



Industry participants, customers
and other interested parties

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Dear Colleague

Balancing and Settlement Code (BSC) modification proposals on zonal transmission losses

Background

On 14 September 2007, Ofgem published a letter ("the September 2007 decision letter") on BSC modification proposals P198, the P198 Alternative, P200, the P200 Alternative, P203 and P204 (the "losses proposals"), all of which seek to alter the rules under which transmission losses are allocated to users of the electricity transmission system such that losses are allocated on a locational basis.

The September 2007 letter set out the Authority's decision (the "September 2007 decision") that it would not make its final decisions concerning the losses proposals on or before 20 September 2007.

A key reason for the delay in taking the final decisions related to the concerns raised by Oxera regarding the assessment that it had prepared on the financial and environmental benefits of the proposals. This analysis was commissioned by Elexon as part of the industry assessment of the proposals under the governance of the BSC. In particular, Oxera had raised concerns, in response to the consultation on the Authority's minded-to decisions on the losses proposals, regarding the extent to which the Authority had placed weight on the Oxera assessment in its minded-to decisions. As a result the Authority considered that it would be appropriate to delay taking its final decisions concerning the proposals until a further review of Oxera's analysis, and the reliance placed upon it, had been undertaken.

In December 2007, Ofgem received notice of a legal challenge raised by a number of industry parties (the "Claimants") in respect of the Authority's September 2007 decision. The Claimants challenged, by way of judicial review, the Authority's power to make a decision on the losses proposals after the latest date for a decision set out in the Final Modification Reports (FMRs) for each of the proposals (that date being 20 September 2007).

Judgment of the High Court

The case was heard by Kenneth Parker QC sitting as a Deputy Judge of the High Court. He found in favour of the Claimants and issued an order on 2 July 2008 which provided, amongst other things, that:

- (1) the Authority has no power to approve a proposed modification to the BSC if a proposed Implementation Date or decision deadline contained in the relevant FMR has passed;
- (2) the Authority is not entitled to approve any of the six losses proposals that were the subject of the proceedings; and
- (3) the Authority has permission to appeal.

Decision not to appeal judgment

We welcome the comments made by the Judge in granting the Authority permission to appeal following judgment being handed down. These comments noted that the case raises a matter of great practical importance and that it would not be fair to rule out that there is a real prospect of the Authority succeeding on an appeal.

However, having considered the judgement and the issues it raises, we have decided that, on balance, it would be preferable not to pursue the appeal route, given the resource implications of an appeal, together with the regulatory uncertainty that such an appeal may cause.

We recognise that substantial work has gone into the losses proposals from both industry participants and Ofgem. However, to the extent that BSC parties are capable of re-raising the same proposals or similar modification proposals in the future, much of the work that has already been undertaken is likely to remain relevant to a consideration of any such proposals, subject to any delay in a modification proposal being raised. As such, given the work and analysis that has been undertaken, it is our expectation that the time period required for industry to prepare, and for Ofgem to consider, any proposals which are the same as, or materially similar to, the losses proposals would be considerably shorter than might otherwise be the case.

On the basis of these considerations, and given the resource and other potential implications of an appeal, we do not intend to pursue the appeal route.

Given our decision not to appeal and in view of the judgment in this case, the Authority is no longer in a position to reach a decision on the losses proposals. This is because the decision deadline contained in the FMRs for each of the losses proposals has now passed.

We nevertheless intend to publish the additional analysis we commissioned on the Oxera analysis of the losses proposals as we consider that this might assist industry should it decide to bring forward further transmission losses proposals.

In the event that any new modification proposals are raised which address the question of zonal charging for transmission losses, these will be considered on their own merits, in accordance with an assessment against the applicable BSC objectives and the Authority's wider statutory duties.

Practical implications of the judgment

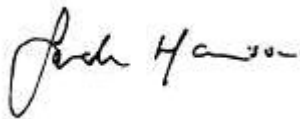
The judgment raises important issues governing decision making and implementation timetables and the flexibility available to the Authority to consider BSC modification proposals, particularly where additional time is needed to evaluate concerns raised regarding either Ofgem or industry assessments of proposals. There is, for example, a risk that resources will have been unnecessarily wasted where the timetable for consideration of BSC modification proposals is inflexible and cannot be extended, for example to undertake further analysis. In this context, the Judge noted:

"In the present case, if the Authority had no power to give itself additional time necessary to evaluate the Proposed Modification in the circumstances that have unforeseeably arisen, the whole exercise – including the work done by the Panel and the Authority – would be frustrated, with the probable attendant waste of time and resources, and also with the potential lost opportunity of securing a Modification that might well bring substantial benefits to licensed persons, and users and consumers of electricity. I accept that the exercise could be re-run with a new timetable, but this would appear to be an inefficient and wasteful duplication of procedures without any obvious countervailing benefits".

The judgment also raises similar issues to those being considered in the codes governance review regarding the Authority's ability to address concerns or deficiencies in industry based analysis. In our recent decision on the scope of the industry codes governance review, we indicated that we intend to bring forward and consult on proposals that would enable the Authority to "send back" modification assessments to the code panels. In the case of the losses proposals, such a power might have helped to address the concerns raised regarding the Oxera analysis. We note that the judgment refers to the potential value of a power to remit matters back to Panels for complete re-consideration.

Ofgem is currently considering how best to address the practical concerns raised by the outcome of the judicial review. We will consult with industry if and to the extent necessary or appropriate on any proposed resolution of these matters.

Yours sincerely



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