Direct Dial: 020-7901-7412

31 January 2003

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No: P95

Dear Colleague,

**Modification to the Balancing and Settlement Code ("BSC") - Decision and Notice in relation to Modification Proposal P95: "Transitional Amelioration of Barriers to Licenced Exempt Generators' Market Participation"**

The Gas and Electricity Markets Authority (the "Authority")[1] has carefully considered the issues raised in the Modification Report[2] in respect of Modification Proposal P95, "Transitional Amelioration of Barriers to Licenced Exempt Generators' Market Participation".

The BSC Panel (the "Panel") recommended to the Authority that neither the original nor the Alternative Modification Proposal should be made.

Having considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives[3] and the Authority's wider statutory duties, the Authority has decided not to direct a Modification to the BSC.

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

[2] ELEXON document reference P95RR, Version No. 1.0, dated 20 January 2003.

[3] The Applicable BSC Objectives, as contained in Condition C3 (3) of National Grid Company's Transmission Licence (the "Transmission Licence"), 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.

This letter explains the background and sets out the Authority's reasons for its decision.

**Background to the proposal**

Smaller generators, including Licence Exempt Generators ("LEGs"), have three trading options available under NETA. First, they can contract with one or more local Suppliers and bypass the central balancing and settlement arrangements, as their output is netted off the demand of the supplier(s) with whom they have contracted. Second, they can be registered in the NETA Central Systems through a BSC Party, who takes responsibility for all the balancing and settlement charges associated with them. The BSC Party can then either trade the smaller generator's output on its own account (with the generator contracting its output to the BSC Party) or on behalf of the smaller generator (who would pay the BSC Party a fee for managing its risks). Third, they can become a BSC Party, which allows them to trade directly with other participants in the bilateral markets and via exchanges, and participate directly in the Balancing Mechanism and Settlement processes.

On the 12 July 2002, Slough Energy Supplies Limited (the "Proposer") submitted Modification Proposal P95: "Transitional Amelioration of Barriers to Licensed Exempt Generators' Market Participation".

The Proposer suggested that LEGs are unfairly disadvantaged in comparison to other generators by NETA as the new arrangements have imposed a number of barriers to LEGs' ability to trade on a fair basis as compared to large generators. The Proposer suggested that there are four barriers that can be identified as follows:

- Energy Imbalance Prices are not cost reflective and therefore the imbalance charges LEGs are exposed to are excessive in comparison to the imbalance costs which they impose on the transmission system;

- LEGs cannot realise the value of the embedded benefits because since they can only trade with licensed suppliers within their Grid Supply Point Group ("GSPG"), they have a weak bargaining position relative to the suppliers;

- there is a lack of liquidity and granularity in the short term markets, which prevents LEGs from alleviating the risk of imbalance and imbalance charges; and

- there are administrative burdens on LEGs in participating in short term markets to alleviate the risk of imbalance and imbalance charges.

In addition, the Proposer suggested that no effective consolidation services have emerged that effectively mitigate these barriers.

The Proposer suggested that the Modification Proposal supports the compliance by the National Grid Company ("NGC") with its obligations under its transmission licence, specifically the obligation under Condition C3, paragraph 1(b) of the transmission licence to have in force a BSC designed so that the balancing and settlement arrangements facilitate achievement of the objectives set out in paragraph 3 of that Condition. The Proposer therefore suggested that the

Modification Proposal would better facilitate the achievement of the Applicable BSC Objective (a) - the efficient discharge by NGC of the obligations imposed upon it by its transmission licence.

The Proposer also suggested that the Modification Proposal mitigates the effects of the perceived barriers to LEGs which would promote competition. Therefore, the Proposer considered that the Modification Proposal would better facilitate the achievement of the 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 would promote efficiency in the balancing and settlement arrangements by introducing temporary changes which would give time and opportunity for the permanent changes to be considered. Therefore the Proposer suggested that the Modification Proposal would better facilitate the achievement of the Applicable BSC Objective (d) - promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

**The Modification Proposal**

Modification Proposal P95 seeks to modify the BSC by applying a Neutral Price calculated as an average of System Buy Price ("SBP") and System Sell Price ("SSP") in each settlement Period to all imbalances attributable to Exemptable Generating Plant[4]. Parties would be allowed to register an Exemptable Energy Account against which they would be able to register Balancing Mechanism Units ("BMUs") which contain only Exemptable Generating Plant. These BMUs would have any imbalance attributable to them settled at the Neutral Price up to the total Exemptable Capacity of the account. The Lead Party for Exemptable Generating Plant BMUs would register the Exemptable Capacity for the BMUs prior to the beginning of each BSC Season. In addition, contract notifications could be made against an Exemptable Energy Account

