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INTERIM REPORT
MODIFICATION PROPOSAL P109 –
A Hedging Scheme for Changes to
TLFs in Section T of the Code

Prepared by ELEXON on behalf of the Balancing
and Settlement Code Panel

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1 RECOMMENDATIONS

The Panel is invited to:

- a) **NOTE the contents of the P109 interim Report and the recommendations of the P109 Modification Group that no guidance is being sought from the Panel in respect of P109 at this stage;**
- b) **AGREE that no provisional thinking be sought from the Authority in respect of any matter associated with P109 at this stage;**
- c) **AGREE that the P109 Modification Group should continue with its assessment of Modification proposal P109, in accordance with its Terms of Reference; and**
- d) **NOTE that the Assessment Report is to be submitted to the Panel Meeting on 13 February 2003.**

2 INTRODUCTION

This Report has been prepared by ELEXON Ltd. on behalf of the P109 Modifications Group (P109MG), in accordance with the terms of the Balancing and Settlement Code ('the Code'). The Code is the legal document containing the rules of the balancing mechanism and imbalance settlement process and related governance provisions. ELEXON is the company that performs the role and functions of the BSCCo, as defined in the Code.

An electronic copy of this document can be found on the BSC Website, at www.elexon.co.uk

3 DESCRIPTION OF THE MODIFICATION PROPOSAL

Modification Proposal P109 'A Hedging Scheme for Changes to TLFs in Section T of the Code' seeks to address a perceived lack of stable signals for long-term investment and the potential stranding of sunk costs were the Transmission Loss Factor (TLF) value in the Code to change from its current value of zero. To this end, P109 recommends embedding a transition scheme for the TLF value in the Code. Under the scheme, any future change to the value of TLF would be phased-in over a 15-year period.

According to the Proposer, the possibility of changes to TLFs creates risks that are impossible to hedge against. It is argued that implementation of P109 would facilitate competition in generation and supply by providing a transitional scheme that would avoid or diminish the distortions created by such risks. It is further proposed that participation in such a scheme is optional on the part of generators. The Proposer asserts that the introduction of such a transitional scheme would protect consumers from the effect of a 'sudden large change in their charges'.

The proposed transition scheme, applicable to both generation and consumption, is based on allocating transmission losses to BM Units on a mixed basis – firstly a fixed quantity, F, of production/consumption would be allocated losses as at present (i.e. a pro-rata allocation equal to 45% or 55% of average losses respectively with a TLF of zero) and the remainder (i.e. the difference between that fixed quantity and actual production/consumption) would be allocated losses in accordance with the relevant new TLF. It is proposed that a uniform reduction to zero (for demand) and a retention (for generation) of the value of F will occur over a 15-year period, subsequently

exposing a BM Unit's entire output/consumption to the effect of the TLF. The result of this F-Factor phasing is to gradually increase the amount of metered output that is exposed to the effect of TLFs.

4 BACKGROUND

P109 has been raised following the discussions on transmission losses by the Transmission Loss Factor Modification Group (TLFMG), during progression of Modification Proposals P75 'Introduction of Transmission Losses' and P82 'Introduction of Transmission Losses on a Average basis'. Both P75 and P82 have been the subject of a 6-month Assessment Procedure and the Assessment Report was presented to the Panel meeting of 14 November 2002. During the Assessment Procedure for Modification Proposals P75 and P82, Modification Proposal P85, 'A Phased Implementation Scheme for changes to TLF in Section T of the code' (P85) was raised by British Energy which dealt with the phased implementation of any changes to TLFs. The Proposer of P85 subsequently withdrew the proposal as phased implementation of changes to TLFs was being considered during the Assessment Procedure for P75 and P82.

The assessment of P75 and P82 included discussions of whether a phased implementation approach was appropriate. Two mechanisms for phasing the implementation of changes to TLFs were discussed; the mechanism suggested by P109 (F-factor phasing) and 'beta' phasing. Beta phasing uses a multiplicative factor to phase-in the full effect of zonally differentiated TLFs over time and was viewed by the TLFMG as the better solution.

