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The National Grid Company, BSC Signatories and
Other Interested Parties

Direct Dial: 020 7901 7491

29 November 2004

Our Ref: MP No P170

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P170 “Amendments to the Balancing and Settlement Code (Code), and to the systems and processes that support it, to allow compliance with the changed application of VAT to Trading Charges”.

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P170, “Amendments to the Balancing and Settlement Code (Code), and to the systems and processes that support it, to allow compliance with the changed application of VAT to Trading Charges.”

The BSC Panel (the “Panel”) recommended to the Authority that Proposed Modification P170 should be made, an implementation date for P170 of 5 Working Days after an Authority decision and the proposed text for modifying the BSC, as set out in the Modification Report for P170.

Having carefully 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

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

² ELEXON document reference P170RR, Version No. Final/1.0, dated 12/11/2004.

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.

⁴ Ofgem’s statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

Authority has decided to direct a Modification to the BSC in line with Modification Proposal P170.

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

On 11 October 2003 Council Directive 2003/92/EC⁵ of 7 October 2003 amending Directive 77/383/EEC⁶ as regards the rules on the place and supply of gas and electricity was published in the Official Journal of the European Union. The amendments contained in the Directive take effect from 1 January 2005 and impact the manner in which VAT is applied to the supply of electricity.

In order to comply with the change to the taxation rules introduced by 2003/92/EC and to overcome the problems described above, BSCCo⁷ agreed a proposed way forward with HM Customs and Excise and recommended to the Panel that a Modification Proposal ought to be raised to consider whether this solution was appropriate, and if so how it could be best expressed in the legal text of the BSC. A feature of this agreement was that VAT imbalances arising as a result of the implementation of these provisions should be settled by BSCCo using its current VAT registration.

Acting upon the recommendation of BSCCo, the BSC Panel submitted Modification Proposal P170 on 12 August 2004. It was suggested that Proposed Modification P170 would better facilitate Applicable Objective (d). This would be achieved by providing an operationally efficient and legally robust framework for BSCCo and Parties to meet the obligations of the new taxation legislation. The proposer suggested that the current absence of appropriate processes and obligations may prevent BSCCo and Parties from complying with this legislation and would therefore detrimentally impact upon Applicable Objective (d).

The Panel considered the Initial Written Assessment at its meeting of 2 September 2004 and agreed to submit Modification Proposal P170 to the Assessment Procedure. A Modification Group (the "Group"), supplemented by additional industry volunteers with VAT expertise, was formed in order to consider the Modification Proposal. The Group met twice, on 6 September and 29 September 2004 to consider P170 against the terms of reference set down by the Panel.

⁵ COUNCIL DIRECTIVE 2003/92/EC of 7 October 2003 amending Directive 77/388/EEC as regards the rules on the place of supply of gas and electricity.

⁶ SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment.

⁷ ELEXON Ltd, or any successor to that company.

The Modification Proposal

Modification Proposal P170 seeks to modify the BSC so as to ensure its compliance with the new taxation rules introduced by 2003/92/EC. To this end the modification seeks to provide BSCCo with authority under the BSC to obtain certain information relating to the tax status of relevant companies, and to provide appropriate amendment to the provisions of the BSC and the systems and processes that support it.

Exxon Clear Limited⁸ produces invoices both for Parties owing Trading Charges and Parties that are owed Trading Charges. It was suggested that it may be appropriate for Exxon Clear Limited to be informed of the VAT status of each Party (ie whether VAT should be charged at the UK rate or zero) and other VAT information which must be provided to EU Parties on a monthly basis.

The Group noted that the new charging regime for VAT would mean that whilst the VAT exclusive Exxon Clear Limited cashflows will continue to balance to zero, this is not the case when VAT is included in the calculation. The Group considered that the principal benefit of P170 was that it would require each Party to indemnify BSCCo and Exxon Clear Limited against VAT liabilities or financial penalties that might arise from incorrect invoicing and VAT payments that it had incorrectly declared, or failed to declare, information that the BSCCo and Exxon Clear Limited needed to determine whether UK prevalent rate VAT should be applied to its charges under the BSC. The Group considered it would not be appropriate for this risk to be borne across all Parties through the funding share mechanism as this would result in Parties incurring costs to rectify errors for which they were blameless. To avoid a situation where Exxon Clear Limited sees a surplus or deficit of funds driven by VAT imbalances (thus exposing it to the risk of insolvency) it was considered appropriate to limit Exxon Clear Limited's liability to make payments on a business day to the VAT exclusive aggregate amounts both to be paid and received.

