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The National Grid Company, BSC Signatories and  
Other Interested Parties

04 August 2004

Our Ref: MP No P158

Dear Colleague,

**Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P158 “Introducing the Ability to Lodge a Consolidated Letter of Credit”**

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 P158, “Introducing the Ability to Lodge a Consolidated Letter of Credit”.

The BSC Panel (the “Panel”) recommended to the Authority that;

- Proposed Modification P158 should not be made;
- the P158 Implementation Date of 3 November 2004 should an Authority decision be received on or before 30 July 2004, or 23 February 2005 should an Authority decision be received after that date but before 12 November 2004; and
- the proposed text for modifying the Code, as set out in the draft Modification Report.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives<sup>3</sup> and the Authority’s wider statutory duties,<sup>4</sup> the Authority has decided not to direct a Modification to the BSC.

<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 P158RR, Version No. Final/1.0, dated 15 June 2004

<sup>3</sup> The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of 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;
- 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.

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

## **Background**

A LoC is a letter issued by a bank or other lending institution promising payment to a third party in accordance with the terms of the agreement. In the context of the BSC LoCs guard against Parties which fall into Credit Default causing financial loss to other market participants. The Code only contains provisions for a Trading Party to apply for a single LoC (Annex M-1), thus preventing a Party owning more than one BSC Party ID<sup>5</sup> lodging consolidated credit cover against the group of Trading Parties. The proposer believes this to be a defect within the current drafting of the BSC.

In order to rectify this situation, British Gas Trading (BGT) submitted Modification Proposal P158, "Introducing the Ability to Lodge a Consolidated Letter of Credit" on 27 Jan 2004.

## **The Modification Proposal**

Modification Proposal P158 seeks to modify the BSC so as to allow a group of affiliated BSC Parties to lodge a single consolidated Letter of Credit (LoC). The use of a consolidated LoC is not considered common commercial practice, although the Group noted that one had been used by the former company TXU in the gas industry. The Group noted that when one party within the group of companies covered by the Letter of Credit was unable to make payments, its structure was such that the entire LoC was called by Transco. The Group therefore considered it appropriate that the allocated amounts of Credit Cover under any consolidated LoC developed under P158 should be 'ring-fenced' to individual Parties according to BSC Party ID, allowing amounts to be treated individually. The Group considered that to do otherwise would lead to additional issues regarding credit checking and default.

The Group determined that only Parties defined as affiliated companies using the definition of a 'trading party group' for the purpose of BSC voting<sup>6</sup> would be eligible to lodge a consolidated LoC. It was decided that although a solution to allow non-affiliated groups of companies to lodge a consolidated LoC could be developed, affiliation would provide a greater level of assurance in terms of the level of risk market participants could potentially be exposed to, should a Party to go into default.

Under P158 a BSC Party (the 'umbrella company') would obtain a proposal for a consolidated letter of credit from a bank on behalf of a group of BSC Parties and then submit a consolidated LoC application to the FAA. The affiliation status of the companies concerned would then be checked by

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<sup>4</sup> 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.

<sup>5</sup> The BSC Party Id is a unique Id given to each BSC Party under Section A 4.3.3 of the Code.

<sup>6</sup> Pursuant to Annex B2 'Election of Industry Panel Members', in which section 3.1.5 defines a Trading Party Group to as a *Trading Party and every affiliate of that Trading Party* (emphasis added).

the FAA against the Companies House register, and if the FAA deemed this group affiliated the consolidated LoC would be approved.

The Group considered whether a consolidated LoC would be less robust than a series of single LoCs. To this end advice was sought from an external legal advisor as to whether the consolidated LoC could be legally robust. The advisor indicated that although it should be noted what was being suggested constituted a relatively untested methodology, the consolidated LoC could be legally robust. The Group also sought advice from a LoC expert who considered that although an untried document, the consolidated LoC could be robust.

