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17 November 2004

Dear Colleague,

BETTA consultation on the recovery of costs incurred as a result of the run-off of the Settlement Agreement for Scotland (SAS) – An Ofgem/DTI consultation

In July 2003, Ofgem published their conclusions and a subsequent addendum[1] to its consultation document on the proposed recovery of costs under BETTA[2]. In those conclusions, Ofgem/DTI stated that, in relation to SAS run-off, full consideration of the matter of cost recovery would be undertaken at the time that any modification of the SAS is brought forward to give effect to the run-off of SAS arrangements. Four such modification proposals have been sent to the Authority for determination.

The purpose of this open letter consultation is to consider the treatment, in terms of cost recovery, of the costs that will be incurred as part of the run-off of the SAS.

Timetable

Any comments on the issues discussed below and on the proposed legal text contained in appendix 1 should be sent by Friday 17 December 2004, to:

David Halldearn
BETTA Project,
Office of Gas and Electricity Markets
9 Millbank,
London SW1P 3GE

[1] "Recovery of costs under BETTA, An Ofgem/DTI conclusions document", and "Addendum to Recovery of costs under BETTA, An Ofgem/DTI conclusions document", July 2003, Ofgem 66/03
[2] "Recovery of costs under BETTA, Ofgem/DTI consultation, April 2003, Ofgem 23/03

Alternatively, comments can be emailed to BETTA.consultationresponse@ofgem.gov.uk. If you wish to discuss any of the issues contained in this consultation, please contact Julie McGuinness, email julie.mcguinness@ofgem.gov.uk, telephone 0141 331 2012.

Background

In April 2003, Ofgem/DTI published a consultation on the recovery of costs under BETTA and in July of 2003 published their conclusions, together with an addendum to those conclusions ("the conclusions documents"). In the conclusions documents, Ofgem/DTI stated that, in relation to SAS run-off, full consideration of the matter of cost recovery would be undertaken at the time that any modification of the SAS is brought forward to give effect to the run-off of SAS arrangements. Four proposals for modifications to the SAS to effect run-off have now been proposed to the Authority and two of them have been approved, the further two being under consideration. The purpose of this open letter is to give consideration to the costs that will be incurred as a consequence of the run-off of the SAS and for each area of such costs:

- the areas where costs will be incurred;
- the extent to which such costs should be recoverable;
- the question of from whom any recoverable costs should be recovered; and
- the mechanisms for such recovery.

Each of these areas is considered in turn below.

Areas of costs to be incurred

Both SP Distribution Limited (SPDL) and Scottish Hydro-Electric Power Distribution Limited (SHEPDL) have been in communication with Ofgem on the topic of the run-off of the SAS and they have identified three areas where costs will be incurred. These areas, which are referred to collectively as 'SAS run-off costs' in this letter, are:

1. The unbilled costs associated with the introduction of supply competition in Scotland in 1998 ("1998 costs"). These costs are due to be completely recovered by October 2005 but at BETTA go-live approximately £4 million will remain to be recovered.

2. The costs to be incurred in running down the staffing of Scottish Electricity Settlements Limited (SESL) (which undertakes the "Scottish Settlements" role under the SAS)

3. The operational costs of SESL under the SAS between BETTA go-live and the termination of the SAS.

The mechanisms under the SAS for the recovery of costs from SAS parties will not be able to operate after BETTA go-live because the data to calculate the shares of the costs to be allocated to each SAS Party will not be available. It will therefore be necessary to put in place an appropriate mechanism to enable the funding of the costs identified above. There are, of course many ways in which such funding could be effected. In this open letter consultation, Ofgem/DTI propose, what they believe to be the simplest solution to this problem.

Recovery of costs

The conclusions documents gave consideration to the costs that might accrue in SESL as a result of the introduction of BETTA and Ofgem/DTI stated their belief that such costs would fall to the Scottish distribution licensees and that such costs should be categorised as costs associated with the wind-up of the old arrangements. Ofgem/DTI further stated that they considered that the recovery of such costs, if they proved to be material, should be subject to the following criteria:

- at the time that the work was undertaken, the work could reasonably have been considered necessary for the timely introduction of BETTA and was work that would not otherwise have been undertaken;

- the costs associated with this work were efficiently and prudently incurred;

- clear and supporting documentation exists to validate each element of any claim for recovery and clear and identifiable costs have been recorded; and

- the costs are not already allowed for under prior, existing or future revenue restrictions or via any other route.

