



Direct Dial: 020-7901-7412

7 March 2003

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref : MP No: P90

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and Notice in relation to Modification Proposal P90: “Improving the Representation of Energy Balancing Actions in Cashout Prices”

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P90, “Improving the Representation of Energy Balancing Actions in Cashout Prices”.

The BSC Panel (the “Panel”) recommended to the Authority that the Proposed Modification P90 should not be made.

The Authority has decided not to direct a Modification to the BSC. This letter explains the background and sets out the Authority’s reasons for its decision.

Background

The National Grid Company plc (“NGC”), as the System Operator (“SO”), incurs costs in keeping the transmission system (the “System”) in Electricity Balance close to, and in, real time. NGC also has to ensure that the System remains within safe operating limits³ and that the pattern of generation and demand is consistent with any System constraints. NGC therefore incurs costs which can be divided between costs associated with “Electricity Balancing” and “System Balancing”. System Balancing costs, which are not caused directly by any particular users are targeted back to all users of NGC’s System. Electricity Balancing costs are targeted back to

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

² ELEXON document reference P090RR, Version No. 1.0, dated 18 November 2002.

³ As prescribed by the Electricity Supply Regulations, 1988 (amended 1998) and consistent with its statutory duties and licence conditions.

Parties on whose behalf the SO has taken Electricity Balancing actions through imbalance cashout. Imbalance cashout ensures that any electricity not covered by contracts is cashed out at a price that reflects the costs that the SO has incurred in undertaking Electricity Balancing actions.

On the 8 July 2002, the First Hydro Company (the "Proposer") submitted Modification Proposal P90, "Improving the Representation of Energy Balancing Actions in Cashout Prices".

The Proposer suggested that Energy Imbalance Prices contain some costs which are attributable to System Balancing. In addition, the Proposer suggested that trades that are deemed to be for System Balancing reasons and removed from the Energy Imbalance Price calculation but have a net impact on the Electricity Balance should not be removed.

The Proposer considered that the Modification Proposal would improve the transparency of NGC's forward trades which would encourage NGC to operate the System in a more efficient, economic and co-ordinated manner. Therefore the Proposer considered that the Modification Proposal would better facilitate the achievement of Applicable BSC Objective⁴ (b) the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system.

The Proposer suggested that the modification would allow Energy Imbalance Prices to better reflect the costs of Electricity Balancing which would promote competition. Therefore the Proposer considered that the Modification Proposal would better facilitate the achievement of Applicable BSC Objective (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.

In addition, the Proposer suggested that the Modification Proposal simplifies the calculation of Energy Imbalance Prices. Therefore the Proposer considered that the Modification Proposal would better facilitate the achievement of Applicable BSC Objective (d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

Modification Proposal P90 was raised during the Assessment of Modification Proposals P74 "Single Cost-Reflective Cash-out Price" and P78 "Revised Definitions of System Buy Price and System Sell Price" and which also sought to make changes to the way in which Energy Imbalance Prices are calculated.

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 P90 seeks to remove the application of perceived arbitrary judgements as to whether balancing actions were taken for the purposes of System or Electricity Balancing. The modification proposes to remove the application of the Continuous Acceptance Duration Limit ("CADL")⁵ and the assessment by NGC as to the purpose of forward trades taken outside the Balancing Mechanism.

The modification proposes to calculate Energy Imbalance Prices from price ordered stacks of all Bid Acceptances and all NGC forward trade sales, and all Offer Acceptances and NGC forward trade purchases. All NGC's forward trade sales and purchases (System and Electricity) would be shown individually in each stack rather than given as a net volume. Therefore the Proposed Modification would require amendment to the mechanism for formulating and reporting NGC's forward trades via Balancing Services Adjustment Data ("BSAD")⁶ which would come under the governance of NGC's transmission licence⁷.

The existing Balancing Reserve Level ("BRL")⁸ Trade Tagging mechanism would be applied to both the purchase and sale stacks. The volume of the balancing actions that are removed by BRL Trade Tagging on the smaller stack would be tagged off the larger stack, to leave the Remaining Imbalance Volume ("RIV"). The balancing actions that comprise the RIV on the larger stack would be used to calculate the 'main' price. The balancing actions that are not removed by BRL Trade Tagging on the smaller stack would be used to determine the 'reverse' price.

