

Our Ref: JM  
Direct Dial: 020 7901 7017  
Email: [David.Halldearn@ofgem.gov.uk](mailto:David.Halldearn@ofgem.gov.uk)  
[Angela.Pearce@dti.gsi.gov.uk](mailto:Angela.Pearce@dti.gsi.gov.uk)

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Dear Colleague,

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

In November 2004, Ofgem/DTI published an open letter consultation<sup>1</sup> to consider the treatment, in terms of cost recovery, of the costs that will be incurred as part of the run-off of the Settlement Agreement for Scotland ('SAS') ('the November 2004 cost recovery consultation').

The purpose of this document is to detail the conclusions of the November 2004 cost recovery consultation. There were six responses to the consultation. A list of respondents is shown in appendix 1. Copies of these responses are available on the Ofgem website [www.ofgem.gov.uk](http://www.ofgem.gov.uk).

**Background**

In July 2003, Ofgem/DTI published their conclusions and a subsequent addendum<sup>2</sup> to its consultation document on the proposed recovery of costs under BETTA<sup>3</sup> ('the July 2003 cost recovery conclusions document'). In those conclusions, Ofgem/DTI stated that, in relation to the run-off of the SAS, full consideration of the matter of cost recovery would be undertaken at the time any modification of the SAS is brought forward to give effect to the run-off of the SAS arrangements. At the time of the November 2004 cost recovery consultation four such modifications proposals had been sent to the Authority for determination. These have now been approved.

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<sup>1</sup> "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", November 2004.

<sup>2</sup> "Recovery of costs under BETTA, Ofgem/DTI consultation", April 2003, Ofgem 23/03.

<sup>3</sup> "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, Ofgem66/03.

The purpose of the November 2004 cost recovery consultation was to give consideration to the areas where costs will be incurred as a consequence of the run-off of the SAS, the extent to which such costs will be recoverable and the source and mechanism of such recovery.

In particular the letter sought views on the following:

- 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 certain 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.

#### Areas of costs to be incurred

In the November 2004 cost recovery consultation, Ofgem/DTI identified the areas where costs are likely to be incurred as part of the run-off of the SAS. Through communication between SP Distribution Limited (SPDL), Scottish Hydro-Electric Power Distribution Limited (SHEPDL) and Ofgem, three areas where costs will be incurred have been identified.

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 November 2005<sup>4</sup> but at the BETTA go-live date (currently anticipated to be 1 April 2005) approximately £4 million will still remain to be recovered.
2. The costs to be incurred in running down the staffing of Scottish Electricity Settlements Limited (SESL).
3. The operational costs of SESL under the SAS between the BETTA go-live date and the date the SAS is terminated.

#### Recovery of costs

In the November 2004 cost recovery consultation, Ofgem/DTI re-stated their belief that the SAS run-off costs should be met by 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 material should be subject to the following criteria:

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<sup>4</sup> In the November 2004 open letter consultation, Ofgem/DTI stated that the 1998 costs would be completely recovered by October 2005. In SESL's response to the consultation they noted that the 1998 costs would not be fully recovered until November 2005.

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

Ofgem/DTI also stated that consideration should 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. The draft price control licence modifications issued as an appendix to 'The Electricity Distribution Price Control Review' by Ofgem in December 2004 incorporated this proposal in the drafting.

#### From whom costs should be recovered

In the addendum to the July 2003 cost recovery conclusions document, Ofgem/DTI concluded that the 1998 costs should continue to be recovered from parties in Scotland. In the November 2004 cost recovery consultation Ofgem/DTI indicated that they were still of this view and considered that a suitable cost recovery mechanism would be one which recovered the costs in substantially the same proportion as these costs are currently recovered, from the same parties.

In addition in the July 2003 cost recovery conclusions document, Ofgem/DTI indicated that staff run-down costs should fall on the Scottish distribution licensees and be recovered through their distribution charges which are applied by suppliers to all Scottish electricity consumers. This was restated in the November 2004 cost recovery consultation, highlighting Ofgem/DTI's view that staff run-down costs should be recovered from those who benefited from them, that is Scottish consumers.

In the November 2004 cost recovery consultation, Ofgem/DTI considered whether it is more equitable for Scottish operational run-off costs to be recovered on a Scottish or on a GB basis. Ofgem/DTI indicated that it would not propose either approach but instead sought views from respondents.

