



Direct Dial: 020 7901 7412

18 September 2003

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No P134

Dear Colleague

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Notice in relation to Modification Proposal P134: “The halting of unnecessary and inefficient work and expenditure associated with approved BSC Modification P82”.

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P134, “The halting of unnecessary and inefficient work and expenditure associated with approved BSC Modification P82”.

The BSC Panel (the “Panel”) recommended to the Authority that Modification Proposal P134 should be made and implemented.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives the Authority has decided not to direct a Modification to the BSC.

This letter explains the background and sets out the Authority’s reasons for its decision.

Background

Some electricity is used up in the process of its transportation from power plants to electricity consumers. The electricity lost on the transmission network is commonly referred to as

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

² ELEXON document reference P134RR, Version No. 1.0, dated 15 August 2003.

"transmission losses". Currently, transmission losses are allocated to suppliers and generators by adjusting their metered volumes. The allocation of transmission losses is on a uniform basis.

In January 2003, the Authority approved Modification Proposal P82 "Introduction of zonal transmission losses on an average basis". Approved Modification Proposal P82 will allocate average transmission losses to generators and suppliers on a zonally differentiated basis. Approved Modification Proposal P82 is due to be implemented on 1 April 2004. A copy of the Authority's decision letter is available on the ELEXON website³. In this decision letter Ofgem outlined the benefits associated with zonal transmission losses. In summary these are:

- It would remove the cross subsidies created by uniform charging, and therefore over time reduce the level of transmission losses. In the short-term losses would be reduced because there would be a greater incentive to use plants located closer to demand. Losses would be further reduced in the long-term because there would be a greater incentive to locate new plants closer to demand⁴. Consumers would benefit from resulting lower costs.
- It would have environmental benefits, principally lower carbon emissions, since it would reduce the overall level of electricity transmitted. In addition, it could reduce the required size of the grid thus having a beneficial effect on any health related effects of transmission and on the environmental impact of the grid.
- It would remove a barrier to competition, since uniform pricing offers less scope for competitors to secure a lower cost.
- Estimates of its costs and benefits by a range of commentators and market participants generally indicated that the anticipated benefits would substantially outweigh the expected low implementation costs.

On 17 January 2003, Ofgem also wrote to the Chairmen of the BSC and Connection and Use of System Code ("CUSC") Panels concerning the modification and amendment processes prior to and during the course of legislation to introduce the British Electricity Trading and Transmission Arrangements ("BETTA")⁵.

In these letters, it was explained that Ofgem's general approach will be to conduct a consultation upon GB issues in relation to any modification proposal submitted for the England and Wales BSC and CUSC when the Bill has received its second reading in Parliament. At this time Parliament will have signalled its support for the principle of the Bill, and whilst still at a considerable remove from legal certainty, the BETTA legislation could be seen to have attained a significant step towards forming part of the legal framework within which Ofgem will operate. Whilst Ofgem must act in accordance with the current legal and regulatory framework, it is because its principal objective is to protect the interests of consumers – which includes future

³ www.elexon.co.uk

⁴ And to retire plants located further from demand.

⁵ These letters are available from Ofgem's webpage on http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/3224_beta_cusc.pdf and http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/1355_beta_cusc_letter.pdf

consumers – that Ofgem took the decision not to wait until Royal Assent of the BETTA legislation, which is the point at which it would achieve legal certainty, before considering the application of a modification proposal in a GB context. Ofgem and DTI are currently working towards implementing BETTA for 1 April 2005, although this date is dependent upon the necessary legislation being introduced to Parliament and receiving Royal Assent within the next parliamentary year.

On 27 June 2003, the DTI announced that, following consultation, the Secretary of State, and the Minister for Energy, E-Commerce and Postal Services, Stephen Timms, are not minded to designate average zonal transmission losses as part of a GB Balancing and Settlement Code.

ELEXON is currently undertaking implementation work to enable implementation of Approved Modification Proposal P82 on 1 April 2004, and has indicated that the majority of the central system costs connected with this proposal will have been spent by the end of November 2003.

The Modification Proposal

British Energy submitted Modification Proposal P134, "The halting of unnecessary and inefficient work and expenditure associated with approved BSC Modification P82" on 30 June 2003. The Proposer considered the Modification Proposal would better facilitate achievement of Applicable BSC Objectives⁶ (b) and (d). This was because the Proposer considered that industry costs may be saved provided work and expenditure on implementing Approved Modification P82 is halted quickly and the BSC reverts to the state without implementation of Approved Modification P82.

