had been unable to reach consensus. The Panel therefore considered the various arguments in the Assessment Report, and concluded that neither P11 nor the Alternative Modification Proposal would better facilitate the Applicable BSC Objectives.

1.3 Rationale for Recommendations

The rationale for the Panel's recommendation is stated in section 6 of this report. In summary, the Panel concluded that both P11 and the Alternative Modification Proposal would hinder "*effective competition in the generation and supply of electricity*" and "*efficiency in the implementation and administration of the balancing and settlement arrangements*" for the following reasons:

- Because of the £50,000 minimum Credit Cover applied to all Trading Parties, and the use of estimated data in calculating historical indebtedness, Modification Proposal P11 would impose arbitrary costs on Trading Parties.
- Under the Alternative Modification Proposal, the additional Credit Cover requirements would be calculated from historical indebtedness data for each Party, and would therefore be less arbitrary than under P11. Nonetheless, the Panel believes that the additional cost of this Credit Cover would outweigh the likely reduction in risk, hindering the achievement of the BSC Objectives. The Proposal would also impose additional and disproportionate Credit Cover costs on Trading Parties involved in certain types of transaction (such as transferring a BM Unit from one Party to another, or terminating a Metered Volume Reallocation Notification).

2 INTRODUCTION

This Report has been prepared by ELEXON Ltd., on behalf of the Balancing and Settlement Code Panel ('the Panel'), in accordance with the terms of the Balancing and Settlement Code ('BSC'). The BSC is the legal document containing the rules of the balancing mechanism and imbalance settlement process and related governance provisions. ELEXON is the company that performs the role and functions of the BSCCo, as defined in the BSC.

This Modification Report is addressed and furnished to the Gas and Electricity Markets Authority ('the Authority') and none of the facts, opinions or statements contained herein may be relied upon by any other person.

An electronic copy of this document can be found on the BSC website, at www.elexon.co.uk

3 PURPOSE AND SCOPE OF THE REPORT

BSC Section F sets out the procedures for progressing proposals to amend the BSC (known as 'Modification Proposals'. These include procedures for proposing, consulting on, developing, evaluating and reporting to the Authority on potential modifications.

The BSC Panel is charged with supervising and implementing the modification procedures. ELEXON provides the secretariat and other advice, support and resource required by the Panel for this purpose. In addition, if a modification to the Code is approved or directed by the Authority, ELEXON is responsible for overseeing the implementation of that amendment (including any consequential changes to systems, procedures and documentation).

A Modification Report must be prepared and submitted to the Authority in respect of each proposed modification and must contain:

- (a) The recommendation of the Panel as to whether or not the Proposed Modification or any Alternative Modification should be made;
- (b) The proposed Implementation Date for implementation of the Proposed Modification or any Alternative Modification;
- (c) The matters set out in Annex F-1 of the BSC. This will usually be in the form of the relevant Assessment Report where the Proposal has been submitted to a Modification Group prior to the Report Phase;
- (d) An explanation of the Panel's rationale should the Panel form a different view of any matters contained in the Modification Group Report; and
- (e) A summary of the representations made by Parties and interested third parties during the consultation undertaken in respect of the Proposed Modification and any Alternative Modification.

4 HISTORY OF PROPOSED MODIFICATION

Modification Proposal P11 was submitted on 9th May 2001 by The European Power Source Company (UK) Limited. The Proposal 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. The Proposer has argued that this reduction in the risks faced by Trading Parties would promote effective competition in the generation and supply of electricity, and promote efficiency in the implementation and administration of the balancing and settlement arrangements.

The BSC Panel meeting on 31st May 2001 agreed that Modification Proposal P11 should be submitted to the Definition Procedure (as defined in section F2.5 of the Balancing and Settlement Code). This Definition Procedure was carried out by the Credit Modification Group, and resulted in the presentation of a Definition Report to the BSC Panel meeting on 26th July.

On 10th August and 4th September 2001, the Credit Modification Group met to consider further the Modification Proposal, and agreed that two solutions should be taken forward for consultation and assessment:

- Modification Proposal P11 itself; and
- A proposed Alternative Modification Proposal.

The Credit Modification Group met again on 6th November 2001 to discuss the consultation responses. At this meeting the Group agreed to recommend that:

- Modification Proposal P11 should be rejected; and
- Were an Alternative Modification Proposal to be recommended, its definition should be changed to reduce the impact on Parties' systems and processes, thus addressing some (but not all) of the concerns raised in Parties' consultation responses and impact assessments. Section 5.2 of this report describes in detail the revised Alternative Modification Proposal.

