

ASSESSMENT CONSULTATION for Modification Proposal P235

'Aligning BSC requirements with the calculation of reconciliation interest performed by the Funds Administration Agent'

Prepared by: P235 Modification Group

For attention of: BSC Parties and other interested parties
Responses due: **12 noon on Thursday 30 April 2009**
(to: modification.consultations@elexon.co.uk)

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P235 seeks to align the Balancing and Settlement Code drafting (Section N.6.4.2(b)) for calculating the interest on Reconciliation Charges with the calculation methodology which has been undertaken by the Funds Administration Agent systems since NETA Go-Live (and which mirrors the methodology used under the Pool).

The Modification Group has developed a **Proposed Modification** with a prospective Implementation Date of 2 Working Days after an Authority decision, and an **Alternative Modification** with a retrospective Implementation Date of 27 March 2001 (NETA Go-Live).

The Group's initial view is that both the Proposed and Alternative Modifications would better facilitate Applicable BSC Objectives (c) and (d) when compared with the current Code drafting.¹ Of these two solutions, the Group's initial view is that the Alternative Modification would best facilitate these Applicable Objectives overall.

PURPOSE OF THIS CONSULTATION

The Group welcomes your views on the merits of P235 and, in particular:

- Whether you agree with the Group that P235 would better facilitate the achievement of the Applicable BSC Objectives when compared with the current Code drafting (and what your avoided costs would be from not changing the existing FAA interest calculation method to align with the Code);
- Which of the Group's solutions (prospective Proposed Modification or retrospective Alternative Modification) would best facilitate the achievement of the Applicable BSC Objectives when compared with each other;
- Whether the prospective Proposed Modification should be implemented on a Settlement Day or Calendar Day basis (see explanation of these terms in Section 3.3); and
- Whether there are any other implementation approaches which you believe would better facilitate the Applicable BSC Objectives when compared with those developed by the Group (e.g. a retrospective Implementation Date of 9 April 2009, the day that the Panel raised P235).

The Group invites you to submit your views using the attached form.

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¹ Appendix 1 includes a copy of the Applicable BSC Objectives for reference.

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1 SUMMARY – WHAT IS P235?

Why has P235 been raised?

ELEXON has recently identified that the Balancing and Settlement Code ('the Code') requirements for calculating the interest on Reconciliation Charges are inconsistent with those undertaken by the Funds Administration Agent (FAA) systems.

The Panel has raised P235 to align the Code requirements with the methodology used by the FAA systems.

What are the inconsistencies identified by P235?

The FAA systems have used the same method of interest calculations since NETA Go-Live, and mirror the methodology used under the Pool arrangements. The BSC requirements are detailed in Section N6.4.2(b) of the Code, and have remained unchanged in this respect since the Code was first drafted.

The FAA interest calculations differ from the Code requirements in four ways:

- 1) The period for which the FAA calculates interest extends all the way back to the Payment Date for the Initial Settlement Run. The Code implies that interest should only be calculated back to the Payment Date of the previous Settlement Run.
- 2) The FAA calculates interest on a daily basis, using the Base Rate applicable to each day in the period, rather than using a single Base Rate as implied by the Code.
- 3) The FAA calculates interest on a compound basis (i.e. the amount on which interest is calculated for each day in the period includes the accumulated interest levied on previous days), rather than a simple interest basis which can be inferred from the Code drafting.
- 4) The period for which the FAA calculates interest excludes the Payment Date of the current Reconciliation, rather than including it as required by the Code.

Why will P235 be an improvement over the current Code drafting?

ELEXON, the Panel and the Modification Group believe that the interest calculation method used by the FAA is preferable to the Code requirements. This is because it:

- Better reflects the nature and intent of BSC processes;
- Gives a fairer and/or accurate result for BSC Parties; and
- Continues the methodology used under the Pool and since NETA Go-Live.

You can find more information in Sections 2-4 of this document.

What is the difference between the Proposed and Alternative Modifications?

The Proposed Modification would be implemented prospectively (i.e. forwards from the Implementation Date). Parties would retain the right to raise a Trading Dispute against prior interest calculations.

The Alternative Modification would be implemented retrospectively back to NETA Go-Live, and would fully eliminate uncertainty by removing Parties' ability to dispute historic interest charges.

You can find more information in Section 3.3.

Will P235 impact my systems and processes?

No, as approval of P235 will align the Code with the calculation method which the FAA already uses. However, rejection of P235 could result in costs to your organisation to align your systems with the Code.

2 INTENTION AND APPROPRIATENESS OF P235

2.1 Principle of Reconciliation interest

The Settlement processes allow for prompt initial Settlement using demand estimates. This initial Settlement calculation, or Initial Settlement Run, is 'refreshed' via Reconciliation Runs which are subsequently made over a 14-month period as actual metered data becomes available. At each Reconciliation Run the Settlement calculation is re-run as though it were the Initial Settlement Run for the relevant Settlement Day, with more accurate metered data having displaced earlier estimates.

The key principle behind Reconciliation Charges is that they should adjust Parties' payments as if the 'correct' monies had been exchanged on the Payment Date of the Initial Settlement Run (see Section N6.1.5 of the Code). The Group agrees with ELEXON and the Panel that this principle should also apply to the interest on Reconciliation Charges, due to the extended nature of the Reconciliation timetable and the time (earning) value of money.

The Group considers that Parties who have overpaid at the Initial Settlement Run or subsequent runs should be compensated (through interest) for the loss of use of their money during the period of overpayment. Similarly, Parties who have initially underpaid should pay interest for the period of the underpayment, to reflect their ability to use money which they would not otherwise have had.

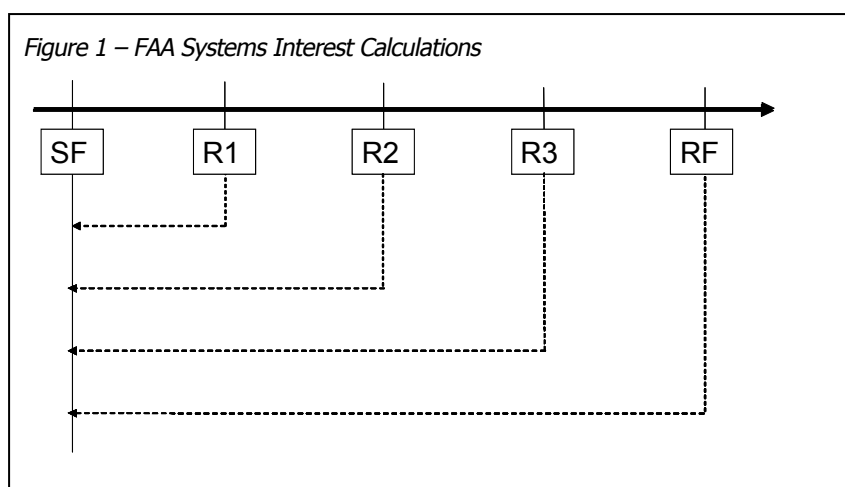
The Group agrees that the existing FAA interest calculation is the appropriate methodology to achieve this principle, and is therefore preferable to the Code drafting.