Ofgem/DTI also stated that consideration would be given to the eligibility of any such costs for recovery as part of the review of distribution price controls to apply from April 2005.

Ofgem/DTI are still of the view that any costs that fall to the Scottish distribution licensees, should be subject to these arrangements. Initial discussions have been held with the distribution licensees about the magnitude of the costs likely to be incurred and arrangements are being made to include an appropriate mechanism to allow approved costs to be recovered through the distribution price controls. Clearly, the exact magnitude of all such costs will not be known until after the run-off completes and the SAS terminates, so that arrangements in the price control will have to allow for the actual sums concerned to be determined later.

From whom should costs be recovered

1998 costs

The conclusions documents gave separate consideration to the recovery of the 1998 costs in the addendum. In that addendum, Ofgem/DTI concluded that any outstanding 1998 costs should continue to be recovered from parties in Scotland subject to a suitable cost recovery mechanism being found.

Ofgem/DTI are still of the view that this is the right conclusion and consider that a suitable cost recovery mechanism would be one which recovered the costs broadly speaking in the same proportion as these costs are currently recovered from the same consumer groups.

Staff run-down costs

In the conclusions documents Ofgem/DTI anticipated that if costs arise as a result of the introduction of GB balancing and settlement, they would fall on the Scottish distribution licensees. As mentioned above, Ofgem/DTI also stated their view that such costs should be categorised as costs associated with the wind-up of the old arrangements. It is Ofgem/DTI's view that, as in relation to the costs of development of new arrangements, the costs of wind up of such arrangements should be recovered from those who have benefited from them. On this basis, such costs should be recovered from Scottish consumers.

Operational run-off costs

In the conclusions documents Ofgem/DTI stated their view that in principle the costs of administering the settlement runs relating to trades that occurred prior to BETTA go-live for the England and Wales market ('England and Wales operational run-off') should be recovered from England and Wales parties and the costs of administering the equivalent SAS settlement runs ('Scottish operational run-off'), from SAS parties. However, Ofgem/DTI concluded, that, given that GB BSCCo will be administering recovery of GB costs and the marginal cost of them undertaking this activity in relation to England and Wales run-off is likely to be relatively small, on the basis of practical considerations any administrative/operational costs in England and Wales associated with running settlement systems in relation to settlement periods occurring prior to BETTA go-live should be recovered on a GB basis post the implementation of BETTA.

Given that England and Wales run-off costs are to be recovered on a GB basis, it is for consideration whether it is more equitable for Scottish operational run-off costs to be recovered on a Scottish or on a GB basis. On the face of it, it would not appear equitable for Scottish consumers to fund a share (about 10% based upon the Scottish energy consumption as a proportion of GB) of England and Wales operational run-off costs and also to fund Scottish operational run-off costs. However, it would only be possible to determine whether any arrangements were entirely equitable if the costs involved can be identified. As mentioned above, Ofgem/DTI are in discussion with the two Scottish distribution licensees about all the SAS run-off costs including the Scottish operational run-off costs and will be able to identify a total for such costs which comply with the criteria set out above. However, because of the form of the contracts between ELEXON and BSC Agents and because of the difficulty of identifying what elements of other costs (overheads, dispute costs etc.) might be considered to be run-off costs, Ofgem/DTI understand that it is not possible to determine what is the magnitude of the England and Wales operational run-off costs.

Ofgem/DTI suggest that one possible measure could be to consider the total of the normal operational costs of SESL and of ELEXON and hypothesise that operational run-off costs for Scottish and for England and Wales arrangements would be in proportion to these totals. SESL's annual operating budget is about £4 million[3] and that for ELEXON (excluding BETTA costs and NETA cost recovery costs) is about £48 million[4]. On the basis of this ratio, 10% of England and Wales operational run off costs would be roughly the same as the total of Scottish operational run-off costs. If such an approach is valid then GB recovery of both England and Wales and Scottish run-off costs would be broadly equitable between the two funding populations.

