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22 November 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No: P36

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") - Decision and Notice in relation to Modification Proposal P36: "The generation of Bid - Offer Acceptances relating to energy delivered as a result of providing Applicable Balancing Services"

The Gas and Electricity Markets Authority (the "Authority"¹) has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P36 "The generation of Bid - Offer Acceptances relating to energy delivered as a result of providing Applicable Balancing Services".

The BSC Panel (the "Panel") recommended to the Authority that the original Modification Proposal should be rejected and that the Alternative Modification Proposal should be accepted. The Panel recommended that the Alternative Modification Proposal should be implemented on 1 December 2002.

The Authority has decided not 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.

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 MR036, 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 10 September 2001, Innogy raised Modification Proposal P36 "The generation of Bid - Offer Acceptances relating to energy delivered as a result of providing Applicable Balancing Services". The Proposer suggested that the Modification Proposal will better facilitate achievement of Applicable BSC Objectives⁴ (b) and (c) as set out in Condition C3.3 of NGC's Transmission Licence.

The Proposer considered that it is inappropriate to apply imbalance charges to imbalances that assist in balancing the System. The Proposer also considered that energy delivered as a result of providing "Applicable Balancing Services" should be valued on the same basis as other energy deliveries associated with Bid/Offer Acceptances ("BOAs"). Currently, providers of ancillary services are not exposed to imbalances if they fail to deliver the contracted levels of these services. A further outcome of this proposal would be to expose non-delivering parties to Energy Imbalance and Non-Delivery Charges.

As the Modification Proposal sought to address similar issues to Modification Proposal P34, the Panel determined that Modification Proposal P36 be assessed by the same Modification Group in conjunction with Modification Proposal P34.

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

Modification Proposal P36 seeks to modify the BSC to require the Transmission Company to determine the energy volumes associated with the provision of Balancing Services for a 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. These energy volumes would be treated as BOAs and would be explicitly excluded from Energy Imbalance Price calculations (as a consequence of these BOAs resulting from System Balancing rather than Electricity 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 proposes 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. As a consequence, payments for the provision of Balancing Services would be made via the Balancing Mechanism although payments associated with the retention of Balancing Services⁵ would remain under the CUSC and Ancillary Services Agreements.

Under the Modification Proposal, Balancing Services providers would be able to “opt out” of the new process. This would be achieved by service providers notifying the Transmission Company that they do not wish to have energy volumes attributable to the provision of Balancing Services notified as BOAs to the BMRA and the SAA under this process. In such cases, service providers “opting out” of the Modification Proposal would remain exposed to imbalances accruing from the provision of Balancing Services.

Alternative Modification Proposal

The Modification Group developed an Alternative Modification Proposal. Under this Alternative Modification Proposal, energy volumes associated with the provision of 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); and/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 also allows for both types of Balancing Services energy volumes (BMU Applicable Balancing Services BOAs and BMU Applicable Balancing Services volume) to be determined and notified for one BMU, where these volumes are attributable to the provision of separate Balancing Services.

⁵ Often also referred to as “holding payments”.

The Modification Group developed the Alternative Modification Proposal 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.

Under the Alternative Modification Proposal, the methodology for determining the energy volumes associated with the provision of Balancing Services, and the list of Balancing Services that it applies to, would be held under the provisions of the BSC.

Both the original and Alternative Modification Proposals have been put forward with an implementation date of 1 December 2002.

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 22 February 2002 for Modification Proposal P36, which invited respondents' views prior to the Panel meeting of 14 March 2002. The report recommended that the original Modification Proposal should be rejected and that the Alternative Modification Proposal should be approved.

In total, ELEXON received 10 responses to the consultation. Of these, eight expressed support for the recommendations made in the Draft Modification Report, one did not support the recommendations and one response was neither in favour nor opposition.

Two of the eight respondents expressing support for the recommendations provided further comments. One respondent supported the Alternative Modification Proposal as it deals with all providers on an equal basis, including those who are not Lead Party BMUs or participants in the Balancing Mechanism. This respondent also considered that the linkage the Alternative Modification Proposal creates with BOAs will enable a market in Balancing Services energy to develop and a market price to be placed on these services.

Another respondent suggested that the Alternative Modification Proposal allows energy delivered as a consequence of providing certain Balancing Services to be treated exactly the same way as other Balancing Services delivered through BOAs. This respondent considered that this would enable the System Operator to properly compare the price of energy delivered automatically from responsive plant with that provided by the acceptance of Bids and Offers in the Balancing Mechanism or other Balancing Services. This respondent also considered the Alternative Modification Proposal would address incentive problems associated with the single reference price currently used for Mandatory Frequency Response.

The respondent who did not support the recommendations was concerned that the Modification Proposal results in payment for frequency response at freely submitted Bid and Offer prices. The respondent believed that the interaction between energy provided through frequency response and energy provided through Bids and Offers needs to be more thoroughly considered.

Panel's Recommendation

The Panel met on 14 March 2002 and considered Modification Proposal P36, the Alternative Modification Proposal, the Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended to the Authority that the original Modification Proposal should be rejected and that the Alternative Modification Proposal should be approved. The Panel recommended that, if approved, the Alternative Modification Proposal should have an implementation date of 1 December 2002.

It was the Panel's opinion that the original Modification Proposal was discriminatory as only the Lead Parties of BMUs who are active in the Balancing Mechanism would benefit from the removal of imbalances attributable to the provision of Balancing Services. However, the Panel was of the opinion that the Alternative Modification Proposal extended the benefits of the original Modification Proposal to all Balancing Services providers and therefore better facilitates the achievement of the Applicable BSC Objectives.

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 original Modification Proposal and the Alternative Modification Proposal do not better facilitate the achievement of the Applicable BSC Objectives. This conclusion has been reached, taking into consideration respondents' views on Modification Proposals P34 and P71, 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 Services⁶.

Ofgem does not believe that it is appropriate to use Bid/Offer prices to remunerate the provision of Mandatory Balancing Services.

Ofgem is concerned that certain providers could effectively exclude themselves from providing Mandatory Balancing Services, such as Mandatory Frequency Response, by submitting extreme Bids and Offers if the original Modification Proposal or the Alternative Modification Proposal were to be implemented. Ofgem considers that this could decrease the amount of Balancing Services available to the System Operator and increase the costs of balancing the System. Ofgem considers this would be to the detriment of facilitating achievement of Applicable BSC Objectives (a) and (b) as set out in Condition C3.3 of NGC's Transmission Licence.

Ofgem notes that section 4.4 of the CUSC requires payments for Mandatory Frequency Response to be cost reflective. However, Ofgem is aware of the work currently being undertaken by the Balancing Services Standing Group ("BSSG") under the governance of the CUSC to develop a market mechanism for frequency response. Ofgem does not, in principle, oppose a move towards a more market based product for Balancing Services where market based arrangements for such products, which incorporate effective competition, can be demonstrated.

Ofgem considers that the reference price that is currently used to compensate for the volume of energy which is due to delivering frequency response may not always accurately reflect the costs incurred or avoided as a consequence of delivering Mandatory Frequency Response. However, as set out above, Ofgem does not believe an approach using Bids and Offers to remunerate Mandatory Balancing Services is appropriate.

Ofgem does not agree with the Panel that the governance of arrangements for any Balancing Services should fall under the BSC. Ofgem considers that the governance arrangements dealing with the procurement and provision of Balancing Services should remain via the Transmission Licence and associated documents. 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 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 notes that the Proposer of the Modification Proposal has also put forward CUSC Amendment Proposal CAP010, which attempts to address the same issue within the CUSC. Ofgem considers that issues should be addressed within their own governance structure, and as already stated, Ofgem considers that payments for Mandatory Balancing Services should remain within the governance of the Transmission Licence/CUSC.

⁶ The CUSC contains provisions for generators to be reimbursed for imbalance costs incurred when providing Mandatory Balancing Services.

The Authority's decision

The Authority has therefore decided not to direct that the Modification Proposal or the Alternative Modification Proposal should be made and implemented.

Having regard to the above, the Authority, in accordance with Section F1.1.4 of the BSC, hereby notifies NGC that it does not intend to direct NGC to modify the BSC as set out in the Modification Report in respect of Modification Proposal P36.

Please contact me on the above number if you have any queries in relation to the issues raised in this letter. 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 P71 “Transfer of imbalances caused by Balancing Services to the Transmission Company Energy Account”

This Modification Proposal is identical to Modification Proposal P34, except it has a prospective implementation date. The Modification Proposal was granted Urgent status by the Authority on the grounds of efficiency as many of the issues had been discussed and consulted on within the industry during the extended Assessment Phase for Modification Proposals P34 and P36.

The Authority has issued a decision to approve the Modification Proposal concurrently with this letter. The Modification Proposal is to be implemented on 25 February 2003.

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.