

November 2003

Modification Proposal P142 Consultation Document

**Modification Proposal P142 'Minor refinement to
allow a Level 2 default cure period in defined
circumstances'**

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1 INTRODUCTION

This document provides background information on Modification Proposal 142 'Minor refinement to allow a Level 2 default cure period in defined circumstances' ('P142'). The background information provided is as follows:

- History of the Proposal
- Description of the Proposal
- Principles of Credit Cover and the Energy Indebtedness calculation
- Initial Assessment of the Proposal
- Proposal Requirements
- Initial conclusions of the SSMG

Responses to the consultation proforma should be sent to modifications@elexon.co.uk by 12.00 on Monday 17 November 2003.

2 HISTORY OF THE PROPOSAL

P142 was raised by Total Gas & Power Ltd on 29 August 2003 (reference 1). ELEXON presented an Initial Written Assessment (reference 2) to the Balancing & Settlement Code Panel ('the Panel') at its meeting on 11 September 2003. The Panel agreed with the recommendation in the IWA that P142 should be submitted to a three month Assessment Procedure to be carried out by the Settlement Standing Modification Group (SSMG). The Assessment Report is scheduled to be presented at the Panel meeting on 11 December 2003.

The Panel noted the following issues brought to its attention in the IWA and determined that these form the Terms of Reference for the SSMG:

- whether P142 would impact the number and type of 90% CCP breaches;
- if P142 will impact whether a Party chooses to actively manage its CCP position;
- whether P142 would increase the complexity of Section M provisions whilst decreasing the deterrent of Level 2 Credit Default;
- whether Parties should be allowed a default cure period to rectify instances of 90% CCP breaches in addition to their ongoing right to manage their positions so that they do not breach 90% CCP;
- whether changes will be required to the authorisation notice (pursuant to Section M3.4) in order to separate the application of Level 1 and Level 2 Credit Default conditions;
- the need to conduct a full impact assessment on BSC Agent systems and documents. In particular, to determine whether a manual solution to implementing P142 would be possible or if ECVAAs system changes will be required;
- if there would be a need to change ECVAAs and BMRA software, as well as the scope and likely cost of such changes;
- the need to conduct a full impact assessment on FAA systems and documents, in particular to determine whether the FAA/ECVAAs interface can implement changes to Credit Cover within prescribed timescales;
- the need to establish whether the two hour period should be applied purely to payments through specified mechanisms; and
- how the Modification Proposal would affect Parties going into Level 2 Credit Default overnight or over the weekend.

3 DESCRIPTION OF THE PROPOSAL

P142 proposes that where a Trading Party's Credit Cover Percentage (CCP) exceeds 90% but remains below 100% outside normal business hours then a Level 2 default cure period shall exist. This default cure period shall last until two hours into the next Business Day. Prior to the expiry of the Level 2 default cure period, the Trading Party shall not be considered to be in Credit Default and the Credit Default Refusal and Rejection Periods shall not commence.

3.1 Rationale for the Proposal

The purpose of this default cure period is to allow the Trading Party the opportunity to lodge additional Credit Cover during banking hours.

The Proposer contends that, due to restrictions on banking hours, it is currently not feasible for a Party to resolve a Level 2 Credit Default outside business hours by lodging additional Credit Cover. The Proposer further suggests that a lack of sufficient liquidity on the traded power exchanges at such times may reduce the opportunities available to the Party to trade out of Credit Default.

It is argued that this combination of restrictions may mean that a Party who 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. A consequence of this is that they may be exposed to significant imbalance charges should a Credit Default Rejection or Refusal Period commence. The consequences of a Credit Default Rejection Period or a Credit Default Refusal Period are prescribed in Section M3.3 of the Code, and are also outlined in Section 4 of this document, but may be briefly summarised as a restriction on the ability of the Party to lodge new contract notifications that do not decrease Credit Cover Percentage in the case of the former, and an ongoing rejection of components of existing contract notifications that do not decrease Credit Cover Percentage in the case of the latter.

It is contended that the intention of Credit Default procedures, to provide protection for the market against exposure to the unpaid Trading Charges of a Party in genuine financial difficulties, needs to be pragmatically balanced against the ability of a financially sound BSC Party to resolve Credit Default circumstances without being exposed to significant imbalance charges. The Proposer suggested that P142 better achieves this balance and therefore better facilitates Applicable BSC Objectives (c) and (d)¹.