#### Mechanisms to effect recovery

With regards to the costs to be recovered on a Scottish basis, Ofgem/DTI indicated in the November 2004 cost recovery consultation that costs that require Scottish recovery should be recovered through an appropriate adjustment to the price controls of the two Scottish distribution licensees. Such a mechanism would require a change to the SAS to ensure that the appropriate costs would be met by the distribution licensees rather than the other SAS parties. It was anticipated that an appropriate SAS modification would be proposed by SESL or parties to the SAS.

In respect of costs to be recovered on a GB basis, Ofgem/DTI indicated in the November 2004 cost recovery consultation that the simplest way of recovering such costs post BETTA would be through the Balancing and Settlement Code (BSC).

Proposed changes to section D of the BSC to accommodate the recovery of Scottish run-off costs from BSC parties across GB, and the repaying of it to parties who initially funded it (that is, Scottish distribution licensees), were included in an appendix to the November 2004 cost recovery consultation.

### **Respondents' comments**

There were six responses to the November 2004 cost recovery consultation. A list of respondents is shown in appendix 1. Copies of these responses are available on the Ofgem website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). One of the respondents, SESL, raised three points of clarification and sought clear guidance on another issue. The points of clarification are noted below and Ofgem intend to discuss the other issue directly with SESL and the Scottish distribution licensees.

SESL raised the following points of clarification with regards to the November 2004 cost recovery consultation:

- the remaining £4 million of the 1998 costs is due to be completely recovered for the period up to November 2005, and not October 2005 as stated in the November 2004 cost recovery consultation
- SESL's operating budget for the year 2004/2005 is £3.6 million. The expenditure is expected to be £3.3 million, and
- the SAS Finance and Audit Panel has, along with SESL, recommended an operational run-off budget of approximately £2.1 million assuming cessation of reconciliation runs after R3.

### Scottish operational run-off costs

With regards to Scottish operational run-off costs four respondents indicated that they were content for these costs to be recovered on a GB basis. Two of these respondents indicated that they believed that it was equitable to recover such costs on a GB basis. One respondent stated that these costs should be recovered from Scottish consumers in the same way as the 1998 costs and SESL staff run-down costs are recovered at present.

### SESL staff run-down costs

Two respondents to the November 2004 cost recovery consultation stated that the SESL staff run-down costs should be recovered on a GB basis. One respondent stated that such costs were not a continuation of the development of Scottish arrangements but a direct result of the introduction of BETTA and as such should be legitimately treated as a BETTA cost. The other three parties were in agreement with the proposal that these costs should be regarded as costs associated with the wind up of the old arrangements and as such recovered from those who have benefited from them, that is Scottish consumers.

### 1998 costs

Two respondents to the November 2004 cost recovery consultation argued that the 1998 costs should be recovered on a GB basis as they believe that there will be an amount unrecovered because the introduction of BETTA will bring an end to the present

mechanism for recovery through Scottish Settlement arrangements. One noted that while it may have been appropriate for costs of development to have been met by Scottish consumers, these consumers would have anticipated that the arrangements would have lasted for a longer period. The other three respondents supported Ofgem/DTI's previous conclusion that these costs should be recovered from Scottish parties in much the same manner as they are at present.

#### Proposed mechanism for recovery of costs through Scottish distribution price controls

Four of the respondents to this consultation stated that if any costs were to be recovered on a Scottish basis then they were content for this to be done through the Scottish distribution price controls. A number of respondents also raised issues about how this could be done equitably. One respondent suggested that the costs could be allocated appropriately based on the historic size of the two distribution areas and also suggested that costs be incorporated into the 2005/2006 distribution price controls. One respondent noted that if recovery is channelled through the distribution price controls that the principal parties from whom costs will be recovered will be the same as those paying the current charges. Another respondent suggested that the costs should continue to be recovered from parties to the SAS in the same way as they are recovered at present. That respondent suggested that this could be done based on freezing SAS parties' market shares prior to the BETTA go-live date and using that data to allocate costs.

#### Proposed mechanism for the recovery of any costs to be recovered on GB basis

Three of the respondents to the November 2004 cost recovery consultation stated that should any costs require to be recovered on a GB basis, the mechanism proposed through the BSC is satisfactory.

