



03 June 2003

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No P109

Dear Colleague

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Notice in relation to Modification Proposal P109: “A hedging scheme for changes to TLFs in Section T of the Code”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P109, “A hedging scheme for changes to TLFs in Section T of the Code”.

The Balancing and Settlement Code Panel (the “Panel”) recommended to the Authority that the Modification Proposal be rejected.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives and the Authority’s wider statutory duties³, the Authority has decided not to direct a Modification to the BSC.

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

Background

Some electricity is used up in the process of its transportation from power plants to electricity consumers. The electricity lost on the transmission network is commonly referred to as “transmission losses”.

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

² ELEXON document reference MR109, Version No. 1.0, dated 18 March 2003.

³ Ofgem’s statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things social and environmental guidance provided to Ofgem by the government.

There are two types of losses: variable losses and fixed losses. Variable losses account for the majority of electricity lost. These are a function of the current flowing through a circuit or transformer windings, causing heating of the transmission lines, cables and transformer windings. These variable losses therefore increase with the distance that the electricity has to travel. Fixed losses, which are unrelated in the short run to the distance that the electricity has to travel, occur in both transformers and the overhead lines. For transformers, the fixed losses arise in their iron cores, which are subject to an alternating magnetic field, and do not vary significantly with the power flow through the transformer. Overhead line fixed losses are relatively small and dependent on voltage levels and weather conditions.

The current arrangements for allocating transmission losses are set out in Section T.2 of the BSC. Transmission losses are presently recovered on a uniform basis and divided between generators and Suppliers⁴ on a 45/55 split⁵. The rules apply a transmission loss multiplier (“TLM”) to all metered volumes of BSC Participants to scale these to account for transmission losses. The TLM is calculated on a half-hourly basis to take account of the actual transmission losses in each Settlement Period. The TLM is derived from a transmission loss factor (“TLF”), which is currently set to zero for all Balancing Mechanism Units (“BMUs”), and transmission loss adjustments (“TLMOs”)⁶, which are different for offtaking and delivering BMUs (TLMO- and TLMO+ respectively). The TLMOs ensure that 45% of the actual transmission losses are allocated to generators (delivering BMUs) and 55% to Suppliers (offtaking BMUs).

The need to review the basis of charging for transmission losses was referred to in the Pooling & Settlement Agreement, introduced in 1990, and there has been a long standing regulatory commitment to reform transmission losses, supported initially by the Director General of Electricity Supply (“DGES”) and subsequently by Ofgem. In November 1995, the DGES wrote to the Electricity Pool (the “Pool”) Chairman asking the Pool to develop proposals for a more cost-reflective charging of transmission losses. Subsequently, a proposal for charging transmission losses on a zonal basis was developed and the proposal was approved by the majority of Pool members. However, this decision was appealed to the DGES for determination. The DGES upheld the Pool’s resolution, and a date of November 1997 was set for implementation of the scheme. Two Pool members challenged the DGES determination by judicial review on procedural grounds. While the judicial review did not proceed to hearing, the arrangements envisaged were not implemented in 1997 and the matter was superseded by the review of the Pool based trading arrangements and the introduction of the New Electricity Trading Arrangements in 2001. The basis for charging for transmission losses was incorporated into the BSC, which was introduced in March 2001, and became subject to the normal governance arrangements for modifying the BSC.

⁴ For the purposes of this letter when Ofgem makes reference to Suppliers this includes all customers who are directly connected to NGC’s transmission system.

⁵ The 45:55 split is equivalent to a 50:50 split, by taking into account that the Defined Meter Point for generation is the high voltage side of the generator transformer, whereas that for demand is the low voltage side of the supergrid transformer. Therefore, the loss volumes calculated do not take into account the supergrid transformer losses already incurred by generators, but do include the supergrid transformer losses on the demand side. This split in the responsibility for losses between generators and Suppliers was introduced with NETA in March 2001. Previously all the losses were allocated to Suppliers.

⁶ It is noted that TLMO is not a direct abbreviation of transmission loss adjustments. However, it is the formulation used in the BSC to denote this.

Powergen submitted Modification Proposal P75 "Introduction of zonal transmission losses" on 5 April 2002. Subsequently, First Hydro Company submitted Modification Proposal P82 "Introduction of zonal transmission losses on an average basis" on 3 May 2002. Both Modification Proposals sought to change the allocation mechanism for transmission losses to enable a zonally differentiated allocation of transmission losses. The Transmission Loss Factor Modification Group (the "TLFMG") assessed both Modification Proposals over a period of six months.

