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The National Grid Company, BSC Signatories and
Other Interested Parties

23 March 2004

Our Ref: MP No P142

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P142 **"Minor refinement to allow a Level 2 Default Cure period in defined circumstances"**

The Gas and Electricity Markets Authority (the "Authority")¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P142, "Minor refinement to allow a Level 2 Default Cure period in defined circumstances".

The BSC Panel (the "Panel") recommended to the Authority that:

- The Proposed Modification P142 should be made; and
- The Implementation Date should be 3 November 2004, if an Authority determination is received before or on 23 March 2004, or 23 February 2005 if Authority determination is received after that date but before or on 13 July 2004.

Having carefully considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives and the Authority's wider statutory duties,³ the Authority has decided to direct a Modification to the BSC in line with Modification Proposal P142.

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 BSC in line with Modification Proposal P142, as set out in the Modification Report.

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

² ELEXON document reference MPR142 Version No. 1.0, dated 20 January 2004.

³ 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.

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

Background

Energy Indebtedness is a megawatt-hour figure, which is translated into a percentage of the Party's Credit Cover lodged with BSCCo known as the Credit Cover Percentage (CCP). If the Energy Contract Volume Aggregation Agent determines that the CCP for a Trading Party has exceeded 90% the Trading Party is considered, subject to an authorisation by ELEXON, to be in Level 2 Credit Default. This has implications for Energy Contract Volume Notifications and Metered Volume Reallocation Notifications which will be refused and rejected during the Credit Default Refusal and the Credit Default Rejection Periods⁴ applied during a Level 2 Credit Default. Such rejections expose the Party concerned to potentially significant imbalance charges.

It was the Proposer's assertion that due to restrictions on banking hours it is infeasible to take effective action to post monies in order to resolve a Level 2 Credit default occurring outside of normal business hours. It was further contended by the Proposer that a lack of sufficient liquidity on the traded power exchanges, should this occur around the time of Default, may reduce the opportunities available to the Party to trade out of that position.

This combination of restrictions may mean that a Party which breaches 90% CCP over a weekend or Public Holiday period may not be able to extricate themselves from this circumstance, even if they are financially sound and wish to resolve the breach.

In order to rectify this situation, Total Gas & Power Ltd submitted Modification Proposal P142, "Minor refinement to allow a Level 2 Default Cure period in defined circumstances" on 29 August 2003.

The Modification Proposal

Modification Proposal P142 seeks to modify the BSC so as to allow a Trading Party which has fallen into Level 2 Credit Default outside of normal business hours and whose CCP exceeds 90% but remains below 100% to post additional funds at the start of the next business day. This would be achieved by the introduction of a Level 2 Credit Default Cure Period, considered to expire at 12.00 hours on the next Business Day.⁵ Prior to the expiry of the Cure Period, the Trading Party would not be considered to be in Level 2 Credit Default, meaning that the Credit Default Refusal and Rejection Periods would not commence.

⁴ The Credit Default Refusal Period is from Gate Closure for the Settlement Period for which a Trading Party's CCP became greater than 90% (referred to as Settlement Period J in section M of the BSC) and ends at the Gate Closure for the Settlement Period after the one for which Credit Cover Percentage becomes less than 90% again. Section P of the BSC states that, during this period, only Energy Contract Volume Notifications and Metered Volume Reallocation Notifications which reduce the Energy Indebtedness of the Trading Party in Level 2 Credit Default may be accepted by ELEXON.

The Credit Default Rejection Period is from the third Gate Closure after the Gate Closure for Settlement Period J (referred to as Settlement Period J+3 in Section M of the BSC) to Gate Closure for the third Settlement Period after the one for which CCP becomes less than 90%. Section P of the BSC states that during this period, any Energy Contract Volume Data or Metered Volume Reallocation Data for any Settlement Period that does not decrease the Energy Indebtedness for that Settlement Period of the Trading Party in Level 2 Credit Default will be disregarded. This is despite the fact that the notification may have been previously accepted.

⁵ The BSC Agent processing window has been included within the cure period meaning that payment must be made by 11.00 hours.

Modification Proposal P142 was introduced to allow Trading Parties the opportunity to lodge additional Credit Cover during banking hours. The justification for the Modification Proposal was that it would better facilitate achievement of the Applicable BSC Objectives⁶ C3 (3) (c) and (d).