#### The period of time over which costs should be recovered

On the question of timescales for cost recovery on a GB basis, two respondents to the November 2004 cost recovery consultation proposed one year and one respondent suggested two years partly on the basis that the sum recovered would be £7 million. Another respondent stated that a two year period of recovery would be satisfactory.

### **Ofgem/DTI conclusions**

#### SESL staff run-down costs and 1998 costs

As mentioned above, in the July 2003 cost recovery conclusions document<sup>5</sup>, Ofgem/DTI concluded that costs incurred in the run-off of the SAS and any remaining 1998 costs should be recovered from those who have benefited from those competitive supply arrangements. Ofgem/DTI note that Scottish consumers will continue to benefit from the introduction of the competitive supply arrangements and the introduction of BETTA will have no effect on this. In the light of the other issues raised in the November 2004 cost recovery consultation, Ofgem/DTI are still of the view that the 1998 costs and the SESL staff run-down costs should be recovered from Scottish consumers.

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<sup>5</sup> "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, Ofgem66/03.

## Mechanism for recovery of costs through Scottish distribution price controls

It is Ofgem/DTI's view that the mechanism for Scottish recovery should be done through the Scottish distribution price controls. Ofgem/DTI note that one respondent suggested an alternative mechanism through freezing market shares prior to the BETTA go-live date and using that data to allocate costs. It is Ofgem/DTI's view that this alternative may be complex and more time consuming to administer in the period between the BETTA go-live date and the date the SAS is terminated than the option proposed by Ofgem/DTI in the November 2004 cost recovery consultation.

The 1998 costs (approximately £4 million) and the SESL staff run-down costs (estimated to be £0.5 million) are estimated at present to be approximately £4.5 million. The total of the costs recovered annually through the Scottish distribution price controls are approximately £300 million. In Ofgem/DTI's view, the inclusion of these costs will have only a small impact on the distribution charges which are applied by suppliers to all Scottish electricity consumers.

SESL has already indicated that on receipt of the conclusions to the November 2004 cost recovery consultation, it will seek to ensure that an appropriate SAS modification is raised. This modification should recover the costs from each of the Scottish distribution licensees (who will in turn recover the costs through their distribution charges) in such a way as to allocate costs to parties in Scotland in substantially the same manner as at present.

## Scottish operational run-off costs and mechanism for costs to be recovered on GB basis

Ofgem/DTI consider that it is appropriate for SAS operational run-off costs be recovered on a GB basis. This recovery will be as indicated in the November 2004 cost recovery consultation through (a revised) section D of the BSC<sup>6</sup>. The mechanism will be as previously stated in the November 2004 consultation<sup>7</sup>. As the cost of SAS operational run-off costs has now been estimated by SESL at approximately £2.1 million, Ofgem/DTI consider that it is appropriate for this amount to be recovered over a period of one year, rather than two years as previously proposed. Amended drafting for Section D of the BSC is at appendix 2 to this letter to give effect to this change. Two other minor changes have also been made to this drafting.<sup>8</sup>

As previously indicated, the recovery of all three areas of costs will be subject to the following criteria:

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

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<sup>6</sup> See Appendix 2

<sup>7</sup> See Appendix 3

<sup>8</sup> In 5.1.1(c) of Section D of the BSC at Appendix 2 the words "final day of" have been deleted. In addition, in Annexe D-5 4.1.2 (a) the words "to the panel" have been removed after 'to the Authority'.

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

Ofgem/DTI anticipate that, on the publication of their conclusions, the Authority will give consideration to directing NGC to make the changes to the BSC shown in the appendix 2 to this letter pursuant to paragraph 6 of standard condition C3 of its transmission licence.

## **Appendix 1**

Respondents to November 2004 Ofgem/DTI open letter consultation:

British Energy plc

EDF Energy

E.ON UK plc

Scottish Electricity Settlements Limited

Scottish and Southern Energy

Scottish Power Energy Management

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## Appendix 2

### Cost Recovery of Scottish Distributor Recoverable Amount

#### Implementation Date:

Section D (version 9.0 6 December 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 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, 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, 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 one year 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:-

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

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:

$$\text{QDRA} * (S1 + S2 + S3) / 3$$

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:

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

\_\_\_\_\_ (ii) Scottish Hydro-Electric Power Distribution Limited:

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

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;

## Appendix 3

The mechanism to achieve GB cost recovery:

- 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;
- 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 one year;
- 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.