

Modification Proposal – BSCP40/03	MP No: 212 <i>(mandatory by BSCCo)</i>
Title of Modification Proposal <i>(mandatory by originator):</i> Main Imbalance Price based on Market Reference Price.	
Submission Date <i>(mandatory by originator):</i> 27 April 2007	
Description of Proposed Modification <i>(mandatory by originator)</i> <p>The modification proposal seeks to replace part of the current energy imbalance price methodology with an alternative method for determining the main imbalance price paid by parties who are in imbalance in the same direction as the system. The solution would use a market-derived reference price.</p> <p>The market reference price for each settlement period will be established by (first) applying the process currently applied in the Market Index Development Statement. As at present the reverse price will be set to be equal to the market reference price. The terms of BSC T4.4.5(b) and T4.4.6(b) would as a consequence remain unchanged. The rules would however be varied so that the main price is also discovered by reference to the market reference price, but (second) with a price differential applied to it to retain incentives to contract.</p> <p>In terms of the main price, sections T4.4.5(a) and T4.4.6(a) will need to be replaced so that:</p> <ul style="list-style-type: none"> ▪ T4.4.5(a) is the same as T4.4.5(b) but with the product increased by [5%]; and ▪ T4.4.6(a) is the same as T4.4.6(b) but with the product decreased by [5%]. <p>For the purposes of determining system length in any settlement period, the existing rules could also need to be changed, and system length might be defined by the difference between total notified contract volumes and a measure of metered volumes in any half hour or by netting off accepted bids in an half hour from accepted offers.</p> <p>There will need to be a default price for the main price to replace the current method for any circumstances where the MIDS volume thresholds are not reached. This might be derived by reference to a price discovered in the preceding settlement period or be administered if the system overall is short perhaps by reference to a floor price.</p>	
Description of Issue or Defect that Modification Proposal Seeks to Address <i>(mandatory by originator)</i> <p>The current rules are not producing a “clean” energy price for the main price. This situation arises because the current tagging rules that seek to remove certain balancing actions from the pricing calculation are defective and are resulting in a high level of pollution of the energy price from costs that relate to maintaining the system balance.</p> <p>In the decision letter on P205 the Authority noted that, in its data sample to test that modification, acceptances arising from Cheviot constraints were apparent in 56 out of 63 periods used. At a presentation by National Grid as part of Ofgem’s cash-out review on 30 March, it was noted that only 25% of offers in the NIV stack between April 2006 and February 2007 were related to energy balancing only; the volume of bids was higher at 41%, but still represented the minority of balancing actions in the stack. National Grid also explained that use of a different energy stack net of “energy-plus” actions (that is acceptances that included costs of addressing at least in part system effects)</p>	

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would have resulted in materially different imbalance prices during November 2006 (SBP-9% on average; SSP+7%; spread 8%). These restated prices (compared against the actual average prices that applied) are shown as an attachment to this proposal form.

As the main imbalance price in any settlement period is intended to reflect only the costs of energy acceptances by National Grid, this situation means that:

- imbalance parties are frequently exposed to an inflated non-cost reflective price when SBP is the main price; and
- imbalance parties are frequently exposed to an understated, non-cost reflective price when SSP is the main price.

One consequence of the application of the current rules is that the main imbalance price is also more peaky and volatile than it should be. This has produced a strong incentive to contract producing a tendency for the system to be excessively long. In turn this has artificially reduced liquidity in the forward energy and created a need for the system operator to routinely constrain off plant in most settlement periods, which is inefficient.

Given the complex nature of balancing the system and the interaction of energy and system balancing, it is contended that any tagging process will always be an approximation and one that is prone to producing volatile and highly inaccurate energy prices. A more reliable and consistent proxy for a true energy price is the MIDS derived price. The derivation using the market-based reference price is appropriate because it reflects the value of short-term energy trades, and it's use has an established track-record since the implementation of P78 for the purpose of setting the reverse price. It avoids complex allocation and tagging methodologies that depend on detailed technical rules and judgements that are applied after the event.

Impact on Code (*optional by originator*)

Changes to section T (Settlement and trading changes), particularly 4.4 which relates to the calculation of imbalance charges. Changes may also be required to Section V (Reporting) and Section X (Definitions and interpretation).

Impact on Core Industry Documents or System Operator-Transmission Owner Code (*optional by originator*)

Possible changes to Grid Code and BSAD methodology statement.

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

Changes to the imbalance price calculation and to the Settlement report (SAA-1014).

Impact on other Configurable Items (*optional by originator*)

None identified

Justification for Proposed Modification with Reference to Applicable BSC Objectives
(mandatory by originator)

The fundamental justification for the proposed modification is that the current rules are systematically producing prices that unnecessarily increase risk in the market-place, amplify costs without cause onto imbalance parties and thus increase costs to consumers.

The proposed modification would be beneficial primarily in terms of objective (c):

- as it would remove competitive distortions inherent in the current imbalance pricing rules which impact on imbalance parties, who tend to be non-vertically integrated players, especially suppliers who are systematically exposed to forecast error, increasing their costs of production and supply relative to other participants; and
- it would also remove a systematic distortion that is discriminating against intermittent technologies who are also more prone to imbalance.

The proposal will also increase liquidity in the short-term market because operators will be less inclined towards “fear of cash-out”, and they will be less concerned to self-hedge and trade their imbalance. There would also be a reduction in imbalance risk in the market more generally. Incentives to vertically integrate would also be reduced.

In view of the simpler, transparent and possibly more predictable nature of imbalance price formation, liquidity of traded markets should also improve. The reduced risk in the market and increased liquidity (as well as reduced complexity and increased transparency) should also act to facilitate new entry. Both of these outcomes would facilitate competition in the sale and purchase of electricity.

There would also be significant benefits in terms of objective (d) given the simpler and more transparent derivation of the main price by reference to an established and proven market benchmark.

The change proposed removes distortions under the current rules because the current formulation of the imbalance price, and the tagging rules on which it depends, is acknowledged not to be cost reflective, thus delivering benefits under objective (b). There will also be benefits in terms of reducing the volatility and improving the predictability of the main imbalance price which should produce collateral improvements in terms of the smooth operation of the transmission system. Reduced “fear of cash-out” should reduce pressures to over-contract requiring fewer interactions (and lower costs) for the system operator.

The proposed modification as formulated also involves a clear incentive to contract by applying a premium to SBP and a discount to SSP when these are the main price respectively. As the system becomes tighter and market prices rise, the monetary value of the incentive will increase and will allow a minimum spread against the market price (except where the market price is zero), which will enhance security of supply.

The analysis referred to above has demonstrated a clear and damaging deficiency and therefore it is appropriate to proceed to assessment rather than a standing group. It is also very desirable that a market price model is considered in parallel to an alternative tagging methods such as that proposed by P211.

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The proposer believes that a market price formulation better meets the applicable objectives and that the principal elements of the approach are defined in this proposal. Details of some aspects of the application of the proposal warrant consideration by the modification group. These include (but are not limited to):

- the size of the increment or decrement to the market price to determine the main price and whether it should be fixed
- the formulation for determining whether the market is long or short
- the definition of the default rules
- the interaction with RCRC.

However the proposer is of the view that the key features of the modification have been properly defined and the proposal should be sent to the assessment phase.

Urgency Recommended: No (delete as appropriate) (optional by originator)

Justification for Urgency Recommendation (mandatory by originator if recommending progression as an Urgent Modification Proposal)

N/A

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Attachments: No (delete as appropriate) (mandatory by originator)

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