



1 August 2001

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 P19: “To provide for the remedy of errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications”

1. The Gas and Electricity Markets Authority (the “Authority”) has carefully considered the issues raised in Modification Proposal P19: “To provide for the remedy of errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications”, and the Urgent Modification Report submitted to it by the BSC Panel (the “Panel”) which recommended to the Authority that Modification Proposal P19 should be rejected. The Authority also considered further representations made to it by London Electricity.
2. The Authority has decided not to direct a modification to the BSC.
3. This letter explains the background to the Modification Proposal and sets out the Authority’s reasons for its decision.

Background to the Proposal

4. On 11 June 2001, London Electricity lodged Modification Proposal P19 to the BSC to provide for the remedy of errors in Energy Contract Volume Notifications and Metered Volume Reallocation Notifications and requested that it be treated as urgent. The Panel agreed with this recommendation and the Authority granted the Modification Proposal urgent status for the purpose of Section F2.9 of the BSC on 12 June 2001. The Authority also agreed the process and timetable. The Modification Group, with the agreement of London Electricity, decided that it would be appropriate to put forward two forms of the modification – Modification Proposal P19 Tidied (where the legal drafting of the Modification Proposal was completed) and the Alternative Modification Proposal P19 Optimised (which included process clarifications). Legal drafting was produced for both versions and is contained in the Panel's Urgent Modification Report. Both versions were published and consulted on.

The Modification Proposal

5. The Modification Proposal P19 (Tidied and Optimised) would have the result of enabling errors in Energy Contract Volume Notifications and Metered Volume Reallocation Notifications (hereafter collectively referred to as “notifications”) to be remedied after Gate Closure. Where notifications did not reflect the true trading position of one or more BSC Parties, a claim could be submitted for a correction to be made within two business days and with payment of a fixed fee. The Modification Proposal would, in addition to applying prospectively, have retrospective application with the effect that claims would be allowed in respect of notification errors that occurred before the approval of the Modification Proposal, as long as any claim was lodged within 5 days of that approval.

Respondents' Views

6. In total, ELEXON received 18 responses (representing 45 parties) to the consultation on Modification Proposal P19. Six responses (on behalf of 23 parties) opposed the Modification Proposal, whereas 11 responses (on behalf of 21 parties) supported the Modification Proposal. In response to whether the BSC should allow for the correction of notifications after Gate Closure, 6 responses (on behalf of 23 parties) opposed the idea and 11 responses (on behalf of 21 parties) were in support. On the question as to whether, if Modification Proposal P19 were to be adopted, it should be applied retrospectively back to NETA Go Live as Modification Proposal P19 proposes, 10 responses (on behalf of 30 parties) opposed this and 7 responses (on behalf of 14 parties) were in support.

7. The respondents' views are comprehensively summarised in the Urgent Modification Report dated 5 July 2001.

Panel Recommendations

8. On 2 July 2001, a group of Panel Members considered Modification Proposal P19 (Tidied and Optimised), the views of the Modification Group, the consultation responses received and the Modification Report. Subsequently these were considered at a Panel meeting on 4 July 2001.
9. The Panel recommended that the Authority should reject Modification Proposal P19 Tidied and the Alternative Modification Proposal P19 Optimised.
10. The Panel expressed the view that Modification Proposal P19 Optimised was preferable to P19 Tidied.
11. The Panel considered that it would be helpful for the Authority to indicate how the issue of retrospective application contributed to the decision it came to.

Ofgem's View

12. Condition 7A.2 of NGC's Transmission Licence defines the concept of "balancing and settlement arrangements" which is to be applied in interpreting NGC's obligation in Condition 7A.1. It therefore defines the scope of those arrangements, so that the Authority, in considering any Modification Proposal, must be satisfied that the Modification Proposal would not cause the BSC to exceed its scope.
13. Ofgem¹ must then consider whether the Modification Proposal is capable of, as compared with the then existing provisions of the BSC, better achieving the applicable BSC Objectives. If so, Ofgem needs to consider whether it is satisfied that it should direct NGC to make the relevant modification to the BSC having regard to its principal objective and other duties in Sections 3A to 3C of the Electricity Act 1989.
14. Ofgem is satisfied that Modification Proposal P19 (Tidied and Optimised) (hereafter referred to as "Modification Proposal P19") is within the scope of the BSC. As noted above, Ofgem will now need to consider whether

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

Modification Proposal P19 is capable of better achieving the applicable BSC Objectives.

