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National Grid Electricity Transmission plc, BSC Signatories and Other Interested Parties

19 June 2006

Our Ref: MP No P196

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and direction in relation to Modification Proposal P196 "Treatment of long term vacant sites in settlement"

The Gas and Electricity Markets Authority (the "Authority")[1] has considered the issues raised in the Modification Report[2] in respect of Modification Proposal P196, "Treatment of long term vacant sites in settlement".

The BSC Panel (the "Panel") recommended to the Authority that Modification Proposal P196 should not be implemented. However, if the Authority decided to approve P196 they recommended that it should be implemented on 22 February 2007 if a decision was received on or before 21 August 2006, or 28 June 2007 if the Authority decision is received after 21 August 2006 but on or before 19 December 2006.

Having considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives[3] and the Authority's statutory duties,[4] the Authority has decided to direct a modification to the BSC in line with Modification Proposal P196.

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

This letter constitutes notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

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[1] Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

[2] ELEXON document reference P196RR, Version No. 1.0, dated 24 April 2006

[3] The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of NGET'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 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; and
d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements

[4] Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and are detailed primarily in the Electricity Act 1989.

Background

Unless the metering system at a non-half hourly (NHH) site has been de-energised, the volume of energy allocated to the supplier in respect of the metering system will be calculated using the latest Estimate of Annual Consumption (EAC). However, where the site is long term vacant (LTV) in many cases non-half hourly data collectors (NHHDCs) are unable to gain access. These sites are likely to be consuming no energy and so until an actual meter reading is taken and entered into settlement, the metering system would continue to be settled on a misrepresentative, positive EAC. This would result in the energy volumes attributable to the supplier responsible for the LTV site being overstated.

Because accuracy and equitability in settlement were considered to suffer as a consequence of LTV sites, the Supplier Volume Allocation Group (SVG) considered the problem of LTV sites at its meetings on 2 December 2003 and 1 March 2005. At the second meeting the SVG agreed that an Issue Group should be formed to further discuss the problems LTV sites cause settlement. The first meeting of the Issue 14 Group was on 15 April 2005.

The Issue 14 Group considered data supplied by Elexon on the overstatement of settlement and Annual Demand Ratios (ADRs), by suppliers on the estimated costs of inaccurate energy being settled and the costs of using existing processes to obtain an actual meter reading and by the Office of the Deputy Prime Minister (ODPM) on the numbers of empty homes[5] in the UK.

The Issue 14 Group unanimously concluded that approximately 1% of the NHH market is made up of LTV sites. They added that the large number of LTV sites in the NHH market lead to an over accounting of energy in settlement. The Issue 14 report to the BSC Panel can be found on the Elexon website[6].

In order to rectify this situation, E.ON submitted Modification Proposal P196, “Treatment of long term vacant sites in settlement” on 25 November 2005.

The Modification Proposal

Modification Proposal P196 seeks to modify the BSC arrangements so as to allow for the equitable treatment of LTV sites in settlement. It intends to do this by adding a process to the BSC and BSC Procedure (BSCP) 504 which would allow suppliers to enter a zero EAC into settlement for as long as a site is confirmed to be LTV.

The process proposed by P196 consists of several stages which can be found in detail in the Modification Report to the BSC Panel. In summary they are:

1. Determination that a site is LTV
2. Submission of zero EAC into settlement
3. Periodic re-confirmation that site is LTV
4. Determination that a site is no longer LTV
5. Submission of positive EAC into settlement

[5] According to the ODPM an empty home is classified as a dwelling, which is vacant either because it is between occupants, undergoing modernisation, in disrepair or awaiting demolition. Second homes and holiday homes are not included as empty homes.

[6] www.elexon.com

In order for a site to be classed as LTV, the supplier must determine that four criteria have been met. A LTV site is a site:

i. which is energised according to the Supplier Meter Registration Service (SMRS);
ii. where the NHHDC is unable to gain access to the property to read the meter;
iii. where the supplier has received, from its NHHDC, at least two consecutive D0004s, each with a site visit check code 02, at least 3 months but not longer than 7 months apart; and
iv. where proactive attempts have been made to identify the owner and obtain a reading.