Sections 2.1-2.7 explain the Group's views on each of the four inconsistencies between the Code and FAA methodology, the materiality of the inconsistencies for Parties' Trading Charges, and on the implications if P235 was rejected. All of these relate back to the overarching principle of the Reconciliation process and the time value of money.

Appendix 2 provides details of the Group's full Terms of Reference, as set by the Panel.

2.2 Start of interest calculation period

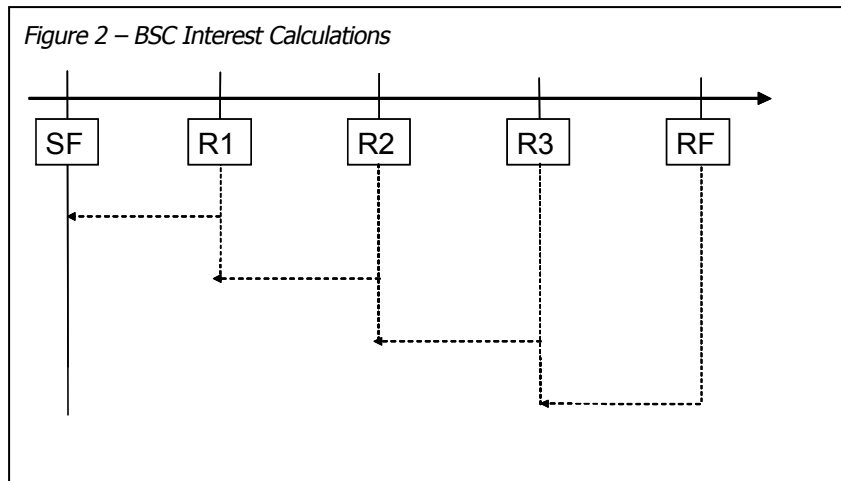
The **FAA systems** calculate interest back to the Payment Date of the Initial Settlement Run (see Figure 1). The interest on the difference between successive Trading Charge amounts is thereby always calculated with reference to the Payment Date of the Initial Settlement Run.



Worked Example 1 in Appendix 3 provides further details.

The Group agrees that the FAA methodology is consistent with the principle of a Reconciliation Settlement Run, as the amounts are calculated as though they had been determined at the Initial Settlement Run.

The **Code drafting** explicitly requires interest to be calculated only as far back as the Payment Date of the previous Settlement Run (see Figure 2). This approach means that interest payments, rather than being referenced to a common point (the Payment Date for the Initial Settlement Run), are referenced only to the last Payment Date (which is a function of the Settlement timetable).



Under the Code drafting, Parties who had underpaid at the Initial Settlement Run and subsequent runs up to Final Reconciliation, and who then paid the correct amount at the Final Reconciliation Run, would only be charged interest back to the previous Settlement Run and not for the entire period of underpayment. Similarly, Parties who had overpaid at the first run and all subsequent runs up to Final Reconciliation, would only be compensated back to the previous Settlement Run. This would place those Parties who had initially overpaid at a disadvantage, since they would have been denied use of their money ever since the Initial Settlement Run.

The Group agrees that the Code drafting is contrary to the principle that Reconciliation should be undertaken as if it were the Initial Settlement Run. In addition, the Group notes that the Code approach contains the opportunity for Parties to game, by systematically submitting lower consumption volumes up to Final Reconciliation.

This risk of gaming is not present under the FAA methodology, since it always calculates interest back to the Initial Settlement Run.

2.3 Daily versus single Base Rate

The **FAA systems** calculate interest on a daily basis using the Base Rate applicable to each day in the interest calculation period.

In contrast, the **Code drafting** implies (although it is arguably somewhat ambiguous on this issue) that a single Base Rate should be applied to the whole calculation period, and that this should be the prevailing Base Rate on the day of the Advice Note for the current run.

The Group agrees that the FAA methodology is consistent with the principle behind Reconciliation interest (to reflect Parties' loss or use of money which they would not otherwise have paid or received). It agrees that the Code drafting fails to reflect the time value of money and results in a less fair outcome for Parties.

For example, if the Base Rate used at Final Reconciliation was appreciably lower than that at the Initial Settlement Run (as in the current economic climate), the interest payment under the Code rules would not adequately compensate Parties for the loss of use of their money over the extended Reconciliation period.

The limitations of the Code approach are well illustrated by the recent dramatic cuts in Base Rate and by Worked Example 2 in Appendix 3.

The Group also agrees that the FAA's methodology is more consistent with normal commercial practice than that presented in the Code.

For example, banks calculating the interest on a standard savings account take account of any change in their interest rates during the relevant period.

2.4 Compound versus single interest

The **FAA systems** calculate interest on a compound basis (i.e. the amount on which interest is calculated, the principal, increases each day in line with the interest rate).

However, the **Code drafting** implies the use of simple interest (i.e. the amount on which interest is charged would remain the same for each day in the calculation period).

Worked Example 2 in Appendix 3 provides further details.

The Group agrees that the FAA methodology delivers the most accurate way of reflecting the time value of money, and therefore delivers a fairer outcome for Parties than the Code drafting.

2.5 End of interest calculation period

The period for which the **FAA systems** calculate interest excludes the Payment Date of the current Reconciliation.

However, the **Code drafting** explicitly requires this to be included in the calculation period.

The Group agrees that, while the difference between the two approaches is not significantly material, the FAA methodology is more consistent with normal commercial practice, and gives a fairer result to Parties than the Code drafting.

The Code requirements could be seen as an (albeit minimal) over-calculation of interest, given that Parties have till the end of the Payment Date to make payment and any payment does not become overdue until the following day.

2.6 Materiality for Parties' Trading Charges

The Group notes that P235 intends to normalise the existing position regarding the calculation of Reconciliation interest, by aligning the Code with the actual FAA methodology. The Group agrees that this is appropriate, as the existing FAA methodology delivers a fairer and/or more accurate interest calculation for Parties. Implementation of P235 could be considered to have a financially neutral effect on Parties, in that it maintains the status quo and would not of itself reopen past interest calculations (avoiding the uncertainty to Parties of whether they might be liable for additional payments).

However, the Group notes that there will be 'winners and losers' on either side when contemplating differences between the Code and FAA interest rules.

