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27 February 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref : MP No: P27

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") - Decision and Notice in relation to Modification Proposal P27: "Amendment to the Derivation of Imbalance Prices"

The Gas and Electricity Markets Authority (the "Authority") has carefully considered the issues raised in Modification Proposal P27 "Amendment to the Derivation of Imbalance Prices".

The Balancing and Settlement Code Panel (the "Panel") recommended to the Authority that the Modification Proposal should be rejected.

The Authority agrees with the Panel's recommendation and 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

The Balancing Mechanism was designed to enable NGC, amongst other things, as the System Operator ("SO"), to keep the transmission system (the "System") in Electricity Balance close to, and in, real time by adjusting levels of generation and demand in the light of the Bids and Offers submitted.

For each Settlement Period the costs of Electricity Balancing are targeted to Parties who are out of balance (if their contracted generation/demand as notified does not equal their metered generation/demand) through the Energy Imbalance Prices. There are dual Energy Imbalance Prices: the System Sell Price ("SSP") and the System Buy Price ("SBP"). When generators are 'short' electricity i.e. metered volumes are less than contracted volumes, the shortfall of generation is paid for at the SBP. When generators are 'long' electricity i.e. contracted volumes are less than metered volumes, the spill is paid at the SSP. Dual cash out prices provide an incentive to participants not to deviate from their notified contractual positions, ensures appropriate incentives for predictability of supply, and encourages reliable plant.

During the early operational experience of NETA, some market participants expressed concern about the spread between SBP and SSP. Some participants additionally believed that imbalances in the opposite direction of the overall System imbalance (for example participants who are long when the System is short) help the SO to balance the System, and that the current methodology for calculating SBP and SSP does not take this into consideration. Therefore some market participants believe that they are exposed to Energy Imbalance Prices that could be regarded as in excess of the cost they impose on the System.

On 26 June 2001, Electricity Direct proposed a modification to the BSC, Modification Proposal P27: "Amendment to the Derivation of Imbalance Prices" which attempts to address this issue.

The Modification Proposal

Modification Proposal P27 seeks to better facilitate the achievement of the relevant BSC Objectives¹ by making amendments to the calculation of Energy Imbalance Prices to determine a correct valuation of net imbalance energy and of energy reverse-flow imbalances.

The Modification Proposal seeks to amend the calculation of SBP and SSP. It suggests that when the system is long the calculation of the SSP will remain unchanged and SBP will be calculated as SSP plus an 'offset'. The offset will be calculated by spreading the costs of NGC accepting Offers in the Balancing Mechanism (generation increases and demand reductions), relative to the costs of buying that energy in the forwards markets, across the total of short Account Energy Imbalance Volumes. Similarly, when the system is short the calculation of SBP will remain unchanged and SSP will be calculated as SBP less an 'offset'. The offset will be calculated by spreading the costs of NGC accepting Bids for electricity in the Balancing Mechanism (generation reductions and demand increases), relative to the costs of selling that energy in the forwards markets, across the total of long Account Energy Imbalance Volumes.

Therefore, the Energy Imbalance Price for energy imbalances that counter the overall imbalance on the System would be calculated by allocating the costs of reverse-flow balancing actions to participants who counter energy imbalance volumes.

The Modification Group (the "Group") considered whether the Modification Proposal would better facilitate the relevant BSC Objectives.

The Group considered the ability of the Modification Proposal to better facilitate the promotion of effective competition in the generation and supply of electricity. The Group believed that the Modification Proposal would reduce the spread between SBP and SSP. The Group considered that this might increase market efficiency through Parties contracting to match their physical exposures. The Group believed this change would especially benefit smaller Parties.

The Group additionally considered that the Modification Proposal would create arbitrage opportunities which could increase liquidity and increase the link between the forward markets and SBP/SSP which again may increase market efficiency.

The Group considered whether the Modification Proposal would better facilitate the efficient, economic and co-ordinated operation of the System. The Group considered that arbitrage opportunities could result in NGC receiving perverse signals as to the degree of balance of the System. Therefore, the Group agreed that the Modification Proposal could impair the efficient, economic and co-ordinated operation of the transmission system.

However, the Group was unable to reach a consensus on whether this effect would be material, and sufficiently outweigh any market efficiency benefit. In addition the Group considered that the Modification Proposal might increase the volatility of Energy Imbalance Prices. NGC considered that the Modification Proposal could reduce the incentive on Trading Parties to contract, which could increase the number of balancing actions, potentially impairing the efficient, economic and co-ordinated operation of the transmission system.