The Proposer commented that the conclusion of the DTI January 2003 Consultation "Transmission losses in a GB electricity market" published on 27 June 2003 is that "the Secretary of State and the Minister for Energy, E-Commerce and Postal Services, Stephen Timms are not minded to designate Average Zonal Transmission Losses as part of the GB BSC".

The Proposer considered that if Approved Modification P82 is implemented on 1 April 2004 and operates for only 12 months until BETTA is introduced the balance of costs and claimed benefits of Approved Modification P82 will change significantly. The Proposer considered that it is extremely unlikely that a net benefit will be achieved by implementing Approved Modification P82 for a few months until BETTA is introduced.

⁶ 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
- (e) without prejudice to the foregoing objectives and subject to paragraph 3A, the undertaking of work by BSCCo (as defined in the BSC) which is:
 - (i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
 - (ii) relevant to the proposed GB wide balancing and settlement code;and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

The Proposer also requested the Modification Proposal be treated as Urgent. ELEXON agreed to recommend to the BSC Panel that the Modification Proposal should be granted Urgent status.

The Panel Chairman sought views from Panel members on the request for Urgent status during a telephone conference on 30 June 2003. All Panel members that were present during the telephone conference agreed that the Modification Proposal should be treated as Urgent. The Panel's rationale for the recommendation was that costs associated with the implementation of P82 that are being incurred both centrally and by participants on an on-going basis may be unnecessary were Modification Proposal P134 to be approved by the Authority. The Panel also recognised that ELEXON was in the process of finalising the terms of the Transmission Loss Factor Agent contract which, if signed, would trigger release of funds to the Transmission Loss Factor Agent.

On 1 July 2003, the Authority rejected the request for treating the Modification Proposal as Urgent. In its decision letter, the Authority noted that, in general, urgent modifications are likely to exhibit at least one of the following characteristics:

- There is a very real likelihood of significant commercial impact upon NGC, industry parties, or customers if a proposed modification is not urgent;
- Safety and security of the network is likely to be impacted if a proposed modification is not urgent; and
- The proposal is linked to an imminent date related event.

The Authority considered that Modification Proposal P134 did not exhibit these characteristics and should therefore be subject to the normal Modification Procedures as detailed in Section F of the BSC.

The Panel considered the Initial Written Assessment at its meeting of 10 July 2003. The Initial Written Assessment contained a recommendation from ELEXON to the Panel that the Panel should submit the Modification Proposal directly to the Report Phase with a recommendation to reject. In making its recommendation, ELEXON considered:

- the Authority's decision letter for Approved Modification Proposal P82,
- the Authority's 17 January 2003 letter to the CUSC and BSC Panel chairmen, and
- the Authority's decision on the request that Modification Proposal P134 be treated as Urgent.

The Panel agreed to submit the Modification Proposal directly to the Report Phase. Moreover, the Panel considered the "minded to" statement by the Secretary of State in relation to whether average zonal transmission losses should form part of a GB BSC should influence its decision in respect of the Modification Proposal. The Panel considered there was a reasonable certainty that average zonal transmission losses would not form part of a GB BSC, and that implementing the

Modification Proposal would prevent some unnecessary costs being incurred. The Panel therefore gave a preliminary recommendation to implement the Modification Proposal.

ELEXON published a draft Modification Report on 24 July 2003, which invited respondents' views by 31 July 2003. The draft Modification Report contained a provisional recommendation by the Panel that the Modification Proposal should be implemented as it would better facilitate achievement of Applicable BSC Objectives (d) and (c).

Respondents' views

ELEXON received 14 responses to the consultation on Modification Proposal P134. Ten respondents (representing 29 Parties and 1 non-Party) expressed support for the Panel's provisional recommendation to implement the Modification Proposal, three respondents (representing 24 Parties) did not support the Panel's recommendations and the remaining respondent (representing one Party) replied with "no comment".

The majority of respondents agreeing with the Panel's provisional recommendation considered that Approved Modification P82 would only be in place for a limited time and therefore would not achieve the benefits of producing long term locational signals for siting generation and demand. The majority of the respondents of this view considered that the Modification Proposal would prevent unnecessary costs being incurred as a result of implementation of Approved Modification P82 and it should therefore be implemented.