Ofgem/DTI believe that the uncertainty with regard to the equitability of the recovery of Scottish operational run-off costs either from Scottish parties or on a GB basis means that they should not

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[3] Budget for year to March 2005 from SESL's tariff calculations (13 January 2004)
[4] Budget for year to March 2006 from ELEXON's Business Strategy and Annual Budget (1 April 2004 to 31 March 2007)

propose either approach. Instead, Ofgem/DTI would welcome views on this question and will reach their conclusion informed by respondents' views.

Mechanisms to effect recovery

Scottish recovery

Under the SAS, costs are recovered from the parties in proportion to the allocation of energy generated and supplied by SAS parties. Distribution charges to suppliers are based upon energy usage, so that, in terms of the allocation of costs to consumers, the two mechanisms are likely to have a broadly similar effect. However, Ofgem/DTI note that such a change would have the effect, for the period of the cost recovery, of moving costs from Scottish generators to Scottish suppliers. Because of the way that costs are allocated under the SAS, only a third of the total costs are allocated to generators. Ofgem/DTI also note that the provision of a mechanism to allocate the SAS run-off costs in a way that directly reflects the present process would be complex and thus inevitably costly. Since the costs concerned are small in terms of the impact upon consumers and any distortion to the market would be of short duration, Ofgem/DTI propose that those costs that are to be recovered from Scottish consumers; that is, the 1998 costs, the SESL staff run-down costs and possibly the Scottish operational run-off costs, should be recovered through an appropriate adjustment to the price controls of the two Scottish distribution licensees. The total of the costs recovered annually through the Scottish distribution price controls is some £300 million. The Scottish distribution licensees have provided information that indicates that the total of all the SAS run-off costs (including operational run-off costs, on which Ofgem/DTI have yet to conclude from whom such costs should be recovered) may be of the order of £7 million. The recovery of such costs will therefore have only a small impact on the price controls or on distribution charges.

Such a mechanism would require a change to the SAS to ensure that the appropriate SAS run-off costs (ie, the 1998 costs, the SESL staff run down costs and possibly the SAS operational run-off costs) fall on the distribution licensees (in appropriate proportion) rather than on other SAS parties. Ofgem/DTI anticipate that, once they have published their conclusions, following this consultation, an appropriate SAS modification will be proposed.

GB recovery

The simplest method for effecting any GB cost recovery is through the BSC. Section D of the BSC[5] already contains a number of mechanisms for recovering costs from BSC parties and repaying such sums to the parties who funded the costs in the first place. It is proposed that, should Ofgem/DTI conclude that any part of the SAS run-off costs should be recovered from GB consumers, the mechanism to achieve this should be as follows:

- all such costs will be funded by the two Scottish distribution licensees (as defined in a modification to the SAS to be proposed) in the first instance;

- following termination of the SAS, the Authority will determine, for each Scottish distribution licensee, the sum to be recovered and repaid which complies with the criteria listed in the section on "recovery of costs" above;

[5] See Annex D-5 Party Funded Amounts

- the Authority will issue a notice to the BSC Panel specifying the sum to be recovered for each distribution licensee and the commencement date for such recovery;

- such a notice will be recognised within the legal drafting of Annex D-5, which will oblige BSCCo to commence the recovery of the sums specified over a period of two years;

- the sums will be recovered from BSC Trading Parties in proportion to their credited energy volumes (in common with other BSCCo costs); and

- in common with all other such mechanisms, sums will be repaid on a quarterly basis and interest will be allowed for from the commencement date.

It is not yet known what the cost of Scottish operational run-off will be but the distribution licensees have indicated that it may be in the range of £1 to £2 million. Under these circumstances, Ofgem/DTI believe that a relatively short period for recovery is appropriate. Views on whether it should be shorter than two years would be welcome.

Legal drafting for Annex D-5 of the BSC to give effect to such a mechanism is shown in the attachment to this letter.

Views Invited

Respondents' views are sought on the issues set out above, and in particular on:

- whether it is equitable for Scottish operational run-off costs to be recovered on a GB basis given that England and Wales run off costs will be recovered on a GB basis;

- the proposed mechanism for the recovery of costs through Scottish distribution charges;

- the proposed mechanism for the recovery of any costs that are to be recovered on a GB basis; and

- the period of time over which such costs should be recovered.

