

Modification proposal:	<b>Use of System Charging Methodology Modification Proposal GB ECM-27: "BSUoS – Removing End of Scheme Year Reconciliation Process"</b>		
Decision:	<b>The Authority has decided not to veto Modification Proposal GB ECM-27</b>		
Target audience:	<b>All transmission system users and all other relevant stakeholders</b>		
Date of publication:	26 January 2011	Implementation Date:	1 April 2010

## The Modification Proposal

On 29 December 2010, National Grid Electricity Transmission plc (NGET) submitted a Conclusions Report (the Report) on Modification Proposal GB ECM-27 to the Authority for a decision. A summary of the background to this Modification Proposal is included in annex 1 to this letter.

The Report recommended to the Authority that two broad changes are made to the reconciliation cycle of the Balancing System Use of System (BSUoS) Charging Methodology, as set out below:

- Removing the End of Year Reconciliation (EoS) period; and
- To spread the volatility in user reconciliations that would otherwise have been consolidated into the EoS over the Final Reconciliation run (referred to as Reconciliation Final or RF).

This proposal would change the BSUoS settlement timetable by moving from three billable stages per settlement day to two billable stages.

## NGET's recommendation

NGET is seeking to implement the proposed changes into the charging methodology statement immediately after a decision by the Authority, and for GB ECM-27 to be applicable for the BSUoS charging year beginning 1 April 2010. This would mean that no EoS reconciliation will take place in June 2011 for the Balancing Services Incentive Scheme, or BSIS scheme<sup>1</sup>, applicable from 1 April 2010 to 31 March 2011 inclusive, or for any subsequent years. Further detail on GB ECM-27 can be found on NGET's website.

In the Report to the Authority, NGET has explained that after consideration of responses, it considers that the proposed modifications to the Use of System Charging Methodology will better achieve relevant objectives as specified in Standard Licence Condition C5(5) (SLC C5(5)) of NGET's electricity transmission licence (the Licence).

## The Authority's decision

The Authority is required to assess any proposed modification to NGET's Use of System Charging Methodology and decide whether to issue a direction to veto such a change.

The Authority has considered the issues raised in GB ECM-27 and, in reaching a decision, the Authority has taken into account the views put forward by industry and assessed the modification against the relevant objectives in SLC C5(5) of the Licence. The Authority has concluded that implementation of GB ECM-27:

- would better achieve the relevant objectives of the Licence; and
- is consistent with the Authority's principal objectives and wider statutory duties.

The Authority has therefore decided **not to veto** the proposed modification.

<sup>1</sup> The current approach allows NGET to keep a proportion of any savings it can make against an annual target level of costs.

## Reasons for the Authority's decision

The Authority recognises that the changes proposed through GB ECM-27 seek to remove an element of the BSUoS settlement process that NGET considers is providing no additional value to users. We note that this view is based on analysis performed by NGET which indicates that while the EoS process does remove some (but not all) volatility out of the subsequent daily RF reconciliation, as envisaged at the time of NETA, in practice it has predominantly caused large one-off annual payment spikes for customers due to the consolidated nature of the reconciliation to the detriment of users' cashflow.

We note the views of respondents to the August 2010 consultation unanimously supported NGET's proposal to remove the EoS process from the BSUoS settlement process. Two main arguments made by respondents in support of this position are set out below.

1. The benefit conferred through an early EoS reconciliation (relative to the daily RF run) in a single transaction is small compared to the administrative burden (in both resource and information system costs) that it places on customers.
2. The process associated with validation and payment would be simpler as there would be just two daily runs for each financial year, and customers would no longer have to consider the inclusion of a consolidated run into their planning arrangements.

We consider that the proposal to remove the EoS reconciliation will eradicate a manually intensive process on existing customers (and NGET) and reduce the administrative burden associated with managing the EoS process (eg moderate internal system expense) for potential new customers. We acknowledge the views expressed by one respondent that the removal of EoS does not require significant change to the information systems or processes of existing customers.

We note that NGET's analysis of the annual differences in BSUoS charges data between the Initial Settlement run (referred to as Settlement Final or SF) and EoS, indicates that the impact of moving reconciliations into the RF run for all historic BSUoS charging years would continue to produce overall reconciliation values between the SF and RF runs that are quite small as percentages of the initially billed values. Excluding 2005/6<sup>2</sup> a range of -£7m (2002/3) to £10m (2004/5) is observed relative to a total BSUoS charge in these years of £377m (2002/3) and £391m (2004/5).

