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22 November 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No: P71

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P71: "Transfer of imbalances caused by Balancing Services to the Transmission Company Energy Account"

The Gas and Electricity Markets Authority (the "Authority"¹) has carefully considered the issues raised in the Modification Report² for Modification Proposal P71 "Transfer of imbalances caused by Balancing Services to the Transmission Company Energy Account".

The BSC Panel (the "Panel") recommended to the Authority that Modification Proposal P71 should not be made.

The Authority has decided to direct a modification to the BSC. This letter explains the background to the Modification Proposal and sets out the Authority's reasons for its decision. In addition, the letter contains a Direction to The National Grid Company plc ("NGC") to modify the BSC as set out in Modification Proposal P71.

This letter constitutes the notice by the Authority under Section 49A of the Electricity Act 1989 in relation to this Direction.

Background to the proposal

NGC contracts with various Parties for the provision of Balancing Services such as frequency response, standing reserve, fast reserve and black start. The delivery of these Balancing Services

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

² ELEXON document reference UMR071, version No. 1.0, dated 18 March 2002.

can result in the provider generating or consuming different volumes of energy than they had contracted for and hence can result in providers incurring imbalance charges.

Generators are compensated via the Connection and Use of System Code ("CUSC") for the imbalance charges incurred under the BSC when providing Mandatory Frequency Response. An Amendment to the CUSC, CAP001³, altered the method used to calculate the response energy volume delivered or avoided by generators to more accurately reflect the energy volume delivered or avoided when providing Mandatory Frequency Response. In addition, it duplicated the BSC algebra used for calculating Non-Delivery Charges to compensate generators for Non-Delivery Charges incurred in the delivery of Mandatory Frequency Response.

On 4 March 2002, NGC raised Modification Proposal P71 "Transfer of imbalances caused by Balancing Services to the Transmission Company Energy Account". The Proposer suggested that the Modification Proposal will better facilitate achievement of Applicable BSC Objective⁴ (b) as set out in Condition C3.3 of NGC's Transmission Licence.

The Proposer considered that it is inappropriate to charge imbalance prices to Parties who have assisted in System Balancing. It was suggested that providers were reluctant to offer Balancing Services to the Transmission Company and some providers were potentially withdrawing these services. This could result in an increase in the costs of System Balancing by NGC having to purchase more expensive Balancing Services. The Proposer also stated that reductions in the availability of Balancing Services could lead to degradation in the security of the System.

NGC recommended that the Modification Proposal should be treated as an Urgent Modification Proposal for the purposes of section F2.9 of the BSC. The Authority granted the Modification Proposal Urgent status and agreed the process and the timetable in accordance with Section F2.9 of the BSC on 6 March 2002.

³ The decision letter for Approved Amendment CAP001 can be found at

<http://www.nationalgrid.com/uk/indinfo/cusc/>

⁴ The Applicable BSC Objectives are contained in Condition C3.3 of NGC's Transmission Licence and 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 by the licensee of the licensee's 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;
- (d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.
- (e) without prejudice to the foregoing objectives and subject to paragraph 3A, the undertaking of work by BSCCo (as defined in the BSC) which is:
 - (i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
 - (ii) relevant to the proposed GB wide balancing and settlement code;

and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

The Modification Proposal

This Modification Proposal seeks to transfer any energy imbalance volumes associated with the provision of certain Balancing Services ("Applicable Balancing Services") from the Energy Account of the service provider to the Energy Account of the Transmission Company, thereby removing this energy from exposure to imbalance charges.

The Modification Proposal is essentially the same mechanism as that proposed by original Modification Proposal P34 but seeks a prospective implementation. The Transmission Company will be required to determine the energy volume associated with the provision of Applicable Balancing Services for each Balancing Mechanism Unit ("BMU") per Settlement Period within two working days of the event (i.e. in time for the Interim Information Settlement Run). These volumes will be reported to the Balancing Mechanism Reporting Agent ("BMRA") for publication on the Balancing Mechanism Reporting Service ("BMRS") and to the Settlement Administration Agent ("SAA") for use in settlement calculations.

The energy volumes associated with providing Applicable Balancing Services will then be transferred from the Energy Account of the Balancing Services provider to the Energy Account of the Transmission Company. This results in no payments being made via the BSC for the provision of the Applicable Balancing Services. Instead, all relevant payments would be dealt with via the CUSC and/or Ancillary and Commercial Services Agreements with the Transmission Company.

As with original Modification Proposal P34, Modification Proposal P71 requires that the methodology for determining the energy volumes associated with the provision of Applicable Balancing Services, and the list of Balancing Services that this Modification Proposal is to apply to, be defined outside the provisions of the BSC.