In other comments made by respondents who agreed with the Panel's provisional decision: one respondent considered that the Authority's decision not to grant Urgent status to the Modification Proposal has led to an unacceptable and needlessly high level of perceived regulatory risk in the market. One respondent was surprised that the Authority did not consider the "minded to" view by the Secretary of State and the Minister for Energy, E-Commerce and Postal services with regard to GB wide zonal transmission losses sufficient to justify granting Urgent status to the Modification Proposal. Another respondent considered the time may be appropriate for Ofgem to review the legal advice it had received prior to the letter it wrote to the Chairmen of the BSC and CUSC Panels on 17 January 2003.

One of the respondents that did not agree with the provisional recommendation of the Panel questioned whether it would be right to forego the benefits in terms of competition and efficiency that zonal transmission loss factors will bring to England and Wales based on the future introduction of BETTA. This respondent considered that it is possible that the implementation of BETTA might be delayed and also that the DTI may change its "minded to" view with regard to GB wide zonal transmission losses. Two of the respondents that did not agree with the Panel's provisional recommendation also argued that consideration needs to be given to the amount of implementation costs for Approved Modification P82 that have already been incurred, and therefore should be considered as sunk. One of these respondents considered that until there is certainty that BETTA will be implemented, the Modification Proposal is a contingent Modification Proposal and that it will not become relevant until the Bill to introduce BETTA has had its second reading in Parliament

The respondents' views are summarised in the Modification Report for Modification Proposal P134, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 14 August 2003 and considered the Modification Proposal, the draft Modification Report, and the consultation responses received.

The Panel recommended on a majority decision that the Authority should approve the Modification Proposal. The Panel recommended that if approved, the Modification Proposal should be implemented two Working Days after the Authority's decision.

The Panel considered that the costs, both to ELEXON and the industry, of implementing Approved Modification P82 were not justified, as the purported benefits of the transmission losses scheme would not be realised over the life of the scheme as the lifetime of the scheme would now be considerably shorter than originally envisaged. The Panel therefore considered the benefits of Approved Modification P82 would be curtailed to the point of being nugatory. The Panel considered that approving Modification Proposal P134 would prevent some unnecessary costs being incurred. The Panel considered this would better facilitate the achievement of Applicable BSC Objective (d).

The Panel considered that contracts could be negotiated without taking into account any changes to the way in which transmission losses are charged if the Modification Proposal were to be accepted. There would also be no uncertainty with regard to the timescale that Approved Modification P82 would be in place for, as it would effectively not be implemented. The Panel considered that this increased certainty in the trading arrangements would lead to better facilitation of the achievement of Applicable BSC Objective (c).

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives, that Modification Proposal P134 would not better facilitate achievement of the Applicable BSC Objectives. In addition, Ofgem considers that this decision is consistent with its wider statutory duties.

Ofgem's decision letter⁷ on Modification Proposal P82 set out the reasons why it considered that P82 better facilitates the achievement of the Applicable BSC Objectives, as compared with the then existing provisions of the BSC. Ofgem considered that, having had regard to the Applicable BSC Objectives and its statutory duties⁸, the original Modification Proposal P82 does better facilitate achievement of the Applicable BSC Objectives (a), (b) and (c). Ofgem considered, on balance and without limitation, that the most significant benefit arises in relation to Applicable BSC Objective (b).

⁷ This letter is available on the Elexon Website.

⁸ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things social and environmental guidance provided to Ofgem by the government.

Ofgem continues to believe that it is appropriate for transmission losses to be charged on an average zonal basis. There are important economic and environmental benefits associated with this. We believe that the costs associated with Approved Modification Proposal P82 (both centrally and by participants) are modest whilst the benefits are positive and significant.

Ofgem considers that P134 would not better facilitate achievement of the Applicable BSC Objectives (a), (b) or (c). In addition, Ofgem considers that P134 would be inconsistent with its statutory duties as explained below. The Applicable BSC Objectives are discussed in their order of importance for the decision being made.

Applicable BSC objective (b) - the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system

Ofgem considers that the adoption of zonal transmission losses under P82 will remove the cross subsidies that are created by uniform charging for transmission losses since the charges faced by participants under uniform charging do not reflect the costs they impose on the system. Since P134 would reintroduce uniform charging, it would result in the cross-subsidies being reinstated. Accepting P134 will tend to have two effects:

- in the short run costs will be higher than would otherwise be the case. Cross subsidisation will lead to some plant generating when it would be less costly for it not to generate, whilst other plant, which it would be more efficient to use, is not generating. Similarly, cross-subsidies are likely to result in the pattern of electricity consumption failing to reflect fully the costs of providing the electricity; and
- in the long run there will be a tendency towards an inefficient (locational) pattern of investment in generation and closure of generation with a consequential adverse impact on transmission. There could also be inefficiency in the location of demand.

