THE BALANCING AND SETTLEMENT CODE: SECTION P6

Computation of the Error Correction Payment

OPINION

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1. Section P6 of the Balancing and Settlement Code (the "BSC") provides a procedure for claiming rectification of what are called "Past Notification Errors".

2. Pursuant to that procedure in December 2003 a Committee appointed by the BSC Panel determined that certain Past Notification Errors should be rectified. As required by paragraph P6.5.1 (a), the same Committee determined the adjustments which needed to be made to relevant contract volume notifications in order to rectify those errors.

3. Paragraph P6.5.2 stipulates that where such adjustments result in a reduced debit or increased credit to the "Relevant Account Energy Imbalance Cashflow of the relevant Contract Trading Parties (or either of them individually)", then such party shall be liable to pay to the BSC Clearer an "Error Correction Payment". Paragraph 6.5.3 includes a formula for calculating the amount of that payment.

4. A dispute has arisen as to how these provisions are to apply in circumstances where a single error has affected volume notifications relating to a chain of trades between three or more parties with the result that the error (and its subsequent correction) has impacted on the net imbalance of the party at each end of the chain but has had no effect on the net imbalance of the party (or parties) in the middle

of the chain, the latter having made erroneous notifications up and down the chain which automatically cancelled each other out.

5. The problem can be illustrated by a simple example in which A transfers contract volume to C via B. The volume intended to be notified was 100 but in error only 50 was actually notified. The example assumes that the Committee appointed under Section P6 has determined that a Past Notification Error has been made and that this error should be rectified by adjusting the volume notifications both as between A and B and as between B and C so that in all cases the corrected volume is 100 rather than 50. The error correction reduces A's balance by 50 and increases C's by the same amount. B's balance remains unchanged because the increased transfer *to* B is matched by an increased transfer *from* B.

6. The issue on which my opinion is sought is this.

7. On behalf of the BSC company, ELEXON, it is argued that "for Error Correction Payment calculations the benefit is derived *individually and independently for each claim* affecting a single Energy Account for a single Settlement Period"[1]. On this basis it is said that the effect of error correction on the notification of the transfer between A and B should be examined "individually and independently" of the effect on the notification of the transfer between B and C and vice versa.

8. The first step in this analysis involves treating B is as the recipient of an additional volume of 50. That additional 50 is to be factored in to a calculation of B's Account Energy Imbalance Cashflow for the Settlement Period in question "individually and independently" of any consideration of the transfer from B to C. If the result is a reduced debit or increased credit then B must pay an error

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[1] Paragraph 5.1 of ELEXON paper entitled "Outcomes of the Error Correction Payment Algorithm" (emphasis added).

correction payment.

9. The same exercise then has to be carried out again to test the effect of the correction of the error in the notification of the transfer between B and C independently of that on the transaction between A and B. This time B is to be treated as the transferee of an additional volume of 50. The reduction of 50 in B's holding is to be factored in to a second and separate calculation of B's Account Energy Imbalance Cashflow for the Settlement Period in question. Once again if the result is a reduced debit or increased credit than B must pay an error correction payment.

10. I shall refer to the above as the "multiple correction method".

11. On behalf of Innogy Plc and its related group companies, it is argued that B's Account Energy Imbalance Cashflow (and Volume) is required by the BSC to be arrived at in a single overall calculation for each Settlement Period. As a result of the adjustments required by the Committee the additional volume of 50 transferred *to* B is automatically off-set by the additional volume of 50 transferred *from* B during the same Settlement Period. There can be no reduced debit or increased credit in the Relevant Account Energy Imbalance Cashflow of B. Error Correction Payments may be due from A and/or C but not from B.

12. I shall call this the "unitary correction method".

13. The above example and the application of the rival propositions to it is well illustrated by four diagrams prepared on behalf of RWE Innogy Plc which I have attached for ease of reference.

14. For simplicity the example has been limited to a chain of notifications involving

only three parties. The logic of the multiple correction method would mean that in a case where there were twenty six transferees, A to Z, each of which passed the same notification error on to the next, then all 24 of the intermediate transferees (i.e. B through to Y) would all be exposed to Error Correction Payments even though the net effect of error correction on each of them was zero and none of them had had any financial interest in the correction of the errors. In addition the cumulative total of these payments would almost certainly exceed the benefit obtained by A and/or Z as a result of correcting the error to an extent which would appear to be arbitrary and lacking in any rational justification.

15. By contrast under the unitary correction method the Error Correction Payments are due only from the party or parties which have benefited financially from the error correction. Furthermore under the unitary correction method the amount of the payments is directly linked to the financial benefit obtained by the paying party from the error correction.

Paragraph P6.5 and the calculation of the Error Correction Payment

16. Where the Panel Committee has determined that a Past Notification Error has occurred, paragraph 6.5 (a) requires the Panel to determine the adjustments required to be made in order to rectify the error. Provision is then made for a "Post-Final Settlement Run or Extra-Settlement Determination" in which the accounting consequences of these adjustments are made. Thus the financial benefit of the rectification is obtained by way of adjustments in account.

17. Paragraph 6.5.2 then provides as follows:

> "Where in relation to a claim for Past Notification Error (or, if claims for more than one Past Notification Error in respect of the same Volume Notification are made, in relation to the sum of all such claims in

> aggregate), the adjustments to the data as determined pursuant to paragraph 6.5.1 result in a reduced debit or increased credit in the Relevant Account Energy Imbalance Cashflow of the relevant Contracting Trading Parties (or either of them individually), such Party or Parties shall be liable to pay to the BSC Clearer the Error Correction Payment(s) applicable to its or their Energy Account(s) in accordance with the further provisions of this paragraph 6.5"

The "further provisions" include a formula in paragraph 6.5.3. The formula compares a Party's "cashflow" on a rectified and non-corrected basis for each relevant Settlement Period. The Error Correction Payment appears to have been intended to be 20% of the cumulative total (for all relevant Settlement Periods) of any reduced debit or increased credit appearing from the above calculations[2].

The background

18. Section P6 derives from BSC Modification Proposal P37 implemented in May 2002. The general background to this is helpfully set out in paragraphs 6 - 26 of the Committee's Determination of 5th December 2003 relating to Investigation I029. For present purposes I shall focus only upon those features which are material to the present debate.

19. What is described as an "alternative" version of P37 was directed to be implemented by the Office of Gas and Electricity Markets (the "regulator") in a letter dated 10th May 2002. The difference between the alternative versions of the P37 proposal concerned the Error Correction Payment. The regulator described the differences at paragraphs 22 and 24 of his letter:

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[2] I say "appears to have been intended" because a quirk in the formula may produce an Error Correction Payment in excess of 20% depending on whether or not separate Volume Notifications have been given for each Settlement Period as distinct from one Volume Notification covering a number of Settlement Periods. I have not been asked to advise upon this particular issue and I express no view about it.

> "22. Where the Panel has determined that a Past Notification Error has occurred and should be rectified, it will arrange for Settlement Runs to be carried out so that all Parties are adjusted appropriately. The financial adjustment in the case of the claimant includes an Error Correction Payment of 20% of the value of the error (ie a maximum of 80% of the costs of the error can be recovered), capped at a maximum of £200,000"
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> "24. The Alternative Modification Proposal P37 (P37 alt) is identical in every respect to P37 Clarified with the exception that the cap of £200,000 on the maximum Error Correction Payment is removed"

20. The regulator expressed his views on the proposals beginning at paragraph 37. He placed great stress on the utmost importance of accurate notification of energy contract volumes and the need to maintain incentives for correct notification. At paragraph 51 he gave his conclusions on the choice between the alternative approaches to the proposed Error Correction Payment:

> "51. [The regulator] continues to believe that, even in the circumstances covered by the Modification Proposal where notification errors may be corrected, it is not generally appropriate to expect that a Party should recover its losses in full nor should it expect to do so. [The Regulator] notes that the Panel has recommended that the discount proposed by P37 of 20% should be accepted.... [The Regulator] does not consider that the cap on recovery, proposed in the original P37, is appropriate and therefore believes that P37 alt better achieves the BSC objective".[3]

21. P37 was implemented as the new Section P6 of the BSC. When administering claims under Section P6, ELEXON (as BSCCo) adopted an approach of allocating a separate claim reference number to each Volume Notification affected by an alleged Past Notification Error.

22. Section P6 was amended at the end of May 2002 so as to give the Panel power, solely for the purposes of the £5000 claim fee, to treat as a single claim two or

[3] The words "cap on recovery" must mean "cap on recovery of the Error Correction Payment": see paragraphs 22 and 24 of the same letter.

more claims resulting from the same cause.

