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24 June 2005

Our Ref: MP No P175

BSC Signatories, National Grid Company  
and Other Interested Parties

Dear Colleague

**Modification to the Balancing and Settlement Code (“BSC”) – Decision in relation to Modification Proposal P175: “Development of Provisions related to certain Bid-Offer Acceptances issued pursuant to the Grid Code (e.g. BC2.9 and BC2.10)”**

The Gas and Electricity Markets Authority<sup>1</sup> (the “Authority”) has carefully considered the issues raised in the final Modification Report<sup>2</sup> in respect of Modification Proposal P175 “Development of Provisions related to certain Bid-Offer Acceptances issued pursuant to the Grid Code (e.g. BC2.9 and BC2.10)”.

The BSC Panel (the “Panel”) recommended to the Authority that Proposed Modification P175 should not be made. In the event that the Authority determines that the Proposed Modification P175 should be made, the Panel recommended an Implementation Date of five working days following an Authority Decision.

Having carefully considered the final Modification Report in respect of Proposed Modification P175 and the Panel’s recommendation, and having regard to the Applicable BSC Objectives<sup>3</sup>

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<sup>1</sup> Ofgem is the Office of the Authority. The terms “Ofgem” and “the Authority” are used interchangeably in this letter.

<sup>2</sup> Elexon document references P175DMR, Version No. Final/1.0, dated 19 January 2005.

<sup>3</sup> The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Company’s (“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.

and the Authority's wider statutory duties<sup>4</sup>, the Authority has decided not to direct a Modification to the BSC to be made as the Authority does not consider that the proposal would better facilitate achievement of the Applicable BSC Objectives.

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

## **Background**

### *Cash out arrangements*

The Balancing Mechanism ("BM") was designed as a tool to assist National Grid Company plc ("NGC"), as the System Operator ("SO"), to keep the transmission system in balance close to, and in, real time by providing a mechanism to adjust levels of generation and demand through the acceptance of Bids and Offers submitted to the BM ("Electricity Balancing"). The SO also uses the BM, amongst other things, to ensure that the system remains within safe operating limits, and that the pattern of generation and demand is consistent with any transmission system constraints ("System Balancing"). System Balancing actions include, but are not limited to, frequency control and the alleviation of locational constraints. The SO also has commercial freedom to trade in the other short term markets and to contract with generators, suppliers and customers to balance the system.

Under the rules of the BSC, a Party is in a position of imbalance if its notified contract volume does not match its metered volume, i.e. the Party is producing (or consuming) electricity which has not been sold (or bought) and is therefore not covered by contracts. Imbalance settlement, or 'cash out', is designed so that any electricity produced or consumed that is not covered by contracts is paid for at, or charged at, a cost reflective price. The arrangements are designed to target the costs that NGC has incurred in buying and selling electricity to match generation and demand onto those Parties that are in imbalance, i.e. those Parties on behalf of which the SO has taken Electricity Balancing actions.

Parties that are 'long' when the market as a whole is 'short' (i.e. generators whose physical output exceeds their contracted volume or suppliers whose customers' demand is less than their contract volume when total demand on the system is greater than the total supply of generation), are not, in any meaningful sense, contributing to balancing the system (except inadvertently). The converse is true for parties who are short when the market is long. Parties with imbalances in the opposite direction to the system can also impose costs on the system (these are the costs associated with the need for a generator or supplier to change its output at short notice) as their contribution to balancing is not guaranteed, requiring the SO to manage the resulting risks.

A dual cash out mechanism exists, in which there are two Energy Imbalance Prices, or 'cash out prices': the System Buy Price ("SBP") and the System Sell Price ("SSP"). Parties that are short are generally charged the SBP for their imbalance volumes and Parties that are long generally receive SSP for their imbalance volumes. These prices apply whether the system itself is long or short. In reflecting the costs that parties in imbalance impose on the system, a dual cash out mechanism provides incentives for parties to contract ahead to meet their customers' demands, as those Parties that are long are likely to receive a lower price for electricity via imbalance

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<sup>4</sup> 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.

settlement than if they had been fully contracted. Similarly, parties that are short are likely to pay a higher price for electricity via imbalance settlement than if they had been fully contracted.