British Energy raised Modification Proposal P85 "A phased implementation scheme for changes to TLF in Section T of the Code" during the Assessment Procedure for Modification Proposals P75 and P82. This scheme was also referred to as "F-factor phasing". The Proposer subsequently withdrew Modification Proposal P85 on the understanding that the proposed phasing scheme would be considered as part of the Assessment Procedure for Modification Proposals P75 and P82.

The TLFMG considered the F-factor phasing scheme, during its assessment of Modification Proposals P75 and P82. However, the TLFMG considered that an alternative phasing scheme for the introduction of zonal transmission loss factors would be more appropriate. This alternative phasing scheme was referred to as "β-phasing" and formed part of Alternative Modification Proposal P75 and Alternative Modification Proposal P82.

British Energy submitted Modification Proposal P109, "A hedging scheme for changes to TLFs in Section T of the Code" on 1 November 2002. The Proposer considered that the Modification Proposal would better facilitate achievement of Applicable BSC Objectives⁷ (c) and (d) as set out in Condition C3.3 of NGC's Transmission Licence.

The Panel considered the Initial Written Assessment at its meeting of 14 November 2002 and agreed to submit Modification Proposal P109 to a three month Assessment Procedure. The Panel also determined that the Modification Group for Modification Proposal P109 (the "Group") should present an Interim Report to the Panel on 12 December 2002. The Group presented its Interim Report at the 12 December 2002 Panel meeting. The Panel considered the Interim Report and agreed that no further guidance needed to be given to the Group and agreed that the Assessment Procedure should continue.

⁷ The Applicable BSC Objectives, as contained in 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) without prejudice to the foregoing objectives and subject to paragraph 3A, 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.

The Modification Proposal

Modification Proposal P109 seeks to modify the BSC to introduce a hedging scheme against future changes to Transmission Loss Factors (“TLFs”) in section T of the BSC. The Modification Proposal set out that the hedging scheme could be applied to any future transmission losses scheme. The Group refined the Modification Proposal and defined that the scheme would be triggered by an Authority determination that changed the value of TLFs. Ofgem approved Modification Proposal P82 on 17 January 2003, when Modification Proposal P109 was still being assessed. When Modification Proposal P82 is implemented on 1 April 2004, TLFs may vary on a zonal basis. The Group acknowledged that the baseline of the BSC had changed, and defined 17 January 2003 as the trigger date for the hedging scheme under Modification Proposal P109. The hedging scheme will last for 15 years from the trigger date.

The Modification Proposal would assign a fixed volume of energy to all Parties to use as a basis for the hedging scheme. This volume is referred to as the “F-factor”. Each Balancing Mechanism Unit (“BMU”) would have a different Offtaking and Delivering F-Factor. The F-factor volumes would be defined differently depending on the status of the BMU:

- ◆ **Incumbent Central Volume Allocation (“CVA”) registered BMUs:** F-factor volumes would relate to levels of output and consumption for a historic sample period. The F-factor volume is fixed for the entire life of the F-factor phasing scheme.
- ◆ **New entrant CVA registered BMUs:** F-factor volumes would be based on average plant characteristics and the value of Generation Capacity for the BMU at the time it registered. The F-factor volume is fixed for the entire life of the F-factor phasing scheme.
- ◆ **Supplier Volume Allocation (“SVA”) registered BMUs:** A single F-factor volume defined for the Grid Supply Point (“GSP”) Group as a whole would be shared on a pro-rata basis. The F-factor volume would relate to levels of output and consumption for a historic sample period. The F-factor volume would gradually be phased out over the life of the F-factor phasing scheme.
- ◆ **Interconnectors:** A single F-factor volume to be defined for the Interconnector, and shared on a pro-rata basis between Interconnector BMUs. The F-factor volume is fixed for the entire life of the F-factor phasing scheme.

Incumbent CVA registered BMUs would only be exposed to the new, zonal TLFs for any differences between actual output and the F-factor volume. For the F-factor output, the BMUs would be liable for transmission losses calculated assuming TLFs have a zero value, as is the case before implementation of Modification Proposal P82 on 1 April 2004. Incumbent, CVA registered BMUs would have a one-off option to choose to take part in the F-factor phasing scheme or be exposed fully to the new transmission losses arrangements that come into effect on 1 April 2004.