Analysis

23. Persons licensed under the Electricity Act 1989 to generate, transmit or supply electricity are required to subscribe to the BSC Framework Agreement. Non-licensees such as electricity traders may also subscribe to the Framework Agreement. I understand that that agreement makes the BSC contractually binding between its subscribers[4].

24. The BSC is an industry wide code approved by the regulator. Subscribers may propose modifications to the BSC. Modifications have to be approved by the regulator.

25. I understand that modifications have recently been proposed which are intended to resolve the issue on which my opinion is sought. In what follows I shall approach the BSC as it currently stands.

26. The BSC is a hybrid between a consensual contract and a regulatory code imposed by force of law. It has many of the features of a commercial contract including provisions for the settlement of accounts and for the arbitration of disputes. It also reflects policy decisions imposed by the regulator.

27. The modern approach to issues of purely contractual construction in English law involves striking a balance between the literal meaning of the words used and the overriding objective of determining and giving effect to the commercial purpose which the parties intended: *Arbuthnott v Fagan* [1996] L.R.L.R. 135; *The Antaios*

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4 See paragraph 9 of the Committee's Determination in Investigation I029.

[1985] AC 191, 201, *ICS v West Bromwich BS* [1998] 1 WLR 896.

28. When applied to the BSC the above approach requires some modification. The BSC is intended to give effect not just to the commercial objectives of the subscribers but also to the policy objectives of the regulator. The context in which the BSC falls to be interpreted includes in my view, any relevant policy statements made by the regulator in the course of approving the passages in the BSC which are in issue.

29. ELEXON does not suggest that the multiple correction approach to the calculation of the Error Correction Payments makes any sense whether from a commercial or a regulatory perspective. On the contrary ELEXON accepts that that approach produces unintended consequences[5]. ELEXON's argument is that it is driven to adopt the multiple correction approach by the language used in P6.

30. As already noted the multiple correction approach can produce results which are arbitrary and irrational depending on how many parties are in a chain of notifications affected by the same error. A related[6] problem is highlighted by the case of EdF which is alleged to face an Error Correction Payment of £750K having succeeded on a claim to rectify an error worth £250K. These results are manifestly at odds with the intention and understanding of the regulator as expressed in paragraph 51 of his letter of 10th May 2002 directing the implementation of P37. A 20% discount on the recovery of a loss of £250K is £50K and not £750K. The results are also at odds with the intentions of the Panel as reflected in paragraph 22 of the same letter. An Error Correction Payment of "20% of the value of the

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5 See paragraph 1.2 of ELEXON paper entitled "Outcomes of the Error Correction Payment Algorithm"

6 I say "related" advisedly. My limited understanding of EdF's position suggests that its problem may also have been contributed to by the quirk in the formula to which I referred in footnote 2 above.

error" cannot possibly be £750K if the error is only worth £250K. Similarly the multiple correction method produces the absurd result that a "correction payment" which is designed to limit the amount "recovered" to "80% of the costs of the error"[7] should wipe out the recovery completely and leave the claimant massively out of pocket.

31. When directing that the alternative P37 be implemented the regulator relied upon the BSC objective of facilitating and promoting effective competition in the generation and supply of electricity. I do not believe that the regulator ever intended to endorse an arbitrary and capricious arrangement such as would result from the multiple correction method. If the regulator did have such an intention I fail to see how it could be reconciled with his statutory duties under s 3A Electricity Act 1989.

32. Similarly I do not believe that the BSC parties and the members of the Panel which promoted P37 can ever have genuinely intended such an arbitrary and irrational arrangement as would result from the multiple correction method.

33. In summary any court or arbitrator called upon to rule on Section P6 would in my view only uphold the multiple correction method if the wording was very clear and incapable of any alternative interpretation.

34. It is with these considerations in mind that I turn to the language of paragraphs P6.5.2 and P6.5.3. I shall start with P6.5.2 because that sub-paragraph makes clear in terms that it is a gateway which must be entered in order to reach P6.5.3. If the conditions in P6.5.2 are not satisfied then there is no liability to pay the Error Correction Payment and there is no question of referring to the further provisions

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[7] See paragraph 22 of the regulator's letter of 10th May 2002

of paragraph P6.5 in order to determine the amount of that payment. I should however add that the BSC, like all contractual or regulatory documents, should be read as a whole and it may be necessary to consider later what light P6.5.3 may throw on the interpretation of P6.5.2 and vice versa.

