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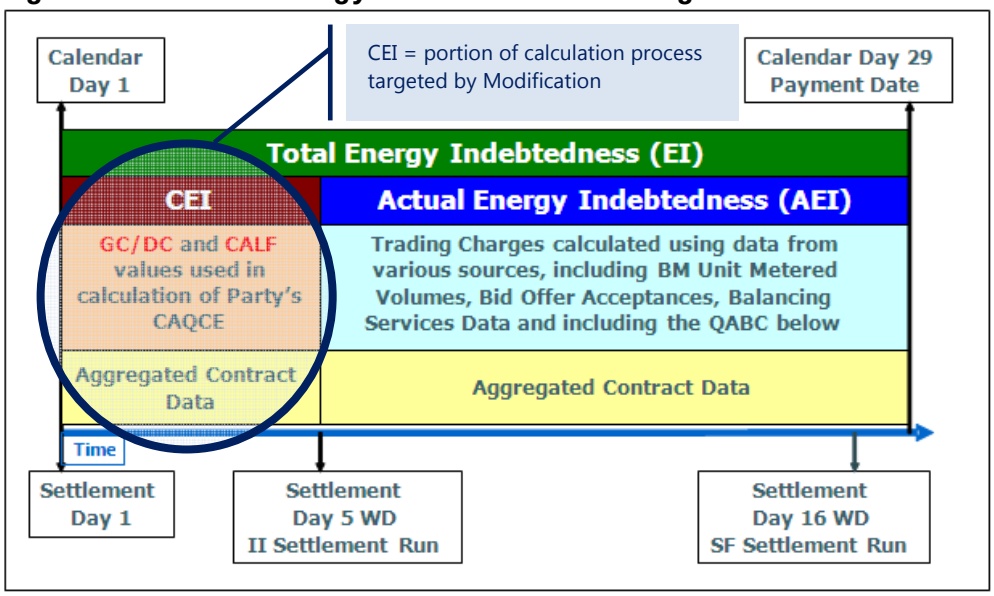
| Modification proposal: | **Balancing and Settlement Code (BSC) P215: 'Revised Credit Cover Methodology for Generating BM Units' (P215)** | | |
| Decision: | The Authority[1] directs that this proposal be made[2] | | |
| Target audience: | National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties | | |
| Date of publication: | 23 April 2008 | Implementation Date: | 25 June 2009 |

## Background to the modification proposal

This modification was raised by Uskmouth Power Limited on 27 July 2007, and seeks to revise the provisions regarding Credit Cover in the BSC for electricity generators. As part of the BSC, parties are required to lodge credit that covers their Energy Indebtedness (EI) due to balancing actions over a 29 day period. At present, EI is calculated using expected flow information (CEI[3]) for the first 5 Settlement Days and more firm data (Actual Energy Indebtedness) for the remainder of the 29 Calendar Day period. See Figure 1 below.

**Figure 1: Current Energy Indebtedness Arrangements**




Source: Modification Report for Modification Proposal P215; 17 March 2008; pg 5

The value derived from the CEI calculation is often inaccurate, estimating expected generation based on flows from the same day and time from the previous year. As such, this can result in parties having to lodge levels of credit that do not reflect their true generation position. If this calculation under-securitises their position, the market as a whole can be at risk if the generator is unable to cover the difference between their estimated EI and their true position at the end of the 29 day period. Conversely, if the party is required to lodge more credit than necessary, this can tie-up capital resources, which is inefficient and can be particularly onerous for smaller generators.

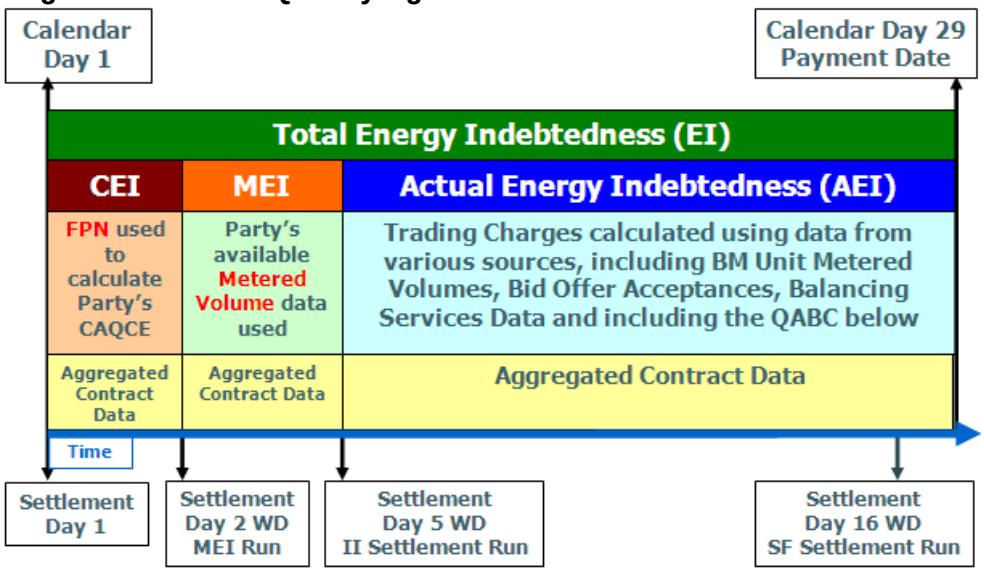
[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] CEI (Credit Assessment Energy Indebtedness) is based on generation flows and information on actual flows from that time in the previous year.