Since NETA Go-Live<sup>5</sup>, in the light of experience gained under the new arrangements, a number of modifications<sup>6</sup> have been made to the way in which Energy Imbalance Prices are calculated as a result of concerns that the rules did not give rise to prices that reflected costs and market conditions on the grounds that the proposed changes would increase the likelihood of this happening<sup>7</sup>. These modifications include the introduction of the Continuous Acceptance Duration Limit (“CADL”)<sup>8</sup> and changes to the treatment of contracts in the calculation of the Energy Imbalance Price. Approved Modification P78 was introduced to address a potential defect in the methodology for calculating Energy Imbalance Prices used at that time which resulted in high levels of SBP that did not reflect the costs that NGC was incurring to balance the system and were considered to be driving the market long, as discussed above.

Approved Modification P78<sup>9</sup> was submitted by NGC on 5 April 2002 in response to concerns expressed by both NGC and market participants that cash out prices were reflective of costs associated with both System Balancing and Electricity Balancing<sup>10</sup>. It was also suggested that SBP was being distorted by System Balancing costs more frequently than SSP and hence the spread between SBP and SSP was larger than would be the case if System Balancing costs were correctly excluded. This, in turn, was creating asymmetric risks for Parties, in response to which they were tending to go long to avoid exposure to a high SBP, with the result that the market itself was long overall.

Approved Modification P78 introduced a mechanism into the BSC to remove a category of acceptances taken for System Balancing reasons from the calculation of cash out prices. Under Approved Modification P78 these acceptances were considered to be characterised by equal and opposite compensatory actions which, in general, were being taken by the SO for System Balancing reasons, for instance the alleviation of locational constraints. Approved Modification P78 also sought to change the derivation of cash out prices such that there would be a ‘main’ price and a ‘reverse’ price. It proposed that the reverse price would be derived from a market price based on short-term energy trades made in the forward and spot markets. The main price

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<sup>5</sup> NETA Go-Live occurred on 27 March 2001.

<sup>6</sup> Approved Modification P10 “Eliminating Imbalance Price Spikes caused by Truncating Effects” was implemented in May 2001 to remove spurious Bid-Offer Acceptances (“BOAs”) for small volumes that resulted in price spikes that did not reflect the costs incurred by NGC in achieving energy balance.

Approved Modification P18A “Removing/Mitigating the Effect of System Balancing Actions in the Imbalance Price” was made in September 2001 to remove actions taken for System Balancing rather than Electricity Balancing reasons from the calculation of Energy Imbalance Prices and to remove Bids and Offers with a duration of less than 15 minutes.

Approved Modification P8 “Introduction of a Price Adjuster to reflect Option Fees for Balancing Services Contracts in setting System Buy Price and System Sell Price” introduced an adjustment mechanism to reflect option fees for balancing services contracts in the calculation of Energy Imbalance Prices.

Approved Modification P78 “Revised Definitions of System Buy Price and System Sell Price” removed further System Balancing actions from the calculation of Energy Imbalance Prices.

<sup>7</sup> In addition, on 2 May 2002, the Authority accepted BSC Modification Proposal P12 “Reduction of Gate Closure from 3.5 hours to 1 hour”, which was implemented on 2 July 2002.

<sup>8</sup> Approved Modification P18A: CID definition 1a.

<sup>9</sup> The Authority’s decision in respect of Approved Modification P78 “Revised Definitions of System Buy Price and System Sell Price” was published on 9 September 2002 and can be found on the Elexon website: [www.elexon.co.uk](http://www.elexon.co.uk).

<sup>10</sup> Since System Balancing costs cannot currently be attributed to particular users they are excluded from the calculation of imbalance cash out prices.

would be derived using a volume weighted average of all the eligible<sup>11</sup> Electricity Balancing actions taken by the SO to alleviate the Net Imbalance Volume (“NIV”) <sup>12</sup>. Under the proposal the main price would apply to imbalances in the same direction as the overall system imbalance and the reverse price would apply to imbalances in the opposite direction. On 9 September 2002, the Authority decided to direct that Approved Modification P78 should be made. Approved Modification P78 was implemented on 11 March 2003.

In summary, the rules used to set cash out prices are designed to produce prices for each half hour Settlement Period that reflect the costs that NGC incurs in balancing generation and demand on the system. Cash out prices are crucial in sending appropriate price signals and creating the right commercial incentives on companies necessary to maintain security of supply. For suppliers, the potential to be exposed to high cash out prices during periods of peak demand provides the incentive to contract with generators in advance to meet their customers’ peak demand. For generators, the potential to be exposed to high cash out prices following, for example, a mechanical failure, during periods when margins are tight provides an incentive to maintain plant and to contract with other peaking plant to provide physical cover.