Consistent with original Modification Proposal P34, Modification Proposal P71 enables Balancing Services providers to "opt out" of the energy volume transfer process. The Lead Party of a BMU would be able to instruct the Transmission Company not to notify energy volumes attributable to the provision of Applicable Balancing Services and therefore remain exposed to imbalances accruing from the provision of Applicable Balancing Services.

A number of BSC Modification Proposals, CUSC Amendment Proposals and a modification to the Transmission Licence have been raised proposing changes to the arrangements for addressing a Party's imbalance exposure when providing Balancing Services. These are outlined in Appendix 1.

Respondents' views

ELEXON issued a draft Modification Report on 6 March 2002 for Modification Proposal P71, which invited respondents' views by 12 March 2002. The report recommended that the Modification Proposal should be rejected.

In total, ELEXON received 15 responses to the consultation on the Modification Proposal. Of these, five considered that the Modification proposal would better facilitate the achievement of the Applicable BSC Objectives. However, three of these five respondents did not support the Modification Proposal and/or did not believe that it offered a complete solution to the issue of

exposure to imbalance for Balancing Services providers. Six respondents did not support the Modification Proposal and the remaining four were neither in favour nor opposition.

The respondents that did support the Modification Proposal agreed in principle that providers of Balancing Services should not be exposed to imbalance charges for the provision of those services.

One respondent suggested that the Modification Proposal seeks to remove the potential imbalance risks currently encountered by the parties providing Balancing Services, thus promoting competition by encouraging more participants to enter the Balancing Services market.

The respondents who did not support the Modification Proposal considered that the accompanying methodology statement should be within the remit of the BSC. One respondent argued that placing the methodology under the BSC would aid clarity when tracking energy flows between accounts. One respondent believed that the creation of a further industry document could potentially create difficulties linked to multiple governance issues, reducing transparency and increasing regulatory burden.

One respondent was concerned that having the methodology statement outside the BSC may allow NGC to make changes to it without proper analysis and due regard to the interests of the industry. This respondent believed that market participants might not have the same ability to contribute to the development of the methodology statement as they would if it was under the governance of the BSC. This issue was raised on the basis that only NGC can initiate changes to methodology statements required under its Transmission Licence, with market participants only able to respond to consultations on proposed revisions.

One respondent believed that raising the Modification Proposal was not in the spirit of facilitating achievement of Applicable BSC Objective (d) as set out in condition C3.3 of NGC's Transmission Licence. The respondent argued that raising the Modification Proposal can be construed as frustrating Modification Proposals that have followed the due process of the BSC and been forwarded by the BSC Panel to the Authority with recommendations.

Panel's Recommendation

The Panel met on 14 March 2002 and considered the Modification Proposal, the Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should reject the Modification Proposal. The Panel's Recommendation was made on the grounds that the Modification Proposal places the definition of the Balancing Services and associated methodology for the volume calculation under the governance structure of the Transmission Licence/CUSC.

The BSC Panel, recommended that, if accepted, the implementation date for the Modification Proposal should be the release date for BSC Systems which first occurs not less than three months after the date of the Authority's determination.

Legal drafting errors

On 25 July 2002 all BSC Parties were made aware of some errors in the legal text to implement Modification Proposals P34, P36, P71 and their respective Alternative Modifications. ELEXON believed these errors to be both minor and inconsequential and that they did not alter the intent or effect of any of the Modification Proposals.

ELEXON issued a short consultation on proposed changes to the legal text to correct these errors on 25 July 2002, requesting responses back by 2pm on 26 July 2002. ELEXON received five responses, none of which objected to the proposed changes.

Subsequently, ELEXON wrote to Ofgem on 1 August 2002 to provide the Authority with supplements to the Modification Reports. The supplements contained the amended legal text for Modification Proposals P34, P36, P71 and their respective Alternative Modification Proposals.

Ofgem's view

Ofgem considers, having had regard to its statutory duties, that the Modification Proposal does better facilitate the achievement of the Applicable BSC Objectives. This conclusion has been reached, taking into consideration respondents' views on Modification Proposals P34 and P36, Proposed Amendments CAP009, CAP010, CAP011 and all related Alternative Modification Proposals and Alternative Amendments as well as the responses to the associated consultation on a Transmission Licence modification. Although the Authority has considered the issues raised in these Modification Proposals, Amendment Proposals and the Transmission Licence Modification consultation concurrently, each proposal is subject to separate Determination.

Ofgem agrees with the Panel that providers of certain Balancing Services should have the option of not being exposed to imbalance risk as a result of imbalance volumes created by the provision of Balancing Services. Ofgem considers that participation from the demand side in providing Balancing Services may be particularly inhibited as demand side participants do not have any compensation mechanism for the imbalance incurred as a consequence of providing Balancing Services⁵. Ofgem considers that the transfer of imbalance volumes from the energy accounts of Balancing Services providers to the energy account of the Transmission Company will remove the perceived disincentive to provide Balancing Services. This should encourage more Parties, including the demand side, to offer Balancing Services, ultimately giving NGC more choice when selecting Balancing Services providers. Ofgem considers that this will further the achievement of Applicable BSC Objectives (a), (b) and (c) as set out in Condition C3.3 of NGC's Transmission Licence.