## The modification proposal

*Proposed Modification*: The Proposed Modification seeks to amend the BSC so that CEI for generators classed as Credit Qualifying Balancing Mechanism (BM) Units[4] would be calculated using Final Physical Notifications (FPNs), instead of a combination of generation capacity and historic flow information as is used currently. The Proposed Modification is intended to increase the accuracy of the CEI, and hence the overall EI, of a party.

*Alternative Modification*: The Alternative Modification also seeks to amend the calculation of CEI for generators classed as Credit Qualifying BM Units. Under the Alternative Modification, CEI calculations for CVA Registered Qualifying BM generators would be calculated using a combination of FPNs (for the first 2 Settlement Days only, instead of the 5 envisaged under the Proposed Modification) and Metered Volumes (for Settlement Days 3-5 of the 29 day EI period). See Figure 2 below.

**Figure 2: P215 Alternative Energy Indebtedness arrangements for CVA-Registered Credit Qualifying BM Units**




Source: Modification Report for Modification Proposal P215; 17 March 2008; pg 9

## BSC Panel[5] recommendation

The Draft Modification Report was considered by the BSC Panel at its meeting on 14 February 2008. The unanimous view of the Panel was that both the Proposed Modification and the Alternative Modification would better facilitate the achievement of Applicable BSC Objectives against the current baseline. However, they agreed a unanimous recommendation to the Authority that the Alternative Modification should be approved because it would better facilitate the Applicable BSC Objectives when compared to the existing code baseline as well as the Proposed Modification. Please see Section 5 of the Final Modification Report (FMR) [6] for full details.

[4] A BM unit shall be considered a Credit Qualifying BM Unit if it is obliged to submit Physical Notifications due either to obligations placed on it under the Grid Code (e.g. they generate over 100 KW) or because it has elected to take part in the Balancing Mechanism. However, interconnectors are not included.
[5] The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC.
[6] BSC modification proposals, modification reports and representations can be viewed on the ELEXON website at www.elexon.com

## The Authority's decision

The Authority has considered the issues raised by the modification proposal and the FMR dated 17 March 2008. The Authority has considered, and taken into account, the responses to Elexon's[7] consultation, which are attached to the FMR. The Authority has concluded that:

1. implementation of either the Proposed or the Alternative Modification will better facilitate the achievement of the relevant objectives of the BSC[8];
2. implementation of the Alternative Modification will best facilitate the achievement of the relevant objectives of the BSC as compared with the current baseline and the Proposed Modification; and
3. directing that the Alternative Modification be made is consistent with the Authority's principal objective and statutory duties[9]

## Reasons for the Authority's decision

The Authority considers that both the Proposed and Alternative Modification would better facilitate the Applicable BSC Objectives as compared with the current baseline. Each would result in a more accurate calculation of credit that generators are required to lodge. However, the Authority's view is that the Alternative Modification should be approved because it would best facilitate the Applicable BSC Objectives compared to both the Proposed Modification and the current baseline. We set out the reasons for our views below.

*Evaluation against BSC Objectives*

The Authority agrees with the Panel that both the Alternative and Proposed Modifications would have a neutral impact on Applicable BSC Objectives (a) and (b)[10].

*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 Authority considers that the Proposed Modification would better facilitate the achievement of Objective (c) over the current baseline.

Analysis shown in the FMR suggests that using FPN data, as outlined by the Proposed Modification, instead of historic data to calculate CEI would result in a more accurate EI calculation than the current methodology. This would ensure a better relationship between the amount of credit generators are obliged to provide and their actual indebtedness.

We further consider that the Alternative Modification would best facilitate the achievement of Objective (c), over both the current baseline and Proposed Modification. Under the Alternative Modification actual Metered Volume data would be used along with FPNs to calculate credit cover for CVA Registered Credit Qualifying generators after

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[7] The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.
[8] As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=4151
[9] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989.
[10] *Objective (a): 'The efficient discharge of the licensee of the obligation imposed upon it by this licence'; and Objective (b): 'The efficient, economic and coordinated operation of the GB transmission system'.*

Settlement Day 2 through to the end of Settlement Day 5. We consider that the methodology for the EI calculation as set out in the Alternative proposal represents a more accurate reflection of the level of risk associated with a generator defaulting relative to the current baseline and the Proposed Modification, thereby increasing the benefits described above.

In particular, we consider that the methodology set out in the Alternative modification provides for a more accurate calculation of credit requirements as these would be based upon more up to date and dynamic parameters (i.e. FPNs and actual metered volumes) that more closely reflect actual indebtedness.

