Modification Proposal	MP No: 95 *(mandatory by BSCCo)*

Title of Modification Proposal *(mandatory by proposer)*:

Transitional Amelioration of Barriers to Licenced Exempt Generators' Market Participation

Submission Date *(mandatory by proposer)*: 12 July 2002

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Description of Proposed Modification *(mandatory by proposer)*:

For Licence Exempt Generators (LEGs), a neutral cash-out price calculated as a simple average of System Buy Price and System Sell Price in each settlement period should be applied to all imbalances attributable to each LEG. Trading parties will be obliged to register such LEGs in separate and transparent "LEG accounts" for the purpose of imbalance settlement or by other means ensure that such accounts are capable of identification.

Because this proposal is seeking to ameliorate failings in the market that are seriously damaging the economic viability of both existing and potential LEGs, a speedy solution is important particularly if competition is to be maintained. Two potential implementation options which can be put in place quickly are suggested below. They are appropriate solutions to address a market structure which gives LEGs an unjustifiably weak bargaining position on account of the barriers referred to in paragraphs 1.1 to 1.4 below. The proposals are as follows:

(1) ELEXON operates or outsources a process (as a service provider) whereby each supplier registers its interest in LEG meters. Up to 1,000 LEG meters could be registered. However, many suppliers may not see a need for registration if they believe that the net residual imbalances from their LEGs are small enough. The supplier then passes a metered and contracted position to the specified service provider for each settlement period. The service provider then calculates rebates to suppliers for imbalances using the proposed average price and credits the supplier with funds provided from the total system energy imbalance cash flow (TCEI):

Or

(2) A separate dummy Trading Party with a Consumption Account is set up with a base BMU in each grid supply point group ("GSP Group") as well as any number of additional BMUs that might be required. A LEG's meter is registered (in either the Central Volume Allocation ("CVA") or Supplier Volume Allocation ("SVA") as might be preferred) in this account. Suppliers and generators then trade with this account which can be settled as normal. The account is credited with excess imbalance payments made by a simple financial transfer out of the TCEI at the average settlement price calculated under this proposal for LEGs. This account is automatically classified as consumption with a deemed negative demand capacity.

The account would need to satisfy all Master Registration Agreement and other accreditation processes. In that respect ELEXON may need to tender to existing suppliers to operate the process, using their own developed processes. In addition, a specified Energy Contract Value Notification Agent may need to be used who could notify contracts made between suppliers and individual LEGs, in order to apportion the residual balances. The dummy Trading Party would use this information to maintain individual imbalance accounts for each LEG (as a de facto parallel registry) for calculating imbalance payments at the single settlement price.

An appropriate method of establishing the required level of credit cover would need to be included.

It is envisaged that this modification will be superseded by modifications which remove the barriers referred to in paragraphs 1.1 to 1.4 below. However, those modifications are expected to be complex and require a longer period for preparation and deliberation. They may also need to be accompanied by changes outside the BSC. Countervailing measures to these barriers are nevertheless urgent in order not to damage seriously the contribution of LEGs to competition in the market, in the light of the extreme financial consequences of the current position of LEGs and the resulting contraction of this sector (see below).

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Description of Issue or Defect that Modification Proposal Seeks to Address *(mandatory by proposer)***:**

1. LEGs are unfairly disadvantaged 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. These barriers can be identified as follows:

1.1 cost reflectivity: namely, the imbalance charges imposed upon LEGs are excessive in comparison to the imbalance costs which they impose on the system. For example, in their report, "NETA – The Next Phase" (March 2002), Ilex Energy Consulting state as follows: "A central theme of the paper is that the dual imbalance prices are not cost reflective, create perverse incentives and inefficient behaviour and drive a substantial and unnecessary increase in the cost and risk of doing business in NETA". A paper by David Milborrow, "Penalties for Intermittent Sources of Energy", demonstrates that imbalance charges as they affect wind energy are unduly high and not cost reflective. For other smaller generation which is not intermittent, the lack of cost reflectivity is yet more extreme. The Combined Heat and Power Association, in their representations in response to the DTI's November 2001 consultation, reported that in the early stages of developing NETA, NGC suggested that variability of plant of less than 100 MW(e) capacity was unlikely to have a significant impact on the system;