The TLFMG agreed that beta phasing that F-factor phasing better achieved Applicable BSC Objective (c)¹ (because the impact of TLFs was limited to new investment and existing investment was sheltered; this concept is replicated by P109). However the TLFMG also agreed that Applicable BSC Objective (d)² was not better achieved because of the severe administrative complexity of the F-factor approach. Furthermore, it was originally considered by some to be infeasible, although a smearing approach for embedded BM Units removed one of the key difficulties. Many members remained sceptical, particularly in respect of the possibility of there being Panel obligations in having to set the F-factors. This has, to some extent, been addressed by the P109 proposal, although further consideration of this aspect is still required.

5 TERMS OF REFERENCE

An Initial Written Assessment (IWA) for Modification Proposal P109 was presented to the November 2002 Panel, as part of its initial consideration of the proposal. The IWA suggested that, since the concept enshrined in the proposal had been considered by the TLFMG, the Modification could be submitted to the Report phase. However, the Panel considered that there were, a number of further issues that might be of relevance and determined that a three month Assessment Procedure should be undertaken by a new Modification Group (P109MG). The P109MG is based on members of the TLFMG and Governance Standing Modification Group and supplemented with members with relevant expertise.

On the basis of the IWA and points raised by the Panel discussion on P109, the P109MG agreed a set of Terms of Reference (Annex 1). These have been subsequently approved by the Panel by correspondence. A key element of the Terms of Reference was the presentation of an Interim Report, which should address any of the wider issues that have been raised. With this in mind, the P109MG concluded that the Interim Report should be presented to the Panel at its December 2002 meeting.

¹ 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

² Promoting efficiency in the implementation and administration of the balancing and settlement arrangements

This would then allow a consultation and Impact Assessment to be undertaken in January and an Assessment Report to be presented to the February 2003 Panel, in line with timescale agreed by the Panel. A comprehensive plan is contained within the Terms of Reference, attached as Annex 1.

In drawing up the Terms of Reference, the P109MG clarified a number of points, as follows:

- The trigger for the scheme was clarified to be a central decision relating to a Modification to the BSC in respect of the differential allocation of Transmission Losses (rather than any change in value of TLFs). Hence, the trigger for the scheme would be a notice from NGC, in accordance with a direction of the Authority, relating to the above matter. There remains some consideration to be given by the P109MG as to whether the above trigger is at the date of the notice itself, or the associated implementation date;
- The Modification Proposal states that the perceived deficiency in the current BSC is that there is a risk of stranding sunk costs and that there are no stable signals for long term investment, in respect of any change to TLF values. Other parts of P109 are clear in describing risks associated with changes to TLF values. Given this, the P109MG were in agreement with a provisional view from ELEXON's legal advisor that the perceived defect is limited to matters associated with the differential allocation of Transmission Losses and, hence, any Alternative Modification would also be so limited. The Proposer confirmed that the intent of the proposal was to limit the hedging scheme to changes in TLF;
- the concept of precedent is not strong in the BSC, since any Modification must be judged on its own merits against the Applicable BSC Objectives. However, although it was noted that decisions made by the Authority might involve some consideration of precedent, precedent was not considered an issue germane to the deliberations of the Modification; and
- as a working assumption, particular factors would apply to an individual Settlement Period, throughout a particular month and would be calculated from a twelve month sample of equivalent Settlement Periods (running from thirteen months to one month prior to the trigger point).

6 INITIAL CONSIDERATION OF THE MODIFICATION PROPOSAL

The following sub-sections detail the issues considered and conclusions reached by the Modification Group during the initial portion of the Assessment Procedure.

6.1 Definition of Modification Proposal

The P109MG confirmed that the trigger would be the relevant NGC notice, but debated whether it was necessary to relate that notice to differential allocation of Transmission Losses, rather than relate it to a change in TLF methodology. Relating the trigger to change in TLF's would enable the specific algebra to be retained, but might allow subsequent Modifications to circumvent the hedging arrangement by leaving TLFs as they are and introducing some new feature that allocates Transmission Losses on a differential basis.

The counter view was that any such proposal would have to demonstrate that Applicable BSC Objectives were better achieved, as compared to the then BSC baseline and such a circumvention would be recognised and would have to be assessed.

It was also acknowledged that a subsequent Modification could (and should) be explicit if the P109 arrangements, if they were in force, should be disapplied. ELEXON will provide a legal view as to

whether such circumvention might be possible. In the meantime, the P109MG would assume that the trigger event (and the F-factor algebra) can be related specifically to TLFs.

