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The National Grid Company, BSC Signatories and
Other Interested Parties

09 December 2004

Our Ref: MP No P181 Urg

Dear Colleague,

Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal Modification Proposal P181 “NGC Emergency Instruction re Damhead Creek19.5.04: Deferral of Settlement Process”.

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P181 “NGC Emergency Instruction re Damhead Creek19.5.04: Deferral of Settlement Process”.

The BSC Panel (the “Panel”) recommended to the Authority that Proposed Modification P181 should not be made, but, in the event the Authority determines Proposed Modification P181 should be made, the Panel recommended an Implementation Date of 2 Working Days following an Authority Decision; and the proposed text for modifying the Code, as set out in the Urgent Modification Report.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives³ and the Authority’s wider statutory duties,⁴ the

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

² ELEXON document reference P181MR, Version No. 1.0, dated 03/12/04.

³ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of NGC’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 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) 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.

Authority has decided to direct a Modification to the BSC in line with Modification Proposal P181.

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

This letter constitutes notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

Background

On 19 May 2004 the first Emergency Instruction in the operation of NETA was issued to stop Damhead Creek Power Station exporting electricity to the Transmission System. The order was issued following the discovery of a piece of high voltage equipment showing signs of distress, such that it needed to be taken out of service in order to prevent the development of an unsafe situation which might have arisen, had the export of electricity from the power station continued.

The current baseline of the BSC classifies an Emergency Instruction issued in respect of a Balancing Mechanism ("BM") Unit⁵ as an Acceptance⁶ for the purposes of Settlement. Acceptances resulting from Emergency Instructions are not distinguished within Settlement from other Acceptances. An Acceptance Volume⁷ has the following effect:

- a payment is made to the Lead Party of the affected BM Unit as a result of the Bid Acceptance at the prevailing Bid or Offer price,
- a payment is made from the Transmission Company to the Lead Party of the affected BM Unit as a result of the Bid Acceptance. This amount will eventually be recovered from all Parties via BSUoS charging outside the BSC, and
- the Acceptance Volume feeds into the Imbalance Price calculation at the prevailing Bid or Offer price, which may impact imbalance payments and the Residual Cashflow Reallocation Cashflow (RCRC) for all Parties

The particular circumstances surrounding the Emergency Instruction to Damhead Creek Power Station meant that the prevailing Bid Price for a large proportion of the Acceptance Volume was £-9,999/MWh.

NGC postponed the submission of the Acceptance Data (to Settlement) due to the likely Settlement implications for Market Participants, and a Trading Dispute was subsequently raised by Damhead Creek Power Station in order to include the Acceptance Data in Settlement. The Trading Disputes Committee (TDC) heard the Trading Dispute on 19 August 2004 and agreed that a Settlement Error had occurred. In accordance with paragraph W4.1.1 of the BSC, the TDC directed that a Bid Acceptance should be entered into Settlement in the R3 Reconciliation Run on 15 December 2004. Inclusion of the Acceptance Data impacts the calculation of System Sell

⁴ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

⁵ In accordance with BC2.9, excluding BC2.9.1.2(e) of the Grid Code.

⁶ As defined in section Q 5.1.3 of the BSC.

⁷ The Acceptance Volume is a quantity of absolute MW for any spot time (a moment of use).

Price (SSP) for the relevant periods. ELEXON's initial estimate of the revised SSPs which will result from the inclusion of the Bid Acceptance was:

- -£96.68/MWh in Settlement Period 27⁸, and
- -£5,870.87/MWh in Settlement Period 28.

As a result, those Parties with a long position in those periods are facing a considerable imbalance exposure as they will have to pay for their imbalance volume at these extreme SSPs. As mentioned above, the TDC decision was that the Acceptance Data associated with the Emergency Instruction at Damhead Creek would feed into settlement, and hence affect imbalance payments and RCRC, on 15 December 2005.

The perceived defect highlighted by the Emergency Instruction issued to Damhead Creek Power Station is also the subject of consideration of Modification Proposals P171/2/3/5.

