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The National Grid Company, BSC Signatories and
Other Interested Parties

04 August 2004

Our Ref: MP No P163

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P163: “Clarification of the circumstances in which paragraph 6.5 of Section P (calculation of Error Correction Payment) should apply”.

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P163: “Clarification of the circumstances in which paragraph 6.5 of Section P (calculation of Error Correction Payment) should apply”.

The BSC Panel (the “Panel”) recommended to the Authority:

- that Proposed Modification P163 should be made;
- an Implementation Date for Proposed Modification P163 of 10 Working Days after the Authority decision; and
- the proposed text for modifying the Code, as set out in the draft Modification Report.

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 Authority has decided not to direct a Modification to the BSC.

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

² ELEXON document reference P163MR, Version No. Final/1.0, dated 17 May 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

This letter explains the background and sets out the Authority's reasons for its decision.

Background

Paragraph P6 of the Code sets out how Past Notification Errors (PNEs) are administered. This paragraph was incorporated into the Code following approval by the Authority of Alternative Modification P37 'To provide for the remedy of past errors in Energy Contract Notifications and in Metered Volume Reallocation Notifications' (P37). The requirements for the ECP calculation are set out in Paragraph P6.5. The Modification Group assessing P37 considered two possible options which would limit cost recovery of PNE claims, a cap of £200,000 and a 20% discount on the financial benefit arising from an upheld claim. It agreed that the 20% discount, proposed under Alternative Modification P37, was the appropriate mechanism. The Panel recommended Alternative Modification P37 to the Authority in its meeting of 31 October 2001. On 10 May 2002 the Authority issued its decision to approve Alternative Modification P37.

The current interpretation of Paragraph P6.5 of the BSC requires the ECP to be calculated separately for claims relating to separate Volume Notifications affecting the same Settlement Period. ELEXON has defined the interpretation of a PNE such that there is one PNE per combination of Settlement Period and Volume Notification and one claim for each PNE. These can be aggregated to one claim per group of PNEs resulting from the same Volume Notification.

Thus, one claim can cover multiple Settlement Periods, providing that each PNE is a result of the same Volume Notification. Upholding such claims will have one of three possible impacts on an Energy Account; to provide financial benefit to the account, to impose a financial detriment to the account, or no overall effect.

Where the overall effect of a claim creates a financial detriment to an Energy Account it is possible that some claims within the netting process will have a financially beneficial effect. As each of these claims must be calculated separately for ECP purposes, claims positively affecting the Energy Account attract an ECP. Considering claims individually when calculating the ECP fails to recognise the absence of an overall financial benefit to the account, causing an ECP to be levied when this is inappropriate.

In the second set of circumstances the overall result of the PNE correction may be of an overall financial benefit. If the claims accruing a benefit are not grouped with those causing a burden, the account may attract an ECP which is inaccurately representative of the overall benefit accruing to the Energy Account (ie significantly more than 20% of the benefit). If the claims were grouped for the purposes of determining whether an ECP was due, and then the net effect of all the claims were considered, the ECP payment would represent 20% of the total financial benefit accruing to the Energy Account.

(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.

Finally it may be the case that a PNE claim does not alter the position of an Energy Account. Whilst this is the case, some claims will be of benefit to the account whilst others will be a financial detriment to it. If the claims were grouped for the purpose of calculating the ECP claim fee the effect of these claims would be balanced out, providing no financial benefit to the account and thus preventing ECP from being generated in relation to the beneficial claims.

As a result it has been argued that ECP's are sometimes levied in inappropriate circumstances, whilst in others it has been suggested that the total ECP can significantly exceed 20% of the total financial benefit to a Party and that this should not occur.

In order to rectify this situation RWE Innogy submitted Modification Proposal P163 on 02 February 2004. The Proposer considered ELEXON's operational interpretation of paragraph P6 of the Code to be incorrect and suggested that the ECP should be calculated on the basis of all adjustments to data resulting from a PNE investigation.⁵ The Proposer perceives a defect constituting a lack of clarity exists in the drafting of paragraph P6 of the Code. Therefore, P163 seeks to modify the Code to clarify that all adjustments resulting from the determination made by the PNE Committee in respect of a PNE investigation would be grouped together for the purposes of calculating the ECP.