In relation to the third criterion, a D0004 is a data flow that is sent from the NHHDC to the supplier over the Data Transfer Network. The flow is sent by the NHHDC to identify sites where it was unable to obtain a reading. To assist the supplier, the NHHDC adds a site visit check code to the flow which is used to identify why a meter reading was not obtained. A site visit check code 02 means that a site is not occupied.

It is intended that all elements of the process are subject to the BSC Audit and use of the process by suppliers will be optional. However, if a supplier does opt to use the process then associated party agents must follow those parts of the process relevant to them.

P196 would also require that a site's LTV status is not passed on to the new supplier when a change of supplier process is carried out.

Finally, if requested, P196 would oblige suppliers to provide a mutually agreed report to distribution network operators (DNOs). The proposed modification specifies the minimum content that a supplier should send in such a report.

The Panel considered the Initial Written Assessment at its meeting of 8 December 2005 and agreed to submit Modification Proposal P196 to the Assessment Procedure. The Group met 3 times during the Assessment Procedure and an Assessment Consultation was issued to industry on 7 February 2006. The Assessment Report was considered by the Panel at its meeting on 9 March 2006. The Group, in its Assessment Report, recommended that the Panel agree that the Proposed Modification should be made[7] and that it should be sent to the Report Phase.

A draft Modification Report was issued for industry consultation on 17 March 2006. It contained the Panel's recommendation that P196 should not be made and invited respondents' views by 3 April 2006.

Respondents' views

Eleven responses were received to the consultation. Five responses (representing 40 Parties and 4 non-Parties) expressed support for the Proposed Modification, five responses (representing 12 Parties) opposed the Proposed Modification and the remaining respondent (representing one non-Party) provided a "neutral" response.

The arguments of those respondents who did not support P196 centred on two broad areas – that the proposed modification i) is not robust enough and ii) could erode incentives to visit a LTV site.

[7] The Group's reasons for reaching this view are set out in detail in section 4 of its Assessment Report, also published on the Elexon website.

It was considered by several respondents that the basis for P196 and the proposed process were not robust enough. They argued that P196 is based on unsubstantiated data, the criteria for determining a LTV site are fallible, using a zero EAC is not necessarily a true reflection of consumption at a LTV site and there are already processes that a supplier can use to ensure accuracy in settlement.

Two respondents said that data on the overstatement of settlement (which was considered as part of Issue 14) did not prove that LTV sites were a distinct contributing factor or provide any detail as to the magnitude of their contribution. Nonetheless, the Issue 14 report concluded that data on the overstatement of settlement combined with data from other sources were enough to prove that LTV sites are a significant issue.

Should a supplier wish to allocate LTV status to a site, P196 proposes that it must satisfy several criteria first. One of these criteria is that the supplier must have received at least two consecutive notifications (D0004s – "Notification of failure to obtain reading" – with site visit check code 02 – "site not occupied") from its non-half hourly data collector (NHHDC). One respondent pointed out that in their experience a D0004, with a code 02 indicator, can be sent in error. For example, unmanned sites may appear to be LTV. This issue was discussed by the Group and it was noted that the Issue Resolution Expert Group (IREG) (a Master Registration Agreement panel) are revising the guidance on the use of status indicators on the D0004.

Some respondents expressed concerns around the use of a zero estimate as opposed to an actual reading. Their concerns were that submitting a zero estimate into settlement is not a guaranteed reflection of consumption at a LTV site and the only way of accurately recording consumption at any site is to obtain an actual meter reading. It was also pointed out that the only way to guarantee zero consumption at a site is to de-energise or disconnect its energy supply. Although concerns were raised, no evidence was provided that could be used to gauge the relative inaccuracy of using a zero EAC as opposed to a positive EAC. Furthermore, it was considered by members of the Group that although a zero EAC may not be a guaranteed reflection of consumption at a LTV site, it was likely to be more reflective than a positive EAC.

