



10 May 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref : MP No: P37

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P37: "To provide for the remedy of past errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications"

- 1 The Gas and Electricity Markets Authority (the "Authority")¹ has carefully considered the issues raised in the Urgent Modification Report in respect of Modification Proposal P37, "To provide for the remedy of past errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications"(P37).
- 2 The Balancing and Settlement Code Panel (the "Panel") recommended to the Authority that:
 - a) The Authority determines in favour of P37 Alternative.
 - b) If the Authority determines in favour of either P37 Clarified or P37 Alternative, that the Implementation Date should be set as 5 Business Days after the date of determination.
- 3 The Authority has decided to direct a Modification to the BSC.

This letter explains the background and sets out the Authority's reasons for its decision. In addition, the letter contains a direction to The National Grid Company plc ("NGC") to modify the Balancing and Settlement Code ("BSC") in line with the Alternative Modification Proposal P37, as set out in the Urgent Modification Report dated 5 November 2001.

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

This letter constitutes the notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

Background to the proposal

- 4 P37 is the third Modification Proposal to have been submitted related to allowing for the retrospective correction of errors in Energy Contract Volume Notifications (ECVNs) and in Metered Volume Reallocation Notifications (MVRNs) after Gate Closure. Such errors are called “notification errors” hereafter in this decision letter. These Modification Proposals followed a number of notification errors that participants made during the first few weeks of NETA. Ofgem decided not to direct that the first two Modifications Proposals should be implemented:- P9: “Correction of Technical Error In Respect of ECVNs and Adjustment of Settlement Data” (proposed by ScottishPower plc) and P19: “To provide for the remedy of errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications” (proposed by London Electricity plc).
- 5 P9 proposed that when participants made notification errors as a result of “no fault technical errors” in their software, they would have been able to apply to have the error corrected. Subject to the approval of the BSC Panel, participants would have been able to resubmit the data that had been incorrectly submitted. The settlement processes would then have been re-run. The Modification Proposal would have applied both in respect of errors that had already taken place (retrospective errors) and errors that might occur in future (prospective errors).
- 6 Ofgem considered that Modification Proposal P9 was insufficiently clear in its purpose, drafting and effect to enable it to be satisfied that it would better facilitate achieving the BSC objectives. Ofgem also considered that the lack of a time limit for notifying claims would not promote efficiency in the administration of the BSC. Indeed, we pointed out that in most markets, the opportunity to correct errors was very limited, and, where error correction was allowed, it had to be initiated very shortly after the error occurred. Ofgem considered that this principle should apply to the BSC.
- 7 P19 also sought to amend the BSC to enable notification errors to be remedied in relation to retrospective and prospective errors. Participants would have had to submit claims for such corrections within 72 hours of the trading period to which the error applied. Claimants would have to pay an administration fee of £5,000 and would have to prove to the BSC Panel that an error had occurred in that the notifications failed to reflect the true trading position of the participant. If the Panel was satisfied that an error had occurred, it would be required to determine the appropriate adjustments to be made to the notification error(s). The adjusted notifications would then be used for the purposes of settlement.
- 8 In rejecting P19, Ofgem first considered the general principle of a correction mechanism for erroneous notifications and subsequently the issue of retrospectivity. Ofgem considered that it could be argued that any losses incurred (and associated windfalls gained) as a result of notification errors are the results of the commercial operation of NETA. We were mindful of the fact that, in a commercial setting, one of the strongest incentives to efficient trading is the knowledge that insufficiently robust risk management systems can result in trading errors and

that losses are a likely consequence of such errors. Consequently Ofgem was of the opinion that it is essential that there should be strong incentives on participants to deliver correct notifications. If the incentives to have robust risk management systems in place were inadequate, it would be likely that notifications would need to be frequently adjusted for errors that could adversely affect the efficient administration of the BSC. A correction mechanism for erroneous notifications could also create a possibility of intentional post-Gate Closure adjustments to traded quantities. There could be the risk of undermining the strong commercial incentives on participants to balance their own positions ahead of real time.