Modification Proposal P19

15. As noted in paragraph 5 above, Modification Proposal P19 would introduce a correction mechanism for erroneous notifications which applies both prospectively and retrospectively. This section first considers the general principle of a correction mechanism for erroneous notifications and subsequently any retrospective application of such a mechanism.
16. Arguments put forward by the respondents to the consultation on Modification Proposal P19 in support of the post-Gate Closure correction, included:
 - If the costs incurred by participants in mitigating the risk of notification errors are disproportionate to the costs that errors impose on the system, real and unnecessary costs are being imposed on the industry;
 - The penalties and windfalls distort the fair competition required by EU and UK legislation by allowing some Parties to price below cost at the expense of other Parties; and
 - It would reduce the risk of “over-the-counter” trading close to Gate Closure and therefore improve liquidity.
17. On the other hand, arguments put forward opposing post-Gate Closure correction included:
 - The Modification Proposal P19 would allow participants to use inadequate systems on the basis that failures in notification can be corrected after the event at minimal cost;
 - The revenues received as a result of the other participants errors can perhaps be considered a fair reward for the investment made by certain participants in their systems to ensure accurate notification ahead of Gate Closure; and
 - It is important to ensure consistency of treatment of manifest errors across the gas and electricity markets.
18. Ofgem is mindful that, in a commercial setting, one of the strongest incentives to efficient trading is the knowledge that insufficiently robust risk management systems and procedures can result in trading errors and that losses are a likely consequence of such errors. Ofgem is of the opinion that it is essential

that there should be strong incentives on BSC Parties to deliver correct notifications. If the incentives to have robust risk management systems in place are inadequate, it is likely that notifications would need to be frequently adjusted for errors that could adversely affect the efficient administration of the BSC. A correction mechanism for erroneous notifications may also create a possibility of intentional post-Gate Closure adjustments to traded quantities. There could be a risk of undermining the strong commercial incentives on participants to balance their own positions ahead of real time.

19. It was specifically noted in the NETA Programme/Elexon consultation document for Manifest Errors in Balancing Mechanism Transactions² that at NETA Go-Live there would be no manifest error provisions for the notification of energy contract volumes or metered volume reallocations. The consultation document stated that it was expected that the industry would put in place appropriate legal and practical arrangements to manage the risk of errors. It went on to say that BSC parties “would, of course be free to make a modification proposal post Go-Live to address this issue, should they wish”. However, Ofgem did not, and could not, give any indication as to whether any modification providing for a correction mechanism for erroneous notifications would be approved or not. Any modification proposal needs to be subject to a consultation and reporting process before it is submitted to the Authority for a final decision.
20. It has been submitted to Ofgem that many other trading markets do provide for a correction mechanism for notifications. Ofgem, however, considers that the arrangements for notifications under NETA are not directly comparable to those existing in many trading markets. In many trading markets transactions are instantaneous, so that there is no opportunity to verify the transaction after the entry is made but before it takes effect. It is recognised that in such situations an error correction arrangement contributes to the efficient running of an orderly market. In contrast, notifications can be made some time in advance of Gate Closure allowing time for review of the numbers being entered.
21. While understanding that it may be impossible to eliminate completely the element of human error or software error, Ofgem observes that BSC Parties have a clear knowledge of the timing of Gate Closure and can, in conjunction with the reporting systems available, take a view on how close to that time they wish to notify and to what extent they wish to check and correct such notifications in the light of the known risk they would be facing. We also note that those Parties who wish to reduce the risk of notification errors can

² The New Electricity Trading Arrangements – Manifest Errors in Balancing Mechanism Transactions – NETA Programme/Elexon Consultation, October 2000

provide additional opportunity for checks by contracting these services elsewhere, for example, with independent dual-notification agents.