The Group notes that the extent to which a Party's Reconciliation interest would be different under the Code rules would depend on how much its Trading Charges vary between Settlement Runs. Parties who establish their physical position quickly in the Reconciliation timetable (e.g. generators and Half Hourly Suppliers with accurate and correct metering) would be unlikely to see a significant effect. The difference could be greatest for Non Half Hourly Suppliers, who replace estimated data with actual Meter readings towards Final Reconciliation, and who are also subject to the effect of Grid Supply Point Group Correction Factor on their Trading Charges.

ELEXON has undertaken a comparison of the actual interest on Trading Charges (as calculated by the FAA) across all Reconciliation Runs² for Settlement Days 1 November 2005 to 31 October 2006 with those charges that would have resulted by applying the calculation as defined in the Code. This analysis provides an indicative materiality of the difference between the two sets of rules.

Trading Charges amounting to approximately £500m were paid or received by Parties over this period. These charges were levied across 123 Party IDs. The absolute³ difference between the FAA-derived interest charges and the Code equivalent for the period is approximately £1m (0.2% of the total Trading Charges).

Table 1 below shows the distributional effect of the difference on Parties. The majority would only see a fractional shift in their interest payments, although a small number of Parties would be more significantly impacted.

Table 1 – Distribution of % impact between Parties

Absolute impact as % of payments at Post Final Reconciliation Run	Affected Parties
Less than 0.10%	109
0.10% to 0.49%	7
0.50% to 1.49%	5
1.50% to 2.99%	2
3.00% or more	0
Grand total	123

The Group notes that the FAA methodology has been used since NETA Go-Live without being disputed by any Party. It also notes that the FAA methodology mirrors that used under the Pool.

ELEXON has investigated the discussions at the time of the Code drafting, and has not identified any evidence that the Code rules were intended to be different from the Pooling and Settlement Agreement. The interest calculation methodology contained in the Requirement Specifications which were used to build the FAA systems match that which has been used for the last eight years. The reasonable assumption of Parties therefore appears to have been that the Pool methodology would continue under NETA. This may explain the lack of disputes, as those Parties who have built their own systems to check the calculation of their Trading Charges are likely to have built them to the same Requirement Specifications as the FAA systems.

The Group notes that the inconsistencies between the interest calculations performed by the FAA and the Code provisions could be considered to be a Settlement Error under the Trading Disputes process.

² Initial Settlement Run to the Post Final Settlement Run.

³ I.e. netting across Settlement Runs and Settlement Days for individual Parties, but ignoring netting between Parties.

The Group agrees with ELEXON's decision not to raise a Trading Dispute at this time, given that it believes the actual FAA methodology to be preferable to the Code and is therefore progressing P235. However, the Group notes that this does not prevent Parties from raising Disputes themselves. Any Dispute would open the possibility that historic calculations might need to be re-run and that Parties' payments might be retrospectively amended.

The Group notes that the raising of a Trading Dispute would not automatically result in the recalculation of past charges. This decision would be taken by the Trading Disputes Committee (in accordance with the Trading Query/Dispute process in Section W of the Code), and is therefore outside the scope of P235.

A Party's ability to raise a Dispute would be affected by:

- The materiality threshold for raising a Trading Query (set at £500 in Balancing and Settlement Procedure 11 'Trading Queries and Trading Disputes');
- The time window set out in Section W of the Code for raising a Trading Query (which under normal circumstances is within 20 Working Days of the Settlement Run in respect of which the Settlement Error occurred);
- The TDC's judgement on whether a Settlement Error had occurred;
- The time limit on rectifying any Settlement Error (even in exceptional circumstances, the Code does not allow errors to be rectified further back than 20 months for runs up to Final Reconciliation, or 29 months if the error occurred in a Post-Final Reconciliation Run or Extra Settlement Determination – so a Party would not be able to dispute all calculations back to NETA Go-Live);
- The TDC's judgement on whether the cost associated with re-running past interest calculations would outweigh the materiality of the Trading Dispute;⁴
- Whether other Affected Parties challenged the outcome of the Trading Dispute; and
- If P235 is approved, the chosen implementation approach for aligning the Code with FAA systems (i.e. the extent to which the alignment applies prospectively or retrospectively – see Section 3.3).

The Group notes that ELEXON has brought the inconsistencies between the FAA methodology and the Code to the industry's attention (through ELEXON Circulars, Newscast and the Panel/TDC), but that no Party has raised a Trading Dispute to date.

Given the timing restrictions on raising and rectifying Disputes, the materiality of those past interest calculations which Parties are able to challenge will not necessarily match that shown in Table 1. Additionally, a Party is unlikely to be consistently a 'winner' or 'loser' in each affected Settlement Period, and the net materiality across runs may not be significant.

The Group initially raised concerns that Parties might be able to 'cherry pick' which historic interest charges to dispute, such that they only challenged those where they stood to make a financial gain. However, the Group notes ELEXON's advice that, if a Party triggers the Disputes process, it would at that point raise a Trading Dispute on behalf of all Parties and covering all eligible runs.

The Group's concerns over the industry uncertainty which could be caused by a Trading Dispute has led it to develop an Alternative Modification for P235, which would apply retrospectively back to NETA Go-Live. Section 3.3 contains further details.

⁴ This cost has not yet been established. Recalculation of past charges would require an Extra Settlement Determination (as only interest amounts would change and not the actual Metered Volumes held in Settlement), requiring TDC approval. It is unlikely that the FAA systems would be used to recalculate each affected run, due to the potential cost. ELEXON might therefore develop a different (auditable) system to establish each Party's amended liability – potentially using its internal Trading Operations Market Analysis System (TOMAS). There may be practical difficulties in establishing the liabilities of Parties who have left the Code, although this applies generally to any Trading Dispute.

2.7 Implications of rejecting P235

The Group notes that, if P235 was rejected, ELEXON would align the FAA systems with the Code provisions going forwards. The Group agrees that this would not be desirable, since it believes that the FAA methodology is fairer and/or more accurate.

The central cost of changing FAA systems has been initially estimated at £100,000. There may also be costs to Parties to amend their own systems which check the calculation of their Trading Charges. The Group considers that these represent avoided costs if P235 is approved.

Additionally, the Group notes that rejection of P235 would leave it open for Parties to raise Trading Disputes against historic interest charges (within the limits of the Section W Disputes process). Section 3.3 explains the Group's views on the appropriateness of any such Disputes.

3 P235 LEGAL TEXT, COSTS AND IMPLEMENTATION APPROACH

3.1 Legal text

Both the Proposed Modification and the Alternative Modification amend Section N6.4.2(b) of the Code, to reflect that interest for Reconciliation Charges is calculated:

- Over a period from (and including) the Payment Date of the Initial Settlement Run up to, but not including, the Payment Date of the current Reconciliation Run; and
- On a daily basis using the relevant Base Rate applicable to each day in the period, and that the interest calculated on each day includes interest levied on previous days in the period (i.e. compound rather than simple interest).

