Modification proposal:	**Balancing and Settlement Code (BSC) P235: Aligning BSC requirements with the calculation of interest performed by the Funds Administration Agent**		
Decision:	The Authority[1] directs that the alternative proposal be made[2]		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	30 June 2009	Implementation Date:	27 March 2001 (NETA Go Live date)

Background to the modification proposal

The Trading Charges payable by BSC Parties for each half-hourly period in which electricity is traded and settled are calculated over a period of 14 months. During this 14-month period, Trading Charges are subject to occasional Reconciliation Runs[3] which may cause adjustments to be made to Parties' Charges as more actual Settlement data replaces estimated data in the calculation of Charges. The adjustments reflect the Trading Charges that each Party ought to have paid at the Initial Settlement Run.

Interest is calculated on the adjustments made at each Reconciliation Run. Interest may be payable by (or due to) each BSC Party based on the amount the Party has previously submitted in Trading Charges and the effect the adjustment has on those Charges.

Elexon has identified a misalignment between how interest would be calculated on adjustments to Charges in accordance with the text in the BSC and how it is actually calculated by the Funds Administration Agent (FAA) systems. The FAA is the central system agent responsible for managing Parties' financial liabilities under the BSC. The FAA systems have used the same method to calculate interest since NETA Go Live. This methodology was in use prior to NETA under the Electricity Pool arrangements. The BSC text (Section N6.4.2 (b)) has remained unchanged since it was drafted for NETA Go Live.

There are four ways in which the calculation differs between the FAA systems methodology and the BSC text requirements:

- the systems calculate interest back to the payment date of the Initial Settlement Run. The BSC text would calculate interest back to the payment date of the previous Settlement Run only

- the systems calculate interest on a daily basis using the applicable Base Rate for that day. The BSC text implies the calculation of interest using a single Base Rate for the calculation period and only as far back as the last payment date, ignoring possible significant movements in interest rates over a calculation period

- the systems calculate interest on a compound basis, accumulated over the calculation period. The BSC text implies the calculation of interest on a simple interest basis only

- the systems calculate interest excluding the payment date of the current Reconciliation Run, meaning that Parties do not pay/receive interest for the day itself, in keeping with normal commercial practice. The BSC text would include the

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[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] There are five timetabled Reconciliation Runs altogether: Initial Settlement (SF), First Reconciliation (R1), Second Reconciliation (R2), Third Reconciliation (R3) and Final Reconciliation (RF).

payment date of the relevant Reconciliation Run which is not in keeping with normal commercial practice

If a BSC Party considers that its Trading Charges may not have been calculated correctly, it can raise a Trading Query or Dispute. A Query must be raised within a specified timeframe (in this case, Settlement Run data which was processed no more than 20 Working Days before the date that the Trading Query or Dispute was raised) and the criteria for a valid Query must be met. If a Trading Query is not resolved, e.g. where the Party disagrees with Elexon that all the relevant criteria are met, the Party may raise a Trading Dispute. Since the matter was brought to the attention of BSC Parties through the raising of the Proposal, no Party has raised a Query or Dispute regarding the calculation of interest relating to the reconciliation of Trading Charges.

P235 Modification Proposal

At the request of Elexon, the BSC Panel raised Modification Proposal P235 (the Proposal) on 9 April 2009. The Proposal seeks to align the text in the BSC with the FAA systems methodology for calculating interest on adjustments to Trading Charges as a result of a Reconciliation Run. The Proposal intends to remove the identified inconsistency between the BSC text and the FAA systems methodology and would reaffirm the status quo as the appropriate way to calculate interest.

The Proposal was discussed by a Modification Group which developed an Alternative Proposal. The only difference between the Proposal and the Alternative Proposal is the implementation approach. The Proposal would be implemented on a prospective Calendar Day basis while the Alternative Proposal would be implemented retrospectively with effect from 27 March 2001 (the NETA Go Live date).

BSC Panel recommendation

The BSC Panel unanimously recommended implementation of the Alternative Proposal at its meeting on 11 June 2009.

The Authority's decision

The Authority has considered the issues raised by the Proposal and the Alternative Proposal and in the Final Modification Report (FMR) dated 11 June 2009. The Authority has considered and taken into account the responses to Elexon's consultation which are attached to the FMR[4]. The Authority has concluded that:

1.   implementation of the Alternative Proposal will better facilitate the achievement of the relevant objectives of the BSC[5]; and
2.   directing that the Alternative Proposal be made is consistent with the Authority's principal objective and statutory duties[6].

Reasons for the Authority's decision

We note that the Modification Group set out reasons under both BSC Applicable Objective (c) – promoting effective competition in the generation and supply of electricity, and

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[4] BSC modification proposals, modification reports and representations can be viewed on the Elexon website at www.elexon.com
[5] As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=4151
[6]The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989.

Applicable Objective (d) – promoting efficiency in the implementation and administration of the balancing and settlement arrangements in support of both the Proposal and the Alternative Proposal. The BSC Panel relied only on Applicable Objective (d) in support of its recommendation. We agree with the Panel that the Alternative Proposal better meets Applicable Objective (d).