22. Ofgem notes that the views of those responding to the consultation on Modification Proposal P19 were divided and the Panel's recommendations were made on the casting vote of the Panel Chairman. London Electricity argued that the recommendation by the BSC Panel to the Authority has been tainted by the policy of the Panel's chairman in exercising his casting vote. However, as noted above, the Authority, in deciding whether to approve a proposed modification, only takes into account the provisions of Condition 7A.5 of NGC's Transmission Licence and its principal objective and other provisions of Sections 3A to 3C of the Electricity Act 1989. The report by the BSC Panel informs the Authority's decision, but its recommendations are not binding on the Authority. Ofgem notes that the report makes clear the votes cast for and against Modification Proposal P19 and the fact that the Panel Chairman used his casting vote.
23. As noted above, Ofgem considers that a key feature of the NETA arrangements underpinning the incentives on Parties to balance their positions is that Parties take active responsibility for the accurate notification of the energy transfer quantities. In the foreknowledge of the risks, many Parties will take care in their notifying arrangements and systems to avoid such errors and the consequences of such errors. Others will choose to use independent agents to notify on their behalf or use the power-exchanges to trade close to Gate Closure. It is not clear whether more trading would take place off the exchanges close to Gate Closure, were an error correction mechanism to be available.
24. On this basis, it could be argued that any losses incurred (and associated windfalls gained) as a result of notification errors are the results of the commercial operation of the NETA arrangements.
25. Nevertheless, Ofgem recognises that some losses may be disproportionate to the incentives necessary to achieve accurate notifications. Therefore, although it rejects the correction mechanism proposed by Modification Proposal P19 which allows for a full recovery of any losses incurred (less the proposed fee) for the reasons outlined above, Ofgem considers that it would not necessarily be incompatible with the BSC Objectives or its statutory duties for a notification error correction modification to be made which would, in the interest of preserving incentives, include:
 - (i) an appropriate and material charge for any party seeking to correct a notification error. A fee of a fixed amount, albeit an amount that can be modified by the Panel, may not, however, be set at such a level as would

be prohibitive to small players (This may argue for any change to the fee to be subject to the Authority's approval);

- (ii) a fixed percentage limit on recovery of a claim, in addition to the fee. Ofgem agrees with one of the respondents that a fixed percentage limit on recovery of a claim, in addition to a fee, may better achieve the relevant objectives by providing an incentive to accurate notification. The effectiveness of such provisions in providing appropriate incentives would need to be kept under review;
- (iii) a short claim period. Ofgem considers that a claim period of less than two business days would be appropriate; and
- (iv) the responsibility for establishing the nature of the error placed on the claimant. In addition, the claimant would be expected to show that it had acted prudently in checking its notifications and that it had promptly put in place steps to avoid a repetition of the error.

26. In summary, therefore, Ofgem agrees with the Panel that the arguments on many issues raised by Modification Proposal P19 are finely balanced. On the evidence currently available, however, Ofgem does not consider that Modification Proposal P19 would better facilitate achieving the BSC objectives, in particular promoting efficiency in the implementation and administration of the balancing and settlement arrangements (Condition 7A.3(d)) and promoting effective competition in the generation and supply of electricity, and promoting such competition in the sale and purchase of electricity (Condition 7A.3(c)), since it does not provide sufficient incentives to submit accurate notifications.

Retrospection

27. Modification Proposal P19 also contained a retrospective element.

28. As set out above, the Authority has decided to reject Modification Proposal P19 on the basis that the modification proposal as currently drafted does not provide sufficient incentives for BSC Parties to submit accurate notifications. The Authority, however, recognises that a notification error correction mechanism may not necessarily be incompatible with the BSC Objectives if it were to include the elements outlined in paragraph 25 above, including a fixed percentage limit on recovery of the claim.

29. Nevertheless, Ofgem notes the Panel's request that the Authority provide feedback specifically on how the issue of retrospective application contributed to its decision whether to approve or reject Modification Proposal P19.