One respondent said that the current process available to suppliers (using warrants to gain access to the LTV site to obtain a reading) is the only way to guarantee accuracy in settlement, is achievable and although costly would ultimately be worthwhile. Although the use of warrants to gain access to a site is a process outside the scope of the BSC, for completeness the Issue 14 group considered the costs and benefits of their use[8].

Several respondents said that P196 could have the effect of eroding existing incentives to regularly visit a LTV site. Their concerns were that if P196 was approved, suppliers would not have so many incentives:

- to obtain meter readings, which could effect the overall accuracy of settlement,
- to de-energise or disconnect a site even if they knew a site would become vacant.

[8] Using data supplied by 8 suppliers (who were also Issue 14 Group members), it was estimated that the annual cost of LTV sites to suppliers (including average energy, agent, DUoS and TUoS costs), after GCF was applied, was about £22.4M. The Group also estimated that it would cost about £11.8M to obtain and use warrants to gain access to LTV sites. Based on this estimate, the Issue 14 Group predicted that for a NHH market of 28M meters (where 1% are LTV), it would cost suppliers about £28M to obtain a warrant and access all LTV sites. The costs of de-energising/disconnecting and re-energising/re-connecting a LTV site were not considered in this analysis.

One respondent said that the costs of LTV sites to suppliers provided an incentive to gain access to these sites and obtain an accurate meter reading. They argued that under P196 those costs would be mitigated. Furthermore, respondents also said that fewer site visits would increase the risk of theft and health and safety issues.

Some Group members and respondents provided an alternative view. They said that incentives to visit a LTV site would be artificially maintained. This would be achieved because the Proposed Modification would require suppliers to organise regular visits to LTV sites by their NHHDC in order to re-confirm their status. Another view was that suppliers would continue to have incentives to obtain meter readings for billing purposes and to meet the obligations of their supply licence.

The views of respondents who supported Modification Proposal P196 can be considered as five broad arguments – i) the accuracy and equitability of settlement would be improved, ii) the proposed process would be pragmatic and cost effective, iii) the basis for the modification and the proposed process are robust, iv) barriers to entry would be reduced and v) customer benefits.

Some respondents commented that accuracy and equitability of settlement would be improved primarily by the submission of a more reflective estimate of consumption at a LTV site – ie a zero EAC. By more accurately reflecting consumption at LTV sites, respondents said that the overstatement of settlement would be reduced. As a consequence suppliers with LTV sites would not need to pay for energy not being consumed and the amount of energy smeared across suppliers as a result of Group Correction Factor (GCF) would be reduced. Some respondents also said that improving the accuracy of settlement would go some way to improving data quality issues. In particular, validation of new meter readings would be made more likely because a meter's consumption history would be more accurate. This principle was argued as part of Modification Proposal P176 "Clarification of the Requirements for Estimation/Deeming of Meter Readings/Advances in Certain Circumstances to Facilitate Correction of Anomalies in Settlement Consumption" which Ofgem approved on 10 May 2005. It was also considered by one respondent that P196 could help reduce the number of aged EACs in settlement.

A view held by several respondents was that P196 would be a pragmatic and cost effective solution. The use of existing processes to obtain meter readings at LTV sites (ie warrants to gain access) is considered to be very costly[9] and require a considerable amount of time and effort, with no guarantee that a warrant will be granted by a court. A couple of Group members pointed out that warrants are very rarely granted for obtaining a meter reading only. In relation to using warrants, respondents also drew attention to the inconvenience that can be suffered by customers (for example when locks are replaced) and the likely negative effect of their use on the industry's credibility. A couple of respondents said that de-energising/disconnecting and re-energising/re-connecting LTV sites would be costly and time consuming for suppliers and consumers. Compared to the cost to industry and consumers of the problem caused by LTV sites and the cost of using existing processes, P196 is considered by some respondents to be much more cost effective and pragmatic.