However, the Modification Group was not able to reach consensus on whether the revised Alternative Modification Proposal would better facilitate achievement of the Applicable BSC Objectives. The Proposer of P11 believed that it would, while the other two Members of the Group present at the meeting believed that it would not.

As a result of this failure to reach consensus, the Assessment Report (which was presented to the Panel on 15th November) requested that the Panel reach a view on whether the Alternative Modification Proposal would better facilitate the Applicable BSC Objectives. The Panel agreed unanimously that neither P11 nor the Alternative Modification Proposal would better facilitate the Applicable BSC Objectives, and that therefore the Draft Modification Report should recommend their rejection.

5 DESCRIPTION OF PROPOSED MODIFICATION

5.1 Proposed Modification

The key features of Modification Proposal P11, as raised by The European Power Source Company (UK) Limited on 9th May 2001, and subsequently clarified in the P11 Definition Report, are as follows:

- On a daily basis, the ECVAAs will determine the Minimum Level of Credit Cover (MLCC_p) for each Party. This minimum level will be the larger of fifty thousand pounds, and a 95th percentile value of Energy Indebtedness (EI_{pj}) over the previous year. The ECVAAs will then check that the actual level of Credit Cover posted by the Party is at least equal to that minimum value.
- If the Party's Credit Cover is less than the minimum required level, ECVAAs will issue a notice to the Party (copied to ELEXON), notifying them that they have two Business Days to put in place additional Credit Cover.
- If at the end of two Business Days, the level of Credit Cover is still less than the required minimum, then (subject to authorisation by ELEXON) the Party will be placed in Level 2 Credit Default (irrespective of their Credit Cover Percentage).

This Proposal was intended to reduce the risk of a Party going into default with settlement liabilities (i.e. imbalance charges and other Trading Charges) in excess of their Credit Cover, and hence reduce the risk of resultant financial loss to other BSC Parties.

5.2 Alternative Modification Proposal

During the course of the Assessment Procedure, the Modification Group developed an Alternative Modification Proposal that differed from P11 in the following respects¹:

- Modification Proposal P11 defined the minimum level of Credit Cover required as the larger of £50k, and a 95th percentile value of historical Energy Indebtedness for that Party. The Alternative Modification Proposal changes this calculation as follows:
 - i) Unlike P11, the Alternative doesn't have a fixed £50k minimum on the minimum level of Credit Cover calculated for each Party.
 - ii) The Minimum Level of Credit Cover should be the highest value of cumulative 29-day indebtedness over the year, not the 95th percentile value.
 - iii) In order to increase the accuracy of the calculation, 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 ECVAAs in credit-checking. The data used would be that from the most recent Initial Settlement or Reconciliation run for each Settlement Day (thus ensuring that the most up-to-date and accurate data is used, and the results of Disputes are reflected in the calculation).
- In order to avoid the expense of continuous monitoring of Parties' Credit Cover levels, the Minimum Level of Credit Cover would only be calculated and checked when a BSC Party sought to reduce their level of Credit Cover.

¹ The Alternative Modification Proposal as described here includes a number of changes agreed by the Modification Group to address issues raised in BSC Parties' responses to the consultation carried out during the Assessment Procedure. Full details of these changes can be found in the P11 Assessment Report.

- There should be a process for a Party to appeal to the Panel if an MLCC value was calculated that was clearly inappropriate. (This might be the case, for example, if a BSC Party disposed of a Supply business or power station, and their historical indebtedness therefore ceased to be a valid indicator of their possible future indebtedness.)

6 RATIONALE FOR PANEL RECOMMENDATIONS

The Panel agreed with the Modification Group's argument (described in section 8.1 of this report) that Modification Proposal P11 would not facilitate the Applicable BSC Objectives, because of the £50,000 minimum Credit Cover applied to all Trading Parties, and the use of estimated data in calculating historical indebtedness.

The Panel also agreed with the view (held by two of the three Modification Group Members present at the 6th November meeting) that the Alternative Modification Proposal would not better facilitate the Applicable BSC Objectives for the following reasons:

- Modification Proposal P2 will significantly reduce the risk that a Trading Party going into default has Trading Charge liabilities greater than their level of Credit Cover. The benefit of Modification Proposal P11 (in making the market robust against credit default) is therefore likely to be outweighed by the cost of increased credit cover to participants. Overall, therefore, the Proposal would increase the costs of participating in the market, which would not facilitate achievement of the BSC Objectives in conditions 7A(3)(c) and 7A(3)(d) of the Transmission Licence.
- The use of historical indebtedness as an indicator of likely future indebtedness is not necessarily appropriate, and could impose disproportionately high Credit Cover costs in certain circumstances (such as when Trading Parties merge or transfer generation assets). Again this would not facilitate achievement of the BSC Objectives in conditions 7A(3)(c) and 7A(3)(d) of the Transmission Licence. (In particular, one of the Panel Members stated that Modification Proposal P2 reduces the role of historical data in calculating Credit Cover requirements. Modification Proposal P11 has the opposite effect, and is therefore a retrograde step which, given the level of merger activity in the market, will potentially inhibit liquidity.)

