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Direct Dial: 020 7901 7491

22 April 2005

Our Ref: MP No P178

The National Grid Company, BSC Signatories and
Other Interested Parties

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and notice in relation to Modification Proposal P178: "Reduction in the BSC withdrawal timescale for parties who have settled the vast majority of their trading debts"

The Gas and Electricity Markets Authority (the "Authority")¹ has considered the issues raised in the Modification Report² in respect of Modification Proposal P178, "Reduction in the BSC withdrawal timescale for parties who have settled the vast majority of their trading debts".

The BSC Panel (the "Panel") recommended to the Authority that Proposed Modification P178 should not be made and that Alternative Modification P178 should not be made. In the event that the Authority determines that either the Proposed Modification or the Alternative Modification should be made, then the Implementation Date should be 29 June 2005 if and Authority decision was received on or before 9 March 2005, or 2 November 2005 if an Authority decision was received after 9 March 2005 but on or before 6 July 2005.

Having considered the Modification Report, the Panel's recommendation and having had regard to the Applicable BSC Objectives,³ the Authority has decided not to direct a modification to the BSC.

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

² ELEXON document reference P178RR, Version No. 1.0, dated 14 January 2005

³ 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.

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

Background

The current criteria for withdrawal from the BSC requires Parties to wait for both the payment date arising from the final determination of its BSCCo Charges, and for the payment date arising from the Final Reconciliation (RF) Settlement Run relating to the Party's last Settlement Day to pass. This means that a Party must remain a Party to the BSC for approximately 14 months⁴ after it ceases trading.

Until a Party is permitted to withdraw from the Code it must pay any Reconciliation Charges or BSCCo charges which accrue to it. If a party fails to pay any of these charges it is deemed to be in default of the BSC. In the event that BSCCo is unable to recover those amounts from the defaulting Party they are recouped by smearing the costs across all other Parties.

It is also possible for a body formerly a Party to the BSC to accrue Reconciliation Charges after its withdrawal from the BSC as a result of a Post Final (DF) Settlement Run or an Extra Settlement Determination (ESD). The BSC provides that such a Party remains liable for those amounts and would be pursued for payment by BSCCo. As above, amounts which can not be recovered by BSCCo are recouped by smearing the costs across all Parties to the BSC.

The Proposer suggested there were three substantive defects in the current requirement to remain a BSC Party until RF:-

- The 14 months which a Party must wait before it can withdraw from the BSC was suggested to be an unnecessary and onerous requirement on Non-Supplier Trading Parties, as such Parties will have settled the vast majority of their Reconciliation Charges by the second Reconciliation Settlement (R2) Run;
- It was suggested that unwarranted legal liabilities upon Non-Supplier Trading Parties exist as a result of a Party continuing to be bound by new obligations introduced via modifications to the Code after the party has ceased to be operational in the market but before it can withdraw from the code at RF; and
- The current withdrawal timescales were thought to result in administrative inefficiencies across the market, particularly for withdrawing Parties.

In order to rectify this situation, Uskmouth Power Company Limited (the Proposer) submitted Modification Proposal P178, "Reduction in the BSC withdrawal timescale for Parties who have settled the vast majority of their trading debts" on 4 October 2004 on the grounds it would better facilitate achievement of Applicable BSC Objectives C3 (3) (c) and (d).

The Panel considered the Initial Written Assessment at its meeting of 14 October 2004 and agreed to submit Modification Proposal P178 to a two month Assessment Procedure by the

⁴ 291 Business Days after the Party's last trades

Settlement Standing Modification Group (the “Group”). Two Modification Group meetings were convened.

The Modification Proposal

Modification Proposal P178 seeks to modify the BSC so as to allow Non-Supplier Trading Parties to withdraw from the Code on a voluntary basis after the second reconciliation run (R2) instead of waiting until after RF, providing the withdrawing Party met all the other withdrawal criteria defined in Paragraph A5.1.3 and that a refundable cash “withdrawal deposit” was lodged with the FAA as security against its estimated Reconciliation Charges between R2 and RF.

Several options were considered for the calculation of the deposit. The Group considered it appropriate to carry forward the model based on the P152 calculation for the reduction of Credit Cover and provided for a “ratchet” mechanism for the recovery of additional amounts from the withdrawn Party, if the deposit proved to be insufficient to cover the actual charges.

The Proposed Modification also amends the current BSC requirement for a Withdrawing Party to remain a Party until the final determination of BSCCo Charges for the BSC Year in which its last Settlement Day fell, such that a Non-Supplier Trading Party could withdraw after R2 having paid only those BSCCo Charges accrued by its Withdrawal Date. BSCCo would invoice the withdrawn Party for any further adjustments in its share of Annual Net Main Costs following the final determination of BSCCo Charges at the end of the BSC Year.