In the Assessment Phase the Modification Group (the "Group") developed an Alternative Modification Proposal. The Alternative Modification Proposal allows Lead Parties for Exemptable Generating Plant BMUs to register the amount of Exemptable Capacity that they have in their Production and Consumption Energy Accounts to create an Exemptable Neutral Band. The Lead Party would be able to settle any imbalances at a Neutral Price up to the total capacity of their Exemptable Neutral Band irrespective of which BMU caused the imbalance. Therefore the Lead Party would know in advance the amount of imbalance on its whole portfolio that could be settled at the Neutral Price, regardless of the performance of the Exemptable Generating Plant. In addition, the Alternative Modification Proposal redefined the Neutral Price as the reverse price which will be introduced by Approved Modification P78[5].

The majority of the Group agreed that the only perceived barrier that would be directly addressed by the Modification Proposal would be non-cost reflective Energy Imbalance Prices. The Group considered that Energy Imbalance Prices are likely to be more cost-reflective

[4] In the Definition Phase the Group decided that the Modification Proposal should be applied to all Exemptable plant based on the definition within section K 1.2.2 (c) and K 1.5 of the BSC.

[5] On 9 September 2002 the Authority approved Proposed Modification P78 with an Implementation Date of 25 February 2003. Documentation in regard to Approved Modification P78 can be found on the ELEXON website, www.elexon.co.uk.

following the implementation of Approved Modification P78. However, the Group considered that it is unlikely that they will be completely cost reflective. Some members of the Group considered that even if Energy Imbalance Prices were completely cost-reflective, Exemptable Generating Plant would still be disadvantaged because of the perceived barriers to managing the risk of imbalance.

The majority of the Group considered that the basis on which Parties pass Energy Imbalance Prices on to Exemptable Generating Plants is a contractual issue that would not be directly addressed by a change to the BSC. Some Group members considered that the Modification Proposal would enable LEGs to realise the value of embedded benefits as Exemptable Generating Plant would get better energy prices from the Parties with whom they are contracted as these Parties would want to realise the benefits from the Modification Proposal. Some members of the Group considered that BSC Parties would have no obligation to pass this benefit on to the Exemptable Generating Plant.

Some members of the Group considered that the Modification Proposal would address the perceived barriers of a lack of liquidity/granularity and administrative burdens in short-term markets by reducing the need for Exemptable Generating Plant to trade in these markets. The Group considered if any effective consolidation services have emerged which could effectively mitigate these perceived barriers. The Group agreed that independent consolidation services had not yet developed materially in the market. Some Group members considered that Parties with a large portfolio are effectively acting as a consolidator when contracting with Exemptable Generating Plant and therefore consolidation services did exist.

The majority of the Group considered that the Modification Proposal would not incentivise Parties to balance their position. The majority of the Group considered that the original Modification Proposal would, due to the Neutral Price definition, give parties the incentive to hold a position opposite to the market length, whereas the Alternative Modification has the potential to increase the volume of imbalance. However, the Group considered that in a 'long' market participants could be incentivised to go less 'long' under the Alternative Modification as they would have a margin for error and therefore be less at risk of being 'short' and exposed to the SBP. The minority view of the Group was that the Modification Proposal would not remove the incentive to balance as the current imbalance risk imposed on Exemptable Generating Plant is disproportionate to their ability to manage it. In addition, a minority of the Group considered that Exemptable Generating Plant would have no means of predicting SSP and SBP and so would remain incentivised to avoid exposure to these prices.

The majority of the Group considered that, unless it was reasonably clear that Energy Imbalance Prices are non-cost reflective for Exemptable Generating Plant as compared to other Parties, then the original Modification Proposal and the Alternative Modification Proposal would potentially introduce a cross subsidy between Parties who can register Exemptable Capacity in their portfolio and those who cannot. The Group discussed whether an imbalance caused by a Party without Exemptable Generating Plant requires more balancing actions to be taken than an identical imbalance caused by a Party with Exemptable Generating Plant in its portfolio. Some members of the Group considered that there is no difference between imbalances caused by an Exemptable Generating Plant and those caused by other parties and were of the view that the Modification Proposal would introduce a cross subsidy. Other members of the Group considered that the imbalance risk upon Exemptable Generating Plant is currently excessive and therefore reducing this risk should not be seen as a cross subsidy.