4 PRINCIPLES OF CREDIT COVER AND THE ENERGY INDEBTEDNESS CALCULATION

The current Credit Default provisions are detailed in Section M3 of the Code. The following summary is intended as a simplified high level explanation and not a definitive statement of the application of the rules to all circumstances.

Under the current trading arrangements, payments to and from Trading Parties in respect of Trading Charges arising on any particular Settlement Day are made, on average, twenty-nine calendar days later. Thus, at any given time, Trading Parties may have debts (or be due payments) in respect of Trading Charges incurred, on average, over the previous twenty-nine days. The purpose of Credit Cover is to ensure that, should a Trading Party default on payments, sufficient collateral is available to pay these debts.

Following Gate Closure for each Settlement Period, the Energy Contract Volume Allocation Agent (ECVAA) calculates the Credit Cover Percentage (CCP) for each Party. The CCP expresses their Energy Indebtedness, which is an approximation of their expected Trading Charges for the last 29 days, as a percentage of the amount of Credit Cover they have lodged.

¹ Legal advice given to ELEXON states that Applicable BSC Objective (d) is concerned with costs incurred by the BSCCo and therefore passed on to BSC Parties.

Should this CCP exceed defined thresholds then the Credit Default provisions specified in Section M3 of the BSC will be triggered, in order to prevent the market from being exposed to unsecured liabilities.

Credit Default is split into two levels, which are separately explained below.

4.1.1.1 LEVEL 1 CREDIT DEFAULT

Level 1 Credit Default provisions are triggered when a Party's CCP exceeds 80%. The ECVAA will issue a level 1 default notice to the Trading Party indicating that this threshold has been breached and that a Query Period has commenced. This Query Period will expire 24 hours and 5 minutes after the time that the ECVAA records this email has been sent.

At any time during the Query Period, the Trading Party may give a default query notice to the ECVAA indicating that it considers that its CCP has been determined erroneously, providing information to support its view.

If a default query notice has been lodged, the ECVAA will review its calculation for the relevant Settlement Period and redetermine it at the end of the Query Period. If the CCP is recalculated and is found to be not greater than 80%, no further action will be taken.

If no default query notice has been lodged and the Party's CCP is not greater than 75% in relation to any Settlement Period during the Query Period, again no further action will be taken.

If neither of the preceding conditions are met, a default cure period will commence upon the expiry of the Query Period and will expire at 24:00 hours on the first Business Day after the day on which the Query Period expired.

If the Party's CCP is not greater than 75% in relation to any Settlement Period during the default cure period, no further action will be taken.

If the CCP has been greater than 75% in relation to all Settlement Periods within the default cure period, then subject to an authorisation notice being in force in relation to that Trading Party pursuant to M3.4 of the Code, the Trading Party shall be in Level 1 Credit Default. The ECVAA will notify the Party that it is in Level 1 Credit Default and post a notice on the BMRS stating this fact as soon as reasonably practicable.

4.1.1.2 LEVEL 2 CREDIT DEFAULT

Level 2 Credit Default provisions are triggered when a Party's CCP exceeds 90%.

In this circumstance, subject to an authorisation notice being in force in relation to that Trading Party pursuant to M3.4 of the Code, the Trading Party shall be in Level 2 Credit Default. The ECVAA will notify the Party of this and post a Level 2 Credit Default statement on the BMRS as soon as practicable.

A Credit Default Refusal Period will commence immediately and will expire upon Gate Closure for the first subsequent Settlement Period where the CCP for the Trading Party becomes not greater than 90%. During the Credit Default Refusal Period any energy contract submitted that does not decrease the CCP of the Trading Party will be refused by the ECVAA in its entirety.

A Credit Default Rejection Period will commence at J+3, where J is the Settlement Period where the 90% CCP breach occurred, and will expire at Gate Closure for the third Settlement Period after the first subsequent Settlement Period in relation to which the CCP for the Trading Party becomes not greater than 90%. Any contract notifications already validated will be treated as rejected, and will have no effect, as to notification data which relates to Settlement Periods for which Gate Closure falls within the Credit Default Rejection Period.

This is shown diagrammatically in Figure 1 below. It should be noted that the Credit Default Rejection Period is applied with a short prospective time lag. The ECVAAs will read all components of ECVNs and MVRNs that are applied to the Settlement Period that is three Settlement Periods after the one for which Gate Closure has just passed. The ECVAAs will reject components for that Settlement Period that do not decrease the Energy Indebtedness of the Party in Credit Default. This means the counterparty has a three Settlement Period window in which to lodge an alternate notification to replace the volume rejected. Figure 1 assumes that there is no material doubt upon the calculation that would constrain the BSCCo from issuing an authorisation notice upon the expiry of the Query Period. Clause K3.4.3(a) of the BSC states that the BSCCo may not issue an authorisation notice to the ECVAAs earlier than the expiry of the Query Period.

