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22 March 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref: MP No: P45

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P45: "Price Adjusters for Settlement Days 05/04/01 to 24/09/01"

The Gas and Electricity Markets Authority (the "Authority") has carefully considered the issues raised in Modification Proposal P45 "Price Adjusters for Settlement Days 05/04/01 to 24/09/01".

The BSC Panel (the "Panel") recommended to the Authority that Modification Proposal P45 should be approved and should be implemented on 27 March 2002 or 5 days after the date of the Authority's determination, whichever is the later, and be effective for Settlement Days 5 April 2001 to 24 September 2001 inclusive.

The Authority has decided to direct a modification to the BSC.

This letter explains the background to the Modification Proposal 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 as set out in Modification Proposal P45. This letter constitutes the notice by the Authority under Section 49A of the Electricity Act 1989 in relation to the direction.

Background to the proposal

NETA is designed to ensure that there is sufficient incentive on participants to balance their individual trading positions and minimise the costs to the National Grid Company plc (NGC) as System Operator ("SO") of balancing the Transmission System ("System"). Market participants can contract ahead in the forwards, futures and short-term markets to balance their contract position ahead of Gate Closure (3½ hours before real time). Gate Closure is the last point at

which Parties can notify their contract position to NETA Central Systems. For each Settlement Period the metered volumes for each Trading Party are used to determine if the actual volumes taken from, or put onto the System match their notified contractual volumes. Parties with a position of energy imbalance will be exposed to the relevant Energy Imbalance Prices for the relevant Settlement Period. The methodology for the calculation of Energy Imbalance Prices is contained in the BSC. These prices are used for the purpose of Imbalance Settlement according to the BSC rules.

On the 27 March 2001 Modification Proposal P3: "Correction Of Price Spikes Generated By De-Minimis NGC Purchases" was submitted by Electricity Direct. Modification Proposal P3 proposed changes to the BSC that would prevent the occurrence of price spikes when option fees, paid by NGC for the provision of reserve, were included in the numerator of the Energy Imbalance Price calculations but there was a very small volume of accepted Offers (or Bids) in such periods.

On 5 April 2001 the Panel made the recommendation to Ofgem¹ that no modification to the BSC was required, on the basis that the issue would be addressed by amending NGC's Balancing Services Adjustment Data ("BSAD") Methodology. In the April 2001, Decision Document² "Correction of Price Spikes in the Balancing Mechanism", the Authority stated that option fees should be included in the calculation of Energy Imbalance Prices. However, it was noted that the current methodology for allocating option fees to Settlement Periods could cause unduly high prices during periods when a relatively small volume of Offers was accepted. The Authority recommended that option fees should remain and price adjusters Sell Price Adjustment ("SPA") and Buy Price Adjustment ("BPA") are used to amend the Energy Imbalance Price calculations.

The Authority recognised that the addition of a price adjuster would be difficult to implement immediately via the BSC due to the time required to develop and implement changes to the NETA Central Systems. In these circumstances the Authority decided that a more immediate solution to anomalous price spikes was required. As an interim solution no changes were made to the BSC and NETA Central Systems, but alterations were made to NGC's BSAD Methodology to calculate a price adjuster for SSP and SBP and to enable correct values of SSP and SBP to be entered into the Settlement Process via Workaround W024. Workaround W024 was only intended to be a temporary measure and involves operational costs and inaccuracies. The Authority recommended that a full solution within the BSC and NETA Central Systems should be developed as a matter of urgency.

On 20 April 2001, NGC proposed Modification Proposal P8 to provide an enduring solution for calculating Energy Imbalance Prices within the BSC and NETA Central Systems and to replace Workaround W024 whilst retaining the same price adjuster functionality. Modification Proposal P8 did not propose a retrospective Implementation Date. However in the Assessment Report, the Modification Group ("the Group") recommended that Modification Proposal P8 be approved and be implemented retrospectively from Settlement Date 5 April 2001.

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

² A copy of this document can be found on the Ofgem website under Publications – www.ofgem.gov.uk

On the 7 August 2001 ELEXON issued a circular EL00161³: "Potential issues with the application of Workaround W024" to all BSC Signatories that warned that errors might have occurred in the application of W024.

The Panel met on the 26 July 2001 and endorsed the views of the Group set out in the Assessment Report. ELEXON published a Draft Modification Report for consultation on 30 July 2001. Following the publication of the Draft Modification Report some concerns were raised in regard to the proposed retrospective Implementation Date. As a result, ELEXON issued a consultation proposing a prospective Implementation Date of the 25 September 2001.

The Panel considered the consultation responses and recommended that the Authority should approve the Modification Proposal and that, if approved, the Modification Proposal should be implemented prospectively on the 25 September 2001. The Authority endorsed this recommendation and approved Modification Proposal P8 on the 25 September 2001. The approval of Modification Proposal P8 meant that Workaround W024 would continue to apply to the reconciliation settlement runs for Settlement Days 5 April 2001 to 24 September 2001.