This aligns the Code drafting with the existing methodology used by the FAA.

The Group's suggested legal text is provided below. Note that, at this stage in the Modification Process, the text is limited to the Group's agreed technical solution. Additional legal drafting will be required to reflect the retrospective application of the Alternative Modification, and if a prospective Calendar Day approach is adopted for the Proposed Modification. An updated version of the text will be consulted on during the Report Phase.

Section N 'Clearing, Invoicing & Payment'

6.4 Reconciliation

6.4.2 Subject to paragraph 5, each Payment Party shall following each Reconciliation Settlement Run be liable to pay to (or (as the case may be) entitled to receive from, the BSC Clearer an amount calculated as being:

- (a) the amount of the difference determined under paragraph 6.4.1; plus
- (b) ~~an amount in lieu of~~ interest, calculated ~~by applying the Base Rate to on a compound basis, ("the interest amount") on~~ the amount of such difference. The interest amount shall be calculated in respect of the period from (and including) since the last Payment Date relating to the Initial Settlement Run to (but not including) the relevant Reconciliation Payment Date by applying the Base Rate (as prevailing on the relevant day) on a daily basis to the amount of such difference.

3.2 Costs and impacts

P235 will have no impact on Parties' or Party Agents' systems or processes, as it will align the Code with the calculations which have been undertaken by the FAA since NETA Go-Live. However, it will affect Parties' ability to raise Trading Disputes in respect of these historic calculations, as explained in Section 3.3 below.

Implementation of P235 will have no impact on the FAA, who will continue to use the existing methodology.

Minor ELEXON implementation costs will be incurred in updating the Code and the FAA Service Description (which is based on the Code drafting and will therefore also need amendment). ELEXON will require 2 Working Days' lead time from the Authority decision to make the necessary Code updates and notify these to industry. If P235 is approved, the Group proposes that ELEXON should update the Service Description as part of the next available BSC Release to follow the Authority's decision.

3.3 Implementation approach & difference between Proposed and Alternative Modifications

3.3.1 Prospective versus retrospective implementation

The Group notes that P235 could be implemented either:

- **Prospectively** (i.e. forwards from the Authority decision), leaving Parties the right to raise Trading Disputes against historic interest calculations; or
- **Retrospectively** (i.e. going backwards to a certain historic point in time), removing Parties' right to raise Trading Disputes against interest calculations which occurred after that point.

The Group notes that the only difference between the two approaches is the effect on Parties' right to raise a Trading Dispute as, even under the prospective approach, ELEXON does not itself intend to amend historic charges.

Table 2 summarises the arguments for and against retrospective implementation, as considered by the Group.

Table 2 – Arguments for and against retrospection

Arguments against retrospection	Arguments for retrospection
<ul style="list-style-type: none"> • There is a general presumption in law against retrospective rule changes, as these can be damaging to market certainty and confidence • A retrospective implementation would deprive Parties of the right to raise a Trading Dispute 	<ul style="list-style-type: none"> • Retrospection can be justified in certain circumstances as shown in past Ofgem decisions⁵ • P235 appears to meet one of the criteria previously referred to by Ofgem for a retrospective implementation, since it relates to a situation which is 'directly attributable to central arrangements' • P235 is an unusual case, in that a retrospective implementation would create less uncertainty (by removing the potential for Trading Disputes and the reopening of Parties' past payments) and have less impact on Parties (by maintaining the status quo) than a prospective-only change • If the Authority agrees that the existing FAA methodology is fairer and/or more accurate, it seems inappropriate to allow the possibility (as a consequence of a prospective-only implementation) that past calculations might have to be rerun

⁵ For example, BSC Modification Proposal [P210](#) 'Revisions to the Text in Section P related to Single Notifications of Energy Contract Volumes and Metered Volume Reallocations'.

Arguments against retrospection	Arguments for retrospection
	<p>and that Parties might be retrospectively faced with less fair/accurate liabilities</p> <ul style="list-style-type: none"> • Retrospection avoids the difficulties (if a Dispute was upheld) of chasing payments from Parties who have left the Code • ELEXON has considered wider relevant legal considerations (such as statutes of limitations), and believes that these do not prevent a retrospective 2001 implementation in this particular instance since it normalises rather than amends Parties' past liabilities

On balance, the Group believes that a retrospective implementation is the most appropriate approach to the specific circumstances of P235 (Section 4 provides the Group's full justification against the Applicable BSC Objectives). However, due to possible industry and/or Authority concerns over retrospection, it agrees that a prospective-only option should also be put forward to the Authority for decision.

The Group has therefore developed:

- A **Proposed Modification** with a prospective Implementation Date of 2 Working Days after an Authority decision; and
- An **Alternative Modification** with a retrospective Implementation Date of 27 March 2001 (NETA Go-Live).

The Group has also considered only applying the change from the day that the Panel raised P235 (9 April 2009). This approach has been followed with previous Modification Proposals (e.g. P210), as it could be argued that this is the point at which the possibility of a retrospective rule change was first flagged and industry uncertainty was first introduced.

However, in this case, the Group considers that it is more appropriate to go back to the point at which the inconsistencies first occurred between the FAA methodology and the Code provisions (i.e. NETA Go-Live). The Group believes that this would fully remove the risk that (if a Trading Dispute was raised), Parties might be faced with changes to their past settled liabilities which would be calculated under a less fair/accurate method.

3.3.2 Prospective Settlement Day versus prospective Calendar Day implementation

The Group notes that there are two possible ways to implement the Proposed Modification on a prospective basis:

- 1) A prospective **Settlement Day** implementation, which aligns the Code with the FAA methodology for all Settlement Runs relating to any Settlement Days which occur after the Implementation Date.

This approach would leave Parties the right to raise Trading Disputes against:

- a) Any Settlement Runs that occur from the Trading Query deadline to the Implementation Date; and
- b) Any Settlement Runs that occur on or after the Implementation Date but which relate to Settlement Days occurring before the Implementation Date (i.e. all runs for these Settlement Days up to 14 months after the Implementation Date, or 28 months with the Post Final Settlement Run).

- 2) A prospective **Calendar Day** implementation, which aligns the Code with the FAA methodology for all Settlement Runs occurring after the Implementation Date (regardless of whether the Settlement Day to which the run relates occurs before or after the Implementation Date).

This approach would reduce the number of runs against which Parties could raise Trading Disputes, such that they could only dispute Settlement Runs occurring between the Query Deadline and the Implementation Date. All runs on or after the Implementation Date would not be disputable.