Cost Recovery of Scottish Distributor Recoverable Amount

Implementation Date:

Section D (version 7.0 1 September 2004)

Amend Section D as follows:

5. PARTY-FUNDED COSTS

5.1 Party-Funded Costs

5.1.1 Certain Parties are entitled to repayment (from Parties or classes of Party collectively), in accordance with this paragraph 5, of amounts incurred by them by reference to the following dates:

(a) no later than the Go-live Date:

(i) to the extent not already recovered under the terms of the Pooling and Settlement Agreement, costs ("**1998 Programme Costs**") incurred by PES Suppliers in respect of the development (in connection with the Pooling and Settlement Agreement) of arrangements for Supplier Volume Allocation;

(ii) costs ("**Pool NETA Costs**") incurred by Pool Members in connection with the development of the arrangements to which the Code gives effect.

(b) no later than the BETTA Effective Date:

(i) costs ("**BETTA Support Costs"**) incurred by Parties in accordance with Section C 8.2.2.

(c) no later than the final day of the Scottish Distributor Start Date:

(i) Scottish Operational Run-Off Costs.

5.1.2 For the purposes of the Code:

(a) "**Party Funded Costs**" means 1998 Programme Costs, Pool NETA Costs, ~~and~~ BETTA Support Costs and Scottish Operational Run-Off Costs;

(b) in relation to each kind of Party Funded Costs:

(i) "**Funding Party**" means the Party or Parties entitled to recover amounts in respect of such Party Funded Costs and, in relation to Scottish Operational Run-Off Costs, means the Scottish Distribution Companies;

(ii) "**Party Charge**" means an amount payable by a Party in respect of the recovery by Funding Party(ies) of such Party Funded Costs;

(iii) "**Funding Party Payment**" means an amount payable to a Funding Party in respect of the recovery of such Party Funded Costs.

Annex D-5 (volume 7.0 1 September 2004)

Add a new paragraph 4 as follows:

4. SCOTTISH OPERATIONAL RUN-OFF COSTS FUNDING

4.1 Recoverable amounts and shares

4.1.1 The amounts recoverable by the Scottish Distribution Companies as Scottish Operational Run-Off Costs are described in this paragraph 4.

4.1.2 For the purposes of this paragraph 4:

(a) "**Scottish Distributor Recoverable Amount**" or "**SDRA**" means the sum of the amounts notified by the Authority to the Panel, with interest at the rate specified as r in paragraph 4.2.1 from the first day of the month following the Scottish Distributor Start Date in respect of the Scottish Operational Run-Off Costs for:

(i) SP Transmission & Distribution Limited and the amount notified shall be known as **SPDLA**; and

(ii) Scottish Hydro-Electric Power Distribution Limited and the amount notified shall be known as **SHEPDLA**;

(b) the "**Scottish Distributor Start Date**" is the next Quarter Date which occurs following the date that the Authority notifies the Panel of the Scottish Distributor Recoverable Amount for each Scottish Distribution Company.

4.1.3 Each Scottish Distribution Company shall be entitled to recover the Scottish Distributor Recoverable Amount in the applicable percentage ("**Scottish Distributor Recovery Share**") set out at paragraph 4.3.1.

4.1.4 The period (the "**Scottish Distributor Recovery Period**") over which each Scottish Distribution Company is entitled to recover amounts in respect of Scottish Operational Run-Off Costs is the period commencing on the Scottish Distributor Start Date and ending two years thereafter.

4.1.5 The Panel shall on or as soon as practicable after the Scottish Distributor Start Date provide a statement of the Scottish Distributor Recoverable Amount and the Scottish Distributor Recovery Shares thereof to all Trading Parties, the Scottish Distribution Companies and the Authority.

4.1.6 The Trading Parties shall provide to the Panel all such information as the Panel may reasonably require in connection with its determinations under paragraph 4.1.5.

4.1.7 In the event of any merger of any Scottish Distribution Company any successor company shall have the aggregate Scottish Distributor Recovery Share of its predecessor. Any successor company to a part only of the Scottish Distribution Company shall have such Scottish Distributor Recovery Share as the Authority shall determine.