The Proposer argued that ease of exit from a market is as important as ease of entry as a means of encouraging competition and that by providing a more simple and expeditious withdrawal route for those Parties which have paid the vast majority of their bills by R2, P178 better facilitated Applicable BSC Objective (c). The Proposer further contended that P178 would benefit Applicable Objective (c) by reducing the administrative burden which the current arrangements place upon withdrawing Parties, other Parties to the BSC, the FAA and BSCCo. It was also suggested that the Proposed Modification would reduce the risk of unpaid reconciliation charges having to be recouped from other Parties as these would have been pre-paid. In relation to Applicable BSC Objective (d) the Proposer suggested that P178 would reduce the effort expended by BSCCo pursuing small amounts of money and allow it to more appropriately target resources on Parties who are operational in the market.

The majority view expressed by the rest of the Modification Group in relation to Applicable Objective (c) suggested that:

- It was not possible to accurately estimate the extent of the Reconciliation Charges which may accrue to a Party between R2 and RF, and although P178 contained a ratchet mechanism for requesting additional payments there was a risk that a Withdrawn Party could either refuse to pay or be unable to pay, leading to the amount being spread across all remaining Parties.
- The provisions within the BSC allowing a Party to lodge cash with the FAA as pre-payment towards its Trading Charges and enabling a Party to reduce its Credit Cover to the minimum amount mean that a Party may simplify its exit without increasing the risks on other parties. The majority of the Group felt that this meant the requirement to remain a Party until RF would not have a negative effect on Applicable BSC Objective (c).

- Any potential barrier to entry created by preventing Parties from withdrawing from the BSC prior to RF could be considered less of a barrier to entry than the potential impact of allowing some Parties to withdraw after R2.
- Withdrawing Parties may also fail to pay any invoices resulting from future adjustments of BSCCo charges, thus increasing the risk to the rest of the market.
- The deposit would not guarantee a withdrawing Party a financial settlement at R2 as it may receive requests for additional sums as a result of the ratchet mechanism until RF, or as a result of DF Runs or ESDs occurring after RF. The majority of the Group considered this reduced the value of P178 to a Withdrawing Party.

The majority of the Group also considered that P178 failed to better facilitate achievement of Applicable BSC Objective (d) on the grounds that

- The requirement to issue confirmation notices for VAT purposes after R2 would reduce any potential savings for the FAA.
- The wider costs of implementing and operating the Reconciliation Charges deposit would outweigh any costs savings for the FAA.
- The cost savings of not having to invoice Parties for small amounts between R2 and RF would be outweighed by the ELEXON implementation and operational costs for P178.

The Alternative Modification developed by the Group was essentially the same as the Proposed Modification differing only due to the addition of two further withdrawal criteria. The first of these stipulated that a Withdrawing Party seeking to withdraw after R2 but before RF must also have paid the Base Monthly Charge for the months between its Withdrawal Date and the payment date associated with its final RF run. The second required such a Party to have lodged a refundable cash deposit to cover the estimated future adjustments in its share of the Annual Net Main Costs in the BSC Year in which its last Settlement Day fell.

The majority of the Group considered that the Alternative Modification was superior to the Proposed Modification on the grounds that it would reduce the risk of non-payment of some elements of a Withdrawing Party's BSC Charges through the addition of a second deposit and by reducing the administrative burden on the Withdrawing Party of dealing with some elements of BSCCo Charges after R2. Whilst this was the case the majority of the Group considered that the alternative Modification would still have a negative impact on Applicable BSC Objectives (c) and (d), when assessed against the current baseline of the BSC, as it would retain the other disadvantages perceived to be associated with the Proposed Modification.

The minority view of the Group expressed by the Proposer also largely reflected the arguments offered in relation to the Proposed Modification, although the Proposer suggested that the Alternative Modification had the advantage of reducing the administrative effort on the Withdrawing Party to manage some elements of BSCCo Charges accruing after R2, thus increasing its capacity to facilitate the achievement of Applicable Objective (c). The Proposer also considered that the Alternative Modification would provide an additional benefit against Applicable Objective (d) by further reducing the burden on BSCCo to invoice and pursue small amounts in the period between R2 and RF.

Respondents' views

ELEXON published a draft Modification Report on 14 December 2004, which invited respondents' views by 23 December 2004. 6 responses were received. No responses expressed support for the Proposed Modification, 5 responses (representing 40 Parties) opposed the Proposed Modification and the remaining 1 response (representing 1 Party) provided a "no comment" response.