The treatment of new entrant CVA registered BMUs is different to incumbent CVA registered BMUs in that they can only lock in the TLFs prevailing at the time of their registration for their F-factor volume.

The treatment of Interconnector BMUs is similar to the treatment of Incumbent CVA registered BMUs, except that the decision to opt in or out of the scheme is taken for the Interconnector as a whole by the Interconnector Administrator.

SVA registered BMUs are treated differently to all other BMUs in this scheme, in the respect that participation in the F-factor phasing scheme is mandatory.

The minority view of the Group was that the Modification Proposal would not better facilitate achievement of Applicable BSC Objectives (b) and (c). This was because the Modification Proposal would reduce the benefits delivered by Modification Proposal P82. In particular, these Group members considered that there would be a reduction in the accuracy of allocating transmission losses by diminishing the locational signals of Modification Proposal P82. The minority of the Group also considered that the perceived reduction in risk would be outweighed by increased variability in TLMs. Finally, the minority view of the Group was that facilitating achievement of Applicable BSC Objective (d) would be undermined because of the cost and complexity of administering the scheme set out in the Modification Proposal.

A narrow majority of the Group considered that the Modification Proposal would better facilitate the achievement of Applicable BSC Objectives (b) and (c). This was because the Modification Proposal would provide a more stable investment environment for generation and supply, and at the same time retain the benefits of the locational signals provided by Modification Proposal P82. Furthermore, these Group members also considered the Modification Proposal would increase the long-term efficiency of investment in generation and supply by limiting the exposure of existing investment to variable transmission losses. Consequently, investment in the transmission system would be more efficient. The majority of the Group also considered the Modification Proposal would reduce the cost of capital and therefore reduce the barriers to entry. Finally, the Majority of the Group considered the benefits of the Modification Proposal outweighed the implementation costs, and therefore facilitating achievement of Applicable BSC Objective (d) would not be compromised.

Consequently, the Group recommended in the Assessment Report submitted to the Panel that the draft Modification Report should contain a provisional recommendation that the Modification Proposal should be made.

ELEXON published a draft Modification Report on 19 February 2003, which invited respondents' views by 28 February 2003. The draft Modification Report contained a provisional recommendation by the Panel that the Modification Proposal does not better facilitate achievement of the Applicable BSC Objectives and therefore should be rejected.

Respondents' views

ELEXON received 13 responses to the consultation on the draft Modification Report. Eight respondents supported the Panel's recommendation to reject the Modification Proposal, four respondents disagreed with the Panel's recommendation and considered the Modification Proposal should be implemented. The remaining respondent did not express an opinion on the Panel's recommendation.

All four respondents opposed to the Panel's recommendation, considered that the Modification Proposal would improve efficiency. Three of these respondents specifically considered that the Modification Proposal would reduce risk across the industry. One of these respondents suggested that a detailed cost-benefit analysis would identify the enhanced efficiency resulting from the reduced cost of capital if the Modification Proposal were implemented. Another of these respondents considered that the Modification Proposal would to some degree offset the "deleterious effects" of Modification Proposal P82.

Six of the respondents supporting the Panel's recommendation considered that the Modification Proposal would compromise the benefits arising from Modification Proposal P82. There were also six respondents supporting the Panel's recommendation which considered that the Modification Proposal was complex, and that this would undermine better facilitating achievement of Applicable BSC Objective (d).

Two of the respondents supporting the Panel's recommendation considered the Modification Proposal would unduly discriminate between Parties.

One respondent supporting the Panel's recommendation also considered that the BSC is not the appropriate vehicle to provide hedging for the risks of individual Parties. This respondent also questioned the validity of the Modification Proposal having been considered at all. The respondent considered that the Modification Proposal was contingent because it was raised before Modification Proposal P82 was approved.

Another respondent supporting the Panel's recommendation was concerned that the method of relying on historical output measures to assign F-factor volumes would not reflect the flexible way in which many Parties operate their plant. The respondent considered that flexibility improves the efficiency of the System and that any signal to be less flexible in order to hedge transmission losses would be detrimental to achieving efficiency.

The respondents' views are summarised in the Modification Report for Modification Proposal P109, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 13 March 2003 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 reject the Modification Proposal. The Panel recommended that, if approved, the Modification Proposal should be implemented on:

- ◆ 1 April 2004, if the Authority decision is received by 14 April 2003, or
- ◆ 1 August 2004 if the Authority decision is received after 14 April 2003 but before 18 August 2003.