6.2 Vires of the Assessment Procedure

The P109MG considered two aspects of vires; the first was whether the scope of the BSC covered hedging, or risk management arrangements and the second was whether there could be said to be a defect in the BSC, given the anticipatory nature of the proposal (i.e. the defect only manifests itself if a subsequent Modification is implemented).

On the first point, it was noted that the BSC already contains credit cover arrangements and these are risk management tools. A counter view was that the credit arrangements covered a risk to all BSC Parties collectively, whilst the proposal related to the risk perceived by individual Parties.

On the second point, it was suggested that the proposal is an implementation approach (especially if the scope is limited to TLFs). However, the P109MG agreed that the defect is not that unhedgeable costs might be imposed at some future time, but that it is asserted that there is a risk of such costs being imposed. It is that perceived risk which is in the current BSC and purports to be the defect.

There was also a view that it was not an issue for the Group to consider matters of vires and that the Panel had invited the Group to undertake an Assessment of the proposal. The Group noted that this question had been explicitly agreed to in its Terms of Reference and that the issue was whether there was a need for guidance from the Panel or provisional thinking from the Authority on this question. The Group concluded that the issue was within the scope of the BSC and that there was a purported defect related to the risk in the current BSC which could be assessed by the Group.

6.3 Anticipatory Nature of Proposal (Governance)

The P109MG considered that the proposal might be; contingent on subsequent changes (i.e. that it could not be given effect in the BSC until some further change had been implemented), or that it might be anticipatory (i.e. that it could be given effect, but with an expectation that some subsequent change will occur), or that it might be neither (i.e. that it could be given effect, regardless of any subsequent changes). Some members of the Group considered that the BSC already contains provisions that take effect when other changes are made (Information Imbalance charges and Transmission Loss Multipliers utilising non-zero TLFs) and that the concept of the proposal 'interfering with regulatory decisions' (this was a concern highlighted in the Terms of Reference) was not meaningful, in that the proposal would, if accepted, be in the BSC and any subsequent proposal could take account of that fact.

Counter to this, it was suggested that the purported removal of regulatory risk would not be achieved, since a subsequent proposal could disapply the arrangements. However, it was argued that any such subsequent proposals would have to demonstrate that the Applicable BSC Objectives would be better achieved by such disapplication, recognising that, if P109 were in force, it would, presumably have been shown to better achieve said Objectives in the first place. A majority view emerged from the Group that P109 can be assessed on the basis that it purports to remove a risk (that imposes a cost on investment) that exists in the current BSC, regardless of future changes, albeit with a mechanism that switches in if TLFs become non-zero. However, there was a counter view that there was a contingent element to the proposal and that provisional thinking should be sought by the Panel from the Authority on the following question:

- *Is it appropriate for a Modification Group to consider Modification Proposals that are contingent on one or more future or Pending Modification Proposals being approved by the Authority?*

6.4 Anticipatory Nature of Proposal (Quantification of Better Achievement of Applicable BSC Objectives)

There were some views that the costs incurred due to the risk of possible future decisions could not be quantified, but some who held that view did consider that a qualitative judgement could be made. Others considered that such risks may be factored into project finance and could therefore be quantified. The Group concluded that the quantification could be adequately dealt with as part of the assessment.

6.5 Limitation of Hedging Scheme to TLFs

It was suggested that, if the scope of the proposal involved hedging against any changes to the Code, this could undermine subsequent proposals and render any such proposals very difficult to justify. However, it was also noted that, in any event Applicable BSC Objectives must always be better achieved; this sometimes renders subsequent proposals more difficult (because the hurdle has been raised) and sometimes more easy (if some pre-requisites have been adequately dealt with). However, the P109MG accepted that view that the Modification proposal was specific as to the scope of the hedging being limited to TLFs and that the proposal (and any alternatives) can be assessed accordingly.

6.6 Interaction with Current Modification Proposals

The Panel has already considered three Modification proposals seeking to change the value of TLFs (P75, P82 and P105) and has made recommendations in respect thereof. These recommendations have all been made with the expectation that no use of F-factors would be involved. This, potentially, may imply some degree of retrospection on this proposal. This was noted by the P109MG.

ANNEX 1 – TERMS OF REFERENCE

See attachment 1