### *Emergency Instructions and intertrips*

#### *Treatment of Emergency Instructions and intertrips under the Grid Code*

Under the Grid Code, NGC can issue Emergency Instructions, which may require BM Units to operate outside their submitted parameters, in order to preserve the integrity of the transmission system<sup>13</sup>. NGC can issue an Emergency Instruction to increase or decrease generation or demand in certain circumstances<sup>14</sup>. An Emergency Instruction can only be rejected by the relevant transmission system user on safety grounds<sup>15</sup>. The Grid Code states that an Emergency Instruction issued to a BM Unit is treated as a Bid-Offer Acceptance (“BOA”), unless it is rejected by the transmission system user or the Grid Code explicitly states to the contrary<sup>16</sup>.

The Grid Code also highlights that when NGC issues an instruction or notification to switch an operational intertripping scheme into or out of service with the result that there is a change in the input or output level of the affected BM Unit, NGC shall issue a BOA or Emergency Instruction, as appropriate<sup>17</sup>.

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<sup>11</sup> Defined as actions that are not: Bids or Offers which have a Continuous Acceptance Duration of less than 15 minutes; De Minimus accepted Bids or Offers; Arbitrage accepted Bids or Offers; NIV Tagged Bids or Offers; or System actions identified in the BSAD methodology.

<sup>12</sup> The NIV is calculated by netting off all purchase actions against all sell actions to give the imbalance of the overall System.

<sup>13</sup> See Grid Code BC2.9.1 and BC2.9.2.

<sup>14</sup> See Grid Code BC2.9.1.2.

<sup>15</sup> See Grid Code BC2.9.2.1.

<sup>16</sup> Grid Code BC2.9.2.3 states that a BOA will not be issued for provision of the Maximum Generation Service, during the Black Start process or the re-synchronisation of a de-synchronised island.

<sup>17</sup> See Grid Code BC2. 10.

*Treatment of Emergency Instructions and intertrips under the BSC when Modification Proposal P175 was raised*

The BSC specifies that these types of Grid Code instructions (referred to in this letter as “deemed Grid Code Acceptances”) shall be classed as Acceptances for the purpose of Settlement<sup>18</sup>. When Modification Proposal P175 was raised, the BSC specified that deemed Grid Code Acceptances were to be handled within Settlement consistent with other Acceptances. Therefore, as for other Acceptance Volumes, deemed Grid Code Acceptances have the following effect:

- ◆ the Lead Party<sup>19</sup> of the affected BM Unit will be paid (or pay) for the Acceptance at the prevailing Bid or Offer price;
- ◆ a payment will be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance, with an associated impact on Balancing Services Use of System (“BSUoS”) charges for all Parties; and
- ◆ the Acceptance Volume feeds into the cash out price calculation at the prevailing Bid or Offer price, which may, subject to the tagging rules, impact imbalance payments and the Residual Cashflow Reallocation Cashflow (“RCRC”) for all Parties.

This treatment applied in the case of the Damhead Creek incident, which is outlined below.

*Damhead Creek incident*

On 19 May 2004, NGC determined that a piece of high voltage equipment was showing signs of distress and needed to be taken out of service as soon as possible in order to prevent an unsafe situation. The location of the distressed equipment meant that it was necessary to stop Damhead Creek Power Station exporting to the transmission system. At 12:51 BST on 19 May 2004, NGC issued an Emergency Instruction to Damhead Creek to perform a controlled shutdown and desynchronise the BM Unit as quickly as possible. The power station complied with the instruction and the equipment was isolated safely.

As outlined earlier, under the then prevailing BSC baseline, Acceptances resulting from Emergency Instructions were not distinguished within Settlement from other Acceptances. In this case, Damhead Creek’s prevailing Bid price for a large proportion of the Acceptance Volume was -£9,999/MWh. Elxon has estimated that the inclusion of the Acceptance data<sup>20</sup> associated with the Emergency Instruction would result in SSP being:

- ◆ -£96.68/MWh<sup>21</sup> for Settlement Period 27; and
- ◆ -£5,870.87/MWh for Settlement Period 28.

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<sup>18</sup> See BSC Q5.1.3 (b) and Q5.1.5.

<sup>19</sup> The Lead Party is the Party registered to the BM Unit pursuant to Section K3 of the BSC.

<sup>20</sup> The acceptance data was not initially included in Settlement. The Trading Disputes Committee subsequently heard a Trading Dispute and directed that a Bid Acceptance should be entered into Settlement in the R3 Reconciliation Run on 15 December 2004.

<sup>21</sup> 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).