The Panel considered that the arguments suggesting that the Modification Proposal does not better facilitate achievement of the Applicable BSC Objectives were more compelling than the arguments put forward by the majority of the Modification Group suggesting that the Modification Proposal does better facilitate achievement of these Objectives.

One Panel member suggested that the arguments relating to the perceived reduction in cost of capital afforded by the Modification Proposal were not robust and that no such reduction had been demonstrated. Another Panel member considered that the Applicable BSC Objectives would not be better achieved by all BSC Parties providing a hedge for particular BSC Parties in respect of zonal transmission losses.

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers that, having had regard to the Applicable BSC Objectives and its statutory duties⁸, the Modification Proposal does not better facilitate achievement of any of the Applicable BSC Objectives. Ofgem considers, on balance, and without limitation, that the Modification Proposal would be particularly detrimental in relation to Applicable BSC Objective (b). Ofgem therefore agrees with the Panel's recommendation that Modification Proposal P109 should not be made and implemented.

Applicable BSC Objective (b) - enhancing the efficient, economic and co-ordinated operation by the licensee (NGC) of the licensee's transmission system.

In Ofgem's decision letter for Modification Proposal P82, Ofgem set out that if charges do not reflect costs, there will be cross subsidisation in the charging arrangements which will tend to have two effects:

- ◆ in the short run costs are higher than would otherwise be the case. Cross subsidisation will lead to some plant generating when it would be less costly for it not to generate, whilst other plant, which it would be more efficient to use, is not generating. Similarly, cross-subsidies are likely to result in the pattern of electricity consumption failing to reflect fully the costs of providing the electricity; and
- ◆ in the long run there will be a tendency towards an inefficient (locational) pattern of investment in generation and closure of generation with a consequential adverse impact on transmission. There could also be inefficiency in the location of demand.

These inefficiencies have economic and environmental costs, the size of which will depend upon system conditions.

Ofgem considers that allowing CVA registered Parties to opt in or out of the F-factor phasing scheme would imply that only Parties that would otherwise be adversely affected would opt in. Similarly, those Parties that are likely to gain from the introduction of Modification Proposal P82

⁸ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things social and environmental guidance provided to Ofgem by the government.

are not likely to opt in. Ofgem considers that those Parties that opt for the F-factor phasing scheme will effectively be subsidised by other Parties, as those that opt in are not charged transmission losses based on their contribution to those losses. Conversely, those that opt out of the F-factor phasing scheme will not receive the full benefits they otherwise would have received, had it not been for the cross-subsidy going to Parties in the scheme. Ofgem therefore considers Modification Proposal P109 could significantly reduce the benefits of the locational signals to be provided by Modification Proposal P82. Ofgem considers that Modification Proposal P109 would effectively lead to the current cross-subsidies flowing from northern customers and southern generators to southern customers and northern generators being retained.

The mechanism under the Modification Proposal would effectively make a payment to Parties that sign up to the F-factor phasing scheme and are located in zones with higher transmission loss contributions than is the case under the present allocation mechanism. This payment is based on the differential between the ALF and the TLF and the volume of the F-factor. The payment is made regardless of the metered position of the Party. Ofgem therefore considers, that it is possible, for example, for a generator to receive a payment even when it is not generating. For Suppliers, that are mandated to sign up to the F-factor phasing scheme, it would be possible to either receive, or be obliged to make, a payment in situations where they do not offtake from the transmission system. Ofgem therefore considers that payments under the F-factor approach may be arbitrary, and not reflective of the actions of the Parties.

Ofgem considers that Modification Proposal P109 would be detrimental to achieving efficiency as it would lead to less cost reflective charging of transmission losses. This detrimental impact on efficiency may have a particular importance over the next 20 years given the potential major changes in the type and distribution of plant, especially as a result of the Government's climate change commitments. Ofgem therefore considers that the implementation of this Modification Proposal will be detrimental to better facilitating the achievement of the Applicable BSC Objective (b).

Applicable BSC Objective (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.