4.2 Amounts payable by Trading Parties

4.2.1 The '**Quarterly Distributor Run-Off Amount**" (QDRA) in respect of each Quarter beginning on the Scottish Distributor Start Date shall be the amount determined in accordance with the following formula: ~~-~~

$$QDRA = \frac{SDRC * r}{(1-(1+r)^{-L})}$$

where:

r is the rate (expressed as a quarterly rate, and as a decimal value) determined by the Panel to be one percentage point per annum above the time weighted average of the Base Rates prevailing during the preceding Quarter;

L is the remaining part of the Scottish Distributor Recovery Period (specified in Quarters) as at the beginning of the relevant Quarter;

SDRC is the remaining portion of the principal amount comprised in the Scottish Distributor Recoverable Amount not recoverable in respect of previous Quarters.

4.2.2 As soon as reasonably practicable after the beginning of each Quarter, BSCCo shall determine the Quarterly Distributor Run-Off Amount in respect of that Quarter.

4.2.3 The amount payable by each Trading Party, in respect of each Quarter in the Scottish Distributor Recovery Period, shall be an amount determined as:

$$QDRA * (S1 + S2 + S3) / 3$$

where:

QDRA is the Quarterly Distributor Run-Off Amount in respect of that Quarter;

S1, S2 and S3 are the Trading Party's Main Funding Shares for each of the three months in that Quarter.

4.2.4 In each Quarter BSCCo will, not less than 16 Business Days before the end of the Quarter:

(a) estimate in relation to each Trading Party:

(i) the Main Funding Share for each month in that Quarter, and

(ii) on the basis of such estimated shares, the amount payable by such Trading Party pursuant to paragraph 4.2.3 in relation to that Quarter;

(b) determine (by way of reconciliation in respect of the preceding Quarter):

(i) the amount payable by each Trading Party pursuant to paragraph 4.2.3 in relation to the preceding Quarter (based on actual data as to Main Funding Shares);

(ii) the difference between the amount previously estimated (under paragraph (a)(ii)) for the preceding Quarter and the amount determined under paragraph (i);

(c) determine the net amount payable by the Trading Party in that Quarter (being the net aggregate of the amounts under paragraphs (a)(ii) and (b)(ii));

(d) notify the amounts so estimated and determined to each Trading Party.

4.2.5 Each Trading Party shall pay, no later than the penultimate Business Day of each Quarter in the Scottish Distributor Recovery Period (which shall be the due date for the purposes of Section D6.2.1), the amount determined under paragraph 4.2.4(c) in respect of that Quarter.

4.3 Reimbursement to Scottish Distribution Companies

4.3.1 The amounts recovered from Trading Parties pursuant to paragraph 4.2 in respect of a Quarter shall be distributed among the Scottish Distribution Companies on the last Business Day of that Quarter according to the following percentages (the "**Scottish Distributor Recovery Share**"):

(i) SP Transmission & Distribution Limited:

$$\text{Scottish Distributor Recovery Share (\%)} = \frac{SPDLA}{SDRA} * 100$$

(ii) Scottish Hydro-Electric Power Distribution Limited:

$$\text{Scottish Distributor Recovery Share (\%)} = \frac{SHEPDLA}{SDRA} * 100$$

4.3.2 Any amounts received late from Trading Parties shall be distributed on the same basis as soon as reasonably practicable following their receipt.

4.3.3 Following the end of each Quarter BSCCo shall monitor the amounts payable by each Trading Party since the start of the Scottish Distributor Recovery Period and the amounts paid by each Trading Party, in each case in accordance with the provisions of this paragraph 4.

4.3.4 After the expiry of the Scottish Distributor Recovery Period, BSCCo shall produce a statement showing the amounts paid by each Trading Party, in each case in accordance with the provisions of this paragraph 4; and Trading Parties shall make appropriate adjusting payments as specified by the Panel in respect of any differences between the amounts referred to in paragraph 4.3.3.

4.4 General

4.4.1 All amounts and charges under this paragraph 4 are exclusive of VAT which shall be added to such charges, if applicable.

4.4.2 In this paragraph 4 references to Quarters are to Quarters during the Scottish Distributor Recovery Period.

Section X-1 (version 24 1 September 2004)

Add to Section X-1 the following:

"Scottish Distribution Company": means Scottish Hydro-Electric Power Distribution Limited and/or SP Transmission & Distribution Ltd and Scottish Distribution Companies means both of those companies;

"Scottish Distributor Recovery Period": means the period described in Annex D-5 4;

"Scottish Operational Run-Off Costs": means the costs described in Annex D-5 4;