Figures 3 and 4 further illustrate the difference between the two approaches, and a further worked example is provided in Appendix 4. Again, the Group notes that the only difference between the two approaches is the effect on Parties' right to raise Disputes.

Table 3 summarises the arguments in favour of each approach, as considered by the Group.

Table 3 – Arguments in favour of a Settlement Day or Calendar Day approach

Arguments for a Settlement Day approach	Arguments for a Calendar Day approach
<ul style="list-style-type: none"> • More consistent with the usual implementation approach for Modification Proposals • Leaves Parties the maximum right to raise Trading Disputes • If the aim is to limit Disputes, it would be better to support the full retrospective option of the Alternative Modification • A Calendar Day approach to the Proposed Modification is a 'half way house' which runs the risk of P235 being rejected if the industry and/or the Authority believe that Parties should be able to raise Disputes 	<ul style="list-style-type: none"> • Applies a single set of rules consistently to all Settlement Runs from the Implementation Date onwards and minimises the period in which the FAA interest calculations are knowingly inconsistent with the Code • Thereby represents a clearer and less complex 'line in the sand' for Parties than a Settlement Day approach (which would maintain the inconsistencies until all past Settlement Days had been through the full Reconciliation timetable) • Minimises the number of Trading Disputes which can be raised, promoting certainty and obtaining the benefits of P235 as soon as practicable • Parties have been aware from the point at which P235 was raised that a Calendar Day approach could be considered

The Group is currently minded (by majority) to adopt a prospective Calendar Day implementation for the Proposed Modification. However, it welcomes industry views on the merits of this approach before making its final decision.

4 INITIAL ASSESSMENT AGAINST THE APPLICABLE BSC OBJECTIVES

The Group's initial view is that both the Proposed and Alternative Modifications would better facilitate Applicable BSC Objectives (c) and (d) when compared with the current Code drafting.

The following reasons have been given by members against these Objectives:

Applicable BSC Objective (c):

- The existing FAA methodology:
 - More fairly and/or accurately reflects the principle behind Reconciliation and the time value of money to Parties (for the reasons described in Section 2); and

- Therefore better promotes competition than the existing Code drafting.

Applicable BSC Objective (d):

- P235 will remove any confusion and potential for misinterpretation over how Reconciliation interest is calculated, and will provide clarity to Parties.
- This will promote transparency and efficiency in the implementation and administration of the BSC arrangements.

The Group believes that P235 would have no effect on Applicable BSC Objectives (a) or (b).

Of its two solutions, the Group's initial view is that the Alternative Modification would best facilitate Applicable BSC Objectives (c) and (d) overall.

The following reasons have been given by members in support of this view:

Applicable BSC Objective (c):

- Certainty is beneficial for competition. The fact that all Parties have paid their Trading Charges (including the interest calculated by the FAA) since NETA Go-Live without dispute has provided certainty for this element of Party cash flows. Any Trading Dispute has the potential to change and redistribute these past cash flows according to a less fair/accurate calculation of liabilities going back to an as yet undetermined time. A retrospective implementation gives maximum certainty to all Parties (whether you are a 'winner' or 'loser') for the reasons given in Section 3.3.
- In the specific case of P235, the certainty provided by retrospection outweighs the potentially anti-competitive effect of removing Parties' right to raise Trading Disputes over how past interest was calculated.

Applicable BSC Objective (d):

- Removing the potential for Trading Disputes will mean greater efficiency for ELEXON in administering the BSC arrangements.

APPENDIX 1: COPY OF THE APPLICABLE BSC OBJECTIVES

The Applicable BSC Objectives, as contained in the Transmission Licence, are:

- (a) The efficient discharge by the licensee [i.e. the Transmission Company] of the obligations imposed upon it by this licence [i.e. the Transmission Licence];
- (b) The efficient, economic and co-ordinated operation of the GB 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.

APPENDIX 2: GROUP'S TIMETABLE, MEMBERSHIP AND TERMS OF REFERENCE

a) P235 progression timetable and costs

The following table shows the assessment activities undertaken so far, as well as the planned dates for the Group's next meeting and the submission of the Assessment Report to the Panel.

You can download all historic P235 documents from the BSC Website [here](#).

Date	Assessment activity
09/04/09	BSC Panel raises P235
09/04/09	ELEXON presents the Initial Written Assessment (IWA) to the Panel / Panel submits P235 to the Assessment Procedure
15/04/09	Modification Group holds its first meeting
17/04/09	ELEXON issues the Assessment Consultation request to industry
30/04/09	Participants return Assessment Consultation responses
01/05/09	Modification Group holds its second meeting (by teleconference)
08/05/09	ELEXON submits the Group's Assessment Report to the Panel
14/05/09	ELEXON presents the Group's Assessment Report to the Panel

The following table shows ELEXON's estimated costs for progressing P235 through the Modification Process to the point of Ofgem decision.

These costs are lower than those originally provided to the Panel in the IWA, as industry interest in the modification has been less than initially expected (and less ELEXON resource has therefore been required to support its progression).

Estimated costs of progressing P235	
Meeting cost	£500
External legal/expert cost	Zero
BSC Agent impact assessment cost	Zero
ELEXON resource	17 man days, equating to approximately £5,500

b) List of Modification Group members and meeting attendees

Member	Organisation	15/04/09
Chris Rowell	ELEXON (Chair)	Y
Kathryn Coffin	ELEXON (Lead Analyst)	Y
Steve Wilkin	ELEXON (Proposer's Representative)	Y
Gary Henderson	SAIC	Y
Hannah McKinney	EDF	Y
Chris Stewart	Centrica	Y
Edward Hunter	RWE	By phone
Andy Colley	SSE	N
Esther Sutton	E.ON	N

Attendee	Organisation	15/04/09
Howard Gregory	RWE	By phone
Abid Sheikh	Ofgem	By phone
Diane Mailer	ELEXON (Lawyer)	Y

c) Modification Group's Terms of Reference

Modification Proposal P235 will be considered by the P235 Modification Group (which will be formed from the Settlement Standing Modification Group, supplemented with individuals with financial and/or funds administration experience/expertise), in accordance with the SSMG's Terms of Reference and this Appendix.

