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National Grid Electricity Transmission plc,
BSC Signatories and Other Interested Parties

10 August 2006

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and direction in relation to Modification Proposal P197 “SVA Qualification Processes Review”

The Gas and Electricity Markets Authority (the “Authority”)¹ has considered the issues raised in the Modification Report² in respect of Modification Proposal P197, “SVA Qualification Processes Review”.

The BSC Panel (the “Panel”) recommended to the Authority that the Proposed Modification should be rejected and that the Alternative Modification should be approved.

Having considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives³ and the Authority’s wider statutory duties,⁴ the Authority has decided to direct a modification to the BSC in line with the Alternative Modification.

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 of the Electricity Act 1989 in relation to the direction.

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

² ELEXON document reference P197RR, Version No. 1.0, dated 13 June 2006

³ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of NGET’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 of the GB 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; and
- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

⁴ Ofgem’s statutory duties are wider than the matters that the Panel must take into consideration and are detailed primarily in the Electricity Act 1989 as amended, including by the Enterprise Act 2002; the Energy Act 2004; the Transitional Provisions; and the Utilities Act 2000.

Background

The BSC Review 2004 concluded that the risks associated with the Supplier Volume Allocation (SVA) arrangements had changed considerably since they were originally implemented in 1998. In particular, the BSC Review said that i) significant initial implementation risk no longer existed and ii) considerable experience had been gained by the operation of the SVA arrangements.

As a consequence of the findings of the BSC Review and concerns raised by Parties at an operational level, the Supplier Volume Allocation Group (SVG) endorsed an Operational Review of the SVA Qualification Processes. The Review's objectives were to i) specify the requirements for the SVA Qualification Processes, ii) identify changes that would improve the transparency, efficiency and effectiveness of the Qualification Processes and iii) draft/recommend changes that would give effect to identified improvements.

At its meeting on 29 November 2005, the SVG considered the findings of the Review⁵, which, following two industry consultations, proposed a new SVA Qualification Process.

In order to give effect to the new SVA Qualification Process, Laing Energy Ltd submitted Modification Proposal P197, "SVA Qualification Processes Review", on 12 December 2005.

The Modification Proposal

Modification Proposal P197 seeks to modify the BSC arrangements to address a number of issues relating to the current SVA Qualification requirements. These are:

- o The circumstances for market entry have changed considerably since the current qualification requirements were established in 1998;
- o There is significant overlap between the qualification and entry process requirements under the BSC and MRA; and
- o Existing BSC test scripts are very detailed but do not account for exception conditions.

Consequently P197 proposes two processes to address these issues – the 'Proposed' and 'Alternative' Modification. Each process would make changes to the BSC and associated BSCPs. For detailed descriptions of the processes and proposed changes to the Code and its subsidiary documents, please read the Final Modification Report which can be found on the Elexon website⁶.

In summary, the Proposed Modification intends to implement a two phase risk-based entry process. Phase 1 can be characterised by five activities – i) application, ii) explanation of process, iii) iterative self-assessment, iv) review and v) PAB decision. Phase 2 would consist of i) pre-entry testing (if required) and ii) PAB decision.

The Alternative Modification is a single phase risk-based entry process and is very similar to phase 1 of the Proposed Modification. The Final Modification Report identifies five main differences between the Proposed and Alternative Modification. They are:

- i. The responsibility for approving Qualification applications would lie with the Panel, however it would be expected that the Panel delegate this responsibility to a Panel Committee such as the PAB, SVG or ISG or a new Panel Committee;
- ii. Phases 1 and 2 of the process would be merged;
- iii. The applicant would be able to go to the Panel or its delegated authority at any point in the process

⁵ The SVA Qualification Processes Review Report can be found at www.elexon.com

⁶ www.elexon.com

- iv. Suppliers would not be required to re-qualify; and
- v. There would be no qualification limit for any participant.

Both processes also describe the circumstances that a party or non-party must re-qualify. In the Proposed Modification, all parties and non-parties would be required to re-qualify if they decided to i) implement a material change to their systems and processes or ii) increase the number of metering systems they are responsible for to above the limit they qualified for. The second circumstance only applies to party agents and supplier meter registration agents (SMRAs).