The majority of the Group agreed that the Alternative Modification Proposal was better than the original Modification Proposal, as the definition of Neutral Price is more appropriate and the implementation costs would be less. However, the majority of the Group considered that neither the original Modification Proposal nor Alternative Modification Proposal better facilitated the Applicable BSC Objectives.

The Panel met on the 12 December 2002 and considered the Group's Assessment Report. The Panel made a provisional recommendation that both the original and Alternative Modification Proposals should be rejected. ELEXON published a draft Modification Report on 18 December 2002, which invited respondents' views by 6 January 2003.

**Respondents' views**

In total, ELEXON received ten responses to the consultation on the draft Modification Report. Of these responses, eight expressed support for the Panel's provisional recommendation, one did not support the Panel's provisional recommendation and one was neither in favour nor opposed to the Panel's provisional recommendation.

Of the respondents that supported the Panel's provisional recommendation, three respondents considered that the Modification Proposal would introduce a cross subsidy between Parties who register Exemptable Capacity and those who do not. Two respondents considered that the Modification Proposal would not incentivise Parties with registered Exemptable Capacity to balance their metered position with their notified contract position. One of these responses indicated that this would be because they would have a margin for error. One respondent considered that LEGs have options by which to mitigate their exposure to Energy Imbalance Prices. In addition, two respondents who agreed with the Panel's recommendation considered that the Modification Proposal does not address a specific fault in the BSC or the perceived defects suggested by the Proposer.

The respondent that did not support the Panel's provisional recommendation put forward a number of arguments. First, that LEGs are exposed to the same imbalance risk as larger generators but, unlike larger generators, are unable to mange their imbalance risk by trading in NETA markets. Second, that the current risk imposed on LEGs is disproportionate to their ability to mange it and the effect of the Modification Proposal would be to reflect that by removing the penal element of Energy Imbalance Prices. Third, that the Modification Proposal retains an incentive to balance because LEGs would have no means of controlling or predicting SSP or SBP and so would remain incentivised to avoid exposure to Energy Imbalance Prices.

The complete texts of all responses are contained in the Modification Report for Modification Proposal P95.

**Panel's Recommendation**

The Panel met on 16 January 2003 and considered the original Modification Proposal, the Alternative Modification Proposal, the draft Modification Report, the views of the Group and the consultation responses received.

The majority of the Panel considered that the implementation of Approved Modification Proposal P78 would make Energy Imbalance Prices more cost reflective, and Exemptable Generating Plant would not be exposed to any significantly non-cost reflective imbalance charges when compared to other parties. The Panel also considered that Modification Proposal P95 would introduce a cross subsidy between Parties. Therefore the majority view of the Panel was that neither the original Modification Proposal nor the Alternative 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.

The Panel also considered that both the original Modification Proposal and the Alternative Modification Proposal decrease the incentive on parties to balance and therefore would not better facilitate the achievement of Applicable BSC Objective (b) - the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system.

The Panel recommended that the Authority should reject the original Modification Proposal and Alternative Modification Proposal.

The Panel recommended that, in the event that the Authority determines that the Alternative Modification should be made, the Implementation Date should be 5 November 2003 if a decision is received from the Authority prior to 1 February 2003 or 25 February 2004 if a decision is received on or after 1 February 2003 and prior to 1 May 2003. The Modification Report did not contain legal text for the original Modification Proposal and the Authority confirmed that no legal text was required for the original Modification Proposal at the Panel meeting on the 12 December 2002.

**Ofgem's view**

Having carefully considered the Modification Report, the Panel's recommendation, and the representations of the Proposer, Ofgem considers, having had regard to the Applicable BSC Objectives and its statutory duties, that the neither the original Modification Proposal nor the Alternative Modification Proposal better facilitate achievement of the Applicable BSC Objectives.

As a general principle, Ofgem considers that a dual cash-out mechanism continues to be appropriate for all participants. A Party whose metered volumes differ from their contracted position imposes additional costs on the System Operator ("SO") who is seeking to balance the transmission system in real time. Ofgem continues to consider that it is important that these costs are targeted onto the Party concerned. While it is difficult to value the actual costs imposed by a Party, to assume that the cost is zero by adopting a single price cash-out would be even more arbitrary. With operational experience by NGC and other market participants a number of changes have been made to the BSC since NETA Go-Live which Ofgem considers have resulted in Energy Imbalance Prices being more cost reflective. Ofgem additionally considers that Approved Modification Proposal P78 will make Energy Imbalance Prices more cost reflective.