1.2 embedded benefits: namely, there is no means for LEGs to realise the value of the embedded benefits associated with their generation output other than by trading with licensed suppliers with sufficient consumer demand within the generator's GSP Group. As a result of the market structure, LEGs have a weak bargaining position relative to the suppliers (see 2 below);

1.3 illiquidity/granularity, namely, there is a limited market for small parcels of power. For example, data from UKPX and APX market reports for the periods April to July in each of 2001 and 2002 show a 13% reduction in volumes delivered via the exchanges in this year compared with last year, together with a slight reduction in volumes traded. The Heren EDEM Report also cited UKPX as suffering from liquidity problems. These facts are of particular concern, given that in its report on the initial impact of NETA on smaller generators, Ofgem stated: "there is a lack of liquidity in the within day spot day markets". It follows that the lack of liquidity remains. The UKPX daily report day shows that there was no trading for some periods. There was also no trading on APX for 10 separate days in June 2002.

Additionally in March of this year, IPE "suspended indefinitely" its electricity futures contract, due to lack of liquidity; and

1.4 administrative burdens: there are administrative burdens on LEGs in participating in short term markets to alleviate the risk of imbalance and imbalance charges. These include set up costs and operation and personnel costs. The difficulties in respect of liquidity and granularity (see above) also introduce a major barrier to being able to trade effectively even if the required investment is made.

2. The effects of these barriers are:

2.1 LEGs have restricted trading options under NETA, which has led to a deterioration in their ability to earn returns which reflect the value of their generating capacity;

2.2 LEGs cannot sell a firm product to suppliers, as can generators in the CVA. This is because LEGs cannot manage their own imbalance risk so as to make it practical to sell the supplier a firm product, namely electricity of a fixed quantity and price. Instead they must rely on the supplier's evaluation of that imbalance risk under a market structure which leaves LEGs in a weak bargaining position. The result is that LEGs cannot compete on equal terms with generators in the CVA;

2.3 the choice of supplier to whom LEGs can sell their generation output is limited. Some suppliers nominally available to purchase LEGs' generation output have insufficient consumer demand in any particular GSP Group. The result is that they cannot trade with LEGs (in CVA or SVA) without eroding the embedded benefits associated with the LEGs' generation, which are determined by a supplier's net position after buying from LEGs in the GSP Group. Only a few large suppliers under each GSP Group are likely to have adequate consumer demand to absorb sufficient negative demand; and

2.4 LEGs require some form of adequate backstop price, reflective of the level of prices available to other generators, pending the barriers referred to in paragraphs 1.1 to 1.4 above being removed. LEGs will then be able to negotiate adequate contracts with suppliers without being encumbered by an inequality of market power.

3. Pending the barriers described above being addressed on a long term basis so that LEGs can trade with equal facility to larger generators, this modification seeks to provide temporarily an environment in which they can realise the value of their generation capacity in a fair market by improving their trading position with licensed suppliers. This will occur as a result of LEGs no longer selling their generation output under the disadvantages described in paragraph 2.2 above. It is envisaged that the modification will be superseded by long term measures, addressing the issues set out in paragraphs 1.1 to 1.4 above, being put in place. These may include further BSC modifications as well as other measures outside the BSC.

4. The need for the trading arrangements to provide incentives to balance is recognised. The proposed modification would retain this incentive as a degree of imbalance risk would remain; namely the neutral cash out price would be subject to fluctuation dependent on the current levels of SSP and SBP. For the period in which this modification would remain in effect, this incentive to balance is likely to be at least as effective as under the current arrangements.

5. The prices currently offered to LEGs through their contracts with suppliers incorporate the full impact of the distortions of the current market introduced by suppliers over-contracting, from which large generators can profit through participation in the Balancing Mechanism. If the market were in balance, the imbalance price would be equivalent to a simple average. This is appropriate to the pricing of spill from LEGs who are unable to influence the balancing process or benefit from it.