The Alternative Modification differs from the Proposed in two respects. First, suppliers would not be required to re-qualify and second, instead of a threshold limit, the need to re-qualify would be triggered if it was decided by the agent or SMRA to make a significant step-change in the number of registered metering systems; for example a percentage change.

The Panel considered the Initial Written Assessment at its meeting of 12 January 2006 and agreed to submit Modification Proposal P197 to the Assessment Procedure. The Group met 6 times during the Assessment Procedure and Assessment Consultations were issued to industry on 10 March 2006 and 05 April 2006. The Assessment Report was considered by the Panel at its meeting on 11 May 2006. The Group, in its Assessment Report, recommended that the Panel agree that the Proposed Modification should not be made, the Alternative Modification should be made and that P197 should be sent to the Report Phase⁷.

A draft Modification Report was issued for industry consultation on 16 May 2006. It contained the Panel's recommendation that the proposed modification should not be implemented but the alternative should and invited respondents' views by 30 May 2006.

Respondents' views

ELEXON published a draft Modification Report on 16 May 2006, which invited respondents' views by 30 May 2006. Nine responses were received to the consultation. Respondents' unanimously agreed that the proposed modification should not be made. In relation to the alternative modification, five respondents (representing 30 Parties and one non-party) supported it and four respondents (representing 24 Parties) opposed it.

Proposed Modification

There was unanimous support for not implementing the Proposed Modification. Respondents considered that it would not better facilitate any of the Applicable BSC Objectives.

Some respondents argued that the Proposed Modification was not robust enough and the Modification Group could have spent more time developing it. Consequently, it was considered that implementing the Proposed Modification could have the effect of loosening the entry requirements and potentially introducing gaps in the existing Performance Assurance Framework (PAF); for example the industry could become more reliant on detective and remedial assurance techniques.

Several respondents said that the Proposed Modification would be no less onerous than the existing entry process. For example it was considered by some that a two phase process would be unnecessarily bureaucratic and inflexible. Furthermore, it was

⁷ The Group's reasons for reaching this view are set out in detail in section 4 of its Assessment Report, also published on the Elexon website.

considered that the Proposed Modification did not warrant the costs and effort required to implement it.

Some respondents also said that including the requirement for suppliers to have to re-qualify was unjustified. Contrary to this view one respondent considered that the inclusion of terms for supplier re-qualification was an advantage of the process. They felt that because of their potential impact on Settlement (eg when completing a system migration or as a result of industry consolidation), suppliers should be subject to the re-qualification process.

Alternative Modification

Respondents who supported the Alternative Modification said foremost that it would reduce existing perceived barriers to entry. It would achieve this by implementing a risk based model which would be more appropriate, flexible and tailored to the current state of the market. Ultimately competition would benefit because applicants would be subject to a less onerous and costly entry process.

It was also considered that a Qualification Board, independent of the PAB, could be more efficient than the PAB. The majority of the Modification Group agreed that the creation of a Qualification Board would be advantageous because it could i) work more closely with an equivalent entry process board under the MRA, ii) operate without being constrained by the PAB's current terms of reference and iii) provide a clear distinction between the roles of assisting entry to and assessing compliance with the BSC.

Another area where respondents showed support for the Alternative Modification was in relation to the exclusion of suppliers from the re-qualification process. Respondents re-iterated the view that supplier re-qualification was unjustified. It was considered by a majority of the Modification Group that because suppliers' systems and processes only have a small direct effect on Settlement that it was disproportionate to require suppliers to have to re-qualify. Furthermore, other techniques available as part of the Performance Assurance Framework (PAF) would be more effective at resolving supplier related problems.

Respondents who did not support the implementation of the Alternative Modification argued that it i) would increase the level of market risk, ii) could undermine the existing PAB, iii) should have been developed in greater detail and iv) should have included suppliers in the re-qualification process.

Some re-iterated an argument used against the Proposed Modification, ie by loosening entry processes, market participants may be subject to greater risks and there may become a greater reliance on alternative assurance techniques. To highlight the potential increase in market risk one respondent drew attention to the number of data quality issues affecting the market. They expressed the view that industry processes are not well designed for rectifying problems retrospectively and beside education, supplier Qualification and re-qualification were the only other preventative measures available as part of the current PAF.

Another view that was expressed was that creating a separate Qualification Board could undermine the PAB. This was on the grounds that the PAB has over time developed extensive experience of market entry but also of operating the PAF.