### *Subsequent revision to the treatment of Emergency Instructions under the BSC*

However, the way in which Acceptances linked to Emergency Instructions are treated in the calculation of cash out prices has been revised since Modification Proposal P175 was raised due to the Authority's approval of Modification P172 ("Removal of Emergency Instructions taken for System reasons from Imbalance Price").

Modification P172 was submitted on 25 August 2004 by British Gas Trading ("BGT") and it revised the way in which Acceptances linked to Emergency Instructions are included in the calculation of cash out prices. Modification P172 gives NGC, as SO, the discretion to identify whether an Emergency Instruction was issued for Electricity Balancing reasons or for System Balancing reasons. In the event that an Emergency Instruction is flagged by NGC as being an Electricity Balancing action, it would be treated no differently from any other Acceptance within Settlement, as outlined above. However, in the event that an Emergency Instruction is flagged by NGC as being a System Balancing action, it would be distinguished within Settlement. As a result of Modification P172, a System Balancing Emergency Instruction Acceptance will be treated within Settlement as follows:

- ◆ the Lead Party of the affected BM Unit will be paid (or pay) for the Acceptance at the prevailing Bid or Offer price (as was previously the case);
- ◆ a payment will be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance with an associated impact on BSUoS charges for all Parties (as was previously the case); and
- ◆ the Acceptance Volume will feed into the cash out price calculation as an unpriced volume.

Therefore, Modification P172 has revised the treatment of System Balancing related Emergency Instructions Acceptances by making them unpriced Acceptance Volumes for the purposes of calculating cash out prices.

Modification P172 was approved by the Authority on 29 April 2005 and it was implemented on 9 May 2005. Therefore, this decision on Proposed Modification P175 is made against the BSC baseline following the approval of Modification P172.

### **The Modification Proposal**

In response to its concerns about the potential for cash out prices to be affected by deemed Grid Code Acceptances in the future and to seek to ensure that parties can be effectively remunerated for any costs associated with such Acceptances, on 1 October 2004 RWE Npower submitted Modification Proposal P175: "Development of Provisions related to certain Bid-Offer Acceptances issued pursuant to the Grid Code (e.g. BC2.9 and BC2.10)".

Modification Proposal P175 seeks to amend the way in which Emergency Instructions and intertrips are distinguished within Settlement as follows:

- ◆ the Lead Party of the affected BM Unit would not be paid (or pay) for the associated Acceptance at either the prevailing Bid or Offer price or any replacement price. The Lead Party would be able to apply under the BSC for compensation for any costs incurred in responding to the instruction, including costs associated with plant damage

but excluding any amounts received or paid under the Connection and Use of System Code (“CUSC”) or any other bilateral agreement with NGC. The Panel would make a determination on each cost claim received. The Lead Party would be paid (or pay) any upheld compensation claim.

- ◆ a payment would not be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance on the basis of the prevailing Bid or Offer price or any replacement price. However a payment would be made from (or to) the Transmission Company on the basis of any upheld compensation claim.
- ◆ replacement BOAs, derived on the basis of the Bids and Offers that would have been taken had the deemed Grid Code Acceptance not been issued, would be included within Settlement for the purposes of calculating cash out prices. This is effectively akin to applying a replacement price to the deemed Grid Code Acceptance volume based on an equivalent overall volume of Bids/Offer which would have been taken in the absence of the deemed Grid Code Acceptance. The Panel or a delegated sub-committee would have responsibility for approving the replacement price.

Therefore, Modification Proposal P175 seeks to revise the treatment of deemed Grid Code Acceptances by pricing them at a replacement price for the purposes of calculating cash out prices and by revising the mechanism by which payments are made to or from Parties affected by deemed Grid Code Acceptances. The proposed payment mechanism creates a compensation route under the BSC in the event that the affected Party wishes to make a claim for costs associated with the Acceptance that have not been recovered via the CUSC or bilateral agreements.

The Proposer considers that this Modification Proposal better facilitates the achievement of Applicable BSC Objective (b) “the efficient, economic and co-ordinated operation by the licensee of the licensee’s transmission system” as it would ensure that the Lead Party of the affected BM Unit will remain cost neutral as a result of responding to Grid Code instructions, removing any potential commercial disincentive to respond to the Grid Code instruction which may arise if its prevailing Bid-Offer price did not adequately compensate it for the actions requested by NGC.