These inefficiencies have economic and environmental costs, the size of which will depend upon system conditions.

Rejecting P134 and retaining zonal charging for transmission losses will therefore enhance efficiency through more cost reflective charging which could be expected to influence both short and long term business decisions. Consequently, Ofgem considers that accepting P134 would not better facilitate the achievement of Applicable BSC Objective (b).

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

In general, uniform pricing presents a barrier to competition as it offers less scope for competitors to secure a lower cost. The uniform pricing arrangements that would be reintroduced if P134 were to be accepted, artificially impose higher costs on generators in the south and suppliers in the north. This would restrict the market for generation alternatives in the south (whether this be Combined Heat and Power ("CHP") or other forms of new generation) and supply in the north. Consequently, the removal of differential charges could have a

detrimental effect on competition. Ofgem therefore considers that accepting P134 would not better facilitate the achievement of Applicable BSC Objective (c).

Applicable BSC Objective (a) - the efficient discharge by the licensee of the obligations imposed upon it by this licence

NGC has a range of statutory duties and licence obligations which include ensuring the efficient, economic and co-ordinated operation of the system, the facilitation of competition⁹ and non-discrimination¹⁰. As set out above, Ofgem considers that accepting P134 would be detrimental to the discharge by NGC of the first two of these obligations. Reintroducing the cross subsidy inherent in uniform charging for transmission losses would introduce the discrimination that the introduction of zonal charging for transmission losses sought to remove. Therefore accepting P134 will not better facilitate the achievement of Applicable BSC Objective (a).

In summary, Ofgem considers that accepting P134 would not better facilitate achievement of Applicable BSC objectives (a), (b), or (c).

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

The majority of respondents and the BSC Panel considered that accepting Modification Proposal P134 would better achieve Applicable BSC Objective (d) by preventing ELEXON and market participants from incurring the implementation costs of Accepted Modification P82.

When Ofgem took its original decision on P82 careful consideration was given to all of the costs involved. The central costs associated with implementing P82 were estimated as £109,100 (ex VAT) with on-going costs of £1440 per month. In addition, ELEXON would have to appoint a Transmission Loss Factor Agent (“TLFA”). ELEXON’s current budget for implementation of P82 is £670,000, including the costs of appointing the TLFA. The majority of respondents who commented on participants’ costs expressed the view that they were either minimal or zero. The views of respondents to the subsequent DTI consultation on the implementation of GB losses appear broadly consistent with those expressed in relation to P82.¹¹ Consequently, Ofgem considers that, whatever the future outcome, the potential for wasteful expenditure in the implementation of Accepted Modification P82 is small, and unlikely to outweigh its benefits. Moreover, Ofgem does not accept that it can be asserted with any significant degree of certainty that the benefits will be curtailed by the introduction of BETTA.

Obviously, as the implementation costs become sunk over time, the balance of costs and benefits surrounding the implementation of zonal charging for transmission losses will change to become even more favourable.

Additional considerations

⁹ Section 9 (2) (b) of the Electricity Act 1989

¹⁰ Condition C7C of the Transmission Licence

¹¹ The DTI did not publish individual responses to its consultation but it did publish a summary of responses.

In making the decision to approve the original Modification Proposal P82 to the BSC, the Authority decided not to conduct a consultation upon GB issues in relation to the Modification Proposal. On the same day that Ofgem issued the decision letter for P82, it issued a letter which explains the consultation process for Modifications to the BSC prior to and during the course of legislation to introduce BETTA.

It is Ofgem's opinion that the only relevant circumstantial changes since it made its decision upon P82 are the issuing of the "minded to" statement by the Secretary of State and the Minister for Energy, and the deferral of the target date for implementation of BETTA from 1 October 2004 to 1 April 2005.

However, as noted, because of its duty to protect the interests of future consumers as well as present ones, Ofgem does make every effort, where appropriate and legally acceptable, to consider matters that could impact upon those consumers. Hence, Ofgem is cognisant of the current views of the Secretary of State and the Minister for Energy, but, against the "minded to" statement, it also weighed: the further delay in the BETTA legislation, the consequential further slippage in the proposed timetable to implement BETTA, and the progress made in implementing P82 and the costs associated with that.

Given the uncertainty associated with the future, Ofgem believes that the potential for future economic and environmental benefits from the implementation of Accepted Modification P82 outweighs the implementation costs associated with the Modification. Ofgem additionally considers that, even if the zonal charging for transmission losses was not to be included in the GBBSC, then the incremental costs that participants would incur in implementing this reversal would be nugatory.