Concerns were raised by some respondents in relation to the Modification Group's development of P197, ie the extent to which they considered alternatives, projects/reviews running in parallel to the modification (eg the PAF Review), the level of detail required to give effect to P197. One respondent said that elements of the current entry processes should not be removed but improved and better cost-benefit analysis

could have been performed. Some respondents considered that the Alternative Modification had not been developed in sufficient detail. In particular one respondent was concerned that although the Alternative Modification would allow Party Agents to voluntarily withdraw, there was no defined process. They said that such a process should be fully consulted on because there was the potential for it to have a detrimental effect on Settlement and the change of supplier process. One respondent expressed the view that the case for implementing the Alternative Modification was weakened because it may be superseded in future by changes recommended by the PAF Review.

Several respondents raised concerns to do with the re-qualification process; in particular the exclusion of suppliers from this process and the circumstances that trigger it. Several respondents (including one who supported the Alternative Modification) held the view that suppliers should not be excluded from the re-qualification process because market risks could increase as a result. As explained above, one respondent said that re-qualification is an effective preventative assurance technique that suppliers should be subject to. They also said that although suppliers may be required to re-qualify as a result of major industry change, experience shows that its inclusion as part of a modification often receives inadequate attention. It was also suggested that suppliers could end up qualifying to different baselines.

The current re-Qualification process can be triggered if a party agent exceeds an agreed threshold limit. The Alternative Modification intends to replace this with a step-change trigger, ie where a party agent plans to increase the number of meters registered to it by more than an agreed proportion. One respondent said that defining what a step change is in operational terms could be difficult. Another suggested that depending on the rate at which an agent grows (and therefore registers meters), they may need to serially re-qualify. It was also considered that the current trigger for re-qualification was preferable because a threshold could be objectively set; for example at a point when an agent would most likely upgrade its systems.

The respondents' views are summarised in the Modification Report for Modification Proposal P197, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 8 June 2006 and considered the Modification Proposal, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should reject the Proposed Modification, approve the Alternative Modification and, if approved, the Proposed or Alternative Modification should be implemented on 1 November 2007 if an Authority decision is received on or before 28 September 2006, or 28 February 2008 if the Authority decision is received after 28 September 2006 but on or before 25 January 2007.

Applicable BSC Objectives – the Panel's justification

The Panel unanimously recommended that the Proposed Modification should not be implemented. It was considered that it would not better facilitate any of the Applicable BSC Objectives because i) the process would not be robust enough, ii) loosening the entry requirements could lead to the PAF using alternative remedial techniques (as opposed to preventative), iii) the process could be as onerous as the existing process and iv) there is no justification for the re-Qualification process to include suppliers.

In relation to the Alternative Modification, the Panel unanimously recommended that it should be implemented. The Panel's justification was that it would better facilitate

Applicable BSC Objective (c) for the following reasons: i) the current process is over complicated and therefore forms a barrier to entry, ii) it would be more appropriate and flexible for the current market, iii) replacing the current threshold trigger with a step change trigger would be more efficient, iv) self assessment places an incentive on applicants to demonstrate their readiness for market entry, v) a specific Qualification Board would be more efficient and vi) the exclusion of suppliers from the re-Qualification process focuses the overall process on more appropriate risks.

Ofgem's view

Having considered the Modification Report and the Panel's recommendation, Ofgem considers that the Proposed Modification will not better facilitate the Applicable BSC Objectives. Conversely, Ofgem considers that the Alternative Modification will better facilitate achievement of Applicable BSC Objective (c) and is consistent with its wider statutory duties.

This Objective seeks to promote effective competition. Competition exerts necessary pressure on market participants to innovate and become more efficient. An effective way of encouraging new market entry and therefore competition is by reducing barriers to entry.

Proposed Modification

Ofgem agrees with the Panel's recommendation and considers that the Proposed Modification will not better facilitate any of the Applicable BSC Objectives.

Ofgem also shares the views of Respondents, the Modification Group and the Panel, that the Proposed Modification would not be an improvement on the current BSC baseline and reflective of current market maturity and experience. This is because the Proposed Modification would be as onerous as the existing process. In particular, there are two areas that are unnecessary and inefficient - i) the two phase approach, and ii) inclusion of suppliers in the re-Qualification process.

Because the PAB would need to make at least two decisions (ie at the end of each phase), Ofgem considers that a two phase process would be unnecessarily lengthy and bureaucratic.

Ofgem also hold the view that the inclusion of suppliers in the re-Qualification process is unjustified. Those who hold a contrary view argue that because suppliers are ultimately responsible for the metering systems they have registered and therefore their impact in settlement (ie through the supplier hub principle), they should also be required to re-Qualify whenever they make significant changes to their systems and processes. However, Ofgem share the views that i) suppliers are not included in the current re-Qualification process; ii) natural incentives already exist on suppliers to remain compliant with the BSC and maintain the accuracy of settlement and iii) the PAF exists to identify and resolve issues of compliance or in relation to settlement equitability.

Alternative Modification

BSC Objective (c)

Ofgem considers that the Alternative Modification will better facilitate Applicable BSC Objective (c) because it will implement a risk based and less onerous Qualification process. There are several benefits to the development of a risk based process; Ofgem considers that the Alternative Modification will provide a process that is appropriate, flexible, and targeted toward the risks of entering the market today.

Appropriate

Two of the main findings of the BSC Review were that since 1998 significant initial implementation risk no longer existed and considerable experience had been gained by the operation of the SVA arrangements. Ofgem considers that the Alternative Modification addresses these findings and will therefore implement a more appropriate Qualification process. It will do this by assessing applicants based on their risk to the BSC arrangements and using a clearly and independently defined Qualification board.

Assessing applicants based on their risk is fundamental to the Alternative Modification's process. As opposed to all applicants being subject to the same process and test scripts, the Alternative Modification will mean they will be assessed on their individual merits.

Flexibility

The Alternative Modification will provide greater flexibility in relation to its iterative nature. Applicants would have the opportunity to have their self-assessment document reviewed, possibly multiple times, before its formal submission. This would give the applicant the chance to ensure its application is complete, as well as the opportunity to ask questions about what is expected of them. By putting the applicant in the driving seat they can better manage their market entry.

Applicants using the Alternative Modification's process would also have the opportunity to take their application to the Panel or its delegated authority for decision at any time - even if Elexon or the relevant service provider does not believe the applicant has completed the Qualification process.

Targeted

As well as being more appropriate and flexible, the Alternative Modification would be more targeted. In its broadest sense this would be achieved because the Alternative Modification would implement a risk based Qualification process, ie each applicant would be judged on its individual merits. More specifically, the Alternative Modification's process would require the applicant to prove its readiness for market entry by submitting evidence in its self-assessment document. In other words, the applicant would perform its own entry testing in the areas it considered necessary. Where Elexon or the relevant service provider decided that further proof or testing was required, they could advise the applicant of the need during the iterative development of the self-assessment document. Furthermore, when reviewing an applicant's final self-assessment document, Elexon or its agent could request further specific evidence or request that they witness some of the applicants testing.

Ofgem share the view held by some Modification Group members that prospective new entrants should be able to tackle exceptions to the normal operation of industry processes. Consequently Ofgem is supportive of the idea that applicants, as part of their self-assessment document, explain how they would cope with exceptions. This would also encourage the applicant to target and test their ability to tackle non-standard problems that may affect them, settlement or other participants.

Less Onerous

As a consequence of implementing a more appropriate, targeted and flexible Qualification process, Ofgem considers that the Alternative Modification's process will be less onerous. It will be less costly, more efficient and quicker to complete. These benefits will have the effect of reducing barriers to entry, which in turn encourages greater market entry and therefore competition. Ofgem notes the view of one respondent who said that if the

Qualification process was not effective it could result in a reduction in competition; poorly qualified new entrants could have an adverse effect on the BSC arrangements which could result in their exit or the exit of other participants. Ofgem notes this view but considers that the existing BSC baseline and the proposed Alternative Modification mitigate this concern. In relation to the Alternative Modification, Elexon or its agent would have the opportunity to provide guidance to the applicant throughout the process. Whilst reviewing the self-assessment document, Elexon or its agent would also have the opportunity to request further evidence or witness the applicant's tests to gain further assurance. Finally, the Qualification Board would be able to grant market entry subject to certain conditions.

Ofgem also consider that the existing BSC arrangements would mitigate the impact of new entrants. For example, the PAF allows the PAB to monitor and take enforcement action against participants where necessary.

In addition to these views, Ofgem notes that whilst there may be a perceived risk associated to new entrants, there is no data to suggest that they have a materially detrimental effect on the operation of the BSC arrangements.

The current process is fragmented across different sections in the BSC and multiple BSCPs. The Alternative Modification intends to implement a process that is applicable to all new entrants and maintained in a single BSCP. Ofgem hold the view that the Alternative Modification will be more transparent to applicants.

Other Considerations

Beside arguments to do with better facilitating Applicable BSC Objectives, Ofgem considers there are other issues that require consideration.

Re-Qualification

Under the Alternative Modification the circumstances for triggering the re-Qualification process would be the same as under the Proposed Modification, ie where a material change had been made to systems and processes. However the Alternative Modification differs in two respects from the Proposed: i) a step-change in ,for example, the volume of registered metering systems would be used as an example of a material change as opposed to crossing a threshold and ii) suppliers would not need to re-Qualify. These two variations have split industry opinion.

Ofgem notes the views expressed by respondents and the Modification Group in relation to the re-Qualification process. In particular, it notes the view that a step change trigger could be difficult to define. Ofgem recommends that when drafting the appropriate code subsidiary document, the step change trigger is considered carefully.

Ofgem supports the view that suppliers should not need to re-Qualify unnecessarily. This is because i) suppliers are not included in the current re-Qualification process; ii) natural incentives already exist on suppliers to remain compliant with the BSC and maintain the accuracy of settlement; iii) the PAF exists to identify and resolve issues of compliance or in relation to settlement equitability; and iv) excluding suppliers from re-Qualifying could focus the process on more appropriate risks.

Implementation

The Final Modification Report recommends that the Alternative Modification needs 54 weeks to be implemented, and suggests that it could be capable of either standalone implementation or inclusion in a scheduled SVA release. The earliest scheduled release identified as a candidate was 1 November 2007, 64 weeks from today.

Given the proportionally⁸ small cost difference identified between the deployment of P197 in a standalone release as compared to in a scheduled release, and the significant delay between the required lead time and the earliest identified scheduled release, we consider that a standalone implementation would be justified. We are therefore directing that Alternative Modification P197 be implemented 54 weeks from today, on 23 August 2007.

We note that the code provides a mechanism⁹ whereby the Panel may request that an Implementation Date be brought forward where it is reasonably satisfied that an Approved Modification is capable of being implemented sooner than its existing timetable. We are in agreement with the Panel's unanimous view that P197 is a necessary reform to market entry processes, and highlight that were a robust and cost-effective implementation to progress ahead of schedule we would be minded to react positively to any such request.

Alignment with the MRA

A common view held by market participants is that there would be benefits to aligning the MRA and BSC entry processes. This desire was reflected as part of P197 and a parallel change to the MRA's entry processes. However, the change to the MRA was rejected when it was initially considered by the MRA Development Board and subsequently when it was appealed to the MRA Forum. Whilst Ofgem share the view that there may be benefits to aligning the two processes, we consider that they are not dependent on one another.

Direction under Condition C3 (5) (a) of NGET'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 NGET under Section 6 of the Electricity Act 1989 (the "Transmission Licence"), hereby directs NGET to modify the BSC.

This modification shall be in accordance with the Alternative Modification as set out in the Modification Report.

The Implementation Date for the Alternative Modification will be 23 August 2007.

In accordance with Condition C3 (5) (c) of NGET's Transmission Licence, NGET shall modify the BSC in accordance with this direction of the Authority.

If you have any questions, please contact Nicholas Rubin on 020 7901 7176.

Yours sincerely,

Philip Davies

Director, Consumer Markets

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

⁸ Section 3 of the Modification Report suggests that ELEXON person day costs would be 7% higher for a standalone implementation when compared to a scheduled release. There are currently no Approved Modifications or Change Proposals scheduled for inclusion in the November 2007 release, and therefore no guarantee that project overhead costs would be mitigated even were it included in that release. We note that the FMR suggests that P197 has no impact on the Transmission Company, and that market participants require no more than six months to implement its changes – well within the 54 weeks given by this direction.

⁹ See F2.11.9 of the code.