35. For reasons to which I shall revert I am not persuaded that ELEXON is right to read Section P6 as requiring each Volume Notification affected by an error to be subject to a separate and distinct claim. For the present I shall however accept ELEXON's premise because my principal difficulty with the multiple correction method does not depend on whether each erroneous volume notification is required to be the subject of a separate claim.

36. Having referred to a "claim for Past Notification Error", paragraph P6.5.2 then asks whether "the adjustments to the data as determined pursuant to paragraph P6.5.1 result in a reduced debit or increased credit in the Relevant Account Energy Imbalance Cashflow of the Relevant Contract Trading Parties (or either of them individually)". "Account Energy Imbalance Cashflow" (CAEI) is defined algebraically in Section T4.7.1 so as to produce a figure which applies "in respect of each Settlement Period for each Energy Account". The relevant Settlement Period is connoted by a sub-script j and the relevant Energy Account by a sub-script a. It is thus inherent in the definition that there can only be one $CAEI_{aj}$ per Settlement Period and Energy Account.

37. If the Account Energy Imbalance Volume ($QAEI_{aj}$) is greater than zero then the $CAEI_{aj}$ for Settlement Period j and Energy Account a is a negative value cashflow of $QAEI_{aj}$ multiplied by the System Sell Price (SSP) for the same period. If $QAEI_{aj}$ is less than or equal to zero then the $CAEI_{aj}$ for Settlement Period j and Energy Account a is a positive value cashflow of minus $QAEI_{aj}$ multiplied by the System Buy Price (SBP) for the same period.

38. $QAEI_{aj}$ is defined like $CAEI_{aj}$ by reference to a particular Settlement Period and Energy Account. As with $CAEI_{aj}$, it is inherent in the definition that there can only be one $QAEI_{aj}$ per Settlement Period and Energy Account. $QAEI_{aj}$ is the Account Credit Energy Volume less the Account Period Balancing Services Volume and less the Account Bilateral Contract Volume for the same Settlement Period and Energy Account. Of these the one which is affected by volume notifications is the Account Bilateral Contract Volume ($QABC_{aj}$). The definition of $QABC_{aj}$ is in Section P4.1.1. Sub-paragraph (a) of P4.1.1 requires the summation of volume notifications to extend to *all* Energy Contract Volume Notifications in force for the particular Energy Account and Settlement Period.

39. Even assuming as ELEXON do, that what the Panel has determined are two separate and independent "claims" for Past Notification Error, one in respect of the A/B pairing and the other in respect of the B/C pairing[8], it does not seem to me that anything in either P6.5.1 or P6.5.2 envisages or permits two separate "Post-Final Settlement Runs" or "Extra Settlement Determinations" one to determine the correction to the Account Energy Imbalance Cashflow arising out of the correction of the notification under the A/B pairing and another in respect of the B/C pairing. The structure of P6.5.1 and P6.5.2 envisages that there will be one Post-Final Settlement Run which takes into account all the adjustments required by all upheld claims to rectification and produces a single corrected Account Energy Imbalance Cashflow for each Energy Account and Settlement Period. I am confirmed in this view by the fact that P6.5.2 uses the defined term "Account Energy Imbalance Cashflow" and that the definition of that term only permits there to be one such imbalance per Energy Account and Settlement Period: see above.

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[8] Following the example given at paragraph 5 above

40. The same conclusion follows if paragraph 6.5.2 requires one to work backwards from the Post-Final Settlement Run in order to construct a non-corrected run with which the corrected run is then compared. Nothing in paragraph 6.5.2 either requires or permits such non-corrected run to involve the calculation of two different Account Energy Imbalance Cashflows for the same Energy Account and Settlement Period.

41. I can follow the logic of a back-calculation which is designed to compare the Post-Final Settlement Run with a situation which had previously existed. The unitary method achieves this. I can see no logic in performing two back-calculations (one for the A/B pairing and a separate one for the B/C pairing) in order to compare the Post-Final Settlement Run with two entirely fictional constructs neither of which in fact ever existed or could have existed.

42. To perform two separate calculations (or back-calculations) of either the corrected or non-corrected Account Energy Imbalance Cashflow for the same Energy Account and same Settlement Period introduces an accounting anomaly which is not permitted either by P6.5 or, so far as I am aware, by any other provision in the BSC. It is an anomaly which is alien to every one of the BSC accounting definitions to which I have referred, each of which requires a unitary calculation for each Settlement Period and Energy Account. If what had been intended was some kind of multiple calculation method then I would have expected the draftsman to create a special set of definitions which required, for example, a "Step 1 Account Energy Imbalance Cashflow" and a "Step 2 Account Energy Imbalance Cashflow" both in respect of the same Settlement Period. I am not surprised that this exercise is missing from P6.5. It would have no practical consequence other than to produce the perverse effects upon the Error Correction Payments to which I have already referred.