The Proposer considers P163 would be consistent with the Authority conclusion regarding P37, a Modification approved on the basis of better facilitating achievement of Applicable BSC Objective (c), and that by fulfilling the intent of P37 P163 would better facilitate achievement of Applicable BSC Objective (c). The Proposer was also of the view that the Authority indicated, via the P37 decision letter, that the intention of the adjustment was to include an ECP equivalent to 20% of the value of the error and that the methodology for calculation proposed by ELEXON goes further than this. Therefore, it is the view of the Proposer that P163 would also better facilitate achievement of Applicable BSC Objective (d).

The claims potentially impacted by P163 are those associated with PNE Investigations I003, I020, I029 and I030.

The circumstances of P163 are also the subject of Modification Proposal P160.

ELEXON presented an Initial Written Assessment (IWA) (reference 3) to the Balancing & Settlement Code Panel ('the Panel') at its meeting on 12 February 2004. The Panel agreed with the recommendation in the IWA that P163 be submitted to a two month Assessment Procedure to be carried out by the Error Processing Modification Group (the 'Group').

The Group met three times during the Assessment Procedure and P163 was issued for industry consultation and impact assessment in order to support the group's assessment. At its meeting on 9 April 2004, the Panel considered the Assessment Report and supported the recommendation of the Group that Modification Proposal P163 should be submitted to the Report Phase with a recommendation that Proposed Modification P163 be made.

⁵ The undefined term 'investigation' was used throughout the PNE process when referring to a group of claims with the same underlying cause.

The Modification Proposal

Proposed Modification P163 would group all claims arising from the same cause for the purpose of the ECP calculation in paragraph P6.5.2. In so doing it would ensure that all adjustments to data arising from Volume Notifications affecting the same Energy Account would be given net treatment for the purposes of calculating the ECP, whether or not those Volume Notifications affect common Settlement Periods. However, unlike Alternative Modification P160, this grouping would only apply to paragraph P6.5.2. Thus, P163 would provide a net calculation as to whether the overall financial benefit provided by the Volume Notifications in question was beneficial to the Energy Account, whilst the ECP attributable to the Energy Account would be calculated based on the perceived benefit of each Volume Notification on an individual basis. The Group considered that this grouping addressed some of the issues identified in relation to multiple upheld claims affecting the same Party Energy Account and Settlement Period. However, it noted that, under Proposed Modification P163, the ECP may not represent 20% of the total financial benefit to the Energy Account in some cases because, if multiple Volume Notifications are to be corrected and an overall benefit is received such that an ECP is due, the netting effect between Volume Notifications would not be taken into account when calculating the ECP.

The Group concluded that Proposed Modification P163 would better facilitate achievement of the Applicable BSC Objectives in comparison to the current baseline. In particular it was the view of the Group that:

- Clarifying the ECP calculation, such that the majority of Parties would not be required to pay significantly more than 20% of the actual net financial benefit of any upheld claims, would better achieve Applicable BSC Objective (c);
- The Group noted that in general retrospective changes to rules do not facilitate competition and have a negative effect on the achievement of Applicable BSC Objective (c). The majority of the Group were of the view Proposed Modification P163 would provide clarification rather than a retrospective amendment. However, some members of the Group supported ELEXON's current operational interpretation of the Code and therefore viewed P163 as a retrospective Modification Proposal.
- On consideration of P163 as a retrospective amendment, a number of Group members noted that Parties should have considered the effects of the ECP prior to raising any claims and, as such, a retrospective amendment may not be viewed as justified. However, the majority of the Group were of the view that the issues with the ECP calculation identified under P163 are a result of the complexities of the investigations affected and could not have been reasonably foreseen. Furthermore, the majority of the Group considered that the issues identified with the ECP calculation could be attributed to a failure of the Central Arrangements (as the existing Code drafting does not cater for the scenario where multiple claims affect the same Energy Account and Settlement Period). As such, the majority of the Group concluded that, if P163 were seen as a retrospective amendment, retrospection would be justified in order to address the defect identified.
- The Group noted that clarification of the ECP process would reduce the possibility of legal challenge in this area and hence promote efficiency. Therefore, the Group agreed that Proposed Modification P163 would better facilitate achievement of Applicable BSC Objective (d).

Overall, the majority of the Group agreed that P163 would provide clarification rather than a retrospective amendment, and would provide potential benefits to competition resulting from increased consistency in the calculation of the ECP. Therefore, the majority of the Group concluded that Proposed Modification P163 would better facilitate achievement of the Applicable BSC Objectives in comparison to the current baseline.

