Bringing choice and value to customers

National Grid Electricity Transmission plc,
BSC Signatories and Other Interested Parties

Our ref: BSC/Mod/P201&P202
Direct Dial: 020 7901 7389
Email: steve.smith@ofgem.gov.uk

07 September 2006

Dear Colleague,

Balancing and Settlement Code (BSC) Modification Proposal P201 "Energy Imbalance Tolerance Band" and P202 "Energy Imbalance Incentive Band" - Decision

Ofgem has carefully considered the issues raised, and the responses received, in respect of Proposed Modifications P201, "Energy Imbalance Tolerance Band" and P202, "Energy Imbalance Incentive Band" (the "proposals").

The BSC Panel (the "Panel") recommended that neither Proposed nor Alternative Modifications P201 and P202 should be approved. In the event that we determine that Proposed or Alternative Modifications P201 and P202 should be made, the Panel recommended an Implementation Date of 2 November 2006 where our decision is received on or by 7 September 2006. If our decision is received after this date but before 19 December 2006, the Panel recommended that the Implementation Date should be 28 June 2007.

Having considered the final Modification Reports[1] in respect of Proposed and Alternative Modifications P201 and P202, the Panel's recommendation and having had regard to the Applicable BSC Objectives[2] we have decided not to direct a modification to the BSC in line with Proposed or Alternative Modifications P201 or P202.

Background to the proposals

Ofgem approved BSC Modification Proposal P194 on 23 March 2006[3] and it is due to be implemented on 2 November 2006. This modification will change the way cash-out prices are calculated. Under the new arrangements only a predefined

[1]http://www.elexon.co.uk/changeimplementation/ModificationProcess/ModificationDocumentation/modProposalView.aspx?propID=219

[3] The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Electricity Transmission plc's 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 of the GB 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; and
d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

[3] The reasons for that decision can be found in Ofgem decision letter regarding modification proposal P194: "P194: Revised derivation of the main energy imbalance price", Ofgem, March 2006 .

volume of balancing actions will contribute to the calculation of a volume weighted imbalance price. This volume will be set to 100MWh (referred to as the 'Price Averaging Reference' (PAR) 100 Volume) of the most expensive balancing actions remaining following the tagging procedure.

The Modification Proposals

Utilita submitted Modification Proposal P201 "Energy Imbalance Tolerance Band" on 26 May 2006. Bizz Energy submitted Modification Proposal P202 "Energy Imbalance Incentive Band" on 7 June 2006.

P201 seeks to introduce a tolerance band for Imbalance Charges to Supplier Consumption Energy Accounts. Where a Supplier was short on its Consumption Energy Account and the System was short, the Party would be charged a Tolerance Price for the first 20 MWh of imbalance (rather than the Main Price). The Tolerance Price would be the Market Price adjusted to include a premium (plus 10%).

Proposed Modification P202 is identical to Proposed Modification P201 with the exception that the tolerance band would also apply where the Party was long and the system was long. In this situation, the Tolerance Price would be the Market Price minus 10%.

Alternative Modifications P201 and P202 remove the restriction to Suppliers (i.e. they would apply to all categories of BSC party); in addition the Tolerance Band would be reduced to 10 MWh.

The proposals seek to address a perceived defect that small suppliers face excessively high costs of balancing because of a lack of liquidity in the spot market and due to them having less access to balancing tools than larger players. The proposers are particularly concerned about the effect of higher imbalance charges once Approved Modification P194 is implemented on small suppliers.

BSC Modification process

The Panel considered the Initial Written Assessment at its meeting of 8 June 2006 and agreed to submit Modification Proposals P201 and P202 to the Assessment Procedure. The Modification Group (the Group) considered the Modification Proposals at three meetings. Elexon issued an Assessment Consultation on 11 July 2006, and published a final Modification Report (FMR) on 11 August 2006.[4]

Panel's recommendation

The Panel met on 11 July 2006 and voted by majority to recommend that the Authority reject the proposals.

Impact Assessment

Both proposals were granted urgency[5] in part because of their linkage to an imminent date-related event: the implementation of Approved Modification P194 on 2 November 2006.

[4] See footnote 1 for link to all relevant modification documents
[5] These decisions are published on our website here: http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/elecgov/egov01

We were mindful that were we to conduct an impact assessment then this would preclude our ability to reach a decision before 7 September 2006, and therefore the possibility that either proposal could be implemented by 2 November 2006, if approved. This would be inconsistent with the rationale for allowing these proposals to be treated as urgent. We therefore concluded that it was impracticable and inappropriate for us to conduct an impact assessment on these proposals.

Ofgem's views

Ofgem has carefully considered the views of respondents and the Panel in relation to the proposals. We do not think that it has been demonstrated that the proposals would better facilitate the achievement of the Applicable BSC Objectives compared to the existing baseline.

In this section we set out the reasons for this decision in the context of our assessment of the proposals against the relevant code objectives.

There are effectively four modification proposals to consider – P201 original, P201 alternative, P202 original and P202 alternative. Although we have considered the effect and relative merits of each Modification Proposal individually, the majority of arguments below apply to all four modifications. Unless stated otherwise, therefore, all points below should be taken to pertain to P201, P202 and their alternatives.