Ofgem considers that it is appropriate that the definition of "Applicable Balancing Services" and the associated methodology for calculating the volume of these actions should fall under the governance of the Transmission Licence and CUSC. Currently the definition of Balancing Services is contained within the Transmission Licence and Procurement Guidelines, whilst the contractual mechanisms for mandatory Ancillary Services are described within the CUSC. This governance structure has been agreed through a number of industry consultations prior to the introduction of NETA. Ofgem considers that placing this methodology under the governance of

⁵ The CUSC contains provisions for generators to be reimbursed for imbalance costs incurred when providing Mandatory Balancing Services.

the BSC could result in duplication between the BSC, the CUSC and the Transmission Licence and could ultimately lead to inconsistencies between the BSC, the CUSC and the Transmission Licence. Ofgem therefore considers this would be detrimental to the achievement of Applicable BSC Objective (d) as set out in Condition C3.3 of NGC's Transmission Licence.

Ofgem considers that the Transmission Licence provides a flexible and transparent governance structure for the required Applicable Balancing Services Volume Data Methodology Statement. Furthermore, the recent revision to the Transmission Licence⁶ allows for within year modifications to the subsidiary documents required under special condition AA4, thereby providing a flexible means for updates to be made to these statements. Additionally, any revisions to the statements under special condition AA4 can only be made following consultation with BSC Parties and after gaining the approval of the Authority. The same provisions will be applied to the Applicable Balancing Services Volume Data Methodology Statement to ensure clarity and consistency. Ofgem considers that these provisions will provide certainty to market participants and address respondents' concerns over the transparency of a methodology defined under the Transmission Licence and/or CUSC.

Ofgem does not agree with the respondent which believed that raising the Modification Proposal can be construed as frustrating other Modification Proposals that have followed the due process of the BSC and been forwarded by the BSC Panel to the Authority with recommendations. As the respondent pointed out, both Modification Proposal P34 and P36 had been allowed to follow the due modification process as set out in section F of the BSC. Ofgem notes that Modification Proposal P71 was progressed to a timescale that allowed the Panel to consider Modification Proposals P34, P36 and P71 at the same meeting. Ofgem therefore disagrees that raising the Modification Proposal was not in the spirit of facilitating achievement of Applicable BSC Objective (d) as set out in condition C3.3 of NGC's Transmission Licence.

The Authority's decision

The Authority has therefore decided to direct that the Modification Proposal should be made and implemented.

Direction under Condition C3.5(a) of NGC'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 NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the BSC as set out in the Modification Report, as amended by the supplement to the Modification Report sent to Ofgem on 1 August 2002.

The Implementation Date for Modification Proposal P71 is 25 February 2003.

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

⁶ These changes were introduced to Special Condition AA4 of NGC's Transmission Licence with effect from 1 April 2002. A copy of the changes to the Transmission Licence can be found at <http://www.ofgem.gov.uk/licensing/notices.htm>

Please contact me on the above number if you have any queries in relation to the issues raised in this letter or alternatively contact Richard Ford on 020 7901 7411.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Sonia Brown'.

Sonia Brown

Director, Electricity Trading Arrangements

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

Appendix 1 – Related decisions

Modification Proposal P34 “Transfer of imbalances caused by Balancing Services to the Transmission Company Energy Account”

This Modification Proposal seeks to remove exposure to imbalance charges for providing Balancing Services.

The Modification Proposal requires that the methodology for determining the energy volumes associated with the provision of Balancing Services, and the list of Balancing Services that this Modification Proposal is to apply to (“Applicable Balancing Services”), be defined outside the provisions of the BSC. The Modification Proposal enables Balancing Services providers to “opt out” of the energy volume transfer process. The Modification Proposal has a retrospective implementation date of 23 August 2001.

During the assessment of the Modification Proposal, the Modification Group also developed an Alternative Modification Proposal. This Alternative Modification Proposal is based on the original Modification Proposal. The difference compared to the original Modification Proposal is that the Alternative Modification Proposal requires that the definition of Applicable Balancing Services and the methodology for calculating energy volumes associated with these Balancing Services are contained in a framework document linked to the BSC. The implementation date for the Alternative Modification Proposal is 1 December 2002.

The Authority has issued a decision to reject the Modification Proposal and the Alternative Modification Proposal concurrently with this letter.

Modification Proposal P36 “The generation of Bid/Offer Acceptances relating to energy delivered as a result of providing Applicable Balancing Services”

This Modification Proposal sought to address similar issues as Modification Proposal P34.