6. No effective consolidation services which could effectively mitigate the barriers referred to in paragraphs 1.1 to 1.4 above have emerged. This is accompanied by the absence of any effective consolidation in the SVA. There is also no credible prospect of such consolidation services developing.

7. Other modifications currently being considered (particularly, P74 and P78) are not sufficient to address the effects of the barriers referred to above and still leave the LEGs exposed to an imbalance risk which they do not have the practical opportunity to manage. Modification P12 (which reduces gate closure to one hour) will not assist LEGs in managing their imbalance risk, because of the barriers to LEGs participating in the market referred to above.

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Impact on Code *(optional by proposer)***:**

N/A

Impact on Core Industry Documents *(optional by proposer)***:**

N/A

Impact on BSC Systems and Other Relevant Systems and Processes Used by Parties *(optional by proposer)***:**

The impact of this modification is small and constitutes an additional process in respect of existing settlement arrangements rather than any structural change.

There are precedents for modifications which are envisaged as interim measures. An example is the "Workaround" undertaken by ELEXON pending the full implementation of modification P18A.

Impact on other Configurable Items *(optional by proposer)***:**

N/A

Justification for Proposed Modification with Reference to Applicable BSC Objectives *(mandatory by proposer)***:**

(a) the efficient discharge by NGC of the obligations imposed upon it by the Transmission Licence:

This modification supports the compliance by NGC of its obligation under Condition C3, paragraph 1(b) 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. In particular, this will support the objective set out at paragraph 3(c) of that Condition to promote effective competition in the generation and supply of electricity, as explained in more detail at (c) below.

(b) the efficient, economic and co-ordinated operation by NGC of the Transmission System:

N/A

(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 modification promotes competition in the generation and supply of electricity, in that:

(i) the effect of the barriers referred to above has been to cause the introduction of NETA to have a disproportionate and damaging effect upon LEGs. This has resulted in withdrawals from the LEG sector and extreme financial consequences for that sector which threaten its continued participation in the generation market. It is not in the interests of competition that the LEG sector, which is up to an estimated 8% of the generation market in England and Wales, should be excluded from the market and its potential economic and environmental benefits as embedded generation denied to consumers;

(ii) although this modification proposes a system of settlement which would distinguish LEGs from other generators, it does not discriminate against other generators. Its effect is only to alter the settlement system so that, pending permanent changes being made, the effects of the barriers referred to in paragraphs 1.1 to 1.4 above do not place LEGs at an unfair disadvantage to other generators; and

(iii) the modification has the effect of introducing a change to the BSC which assists in causing it to be consistent with:

- (A) the duty of Member States under Articles 3(g), 10 and 81 of the EC Treaty not to take any measures which could jeopardise the effectiveness of the rules of competition;
- (B) the requirements of Directive 96/92 (the Electricity Directive) that Member States "ensure that electricity undertakings are operated in accordance with the principles of this Directive, with a view to achieving a competitive market in electricity and shall not discriminate between these undertakings as regards either rights or obligations …"; and
- (C) the duties of the Secretary of State and Ofgem pursuant to Section 3A of the Electricity Act 1989.

The modification is also consistent with the compliance by NGC of its duties as to competition under the laws of England and Wales and those of the European Union.

The modification does not involve any aid favouring particular undertakings, nor aid from the State. The modification rather cures, on an interim basis, an existing distortion of the market.

(d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements:

This modification promotes efficiency in administration. It introduces a necessary change to the settlement system as it relates to LEGs by means of a modification which is envisaged to be superseded by permanent changes, to give time and opportunity for the permanent changes to be considered with care and in a proper timescale. This will facilitate the finding of the best means of removing the barriers referred to in paragraphs 1.1 to 1.4 above and ensure the efficient implementation of the necessary changes.

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Attachments: NO

If Yes, Title and No. of Pages of Each Attachment:

