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Dear Nick

Ofgem's Provisional thinking on Modification Proposal P59: "The Acceptance of Bids and Offers to Honour a BM Unit's Dynamic Parameters Beyond the Balancing Mechanism Window"

These comments are provided in response to the Panel's request, under BSC F2.6.10 (b), for the Authority's preliminary view on an interim report on P59: "The Acceptance of Bids and Offers to Honour a BM Unit's Dynamic Parameters Beyond the Balancing Mechanism Window". The following view is therefore without prejudice to the Authority's considerations after receipt of a Final Modification Report on this Modification Proposal.

Background

In accordance with the Grid Code, NGC are only able to issue Bid-Offer Acceptances (BOAs) for periods up to the "wall" (the end of the Balancing Mechanism window). If no subsequent BOA is issued then at the end of the "wall", the Balancing Mechanism Unit ("BMU") can be left out-of-balance (when notified contracted volume does not match metered volume) if the BMU's physical parameters prevent it from returning to its Physical Notification ("PN") instantaneously. It has been argued that this can discourage participation in the Balancing Mechanism or encourage the submission of more extreme Bid and Offer prices in order to manage the risk of imbalance exposure due to the risk of BMUs being left out-of-balance beyond the "wall".

Currently NGC operates an informal agreement with BMUs to address this issue. At the time that the BOA is issued, NGC agrees with the BMU that before the BMU reaches the "wall", NGC will issue a further BOA (consistent with submitted Dynamic Parameters) to return the BMU to its original PN level. This is provided that the BMU does not submit any revisions to its costs or other parameters in the meantime.

On the 3 December 2001 Innogy submitted Modification proposal P59: "The Acceptance of Bids and Offers to Honour a BM Unit's Dynamic Parameters Beyond the Balancing Mechanism Window". The Proposer believes that the procedure for accepting Bids and Offers from BMU's with dynamic parameters that would extend the impact of the acceptance Beyond the Wall should be formalised within the BSC.

The Modification Proposal

Modification Proposal P59 seeks to formalise the currently informal agreement within the BSC. The Modification Proposal would require changes to NETA Central Systems to automatically calculate the BM Unit's Cashflows, and subsequent Energy Imbalance Prices, using Bid-Offer Prices submitted for a prior Settlement Period.

During the Assessment Phase the Group considered that an automatic solution that would require changes to BSC Systems creates additional complexity and would not better facilitate the achievement of the relevant BSC Objectives¹. The Group proposed an Alternative Modification which only places an obligation in the BSC on NGC to formalise the 'gentleman's agreement' rather than implement major BSC Systems changes as per the original Modification Proposal.

The effect of the Alternative Modification Proposal could be seen to be the same as NGC's proposed amendment to the Balancing Principles Statement. However the Modification Group felt there was merit in placing the obligation in the BSC for the reasons that:

- it is more transparent to have the obligation within the BSC;
- there is a material risk to Parties being left out of balance due to balancing actions taken by the System Operator (SO);
- the BSC Modification process ensures that any further changes would better facilitate the achievement of the relevant BSC Objectives; and
- the process for disputing a BOA is clearer within the BSC and would allow Settlement rules to be amended if necessary.

The Panel sought the Authority's provisional thinking on the governance structure proposed under the Alternative Modification.

Ofgem's View

Ofgem² believes that on the basis of the analysis undertaken by the Group so far the informal agreement should not be formalised in the BSC. Ofgem provisionally believes that the process that NGC has undertaken to formalise the informal agreement in the Balancing Principles Statement addresses the issue appropriately. Ofgem considers that the proposed modification to the BPS removes the risk of imbalance exposure should a BMU be out-of-balance at the "wall" and addresses concerns that this risk may have discouraged participation in the Balancing Mechanism. On the 26 February 2002 Ofgem approved NGC's proposed modification to the BPS.

The purpose of the BPS is to set out the principles and criteria by which NGC uses Balancing Services and aims to assist BSC participants in understanding NGC's actions in achieving the

¹ The relevant 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.

² Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

efficient, economic and co-ordinated operation of the transmission system. Formalising the informal agreement via the proposed changes to the BPS enhances the clarity of the BPS and improves transparency for BSC Parties. Ofgem believes that incorporating the proposed changes into the BPS is appropriate as it will ensure that a complete set of the principles and criteria used by NGC when selecting Balancing Services is included within this framework.

Ofgem considers that formalising the proposed changes in the BPS addresses the material risk of a Party being left out-of-balance due to balancing actions taken by the SO. BMUs that have provided a Balancing Service will not be left out-of-balance following provision. Instead they will be returned to their PN thereby removing the material risk associated with being out-of-balance.

When considering modifications to the BPS, Ofgem has regard to the objective of the BPS which is to assist BSC participants in understanding NGC's actions in achieving the efficient, economic and co-ordinated operation of the transmission system. Currently, following an annual review of the BPS, NGC is required to provide the Authority with any written representations or objections from BSC Parties and other interested parties, including proposals for revision not accepted by the licensee during the consultation.

Ofgem has noted that some respondents believed that there might be inadequate arrangements to enable modification of the BPS other than at the time of the annual review conducted in accordance with the Transmission Licence. On this issue, Ofgem is currently proposing licence amendments through Section 11 of the Electricity Act 1989 that will establish a governance structure that allows modifications to the BPS within year. If, subject to consultation and NGC's consent, this amendment is incorporated into the Transmission Licence, arrangements will be put in place to allow modifications to the BPS within year.

Ofgem is therefore minded to reject Modification Proposal P59: "The Acceptance of Bids and Offers to Honour a BM Unit's Dynamic Parameters Beyond the Balancing Mechanism Window". Ofgem's comments and our provisional thinking on these issues are without prejudice to our final consideration on this matter at the time of receipt of a final Modification Report.

Please do not hesitate to contact me on the above number if you have any queries in relation to the issues raised in this letter or alternatively contact Anthony Doherty on 020 7901 7159.

Yours sincerely



Sonia Brown

Head of Electricity Trading Arrangements

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