In general, uniform pricing presents a barrier to competition as it offers less scope for competitors to secure a lower cost. The present uniform pricing arrangements artificially impose higher costs on generators in the south and Suppliers in the north. This restricts the market for generation alternatives in the south (whether this be Combined Heat and Power ("CHP") or other forms of new generation) and supply in the north. Ofgem considers that the implementation of Modification Proposal P82 will allow for differential charges for transmission losses, which could have a positive effect on competition. Ofgem considers that Modification Proposal P109 will significantly reduce the effect of the introduction of differential charges for transmission losses. Ofgem considers this is particularly the case for Suppliers, as participation in the F-factor phasing scheme will be mandatory for SVA registered BMUs. Ofgem therefore considers that the Modification Proposal will be detrimental to better facilitating the achievement of Applicable BSC Objective (c).

Applicable BSC Objective (a) - the efficient discharge by the licensee (NGC) of the obligations imposed upon it by this licence.

NGC has a range of statutory duties and licence obligations which include ensuring the efficient, economic and co-ordinated operation of the system, the facilitation of competition⁹ and non-discrimination¹⁰. As set out above, Ofgem considers that the Modification Proposal will be detrimental to NGC's discharge of the first two of these obligations. Ofgem also considers the Modification Proposal would be detrimental to NGC's discharge of its non-discrimination obligation.

Ofgem understands the problems associated with developing the CVA solution fully on the demand side. However, despite these problems, Ofgem does not accept the difference in treatment between CVA registered generation and SVA registered demand. Ofgem considers it discriminatory that Suppliers do not have the option to opt in or out of the F-factor phasing scheme, as CVA registered generators do. Suppliers with demand in GSP groups that are likely to pay less for their transmission losses when Modification Proposal P82 is implemented will be hindered in obtaining this benefit.

Notwithstanding the previous paragraph, Ofgem also considers that the arrangement of gradually phasing out the F-factor for Suppliers, but allowing the full F-factor value for the entire 15 year period of the scheme to apply CVA generators would be discriminatory. Ofgem does not consider that Suppliers and generators have any fundamental differences in their ability to adjust either to a gradual or discrete change in the F-factor value.

Ofgem also considers that the Modification Proposal would lead to discrimination between incumbent and new entrant generators. Incumbents will have the opportunity to lock in only the present methodology for calculating transmission losses for the F-factor volume. In contrast, new entrants will have the opportunity to lock in only the transmission loss factors prevailing at the time they register for the F-factor volume. Ofgem considers this would lead to significantly different treatment of incumbents and new entrants. For example, it would be possible that a new entrant in a zone where the new zonal transmission loss factors are considered beneficial to generators would opt to lock in the prevailing zonal loss factor for its F-factor volume. The generator would then be ensured, for the remainder of the life of the F-factor phasing scheme, to receive the locked in transmission loss factors for its F-factor volume. Ofgem considers transmission loss factors could change as Parties respond to the new zonal transmission loss factors. Ofgem considers that the Modification Proposal would allow newly commissioned generators to lock in a beneficial transmission loss factor, effectively ensuring that it is not affected by changes in the transmission loss factors over the lifetime of the F-factor phasing scheme. Ofgem considers that this different treatment of incumbents and new entrants would be discriminatory.

For the reasons set out above, Ofgem considers the Modification Proposal would lead to discriminatory treatment of Parties. Ofgem therefore considers the Modification Proposal would be detrimental to better facilitating achievement of Applicable BSC Objective (a).

⁹ Section 9 (2) (b) of the Electricity Act 1989.

¹⁰ Condition C7C of the Transmission Licence.

Applicable BSC Objective (d) – promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

Ofgem agrees with the Panel that the cost and complexity of the Modification Proposal seem high. As set out above, Ofgem also considers that the Modification Proposal would be detrimental to achieving the benefits to be delivered by Modification Proposal P82. Therefore, Ofgem considers that the Modification Proposal would be detrimental to better facilitating achievement of Applicable BSC Objective (d). Ofgem considers that the detrimental impact of the Modification Proposal in better facilitating achievement of Applicable BSC Objectives (a), (b) and (c) are of such significance that the Authority's decision would not have been different had the Modification Proposal not been detrimental to better facilitating achievement of Applicable BSC Objective (d).

In summary, Ofgem considers that the Modification Proposal will be detrimental to better facilitating achievement of Applicable BSC Objectives (a), (b), (c) and (d).

Ofgem considers that, as Modification Proposal P82 is based on ex-ante determined transmission loss factors, there could be scope for the market to develop hedging instruments to insure against future fluctuations in the transmission loss factors. Ofgem does not consider that any such hedging schemes should be incorporated into the BSC as this may potentially distort the price of electricity.