9 Although Ofgem rejected this Modification Proposal, we stated that a modification to allow contract notification errors to be corrected would not necessarily be incompatible with the BSC objectives or Ofgem's statutory duties if it, in the interest of preserving incentives, included an appropriate and material charge for any party seeking to correct a notification error, limits on the recovery of losses incurred as a result of an error, a short claim period and a requirement for the claimant to establish the nature of the error. Ofgem concluded that, although the arguments for and against P19 were finely balanced, it should reject the Modification.

10 Ofgem also indicated that, in general, retrospective changes to the BSC would damage market confidence in, and the efficient operation of, NETA. Ofgem stated that there are generally accepted and well understood legal reasons why retrospective modifications should be avoided but accepted that there may be a small number of particular circumstances that could give rise to the need for a retrospective rule change, including:

- 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.

11 We further stated that for a retrospective change to be justified, the loss sustained would need to be material.

12 Modification Proposal P37, "To provide for the remedy of past errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications", was submitted on 11 September 2001 by London Electricity. Amongst the justifications for the Modification Proposal was the better facilitation of the Applicable BSC Objectives² contained in condition C3 (3) (a), (c) and (d) of NGC's licence (previously condition 7A.3 (a), (c) and (d)). London

² The Applicable BSC Objectives, as contained in Condition C3 (3) of National Grid Company'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.

Electricity claimed that the Modification would promote effective competition in the generation and supply of electricity (condition C3 (3)(c)), by allowing the BSC Parties, and new entrants in particular, to place reliance on the effectiveness of the BSC in addressing unfairnesses. To the extent that new entrants to the market may be more likely to make notification errors, then the Proposed Modification may further serve to promote competition from new entrants, by protecting them from the disproportionate consequences of such errors. London Electricity also claimed that the Modification would promote efficiency in the implementation of balancing and settlement arrangements (condition C3 (3) (d)), by reducing the risk to Parties of participating in the BSC, and thereby reducing the risk-related costs of balancing and settlement activity.

- 13 Ofgem granted the Modification Proposal urgent status for the purposes of Section F.2.9 of the BSC on 13 September 2001, and also established timescales for evaluation. These timescales were revised on 9 October 2001 due to the fact that the Modification Group, during their second meeting, requesting Provisional Thinking from Ofgem (which was given on 12 October 2001) and also to accommodate a third Modification Group meeting which was held on 19 October 2001.
- 14 On 25 October 2001, Ofgem agreed to a delay of one further day in issuing of the Draft Report to the Panel in order to accommodate the Panel's deliberations on 31 October 2001. Although the Modification Group was unable to come to a consensus view, the Modification Group formulated an agreed set of clarifications to the original Modification Proposal, forming "P37 Clarified" and an Alternative Proposal (which also incorporates the agreed clarifications).
- 15 The Panel noted at its meeting on 31 October 2001 that:
 - The Modification Group could not reach a single view on whether P37 Clarified better facilitated achievement of the Applicable BSC Objectives, there being strong views for and against.
 - The Modification Group could not reach a single view on whether the Alternative Proposal better facilitated achievement of the Applicable BSC Objectives, there being strong views for and against.
 - The Modification Group could not reach a single view on whether the Alternative Proposal better facilitated achievement of the Applicable BSC Objectives, in comparison with P37 Clarified, there being strong views for and against.
- 16 As a result, the Panel voted to recommend one of the following:
 - Adoption of P37 (Clarified).
 - Adoption of the Alternative to P37 (Clarified).
 - Rejection of both P37 (Clarified) and the Alternative to P37 (Clarified).