Contrary to the views of other respondents, it was considered by some that the Proposed Modification is based on robust supporting evidence and would provide a robust alternative to a costly problem. Several respondents supported the work of the Issue 14 group. In particular they highlighted its unanimous conclusion that approximately 1% of

[9] See above for Issue Group 14's analysis of costs.

the NHH market is made up of LTV sites and the large number of these in the NHH market lead to an over accounting of energy in settlement. With regard to the proposed process, several respondents said that the Group had spent considerable time and effort developing the proposed process and as a result they thought it was transparent and robust. Respondents also said that the proposed process was developed so that it could be fully audited.

Some respondents commented that the potential improvements that could be derived from P196 would be of particular benefit to small suppliers and customers, small suppliers being more sensitive to settlement inaccuracies and data quality issues. In addition, some respondents have expressed the view that small and new suppliers would also benefit because the proposed process is thought to be transparent and robust. It was also considered by some respondents that P196 could ultimately have benefits for customers. For example suppliers and therefore customers would not have to pay for erroneous energy consumption, improved data quality would speed up the change of supplier processes and improved accuracy of a customer's consumption history could improve the accuracy of that customer's bill.

Although one respondent marked its consultation response neutral, its comments were in support of the Proposed Modification. It held the view that P196 would better reflect consumption at LTV sites in settlement. its decision to remain neutral was due to it being a party agent such that the Modification would have little or no effect on it.

The respondents' views are summarised in the Modification Report for Modification Proposal P196, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 13 April 2006 and considered Modification Proposal P196, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel disagreed with the Group, reaching a recommendation that the Authority should reject the Proposed Modification.

Applicable BSC Objectives – the Panel's justification

The majority of the Panel did not consider that the Modification Proposal would better facilitate the achievement of Applicable BSC Objective (c). Their view was that the Modification would create inconsistencies between suppliers. For example suppliers who have made a decision to read their meters on an annual cycle would be excluded from participating in the process. Some Panel members also pointed out that suppliers who incorrectly identify a LTV site would cause other suppliers in the Grid Supply Point (GSP) group to pay for the cost of energy consumed at the LTV site.

It was also considered that Applicable BSC Objective (d) would not be better facilitated by P196. This was because some Panel members held the view that the implementation and auditability of the proposed process would not be robust enough. In addition it was also argued that by reducing incentives on suppliers to obtain meter readings, the accuracy of settlement would be harmed which could lead to a decrease in the efficient implementation and administration of the BSC arrangements.

On the other hand, a minority of the Panel considered that the Modification Proposal would better facilitate the achievement of Applicable BSC Objectives (c) and (d). A couple

of Panel members held the view that P196 would provide a pragmatic solution to dealing with LTV sites. They said that the process for estimating a LTV sites consumption would be more efficient and better reflect the consumption at such a site. A Panel member also said that the proposed process would not be problematic to audit.

Ofgem's view

Having considered the Modification Report and the Panel's recommendation, Ofgem considers that Proposed Modification P196 will better facilitate achievement of Applicable BSC Objectives (c) and (d) and that the making of the direction to modify is consistent with Ofgem's statutory duties.

BSC Objective (c)

Ofgem considers that P196 will better facilitate Applicable BSC Objective (c) by i) improving the accuracy and equitability of settlement, ii) providing a robust, cost effective and pragmatic process for managing LTV sites and iii) creating new incentives to visit LTV sites. The effect of these will be to better target settlement charges and remove unnecessary costs to parties. Ofgem considers that by achieving these, barriers to entry and growth (for example uncertainty) would be reduced and competition better facilitated. The remainder of this section considers these effects in more detail.

Improving accuracy and equitability

P196 is intended to increase the accuracy and equitability of settlement in relation to LTV sites. Ofgem considers that the Modification Proposal will achieve this by ensuring that more reflective estimates of consumption at LTV sites are entered into settlement. As a consequence of more reflective consumption data (a zero EAC as opposed to a positive EAC) being entered into settlement, suppliers will be billed more accurately for their consumption. This would happen in two ways. First, suppliers with LTV sites would be billed to reflect a level of consumption more likely to be zero. Second, all suppliers would be billed more accurately as a result of more accurate application of the GCF mechanism.