In addition, we note the view expressed by NGET that the potential volatility introduced into the RF run as a result of moving reconciliations into the RF run would remain small as a percentage of the SF run and daily fluctuations in the context of total BSUoS charges. Excluding 2005/6 the difference in percentage terms between the SF and RF reconciliation does not exceed -1.89% or 2.66%. Furthermore, NGET's analysis indicates that the maximum daily spike in the subsequent RF run has historically always been substantially lower than the total 'spike' to reconcile the EoS with the initial BSUoS charge provided by the SF run (always less than 35% of the total EoS).

We note that NGET are of the opinion that the removal of EoS confers an additional benefit on customers by smoothing the associated cashflows over a longer period which, in turn, should produce a process that should be more manageable for industry participants.

We note that NGET's intention is for the proposals to be incorporated into the charging methodology statement to take effect immediately, and for the charging changes to be applicable to the full charging year from 1 April 2010 to 31 March 2011. We acknowledge the views of respondents who supported the retrospective application of the proposal to the 2010/11 BSIS scheme year. For the reasons set out below, we consider that retrospective application to the 2010/11 BSIS scheme year, and for any subsequent years, is appropriate.

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<sup>2</sup> Where there was an additional Income Adjusting Event to cover costs associated with the introduction of BETTA.

- We note NGET's Report contains a clarification that the modification proposal would constitute a revision to the reconciliation cycle, and does not change the method of calculation of BSUoS charges and allocation across customers.
- We acknowledge the explanation that the proposal does not change the regulatory approach to the BSUoS charge setting or cost recovery process with regard to such items as Income Adjusting Events and changes to the BSIS scheme, all of which will be required to follow the same process as they do now.
- We acknowledge the views expressed by NGET that keeping the basis of invoicing of BSUoS charges on an iterative daily basis improves the transparency of the methodology and has the additional benefit of smoothing the cashflows of parties over a longer period.

Against this background, NGET is of the opinion that the removal of EoS from the BSUoS reconciliation cycle is the simplest manner in which to settle BSUoS charges on the basis that EoS does not appear historically to have added much value to the process when considered against the administrative burden it imposes. As such, NGET proposes that changes to the BSUoS settlement and reconciliation process are therefore made applicable from the beginning of the BSIS scheme year just completed, 1 April 2010.

We are of the opinion that there are reasonable grounds that warrant the retrospective application of the proposed changes to the settlement of BSUoS charges to the charging year from 1 April 2010. We also agree with the view that the removal of the EoS process will improve the general transparency of the BSUoS settlement arrangements overall. We acknowledge that this change may alter the manner in which parties were expecting to manage their cash flows. However, we are of the opinion that this impact is not material to parties.

In the next section we set out the key issues that informed the Authority's decision and the Authority's assessment of GB ECM-27 against the relevant objectives as specified in SLC C5(5) of the Licence and its wider statutory duties. These sections contain reference to respondents' views where appropriate.

**SLC C5(5)(a) – Facilitates effective competition in the generation and supply of electricity and facilitates competition in the sale, distribution and purchase of electricity**

We consider that the methodology change associated with GB ECM-27 better achieves SLC C5(5)(a).

We consider that the modification proposal is likely to have a broadly beneficial impact on competition by further refining the use of system charging arrangements and providing a simpler daily basis on which to settle BSUoS charges. We are of the opinion that these measures improve the simplicity of the process through fewer and more similar processes that are easier for everyone to understand. This, in turn, allows the methodology to calculate and invoice accurate charges, reduce complexity in the general settlement process and show more clearly the change to BSUoS charges over time. We note that this, in turn, will facilitate effective competition by enabling the arrangements to be more clearly understood, improving the functioning of the BSUoS arrangements and hence removing a potential barrier to entry.

Furthermore, we consider that the changes proposed through GB ECM-27 will ensure that calculation and settlement of BSUoS charges will provide more accurate and stable cost messages, and will improve a customer's ability to form their own view on future charges.