In order to temporarily address this situation, Economy Power Limited submitted Modification Proposal P181 "NGC Emergency Instruction re Damhead Creek 19.5.04: Deferral of Settlement Process" on 16 November 2004 on the grounds that these charges could adversely affect the trading activities and ability to compete in the market of some Parties.

The Modification Proposal

Modification Proposal P181 seeks to modify the BSC so as to delay the introduction of Acceptance Data related to the Damhead Creek Emergency Instruction into the settlement process until the Reconciliation Final ("RF") Run for 19 May 2004. This would cause the Trading Charges associated with the Emergency Instruction to be realised in July 2005, rather than on 15 December 2004, as would otherwise be the case. It would also cause Parties due to receive an overall payment from the Emergency Instruction to be subject to a similar delay in receipt of this payment. The delay also means an Authority determination on P171/2/3/5 may be made prior to the Acceptance Data being entered into Settlement.

The Panel were of the view P181 should be treated as urgent, on the grounds of its link to an imminent date related event, consequentially the Panel requested the Authority grant urgent status. The Authority granted urgency on 18 November 2004 and the modification was progressed to an urgent timetable. The Pricing Standing Modification Group (the Group) met twice (on the 22 and 30 November 2004) to consider P181 and provide a recommendation to the Panel on whether or not P181 would better facilitate the Applicable BSC Objectives.

It was suggested by the Group that the implications of such a delay in the application of the charges were in terms of how interest is accounted for between Reconciliation Runs. The Group noted that Under Section N 6.4.2 of the BSC, interest is paid on Reconciliation Trading Charges at the Base Rate. The Group considered that, as Reconciliation Trading Charges account for interest between Runs at the Base Rate, the materiality of P181 is the difference between the Base Rate⁹ and the 'capital rate' an individual Party could earn (or must pay) outside the Code. This was defined as:

⁸ NB: A negative SSP will mean that a Party who was 'long' during the Settlement Period will pay the absolute value of SSP for its imbalance volume (rather than receive it).

⁹ The rate of interest defined in the BSC.

- for Parties due to benefit from the Damhead Creek Acceptance would be at a Dis-Benefit of $[R3 \text{ Payment} * (\text{Individual Party's Capital Rate} - \text{Base Rate}) * \text{Time from R3 to RF}]$, and
- for Parties due to dis-benefit from the Damhead Creek Acceptance would be at a Benefit of $[R3 \text{ Charge} * (\text{Individual Party's Capital Rate} - \text{Base Rate}) * \text{Time from R3 to RF}]$.

The Group considered P181 would create a cross subsidy, from those Parties due to benefit from the Damhead Creek Emergency Instruction, acting in favour of those due a disbenefit, as those due to benefit from the Emergency Instruction could be seen as providing credit to those facing a disbenefit. The Group considered that to allow this situation would be to the detriment of Applicable Objective (c). The Group also noted that these circumstances have been present between SF and R3, due to the delay in entering the Acceptance into Settlement at the SF Run, and that P181 would prolong this situation.

It was the view of the Group that the detrimental impact on Parties which would be a consequence of charging at R3, rather than RF, would effectively relate to the difference between the cost of these Parties obtaining credit and the Base Rate. In addition, it was noted that there may be a similar detrimental impact on some Parties should P181 be implemented. The Group considered that, in the absence of any knowledge of individual Party's capital rates and exposure to the Emergency Instruction, the impact of not implementing P181 on any other sector of the market (e.g. supply/generation or large/small Parties) could not be judged more material than the impact on another sector if the change were to be implemented. It was noted that a Party's ability to minimise its cost of capital was a legitimate source of competitive advantage and P181 proposes to remove an element of this.

It was the view of the Group that the deferral of Trading Charges between Reconciliation Runs, as proposed by P181, effectively defers a liability and, during the deferral period, the market as a whole underwrites this liability, leading to an increased risk. The Group considered this would be detrimental to Applicable Objective (c). It should be noted that this point was raised in relation to deferral of Settlement in general, rather than in relation to any of the individual Parties affected by the issues raised under P181.