The Group further considered that the Modification Proposal would have an impact on the determination, timing and publication of Energy Imbalance Prices. Although the reverse-flow imbalance cost envisaged by the Modification Proposal could be calculated shortly after the end of each Settlement Period, the offset price could only be calculated after all imbalances on all Trading Parties' accounts have been established. In addition, the availability of Market Price data for calculating the offset price in real-time would depend on the source of data designated for the purposes of establishing the Market Price.

The Group concluded that the Modification Proposal would better facilitate the achievement of the relevant BSC Objective of "promoting effective competition in the generation and supply, and (so far as

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.

consistent therewith) promoting such competition in the sale and purchase of electricity". However, the Group also concluded that the Modification Proposal would impair the achievement of the relevant BSC Objective of "efficient, economic and co-ordinated operation of the Transmission System". The Group was unable to conclude which effect would outweigh the other, and hence was unable to conclude whether the Modification Proposal would, overall, better facilitate the achievement of the relevant BSC Objectives.

The Group recommended that the Panel should determine if the Modification Proposal better meets the relevant BSC Objectives based upon the analysis, consultation and assessment undertaken and the resultant findings outlined in the Assessment Report.

The Panel considered the Group's Assessment Report at their meeting of 18 October 2001 and decided to proceed to the Report Phase with a recommendation to reject the Modification Proposal. ELEXON published a draft Modification Report on 30 October 2001 and invited responses to the report.

Respondents' views

In total, ELEXON received eight responses to the consultation on the draft Modification Report. Of the responses, one expressed support for the Modification Proposal and seven were opposed to the Modification Proposal.

The respondent supporting the Modification Proposal felt that issues had not been fully explored and was disappointed that the Assessment Phase had not been extended. The respondent also disagreed with the assessment by NGC that the Modification Proposal would lead to an increase in the number of balancing actions.

Of the respondents that did not support the Modification Proposal, one respondent suggested that the current imbalance regime puts an incentive on Parties to be long in order to avoid SBP but that this Modification is not the appropriate way of addressing this issue as it would create a perverse incentive on Parties to attempt to estimate the overall market imbalance and move in the opposite direction to balance their position. This would increase the need for NGC to take balancing actions and would be against the BSC Objective of an efficient, economic and co-ordinated operation of the System. In addition the respondent expressed concern that the Modification Proposal could lead to a delay in the publication of Imbalance Prices. Two respondents argued that they could not support the Modification Proposal on the basis that it created a diminished incentive to balance. Three respondents suggested that whilst they do not support the Modification Proposal, they would like to see a wider review of the imbalance pricing mechanism.

Panel's Recommendation

The Panel met on 15 November 2001 and considered Modification Proposal P27, the Modification Report, the views of the Group and the consultation responses received.

The Panel recommended to the Authority that the Modification Proposal should be rejected on the grounds that, whilst it felt that there was some merit in addressing the issues that the Modification sought to address, it had not been established that the particular Modification Proposal would better facilitate the achievement of the relevant BSC Objectives.

Ofgem's view

Ofgem², having had regard to its statutory duties, agrees with the Panel that Modification Proposal P27 does not better facilitate achievement of the relevant Objectives of the BSC.

Ofgem considers that it is important that NGC, as SO, is given accurate information from market participants prior to Gate Closure concerning physical positions to ensure that it can make properly informed decisions about balancing the system. If participants do not face the appropriate incentive to provide the SO with accurate information with which to balance the System, this could result in the SO taking inefficient balancing actions and inhibit the efficient, economic and co-ordinated operation of the

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

System. Ofgem is of the view that the Modification Proposal could reduce the incentives to provide accurate information since it would reduce the SBP/SSP differential.

Ofgem believes that participants who spill electricity are not contributing to balancing the system (except accidentally). Consequently, it is appropriate that participants who are spilling electricity should receive a lower price for their electricity than if they had been fully contracted since they may be imposing costs on the system. Conversely, participants on whose behalf the SO has to procure the flexible delivery of electricity at short notice should pay the full cost of power delivered over short timescales. The use of a dual cash-out price regime incentivises participants to balance their own positions by Gate Closure and hence the actions that the SO has to take are minimised. Thus, dual cash-out prices also assist in minimising the role of centrally administered mechanisms and facilitate bilateral trading of electricity.

Ofgem agrees with the Group that the Modification Proposal would have an impact on the determination, timing and publication of Energy Imbalance Prices. Ofgem considers that a delay in the publication of Energy Imbalance Prices would reduce market transparency. A reduction in market transparency will not better facilitate the achievement of the relevant BSC Objective of "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".

The Authority's decision

The Authority has therefore decided not to direct that Modification Proposal P27 should be 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 to implement Modification Proposal P27.

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



ling Arrangements

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