We are of the opinion that when taken together, we consider that the changes proposed through GB ECM-27 will promote more effective competition overall.

### **SLC C5(5)(b) – Costs reflectivity – charges which reflect, as far as reasonably practicable, the costs incurred**

The Modification Proposal is a refinement to the reconciliation cycle of the BSUoS Charging Methodology. With this in mind, we consider that GB ECM-27 is neutral towards the achievement of SLC C5(5)(b).

In the context of this modification proposal, the removal of EoS will reduce costs to industry participants by eliminating the need to pay for the additional reconciliation itself (which are passed through), lower long term costs by reducing the sophistication of systems required to manage reconciliation and improve the simplicity of the process through fewer and more similar processes that are easier for everyone to understand. We consider that these improvements to the process will show more clearly the change to BSUoS charges over time and should produce a process that should be more manageable for industry participants.

We note that one respondent raised the specific point that removing the EoS reconciliation period will introduce slightly more volatility to the daily RF run than would otherwise have been consolidated into the EoS. While this is true, we note the view expressed by NGET that this is countered by the removal of the large one off payment/credit spike caused by the EoS itself. The daily volatility of reconciliations, which is currently slightly masked by EoS, is therefore spread over the subsequent daily RF run. This also has the benefit of smoothing cash flows over a longer period (ie 12 months of daily RF run).

### **SLC C5(5)(c) – Properly taking account of developments in the transmission system**

We consider that the methodology change associated with GB ECM-27 is neutral towards the achievement of SLC C5(5)(c).

### **Assessment against the Authority's statutory objectives and duties**

As well as evaluating how the modification would facilitate the relevant objectives, the Authority must consider whether the implementation of GB ECM-27 is consistent with its principal objective and statutory duties.

We note that the process adopted by NGET is aimed at providing more transparency in the BSUoS methodology and settlement process. We are of the view that GB ECM-27:

- Is likely to support more effective competition than otherwise would be the case and
- Will not have a material impact on sustainable development.

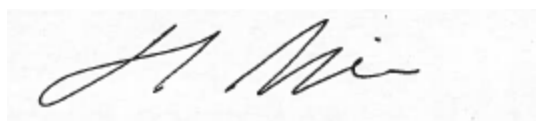
We consider that GB ECM-27 better achieves the relevant objectives, and is consistent with the Authority's statutory duties.

### **Decision notice**

### **In accordance with, the Authority has therefore decided not to veto Modification Proposal GB ECM-27.**

We expect NGET to implement the modification proposal in the manner proposed; hence the modification will take effect on 26 January 2011 and be applicable from the charging year beginning 1 April 2010 as requested by NGET.

**Hannah Nixon**



Partner, Transmission

**Signed on behalf of the Authority and authorised for that purpose**

## Annex 1

### Background to the Modification Proposal

National Grid Electricity Transmission plc (NGET) is the system operator (SO) for the National Electricity Transmission System (NETS)<sup>3</sup>. In this role NGET is responsible for making sure that electricity supply and demand stay in balance in real time and ensuring the stable and secure operation of the NETS. In doing so, NGET will procure and utilise a range of energy and system balancing services and incur a range of costs.

The costs that NGET is allowed to recover is subject to an incentive scheme (the Balancing Services Incentive Scheme, or BSIS scheme<sup>4</sup>) to encourage NGET to undertake its actions in such a way that its total costs are at an efficient level. This is to the benefit of existing and future consumers who ultimately pay for balancing costs.

Under the terms of its electricity transmission licence<sup>5</sup> (the Licence), NGET is allowed to recover the costs associated with its SO activities, including any incentive adjustment elements, through the Balancing Services Use of System (BSUoS) charge.

Standard licence condition (SLC) C4 (Charges for use of system) of the Licence requires NGET to produce a use of system charging methodology statement setting out the basis of charges for use of the NETS. The statement explains the methodology used by NGET to calculate the BSUoS charges levied on all Connection and Use of System Code (CUSC) parties<sup>6</sup>.

Key to the calculation of BSUoS charges for each settlement day is the ability of NGET to access up to date volume information and appropriate balancing cost information<sup>7</sup>. While some balancing services costs can be identified on a half hourly basis, some will be incurred over longer timescales<sup>8</sup> and there is no simple method for NGET to allocate these costs to individual (ie half hourly) settlement periods.

