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6 October 2008

Dear Colleague,

**Balancing and Settlement Code (BSC) modification proposals on zonal transmission losses – review of Oxera’s analysis**

On 17 July 2008, Ofgem published a letter<sup>1</sup> (“the July 2008 letter”) which related to modification proposals on zonal transmission losses. Our July 2008 letter set out the judgment of the High Court in relation to a legal challenge raised by a number of industry parties (the “Claimants”). This legal challenge related to the Authority’s power to make a decision on certain BSC modification proposals after the latest date for a decision set out in the Final Modification Reports (FMRs) for each of the proposals (that date being 20 September 2007). The proposals to which the challenge related are P198, the P198 Alternative, P200, the P200 Alternative, P203 and P204 (the “losses proposals”). These proposals sought to alter the rules under which transmission losses are allocated to users of the electricity transmission system such that losses are allocated on a locational basis.

We set out in the July 2008 letter that the judgment was in favour of the Claimants and we also set out the reasons why we decided not pursue the appeal route that was permitted when the judgment was handed down. We also noted that whilst the Authority was no longer in a position to reach a decision on the losses proposals, we nevertheless intend to publish the additional analysis we commissioned on the losses proposals. We consider that this information might assist industry should it decide to bring forward further transmission losses proposals.

The additional analysis we referred to in the July 2008 letter is the review of Oxera’s analysis on the introduction of zonal losses, undertaken by the Brattle Group (“Brattle”), in accordance with terms of reference established by Ofgem (set out in appendix 1).

In an open letter published on 14 September 2007<sup>2</sup> (“the September 2007 letter”) we set out that the Authority considered a review of Oxera’s analysis was appropriate in light of the many criticisms raised concerning this analysis, and Oxera’s own comment that it considered that the Authority had placed more weight than appropriate on Oxera’s analysis in arriving at its minded-to decisions.

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<sup>1</sup><http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCCode/BSC/Documents1/Losses%20open%20letter%20%20-%20final-%2017%20July.pdf>

<sup>2</sup>[http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCCode/Ias/Documents1/070914\\_Zonal\\_Losses\\_Delay\\_Decision\\_Letter.pdf](http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCCode/Ias/Documents1/070914_Zonal_Losses_Delay_Decision_Letter.pdf)

We have now published on our website the report setting out Brattle's review of Oxera's analysis<sup>3</sup>. For the avoidance of doubt, the review was entirely undertaken by Brattle and as such the opinions expressed in the report are those of Brattle and not Ofgem.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Stuart Cook', written over a horizontal line.

**Stuart Cook**  
**Director, Transmission**

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<sup>3</sup>[http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCCode/Ias/Documents1/20081002\\_Brattle\\_losses\\_report.pdf](http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCCode/Ias/Documents1/20081002_Brattle_losses_report.pdf)

## Appendix 1: Terms of reference for the review of Oxera's analysis<sup>4</sup>

### 1. Background

- 1.1. Four BSC modification proposals (P198 and its alternative, P200 and its alternative, P203 and P204) to introduce locational allocation of variable transmission losses have been submitted to the Authority. Prior to the submission, as part of the assessment procedure for these proposals, Oxera had been commissioned by Elexon to undertake a cost benefit analysis. The Oxera analysis was set out in the two Oxera reports and submitted to the Authority as part of the Final Modification Reports (FMRs) on the proposals. The Authority took the Oxera analysis into account in reaching its minded-to decisions to approve P203 and reject the other proposals. The reasons for those minded to decisions were set out in Ofgem's consultation document of June 2007 (the 'minded-to consultation'), which followed on from Ofgem's impact assessment (the 'impact assessment') of February 2007.
- 1.2. The Oxera analysis was criticised by a number of respondents to both Elexon's consultations and Ofgem's consultations, in the latter case parties also criticised Ofgem's use of Oxera's analysis in its assessment of the efficiency benefits and associated impact on emissions. In particular, Oxera submitted a response to the minded-to consultation stating its view that Ofgem had "*placed more weight than appropriate*" on Oxera's analysis in reaching those minded-to decisions.
- 1.3. In the light of all the information available to it, including all the responses to the minded-to consultation, the Authority announced on 14 September 2007 that it would be appropriate for Ofgem to undertake a further review of Oxera's analysis, and the reliance placed upon it, before the Authority makes its final decisions with respect to the proposals.
- 1.4. The purpose of this document is to set out the ToR for the Review. A key requirement for this work is that it is carried out by an impartial and independent person and tenderers will need to satisfy Ofgem that no actual or perceived conflict of interest exists.