Ofgem considers that in general, those Parties that are concerned about risk elements, such as future energy price variations, could consider arranging business insurance via the financial markets.

Ofgem notes that the BSC Panel, in light of recent legal advice, considers that the Modification Proposal should not have been allowed to progress through the Modification Procedures. The legal advice gave two main criteria against which to judge whether a submitted Modification Proposal should be taken forward:

- ◆ A proposal must imply a change to the prevailing BSC (F2.1.2 (f) refers), in order to be a Modification Proposal, as defined. If the proposal implies a change to some future version of the BSC (i.e. the prevailing BSC, plus one or more Approved Modifications) then it is a contingent proposal and is not a Modification Proposal, according to the BSC definition. In this latter case, such a proposal can not be considered under section F of the BSC.
- ◆ If a proposal is considered to be a Modification Proposal then, under F2.1.2, it must address an issue or defect with the prevailing BSC (F2.1.2(c) refers). If, however, the Modification Proposal describes an issue or defect that may manifest itself at some future point, as a result of one or more subsequent BSC Modifications, but is not an issue or defect with the prevailing BSC then the Modification Proposal is anticipatory and the Modifications Secretary (or the Panel) may refuse the Modification Proposal, since no issue or defect currently exists.

The Panel also received legal advice that if a Modification Proposal has not been refused, it must be allowed to complete the Modification Process. Ofgem agrees with the criteria set out above for deciding whether a Modification Proposal should be taken forward. Ofgem considers that in future, if the Panel is in any way in doubt of the validity of a Modification Proposal, it should promptly seek legal guidance on the issue to avoid nugatory work being undertaken at the expense of all BSC Parties.

Ofgem is bound to act within the confines of its statutory duties as set out in the Electricity Act 1989 and other relevant legislation. Ofgem therefore does not agree with the view that its decisions may in any way increase regulatory risk. In Ofgem's view, participants already have had considerable time to prepare for the new arrangements since a change to strengthen the signals of transmission losses has been foreshadowed since 1990. Ofgem considers that market participants have had the opportunity to consider this in planning and making investment decisions over the intervening years.

Better charging signals will lead to more efficient use of existing plant and more informed locational decisions, both of which are immediate as well as long term issues (decisions on closures and new plant are likely to have to be taken in the next few years as well as over the longer term).

On this basis Ofgem considers that the case for further delay in implementing better charging signals for transmission losses is unpersuasive and that there is a strong efficiency case for the earliest possible implementation of the improved price signals.

Ofgem agrees with one member of the Panel that the arguments put forward in favour of the Modification Proposal to the effect that it mitigates perceived increases in the cost of capital are not robust. These arguments were based on the assertion that protection from potential future changes in the way transmission losses are allocated would decrease regulatory risk and thereby decrease the cost of capital. Ofgem considers that this claim is not substantiated. The decision to move to a more cost reflective allocation of transmission losses has been foreshadowed since 1990 and should not have come as a surprise to any Party. Even if it were unexpected, consistent with assessment of cost of capital in price reviews across all utilities, there is no basis to assume that such changes would have any material effect on the cost of capital.

As set out above, Ofgem considers that any informed market participant should have been aware of the long history that precedes the reform to transmission losses arrangements. Indeed, Ofgem considers that it could be that regulatory risk would have increased, had the Authority not determined in favour of Modification Proposal P82. Ofgem does not consider that market participants that have considered the history of reform to transmission losses when deciding on where to site new generation and demand, should have to continue to subsidise those Parties that chose to ignore these signals.

Ofgem notes that the Panel considered that the Modification Proposal could increase the variability of TLMs. Ofgem considers that this would increase the costs imposed on Parties that wish to contract ahead to limit their exposure to transmission losses. Ofgem considers this could increase the costs to the end consumer. It is Ofgem's principal objective to protect the interests

of consumers and Ofgem considers such a cost increase would be detrimental to fulfilling Ofgem's principal objective.

The Authority's decision

The Authority has therefore decided not to direct that Proposed Modification P109, as set out in the Modification Report for Modification Proposal P109, should be made and implemented.

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 the Modification Report.

Please contact Sonia Brown on 020 7901 7412 if you have any questions in relation to this letter. Alternatively, please contact Richard Ford on 020 7901 7411.

Yours sincerely

A handwritten signature in black ink, appearing to read 'B Moselle', written in a cursive style.

Boaz Moselle

Managing Director, Competition and Trading Arrangements

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