To address this issue, BSUoS charges are calculated, billed and reconciled at scheduled intervals for each settlement day. The process seeks to utilise the best estimate of costs and to refine the daily charge calculation over time through the use of reconciliations based on updated volume<sup>9</sup> and cost information at each incremental settlement stage.

There are currently three stages to settling BSUoS charges for each full settlement day:

- Initial Settlement (referred to as Settlement Final or SF). This produces an "initial" daily BSUoS charge that is invoiced 16 working days after the settlement day.
- End of Scheme Reconciliation (EoS). This produces a consolidated charge for all the settlement days within the BSIS year just completed (1 April to 31 March inclusive).
- Final Reconciliation (referred to as Reconciliation Final or RF) produces a "final" daily BSUoS charge that is invoiced 14 months after the settlement day.

The EoS reconciliation was introduced to the BSUoS charging methodology on 1 April 2001 with the implementation of the New Electricity Trading Arrangements (NETA). EoS was developed in recognition that some components of the initial BSUoS charge are based upon

<sup>3</sup> The NETS (currently split into three transmission licence areas which are defined as England and Wales, South of Scotland and North of Scotland) will be extended into offshore waters at a point where assets are treated as part of the NETS.

<sup>4</sup> The current approach allows NGET to keep a proportion of any savings it can make against an annual target level of costs.

<sup>5</sup> Part 2 of special condition AA5A (Revenue restriction provision).

<sup>6</sup> From 1 January 2011, the methodologies are contained within Section 14 of the CUSC.

<sup>7</sup> The method of BSUoS charging applied by NGET is to determine the total BSUoS cost (£) associated with its SO activities for each hh period of a settlement day, then divide it by the total metered volume (MWh) for the same period to determine a total hh BSUoS price (£/MWh). The BSUoS price is then multiplied by each customers metered energy taken from or supplied to the NETS to calculate the hh BSUoS charge payable or to be received by each customer.

<sup>8</sup> NGET is free to contract for balancing services from generators, suppliers and large customers in real time and can purchase balancing services in the Balancing Mechanism over longer timescales.

<sup>9</sup> Updated metered volume data is based on the information provided through the settlement runs administered by Elexon.

forecast cost data and some components within the BSIS scheme are subject to indexation. Hence, once actual costs became available, it was considered efficient to reconcile the charges for the BSIS scheme year just completed against the initial daily BSUoS charge.

The difference between the revised charge produced by EoS and the payments already made at the SF stage, for each day, are consolidated into a single transaction covering all days in the relevant BSIS scheme year ahead of the daily RF run. The total difference is then charged or refunded by NGET, via a single payment to industry participants.

Following EoS, BSUoS charges are revised once more when the RF run becomes available for each settlement day of the BSIS scheme year just completed. The difference between this final BSUoS charge, and that calculated at the EoS will be billed or refunded on a daily basis.

At the time of NETA it was anticipated that introducing EoS into the BSUoS settlement process would add value to the functioning of the new arrangements by reducing the volatility of all subsequent daily RF run and minimising the reconciliation for the final daily BSUoS charge. EoS is effectively a cost catch-up exercise and was intended to reduce the anticipated difference in charges between the EoS and the RF run. It was therefore expected to smooth the cashflow associated with the settlement of BSUoS charges for NGET and users alike.

Under the terms of its Licence<sup>10</sup>, NGET is required to keep its methodology under review at all times and to make proposals to modify that methodology where it considers a modification would better achieve the relevant objectives<sup>11</sup> in relation to: a) competition, b) cost-reflectivity and c) developments in the licensees' transmission businesses.

In the course of reviewing the overall BSUoS settlement process, NGET's analysis indicated that the anticipated need for the EoS process at the time of NETA has not been apparent in the subsequent nine years of operation. Accordingly, NGET's preferred solution, originally set out in August 2010, is to modify the BSUoS methodology to remove the EoS reconciliation period and revert to having only two iterative daily runs for reconciliations of the BSUoS charge for full each settlement day. GB ECM-27 seeks to deliver this change.

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<sup>10</sup> SLC C5 (1) (Use of system charging methodology).

<sup>11</sup> The relevant objectives are contained in SLC C5 (5) of the electricity transmission licence.