The reference to the Query Period lasting for 24 hours and 5 minutes results from the interaction of the BSC and the Communications Requirement Document (reference 4), which is a Code Subsidiary Document. Clause M3.2 of the BSC states that the Query Period ends 24 hours after the time at which the level 1 default notice is treated as received by the Trading Party. Clause 3.2 of the Communications Requirement Document states that a level 1 default notice is treated as received 5 minutes after the ECVAAs issues it.

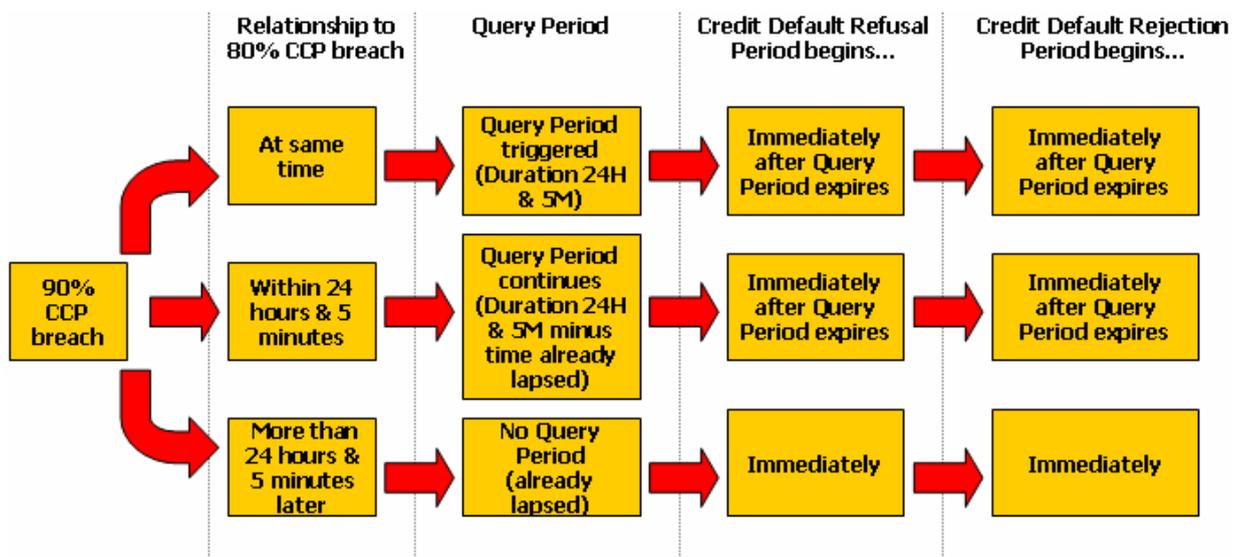


Figure 1: Timings for the application of Credit Default Refusal and Rejection Periods under the current rules

4.1.1.3 INTERACTION BETWEEN LEVEL 1 AND LEVEL 2 CREDIT DEFAULT

Level 1 and Level 2 Credit Default constitute discrete provisions within the Code, however it should be noted that there is an element of mutual linkage when considering the actions that the ECVAAs can take.

Parties breaching 90% CCP will have triggered a Level 1 Query Period in the course of reaching this CCP level and this Query Period may have expired or be ongoing at the time of the 90% CCP breach. This Query Period may overlap all, part or none of a Business Day dependent on the time it was triggered. M3.4 of the Code stipulates that a Trading Party cannot be in Credit Default unless BSCCo has issued an authorisation notice to the ECVA in relation to them. M3.4.3 goes on to state that such authorisation may not be given earlier than the expiry of the Query Period.

A primary consequence of this is that a Party cannot enter authorised Level 2 Credit Default within 24 hours and 5 minutes of being notified that they have breached the Level 1 Credit Default threshold. This means that a Party breaching the 90% CCP threshold will always have had some prior external warning that their CCP had reached high levels prior to the commencement of Credit Default Refusal or Rejection Periods. They are guaranteed some opportunity to address the Level 1 Credit Default during a Business Day due to the default cure period. They may, or may not, have some opportunity to address the Level 2 Credit Default during a Business Day dependent on the time period covered by their Query Period.