Objective (a) – the efficient discharge by the licensee (i.e. the Transmission Company) of the obligations imposed upon it by its licence

Assessment against objective (a) is covered by the discussion against objectives (b) and (c) below. We do not consider that the proposals better facilitate the achievement of objective (a).

Objective (b) – Efficient, economic and coordinated operation of the transmission system

The electricity cash out arrangements are designed to provide appropriate commercial incentives on market participants to balance their own positions to the extent that they are able to do so efficiently at lower cost than the System Operator (SO). This is because if parties do not balance their own positions it is necessary for the SO to resolve any imbalances to ensure that the overall system remains in balance at all times.

The current cash out arrangements provide these commercial incentives by charging market participants a price that reflects the costs the SO incurs in balancing the system. The proposals seek instead to provide market participants with an appropriate commercial incentive to balance by charging them a premium of 10% over the Market Price, for the first 20MWh of any imbalance, known as a tolerance band.

The majority of respondents considered that the proposals would reduce the commercial incentive on market participants to balance their own positions. This is supported by our own analysis based on publicly available information. The proposed tolerance band would reduce imbalance prices in 89% of periods when the system was short over the period that was assessed (between April 2004 and

March 2006)[6]. We also conducted this analysis using information on what prices would be under the P194 calculations and the outcome was only marginally different. This suggests that the imbalance price under the proposals would be lower for most periods, than under the current rules and the rules once P194 is implemented. We therefore agree that the commercial incentive to balance would be reduced if the proposals were implemented.

However, we do not think that sufficient analysis has been undertaken to understand whether a 10% premium on Market Price would continue to provide sufficient commercial incentive for parties to balance. Faced with an imbalance price within the tolerance band of the Market Price plus a 10% premium, market participants could be expected to balance if they expected transaction costs of trading out imbalances to be below 10% of the Market Price in that balancing period.

These transaction costs would vary for different parties but could include the costs of running twenty four hour trading desks, exchange fees and/or the cost of using a third party to trade on the participant's behalf. These costs are likely to be fixed and might not vary much from balancing period to balancing period. But the cost of not trading out the imbalance would vary with the Market Price and would be higher in periods where market prices are high. In the absence of analysis and evidence from the supporters of the proposals it is not possible to conclude that the proposals would provide an appropriate commercial incentive for all balancing periods.

This could give rise to a greater need for the SO to take balancing actions and this could, if the SO trades at a premium to the Market Price when it takes balancing actions and procures balancing services, give rise to higher balancing costs and reduced efficiency.

Further, the analysis and evidence provided in the assessment of the proposals does not consider the potential longer term effects of the proposals. The market price will reflect the supply and demand balance prior to gate closure. The supply and demand balance may change post gate closure if, for example, there was a sudden and unexpected loss of generation capacity or a change in demand. This could give rise to circumstances where the SO has to take balancing actions at much higher prices than the Market Price prior to gate closure reflecting the change in the supply/demand balance. Under the existing rules market participants who were out of balance would be exposed to the costs incurred by National Grid Electricity Transmission PLC (NGET), as SO, in resolving this imbalance. But if the proposals were implemented, all participants who were out of balance would only be exposed to the lower tolerance price for the first 20MWh, or in the case of the alternatives 10MWh, of any imbalance.

This could undermine their longer term incentives to seek to manage their imbalances. For a generator, this exposure to a lower price could undermine their incentive to invest to maintain their plant and manage the risk of any unplanned outages. For a supplier, this could lower their incentive to invest in better demand forecasting or metering technology to allow them to more accurately forecast their demand. If these incentives were undermined in this way, it would lead to the SO having to take more balancing actions and less efficient system operation over time. This potential effect has not been analysed or considered in the assessment of the proposals.

[6] This analysis is based on proposal P201. For proposal P202, prices are affected in 87% of periods.

We have, therefore not been able to conclude that the proposals better facilitate the relevant objective (b) on the basis of the lack of analytical evidence put forward either in support or opposition to them.

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 proposers of P201 and P202 (and some respondents) consider that the proposals will increase competition because under the current rules, and more so under P194, small suppliers are unfairly disadvantaged due to their lack of access to balancing tools such as upstream generation, and the proportionately higher cost to them of purchasing small volumes to balance their positions. In this section we set out our views against the key issues raised.

Liquidity

The proposers are concerned that liquidity in the electricity market has declined and that minimum tranche sizes available are greater than the purchase requirements of many small suppliers.

Analysis carried out by APX, as part of the assessment of the proposals, shows that over a quarter of all trades are for volumes below 10MWh. 97.3% of orders that are submitted into APX's Spot and Prompt market are able to be matched in increments of 1 MWh up to their maximum specified volume. Only 2.7% of the orders are submitted with the constraint that they can only be matched at the full submitted volume.[7]

As a result of this analysis, both the majority of respondents to the consultation and the majority of the Panel expressed the view that there was no evidence of the perceived defect that the proposals are seeking to address. Ofgem agrees that it has not been demonstrated that such a defect exists.