The Modification Proposal

- 17 The Clarified and Alternative Proposals provide for the remedy of past notification errors in ECVNs and in MVRNs. P37 defines a "Past Notification Error" as an error occurring prior to the Implementation Date of the Modification and precludes any claims made under the Proposal that occur more than five Business Days after the implementation date.
- 18 Where a Party makes a claim, P37 proposes that they are subject to a non-returnable administration fee of £5,000 to the Balancing and Settlement Code Company (BSCCo) (or such other amount that the Panel determines after consultation with Parties and approval from Ofgem). The claim must be accompanied by confirmation of the Past Notification Error by any other Parties directly involved in the notification and must not have been the subject of a previous claim.
- 19 The BSC Panel (or a Panel Committee appointed to discharge the BSC Panel's functions) would determine whether a Past Notification Error had occurred and, if so, whether it should be rectified. The determination would be based upon the evidence provide by the parties and the findings of any investigation by the BSCCo.
- 20 The BSC Panel would decline to rectify a Past Notification Error where it considers that the relevant Party and/or Agent did not:
 - have in place prudent systems and processes. The question of whether such systems and processes were prudent would be judged in the light of the circumstances at the time the error was made and/or
 - promptly take all appropriate steps to rectify, reverse or otherwise mitigate the effect of the error; and avoid a repetition of the error, following its discovery.
- 21 The Panel may have regard, among other things, to the following factors, where the Panel considers such factors to be relevant:
 - the extent to which the Past Notification Error was directly attributable to a failure of BSC Systems;
 - the extent to which the Past Notification Error was directly attributable to an inaccuracy in or the non-availability of the Forward Notification Report (also known as the 'seven day report');
 - the extent to which the Past Notification Error and/or the magnitude of the loss suffered by the relevant Parties in respect of Trading Charges as a result of the error was attributable to a combination of circumstances which could not reasonably have been foreseen; or
 - the extent to which the magnitude of the loss suffered by one or both of the relevant Contract Trading Parties in respect of Trading Charges as a result of the Past Notification Error was wholly disproportionate, due weight being given to the

desirability of incentivising Parties to avoid mistakes in the submission of notifications.

- 22 Where the Panel has determined that a Past Notification Error has occurred and should be rectified, it will arrange for Settlement Runs to be carried out so that all Parties are adjusted appropriately. The financial adjustment in the case of the claimant includes an Error Correction Payment of 20% of the value of the error (i.e. a maximum of 80% of the costs of the error can be recovered), capped at a maximum of £200,000.
- 23 Appeals may be made by any BSC Party to Ofgem, no later than five Business Days after the determination, but only on the grounds that the procedures of the determination have not been followed or in the light of new information.
- 24 The Alternative Modification Proposal P37 (P37alt) is identical in every respect to P37 Clarified with the exception that the cap of £200,000 on the maximum Error Correction Payment is removed.
- 25 ELEXON published a Consultation Report on 21 September 2001, which invited respondents' views by 27 September 2001. Further consultation was sought on 23 October 2001, following the issue of provisional thinking by Ofgem.

Respondents' views

- 26 In total, ELEXON received 17 responses to the first consultation. Nine respondents (on behalf of 16 Parties) supported the proposal and eight respondents (on behalf of 37 Parties) opposed it.
- 27 The respondents who supported P37 generally argued that its implementation was justified on the grounds that some of the early imbalance prices and hence imbalance charges were disproportionately high, particularly where the notification errors had not caused NGC, as system operator, to incur any costs in balancing the system. Those respondents who did not support the Modification were mainly opposed to the idea of the retrospective correction of notification errors.
- 28 Respondents were asked to answer a number of specific questions mainly relating to the details of the Modification Proposal (such as the definition of notification errors, the time limit for making claims, the level of the proposed administration fee and Error Correction Payment, and the body who should decide on whether a claim is allowed). In addition, respondents were asked to comment on whether their actions and behaviour would have been different if a mechanism for correcting notification errors had been in place at Go-Live. In relation to their behaviour, 3 respondents (on behalf of 20 Parties) said that it was likely that they would have behaved differently (at least in relation to the timing of contract notifications) if there had been a notification error correction mechanism in place at Go-Live.
- 29 On the question of the Error Correction Payment, only three of the seventeen respondents believed that the percentage was too low i.e. that the maximum percentage of costs recoverable should be lower; the remainder either agreed with the 20% level or felt the

figure was too high, some preferring a cap. Five of the eight respondents who were not in favour of P37 considered that, if the Modification were to be implemented, the 20% level would be appropriate.