The Panel considered the Initial Written Assessment at its meeting of 11 September 2003 and agreed to submit Modification Proposal P142 to the Assessment Procedure. The Modification Proposal was considered by the Settlement Standing Modification Group (the "Group").

During the Assessment Procedure for Modification Proposal P142, the Group met on 17 September 2003, 21 October 2003 and 18 November 2003. The Group undertook one consultation and one impact assessment from the BSC Parties, BSC Agents, BSCCo and the Transmission Company. The Group concluded that Modification Proposal P142 would not dilute the deterrent effect of Level 2 Credit Default or expose the market to unnecessary risk, but would better facilitate Applicable Objective (c) by:

- Reducing incentives for the over-provision of Credit Cover thus reducing the opportunity cost of excessive collateral being lodged for this purpose. It was the Group's view that this would not only benefit existing Parties but could also reduce barriers to entry through a decrease in the amount of collateral required for Credit Cover for new Parties.
- Removing perverse incentives upon a Party whose Credit Cover exceeds their estimated Trading Charges, but who has breached 90% CCP outside business hours, to potentially submit commercially undesirable Volume Notifications purely to reduce their CCP.
- Reducing the necessity of a Party breaching 90% CCP to trade out of this position in defined circumstances. It was the Group's view that this may reduce the likelihood of trades to avert Credit Default being provided to Market Index Data Providers, and therefore increase the likelihood that the Energy Imbalance Price calculated from Market Index Data is representative of short-term prices for energy ahead of Gate Closure in the forwards and spot markets.

The Panel considered the Assessment Report for Modification Proposal P142 at its meeting on 11 December 2003. At this meeting the Panel did not agree with the Group's recommendation. The Panel concluded that the costs related to the implementation and operation of Modification Proposal P142 would outweigh any benefits and provided an initial recommendation that it should not be made. ELEXON published a draft Modification Report and associated industry consultation on 19 December 2003 which invited respondents' views by 6 January 2004.

⁶ 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.

ELEXON consultation respondents' views

9 responses were received. 5 responses (representing 26 Parties, did not support the Panel's provisional recommendation that Modification Proposal P142 should not be made, 3 responses (representing 20 Parties) supported the Panel's provisional recommendation that Modification Proposal P142 should not be made and the remaining respondent, representing one Party, provided a "no comment" response on the Panel's provisional recommendation.

Of those who supported the Panel's initial decision, one respondent, which had previously supported the aim of Modification Proposal P142, agreed with the Panel's initial view that the purported benefits of the Modification Proposal would be outweighed by the costs of implementing and administering the new arrangements. Another respondent stated that it agreed with the Panel's view that Modification Proposal P142 should not be made as it did not consider allowing a default cure period to last a further two hours into the next Business Day would better achieve the applicable BSC Objectives. The respondent considered that the result would be to extend the risk posed by a party in Level 2 Credit Default a further two hours into the next business day, and would not incentivise those Parties to manage their risk position with a view to minimising their exposure and the cost of their credit cover. The third respondent in support of the Panel's initial recommendation questioned whether any previous events of default would have benefited from the additional time had it been available. Accordingly the respondent considered that the high cost of Modification Proposal P142 could not be justified by the intangible benefits the Modification would provide.

Several respondents supporting the implementation of Modification Proposal P142 considered that the Modification provided the appropriate balance between protecting the market from exposure to the unpaid Trading Charges of a Party, and enabling a financially sound party to resolve Credit Default circumstances without being exposed to significant imbalance charges. Two responses commented that denying a party which has inadvertently entered a Level 2 Credit Default the opportunity to correct that breach could result in significant damage being done to its reputation. This was suggested to be a critical intangible benefit. It was further suggested that publication of the default on the BMRA website could cause counterparties to mistakenly believe that the company concerned was a bad credit risk and refuse to trade with it, exacerbating the situation. A further comment stated that the current arrangements incentivise Parties to provide excessive Credit Cover in order to avoid the risk of falling into Level 2 Credit Default as a result of being unable to post additional Credit Cover outside business hours. In this respondent's view implementing Modification Proposal P142 would remedy this situation and realise a net benefit to the market, offsetting the implementation costs of the modification.