Ofgem's statutory duties

Standard Licence Condition C3.5 of NGC's transmission licence states that when a Modification Proposal is sent to the Authority for decision, the Authority must assess whether the proposal, as against the existing provisions of the BSC, better facilitates the achievement of the Applicable BSC Objectives. If, and only if, the Authority decides that it would, it directs a change to the BSC. NGC must comply with this direction by virtue of section 7(3) Electricity Act 1989. As the Authority is making a direction pursuant to its Part I Electricity Act powers, it is under a duty to act in accordance with its statutory duties. The Authority is not able to approve a Modification Proposal that it does not consider will better achieve the Applicable BSC Objectives. In these circumstances it does not reach the point of having to analyse the proposal in the light of its statutory duties. However, Ofgem is ever mindful of those duties and has considered the proposal in relation to those duties and determined that accepting P134 would not accord with its principal objective¹² to protect the interests of consumers, present and future, where appropriate by promoting competition in the electricity industry.

¹² The principal objective and general duties of the Authority are set out at section 3A, 3B and 3C of the Electricity Act 1989. The principal objective of the Authority is to "protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity." Section 3A (6) provides that "consumers" includes both existing and future consumers.

Reintroducing uniform charges for transmission losses will reinstate a cross subsidy which will mean that northern consumers pay too much for their electricity and southern generators get paid too little (and vice versa). In addition, uniform charges can be expected to increase the total costs of generating and transmitting electricity (together with concomitant environmental disbenefits) in the short and longer run, to the overall detriment of present and future consumers.

Ofgem additionally has a statutory duty in relation to the environment and has received government guidance on the subject. To the extent that zonal charging of losses influences the use of existing generation, the location of future plant closures and new build, and potentially, also demand, it will tend to reduce the total extent of electricity transmitted and the required size of the transmission grid. This may have a beneficial effect on the environmental appearance of the system and, more significantly, on environmental pollution by avoiding carbon emissions which would otherwise result from the more inefficient development and operation of the transmission system.¹³ Reintroducing uniform charging for losses by accepting P134 would prevent these benefits being realised and hence would not be compatible with Ofgem's statutory duty in relation to the environment.

In considering the adoption of zonal losses, Ofgem carefully considered the position of renewable and CHP generators. Our conclusion was that the position of renewable generators would be largely unaffected, except for projects that were already marginal, since the level of support that such schemes receive would effectively insulate them from the impact of charging changes. This view was confirmed by the analysis that OXERA carried out for the DTI in relation to GB losses, which concluded that the impact of zonal losses on renewables projects "might be very marginal, due to the high value of Renewables Obligations Certificates relative to the wholesale electricity price. Hence it seems unlikely that [zonal losses] will materially affect the probability of meeting the government's renewables target".

In respect of CHP schemes, Ofgem considered that the introduction of zonal losses could be beneficial in that it would favour generators located close to sources of demand. Consequently, the benefits ascribable to the co-location of generation and demand, as in a CHP scheme, could be enhanced.

The need for GB consultation

Ofgem notes the view of the respondent that the time may be appropriate to review the legal advice it had received prior to the letter it wrote to the Chairmen of the BSC and CUSC Panels on 17 January 2003. Ofgem assures all parties that the legal advice in relation to this matter is under constant review and assessment, but that as a result of this on-going review it considers that the legal position has not changed since the date that it wrote to the Chairmen of the BSC and CUSC Panels and that the process set out in that letter remains valid.

Moreover, even taking into account the Secretary of State's "minded to" announcement, Ofgem does not believe that accepting Proposed Modification P134 would better facilitate achievement of the Applicable BSC Objectives and its wider statutory duties.

¹³ For example, depending on the type of plant whose output is reduced as a result of implementing the original Modification Proposal, in the short term carbon emissions could be reduced by between 2000 tonnes p/a and 6000 tonnes p/a. In the long run, the savings could increase to between 48,000 tonnes p/a and 127,000 tonnes p/a.

The Authority's decision

The Authority has therefore decided not to direct that Modification Proposal P134, as set out in the Modification Report, should be made and implemented.

Having regard to the above, the Authority, in accordance with Section F1.1.4 of the BSC, hereby notifies NGC that it does not intend to direct NGC to modify the BSC as set out in the Modification Report.

Please contact me on the above number if you have any questions in relation to this letter.

Yours sincerely

A handwritten signature in black ink, appearing to read "Sonia Brown".

Sonia Brown

Director, Electricity Trading Arrangements

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