In relation to billing based on a more reflective level of consumption, Ofgem share the view put forward by some respondents that a zero EAC is likely to be more accurate than if the positive EAC was maintained. LTV sites are likely to consume little or no energy.

Ofgem considers that capturing the consumption at LTV sites in settlement more accurately would benefit all suppliers because the GCF mechanism would operate more accurately and equitably. This is because at present suppliers with no or a low proportion of LTV sites in a GSP group benefit from having the amount of energy they consumed reduced by the GCF mechanism. The Issue 14 report suggests that this happens in eleven of twelve GSP groups in England and Wales where settlement was overstated for the period 8 December 2004 to 7 December 2005. Improved consumption accuracy would provide greater assurance and certainty to industry participants that settlement costs are attributed more equitably.

A robust, cost effective and pragmatic process

The second area where Ofgem considers P196 will better facilitate Applicable BSC Objective (c) is by providing a robust, cost effective and pragmatic process for managing LTV sites. Ofgem notes the view of some respondents that considerable time has been spent during Issue 14 and the modification process to develop a robust process for

managing LTV sites. As a consequence the proposed process for applying a zero EAC to LTV sites will be detailed and transparent.

The Group has proposed a process which will require four criteria to be met in order for a site to be deemed LTV (see above). These criteria must then be renewed at regular intervals (within 7 months of the last D0004, code 02) to provide assurance that settlement accuracy is maintained. Upon any of the criteria not being met, the site being transferred because of a change of supplier or the supplier identifying the customer, the site ceases to be LTV and the supplier must instruct his NHHDC to submit a positive EAC into settlement.

However, it is considered by some respondents and Panel members that the process, and in particular the criteria for determining a LTV site, are not robust or transparent enough. They have expressed the view that sites may be incorrectly granted the status of LTV. If this were to happen then accuracy and equitability in settlement could be undermined.

Ofgem shares those Panel members' and respondents' concerns that the proposed process could lead to some sites being incorrectly identified as LTV. However, it also notes that the Group has considered ways of mitigating the potential for sites to be incorrectly identified as LTV. Ofgem considers that P196 will provide a robust process by using preventative and remedial measures for ensuring sites are correctly identified as LTV. For example, Ofgem notes the work of the IREG to provide more detailed and clear guidance on the correct use of the flow and the site visit check codes. This work should go some way to ensuring NHHDCs use the correct site visit check code for LTV sites (ie a code 02). Furthermore, the proposed process has been developed to provide assurance by ensuring the process is fully auditable and places an obligation on suppliers to send a regular report to DNOs, if they request one. The report, as a minimum, would provide DNOs with a breakdown of Metering System Identifiers (MSIDs) and the dates that they became LTV. This report could be more detailed should the DNO and supplier agree. In the event that under P196 some sites are erroneously classified as LTV, the negative effect those sites could have on settlement is likely to be considerably smaller than the effect all LTV sites have on settlement at present.

We note the concern raised by one Panel member in relation to what constitutes a proactive attempt to identify the owner and obtain a reading at a LTV site. The Group provided a non-exhaustive list of methods; the Modification Report included two examples – i) if possible, check to see whether there are problems obtaining a gas meter reading and ii) attempts have been made to contact such bodies as estate agents, letting agents, councils, land registry etc to find out who the owner is. Ofgem considers that it might be useful to develop guidance for suppliers in this area. Guidance may also be useful for an auditor when determining whether a supplier has complied with the proposed process.

Ofgem considers that P196 is a pragmatic and cost effective solution. The only way of gaining access to a LTV site is to obtain a warrant from a court. As discussed, although the costs of using this process are less than the cost of LTV sites in settlement, they are still relatively high. These costs may be doubled because the supplier would need to regain access to the site to obtain a second reading which would then make the EAC equal zero.