- 30 The responses to this consultation were considered at a Modification Group meeting on 1 October 2001. A further Modification Group meeting was held on 19 October 2001 that considered Ofgem's Provisional Thinking and discussed certain specific details regarding the legal drafting of the Modification Proposal. A further consultation invited views on the clarifications made to the original P37, on the Alternative Proposal, and on the legal drafting of both P37 Clarified and the Alternative Proposal. In total, ELEXON received 14 responses to the second consultation. No fundamental new arguments arose as a result of this further consultation and many respondents used this consultation period to reiterate the views that they had expressed in the earlier consultation. Of those who responded to both consultations, none changed their views as a result of the clarifications introduced in the Modification Group. Those originally in favour remained in favour; those originally against maintained their position.
- 31 The respondents' views are summarised in the Urgent Modification Report³ for Modification Proposal P37, which also includes the complete text of all respondents' replies.

Panel's Recommendation

- 32 The Panel met on 31 October 2001 and considered the Modification Proposal P37, the Urgent Modification Report, the views of the Modification Group and the consultation responses received.
- 33 The Panel voted on whether to recommend Modification Proposal P37 or Alternative Modification Proposal P37, under three different sets of assumptions relating to the legal interpretation of the words "by reference to ... quantities of electricity contracted for sale and purchase between BSC Parties" in condition C3(2)(b)(ii) of NGC's licence.
- 34 In each instance, the Panel voted against recommending Modification Proposal P37 and in favour of recommending Alternative Modification Proposal P37. Under the first two sets of assumptions, which were based on the legal advice given to ELEXON that the notified contract volumes should be deemed to be the quantities of electricity contracted for sale and purchase for the purposes of condition C3(2)(b)(ii), the Panel voted 5 to 4 in favour of recommending Alternative Modification Proposal P37. The final set of assumptions was based on the legal advice provided to London Electricity that condition C3(2)(b)(ii) contemplates that "there will be, quite independently of amounts notified under the BSC, an ascertainable contracted trading position, by reference to which the imbalance settlements should be effected"; under these assumptions the Panel voted 7 to 1 in favour of recommending Alternative Modification Proposal P37.

³ ELEXON document reference P37_UMR_GEM, Version No. 1.0, dated 5 November 2001

- 35 The Panel therefore recommended that Ofgem should reject the Proposed Modification P37 and approve the Alternative Modification Proposal P37 and issued its Urgent Modification Report to Ofgem on 5 November 2001.
- 36 The Panel proposed that the Proposed Modification should be implemented five Business Days after the date of determination.

Ofgem's view

- 37 When Ofgem initially considered this Modification Proposal we were concerned that it would be inappropriate for us to take any decision pending the outcome of the litigation between ScottishPower and ELEXON. However, having now intervened in those proceedings and having had the opportunity to consider the relevant matters further and in more detail, Ofgem has decided that, notwithstanding the litigation, it is appropriate for us to issue a decision in relation to Modification Proposal P37.
- 38 Having assessed the relevant issues and reviewed the consultation responses, Ofgem has considered the Modification Report pursuant to our duty under condition C3 5(a) of NGC's licence and in the light of our statutory duties. In Ofgem's opinion, the arguments for and against the retrospective correction of errors made in ECVNs and MVRNs continue to be finely balanced. Nevertheless, Ofgem is of the opinion that Modification Proposal P37 will better facilitate achievement of the BSC Objective in Condition C3 (3) (c) for the reasons set out below.
- 39 Throughout the development and implementation of NETA, Ofgem has made it clear that we considered that the accurate notification of energy contract volumes is of the utmost importance to ensure the effective operation of the balancing and settlement mechanism and, therefore, the market. It was because of the need for accurate notifications that Ofgem and the DTI made it clear, following consultation, that there would be no error correction provisions for the notification of ECVNs or MVRNs in the BSC. There were significant concerns that allowing any form of error correction for contract volume notifications could dilute the incentives to provide accurate notifications.
- 40 Furthermore, Ofgem has previously stated, and continues to believe, that:-
- It is essential that there should be strong incentives on BSC Parties to deliver correct notifications. If the incentives to have robust contract notification systems in place are inadequate, it is likely that participants would wish to adjust or correct their notifications more frequently due to errors and this could adversely affect the efficient administration of the BSC.
 - A correction mechanism for notification errors might effectively allow ex post trading to take place since participants might seek to make intentional post-Gate Closure adjustments to their traded quantities. As Ofgem has made clear in our various NETA consultations, we have concerns that ex post trading might increase the opportunities for players with generation assets, even in a generally competitive