It should be noted that ELEXON has found that in cases where CCP breaches 90%, this frequently occurs within 24 hours and 5 minutes of an 80% CCP breach, resulting in some or all of a Query Period being honoured before Credit Default Refusal or Rejection Periods commence. This may have resulted in an industry perception that an explicit Query Period exists for Level 2 Credit Default. This is not the case.

5 INITIAL ASSESSMENT BY THE SSMG

5.1 Definition of normal business hours

'Business hours' is not a defined term within the BSC although Business Day and Working Day are. The definition of Business Day within the BSC is that it 'Means a day (other than a Saturday or a Sunday) on which banks are open in London for general interbank business in Sterling and, in relation to payment in euro, any such day when in addition the Trans European Automated Real-time Gross Settlement Express Transfer System is operating'. Working Day 'shall have the same meaning as Business Day'.

The FAA Service Description defines Working Day as 'the hours between 8:00am and 6:00pm Monday to Friday excluding bank or other public holidays in England and Wales'.

SSMG agreed that a two hour default cure period within business hours should be considered to expire at 11:00am on a Business Day. This was based upon common agreement that ordinary banking hours should be considered to be 09:00am to 17:00pm on a Business Day. For the avoidance of doubt, references to a two hour default cure period within this Consultation Document should therefore be taken to mean one that expires at 11:00 am on a Business Day.

It should be noted that the SSMG is seeking views upon the precise duration of the default cure period via the consultation questions.

5.2 Thresholds

The SSMG agreed that P142 was specifically targeted at defined circumstances where CCP exceeds 90% but remains below 100% outside business hours.

No change is suggested to the treatment of >100% CCP breaches. The SSMG was in agreement that there is a logical basis for different treatment of CCP breaches within the 90 - 100% bracket. This is because CCP breaches within this bracket may currently result in the refusal or rejection of contract notifications despite the affected Party having Credit Cover in excess of their estimated Trading Charges. This is not the case with 100% CCP breaches.

No change is proposed to Level 1 Credit Default provisions applied to 80% CCP breaches as it is not contended that a defect exists in their treatment.

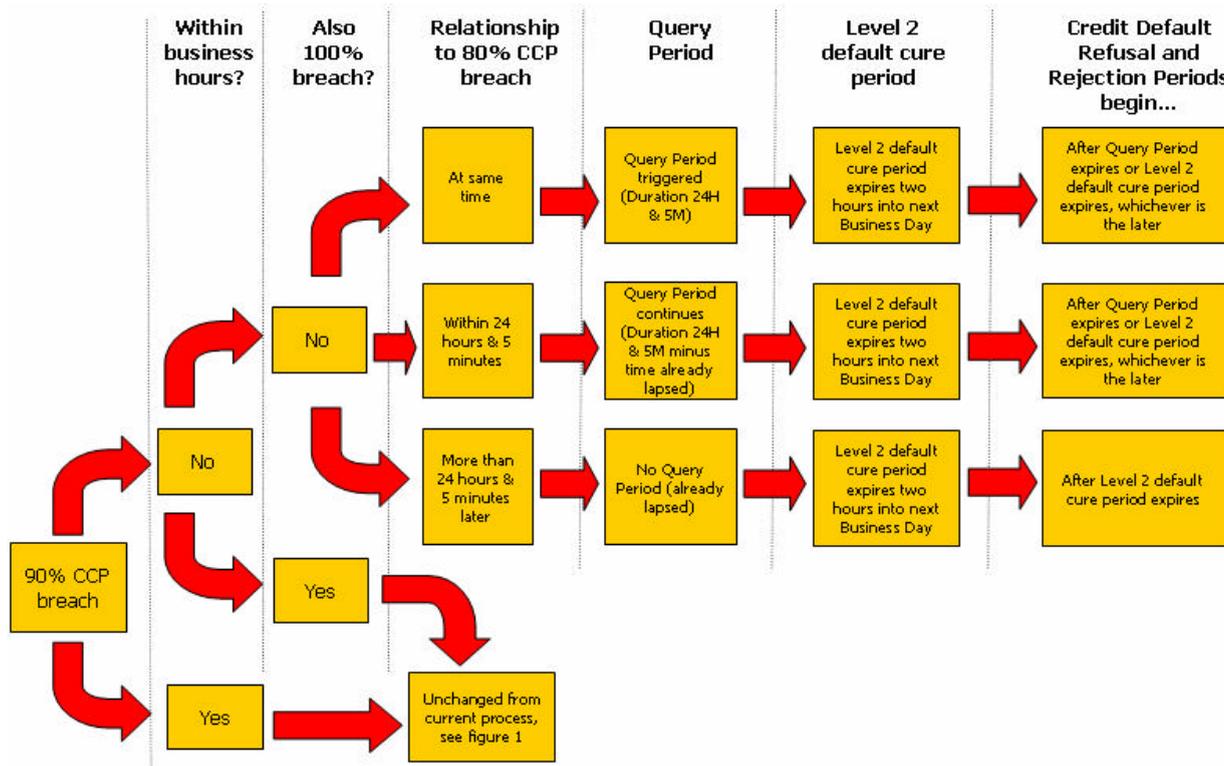
5.3 Use of Query Period to address 90% CCP breaches