During assessment it was noted that the Code should clarify the treatment of VAT imbalances that will be realised by Exxon Clear Limited from 1 January 2005 and that any VAT imbalances experienced by the Exxon Clear Limited will be accounted for to Customs and Excise by BSCCo. The Group believed that it was appropriate the Code should stipulate the obligations of both BSCCo and Exxon Clear Limited in this regard, in order that Parties had visibility on how these cashflows would operate and to confirm that the liability for operational Exxon Clear Limited VAT balancing rests with the BSCCo.

It was the view of the Group that the Code currently lacks robust obligations for Parties to provide sufficient relevant information to allow the correct application of VAT after 1 January 2005. Furthermore, Parties are not under any Code obligation to confirm whether they are liable to UK VAT or not, either before or after accession. The Group considered that the provision of relevant data to the BSCCo to allow the correct invoicing of charges accrued under the Code should be mandatory rather than voluntary as this would be easier to enforce and administer.

The Group considered three options by which Parties could be obligated to provide relevant information to BSCCo in order that the correct application of VAT charges may be incurred under the BSC. The first was to explicitly stipulate all the information required under the BSC,

⁸ The company operating in the capacity of BSC Clearer, or any successor to that company.

the second was to make BSC obligations on the provision of VAT information generic, placing an obligation on Parties to provide BSCCo with all relevant information to allow the correct application of VAT, whilst the third was to include a provision placing an obligation on Parties to provide such information as stipulated in a Code Subsidiary Document (CSD).⁹ The third option was preferred by the Group as it was felt to minimise the risk of future changes to the BSC being required by avoiding the need to specify all the required information within the BSC. The Group also felt that by placing the mechanism for revision within the CSDs appropriate scrutiny by Parties and other stakeholders would be ensured.

The Group concluded the efficiency savings described above would allow P170 to better facilitate Applicable BSC Objective (d). The Group considered whether P170 could be considered to better facilitate Applicable BSC Objective (c), but concluded that the Modification Proposal would have neither a positive nor a negative effect on the promotion of competition in the generation and supply of electricity.

ELEXON published a draft Modification Report on 20 October 2004, which invited respondents' views by 17.00 on 27 October 2004.

Responses to ELEXON Consultation

Three responses were received. All of these responses (representing 26 Parties and 0 non-Parties) expressed support for the Panel's views on P170 and the provisional recommendation to the Authority that P170 should be made.

These respondents commented to the effect that P170 would enable the BSC to meet the obligations of European taxation legislation, allow these obligations to be more efficiently administered by BSCCo, and that P170 would provide clarity to market participants as regards to their responsibilities in respect of UK VAT and its application to them under the BSC.

The respondents' views are summarised in the Modification Report for Modification Proposal P170, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 11 November 2004 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 approve the Proposed Modification and that, if approved, the Proposed Modification should be implemented 5 Working Days after an Authority Decision.

⁹ Code Subsidiary Documents exist beneath the BSC and contain the detailed provisions which are intended to give effect to the intention of the provisions of BSC. Typical Code Subsidiary Documents include BSC Procedures, Codes of Practice, BSC Service Descriptions, Party Service Lines, Data Catalogues, Communication Requirements Documents, and the Reporting Catalogue.

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that Proposed Modification P170 will better facilitate achievement of Applicable BSC Objective (d).

It is Ofgem's view that it is appropriate for the BSC to reflect the requirement for Parties to become compliant with the change to the European taxation rules introduced by 2003/92/EC.

P170 will better facilitate the efficient implementation and administration of the balancing and settlement arrangements by obliging Parties to provide the relevant VAT information so as to enable BSCCo and Elexon Clear Limited to correctly invoice and account for payments received or payable under the BSC. Ofgem further agrees with the view of the Group that it is appropriate for Parties to indemnify BSCCo and Elexon Clear Limited against VAT liabilities or penalties which might arise from an incorrect declaration of the Party's liability to UK VAT, rather than for those liabilities to be smeared across all Parties through the funding share mechanism.

Ofgem also notes that P170 clarifies the treatment of VAT imbalances that may from time to time be realised by Elexon Clear Limited. As was noted above, any VAT imbalances experienced by Elexon Clear Limited will be accounted for to Customs and Excise by BSCCo. Ofgem considers that stipulating the obligations of BSCCo and Elexon Clear Limited, and confirming that the liability for BSC Clear VAT balancing rests with BSCCo will increase transparency in the market and better facilitate Applicable Objective (d).

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

Yours sincerely,

A handwritten signature in black ink, appearing to read '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