1 ASSESSMENT PROCEDURE

- 1.1 The Modification Group will carry out an Assessment Procedure in respect of Modification Proposal P235 in accordance with Section F2.6 of the Code.
- 1.2 The Modification Group will produce an Assessment Report for consideration at the BSC Panel Meeting on 14 May 2009.
- 1.3 The Modification Group shall consider:
 - The appropriateness of the following four aspects of the P235 solution (and the implications of not aligning the BSC with the FAA methodology in these areas):
 - Calculating interest back to the Payment Date for the Initial Settlement Run, rather than to the Payment Date of the previous Settlement Run;
 - Calculating interest on a daily basis using the Base Rate applicable to each day in the period, rather than using a single Base Rate;
 - Calculating interest on a compound basis (i.e. the amount on which interest is calculated for each day in the period includes the accumulated interest levied on previous days), rather than a simple interest basis; and
 - Excluding the Payment Date of the current Reconciliation from the period for which interest is calculated, rather than including it;
 - ELEXON's suggestion that the modification should be implemented on a prospective Settlement Day basis (meaning that it would only apply to Settlement Days occurring after the Implementation Date);
 - Whether the particular circumstances of this modification warrant a different approach (e.g. a retrospective Calendar Day Implementation Date of the date the modification was raised) and whether this could form an Alternative Modification;
 - Whether the Proposed Modification would better facilitate the achievement of the Applicable BSC Objectives when compared with the existing Code drafting;
 - Whether any Alternative Modification would better facilitate the achievement of the Applicable BSC Objectives in relation to the issue or defect identified in the Modification Proposal, and when compared with:
 - The existing Code drafting; and
 - The Proposed Modification;

- ELEXON's suggested legal drafting, and whether any amendments/additions are required to this drafting to reflect the Group's agreed solution.

APPENDIX 3: WORKED EXAMPLES OF DIFFERENCES BETWEEN THE CODE AND FAA SYSTEMS

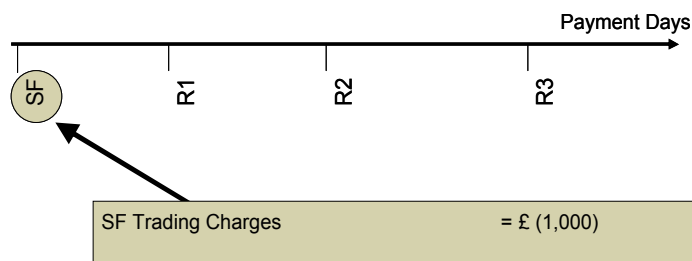
Worked Example 1: Calculation back to the last Reconciliation Run versus back to the Initial Settlement Run

This example is intended to show how applying interest back to the Payment Date for the Initial Settlement Run is consistent with the overall principle of any Reconciliation Settlement Run: namely that it "be determined as though it were the first Settlement Run to be carried out in relation to the relevant Settlement Day, and so disregarding any payments which may on any prior Payment Date have been paid or payable in respect of the relevant Settlement Day" (Section N6.1.5).

1) Initial Settlement (SF)

At the Initial Settlement Run, the Trading Charges amount is calculated to be -£1,000.

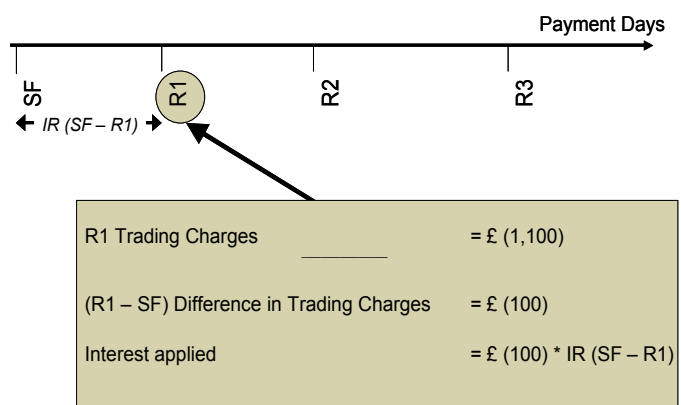
- A payment of £1,000 would be made.



2) 1st Reconciliation (R1)

At the 1st Reconciliation Run, the Trading Charges amount is recalculated to be -£1,100.

- The difference in charges between the R1 and SF runs is minus £100.
- Interest is applied to this difference. Under both the BSC and the FAA calculation interest would be applied back to the SF Run.
- The Reconciliation Charge is obtained by adding the difference and the interest amount (i.e. the two bullets above).



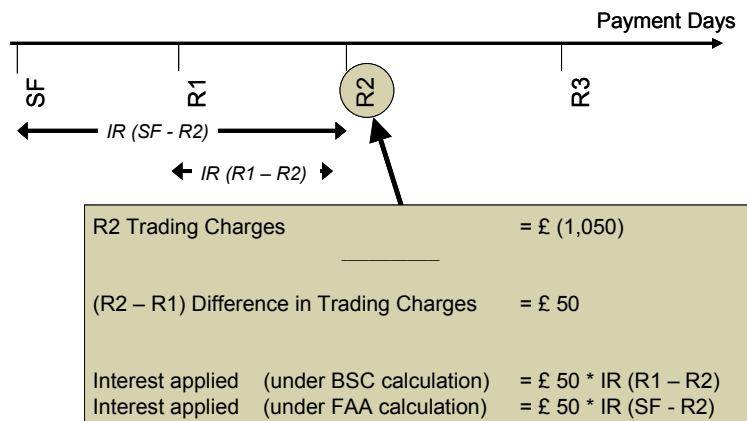
Applying this interest on the difference has the same effect as if £1,100 had been paid when the Initial Settlement Run was undertaken.

This occurs in both the FAA calculation and the Code calculation (albeit under the Code calculation a simple single interest rate is applied, whereas a daily compound interest rate is applied by the FAA systems).

3) 2nd Reconciliation (R2)

At the 2nd Reconciliation Run, the Trading Charges amount is recalculated to be -£1,050.

- The difference in charges between the R2 and R1 runs is plus £50.
- Interest is applied to the difference:
 - Under the Code, interest would be applied only back to R1
 - Under the FAA calculation, interest would be applied fully back to SF.
- The Reconciliation Charge is again obtained by adding the difference and the interest amounts. However, in this case the interest amounts differ dependent on how the interest is calculated.



Applying the interest back to the Initial Settlement Run (i.e. as per the FAA calculation) has the same effect as if £1,050 had been paid when the Initial Settlement Run was undertaken.

Applying the interest back only to the 1st Reconciliation Run (i.e. as per the Code calculation) fails to recognise that, if the 2nd Reconciliation Run data had been available when the Initial Settlement Run was conducted, then £1,050 should have been paid at the Initial Settlement Run. The calculation fails to recognise that the £50 difference applies back to the Initial Settlement Run and not just the First Reconciliation Run. The lost "time value of money" amounts to $£50 * IR (SF - R1)$.

If the Party had made an overpayment at the 1st Reconciliation Run, then this effect would amount to a loss in the real time value of its money. Similarly, if the Party had made an underpayment at that run, this effect would have given them an inadvertent benefit. In each case, equal and opposite effects will be imposed on other Parties as the monies must still sum to zero overall.