It was identified that Parties breaching 90% CCP will have triggered a Level 1 Query Period in the course of reaching this CCP level and that this Query Period may have expired or be ongoing at the time of the 90% CCP breach. It was further identified that this Query Period may overlap all, part or none of a Business Day dependent on the time it was triggered.

The SSMG agreed that the intention of P142 is to address the circumstance where a Query Period does not overlap a Business Day. The SSMG further agreed that P142 is not intended to be applied where the Query Period overlaps an entire Business Day, as the Party breaching 90% CCP would have had an opportunity to lodge further Credit Cover prior to the expiry of the Query Period. The SSMG did not reach an initial agreement with regard to whether the P142 solution should be applied where a Query Period overlaps part of a Business Day.

The proposed process is shown diagrammatically in Figure 2 below. Explanations regarding application of Credit Default Rejection Period and Query Periods and the

Figure 2: Timings for the application of Credit Default Refusal and Rejection Periods under the proposed P142 rules



assumption of absence of material doubt remain in common with the Figure 1 scenario detailed in section 4.1.1.2 of this document.

5.4 Analysis of benefits

During their first two meetings to discuss P142, the SSMG reached a number of provisional findings on the benefits of P142.

The SSMG agreed that P142 did not dilute the deterrent effect of Level 2 Credit Default as the treatment of 100% CCP breaches would remain unchanged, and Parties would therefore still be incentivised to ameliorate high levels of CCP to avoid the risk of contract refusal or rejection. Additionally, P142 provides that where a Level 2 default cure period lapsed without the Party taking action to reduce their CCP below 90% that they should be considered to be in Level 2 Credit Default with a Credit Default Rejection and Refusal Periods triggered. The SSMG therefore did not believe the market would be exposed to risk by P142.

The SSMG considered that P142 may facilitate more effective competition in the market upon several grounds.

It may reduce incentives for the over-provision of Credit Cover. P142 seeks to avoid the circumstance whereby a Party may enter authorised Level 2 Credit Default with a CCP of under 100% and without having had an opportunity to lodge additional Credit Cover since triggering the Query Period. Parties may be providing excessive levels of Credit Cover in order to avoid the risk of this occurrence. P142 may provide assurance that will allow Parties to lodge Credit Cover at more realistic levels.

The easing of such incentivisation towards over-provision of Credit Cover may also remove a barrier to entry to the market by reducing the collateral needed by a new market entrant.

Additionally, the SSMG considered that P142 may ameliorate perverse incentives on trading behaviour resulting from Level 2 Credit Default. The SSMG considered that under the current baseline, where no default cure period exists for Level 2 Credit Default, a Party breaching 90% outside business hours may be left with no alternative but to trade out of their position. This may result in the Party adopting a non-optimal trading position purely to manage their CCP. The SSMG considered that this would be unfair on a Party whose CCP remained below 100% as they would be constricted in their ability to trade freely despite having Credit Cover in excess of their estimated outstanding Trading Charges.

The SSMG further noted that the lack of an alternative to the Party beyond trading out of their position may impact upon System Buy and Sell Price (SBP/SSP) volatility as they may engage in trades with the Market Index Data Providers (MIDPs) with little flexibility on whether to accept energy prices quoted.

6 PROPOSAL REQUIREMENTS

6.1 Requirements Specification

The SSMG agreed that Detailed Level Impact Assessments should be sought after the first meeting in order to establish indicative costs and suggested solutions. It was further agreed that the solutions suggested should not be overly prescriptive, as this would give the BSC Agents greater scope for identifying a robust and cost effective approach.