One respondent commented that potential new entrants are more likely to accede to the Code if they have assurance that fellow participants are likely to participate in the longer term and therefore more likely to settle their bills, rather than join, trade for a short period, then exit the market, potentially leaving behind unpaid liabilities. The respondent therefore believed that the Proposed Modification would be detrimental to competition. The respondent also believed the proposed deposit mechanism would result in more work and costs for the BSCCo and would therefore reduce the efficiency of the Code.

Another respondent stated there could be no accurate methodology for estimating a Party's future liabilities with the result that remaining parties could be exposed to bad debt. The respondent considered that this could not be seen to better facilitate competition.

Another respondent argued that there could be no guarantee that remaining Parties would not become liable for any unforeseen charges incurred after one Party's withdrawal. The respondent cited the Emergency Instruction issued on 19 May 2004⁵ as an example of how it is not possible to predict future charges.

The respondents' views are summarised in the Modification Report for Modification Proposal P178, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 13 January 2005 and considered Modification Proposal P178, the draft Modification Report and the consultation responses received.

The Panel recommended that the Authority should reject the Proposed Modification and the Alternative Modification but that, if approved, the Proposed or Alternative Modification should be implemented on 29 June 2005 if an Authority decision is received on or before 9 March 2005, or 2 November 2005 if an Authority decision is received after 9 March but on or before 6 July 2005.

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem agrees with the BSC Panel that neither the Proposed Modification nor Alternative Modification P178 would better facilitate achievement of the Applicable BSC Objectives.

There may be circumstances in which it is desirable to allow a withdrawing Party to be free of its obligations under the Code at an earlier point than the current withdrawal criteria permit. Whilst

⁵ NGC Instruction re Damhead Creek 19.05.04

this is the case it is Ofgem's view that, in the circumstances described during the assessment of P178, it is appropriate for a Party to fully discharge all of its liabilities incurred as a result of being Party to the Code before it is permitted to withdraw.

At present, it is not possible to accurately calculate these liabilities earlier than the current withdrawal criteria allow. Ofgem does not consider it appropriate to allow a Party in the circumstances envisaged by P178 to withdraw before the estimations can be more accurately confirmed. Ofgem notes the Modification Proposal provides for a "ratchet" mechanism under which additional liabilities could be calculated and subsequently billed to a Withdrawn Party, but is concerned that the process suggested in P178 may not provide the necessary assurance of payment.

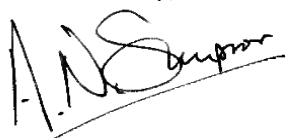
Ofgem considers that the potential additional risk of unpaid liabilities of Withdrawn Parties being smeared across remaining market participants, and the lack of confidence in the operation of the balancing arrangements which this may engender, outweighs the benefits P178 offers, in terms of the promotion of competition in the generation and supply of electricity, by providing a faster exit route for Parties seeking to withdraw from the BSC. Whilst it is not possible to guarantee that BSC Parties will always pay their liabilities and never default, it is Ofgem's view that, on balance, it is preferable to reject the solution developed within P178 as the current arrangements retain a reasonable level of assurance that the liabilities of withdrawing parties will be met in full.

Ofgem notes that although P178 may potentially reduce some of the administrative tasks presently required under the Code it also introduces other administrative tasks, the number of which increase if the deposit calculation is underestimated or if a Party defaults on payment. As a result Ofgem does not consider that the achievement of Objective (d) is better facilitated overall.

Section M2.3 provides a mechanism within the current baseline for Parties to apply for a reduction of their credit cover. The operational realities of the BSC have also developed an informal mechanism in which some Parties choose to lodge a cash deposit with the FAA as a form of prepayment of their Trading Charges.⁶ Ofgem considers that either of these mechanisms might be utilised by a Party seeking to withdraw from the BSC in order that the process of withdrawal can be simplified and that doing so would enable such a party to gain some of the administrative benefits contained in P178. Parties may also wish to consider whether it is appropriate to codify the existing informal arrangements to make them more formal.

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

Yours sincerely,

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

Nick Simpson
Director, Modifications

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

⁶ Trading Charges are defined within the BSC as Daily Party Period BM Unit Cashflows, Daily Party BM Unit Period Non-Delivery Charges, Daily Party Energy Imbalance Cashflows, Daily Party Information Imbalance Charges, Daily Party Residual Settlement Cashflow, and Daily System Operator BM Cashflows (in each case as determined in accordance with Section T); and where the context requires includes Reconciliation Charges in accordance with Section N.