

<b>Modification Proposal – BSCP40/03</b>	MP No: P235
<b>Title of Modification Proposal:</b> <b>Aligning BSC requirements with the calculation of reconciliation interest performed by the Funds Administration Agent</b>	
<b>Submission Date: 09 April 2009</b>	
<b>Description of Proposed Modification</b> <i>(mandatory by originator)</i>	
<p>This Modification Proposal seeks to amend the Balancing and Settlement Code (BSC) so that the method of calculating interest when determining Reconciliation Charges, as specified in Section N 6.4.2 (b), is revised and aligned to the calculation of reconciliation interest performed by the Funds Administration Agent (FAA) – a method which has been employed since before NETA Go-Live.</p> <p>In particular, the BSC requirements should reflect that the interest for each Reconciliation Settlement Run is calculated:</p> <ul style="list-style-type: none"> <li>- over the period from, and including, the Payment Date of the Initial Settlement Run up to, but not including, the Payment Date of the relevant Reconciliation Run; and</li> <li>- Using compound interest calculated using the relevant Base Rate applicable as at, and to, each day in the period.</li> </ul> <p>In accordance with the general principle that Modifications should not be implemented in a retrospective manner, it is proposed that this Modification is implemented on a prospective Settlement Day basis i.e. it would only apply to those Settlement Days occurring after the implementation date, and not to those Settlement Days occurring before. However, the Modification Group should consider whether the particular circumstances of this Modification warrant a different implementation approach and/or Implementation Date. For example, a retrospective Implementation Date of the date this Modification was raised (09 April 2009) with a Calendar Day implementation approach may be more suitable (or could form an Alternative Modification Proposal if the Group believe it appropriate).</p>	
<b>Description of Issue or Defect that Modification Proposal Seeks to Address:</b>	
<p>ELEXON has recently identified that the method of calculating interest when determining Reconciliation Charges in the BSC does not match the method that has been used by the FAA since before NETA Go-Live. Investigation suggests that the FAA's method is preferable to that specified in N6.4.2 (b). This Modification therefore seeks to amend the BSC to bring it in line with the calculation method used by the FAA.</p> <p>The settlement processes allow for prompt initial settlement using demand estimates. This initial settlement calculation, or Initial Settlement Run, is 'refreshed' via Reconciliation Runs which are subsequently made over a 14 month period as metered data becomes available. At each Reconciliation Run the settlement calculation is re-run as though it were the Initial Settlement Run to be carried out in relation to the relevant Settlement Day, albeit with more accurate data.</p> <p>The extended nature of the Reconciliation timetable, and the earning value of money, means that interest has to be accounted for during the settlement process. The principle behind Reconciliation interest is that, by adjusting the payments for interest back to Payment Date of the Initial Settlement Run it is as if the "correct" monies had been exchanged at the Initial Settlement Run. The opportunity to game e.g. by submitting lower consumption volumes prior to Final Reconciliation is therefore avoided.</p>	

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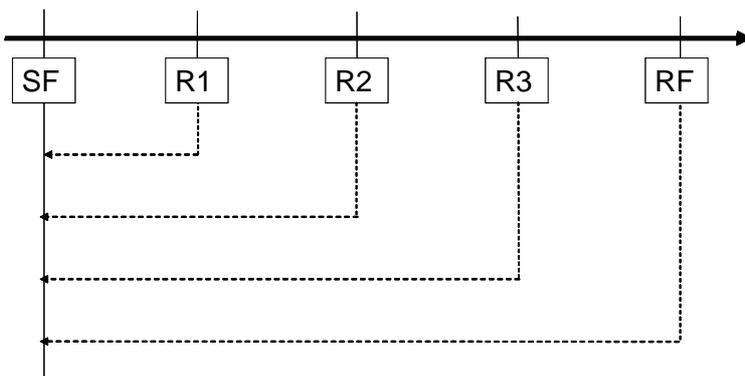
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In line with Section N6.4.2.(a) of the BSC, at each Reconciliation Settlement Run the difference between the Trading Charges Amounts calculated in the current Reconciliation Settlement Run and that calculated in the previous Reconciliation Settlement Run is also determined. No change is sought to clause N 6.4.2 (a).

However, ELEXON has recently discovered that the BSC requirements for calculating interest when determining Reconciliation Charges (stated in N 6.4.2 (b)) are inconsistent with those undertaken by the FAA systems.

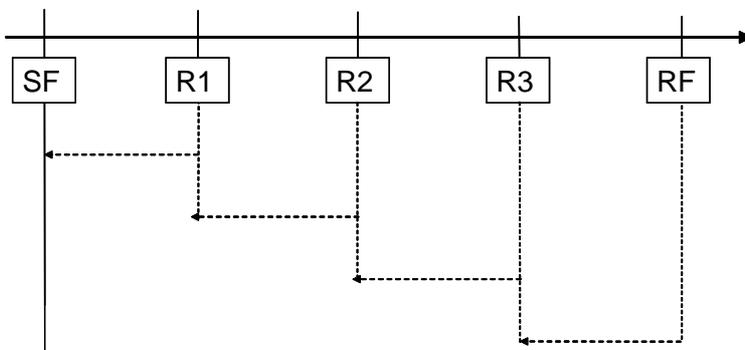
The FAA systems calculate interest on a daily basis back to the Payment Date of the Initial Settlement Run. The interest on the difference between successive Trading Charge Amounts is thereby always adjusted to the Payment Date of the Initial Settlement Run. This is consistent with the overarching principle of a Reconciliation Settlement Run, as the amounts are calculated as though they had been determined at the Initial Settlement Run.