The SSMG did not consider any explicit alternative Modifications at its first two meetings but sought to provide a number of alternative options for how P142 could be given effect in order to establish a range of indicative costs and implementation approaches. Three explicit options are identified within the document 'Requirements Specification for Modification Proposal P142 'Revised Credit Cover methodology for Interconnector BM Units'' (reference 3).

6.2 Initial response from BSC Agents

The NETA Central Service Agent has provided initial change specific estimates of between £52,000 and £118,000 to implement the ECVAA changes for P142, dependent on upon whether a semi-manual workaround or fully automated approach is adopted. These estimates are identical regardless of which of the three stated implementation options outlined in the Requirements Specification (reference 3) was pursued.

The Funds Administration Agent (FAA) has provided an initial change specific estimate of £2,000 to implement the FAA changes for P142.

The BSCCo (Service Delivery) has provided an initial change specific estimate of £8,800.

The above estimates do not include any release costs. These could not be easily quantified until confirmation exists of whether P142 changes would be batched with other BSC Systems changes as part of a scheduled release.

7 INITIAL CONCLUSIONS

On the basis of the foregoing the SSMG has provisionally concluded the following:

- P142 would not dilute the deterrent effect of Level 2 Credit Default or expose the market to unnecessary risk.
- P142 would facilitate more effective competition by:
 - reducing incentives for the over-provision of Credit Cover and therefore reduce the opportunity cost of excessive collateral being lodged for this purpose. This would not only benefit existing Parties but also potentially reduce barriers to market entry through a decrease in the amount of collateral required for Credit Cover for new Parties; and
 - remove 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 contract notifications purely to reduce their CCP.
- P142 would reduce the necessity of a Party breaching 90% CCP to trade out of this position in defined circumstances. This may reduce the likelihood of trades to avert Credit Default being entered into with Market Index Data Providers, and therefore increase the likelihood that the Energy Imbalance Price calculated from Market Index Data (MID) is representative of short-term prices for energy ahead of Gate Closure in the forwards and spot markets.
- For the above reasons, the SSMG initially concluded that P142 would better facilitate Applicable BSC Objective (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’.

The SSMG was minded that were the BSC Agents to quote similar costs across the three suggested implementation options detailed in ‘Requirements Specification for Modification Proposal P142 ‘Revised Credit Cover methodology for Interconnector BM Units’’ (reference 3), that Option 3 would be preferred. This option was considered preferable as it maximises the proportion of the two hour default cure period available to the Party in which to lodge additional Credit Cover.

II ANNEX 1 - DOCUMENT CONTROL

a Authorities

Version	Date	Author	Signature	Change Reference
0.1	23/10/03	Change Delivery		Initial Draft
0.2	29/10/03	Change Delivery		Updated for SSMG review
1.0	03/11/03	Change Delivery		Updated for Consultation

Version	Date	Reviewer	Signature	Responsibility
0.1	23/10/03	Change Delivery		Peer review
0.2	29/10/03	Change Delivery		SSMG review
1.0	03/11/03	Change Delivery		Consultation

b Distribution

Name	Organisation
Each BSC Party	Various
Each BSC Agent	Various
The Gas and Electricity Markets Authority	Ofgem
Each BSC Panel Member	Various
energywatch	energywatch
Core Industry Document Owners	Various

c Related Documents

Ref.	Title	Owner	Issue date	Version
1	Modification Proposal P142	Total Gas & Power Ltd	29/08/03	1.0
2	P142 Initial Written Assessment (IWA P142)	ELEXON	05/09/03	1.0
3	Requirements Specification for Modification Proposal P142 'Revised Credit Cover methodology for Interconnector BM Units'	SSMG	03/10/03	1.0
4	Communications Requirements Document	ELEXON	24/06/03	7.0

d Intellectual Property Rights and Copyright

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III ANNEX 2 – MODIFICATION GROUP

The Panel agreed with the recommendation in the IWA that the Settlement Standing Modification Group (SSMG) be convened to progress P142, as the Modification's subject matter falls within the remit of its Terms of Reference. The table below indicates the membership of the SSMG that is considering P142.

MEMBER	ORGANISATION
Roger Salomone (Chairman)	ELEXON
Richard Hall (Lead Analyst)	ELEXON
Sharif Islam (Proposer)	Total Gas & Power Ltd
Mark Manley	Centrica
Paul Jones	Powergen
Mark Pearce	National Grid Company
Joanne Ellis	Cornwall Consulting
Jerome Williams	Ofgem
Steve Drummond	EDF Trading Ltd