### 2. Objective of the review

- 2.1. The key objective of the Review is to critique the Oxera analysis, and potentially also to comment on Ofgem's reliance on that analysis. We do not, however, anticipate a full-scale repetition of Oxera's work.

### 3. Scope of Review

The Oxera analysis

- 3.1. At a high level, the key questions to be considered in the Review of the Oxera analysis include the following:
  - Were the terms of reference for the Oxera analysis appropriate?
  - Did the Oxera analysis fulfil its terms of reference?
  - Was Oxera's modelling methodology appropriate for the given terms of reference?
  - Are the input assumptions underpinning Oxera's market scenarios credible?
  - Are the conclusions of the Oxera analysis reasonable, taking into account any limitations in the analysis as identified in the Review?
- 3.2. The tasks to be undertaken in order to address the above questions are set out below.

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<sup>4</sup> This information is an extract from the invitation to tender issued by Ofgem in October 2007.

### *Terms of reference for the Oxera analysis*

- Summarise the context in which Oxera was commissioned
- Summarise the terms of reference for the Oxera analysis and the process by which they were agreed
- Comment on the appropriateness of the agreed terms of reference for the purposes of the industry assessment of the proposals against the applicable BSC objectives
- Comment on the extent to which the Oxera analysis ultimately fulfilled its terms of reference

### *Modelling methodology*

- Describe Oxera's modelling methodology and the factors taken into account
- Comment on its appropriateness in the context of its terms of reference and in relation to other approaches commonly used within the industry
- Comment on the extent to which the results using Oxera's modelling methodology may be sensitive to choice of input assumptions and the temporal resolution in modelling the year

### *Input assumptions*

- Summarise the input assumptions underpinning Oxera's market scenarios
- Comment on the validity of those assumptions based on the information available at the time the analysis was undertaken
- Comment on the validity of those assumptions based on the information available now

### *Results*

- Summarise the key results from the Oxera analysis
- Comment on variation in the modelled benefits associated with generation redespach both from year to year and between modelled scenarios
- Provide an independent view on the conclusions which may be drawn from those results, particularly in terms of efficiency benefits associated with generation redespach, relative to the total implementation and operating costs, and how these may differ between proposals

### *Overall*

- Identify any limitations arising due to the choice of input assumptions, modelling methodology or presentation of the analysis, taking into account issues raised by respondents and the views set out in Ofgem's impact assessment and minded-to consultation
- Comment on the extent to which the treatment of fixed losses affect the results and the conclusions to be drawn from those results

### Ofgem's analysis

3.3. The successful tenderer may also be asked to provide support as required to Ofgem in considering its use of the Oxera analysis, taking into account the issues raised by respondents. In this context, the specific tasks may include:

- Efficiency benefits
- Emission savings

## **4. Resources**

4.1. Ofgem will provide (where appropriate, links to) the following key documents to be taken into account in the Review:

- Oxera's July 2006 report (covering P198 and P203)
- Oxera's September 2006 report (covering P204)
- Elexon's March 2006 P198 Cost Benefit Analysis Requirements Specification

- Elexon's September 2006 FMRs for P198, P200, P203
- Elexon's November 2006 FMR for 204
- Ofgem's February 2007 impact assessment and June 2007 minded-to consultation
- Non-confidential responses to Ofgem's impact assessment and minded-to consultation
- Other papers as appropriate.

4.2. Further information with respect to the proposals and Oxera's analysis is available on Elexon's website. In addition, in order to assist with the Review Ofgem may request further information from Elexon with respect to the Oxera analysis. It is likely that any such request, and associated response from Elexon, will be made publicly available by Ofgem and/or Elexon.

4.3. The successful tenderer will be expected also to use whatever sources they think are appropriate provided that they are clearly stated and wherever possible publicly available. Tenderers should set out in their proposal what information sources they consider appropriate.