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

We note that both the Proposal and the Alternative Proposal would reaffirm the method for calculating interest currently used, namely, the FAA systems approach. The FMR highlights that there is a cost attached to reverting to a calculation based on the BSC text, which would result if both the Proposal and the Alternative Proposal are rejected. This cost (to central systems and to Parties) is significant. We also note that Parties would continue to be able, if they so wished, to raise Trading Queries and Disputes regarding past interest calculations.

We regard it as significant that no Party has raised a Query or Dispute to date, even after the Panel raised the Proposal. In view of the significant cost involved in changing the FAA systems to bring them in line with the BSC text, we note that Parties are generally comfortable that the existing method of calculation is the most appropriate one. We have no evidence to suggest that the calculation of interest in accordance with the BSC text would result in a fairer and more appropriate method of calculation.

We also note that Elexon's analysis of the materiality of the impact of changing the calculation suggested that there would be a very limited impact across the vast majority of BSC Parties in terms of redistribution of monies. Those who may become 'winners' in some Settlement Periods through a change to the method of calculation would become 'losers' in other Settlement Periods, with a neutral effect overall.

In our view, both the Proposal and the Alternative Proposal ensure that there is clarity and transparency about the method of calculation of interest for all BSC Parties. There would be a real risk of confusion for Parties if the calculation of interest according to the FAA systems reverted to the method set out in the BSC text, or indeed if the current differences in approach (between the FAA systems and BSC text) to calculating interest continued. Parties have not had reason to query the existing FAA systems approach before and it has been accepted as providing a fair and appropriate means of calculation since before NETA Go Live.

We also note the strong arguments in favour of maintaining the existing method of calculation based on the potential (avoidable) costs of making a change. There would be significant costs to central systems and Parties of re-doing all interest calculations going back to NETA Go Live. In addition, there would be uncertainty around whether Parties would wish to raise Trading Queries and Disputes regarding past Settlement Periods, the cost of which would be additional to the system changes. Furthermore, it is unclear how Parties who have left the BSC would be able to recover or pay any interest calculated by bringing FAA systems in line with the BSC text.

In our view, there appears to be minimal material impact on Parties arising from a change to the prescribed method within BSC text of calculating interest. We consider that bringing the BSC text in line with the status quo approach of calculating interest through the FAA systems would promote the efficient implementation of the balancing and settlement arrangements.

The Proposal v. the Alternative Proposal – retrospective implementation

We note that the only significant difference between the Proposal and the Alternative Proposal is the implementation approach. The Proposal would continue to allow room for Trading Queries and Disputes to be raised for a limited number of historic Reconciliation Runs where the calculation of interest in line with the BSC text could be applied. The Alternative Proposal would be implemented retrospectively going back to the NETA Go Live date which, as the Modification Group, consultation respondents and the Panel highlighted, would remove uncertainty for all Parties by effectively removing the right to raise Trading Queries and Disputes for all Settlement Periods going back to NETA Go Live. In doing so, it would also remove the need to unwind the calculation of interest for any historic Reconciliation Runs.

As already noted, we consider that the removal of the ability to raise Trading Queries and Disputes in the specific circumstances set out in these Proposals would provide more certainty, clarity and transparency to all BSC Parties. The costs of re-calculating interest would be significant and avoidable and outweigh the minimal cost of reaffirming the status quo of calculating interest in line with FAA systems.

We note the views of a number of consultation respondents, whilst supportive of this proposal, commented that it would be generally inappropriate to retrospectively make changes to the rules governing the trading arrangements. We agree that the retrospective implementation of rule changes creates uncertainty for market participants and damages market confidence and the efficient implementation of the trading arrangements. However, in the past, the Authority has agreed to make retrospective changes in very limited circumstances and in accordance with very specific criteria[7], namely:

- a situation where the fault or error occasioning the loss was directly attributable to central arrangements;
- combinations of circumstances that could not have been reasonably foreseen; or
- where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect.

In our view, the error which has occurred here is that there has been a defect in the BSC text which has not been picked up and has created potential uncertainty for BSC Parties. The circumstances of this modification are unusual in that there is a risk of loss (the avoidable costs of recalculating interest in line with the BSC text) *if a change is made to the central arrangements (the FAA systems) rather than if the status quo is reaffirmed*.

We also note and agree with the view of some respondents that, since the issue has been flagged with BSC Parties through the Proposal and the Alternative Proposal, with the possibility that a retrospective change may be made, no Party has chosen to raise a Trading Query or Dispute regarding the calculation of interest. This would suggest that BSC Parties are comfortable with the retrospective implementation approach of the Alternative Proposal going back to NETA Go Live.

For the above reasons, we are satisfied that implementation of the Alternative Proposal is appropriate and would further BSC Applicable Objective (d), in particular by removing the potential for confusion and conflicting practices.

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[7] Most recently the Authority's decision on BSC Modification Proposal P210 (dated 29 March 2007).

We are also satisfied that implementation of the Alternative Proposal is consistent with the Authority's principal objective and wider statutory duties.

Decision notice

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority, hereby directs that the Alternative Proposal to P235: *'Aligning BSC requirements with the calculation of interest performed by the Funds Administration Agent'* be made in accordance with the implementation approach set out in the FMR, namely, retrospective implementation on 27 March 2001 (the NETA Go Live date).

Mark Feather
Director, Industry Codes and Licensing
Signed on behalf of the Authority and authorised for that purpose.

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