



Promoting choice and
value for all customers

Direct Dial: 020 7901 7491

The National Grid Company, BSC Signatories and
Other Interested Parties

30 July 2004

Our Ref: MP No P160

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P160: “Removal of the Anomalous Effect of the Error Correction Payment (ECP) for Multiple Claims Affecting the same Settlement Period and Energy Account”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P160, “Removal of the Anomalous Effect of the Error Correction Payment (ECP) for Multiple Claims Affecting the same Settlement Period and Energy Account”.

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

- Alternative Modification P160 should be made;
- Proposed Modification P160 should not be made;
- an Implementation Date for Alternative Modification P160 of 10 Working Days after the Authority decision;
- an Implementation Date for Proposed Modification P160 of 10 Working Days after the Authority decision, in the event the Authority determines that the Proposed Modification P160 should be made; and

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 P160RR, 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:

Authority has decided to direct a Modification to the BSC in line with Alternative Modification Proposal P160.

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 of the Electricity Act 1989 in relation to the direction.

Background

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), paragraph P6 of the Code sets out how Past Notification Errors (PNEs) are administered. The provisions relating to the ECP calculation are found in Paragraph P6.5. The Modification Group assessing P37 considered two possible options which would limit the financial recovery relating to PNE claims (1) a cap of £200,000 and (2) a 20% reduction on the financial benefit arising from an upheld claim. It agreed that the 20% reduction, 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 approving 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. However, these claims 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 would 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 under this approach.

-
- (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.

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.

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 EdF Trading Ltd submitted Modification Proposal P160, "Removal of the Anomalous Effect of the Error Correction Payment (ECP) for Multiple Claims Affecting the same Settlement Period and Energy Account" on 29 January 2004. The proposer considered that by amending the ECP calculation such that Parties would not be required to pay significantly more than 20% of the actual net financial benefit of any upheld claims P160 would ensure that the calculation and effect of the ECP is consistent for all PNE claimants and, as such, P160 would better facilitate achievement of Applicable BSC Objective (c). Furthermore, the Proposer believed that P160 would better facilitate Applicable BSC Objective (c) by fulfilling the intent of P37, a Modification also deemed to better facilitate the achievement of that Objective.

The claims potentially impacted by P160 are those associated with PNE Investigations I003, I020, I029 and I030.

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

ELEXON presented an Initial Written Assessment (IWA) to the Panel at its meeting on 12 February 2004. The Panel agreed with the recommendation in the IWA that P160 be submitted to a two month Assessment Procedure to be carried out by the Error Processing Modification Group (the 'Group').

The Modification Proposal

Proposed Modification P160 seeks to address the defect perceived by the Proposer of the Modification by providing for the grouping claims which affect the same Energy Account and Settlement Period for the purpose of the ECP calculation. By netting the impact on an Energy Account of all corrected Volume Notifications affecting one or more common Settlement Periods, Proposed Modification P160 seeks to ensure that the ECP calculated for those Volume Notifications represents 20% of the actual benefit received from upheld claims. The ECP for another Volume Notification relating to the same Energy Account, but not impacting common Settlement Periods, would be calculated separately. Should this Volume Notification constitute

a detriment to the Energy Account, the ECP applicable could prove larger than 20% of the total financial benefit accruing to the Energy Account as the netting effect of the Volume Notification constituting a detriment would not be taken into account. The Group considered that the potential for the ECP to be greater than 20% of the benefit to the Energy Account represented a potential deficiency.

Due to the perceived deficiency in Proposed Modification P160 the Group developed Alternative Modification P160. The Alternative seeks to 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. Thus P160 Alternative would provide a net calculation as to whether the overall financial benefit provided by the Volume Notifications in question were beneficial to the Energy Account, and should there be an overall benefit, calculate the ECP for the Energy Account based on the group of Volume Notifications as a whole. The Group suggested that the approach detailed in the Alternative would better ensure that the ECP for an Energy Account is not substantially more than 20% of the overall financial benefit to the Energy Account, solving the defect identified by the Group in relation to the Proposed Modification.

It was recognised that the proposed changes to the calculation of the ECP under P160 could constitute retrospective modifications. The Group considered whether P160 (Proposed or Alternative) would constitute a retrospective Modification and if so whether a retrospective rule change could be justified. The majority considered that P160 would constitute a retrospective Modification. It was the view of the majority that P160 would amend the methodology for ECP calculation approved and agreed by industry under P37 and, as such, Proposed and Alternative Modification P160 constituted a retrospective amendment. In contrast to the majority view, some members considered that the original intent of P37 was to include an ECP at 20% of the financial benefit of upheld PNE claims. They suggested that as the current Code drafting does not deliver this intent where multiple claims affect the same Party Energy Account and Settlement Period, the Code is currently inconsistent with the intent of P37 and the industry perception as to the appropriate operation of the ECP calculation. Thus, these members suggested that P160 would implement a correction to an oversight in the original legal drafting of P37 rather than a retrospective rule change.