The Proposer also considers that this Modification Proposal better facilitates the achievement of Applicable BSC Objective (c) “promoting effective competition in the generation and supply of electricity and promoting such competition in the sale and purchase of electricity” because this modification would, via the proposal for an explicit mechanism for determining appropriate compensation, remove any potential distortion to prices faced by NGC brought about by Lead Parties attempting to factor the costs of responding to Grid Code instructions into their Bid or Offer prices. Additionally, the Proposer considers that this Modification Proposal would remove the potential for distortion of cash out prices as a result of deemed Grid Code Acceptances.

### **Related Modification Proposals**

Several related Modification Proposals were considered by the Pricing Standing Modification Group (“PSMG”) alongside Modification Proposal P175.

*Modification Proposal P171 “Retrospective removal of Emergency Instructions taken for System reasons from Imbalance Price” and Modification P172 “Removal of Emergency Instructions taken for System reasons from Imbalance Price”*

Modification Proposals P171 and P172 were submitted on 25 August 2004 by BGT. The intended effect of Modification P172 has been outlined above. As the solutions proposed under Modification Proposals P171 and P172 are identical in all but one respect, the details of the proposed solutions under Modification Proposal P171 are not repeated here. Modification Proposals P171 and P172 differ in terms of the proposed implementation approach in that Modification Proposal P171 proposed retrospective implementation while Modification P172 proposed prospective implementation.

As outlined above, Modification P172 was approved on 29 April 2005 and implemented on 9 May 2005. Modification Proposal P171 was rejected on 29 April 2005. The decision in relation to Modification Proposal P175 has therefore been considered in the light of the revised BSC baseline following the approval of Modification P172.

*Modification Proposal P173 “Revised Settlement Arrangements for Emergency Instructions”*

Modification Proposal P173 was submitted by National Grid Transco on 25 August 2004. It proposes to amend the way in which Emergency Instructions are distinguished within Settlement as follows:

- ◆ the Lead Party of the affected BM Unit would be paid (or pay) for the associated Acceptance at a replacement price rather than the prevailing Bid or Offer price. The replacement price would be calculated for the affected BM Unit and agreed by the Panel post-event. The proposal is that the replacement price should represent Avoidable Costs, as currently defined in Section G.2 of the BSC, with the intention that the Lead Party of the affected BM Unit would be ‘cost neutral’ as a result of responding to an Emergency Instruction;
- ◆ a payment would be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance on the basis of the replacement price based on Avoidable Costs rather than the prevailing Bid or Offer price. BSUoS payments for all Parties would reflect the replacement price rather than the prevailing Bid or Offer price; and
- ◆ the Acceptance Volume would feed into the cash out price calculation at the replacement price based on Avoidable Costs rather than the prevailing Bid or Offer price.

Alternative Modification P173 proposes the same solution in terms of the treatment of Emergency Instructions within Settlement but proposes a wider definition of Avoidable Costs upon which to base the replacement price. The wider definition proposed under Alternative Modification P173 includes additional cost categories which are specifically excluded under the existing Avoidable Costs definition included in Section G.2 of the BSC. Under the wider definition the following cost categories can be included where demonstrably incurred:

- ◆ costs or losses in respect of damage to property (including plant or apparatus) or death or injury to persons;
- ◆ increases in insurance premia; and

- ◆ increases in financing costs and overhead costs.

The decision in relation to Proposed Modification P175 has been made independently of those on Proposed and Alternative Modification P173.

## **Respondents' views**

### *Assessment Consultation*

Elxon published an Assessment Consultation in relation to Modification Proposal P175 on 28 October 2004, which invited respondents' views by 9 November 2004. Elxon received nine responses to the Assessment Consultation. The views received can be summarised as follows:

- ◆ three respondents considered that Proposed Modification P175 better facilitated the achievement of the Applicable BSC Objectives, while six respondents did not.

Those in support of Modification Proposal P175 considered that it would reduce the potential for Parties being exposed to unrepresentative Energy Imbalance Prices as a result of the impact of deemed Grid Code Acceptances. These respondents considered that the calculation of a replacement price for these Acceptances would reduce this potential exposure and would, therefore, better facilitate the achievement of Applicable BSC Objective (c). One respondent additionally considered that it would be advantageous for lead parties to be able to claim compensation for incurring costs associated with deemed Grid Code Acceptances where these costs are not remunerated under the CUSC.