On 9 September 2002 the Authority approved Proposed Modification P78 with an Implementation Date of 25 February 2003⁹. Approved Modification P78 changes the derivation of Energy Imbalance Prices such that there will be a main and reverse price. The reverse price will be derived from a market price based on short-term energy trades on the forwards and spot markets. The main price will be derived from NGC's Electricity Balancing actions taken to alleviate the Net Imbalance Volume ("NIV"). The NIV is calculated by netting off all System and Electricity Balancing purchase actions against all sell actions to give the imbalance of the overall System. Approved Modification P78 will retain CADL tagging. However, CADL volumes will be re-included to determine the NIV but will have a zero price attached. BSAD variables will be included in the NIV calculation, as net System and Energy volumes and System BSAD variables

⁵ CADL is used to remove short duration BOAs associated with System Balancing actions from the Energy Imbalance Price calculation. BOAs are excluded from the calculation if they have a Continuous Acceptance Duration ("CAD") of less than the value of CADL, which is currently set at 15 minutes.

⁶ In addition to accepting Bids and Offers in the Balancing Mechanism, NGC can contract ahead of Gate Closure for the provision of balancing services, where it is efficient and economic to do so. Since Energy Imbalance Prices are intended to reflect the costs incurred by NGC, as System Operator, in matching generation and demand ("Electricity Balancing"), there needs to be a mechanism whereby the costs of Electricity Balancing contracts can be included in Energy Imbalance Prices. For this purpose, NGC submits defined BSAD variables to NETA Central Systems containing the volumes and prices of pre Gate Closure contracts.

⁷ Special Condition AA4 of the transmission licence.

⁸ The BRL is a parameter used in the Trade Tagging process to differentiate between Balancing Mechanism actions taken for Electricity Balancing and System Balancing purposes. Broadly speaking BRL Trade Tagging removes matched volumes of the highest price accepted Offers and the lowest priced accepted Bids until the volume of Bids or Offers remaining reaches the BRL.

⁹ On the 17 February 2003 the BSC Panel Chairman requested the Authority to extend the Implementation Date for Approved Modification Proposal P78 to the 11 March 2003. On the same day the Authority approved the request in accordance with Section F2.11.7 of the BSC.

will also have a zero price attached. BRL tagging is no longer required under Approved Modification P78.

Following the Authority determination on Modification Proposal P78, the Modification Group (the "Group") assessed Modification Proposal P90 against the Approved Modification P78 baseline. The Group discussed a potential Alternative Modification Proposal P90 based on the Approved Modification P78, but with disaggregated NGC forward trades included in the purchase and sale stacks. This potential Alternative Modification would use the mechanism being implemented by Approved Modification P78, but instead of using Net System and Net Energy BSAD in the NIV calculation, the disaggregated NGC forward trades would be included individually in the NIV calculation.

The Group looked at the possibility of undertaking analysis of the impact on Energy Imbalance Prices of the potential Alternative Modification Proposal P90 in comparison to Approved Modification P78. However, the Group noted that such analysis would be very difficult to undertake as a consequence of the complexities involved. The Group further noted that such an assessment would, necessarily, be subjective, and therefore, validation and comparison of the Energy Imbalance Prices resulting from Approved Modification P78 and the potential Alternative Modification Proposal P90 could not be easily achieved. Therefore the Group agreed not to continue assessing the potential Alternative Modification Proposal P90.

The majority of the Group considered that the reporting of disaggregated NGC forward trades in the Proposed Modification may improve transparency for Parties, which may also incentivise NGC to balance the market more efficiently and effectively. However, the majority of the Group considered that the Proposed Modification does not create a better differentiation between System and Electricity Balancing actions as a result of removing the application of CADL. The majority of the Group considered that the implementation of a potentially less cost-reflective cash-out regime may reduce the incentives on Parties to balance their positions ahead of Gate Closure, which may increase the number of actions the SO has to take to correct the imbalance of the System.

The majority of the Group considered that any reduction in the cost-reflectivity of Energy Imbalance Prices creates the potential for the costs of Electricity Balancing to be less correctly targeted at those causing the imbalance, thus potentially reducing competition by creating cross subsidies. In addition, the majority of the Group considered that an increase in the risk of exposure to imbalance may have the effect of discouraging Parties from trading closer to real time, thus reducing liquidity in the forwards and spot markets. Therefore the majority of the Group considered that the Proposed Modification would not better facilitate the achievement of Applicable BSC Objective (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.

