

Modification proposal:	Balancing and Settlement Code (BSC): 'Notification of Energy Contract Volumes and Meter Volume Reallocations' (P210)		
Decision:	The Authority¹ directs that this proposal be made²		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	29 March 2007	Implementation Date:	5 February 2007

Background to the modification proposal

The imbalance position of each Party to the Balancing and Settlement Code ('the Code') is determined from the difference between its notified contractual position and its actual physical production or consumption.

The Code contains provisions that allow a signatory to dispute the outcome of settlement processes if it considers that these have been applied incorrectly ('the Trading Disputes process'³). A query raised against a settlement error in the notification process must be raised within 20 Working Days of the first Settlement Run in which the error first occurred.

The outcome of a Trading Dispute may include the correction of data, processes or the application of rules. Such corrections may financially impact both the appellant and other BSC Parties (because overall settlement cash-flows balance to zero, meaning that a reduction or increase in the appellant's debits/credits will alter the overall balance of debits/credits).

The modification proposal

Modification Proposal P210 ('the Proposal') was raised by the Panel at the request of the BSCCo (ELEXON).

The Proposal argues that some aspects of Section P of the Code relating to contractual notifications are unclear and may be open to misinterpretation. It suggests that these may create inefficiencies and uncertainties in the application of the Code; with a knock-on effect that there is an increased risk that the notified contract position of a Party (or Parties) may contain financially material errors.

In order to remedy the perceived defect, the Proposal puts forward a number of proposed changes to the wording of the Code that are intended to ensure that the Code unambiguously reflects the manner in which contractual notifications are required to be processed.

In view of the potentially significant commercial impact of any erroneously notified contract position on the affected Party (or Parties), we acceded to the Panel's request that we grant urgent treatment to this proposal in order to expedite resolution of the matter⁴.

A Proposed Modification and an Alternative Modification were developed by industry. These proposals are identical in all regards except that the Proposed Modification would

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

³ The Trading Disputes process is detailed in Section W of the Code.

⁴ Both of these letters are available on the Elexon website. See footnote 7 for a hyperlink.

take retrospective effect from the date on which P210 was raised, 5 February 2007, whilst the Alternative Modification would take effect prospectively, one Working Day after an Authority decision.

BSC Panel⁵ recommendation

The Panel met to reach its recommendation on P210 on 14 March 2007. It considered that both the Proposed and Alternative Modifications better facilitated the code objectives but that the Proposed Modification was the optimal of the two.

The Panel recommended unanimously that the Proposed Modification be made with a retrospective implementation date of 5 February 2007, and that the Alternative Modification not be made.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 15 March 2007. The Authority has considered and taken into account the responses to ELEXON's⁶ consultation which are attached to the FMR⁷. The Authority has concluded that:

1. implementation of either the Proposed or the Alternative Modification will better facilitate the achievement of the relevant objectives of the BSC⁸, but that the Proposed Modification better facilitates the objectives to a greater extent; and
2. directing that either the Proposed or the Alternative Modification be made is consistent with the Authority's principal objective and statutory duties⁹.

Reasons for the Authority's decision

Applicable BSC Objectives (a) and (b)

Collectively the Panel, Modification Group, and industry respondents did not identify any arguments to suggest that either Applicable BSC Objective (a) or (b) would be better facilitated by the Proposed or Alternative Modification, or that either would have negative effects against these objectives. The Modification Group agreed that the Proposed and Alternative Modifications would have a neutral impact on Applicable BSC Objective (a) and (b). We agree with these conclusions.

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'

Whilst there was some divergence of views on whether the proposed changes should be retrospectively or purely prospectively applied, the Panel and Modification Group considered that competition would be better facilitated by providing certainty in the interpretation of the Code, and that this would avoid inefficiency and potentially significant costs. It was contended that uncertainty creates risks that may discourage Parties from full participation in the market. Removing this uncertainty was perceived to

⁵ The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC.

⁶ The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.

⁷ BSC modification proposals, modification reports and representations can be viewed on the Elexon website at www.elexon.com

⁸ As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: <http://62.173.69.60/index.php?pk=folder132230>

⁹ The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989.

assist both new entrants and market incumbents in correctly interpreting the notification rules, therefore engendering market confidence in them.

These arguments used by the Panel and the Modification Group captured those put forward by industry consultation respondents who supported the view that this objective was better facilitated.

The issue of retrospective application prompted differing views within industry and the Modification Group. Those who opposed it cited a general principle against retrospective rule changes, arguing that they may undermine certainty of market operation and therefore diminish confidence to participate fully in the market place.

Those who supported retrospective application considered that the specific circumstances of this proposal merited such treatment. It was noted that the uncertainties around code interpretation could lead to material notification errors and that prompt resolution would reduce the opportunity for Parties to take advantage of the uncertainty (i.e. "game" a currently exposed loophole). The Panel in particular noted that retrospective application was necessary to ensure an orderly market.

We consider that this proposal has highlighted that in the treatment of contract notifications there is a significant mismatch between what the Code says, and what the central systems actually do, when a new contract notification is submitted that seeks to overwrite an existing contract position. In certain circumstances, this mismatch may result in a different pattern of trades being recorded in the central systems than that which the Code requires to be recorded.