Under this Modification Proposal, the Transmission Company would be required to determine the energy volumes associated with the provision of Applicable Balancing Services for each BMU per Settlement Period. These energy volumes would be treated as Bid/Offer Acceptances (“BOAs”), but would be explicitly excluded from Energy Imbalance Price calculations as these BOAs are deemed to be due to System Balancing rather than Energy Balancing actions. As a result of these BOAs, the service provider would have any energy associated with the provision of Applicable Balancing Services cashed out at the Bid/Offer price and would not be exposed to imbalances due to these energy volumes. The Modification Proposal requires that the methodology for determining the energy volumes associated with the provision of Balancing Services, and the list of Balancing Services that it applies to, be held under the provisions of the BSC.

The Modification Group developed an Alternative Modification Proposal where energy volumes associated with the provision of Applicable Balancing Services would be notified in two different ways:

- as a BMU Applicable Balancing Services BOA (essentially the same mechanism as original Modification Proposal P36); or

- as a BMU Applicable Balancing Services volume, which will be removed from the Energy Account of the Balancing Service provider and transferred to the Energy Account of the Transmission Company (the mechanism set out in Modification Proposal P34).

The Alternative Modification Proposal was developed to cover all aspects of Balancing Services provision, as the original Modification Proposal effectively excluded Balancing Services providers who are not the Lead Party of the BMU and/or are not active participants in the Balancing Mechanism.

The Authority has issued a decision to reject the Modification Proposal and the Alternative Modification Proposal concurrently with this letter.

Proposed Amendment CAP009 "Mandatory frequency response"

This Proposed Amendment proposes changes to the methodology used for calculating frequency response volumes.

The Authority is minded to accept the Proposed Amendment. However, Ofgem considers it is important that the Proposed Amendment is not implemented prior to Modification Proposal P71 being implemented. The Amendment Report in respect of the Proposed Amendment contained a recommendation to implement the Proposed Amendment 10 business days after the Authority's decision. The Authority expects to issue its decision in relation to the Proposed Amendment on or after 12 February 2003.

Proposed Amendment CAP010 "Mandatory response imbalance exposure"

This Proposed Amendment seeks to better reflect generating Units' costs when providing frequency response by replacing the current reference price with a mechanism that uses Bid prices for high frequency response and Offer prices for low frequency response.

The Authority has issued a decision to reject Proposed Amendment CAP010 concurrently with this letter.

Proposed Amendment CAP011 "Changes to frequency response payments to reflect a potential change to the BSC"

This Proposed Amendment seeks to address the necessary changes to the CUSC if Modification Proposal P34 or any other Modification Proposal with the same effect were to be implemented. The CUSC Panel recognised that there would also need to be changes to the CUSC if Modification Proposal P36 or any other Modification Proposal with the same effect were to be implemented. An Alternative Amendment was therefore drafted to address the changes needed if Modification Proposal P36 or any other Modification Proposal with the same effect were implemented.

The Authority has issued a decision to accept the Proposed Amendment and reject the Alternative Amendment concurrently with this letter. The Proposed Amendment is to be implemented on 25 February 2003, the same day as Modification Proposal P71 is to be implemented.

Modification to the National Grid Company's Transmission Licence: Applicable Balancing Services Volume Data ("ABSVD") Methodology Statement

Modification Proposal P34 and Modification Proposal P71 both require an ABSVD Methodology Statement to be introduced under the governance of the CUSC/Transmission Licence. Ofgem issued a consultation on a modification to NGC's Transmission Licence on 23 September 2002 seeking to introduce a requirement for NGC to put in place an ABSVD Methodology Statement that would define:

- services for which a service provider would be allowed to transfer any imbalance volume caused by the delivery of the service to NGC's Energy Account, and
- the methodology by which such transferred imbalance volumes would be calculated.

In addition, the licence modification would also place an obligation on NGC to provide the Authority with information on the level of energy volumes that had been transferred to NGC's Energy Account via the mechanism defined in the ABSVD Statement.

The Authority has issued a decision to approve the modification to NGC's Transmission Licence concurrently with this letter.

Applicable Balancing Services Volume Data ("ABSVD") Methodology Statement consultation

NGC issued a consultation on establishing an ABSVD Methodology Statement on 1 October 2002 which invited views from respondents by 29 October 2002. NGC issued its report on the consultation to the Authority on 5 November 2002. In the report NGC recommended that a revised version of the ABSVD Methodology Statement should be approved if Ofgem decides to direct the necessary modification to NGC's Transmission Licence.

Ofgem is currently considering the findings of the report and the views expressed by interested parties. Ofgem will make its decision to approve or reject the proposed ABSVD Methodology Statement in due course.