Two banking sources were consulted as to whether they would be willing to offer a consolidated LoC. One of these sources (provided by the Proposer) confirmed it would be willing to enter into such an agreement, whilst the other (provided by the FAA) asserted it would not due to the extra workload involved and noted the potential risks of the entire LoC being frozen. The possibility of the consolidated LoC being frozen which could arise if a defaulting Party applied for a court order, preventing the bank from paying which could lead to the whole letter being frozen, was considered by the Group, which identified the following areas of risk:

- where either one Party or all the Parties covered by a consolidated LoC goes into Payment Default and the credit cover for the Party/ies is frozen as a result of a flaw in the drafting of the consolidated LoC. If a consolidated LoC were less robust than a single LoC this would constitute an increased risk to the market, which would have to pay a share of any of the unsecured liabilities arising, and
- where a Party covered by a consolidated LoC goes into Payment Default and the entire letter is frozen, whilst the other Parties do not enter Payment Default, those Parties would have their Credit Cover set to zero, an event which the Group considered may lead them into credit default which in turn could lead to the publication of that Party's name on the BSC website and have the effect of causing Volume Notifications to be rejected.

The Group concluded that there would be a slightly increased risk of a court freezing a consolidated LoC as opposed to a single LoC. The Group noted advice to the effect that the proposed consolidated LoC was robust but considered that this advice was not based on empirical evidence.

The majority of the Group were of the view that Proposed Modification P158 would not better facilitate achievement of Applicable BSC Objective (c). A proportion of this majority were of the opinion that, although P158 does not better facilitate the Applicable BSC Objectives, P158 would not necessarily increase risk; the remainder of the majority were of the opinion that P158 would increase risk.

Group opinion that P158 posed an increased risk and would not better facilitate the Applicable BSC Objectives:

- there is a relative lack of historical evidence to suggest that a consolidated LoC has been utilised in the past. Whilst acknowledging the external legal advice obtained by BSCCo, some members of the Group were of the opinion that the drafting of the consolidated LoC does not provide an equal level of assurance when compared to the current single LoC;

- the untested methodology of the consolidated LoC process could potentially weaken the existing LoC process and jeopardise the markets' confidence in LoCs and therefore impose a barrier to entry. The Group also felt that a new process would be inherent of risk;
- the provider may potentially exploit loop-holes in the consolidated LoC. This could result in the provider not honouring the LoC and therefore potentially subjecting the rest of the market to the risk of having to settle the outstanding liabilities of a defaulting Party. The Group felt that this was an example of the potential risks that could be introduced as a result of implementing P158 and strengthens the argument that it would have a negative impact on competition;
- that any amendments made to a consolidated LoC would be carried out purely by the Umbrella Company and not by the individual Parties covered by the LoC. This could potentially be seen as detrimental to the flexibility of the current LoC amendment process. However, in relation to this point the SSMG noted that a Party's decision to lodge a consolidated LoC would be a voluntary and commercial decision and the strength of this argument could be weakened by the fact that applicants should consider these issues prior to lodging a consolidated LoC; and
- that although there were potential savings for Parties renewing multiple LoCs, this benefit was outweighed by the risks associated with the consolidated LoC.

Group opinion that P158 would not increase risk, but did not better facilitate achievement of Applicable BSC Objectives:

- that although there were potential savings to Parties, it was considered that this benefit was limited to specific types of Parties and was not sufficient to better facilitate achievement of Applicable BSC Objective (c); and
- that the uncertainty created by the perceived risks identified by some participants outweighs any efficiency savings to Parties.

The minority of the Group (the Proposer) was of the view that P158 would better facilitate achievement of Applicable BSC Objective (c) by promoting competition. The following arguments were expressed in support of this view:

- that P158 offers existing Parties and those entering the market a more efficient mechanism for sourcing Credit Cover;
- that P158 offers Parties the ability to reduce administration costs by reducing the number of LoCs and labour resources used to lodge and refresh LoC on behalf of its BSC Parties. This minority view also acknowledged that this benefit, albeit small, was significant for those Parties who wished to lodge a consolidated LoC;
- that there were no additional risks associated with the consolidated LoC, as BSCCo had sought advice from an external legal advisor as well as from an external LoC expert. Both of which confirmed that the consolidated LoC was robust; and

- that potential loop holes could equally exist under the current single LoC.