As outlined above, the majority of respondents did not consider that Modification Proposal P175 would better facilitate the Applicable BSC Objectives. Several of these respondents expressed concern that Modification Proposal P175 entails a departure from the pay-as-bid principle, which is regarded as a fundamental characteristic of the Balancing Mechanism and NETA. These respondents considered that the Bid-Offer Prices submitted by market participants are appropriate as they are based on the costs and risks of a plant being removed from the system as a result of complying with a BOA. These respondents stated that Parties submit their Bids and Offers in the context of a competitive market and considered that it was not clear why these prices are inappropriate for the purposes of deemed Grid Code Acceptances. Therefore, the view expressed by these respondents was that deviating from pay-as-bid would be inappropriate and could have a detrimental impact on competition in the supply and generation of electricity, which would not better facilitate Applicable BSC Objective (c).

One respondent was also concerned that having to go through a compensation claims process to secure remuneration for a deemed Grid Code Acceptance would disadvantage the affected Party and represents a risk for all Parties which may operate against the achievement of Applicable BSC Objective (c). Another respondent added that any post-event adjustment requiring the judgement of a committee would cause lengthy legal argument, substantial costs and add uncertainty to the Settlement arrangements, which would be detrimental to the achievement of Applicable BSC Objective (c). Several respondents also considered that the post-event calculation process suggested under Modification Proposal P175 would significantly complicate the Settlement arrangements and would be detrimental to the achievement of Applicable BSC Objective (d).

Several other respondents did not consider that it would be appropriate for the compensation to go beyond the existing definition of Avoidable Costs by including plant damage. One of these respondents considered that this could be seen as a replacement for plant insurance, underwritten by the rest of the industry. Another respondent was concerned that including plant damage within the compensation would result in suppliers underwriting the generation side of the market.

#### *Draft Modification Report*

Subsequently, Elexon published a draft Modification Report in relation to Proposed Modification P175 on 16 December 2004, which invited respondents' views by 23 December 2004. Elexon received ten responses to the consultation on the draft Modification Report for Proposed Modification P175. One respondent considered that Proposed Modification P175 would better facilitate the achievement of the Applicable BSC Objectives. Eight respondents considered that Proposed Modification P175 would not better facilitate the achievement of the Applicable BSC Objectives. The remaining respondent offered no comment.

The one respondent in support of Proposed Modification P175 considered that if it is accepted that the pay-as-bid principle is not relevant for Emergency Instructions and Intertrips, then Proposed Modification P175 is an appropriate solution in terms of deriving cash out prices and remunerating Parties that respond to NGC's instructions.

The respondents who opposed Proposed Modification P175 reiterated their views that it would be inappropriate to move away from the principle of pay-as-bid, which some considered was a fundamental part of the competitive functioning of the market under NETA. One respondent additionally stated that Proposed Modification P175 does not provide any assurance that a Party providing the relevant services will be able to recover its costs and reasonable return, either by compensation under the BSC, under other governances, or bilaterally. It was this respondent's view that Proposed Modification P175 does not better facilitate Applicable BSC Objective (c), as a service is provided by a particular party for the benefit of others, but potentially not paid for.

Another respondent not in support of Proposed Modification P175 considered that it would not be appropriate to allow remuneration for a number of cost categories, such as plant damage. This respondent considered that the Avoidable Costs provisions currently contained within the BSC have already made this distinction and introducing contrary provisions could undermine those that already exist.

#### **Panel's recommendation**

The Panel met on 13 January 2005 and considered Proposed Modification P175, the draft Modification Report, the views of the PSMG and the consultation responses received.

The Panel unanimously considered that Proposed Modification P175 would not better facilitate achievement of the Applicable BSC Objectives. These Panel members were of the opinion that departing from the pay-as-bid principle for Bid-Offer Acceptances would work to the detriment of Applicable BSC Objective (c), and considered that it was generally desirable for prices to be set by the market and that intervention is kept to a minimum.

Therefore, the Panel recommended to the Authority that Proposed Modification P175 should not be made. In the event the Authority determines that Proposed Modification P175 should be made, the Panel recommended an Implementation Date of five working days following an Authority Decision.

### **Ofgem's view**

Having carefully considered the final Modification Report, the respondents' views and the Panel's recommendation, Ofgem, having regard to the Applicable BSC Objectives, is of the view that Proposed Modification P175 would not better facilitate achievement of the Applicable BSC Objectives. Ofgem considers this to be the case against the BSC baseline at the time Modification Proposal P175 was raised and against the revised BSC baseline following the approval of Proposed Modification P172.