The argument was also put forward that a 20MWh (and to a lesser extent a 10MWh) tolerance band would reduce the demand for small volume products, thus reducing liquidity in the market as these products would no longer be provided.

Ofgem agrees with those respondents that suggest a tolerance band as defined by the proposals may lead to a reduction in liquidity, which is likely to be detrimental to the long term development of the market and competition. We do not consider that it has yet been demonstrated that existing tools are inadequate to assist small players to balance their positions.

Furthermore, it has not been demonstrated that barriers exist to the use of other tools, such as consolidation/aggregation services, that might assist smaller players to balance their positions. We are of the view that the sharper imbalance signals that will exist under Approved Modification P194 will mean there are greater incentives on such players to seek more innovative solutions to manage their imbalance risk, rather than leaving it to NGET, as SO, to undertake this role for them.

---

[7] APX's analysis appears in full on the Elexon website: http://www.elexon.co.uk/documents/modifications/202/P201P202AC_Attachment1_APXAnalysis.pdf

Competition and distributional effects

The proposers and some respondents argue that small suppliers can only balance their positions at a disproportionate cost, as a result of the current trading rules which they say encourage integration and consolidation. They consider that the introduction of a tolerance band would encourage competition among existing players and remove a barrier to entry. However, other respondents felt that the proposals would distort competition by giving an undue competitive advantage to small suppliers.

It is possible to design arrangements that would introduce cross subsidies, for example between small and larger suppliers that seek to promote competition by encouraging participation in the market. However this will not have the effect of promoting effective competition in either the short or the long run and this could even promote ineffective competition by encouraging inefficient entry into either the wholesale or retail markets.

In a market with effective competition, those companies who are best able to balance their positions (and hence impose less costs on consumers) will be rewarded with a competitive advantage through lower costs. To the extent that these proposals socialise the costs of imbalance, more efficient parties may have to pay a share of the costs of less efficient parties that are not seeking to, or are not able to actively manage their own imbalance positions. These companies could therefore lose the legitimate competitive advantage they would otherwise have over parties that are less efficient at balancing their positions.

The proposers have argued that these proposals duly discriminate in favour of small suppliers, who are disadvantaged by the current market rules. We consider that there has not been sufficient evidence presented during the modification process to demonstrate this. The alternative argument is that larger players have a legitimate advantage over smaller players given their scale, or business models, which result in them not facing the same degree of imbalance exposure risk. It also could be the case that smaller suppliers could access such benefits through consolidation services. However, this issue was again not sufficiently explored through the modification process.

Having considered the available evidence, we consider that on balance it has not been demonstrated that the proposals will better facilitate relevant objective (c), the promotion of effective competition in the generation and supply of electricity when compared to the current baseline.

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

Implementation costs

Ofgem notes the £560,000[8] cost to central systems that NGET has estimated for implementation of either of the proposals or their alternatives.[9] We note that there has been a 'workaround' solution developed to enable implementation of the proposals in parallel with Approved Modification P194. This workaround solution would incur a further administration cost of between £52,000 and

[8] Around £290,000 of this would be change-specific (i.e. not associated with the costs of the general release).
[9] Service provider costs would be approximately £5000 higher for implementation of either alternative.

£61,000. We agree with the Panel view that these combined costs are significant, and therefore on balance do not promote efficiency in the implementation and administration of the balancing and settlement arrangements.

Complexity

The introduction of a tolerance band and corresponding tolerance price as defined by the proposals would add increased complexity to the cash out arrangements. The arrangements are already complicated and can be burdensome for industry (and potential new entrants to the industry) to understand and follow. Additionally, the introduction of the required workaround solution would further increase the complexity of these arrangements.

Overall, relative to the other relevant code objectives, we do not consider the impact on promoting efficiency in the implementation and administration of the BSC arrangements to be a major consideration in determining our final view on these proposals. However, we believe that the impact of the estimated implementation costs and increased complexity of both proposals would, on balance, not better facilitate the achievement of relevant objective (d).

Assessment against Ofgem's other statutory duties

Since we do not consider that the modification proposals have been demonstrated to better facilitate the Applicable BSC Objectives we have not considered the proposals against Ofgem's wider duties.

Ofgem's decision

For the reasons outlined above, Ofgem considers that neither Proposed nor Alternative Modifications P201 and P202 would better facilitate the achievement of the Applicable objectives set out in Standard Condition C3 (3) of NGET's Transmission Licence.

Therefore, Ofgem has decided not to direct a modification to the BSC.

Areas for further industry review

We note that other proposals to modify the electricity cash out arrangements are currently under consideration and will be coming to Ofgem shortly for decision. After decisions have been taken on those modification proposals, Ofgem would like to consider further the issues raised by the current proposals, and whether there are options which better address the defects identified.

If you have any questions, please contact Ben Woodside on 020 7901 7471.

Yours sincerely,

Stephen Smith
Managing Director, Markets
Signed on behalf of the Authority and authorised for that purpose by the Authority