Ofgem notes the views of some Panel members that the proposed process may not be used and exclude some suppliers from using it. Although the proposed process would be optional, Ofgem considers that the number of respondents in support of the Modification Proposal indicates that the process is likely to be used by the industry. Furthermore,

Ofgem considers that all suppliers, including those who have annual read cycles, would have the option to use the process if they wanted to. We hold the view that if a supplier with an annual read cycle wanted to use the proposed process then they could do so by increasing their read cycle.

New incentives

A concern held by several respondents, Group members and Panel members was that P196 would erode incentives to visit a site to obtain a meter reading. It was considered by one respondent that the costs of LTV sites in settlement provided a natural incentive on suppliers to gain access and obtain meter readings. P196 would remove these costs and would therefore remove an incentive to obtain a meter reading. Overall, as a consequence of this perceived reduction in incentives, it was considered that less actual meter readings would be entered into settlement, resulting in a decrease in settlement accuracy and equitability and the potential for onsite risks (eg theft and health and safety issues) would increase.

Ofgem notes these concerns but considers that P196 introduces an obligation to regularly visit LTV sites. The proposed process requires that the supplier must renew the four criteria of a LTV site within seven months of the last D0004, code 02. Revisiting a site once every 7 months could in some cases increase the frequency that LTV sites are visited at present.

Ofgem shares the view of some respondents that improving accuracy and equitability in settlement and providing an optional, cost effective, robust alternative to an existing process could ease barriers to entry. This is because it is considered that small suppliers and new entrants are generally more sensitive to high and unnecessary costs, poor data quality and opaque and inflexible business practices.

Barriers to growth would also be eased because greater certainty of sites' consumption and the costs associated could lead to more effective and efficient portfolio management, improvements in the fluidity of the customer transfer process and possibly product innovation.

<u>BSC Objective (d)</u>

In relation to Applicable BSC Objective (d), Ofgem considers that by improving certain aspects of data quality P196 may result in the BSC's central costs being spent more effectively and efficiently. For example an improvement in consumption accuracy over time could have the effect of increasing the percentage of energy settled on an actual meter reading – therefore focusing the work of the Performance Assurance Board who monitors supplier's performance in accordance with BSC Supplier Volume Allocation Serial SP08a.

<u>BSC Audit</u>

In recognition of the potential risks associated with the proposed process, we consider that the BSC Audit would be an effective way of monitoring suppliers' use of the process and providing assurance to BSC Parties, non-Parties and interested parties. The BSC Audit would also be able to provide recommendations on developing the proposed process. As part of the modification process, the BSC Auditor provided a confidential report to the Group explaining the likely costs and implications of adding the proposed process to the BSC Audit scope. In order for the BSC Auditor to comprehensively audit the proposed process, the annual cost of extending the BSC Audit scope could be

substantial. However, Ofgem considers that these costs would be less than the estimated current annual cost of LTV sites or the cost of using existing processes to gain access to LTV sites.

Direction under Condition C3 (5) (a) of NGET's Transmission Licence

Having regard to the above, the Authority, in accordance with Condition C3 (5) (a) of the licence to transmit electricity granted to NGET under Section 6 of the Electricity Act 1989 (the "Transmission Licence"), hereby directs NGET to modify the BSC.

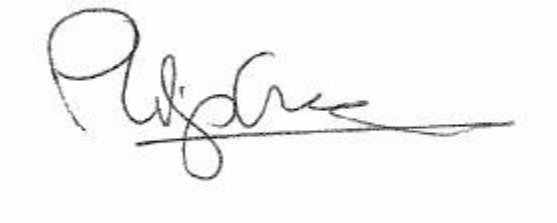
This modification shall be in accordance with the Proposed Modification P196 as set out in the final Modification Report.

The implementation date for the Proposed Modification P196 is 22 February 2007.

In accordance with Condition C3 (5) (c) of NGET's Transmission Licence, NGET shall modify the BSC in accordance with this direction of the Authority.

If you have any questions, please contact either myself on the above number or Nicholas Rubin on 020 7901 7176.

Yours sincerely,



Philip Davies
Director, Consumer Markets
Signed on behalf of the Authority and authorised for that purpose by the Authority