Increasing the accuracy of the credit calculation will allow both individual generators and the market as a whole to benefit from more accurate market incentives. In respect of the market as a whole, any improvement in the calculation of credit cover will result in a reduction in overall market risk caused by the potential failure of companies who are under securitised, hence reduceing a potential barrier to entry.

Individual generators also benefit from increased accuracy of the EI calculation because this reduces any excessive costs incurred by generators when they lodge credit (such as the costs of securing credit and/or tying up existing financial resources). These costs can be particularly significant for smaller generators. The more accurate and predictable calculation of EI under the Alternative Modification would reduce the need for generators to have such large and variable lines of credit. This in turn leaves generators better able to predict and manage costs related to credit cover, which may promote competition by making it easier for existing generators to remain in the market, and encourage new entrants into generation.

We note evidence presented in the FMR that both the Alternative and Proposed Modifications may result in the credit cover required from generators being systematically under-securitised[11]. Whilst the analysis provided does not give us reason for particular concern, as the under securitisation is marginal, and closely tracks actual indebtedness, this is something we expect ELEXON and the BSC Panel to keep under review, and flag, if appropriate. However, we consider the risks to the market resulting from slight systemic under-securitisation are outweighed by the benefits of the overall increased accuracy and predictability of EI calculations. Therefore, the Proposed Modification would be an improvement over the current baseline, which arbitrarily over or under-securitises credit and is subject to much greater volatility within its credit calculation. The risks of under-securitisation are further reduced in the Alternative Modification by the use of Metered Volume data to increase accuracy of the credit calculation for CVA Registered Credit Qualifying generators.

*Objective (d): 'Promoting efficiency in the implementation and administration of the balancing and settlement arrangements'*

We consider that both the Proposed and Alternative Modification would better facilitate the achievement of Objective (d) over the current arrangements. However, we again consider that the Alternative Modification would best facilitate this objective over the Proposed Modification.

The Alternative Modification would facilitate Objective (d) by increasing the efficiency and accuracy of the EI model. Under both the current calculation of CEI and under the Proposed Modification, the CEI does not reflect Bid-Offer Acceptance (BOA) action and plant outages associated with the relevant settlement period. The use of Metered

[11] Modification Report for Modification proposal P215: 'Revised Credit Cover Methodology for Generating BM Units'; 17 March 2008; pg 18, Figure 5.

Volume data within the EI calculation as outlined in the Alternative Modification would ensure that any such actions or outages for CVA Registered Credit Qualifying BM Units are included within the CEI calculation for the period for which this data is used. For these generators the Alternative Modification feeds Metered Volumes into the EI calculation for Settlement Day 3, 4 and 5. This means outages and other events that occur after Gate Closure are more quickly incorporated into the EI calculation; and are, therefore, reflected in the amount of credit CVA generators must lodge. As a result, in the case of BOA action and plant outages, the credit calculation is likely to be more accurate under the Alternative Modification than the Proposed Modification.

Ofgem also considers that the increased accuracy of the CEI calculation in both the Proposed and Alternative Modifications is likely to reduce the need for CALF appeals (the mechanism by which parties can appeal their energy indebtedness). In both cases the portion of the estimated CEI calculation that relies on CALF values would be replaced by more accurate and up-to-date estimates in the form of FPNs with the Proposed Modification, or both FPNs and actual Metered Volumes with the Alternative Modification. This would in turn, reduce the administrative burden on ELEXON, who administer CALF appeals.

We note the view expressed by one respondent, that using FPNs to calculate credit cover may create some financial incentive to misrepresent FPNs. This modification relies on the accuracy of FPNs, which generators have historically submitted for the purpose of system balancing. The respondent raised concerns that intentional mis-reporting of FPNs by qualifying generators could result in an increase in overall system imbalance and hence have a negative impact on the facilitation of Objective (d). We note that the Generation Licence requires licensees to comply with the Grid Code, and the Grid Code requires that the FPNs submitted must be accurate. Also, the benefit to generators from manipulating FPNs should be relatively limited, particularly under the Alternative Proposal, as FPNs will account for a relatively small proportion of the 29 day period, and metered flows will account for the bulk of how credit is calculated. We further note that the Panel would have the right, if it considered it appropriate, to review (and could request that the Transmission Company provide data to assist in such review) a Party's submission of FPNs. On balance, we are satisfied that the formal and informal measures currently in place are sufficient to deter the misrepresentation of FPNs for the purpose of manipulating EI calculations.

*Evaluation against Statutory Duties*

Approving the Alternative Modification is consistent with our principal objective and statutory duties; in particular our duties to protect consumers by promoting effective competition. This modification will reduce volatility around credit cover, which may ease cash flow constraints for generators. As noted by a Panel member, this may particularly benefit small generators, encouraging them to enter and remain in the market. This may also provide indirect security of supply benefits.

## Decision notice

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority, hereby directs that Alternative Proposal BSC 215: 'Revised Credit Cover Methodology for Generating BM Units' be made.

**Kersti Berge**
Head of GB Markets
**Signed on behalf of the Authority and authorised for that purpose.**