market, to drive up the prices that participants with short positions have to pay to reduce their imbalance exposure after real time and before contract notification.

- 41 In addition, as discussed in our P19 decision letter, Ofgem believes that there are widely accepted and well understood reasons why retrospective modifications are normally to be avoided; modifications generally ought not to change the character of past transactions completed on the basis of the then existing rules. Retrospective changes to the BSC will tend to damage market confidence in, and the efficient operation of, NETA. Ofgem takes the view that BSC Parties generally prefer the assurance of rules that are unlikely to be changed retrospectively. Many of the respondents supported this view with regard to the retrospective element of Modification Proposal P19.
- 42 On the basis of the responses to the consultation on this Modification, it is clear that at least some participants, having regard to their perception of the risks of the rules that were in place at Go-live, acted in ways that they might not have done had a correction mechanism for notification errors been in place from Go-Live. This will have increased the costs that they incurred in preparing for, and operating under, NETA.
- 43 It has been argued however, that in the early stages of NETA when participants were still getting to grips with the new arrangements, it is possible that even prudent operators may have made material errors as a consequence of their inexperience in dealing with the new systems. Although it was only to be expected that imbalance prices would be particularly volatile initially, this volatility coincided with the period during which participants were becoming accustomed to the operation of NETA.
- 44 Given that it is unclear whether or not such occurrences have actually taken place, Ofgem considers that it is appropriate to allow the Panel to determine whether any imbalance charges incurred by prudent Parties due to notification errors (particularly those during the early days of NETA) should be rectified, subject to the limits on cost recovery incorporated in the Modification and the other relevant criteria.
- 45 As we have previously made clear, Ofgem accepts that the possibility of introducing retrospective rule changes in certain limited circumstances must be allowed. To this extent, the Modification is consistent with Ofgem's thinking. In relation to this Modification, Ofgem, on balance, believes that potentially allowing for retrospective corrections in the very strictly defined circumstances (in this instance in respect of notification errors that may have been made by prudent operators particularly during the early days of NETA), of itself, provides comfort both to existing and prospective participants and thus encourages active participation in these trading arrangements, thereby promoting effective competition. Whilst there is no certainty that a specific retrospective correction will be approved in any particular case, by making available that possibility, this Modification better achieves the Applicable BSC Objective of promoting effective competition (condition C3 (3) (c)).
- 46 Ofgem expects that if the relevant tests set out in P37 are rigorously applied by the Panel very few, if any, errors will warrant correction. Since each alleged error will be reviewed on its merits and in the light of the circumstances applying at the time the alleged error was

made, the proposed process will provide the case by case review which Ofgem previously indicated was necessary in our decision letter on P19.