The Group considered that, were P181 Approved, a precedent could be set for Parties to request delays to invoices in future situations or to circumvent the process under which TDC decisions are determined. The Group was concerned that, were deferral granted in the limited circumstances identified in P181, similar arguments might be applied in the future, despite this not being the original intention. As the Group generally viewed the deferral of payments as detrimental to competition this was seen as a concern by the majority of members. The majority of the Group considered that creating such a precedent may undermine the provisions of processes under the BSC, and that the negative impact in terms of efficiency and the prolonged uncertainty surrounding the settlement process would be detrimental to the achievement of Applicable Objectives (c) and (d). Whilst this was the case, other members of the Group were of the opinion that the Authority considers each Modification Proposal individually and no precedents are set, meaning that such arguments should not be considered when assessing P181. The Group noted an additional point raised in this area via consultation that, were it considered acceptable to delay payments in the limited circumstances of P181, this could set a materiality threshold against which future delays could be requested.

When the TDC made its ruling on the rectification of DA223 (the Damhead Creek Trading Dispute), it was decided that rectification should occur at the R3 Run. It was noted by the Group, that the TDC determination to uphold the Damhead Creek Trading Dispute had been made on 19 August 2004, such that impacted Parties have had 4 months notice of liabilities due to be incurred in the R3 Run. Therefore, impacted Parties have had 4 months to make arrangements in relation to these liabilities.

The Group noted that one consultation respondent had put forward a potential Alternative Modification, whereby the payment for the Emergency Instruction Bid Acceptance (to the affected BM Unit from the Transmission Company) would be retained whilst the remainder of Settlement would be conducted with this Acceptance omitted. It was the view of the Group that the fundamental concerns raised by P181 would not be addressed by the Alternative Modification and that the proposed Alternative was too complex. In addition, some members of the Group considered that this solution would not form a valid modification on the grounds that the defect identified under P181 related to the entry into Settlement of specific Acceptance Data, rather than the deferral or non-deferral of individual cashflows.

Responses to ELEXON Consultation

ELEXON published an Urgent Modification Consultation on 23 November 2004, which invited respondents' views by 12pm on Monday 29 November 2004. Eleven responses were received. Two responses (representing 2 Parties and 0 non-Parties) expressed support for the Proposed Modification, eight responses (representing 45 Parties and 0 non-Parties) opposed the Proposed Modification and the remaining response (representing one Party and 0 non-Parties) provided a "no comment" response.

The key arguments expressed by those in support of P181 included:

- small Suppliers would be affected disproportionately by the Emergency Instruction. This is because small Suppliers are more likely to be long than large Suppliers due to NETA incentives, and
- P181 would remove an unintended consequence of a rule that if left in place will distort competition.

The key arguments expressed by the majority not in support of P181 included:

- P181 would impact cash-flows by delaying payments due to or from Parties. A cross-subsidy would result from those who benefited from the issuing of the Emergency Instruction, to those who lost out. While this has already occurred between the SF and R3 runs due to the initial delay in data entry; respondents argued that Proposed Modification P181 would prolong this situation if implemented,
- delaying payments would place a risk on the rest of the industry in terms of deferred liabilities,
- the implementation of Proposed Modification P181 could set a precedent for overturning a TDC determination via a Modification,
- the implementation of Proposed Modification P181 could set a precedent which would encourage Parties to raise Modification Proposals to defer Settlement if substantial amounts of money were involved,

- some respondents believed that any benefits that could be realised under P181 were contingent on P171 and could not be taken into account in the assessment of P181 against the existing baseline, and
- one of these respondents stated any efficiency benefits that would be realised under P181 were P171 also Approved would be negligible, on the basis that all Parties would be receiving invoices at the R3 Run with or without P181 and only the amounts on these invoices would vary.