This minority therefore concluded that P158 would improve competition by increasing efficiency of the credit arrangements for Parties using consolidated LoCs, with no impact on risk and no change to the level of protection for Parties.

The cost benefits identified by way of consultation and considered by the Group included an incremental cost<sup>7</sup> for P158 of £13,600 and a per-party cost savings estimated at between £500 and £11,000 per annum.

### **Responses to ELEXON Consultation**

ELEXON published a draft Modification Report on 20 May 2004, which invited respondents' views by 12:00 on Friday 28 May 2004. Eight (8) responses were received. One (1) response (representing 1 Party and 0 non-Parties) expressed support for the Proposed Modification, Five (5) responses (representing 43 Parties and 1 non-Party) opposed the Proposed Modification and the remaining Party (representing 1 Party) provided a "no comment" response.

Four of the respondents commented to the effect that P158 exhibited a combination of potentially high risks and minimal benefits, such that they did not consider themselves able to support the implementation of the Modification.

Another respondent noted that the benefits of P158 would only be available to large players, and even in this class likely uptake was thought to be limited. Raising a related issue a further respondent commented that P158 had the potential to increase risk to small players even though they were excluded from accessing the benefits the Modification might bring about.

Two respondents noted the unknown element of the proposals, commenting that the Modification Proposal was based on untested methodologies and would be subject to operational unknowns.

One respondent raised its concern that the legal status of a consolidated LoC is such that the providers of the letters would seek to exploit any potential loop-hole or legal uncertainty to avoid honouring the LoC, potentially exposing other market participants to increased costs.

One response encapsulated the arguments in favour of the Modification Proposal that were put forward in the Group.

The respondents' views are summarised in the Modification Report for Modification Proposal P158, which also includes the complete text of all respondents' replies.

### **Panel's recommendation**

The Panel met on 13 May 2004 and considered Modification Proposal, the draft Modification Report, the views of the Modification Group and the consultation responses received.

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<sup>7</sup> The cost of adding that Modification Proposal to the scope of an existing release.

The Panel recommended that the Authority should reject the Proposed Modification but that, if approved, the Proposed Modification should be implemented on 3 November 2004 should an Authority decision be received on or before 30 July 2004, or 23 February 2005 should an Authority decision be received after that date but before 12 November 2004.

## **Responses to Ofgem GB Consultation**

On 5 December 2003 Ofgem undertook to invite responses on additional implications that a Proposed Modification may have, were it to be applied on a GB wide basis, as opposed to being limited to England and Wales. In order to discharge this undertaking Ofgem published a GB Consultation Paper on 25 May 2004 which invited respondents' views by 5pm on Monday 21 June 2004. No responses were received.

The Consultation Paper, the responses to it and other related documents can be found on the *BETTA GB Consultation* section of the Ofgem website.<sup>8</sup>

## **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 Proposed Modification P158 would not better facilitate achievement of the Applicable BSC Objectives.

Modification Proposal P158 has the potential to provide benefits for certain Parties. Whilst this is the case, Ofgem understands these benefits are relatively small comparative to the cost of implementation and notes that these benefits only accrue to a limited number of large players and as such could introduce an element of discrimination as the implementation costs will not be appropriately targeted.

Ofgem also considers that whilst a very unlikely event, a default arising from a problematic consolidated LoC would be likely to be very material.

Therefore on this occasion Ofgem considers that the balance of benefit and risk associated with Modification Proposal P158 is such that it can not be adjudged to better facilitate the Applicable BSC Objectives.

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

Yours sincerely,



**Nick Simpson**  
**Director, Modifications**

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

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<sup>8</sup> <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>