The respondents' views are summarised in the Modification Report for Modification Proposal P142, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 15 January 2004 and considered Modification Proposal P142, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel considered the arguments in favour of Modification Proposal P142 made by respondents to the consultation and also a clarification of its implementation costs. As a result of refinements made to the arguments by respondents and also clarification of the of the implementation costs, the Panel overturned its previous provisional recommendation. The Panel agreed by a majority a final recommendation that Modification Proposal 142 should be made.

The Panel recommended that the Authority should approve the Proposed Modification and that, if approved, the Proposed Modification should be implemented 3 November 2004, if an Authority determination is received before or on 23 March 2004, or 23 February 2005 if Authority determination is received after that date but before or on 13 July 2004.

Ofgem GB Consultation respondents' views

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 7 January 2004 which invited respondents' views by 5pm on Tuesday 3 February 2004. One response (representing 1 Party) was received; the response opposed the Proposed Modification.

The contents of the response covered similar areas to those addressed in the ELEXON consultation. It did not identify any implications Modification Proposal P142 may have were the Modification Proposal to be implemented on a GB basis rather than in England and Wales.

The Consultation Paper, the responses to it and other related documents can be found on the *BETTA GB Consultation* section of the Ofgem website.⁷

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 Proposal P142 will better facilitate the achievement of Applicable BSC Objective C3 (3) (c).

When compared to the continuous operation of the competitive electricity market, the hours of business in the banking community are limited. Ofgem considers that the particular circumstances identified by Proposed Modification P142 illustrate a potential restriction on a Trading Party's ability to resolve a Level 2 Credit Default occurring outside banking hours by lodging additional Credit Cover. Proposed Modification P142 will alleviate this restriction by providing Parties additional flexibility to resolve an inadvertent breach of the Level 2 Credit Default provisions within the BSC without significantly increasing the risks faced by other market participants. In doing so these measures should promote effective competition in the generation and supply of electricity and facilitate the achievement of Applicable Objective (c).

Ofgem recognises the concern raised through a response to industry consultation that Modification Proposal P142 could extend the risk posed by a defaulting Party to the market a

⁷ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

further two hours into the next business day. Ofgem considers that the circumstances in which the provisions introduced by Modification Proposal P142 could be used are limited, meaning that any such extension will be a rare occurrence. In addition, the impact of extending such a risk is mitigated by the increased stability provided to the market gained by safeguarding against a situation in which a company is mistakenly presented to the market as a bad credit risk through the publication of the Default on the BMRS website. This should promote a stable trading environment through the provision of accurate market data; also better facilitating Applicable Objective (c).

The costs of implementing and maintaining the provisions introduced by Modification Proposal P142 could be significant. Ofgem is concerned that as the Modification seeks to alleviate a rarely exposed defect in the way the provisions of the Code interact with commercial realities external to it, that efforts are made to keep implementation costs to a minimum. Notwithstanding this, Ofgem is satisfied that in the long term direct cost savings to the industry will accrue, as companies will be able to sensibly match credit cover requirements to real exposures. The Authority accepts this is currently difficult to achieve, as companies may feel pressured into the over-provision of credit in order to avoid the consequences of a Level 2 Credit Default. Thus despite the infrequent occurrence of the circumstances highlighted and the initial costs of implementing the Modification, Ofgem considers that the potential cost savings in the longer term mean that Modification Proposal P142 will reduce the costs of market operation incurred by parties, better facilitating competition in the generation and supply of electricity and reducing barriers to market entry.

The purpose of retaining Credit Cover is to provide adequate protection for situations in which an individual Party accumulates significant liabilities. In addition it is intended that the circumstances which flow following the realisation of a Credit Default should be an effective tool to incentivise parties to manage their risk and deter the inadequate provision of credit. Ofgem considers that the implementation of Modification Proposal P142 will not significantly reduce the deterrent effect of Level 2 Credit Default, as the treatment of 100% CCP breaches will remain unchanged.

Conclusion

Ofgem considers that Proposed Modification Proposal P142 will better facilitate the achievement of Applicable BSC Objective C3 (3) (c).

Yours sincerely,

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

Nick Simpson
Director of Modifications

The Authority's decision

The Authority has therefore decided to direct that the Proposed Modification P142, 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 Implementation Date for Modification Proposal P142 is 3 November 2004.

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 Nick Simpson on the above number.

Yours sincerely,

A handwritten signature in black ink, appearing to read "J. Neilson". The signature is written in a cursive style with a long horizontal stroke at the beginning.

John Neilson
Managing Director, Corporate Affairs

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