Applying the FAA calculation and always establishing the monies as if they had been established at the Initial Settlement Run:

- Negates the benefits/disadvantages that would arise from variations in Parties' positions that are identified between Reconciliation Runs; and**
- Is consistent with the overarching principle of a Reconciliation Settlement Run.**

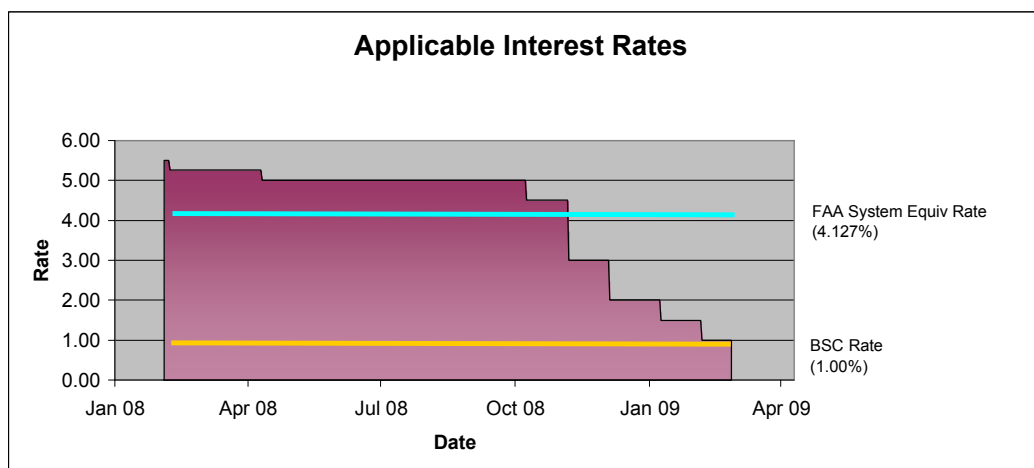
Worked Example 2: Simple Single Base Rate versus Daily Compound Base Rate

This example is intended to show the difference between using a simple single interest rate (as the Code drafting currently implies) and a daily compound rate (as the FAA systems currently calculate).

To illustrate the effect, the examples uses data relating to the Final Reconciliation Settlement Run for Settlement Day 6 January 2008. Across this period there were 8 different Base Rates, ranging from 5.50% to 1.00%.

Settlement Date	06-Jan-2008	BSC Party	Example Company
Settlement Code	RF		
Calendar Payment Date	27-Feb-2009		

Start Date	End Date	No of Days	Principal	Interest Rate	Interest Amount	Total Including Interest
04-Feb-2008	07-Feb-2008	4	(1,000.0000)	5.50	(0.6029)	(1,000.6029)
08-Feb-2008	10-Apr-2008	63	(1,000.6029)	5.25	(9.1077)	(1,009.7105)
11-Apr-2008	08-Oct-2008	181	(1,009.7105)	5.00	(25.3465)	(1,035.0570)
09-Oct-2008	06-Nov-2008	29	(1,035.0570)	4.50	(3.7071)	(1,038.7641)
07-Nov-2008	04-Dec-2008	28	(1,038.7641)	3.00	(2.3932)	(1,041.1573)
05-Dec-2008	08-Jan-2009	35	(1,041.1573)	2.00	(1.9986)	(1,043.1559)
09-Jan-2009	05-Feb-2009	28	(1,043.1559)	1.50	(1.2010)	(1,044.3569)
06-Feb-2009	26-Feb-2009	21	(1,044.3569)	1.00	(0.6010)	(1,044.9580)
			Total Interest		(44.9580)	



- Using the simple single interest rate, interest would be applied at 1.00% (i.e. the Base Rate in place on the Advice Note date, in this case 24 February 2009).
- Using the daily compound rate, the equivalent interest rate for the period would be 4.127%.

In the example, the principal to which the interest is applied is £1,000.00. Using a simple single interest rate, the total interest would be £10.6575. Using the daily compound rate, the total interest due is £44.9580.

Whilst the movement in interest rates may have been pronounced across this period, this example shows that across the 14-month period **the FAA System calculation more fully reflects the interest rates experienced by Parties and hence the value of money.**

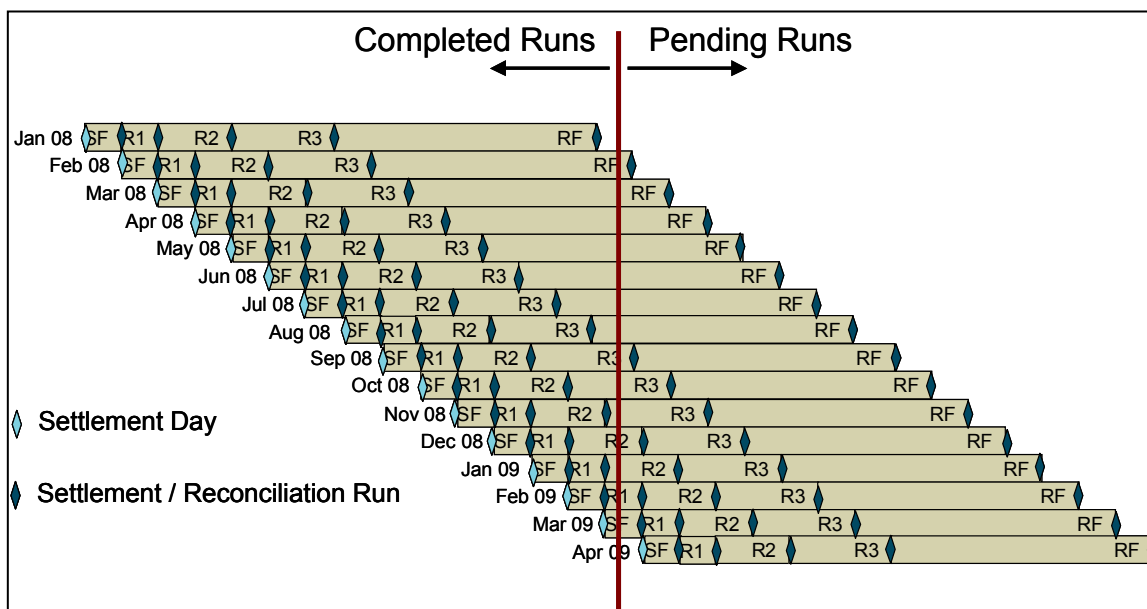
Note: The tabulated data mirrors the manner in which the calculation is presented in the Advice Note Backing Sheets. The Backing Sheets clearly show the differing Base Rates and the period for which they apply. The interest that has been applied is also clearly shown.