The criteria for determining whether a retrospective change ought to be made were set out by Ofgem in the decision letter for P19 "To provide for the remedy of errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications" and repeated in P37. These criteria set out circumstances in which a retrospective modification may be justified and included;

- 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 retrospective action had been clearly flagged to participants in advance and only the details and process were decided retrospectively.

Ofgem further commented that for a retrospective change to be justified, the loss would need to be material.

It was the view of the Group that the issues identified with the ECP calculation were a result of the Code drafting developed under P37 not being robust to the scenario where multiple claims affect the same Settlement Period and Party Energy Account. As such, it considered that the perceived defect identified under P160 could be viewed as an error or fault directly attributable to Central Arrangements. The Group also suggested by a majority that the issues with the ECP calculation identified under P160 were examples of circumstances which could not be reasonably foreseen, although a minority view considered that the ECP calculation was clearly defined in the Code and that Parties should have considered the potential results prior to raising claims. The Group did not consider that retrospective action had been flagged to the Group in advance.

The Group considered that both the Proposed and the Alternative Modification would better facilitate the achievement of the Applicable BSC Objectives in comparison to the current baseline. However it was unanimously agreed that Alternative Modification P160 would ensure that the effect of the ECP is consistent across claimants to a greater extent than Proposed Modification P160. Therefore, the Group unanimously agreed that Alternative Modification P160 would better facilitate achievement of the Applicable BSC Objectives in comparison to Proposed Modification P160. The Group considered the arguments for and against the better achievement of the Applicable BSC Objectives under Alternative Modification P160 as follows:

- The Group supported the rationale provided by the Proposer that amending the ECP calculation such that Parties would not be required to pay significantly more than 20% of the actual net financial benefit of any upheld claims, would ensure that the calculation and effect of the ECP is consistent for all PNE claimants and, as such, would better achieve Applicable BSC Objective (c).
- The Group noted that in general retrospective changes to rules do not facilitate competition and, as such, Alternative Modification P160 could be considered to have a negative effect on the achievement of Applicable BSC Objective (c). In particular 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 effects of the ECP calculation identified under P160 are a result of the complexities of the investigations and outcomes that could not have been reasonably foreseen. Furthermore, the majority of the Group were of the view 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 a retrospective change was justified in this case.
- 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 Alternative Modification P160 would better facilitate achievement of Applicable BSC Objective (d).

Overall, the majority of the Group agreed that potential benefits to competition resulting from increased consistency in the calculation of ECPs would outweigh any negative effect of introducing a retrospective rule change. Therefore, the majority of the Group concluded that Alternative Modification P160 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 17 Parties) expressed support for the Alternative Modification, two (2) responses (representing 39 Parties) opposed the Proposed Modification and the remaining response (representing 1 Party) provided a "no comment" response.

The four respondents to the consultation in support of P160 all favoured the Alternative Modification over the Proposed. One of these respondents noted that the Proposed Modification was also an improvement over the current baseline, whilst another commented that although it considered the Alternative Modification should be approved, it also considered Proposed Modification P160 better than Modification Proposal P163.

Of those respondents advocating the approval of the Alternative Modification, two commented to the effect that the Alternative Modification should be approved as to do so would provide fair treatment for all Parties in the ECP calculation by removing the unintended effect of the current wording, and that the Alternative should be preferred as it addressed all instances of an erroneous ECP being levied. The Alternative Modification was supported by two respondents on the grounds that it was consistent with the solution developed under P37 and that it delivered the expectation of that Modification for all Parties. The other respondent in favour commented that it concurred with the view that approval of the Alternative Modification would reduce the possibility of a legal challenge as regards the level of the ECP levied against a minority of successful claimants. The respondent considered that this would better facilitate achievement of Applicable BSC Objective (d) as any legal defence made by ELEXON would be funded by BSC signatories. It was further suggested by one of the respondents in favour of the Alternative Modification that as the Modification corrects an error in the original text and in Central Systems which parties could not have reasonably expected to produce the ECP figures indicated, P160 Alternative should be characterised as an acceptable retrospective modification.