The Urgent Modification Report for Modification Proposal P181 includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 2 December 2004 and considered the draft Urgent Modification Report. Having noted the contents of the draft Urgent Modification Report and consultation responses, the Panel agreed the contents of the Urgent Modification Report which was issued to the Authority on 3 December 2004.

The Panel recommended that the Authority should reject the Proposed Modification but, if approved, the Proposed Modification should be implemented 2 Working Days following an Authority Decision.

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that Proposed Modification P181 will better facilitate achievement of Applicable BSC Objective (c).

The Emergency Instruction issued to Damhead Creek Power Station was the first such event since NETA GoLive. Ofgem notes that the acceptance data arising from this event resulted in the derivation of extreme prices. In raising this Modification Proposal the Proposer noted that its trading activities and ability to trade effectively in the market will be adversely affected were P181 not accepted. Ofgem notes that the Proposer and other market participants consider that these events have had a significant material effect on certain Parties. Ofgem acknowledges the significant material effect on some Parties arising as a result of the Emergency Instruction.

The effect on Parties discussed above has been brought about by a perceived deficiency in the arrangements, which industry participants generally agree it is appropriate to address. Indeed, a group of Modification Proposals are being progressed with the intention that a solution to this perceived defect may be found. One of these modifications seeks retrospective implementation and would, if approved, result in a reversal of the payments that P181 is seeking to delay. Ofgem is not yet in a position to reach a decision on these Modification Proposals as it has not as yet received the relevant Modification Reports. Given these specific circumstances, it is Ofgem's view that to allow potentially material Trading Charges to be visited on affected market participants before it has carried out proper assessment and consideration of the deficiency and the possible solutions would be contrary to the interests of competition in the generation and supply of electricity and Applicable Objective (c).

A group of Modification Proposals are being progressed with the intention that a solution to this problem may be found. Ofgem notes that, whilst it may prove to be inappropriate to address circumstances pertaining to the Damhead Creek incident by way of a retrospective alteration to the BSC, it is possible that such a solution could be developed. Ofgem acknowledges that delaying the application of these Trading Charges may have a negative effect on the competitive position of those market participants who are due to receive rather than make payments which are affected by the inclusion or otherwise of the relevant acceptance data. Whilst this is the case it is Ofgem's view that, on balance, the achievement of the Applicable Objectives is better facilitated by a postponement of these Trading Charges as suggested in P181.

The considerations of the Group in relation to the materiality of P181 focussed on the difference between the Base Rate of interest defined in the BSC and the capital rate which a party would pay (or could earn) outside the BSC. Ofgem notes that the cost of working capital varies between companies and that the interest rates allowed under the BSC have been agreed as a neutral rate for Parties which may receive, or become liable to settlement sums.

Industry participants have noted that the solution proposed by P181 effectively defers a liability, and during the deferral period, the market as a whole underwrites the liability leading to increased risk. Whilst Ofgem accepts that deferral of the liabilities could lead to an increased risk of default, it is by no means clear that this would be anything more than negligible.

Submissions have been made to the effect that the implementation of P181 may create a precedent concerning delay to invoices in future situations. Ofgem considers that the specific circumstances surrounding P181, particularly the agreement of industry participants that a defect exists, and the magnitude of that defect, should be sufficient to allay concerns about injudicious precedent setting.

However, on balance, Ofgem considers P181 will better facilitate Applicable Objective (c), as the approval of this modification will alleviate the adverse material affects arising as a result of the exceptional market circumstances surrounding the Emergency Instruction to Damhead Creek Power Station and which would otherwise vest upon certain market participants.

Ofgem notes that nothing in this decision letter, whether taken in part or as a whole, should be construed as fettering the Authority's discretion to determine any of the Modification Proposals seeking to address the perceived defects highlighted by the Emergency Instruction to Damhead Creek Power Station or to any other related Modification Proposal to the BSC which may be raised in the future.

If you have any questions, please contact me on the above number.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'N. Simpson', written over a horizontal line.

Nick Simpson
Director, Modifications

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