43. In short I do not believe that P6.5 either permits or requires the correction of the A/B and B/C volume notifications to be rectified independently and in isolation from one another.

44. As already noted I am not in any event persuaded that ELEXON is right to require each Volume Notification affected by an error to be treated as being subject to a separate and independent "claim". I should make clear that I can see no objection to ELEXON having done this for its own internal administrative purposes (eg in the allocation of claim reference numbers) provided the administrative exercise is not then said to have substantive consequences which are unwarranted by Section P6.

45. The word "claim" is not defined either in 6.5.2 or elsewhere in Section P6. Paragraph P6.2 explains how to make a "claim". The requirements are set out in sub-paragraph P6.2.1. The claim has to be made in writing and has to identify the Past Notification Error and relevant Settlement Period. Past Notification Error is defined unsurprisingly as requiring an error in the submission of a volume notification. Nobody is suggesting that a Past Notification Error ceases to be a Past Notification Error just because the same error affects multiple notifications and/or multiple Settlement Periods. The definition of Past Notification Error provides no assistance in understanding how many notifications (or errors) can be the subject of the same "claim".

46. It is true, as ELEXON observe, that the words in parenthesis in lines 3 - 5 of 6.2.2 and in lines 1-3 of 6.5.2 allow claims for multiple errors affecting the same notification to be treated as a single claim. If anything, this may suggest that for all other purposes it is the error rather than notification which determines what can be included in a claim and that if the same error affects multiple notifications it can be the subject of a single claim.

47. Paragraph P6.2.3 gives marginal support to the ELEXON position because it requires a "claim" to be accompanied by a statement in writing "from the other relevant Contract Trading Party" that the latter considers that a Past Notification Error has occurred. This suggests that what the draftsman had primarily in mind as constituting a claim was the erroneous notification of a bi-lateral trade rather than a complex structure or chain of trades. I am however unable to read paragraph P6.2.3 as going so far as to prohibit a single claim in respect of more than one notification. This is not what paragraph 6.2.3 says and it is not its purpose.

48. In the case of a claim involving more than one other "relevant Contract Trading Party" I would read paragraph 6.2.3 as requiring the consent of all relevant Contract Trading Parties. Section X, paragraph 2.1.1 of the BSC expressly endorses this approach.

49. Next ELEXON relies on the reference in the singular to the "relevant Volume Notification" in 6.5.3 (a). If one reads this literally as referring to a single Volume Notification regardless of how many Volume Notifications are subject to adjustments, then it leads back into precisely the same anomaly to which I referred earlier, namely that the definition of Account Energy Imbalance Cashflow does not lend itself to an approach which takes into account one Volume Notification for a relevant Energy Account/Settlement Period whilst excluding another and/or which requires multiple and sequential calculations of different Account Energy Imbalance Cashflows for the same Energy Account and same Settlement Period. I regard this as fundamentally inconsistent with the BSC's whole approach to Settlement Period accounting. "Relevant Volume Notification" in 6.5.3 (a) has to be read as including "relevant Volume Notifications" in order to make sense of the scheme of paragraph 6.5 when read as a whole.

50. I regard the point on 6.5.3 (a) as yet another example to which the general proviso in Section X, paragraph 2.1.1 of the BSC applies. In any event I see reliance on nothing more than the use of the singular rather than the plural as a flimsy basis for undermining the BSC's general approach to accounting for each Settlement Period and Energy Account.

51. I have noted ELEXON's reliance on the reference to "the Past Notification Error" in 6.5.3 (c). For reasons explained elswhere I do not regard the definition of Past Notification Error as requiring each Volume Notification affected by an error to be the subject of a separate and independent claim.

52. In summary it is my view that P6.5 requires ELEXON to adopt what I have called the unitary correction method for calculating both the corrected Post-Final Settlement Run and the non-corrected version with which this is to be compared. ELEXON would not be justified in adopting the multiple correction method whether for calculating the Error Correction Payments, or so far as I can see, for any other purpose.

DAVID MILDON QC

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