*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*

#### *Pricing deemed Grid Code Acceptances for cash out purposes*

In order to avoid the potential for the cost of System Balancing related deemed Grid Code Acceptances to distort Energy Imbalance Prices, Proposed Modification P175 proposes that all deemed Grid Code Acceptances would be priced at a replacement price based on Bids and Offers that would have been accepted in the absence of the deemed Grid Code Acceptance. Ofgem agrees that it is appropriate to reduce the risk that System Balancing related Emergency Instructions do not lead to unrepresentative Energy Imbalance Prices.

Applying the replacement price to deemed Grid Code Acceptances is also intended to reflect within Energy Imbalance Prices any consequential Electricity Balancing energy delivered by a deemed Grid Code Acceptance. This aims to ensure that Energy Imbalance Prices are more representative of the SO's Electricity Balancing costs than would be the case if the action was unpriced. Ofgem acknowledges that pricing these acceptances at a replacement price based on those actions that the SO would have taken for Electricity Balancing purposes (had its choices not been restricted) offers a way to incorporate into Energy Imbalance Prices the costs of consequential Electricity Balancing delivered by a deemed Grid Code Acceptance. This arguably results in cash out prices that are more representative of the costs of Electricity Balancing, which would better facilitate the achievement of Applicable BSC Objective (c).

However, Ofgem notes that the methodology for calculating the replacement price could, in certain circumstances, mean that the price of a deemed Grid Code Acceptance which has been taken for System Balancing reasons could form all or part of the replacement Bid-Offer Pairs and, hence, the replacement price. Ofgem considers that it would be inappropriate for a System Balancing action to form all or part of the replacement price, as this would mean that System Balancing actions are distorting Energy Imbalance Prices, which would be to the detriment of the achievement of Applicable BSC Objective (c). On balance, Ofgem considers that this possibility negates the potential benefits of seeking to reflect within Energy Imbalance Prices any consequential Electricity Balancing energy delivered by a System Balancing deemed Grid Code Acceptance.

Ofgem considers that the Damhead Creek incident has highlighted a wider issue of the extent to which detailed, mechanistic rules are the most effective way of distinguishing between System Balancing and Energy Balancing actions. The alternative is to rely on the discretion of the System Operator to make the distinction reducing the need for complex rules and reducing the risk that the rules are found not to work as intended in certain circumstances. This issue may merit further consideration.

#### *Pricing deemed Grid Code Acceptances for payments to/from affected Parties*

Under Proposed Modification P175, there would be no BOA payments to/from the Party affected by the deemed Grid Code Acceptance. The intention is that payments would instead be made under the CUSC or bilateral contracts with NGC, with a compensation claims route available under the BSC for costs incurred (and not already covered) as a result of the deemed Grid Code Acceptance. Therefore, Parties would not be paid-as-bid for deemed Grid Code Acceptances. During the development of NETA, it was considered appropriate for all Balancing Mechanism trades to be settled at the prices included in the accepted Bid or Offer i.e. under a pay-as-bid system. Ofgem continues to consider that, in general, the pay-as-bid approach is the appropriate method by which to settle energy procured via market arrangements.

However, Ofgem acknowledges the concern that it may be inappropriate for the pay-as-bid approach to apply in certain circumstances when actions are taken outside the normal operation of the market. Ofgem notes that the deemed Grid Code Acceptances included within the scope of Proposed Modification P175 are only taken in limited circumstances in order to ensure the integrity of the system and that they can represent a departure from normal Balancing Mechanism operation. Given this, Ofgem considers that different treatment of these deemed Grid Code Acceptances in Settlement in terms of the payments made to/from affected parties may be warranted. This is particularly the case given the potential for “sleeper” Bids, which may be submitted as a signal of a market participant’s unwillingness to be flexible, to be accepted as deemed Grid Code Acceptances with potentially significant implications for Settlement and associated cashflows.

On a related point, Ofgem notes that, following the approval of CUSC Amendment Proposal CAP076<sup>22</sup> and BSC Proposed Modification P177<sup>23</sup>, operational intertrips are no longer treated as BOAs within the Balancing Mechanism and that different compensation arrangements are now in place for such actions. On the basis that Emergency Instructions are generally issued outside the normal operation of the market, Ofgem considers that it may be appropriate for alternative compensation arrangements to be put in place for Emergency Instructions under which, as is now the case for operational intertrips, Emergency Instructions are not remunerated in the same manner as BOAs in the Balancing Mechanism. Ofgem considers that this issue may merit further consideration by market participants, including NGC.

#### *Compensation claim process*

As mentioned above, under Proposed Modification P175, a compensation claims route would be available under the BSC for Parties responding to deemed Grid Code Acceptances to seek to recover costs not already recovered via the CUSC or bilateral contracts. Ofgem notes the

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<sup>22</sup> CUSC Amendment Proposal CAP076: “Treatment of System to Generator Intertripping Schemes”.