APPENDIX 4: EFFECT OF A SETTLEMENT DAY OR CALENDAR DAY APPROACH

Following a given Settlement Day (D), a number of Settlement Runs are undertaken. These occur in accordance with the schedule set out in the Settlement Timetable. The timetable is based around:

Settlement Day	D
Initial Settlement Run (SF)	D + 16 WD
1st Reconciliation (R1)	D + 36 WD
2nd Reconciliation (R2)	D + 81 WD
3rd Reconciliation (R3)	D + 147 WD
Final Reconciliation (RF)	D + 288 WD

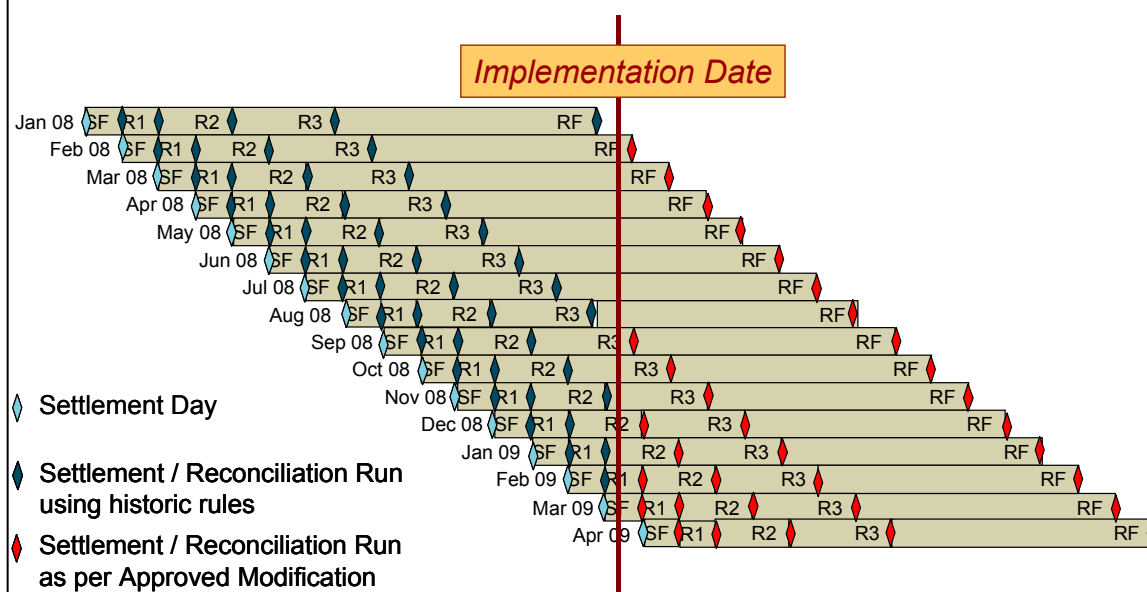
The effect is that on any given day there are a series of runs (Initial Settlement Run and Reconciliations) that will have completed, and a series that are still pending. This is illustrated in the diagram below, which for simplicity shows only one run per month.



When a Modification Proposal is approved, it is necessary to be clear on whether Settlement and Reconciliation Runs carried out after the Implementation Date of the Approved Modification in respect of Settlement Days prior to that date should be carried out under the old or the new rules.

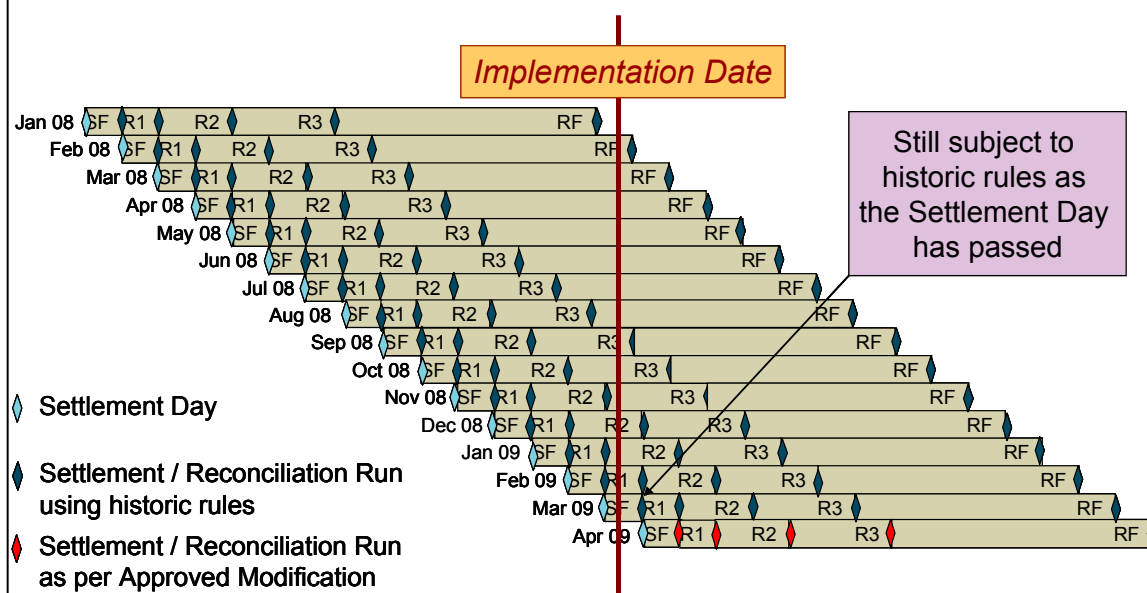
For prospective (i.e. forward-looking) changes there are two distinct means by which they can be implemented: a Calendar Day approach or a Settlement Day approach. The differing effects of these are demonstrated in the diagrams below. These show what the effect would be if implementation took place in the current month (April 2009). However, the pattern of effect will be the same regardless of the point from which the change prospectively applies (although the exact affected Settlement Days/Runs will be different).

Calendar Day Implementation



Under a **Calendar Day** implementation, all runs on or after the Implementation Date will be conducted according to the rules set out in the Approved Modification. In practice this means that, for some Settlement Days (see the February 2008 through to February 2009 series), the rules applying to runs conducted on or after the Implementation Date will be the new Approved Modification rules, while for earlier runs the rules applied will have been the historic rules.

Settlement Day Implementation



Under a **Settlement Day** implementation, the rules of the new Approved Modification only apply to those runs for which the Settlement Day is on or after the Implementation Day. Thus for the March 2009 series of runs (the penultimate line), all runs will still be conducted under the historic rules as the Settlement Day was before the Implementation Date. All Settlement Days onwards from the April 2009 Settlement Day will be conducted under the rules of the Approved Modification.