*Diagram 1 – FAA Systems Interest Calculations*



The BSC drafting requires interest to be calculated, using a single Base Rate, only as far back as the last Payment Date. This approach means that interest payments, rather than being referenced to a common point (the Payment Date for the Initial Settlement Run), are referenced only to the last Payment Date which is a function of the Settlement Timetable.

*Diagram 2 – BSC Interest Calculations*



Analysis undertaken by ELEXON indicates that the method of interest calculation used by the FAA is preferable to the BSC requirements as it is more consistent with, and better, reflects the nature of BSC processes. And it gives a fairer and/or more accurate result for Parties. The methodology used is also

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consistent with the calculations undertaken by the Pool and Settlement Arrangements systems and rules.

The FAA methodology is deemed fairer than the BSC requirements as:

- The BSC drafting states that interest is only calculated back to the previous Settlement Run. Therefore, Parties who have previously overpaid would only be compensated back to the previous Settlement Run and not for any period before that. Similarly, Parties that had underpaid would only have to pay interest back to the previous Settlement Run and would not have to pay adjustments back to the Initial Settlement Run. This is contrary to the principle that Reconciliation is to replace the first Settlement Run.

To illustrate the issue, under BSC N 6.4.2 (b), Parties who have underpaid at the Initial Settlement Run and subsequent runs prior to the Final Reconciliation, and then paid the correct amount at the Final Reconciliation Run, would not be charged interest over the entire period. This would place other Parties at a disadvantage, who had correspondingly overpaid at the Initial Settlement Run and been denied use of their money ever since. It would also mean that Parties might receive “excess interest”. In other words, if a Party initially paid an amount (for e.g.) at the SF Run and then at the R1 Run this was found to be an “overpayment”, the Party would receive the difference plus interest. However, if at the R2 Run it was found that the Party had “underpaid” at R1, it would not refund the “excess” interest paid for the SF-R1 period.

- The BSC is drafted to calculate interest using a single Base Rate. If the Base Rate used at Final Reconciliation is appreciably lower than that at the Initial Settlement Run (as in the current economic climate), the interest payment will not adequately compensate the Party for the loss of use of their money over the extended course of the reconciliation period.

However, the FAA calculates interest on a daily basis using the Base Rate applicable to each day in the period. Since an interest payment is intended to compensate Parties for the loss of use of their money over the extended period of reconciliation timetable, the FAA methodology can be seen to be fairer than the BSC requirement. The limitations of the BSC approach are well illustrated by the recent dramatic cuts in Base Rate.

- Interest calculations under BSC requirements include the Payment Date for the current Reconciliation Settlement Run. This means that Parties have to pay, or are paid, interest for the day on which they receive, or make, payment. This is inconsistent with normal commercial practice and could be said to represent (albeit minimal) an over-payment, or as case may be underpayment, of interest. The FAA excludes the Payment Date of the current Reconciliation period in its interest calculations, making it a fairer method.
- The calculations made by the FAA systems are consistent with those used to perform Reconciliation Run interest calculations under the Pooling and Settlement Agreement (both systems and rules) and have not been subject to query or dispute under the BSC.

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<p><b>Impact on Code:</b>  Section N,6.4.2 (b) will be revised to reflect the current systems methodology of calculating interest when determining Reconciliation Charges as performed by the FAA.</p> <p>It is proposed that paragraph 6.4.2 would read:</p> <p style="padding-left: 40px;">Subject to paragraph 5, each Payment Party shall following each Reconciliation Settlement Run be liable to pay to (or (as the case may be) entitled to receive from, the BSC Clearer an amount calculated as being:</p> <p style="padding-left: 40px;">(a) the amount of the difference determined under paragraph 6.4.1; plus</p> <p style="padding-left: 40px;">(b) <u>an amount in lieu of interest, calculated by applying the Base Rate to on a compound basis, (“the interest amount”) on the amount of such difference. The interest amount shall be calculated in respect of the period from (and including) since the last Payment Date relating to the Initial Settlement Run to (but not including) the relevant Reconciliation Payment Date by applying the Base Rate (as prevailing on the relevant day) on a daily basis to the amount of such difference.</u></p> <p>The exact wording should be considered and determined by the Modification Group.</p>	
<p><b>Impact on Core Industry Documents or System Operator-Transmission Owner Code:</b>  None</p>	
<p><b>Impact on BSC Systems and Other Relevant Systems and Processes Used by Parties:</b>  None</p>	
<p><b>Impact on other Configurable Items</b>  None</p>	
<p><b>Justification for Proposed Modification with Reference to Applicable BSC Objectives</b></p> <p>The FAA method of calculating interest when determining Reconciliation Charges is fairer and/or more accurate than the method detailed in the BSC. To align the BSC with the actual method undertaken by the FAA would remove any confusion over how interest is calculated and provide clarity to participants.</p> <p>This Modification Proposal would better facilitate Applicable BSC Objective (d) by reducing the potential for confusion over how interest is calculated for Reconciliation Charges, thereby promoting transparency and efficiency.</p>	
<p><b>Urgency Recommended: No</b></p>	
<p><b>Justification for Urgency Recommendation</b> <i>(mandatory by originator if recommending progression as an Urgent Modification Proposal)</i></p>	

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<b>Details of Proposer:</b>		
<i>Name</i>		
<i>Organisation</i> BSC Panel		
<i>Telephone Number</i>		
<i>Email Address</i>		
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<b>Details of Representative's Alternate:</b>		
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<b>Attachments: No</b>		