<sup>23</sup> Modification Proposal P177: “Removal of Intertrip Provisions from the BSC”.

concerns raised that potentially having to go through a compensation claims route in order to receive payment for responding to a deemed Grid Code Acceptance would disadvantage the affected Party to the detriment of Applicable BSC Objective (c). Ofgem also notes that some considered that, depending upon the exact cost categories to be included within the compensation process, the approach under Proposed Modification P175 may provide more appropriate remuneration. However, in the absence of established mechanisms for remunerating deemed Grid Code Acceptances under either the CUSC or bilateral contracts with NGC, it is difficult to assess whether or not Proposed Modification P175 would provide more appropriate compensation for affected Parties than the existing baseline.

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

Ofgem notes that concerns have been raised during the progression of Modification Proposal P175 in relation to the complexity of the solution, particularly the post-event compensation claim process. Ofgem agrees that this process could indeed be lengthy and complex for both market participants and the Panel, given the need to provide and assess information upon which to determine a claim, potentially introducing considerable complexity to the arrangements relative to the existing baseline. Ofgem considers that this could be to the detriment of Applicable BSC Objective (d).

Furthermore, as previously outlined in its decision letter in relation to Modification Proposal P80<sup>24</sup> in the context of disconnections from the transmission system, Ofgem does not consider it is appropriate in this situation for the BSC Panel to determine compensation claims. Ofgem therefore considers this to be an additional reason why Proposed Modification P175 would be detrimental to the achievement of Applicable BSC Objective (d).

Finally, Ofgem continues to consider, as outlined in its decision letter relating to Modification Proposal P80, that compensation following faults on the transmission system belong within the governance structure of the CUSC and/or NGC's charging methodologies rather than the BSC. Following its decision in relation to Modification Proposal P80, Ofgem recognises that part of the intent of Modification Proposal P175 was to place the primary requirement for compensation for deemed Grid Code Acceptances outside of the BSC. However, in the absence of any corresponding developments under the CUSC, it is difficult to assess whether the solution proposed under Proposed Modification P175 is appropriate. Ofgem would welcome further work on this area in order to define the compensation for deemed Grid Code Acceptances related to transmission faults within the CUSC and/or NGC's charging methodologies. Ofgem also considers that as part of this work it is important to consider the appropriate manner in which these Acceptances impact upon Energy Imbalance Prices.

### *Summary*

Overall, Ofgem considers that Proposed Modification P175 would not better facilitate the achievement of the Applicable BSC Objectives, notably Applicable BSC Objective (c). This is because pricing all deemed Grid Code Acceptances at the replacement price may lead to unrepresentative Energy Imbalance Prices. Ofgem considers this to be the case against both the

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<sup>24</sup> Modification Proposal P80: "Deemed Bid/Offer Acceptance for Transmission System Faults".

BSC baseline which existed at the time that Modification Proposal P175 was raised and the revised BSC baseline following the Authority's approval of Proposed Modification P172.

### *Sleeper Bids*

The Damhead Creek incident has highlighted the issue of the potential effects of high priced "sleeper" Bids on the operation of the market and market participants. NGC has provided analysis which suggests that in the Settlement Periods affected by the Damhead Creek incident around 30 per cent of Bids submitted may be "sleeper" Bids and has stated that high, negative Bid prices are not uncommon. Ofgem has previously expressed in the consultation document relating to the guidelines for applying the Market Abuse Licence Condition under NETA<sup>25</sup> concerns about the potential for "sleeper" Bids, if accepted, to distort competition, which could be to the detriment of customers. Ofgem has also published guidance in relation to the application of competition law in the energy sector<sup>26</sup>, which is intended to help market participants assess their conduct to avoid potential breaches of competition law. This guidance applies to the bidding strategies of market participants in the Balancing Mechanism. Ofgem considers that the issue of "sleeper" Bids may merit further consideration and is of the view that this could be a topic for consideration at a forthcoming NGC Operational Forum.

If you would like to discuss any aspects of this letter, please contact me on the above number or Simon Bradbury on 020 7901 7249.

Yours sincerely



**Sonia Brown**  
**Director, Markets**

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<sup>25</sup> 'The Market Abuse Licence Condition under NETA: Guidelines, A consultation document', Ofgem, September 2000.

<sup>26</sup> 'Competition Act 1998 – Application in the Energy Sector, OFT and Ofgem, January 2005.