Responses to ELEXON Consultation

ELEXON published a draft Modification Report on 14 April 2004, which invited respondents' views by 28 April 2004. Seven (7) responses were received. Four (4) responses (representing 22 Parties) expressed support for the Proposed Modification, two (2) responses (representing 17 Parties) opposed the Proposed Modification and the remaining response (representing 1 Party) provided a "no comment" response.

Several respondents considered the interaction between P160 and P163 in their responses. These respondents made comments to the effect that should Alternative Modification P160 be approved, Proposed Modification P163 would not be required as Alternative Modification P160 would provide clarification which is consistent with P163 and therefore addresses the defect identified under P163. Furthermore, several respondents indicated the view that Alternative Modification P160 would better facilitate achievement of the Applicable BSC Objectives to a greater extent than Proposed Modification P163.

One response in favour of the Proposed Modification provided more specific comments on the Modification, noting the respondent's agreement with the majority view of the Group that P163 is a clarification of the existing baseline. The respondent propounded that the section of the BSC in question would benefit from additional clarification and that this would be provided by P163 which would reduce the number of instances in which an erroneous ECP is calculated, thus better facilitating the achievement of Applicable Objective (c).

Of the responses not in favour of the Panel's recommendation that P163 should be approved, one did not support the Modification as it did not consider that competition would be facilitated on the grounds that PNE claims and associated payments are one off events, affecting a limited number of current market participants. Because of this the respondent did not believe that rejecting P160 would deter entrants to the market. This respondent also commented on the Authority's decision in relation to P84 "Amendment To Process For Past Notification Errors (2)" to the effect that the issue which P163 seeks to address should have been dealt with at the time of P84 and that claimants should have taken this into account before submitting their claim.

The second response advocating against the implementation of P163 commented that although the respondent had sympathy with the intention of this modification, it was concerned that approving the Modification may widen the scope for further retrospective modifications, and that such Modifications should be avoided where possible due the damage caused to regulatory certainty. In addition, the respondent also commented that the logic which determined the modification to be a clarification rather than an amendment was flawed. To this end the respondent commented that a clarification purely seeks to confirm the interpretation of an ambiguous section of text and that the meaning of the text which is the subject of P163 was not ambiguous. The respondent therefore considered that as P163 would alter the current meaning of the text, the Modification represents more than a clarification. One respondent to the consultation noted its concerns about the assertion that avoiding potential legal challenge

facilitates the better achievement of Applicable BSC Objective (d). This respondent also commented that there are very few modifications which receive unanimous support from participants and that it is therefore hypothetically possible for every decision to be legally challenged. It was suggested that there is no value in pre-empting such action when considering the Applicable Objectives against the current baseline and to do so would set an undesirable precedent. The respondent concluded by noting that a Modification should be judged on its own merits and not on speculation about what the proposer may or may not do if the Modification is proposed by the Authority.

The respondents' views are summarised in the Modification Report for Modification Proposal P163, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 13 May 2004 and considered 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 10 Working Days following the Authority Decision.

Responses to Ofgem GB Consultation

On 5 December 2003 Ofgem undertook to invite responses on additional implications that a Proposed Modification may have, were it to be applied on a GB wide basis, as opposed to being limited to England and Wales. In order to discharge this undertaking Ofgem published a GB Consultation Paper on 25 May 2004 which invited respondents' views by 5pm on Monday 21 June 2004. No responses were received.

The Consultation Paper, the responses to it and other related documents can be found on the *BETTA GB Consultation* section of the Ofgem website.⁶

Ofgem's view

Ofgem has carefully considered P163 in the context of the Modification Report for the Proposed Modification, the Panel's recommendation, the Applicable BSC Objectives and its own Statutory Duties.

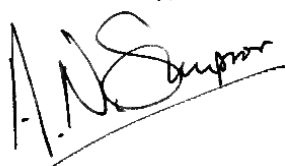
The Authority issued a letter formally approving Alternative Modification P160 on 31 July 2004 which addressed a wider range of erroneous ECP calculations. Therefore Ofgem considers that as a result of this letter P163 has been rendered redundant and the implementation of P163 would not contribute to the better facilitation of the Applicable BSC Objectives, and as such the Authority has determined it appropriate to reject Proposed Modification P163.

⁶ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

Ofgem acknowledges that views have been expressed that the possibility of legal challenge would be reduced if P160 was approved and this would better facilitate the achievement of Applicable BSC Objective (d). Ofgem wishes to convey that the possibility of legal challenge is an inappropriate consideration within the context of Applicable BSC 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