30. Therefore, Ofgem considers that it might be helpful for the industry, the Panel and Elexon, if it provided its indicative views on the issue of a retrospective correction mechanism for erroneous notifications, in particular, since it has now received two Modification Reports which have considered retrospection with arguments for and against the concept clearly propounded.

31. In general, Ofgem considers that retrospective changes to the BSC will damage market confidence in, and the efficient operation of, the new trading arrangements. Rather than protecting Parties from “unforeseen unfairnesses”, Ofgem takes the view that BSC Parties would generally prefer the assurance of rules that are unlikely to be changed retrospectively. Many of the respondents support this view with regard to the retrospective element of Modification Proposal P19. Ofgem believes that there are generally accepted and well understood legal reasons why retrospective modifications are to be avoided. It is a general principle of law that rules ought not to change the character of past transactions completed on the basis of the then existing rules.

32. In this instance, some participants are likely to have modified their behaviour in various ways in response to the rules and the perceived risks in a way that they may not have done were a correction mechanism for erroneous notifications in place from Go-Live. They may have tested their arrangements more thoroughly than otherwise and planned their systems, procedures and trading so as to avoid an erroneous notification. They may have desisted from ‘over-the-counter’ trading close to Gate Closure. They may also have acted on the basis of revenues expected to accrue from the Residual Cashflow Reallocation Charge on the assumption that the revenues would only be subsequently adjusted in accordance with the terms of the BSC then applying.

33. London Electricity, and others supporting retrospection, cited a number of mitigating factors in support of a retrospective application of Modification Proposal P19, including:

- the number of circulars and bulletins relating to central system problems made validation “unusually difficult”;
- the early months of the NETA produced very high imbalance prices;
- NETA was implemented with a tight timescale with consequential problems including inadequate ability to check notified contract positions; and

- a number of errors are material and disproportionate to imposed costs giving rise to disproportionate windfall gains for other BSC Parties.

34. Arguments put forward by respondents opposing retrospective application included the following:

- Whilst short term central reporting could be improved, adequate information should have been available at the time to mitigate the risk associated with within-day notifications.
- The importance of accurate notifications and the potential financial risk of making errors were well understood by BSC signatories prior to Go-live. As a result many companies have invested hundreds of thousands of pounds in additional manpower, systems and procedures just to minimise these risks.

35. For the reasons set out in paragraphs 31 and 32 above, Ofgem is, in general, against approving modifications which have retrospective effects. However, despite the general principle against retrospective rule changes, Ofgem believes that there may be a small number of particular circumstances that could give rise to the need for a modification which would have a retrospective effect as evidenced in a small number of modifications approved for the Network Code.

36. The particular circumstances which could give rise to the need for a retrospective rule change could, for instance, include:

- a situation where the fault or error occasioning the loss was directly attributable to central arrangements;
- combinations of circumstances that could not have been reasonably foreseen; or
- 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.

In any event, the loss sustained would need to be material.

37. If a future modification proposal were submitted which sought to address the question of a correction mechanism for erroneous notifications retrospectively, Ofgem would want to consider such a proposed modification in the light of its comments above. However, Ofgem considers it appropriate, in the light of the view expressed in paragraph 19 above, that there should be

a more stringent cap on the retrospective recovery of monies lost through errors in notification. Ofgem would expect that those concerned would address these points in the consideration of any future modification proposal.

38. Ofgem considers that, in general, it is more appropriate to consider any retrospective modifications on a case by case basis, in the light of the circumstances relevant to the particular event and the proposals and reasons for rectification. Even if only one company was affected, this would not, of itself, mean that an appropriate Modification Proposal could not better facilitate the BSC objectives or be inconsistent with the Authority's duties under Sections 3A-C of the Electricity Act 1989.

The Authority's Decision

39. The Authority has therefore decided not to direct that either Modification Proposal P19 Tidied, or the Alternative Modification Proposal P19 Optimised should be made and implemented.

40. Having regard to the above, the Authority, in accordance with Section F1.1.4 of the BSC, hereby notifies NGC that it does not intend to direct NGC to modify the BSC as set out in Modification Proposal P19.

Nick Simpson
Director, Industry Codes Development

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