The use of a dual cash-out regime incentivises participants to balance their own positions by Gate Closure and hence the actions that the SO has to take are minimised. More over, through ensuring that costs fall where they should ensures that there are correct incentives for reliability and predictability, both of which are important for security of supply.

Ofgem has carefully considered whether it is appropriate to apply a Neutral Price to the imbalance volumes of Exemptable Generating Plant, as proposed in both the original Modification Proposal and Alternative Modification Proposal.

Ofgem agrees with the majority of the Group and the Panel that both the original Modification Proposal and the Alternative Modification Proposal would be discriminatory through introducing a cross subsidy between Parties who have registered Exemptable Capacity in their portfolios and those without. Ofgem considers that neither the original Modification Proposal nor the Alternative 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. As previously stated it is important that electricity imbalance costs are targeted back to those participants that cause them to prevent cross subsidies and distortions to the market.

Over the coming years it is expected that a large amount of change will be introduced to the electricity market to reflect the Governments environmental objectives. Given this it is important that the correct incentives exist for all types of generation to be reliable and predictable. Ofgem agrees with the majority of the Group and the Panel that the original Modification Proposal and the Alternative Modification Proposal would reduce the incentives on parties to balance. Ofgem therefore considers that it is important that the dual cash-out arrangements apply to all types of generation. Thus Ofgem is of the view that neither the original Modification Proposal nor the Alternative Modification Proposal would better facilitate the achievement of the Applicable BSC Objective (b) - the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system.

NGC has a range of statutory duties and licence obligations which include ensuring the efficient, economic and co-ordinated operation of the transmission system, the facilitation of competition[6] and non-discrimination[7]. As set out above, Ofgem considers that neither the original Modification Proposal nor the Alternative Modification Proposal will enhance NGC's discharge of these obligations. Therefore neither the original Modification Proposal nor the Alternative Modification Proposal would better facilitate the achievement of the Applicable BSC Objective (a) - the efficient discharge by the licensee (NGC) of the obligations imposed upon it by its licence.

Ofgem considers that the Alternative Modification Proposal, which introduces an Exemptable Neutrality Band, would not target the benefit directly at the Exemptable Generating Plant. Parties with registered Exemptable Capacity could be cashed out at a Neutral Price for a proportion of their imbalance irrespective of whether the imbalance was caused by Exemptable Generating Plant or even whether the Exemptable Generating Plant actually generated. Ofgem considers that this gives Parties with registered Exemptable Capacity a further competitive advantage over Parties without such capacity.

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[6] Section 9 (2) (b) of the Electricity Act 1989.

[7] Condition C7C of the Transmission Licence.

Ofgem does not agree with the view of some members of the Group that Exemptable Generating Plant are disproportionally affected by Energy Imbalance Prices because they are unable to mange the risk of imbalance. Ofgem considers that Exemptable Generating Plant do have a number of options in respect of how they choose to trade under NETA and they can choose whichever option best meets their needs. In addition, Ofgem considers that the original Modification Proposal and the Alternative Modification Proposal remove some of the incentives for Exemptable Generating Plant to use existing services and for new services for managing imbalance risk to be developed.

Ofgem notes the concerns raised by the Proposer that LEGs cannot access the full value of their output because their supplier(s) are able to pass a disproportionate share of imbalance risk back to LEGs given their stronger negotiating position. Where appropriate Ofgem will ensure it applies its powers of investigation and enforcement under the relevant competition legislation.

Ofgem has received representations suggesting that Modification Proposals P95, P100, P102, P103 and P114 should all be implemented because they are complementary. Each Modification Proposal will be the subject of a separate determination, as required by the BSC and the Transmission Licence. The Authority's decision on Modification Proposal P95 will in no way fetter its discretion as regards any further proposals that may come to it for determination in the future.

**The Authority's decision**

The Authority has therefore decided not to direct that the original Modification Proposal P95 or the Alternative Modification Proposal P95, as set out in Modification Report, 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.

If you have any queries in relation to the issues raised in this letter contact me on the above number or alternatively contact Adam Higginson on 020 7901 7410.

Yours sincerely,

**Sonia Brown**
**Director, Electricity Trading Arrangements**
Signed on behalf of the Authority and authorised for that purpose by the Authority