- 47 Ofgem notes that participants have been continually gaining experience and understanding of the processes of NETA and any trading risks that the Parties may face in consequence of their decisions. Ofgem would therefore expect that the test for a reasonable and prudent Party would effectively become progressively more stringent in relation to notification errors occurring later in time. As such, it is Ofgem's view that it would only be in relation to errors which occurred during the early days of NETA that it could sensibly be argued that a reasonable and prudent operator could not have either foreseen or been expected to bear the risk of alleged errors and their consequences.
- 48 While Ofgem would have preferred the period within which corrections to notification errors can be made to have been shorter, to reject the Modification on this basis in the expectation of a modification delivering this being submitted would prolong the period of uncertainty for all Parties and adversely impact on the efficient operation of the BSC.
- 49 There will always be a risk of high imbalance prices. In these circumstances, it would be reasonable to expect all Parties to ensure that they have in place appropriate systems to deliver accurate notifications. Therefore, the risk of high imbalance charges alone is not a sufficient reason for allowing the correction of notification errors.
- 50 Ofgem notes that the introduction of a correction mechanism that only applies to retrospective notification errors does not raise the same concerns that the correction of prospective notification errors can do, in that it should not affect the incentive of Parties to submit accurate notifications going forward. Acceptance of the proposed Modification does not therefore detract from this incentive.
- 51 Ofgem continues to believe that, even in the circumstances covered by this Modification Proposal where notification errors may be corrected, it is not generally appropriate to expect that a Party should recover its losses in full nor should it expect to do so. Ofgem notes that the Panel has recommended that the discount proposed by P37 of 20% should be accepted. Ofgem's concerns on this matter have been expressed elsewhere. However, Ofgem does not consider that the cap on recovery, proposed in the original P37, is appropriate and therefore believes that P37 alt better achieves the BSC objective.
- 52 Finally, we recognise that P37 alt opens the possibility that participants who have benefited from the reallocation of imbalance charges would lose those benefits should any error correction be allowed by the Panel. However, Ofgem does not consider that, in the limited circumstances in which we expect that error corrections may be allowed under the terms of P37 alt, the loss of such benefits outweighs the better facilitation by the Modification of effective competition.
- 53 On balance, therefore, Ofgem considers that Modification P37 alt better facilitates the promotion of effective competition in the generation and supply of electricity pursuant to the objective specified in the BSC Objective in condition C3 (3) (c) of NGC's licence.

- 54 Ofgem considers that it will be important that the process for considering claims both is, and is recognised as, impartial. This will provide reassurance to all Parties who will be affected by the outcome. Ofgem considers therefore that the Panel should ensure that there is an appropriate degree of representation on the decision body that is independent of industry parties or interests.
- 55 Ofgem would expect the Panel to take prompt action to establish the arrangements to consider claims and to establish a procedure which will ensure that they are progressed to a conclusion in as expeditious a manner as is compatible with proper consideration of the issues. This will require that those putting forward or connected with such claims fully adhere to those procedures.
- 56 Whilst it is unnecessary in the light of its decision in relation to the BSC Objective in condition C3 (3) (c) for Ofgem to reach a decision as to whether the Modification also better facilitates the achievement of the BSC Objectives in conditions C3(3)(a) and (d), Ofgem is not persuaded that it does so.

The Authority's decision

- 57 The Authority has therefore decided to direct that the Alternative Modification P37, as set out in the Urgent Modification Report dated 5 November 2002, should be made and implemented.

Direction under Condition C3 (5) (a) of NGC's Transmission Licence

- 58 Having regard to the above, the Authority, in accordance with condition C3 (5) (a) of the licence to transmit electricity granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the BSC as set out in the Alternative Modification P37 in the Urgent Modification Report as corrected in the attachment to the letter of 9 May 2002 to Ofgem: "Minor Revisions to Legal Text for Modifications P37 and P44".
- 59 The Implementation Date in respect of this Modification is to be 5 Business Days after the date of this decision.
- 60 In accordance with condition C3 (5) (b) of the Transmission Licence, NGC shall modify the BSC in accordance with this direction of the Authority.

Contact point

61 If you have any queries in relation to the issues raised in this letter, please feel free to contact Nick Simpson on 020 7901 7355.

Yours sincerely,

A handwritten signature in black ink that reads "Callum McCarthy". The signature is written in a cursive, slightly slanted style.

Callum McCarthy
Chairman and Chief Executive
of the Gas and Electricity Markets Authority
Signed on behalf of the Authority and authorised for that purpose by the Authority