On the 18 October 2001 the Panel submitted Modification Proposal P45 "Price Adjusters for Settlement Days 05/04/01 to 24/09/01". The Panel argued that the Modification Proposal moves the process for calculating SSP and SBP for Settlement Days 5 April 2001 to 24 September 2001 into the audited NETA Central Systems which improves transparency and ensures that these Settlement Days are settled on Energy Imbalance Prices that include the price adjusters. The Panel believed that the Modification Proposal furthers the achievement of the relevant BSC Objective⁴ of "promoting efficiency in the implementation and administration of the balancing and settlement arrangements."

The Modification Proposal

Modification Proposal P45 seeks to modify the BSC so as to replace Workaround W024 for Settlement Days 5 April 2001 to 24 September 2001 with the solution implemented by Modification Proposal P8 which calculates Energy Imbalance Prices within the BSC and NETA Central Systems. Both Workaround W024 and Modification Proposal P45 attempt to achieve the same Energy Imbalance Prices for the period 5 April 2001 to 24 September 2001.

During the Assessment phase the Group undertook analysis, consultation and assessment of the Modification Proposal against the relevant BSC Objectives.

The Group considered that the implementation of the Modification Proposal would remove the need for Workaround W024 and would therefore reduce operational costs. In addition, the Group considered that using NETA Central Systems for the reconciliation settlement runs instead

³ ELEXON circulars are published on ELEXON's website, www.elexon.co.uk.

⁴ The relevant BSC Objectives are contained in Condition C3.3 of NGC's Transmission Licence and 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.

of Workaround W024 would increase the accuracy of the Energy Imbalance Price calculations for the period 5 April 2001 to 24 September 2001. The Group also suggested that the Modification Proposal would ensure that these Settlement Days are settled on Energy Imbalance Prices that include the price adjusters using the audited NETA Central Systems.

The Group considered that implementation of the Modification Proposal would improve the transparency of calculating Energy Imbalance Prices for Settlement Days 5 April 2001 to 24 September 2001 by moving the process into the NETA Central Systems for these Settlement Days.

The Group considered that the Modification Proposal would necessitate a revision to NGC's BSAD Methodology Statement should the Authority accept or reject the Modification Proposal. The consultation process required for changes to the BSAD Methodology Statement is outlined in special condition AA4 6.(c) of NGC's Transmission Licence and has been carried out separately from the consultation process for the Modification Proposal P45⁵.

The Group did not consider that the Modification Proposal P45 was retrospective as they believed that it intended to implement price adjusters for Settlement Days from 5 April 2001 as they believed had been the intention of Modification Proposal P8. The retrospective element of the Modification Proposal was also considered during the consultation process carried out by the Group and was accepted in the majority of consultation responses. The Group considered that the operational loss sustained by continuing the use of Workaround W024 at a monthly cost of approximately £10,000 together with the risk of inaccuracy and error in the reconciliation settlement runs as a result of continuing with Workaround W024 did constitute a material loss.

The Group agreed that the Modification Proposal would further the achievement of the relevant BSC Objectives. The Group recommended in the Assessment Report that the BSC Panel should proceed to the Report Phase and recommended to the Authority that the Modification Proposal be approved to become effective from Settlement Day 5 April 2001. The Panel endorsed the Group's recommendations. ELEXON published a Draft Modification Report on 28 January 2002 which invited respondents' views.

Respondents' views

In total, ELEXON received 7 responses to the consultation on Modification Proposal P45. Of the responses all 7 expressed support for the Modification Proposal.

Respondents considered that the Modification Proposal would correct errors in imbalance calculations. One respondent commented that although these errors are minor in nature and are not systematic in their effect, to have settlement errors in place could reduce confidence in the market. Respondents suggested that the Modification Proposal would further the achievement of the relevant BSC Objective in respect of promoting efficiency in the implementation and administration of the BSC.

⁵ Details of NGC's consultation on revising the BSAD Methodology Statement to incorporate changes required arising from BSC Modification Proposal P045 can be found on NGC's website www.nationalgrid.com/uk/.

Panel's Recommendation

The Panel met on 14 February 2002 and considered Modification Proposal P45, the Modification Report, the views of the Group and the consultation responses received.

The Panel recommended to the Authority that the Modification Proposal should be approved and should be implemented on 27 March 2002 or 5 days after the date of the Authority's determination, whichever is the later, and be effective for Settlement Days 5 April 2001 to 24 September 2001 inclusive.

Ofgem's view

Ofgem considers, having had regard to its statutory duties, that Modification Proposal P45 will better facilitate the achievement of the relevant BSC Objectives, as it will promote efficiency in the implementation and administration of the Balancing and Settlement arrangements.

Ofgem is not generally supportive of retrospective changes to the market rules. There are commonly understood legal reasons why retrospective rule changes are to be avoided, except in certain limited circumstances. We consider that retrospective changes to market rules, particularly those that relate to the calculation of Energy Imbalance Prices, will damage confidence in the stability of the trading arrangements and the predictability of the form of the trading arrangements if they cannot be reasonably anticipated. Participants trade on the basis of the prices reported and may have closed out positions and/or traded on the basis of an understanding of the rules in place at that time.

Ofgem believes that it is appropriate for Modification Proposals that seek retrospective implementation to be determined on a case by case basis. Ofgem has previously outlined certain criteria as examples of factors that are considered when evaluating whether retrospectivity should apply. Three particular circumstances are provided as examples of factors to be considered in this situation. These are:

- a situation where the fault or error was directly attributable to central arrangements;
- combinations of circumstances that could not have reasonably been foreseen; and
- where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect.

It must be noted that these examples are not intended as an exhaustive list and in all circumstances the materiality of the alleged defect will be taken into account. Ofgem considers that these circumstances are relevant in the consideration of Modification Proposal P45.

The price adjusters were implemented via the BSAD Methodology and Workaround W024 as an interim measure as this change could not be implemented via NETA Central Systems within the short timescales required. Therefore the situation that Modification Proposal P45 seeks to address was directly attributable to the inability for the solution to be implemented within the BSC and NETA Central Systems at the time the solution was identified.

Ofgem notes that both Workaround W024 and Modification Proposal P8 attempt to achieve the same Energy Imbalance Prices. Ofgem has taken into consideration the assessment contained in the Final Modification Report for P45 that the net effect of Modification Proposal P45 on Energy Imbalance Prices for the period from 5 April 2001 to the 24 September 2001 should be zero. Ofgem considers that applying the Modification Proposal retrospectively for the period from the 5 April to the 24 September inclusive should not have a material impact on the prices on which participants have based trading decisions.

Ofgem agrees with the Panel, the Group and respondents that continuing with Workaround W024 to calculate the reconciliation settlement runs for the period from 5 April 2001 to 24 September 2001 would not be efficient and could lead to inaccuracies given the manual nature of Workarounds. The possibility that Workaround W024 might be causing inaccuracies was flagged to BSC Signatories by ELEXON in circular EL00161 on the 7 August 2001. Ofgem believes that continuing with Workaround W024 would not allow participants the same level of confidence as reconciliation settlement runs that use NETA Central Systems. Ofgem considers that allowing the reconciliation settlement runs for the period from 5 April to 24 September 2001 to run through the NETA Central Systems reduces the opportunities for inaccuracies which will reinforce Parties trust in the accuracy of the Settlement Process.

Ofgem does not however consider that the operational loss sustained by continuing the use of Workaround W024 at a monthly cost of approximately £10,000 together with the risk of inaccuracy and error in Energy Imbalance Prices would necessarily constitute a material loss under normal circumstances to warrant a retrospective change to the market rules. However on this occasion Ofgem considers that, as the change is to replicate existing calculations under the BSAD within the NETA central systems to create more robust final settlement runs the efficiency gain is sufficiently large to warrant a retrospective change to market rules.

Therefore Ofgem believes that the Modification Proposal better facilitates the achievement of the relevant BSC Objective of promoting efficiency in the implementation and administration of the Balancing and Settlement arrangements.

The Authority's decision

The Authority has therefore decided to direct that Modification Proposal P45 should be made and implemented⁶.

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 treated as 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 Modification Proposal P45. A copy of the text of the modification to the BSC is attached to this letter.

⁶ In addition, the Authority, in accordance with special conditions AA4.6(c)(iv) and AA4.6(d)(i) of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), agrees that NGC may modify the BSAD Methodology Statement as set out in the Authority Report (Modification Proposal P45 approved version).

The modification is to take effect from 27 March 2002.

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.

Please do not hesitate to contact me on the above number if you have any queries in relation to the issues raised in this letter or alternatively contact Anthony Doherty on 020 7901 7159.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Sonia Brown'.

Sonia Brown

Head of Electricity Trading Arrangements

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

Annex 1

Legal Text to give effect to the Modification Proposal

The following new paragraph 6.3.5 will be inserted in Section Q:

"6.3.5 For the purposes of any Settlement Run to be carried out on or after the date with effect from which this paragraph 6.3.5 takes effect in respect of each Settlement Day between the period 5 April 2001 to 24 September 2001 (both dates inclusive):

- (a) the provisions of the Code as modified with effect from 25 September 2001 to include Buy Price Price Adjustment and Sell Price Price Adjustment in the Balancing Services Adjustment Data and to take such Price Adjustments into account in the determination of Energy Imbalance Prices under Section T4.4 shall apply;
- (b) the Transmission Company shall submit or resubmit the Balancing Services Adjustment Data to the SAA and to BSCCo for each Settlement Period of such Settlement Days as soon as reasonably practicable in order to give effect to paragraph 6.3.5(a); and
- (c) BSCCo shall arrange for such data to be published in accordance with Section V4.2.

6.3.6 For the avoidance of doubt, paragraph 6.3.5 is without prejudice to Settlement Runs carried or to be carried out at any time in respect of Settlement Days commencing with the Settlement Day of 25 September 2001, which have been and shall continue to be carried out in accordance with the provisions of the Code as modified with effect from 25 September 2001."