Such a situation, if left uncorrected, could have a serious adverse impact on the operation of an orderly market.

Uncertainty in the rules that are being applied increases the risk that a prudent operator may inadvertently adopt an erroneous contract position, with potentially serious financial consequences. Perhaps even more significantly, it leaves an open loophole for gaming.

The Trading Disputes process allows for a Party to retrospectively dispute the outcomes of settlement, if it considers that the Code has not been correctly applied. Currently the Code and systems may currently result in different financial outcomes if certain patterns of contracts are submitted. This leaves a very real risk that a Party (or Parties) may choose to selectively arbitrage ex post between the position the systems recorded and the position the Code says should have been recorded through use of the Trading Disputes process. The balancing nature of settlement cash-flows are such that the costs of any such activity would be smeared across other signatories.

The risk of market abuse, or errors, occurring under the current Code drafting are major concerns with potentially material financial consequences to Parties. We agree that the removal of these risks will better facilitate effective competition.

Retrospectivity

In general, we consider that retrospective changes to industry codes will damage market confidence in, and the efficient operation of, the trading arrangements. Rather than protecting participants from "unforeseen unfairness" we take the view that signatories would generally prefer the assurance and certainty of rules that are unlikely to be changed retrospectively. We consider that there are generally accepted and well understood legal reasons why retrospective modifications are to be avoided. It is a general principle of legal policy that law should be certain and therefore that changes to

rules ought not to change the character of past transactions completed on the basis of the then existing rules.

For these reasons, we are, in general, against approving modifications which have retrospective effects. However, despite the general principle against retrospective rule changes, we believe that there may be a small number of particular circumstances that could give rise to the need for a modification which would have a retrospective effect as evidenced in a small number of such modifications approved for the Uniform Network Code and Balancing and Settlement Code.

We have previously highlighted¹⁰ the following as particular circumstances that could give rise to the need for a retrospective rule change (in any event the loss sustained, or consequences of the problem, would need to be material):

- 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 a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect.

We consider that all three of these circumstances are applicable to P210:

- the fault or error is directly attributable to central arrangements, with a mismatch existing between how the code requires contract notifications to be processed and how the central systems actually handle them;
- this mismatch in the treatment of contractual overwrites was inadvertently introduced by the legal drafting for P98, even though that modification did not seek to alter the treatment of overwrites in any way. We do not consider that participants could have reasonably foreseen that P98 would materially change code obligations that were neither explicitly nor implicitly within its intended scope; and
- the possibility of retrospective action to correct these errors was clearly flagged to participants in advance. Consideration of retrospective implementation formed part of the modification group's terms of reference and industry was consulted on its views on this matter during their development of P210. The extent of retrospection is limited to the date on which this proposal was raised, and there are no dates covered by the period of retrospective application within which the market was unaware that the proposal might be enacted.

The purely prospective implementation of the changes proposed by the Alternative Modification would continue to leave the market exposed to the consequences of gaming (should any have occurred) for a period after its implementation, in relation to days that fell before its implementation but after the date on which the presence of this defect was highlighted by the raising of P210. Retrospective implementation to the date that P210 was raised removes this risk.

For this reason, whilst we consider that the retrospective Proposed Modification and the prospective Alternative Modification both better facilitate the relevant objectives, we consider that the former is the optimal of the two and that retrospective application is justified in this case.

¹⁰ See for example the decision letter for BSC P206, 'Publication of BSC Panel election results' or the combined decision letter for UNC117, 'Amendment to Invoice Billing Period', and UNC122, 'Restriction of Invoice Billing Period to Price Control'.

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

The Panel, Modification Group and the majority of industry consultation respondents who expressed clear arguments against the code objectives put forward arguments suggesting that this objective would be better facilitated by both proposals, arguing that lack of clarity in the current Code drafting leads to inefficiencies, particularly through the risk of disputes. One consultation respondent considered that whilst the prospective version better facilitated this objective, the retrospective version did not for the sole reason that it was retrospective.

We note the general undesirability of retrospective rule changes, but consider such a change to be merited in this instance for the reasons detailed in the previous section of this letter.

No case has been brought forward to suggest that the disputes process is inefficient or will become any more efficient as a result of this proposal. Any disputes raised in this area would appear to be a symptom, rather than a cause, of the wider problem of the requirements of the Code and operation of the systems not tallying. Notwithstanding this, we accept that the Proposal should prevent disputes being triggered by Parties either gaming or seeking to correct erroneous positions that could cause administrative costs. As such, in accepting this proposal, the potential for disputes to be triggered is reduced. This should in turn better facilitate promoting efficiency in the administration of the balancing and settlement arrangements.

We also concur with the view that the Code would be less open to multiple interpretations with the proposed changes than is currently the case. We consider that efficiency in the administration of the balancing and settlement arrangements should be better facilitated by the removal of doubt as to what the Code drafting requires. We consider the efficiency benefits suggested against objective (d) to be of a lower order than the competition benefits against objective (c).

Decision notice

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority, hereby directs that modification proposal BSC P210: 'Revisions to the Text in Section P related to Single Notifications of Energy Contract Volumes and Metered Volume Reallocations' be made, with effect from 5 February 2007.



Mark Feather

Associate Director, Industry Codes & Licensing

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