The two respondents in opposition did not give their support to either the Proposed or the Alternative Modifications. The first respondent did not support P160 as it did not consider competition would be facilitated by its introduction as the PNE claims and associated payments are one off events affecting a limited number of current market participants. The respondent therefore believed that rejecting P160 would not deter entrants to the market. The other respondent noted that although the outcome of the calculation was not expected by the majority of the participants and had sympathy with the Modification as it delivered an apparently equitable outcome, the respondent considered that the Modification was retrospective, commenting that retrospective modifications increase market uncertainty and damage confidence in the trading arrangements. It was suggested that the consequences of grouping claims should have been scrutinised to a higher degree and that the potential for long term damage to be caused as a result of retrospective changes should outweigh the material benefits of the Modification.

Both respondents which advocated the rejection of P160 commented on the Authority's decision in relation to P84 "Amendment To Process For Past Notification Errors (2)" to the effect

that market participants should have been more careful in the assessments of their claims and tested the system to ensure it delivered what was intended.

One respondent to the consultation noted its concerns as regards the assertion that avoiding potential legal challenge facilitates the better achievement of Applicable BSC Objective (d). The respondent 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 proposal is approved by the Authority.

The respondents' views are summarised in the Modification Report for Modification Proposal P160, 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 reject Proposed Modification P160, and recommended that the Authority should approve Alternative Modification P160. The implementation timetable for both the Proposed and the Alternative Modification was one of 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.⁵

⁵ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

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 Alternative Modification P160 will better facilitate the achievement of Applicable BSC Objective (c).

The development of Ofgem's views on the recovery of losses arising from Post Notification Errors is detailed in decision letters P19, P37 and P84. During the progression of P37 through the Modifications Process Ofgem noted its concern that to allow 80% recovery of the losses arising as the result of an upheld PNE claim may have been too high. Ofgem also commented that to allow recovery of no monies may have been inequitable given the exceptional circumstances giving rise to the Modification. At the end of the Modification Procedure Alternative Modification P37 which stipulated a 20% ECP was recommended to the Authority by the Panel. The Alternative was approved for two fundamental reasons;⁶

- notwithstanding the concerns raised by the Authority, P37 Alternative was capable of better facilitating achievement of Applicable BSC Objective (c), and
- as the Authority did not consider that the cap on recovery was appropriate, the original Modification Proposal was unsuitable.

Ofgem maintains these concerns, but recognises that the Modification Group assessing P37 intended the ECP to represent 20% of the financial benefit accruing to an Energy Account as a result of an upheld PNE claim and that industry's expectation has crystallised on this figure. Ofgem further recognises that the current provisions of the BSC do not always deliver this outcome. Accordingly, Ofgem considers that measures ought to be taken to ensure the ECP calculation is consistent for all PNE claimants and that P160 Alternative can deliver this consistency to a greater extent than Proposed Modification P160. Ofgem further considers that P160 is consistent with the intention of P37 which was approved by the Authority on the basis that it would better facilitate the achievement of Applicable BSC Objective (c).

As was noted in responses to the draft Modification Report consultation, Ofgem commented in its decision relating to P84 that the governance process is intended to provide time and opportunity for Parties, especially those likely to be affected by a Modification, to ensure that Proposed Modifications and any Alternatives are robust solutions to issues likely to affect them. Consequently Ofgem is disappointed that these issues were not perceived earlier. However, Ofgem does recognise that in this case unforeseen complexities arose and that it may not have been reasonable to analyse every possible outcome of the claims investigations in order to comment on the proposed legal text of P37.

Ofgem agrees with the majority view of the Group to the effect that P160 is a retrospective modification. The Authority has noted in the past that retrospective changes tend to damage market confidence in, and the efficient operation of, NETA. This view was repeated by some members of the Group and in some responses to industry consultation. However as Ofgem has previously made clear, the possibility of introducing retrospective rule changes must be allowed in certain circumstances. In relation to this Modification proposal, Ofgem considers that the

⁶ Full reasoning for the Authority decision is contained in the decision letter pertaining to P37 which can be found on the ELEXON website. www.elexon.co.uk

issues involved are the result of unforeseen complexities, and that the financial loss caused by these complexities and borne by the Parties involved in PNE Investigations I003, I020, I029 & I030 was sufficient, when considered in the wider circumstances of the Modification, for the Authority to consider it material.

Ofgem further notes the responses to the industry consultation to the effect that the PNE claims an associated ECP payments are one-off events affecting a limited number of market participants and that as such rejecting P160 would not deter new entrants to the market. Whilst this is the case Ofgem considers that the introduction of a mechanism that will ensure the effect of the ECP is consistent across all claimants will better facilitate achievement of objective (c)

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