One of the Panel Members also stated that the intention of the Proposal was to 'bias' the Credit Cover arrangements in favour of having too much rather than too little Credit Cover. The Panel has already considered the question of whether such a bias would facilitate the Applicable BSC Objectives in the course of setting the Credit Assessment Price (CAP), and concluded that it would not. Furthermore, even if circumstances were to change such that it did become appropriate to oblige Trading Parties to provide Credit Cover in excess of their actual indebtedness, the existing CAP mechanism would allow this to be done without the need for a Modification to the Code².

² This remains true even once Modification Proposal P2 is implemented, although the effect of CAP on required levels of Credit Cover will be reduced at that point.

7 LEGAL TEXT TO GIVE EFFECT TO THE PROPOSED MODIFICATION

In view of the recommendation of the Panel to recommend to the Authority that both the Modification and Alternative Modification Proposal should be rejected, the Panel has consulted with the Authority, and the Authority has agreed that proposed text to modify the Code need not be commissioned for inclusion in the Modification Report.

8 ASSESSMENT

This section of the report summarises the assessment carried out by the Credit Modification Group during the Assessment Procedure. Full details are contained in the P11 Assessment Report, which may be found on the BSC website at www.elexon.co.uk.

8.1 Assessment Against Applicable BSC Objectives

The Modification Group agreed that the Alternative Modification Proposal would be better than P11 at facilitating the Applicable BSC Objectives, and that therefore Modification Proposal P11 should be rejected. The reasons for this were as follows:

- Unlike the Alternative Modification Proposal, P11 imposes a minimum £50,000 Credit Cover requirement on all Trading Parties (including those with no history of indebtedness). Analysis of Parties' current indebtedness performed by the Credit Modification Group suggested that this would have minimal benefit in protecting Parties from default risk. However, it would impose additional costs on BSC Parties, and could act as a disincentive to participation in the market. For this reason, the Credit Modification Group felt that Modification Proposal P11 would not facilitate "efficiency in the implementation and administration of the balancing and settlement arrangements", and would not promote "effective competition in the supply and generation of electricity".
- The Modification Group also felt that the use of estimated indebtedness data in calculating the Minimum Level of Credit Cover would potentially oblige some Parties to put up Credit Cover that was disproportionate to their likely indebtedness, and that this would hinder achievement of the BSC Objectives in Conditions 7A(3)(c) and 7A(3)(d) of the Transmission Licence. The Alternative Modification Proposal addresses this issue by using actual Trading Charge data in the calculation of the Minimum Level of Credit Cover.

However, the Modification Group was unable to achieve consensus on whether the Alternative Modification Proposal would better facilitate the Applicable BSC Objectives. Two of the three Group Members who attended the meeting on 6th November believed that it would not, for the following reasons:

- The Authority has approved Modification Proposal P2, which will significantly improve the accuracy of the credit-checking process. Although the risk to BSC Parties of a Party going into Default with insufficient Credit Cover to pay their Trading Charges has not been entirely eradicated, it has been significantly reduced. Two of the three Group Members therefore believed that the reduction in risk would be outweighed by the cost of implementing the change, and that the overall effect of implementation would therefore be to increase the costs faced by BSC Parties. This increase in costs would hinder both "*effective competition in the generation and supply of electricity*" and "*efficiency in the implementation and administration of the balancing and settlement arrangements*".
- Because the Alternative Modification Proposal bases the minimum level of Credit Cover on historical indebtedness over the past year, which is not necessarily a good indicator of future indebtedness, some Parties might have a minimum level of Credit Cover imposed on them that reflected their historical indebtedness, but was far in excess of their likely future indebtedness. This would impose costs on the particular BSC Parties concerned, without any corresponding reduction in the risk to other BSC Parties, and would therefore fail to facilitate "*efficiency in the implementation and administration of the balancing and settlement arrangements*". The unwarranted costs might also

act as a barrier to entry, thereby failing to "*promote effective competition in the supply and generation of electricity*". Examples of situations in which historical indebtedness might be a poor indicator of future indebtedness include the following:

- i) When a BSC Party transferred an asset (such as a Supply business or power station) to another Trading Party, the imbalance charges associated with the asset would still be reflected in the historical indebtedness data for that Party.
 - ii) When a Metered Volume Reallocation Notification (MVRN) was terminated, the imbalance charges associated with that BM Unit would still be reflected in the historical indebtedness data for the Subsidiary Party to the MVRN.
- Conversely, a BSC Party in financial distress may well incur high levels of indebtedness immediately prior to going into default, without having had any past history of high indebtedness values. (In particular it should be noted that many Parties have consistently maintained 'long' positions since NETA Go-Live, and therefore have little or no history of indebtedness.) The Alternative Modification Proposal does not reduce the risk to BSC Parties of such a Party going into default, further strengthening the argument (in the view of two of the three Members present on 6th November) that the reduction in risk offered by the Alternative may not justify the cost of implementation.

However, the Proposer of P11, who was the third Group Member present at the meeting on 6th November, took the view that the Alternative would facilitate the Applicable BSC Objectives, for the following reasons:

- Although Modification Proposal P2 significantly improves the credit checking arrangements, there is still scope for Parties to run up indebtedness in excess of Credit Cover, imposing risk on other BSC Parties. (For instance, even under P2 metered readings aren't taken into account for five Working Days, so a Generator whose plant tripped could run up a week's exposure to System Buy Price, potentially amounting to millions of pounds, without being obliged to put additional Credit Cover in place.) The reduction in this risk arising from the Alternative Modification Proposal would outweigh the (relatively modest) cost of implementing the change, and the Proposal would therefore promote "*effective competition in the generation and supply of electricity*" and facilitate "*efficiency in the implementation and administration of the balancing and settlement arrangements*".
- In the majority of cases, it is reasonable to use historical indebtedness values as a measure of future risk. For example, a Generator who has experienced high imbalance charges due to plant tripping, or a Party who has experienced high imbalance charges due to a trading error, may well be at increased risk of experiencing another such failure in the future. In those cases where it clearly is not reasonable, the Alternative Modification Proposal includes an appeal mechanism that would provide Parties with a remedy.

8.2 BSC Agent Impact Assessment

Modification Proposal P11 would require changes to the Energy Contract Volume Aggregation Agent (ECVAA) system. The impact assessment obtained during the Assessment Procedure indicates that the BSC Agent implementation cost would be £124,700, and the subsequent maintenance cost would be £1,864 per month. (It should be noted that these figures only include the BSC Agent costs, and exclude ELEXON costs, market testing and VAT.)

As described in section 4 of this report, the Credit Modification Group amended the definition of the Alternative Modification Proposal to address issues raised in the consultation responses. This occurred

after the procurement of impact assessments from BSC Agents, and therefore no assessment of the Alternative Modification Proposal was obtained. For the earlier variant of the Alternative Modification Proposal that was assessed, the BSC Agent cost would be £116,400 (basing the MLCC calculation on Interim Information data), or £207,200 (basing the MLCC calculation on Initial Settlement data). The associated maintenance cost would be £1,746 per month or £3,108 per month respectively. The Modification Group believes that the cost of implementing the revised Alternative Modification Proposal should be less than this.

8.3 BSC Party Impact Assessment

Modification Proposal P11 would require changes to Party systems and processes, such as the following:

- Party systems and processes for managing Credit Cover would require amendment to reflect the new minimum Credit Cover requirements.
- Party systems and processes for responding to Credit Default notices issued by ELEXON would require amendment to reflect the new minimum Credit Cover requirements.
- Party systems and processes for handling the ECVA-1014 report would require amendment to handle the revised format of the data flow.

The impact assessment and consultation responses received from Parties during the Assessment Procedure indicated that the cost of these changes was seen as a significant disadvantage. For this reason the Alternative Modification Proposal (described in section 5.2 of this report) has been simplified, so that its impact on Party systems and processes is limited to the processes for reducing Credit Cover.

9 SUMMARY OF REPRESENTATIONS

[The final version of this report will include a summary of responses to the consultation on the Draft Modification Report. Full copies of the responses will be included in Annex 1.]

A summary and copies of the representations received and considered by the Modification Group during the Assessment Procedure can be found in the P11 Assessment Report. This Modification Report should be read in conjunction with that Assessment Report.

A summary and copies of the original representations received and considered by the Modification Group under the initial consultation on this proposal can be found in the P11 Definition Report.

ANNEX 1 – REPRESENTATIONS

[This annex of the Final Modification Report will contain copies of representations on the Draft Modification Report.]