The Group agreed to recommend to the Panel that the Proposed Modification or any potential Alternative Modification Proposal should not be made and that no further assessment work should be undertaken. The Group suggested that issues raised during consideration of Modification Proposal P90 should be considered by the Pricing Standing Modification Group

(noting that a BSC Party would be required to raise the issue for the standing group to be able to consider it).

Respondents' views

In total, ELEXON received six responses to the consultation on the Draft Modification Report for Modification Proposal P90. Of the responses, all but one response (which did not provide a clear view either way) supported the provisional recommendations of the Panel in the Draft Modification Report to reject the Proposed Modification.

Of the respondents, four considered that that certain aspects of the Proposed Modification had some merit. Two of these respondents considered that NGC's forward trades should be included individually in the purchase and sale stacks. One of these respondents supported the release of greater information on NGC forward trading but considered that the use of this information in the process of setting Energy Imbalance Prices requires further evaluation. One of these respondents considered that the Proposed Modification is not any more or less cost reflective than the present baseline but it provides a simpler and more transparent methodology that does not rely on the judgement of NGC.

Panel's Recommendation

The Panel met on 14 November 2002 and considered Modification Proposal P90, the views of the Group, the Draft Modification Report, and the consultation responses received.

The Panel recommended that the Authority should reject the Proposed Modification.

The Panel agreed with the majority of the Group that the Proposed Modification does not create a better differentiation between System and Electricity Balancing actions, and that therefore the resulting Energy Imbalance Prices would not be any more cost-reflective than under Approved Modification P78.

Ofgem's view

Ofgem considers, having had regard to its statutory duties, that Modification Proposal P90 will not better facilitate achievement of the Applicable BSC Objectives.

Ofgem does not consider that the CADL mechanism for removing System Balancing actions is arbitrary. The definition and methodology for setting CADL was agreed in the course of the modification process for Modification Proposal P18. A value of 15 minutes for CADL was approved by the Ofgem with consideration of NGC's view that it is appropriate to exclude all BOAs with a duration of up to 15 minutes from the Energy Imbalance Prices as, operationally these BOAs were to control the frequency. In addition, Ofgem suggested that the Panel review the CADL at frequent and regular intervals with guidance from NGC regarding operational experience. The Panel has undertaken a review and at their meeting on the 12 December 2002 the Panel agreed that the value of CADL should remain at 15 minutes, with a further review to be conducted in October 2003.

Ofgem considers that any actions taken by NGC operationally to control the frequency of the System for very short durations within particular half hours are more appropriately defined as System Balancing rather than Electricity Balancing, given a balancing period of half an hour. Ofgem considers that the CADL tagging provides an appropriate mechanism to remove the prices of these balancing actions from Energy Imbalance Prices. Ofgem considers that the removal of the application of the CADL to Bid-Offer Acceptances would increase the level of System Balancing actions that are included in Energy Imbalance Prices rather than reduce it.

Ofgem agrees with the majority of the Group and the Panel that the Proposed Modification would not create a better differentiation between System and Electricity Balancing actions. Ofgem considers that the Proposed Modification would result in Energy Imbalance Prices being less cost reflective which potentially could introduce cross subsidies between Parties. Therefore, Ofgem considers that the Modification Proposal would be to the detriment of Applicable BSC Objective (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.

Ofgem notes that some respondents considered that it would be useful for more information to be available on NGC's forward trades. The transparency of NGC's balancing actions will be consulted upon as part of the annual review of the Procurement Guidelines and the Balancing Principles Statement, which NGC is required to undertake by its transmission licence¹⁰. Ofgem will give consideration to any issues raised in regard to the transparency of NGC's balancing actions as part of the annual review of the Procurement Guidelines and the Balancing Principles Statement.

The Authority's decision

The Authority has therefore decided not to direct that Modification Proposal P90 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 P90.

¹⁰ Special condition AA4 3(a) of NGC's transmission licence requires NGC to review the Procurement Guidelines at 12 monthly intervals. Special condition AA4 5(b) of NGC's transmission licence requires NGC to review the Balancing Principles Statement at least once a year.

Please contact me on the above number if you have any queries in relation to the issues raised in this letter. Alternatively, contact Adam Higginson on 020 7901 7410.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Sonia Brown". The signature is written in a cursive style with a large initial 'S'.

Sonia Brown

Director, Electricity Trading Arrangements

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