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National Grid Company, BSC Signatories and
Other Interested Parties

20 July 2004

Our Ref: MP No 139

Dear Colleague

**Modification to the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to
Modification Proposal P139 “Removal of Trading Unit restriction on Interconnector Users”**

The Gas and Electricity Markets Authority (the “Authority”)¹ has carefully considered the issues raised in the Modification Report² in respect of Modification Proposal P139, “Removal of Trading Unit restriction on Interconnector Users”.

The BSC Panel (the Panel) recommended to the Authority that Proposed Modification P139 should be made and that the Implementation Date for Proposed Modification P139 should be:

- ◆ 30 June 2004, should the Authority determination be received before 19 March 2004; or
- ◆ 3 November 2004, should the Authority determination be received on or after 19 March 2004, but prior to 20 July 2004.

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 P139MR Version No. 1.0, dated 22 January 2004.

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 BSACo (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 BSACo performing its other functions under the BSC in accordance with its objectives.

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.

Authority has decided not to direct a Modification to the BSC in line with Modification Proposal P139.

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

Background

A Trading Unit is a group of Balancing Mechanism Units (BM Units)⁵ that are electrically close to each other on the transmission system. These BM Units are collectively afforded "net" treatment, meaning that the overall commercial effect of a Trading Unit's operation is the same as if the demand occurring within the Trading Unit were satisfied directly by generation within the Trading Unit (or vice-versa), with only the net generation or demand being traded over the system. Five classes of Trading Unit are listed in Annex K-2 of the BSC, defining the nature of the configurations and plant types that can be grouped into a Trading Unit. There is no requirement for the BM Units in a Trading Unit to all belong to the same Trading Party, but all of the Lead Parties of the BM Units must be party to the application to group them into a Trading Unit. The benefits of Trading Unit treatment accrue to one or more Lead Parties and may then be shared by the Parties concerned according to any contractual arrangements, outside the scope of the BSC, which the Parties may choose to put in place.

Section K 5.7.1 of the BSC explicitly excludes Interconnector BM Units from forming Trading Units:

"An Interconnector BM Unit may not belong to a Trading Unit other than a Sole Trading Unit."⁶

The proposer contended that this situation is unnecessary and an unfair restriction on Interconnector BM Units who may wish to operate as a Trading Unit in a similar fashion to other BM Units operating at the same site. It was suggested that this unfairness arises because the effect of the current rules are such that certain charges are levied upon each BM Unit active on the Interconnectors for each half hour, whether or not the contracted energy transfers are superposed on one-other and even though the System Operator will only be affected by the 'net' positions.

In order to address this perceived defect, EdF Trading Ltd submitted Modification Proposal P139, "Removal of Trading Unit restriction on Interconnector Users" on 21 August 2003.

The Initial Written Assessment (IWA) was presented to the Panel at its meeting on 11 September 2003. The Panel agreed with the recommendation in the IWA that P139 be submitted to a three

⁵ The term 'BM Unit' is used to describe collections of generation plant and 'demand plant' that import and/or export electricity, so that physical imports and exports can be treated appropriately under the BSC. Because of the number of different types of generation and demand that it must cover, the exact definition of a BM Unit is somewhat involved (see Section K3.1.2 of the BSC).

However, for generating plant, a BM Unit is typically a single generating unit. For demand the definition of a BM Unit is largely dictated by the metering information available to Imbalance Settlement. For large demands, separate metering information is available on a half-hourly basis. In this case, the associated BM Unit is essentially defined as the aggregate of a party's demand behind a single point of connection to the transmission or distribution system.

⁶ Lead Parties of BM Units may elect to form Trading Units comprising two or more BM Units, but all BM Units belong, by default and unless they elect otherwise, to a "Sole Trading Unit", which comprises of only that BM Unit. References to "Trading Unit(s)" are often to those that have been formed with two or more BM Units.

month Assessment Procedure to be carried out by the Settlement Standing Modification Group (the Group).

The Group met four times during the Assessment Procedure and conducted an industry consultation in addition to a Party, BSC Agent and Transmission Company impact assessment. The Assessment Report for Modification Proposal P139 was considered by the Panel at its meeting of 11 December 2003. At that meeting the Panel supported the recommendations of the SSMG and submitted Modification Proposal P139 to the Report Phase with a recommendation to the Authority that Proposed Modification P139 should be made. The Panel agreed that a draft Modification Report based on its provisional views should be issued for industry consultation.

The Modification Proposal

Modification Proposal P139 seeks to modify the BSC so as to remove a restriction preventing Interconnector BM Units from belonging to a Trading Unit other than a Sole Trading Unit (i.e. where there is only one BM Unit), thereby allowing Interconnector BM Units to form Trading Units with other Interconnector BM Units on the same Interconnector. It also suggests that a new class of Trading Unit for Interconnector BM Units may be required, if the existing categories are considered inappropriate. Furthermore, P139 proposes that, for Interconnector BM Units, the Production / Consumption Status (P/C Status) would not change by virtue of belonging to a Trading Unit. The rationale given for raising the Modification Proposal was that the proposer considered it would better facilitate achievement of Applicable BSC Objectives C3 (3) (a), (c) and (d).

Modification Proposal P139 seeks to allow Interconnector Users to realise the Trading Unit benefits which occur as a result of several charges being levied on a net basis for BM Units forming part of an Interconnector Trading Unit. The proposer suggested that by providing new and existing Interconnector Users with similar opportunities for the formation of a Trading Unit to those afforded to other Trading Units in England and Wales, the Modification Proposal would facilitate more efficient and competitive trading activity among neighbouring systems and remove the potential for duplicate charging of BSUoS charges.

Modification Proposal P139 proposes to remove paragraph K 5.7.1 of the BSC, such that Interconnector BM Units would be eligible to join Trading Units. Interconnector BM Units could then be assessed against the criteria for the formation of Trading Units.

BM Units are allowed to form Trading Units due to their proximity on the Transmission System. The existing criteria for the formation of Trading Units allow any BM Units connected by contiguous or dedicated assets to form Trading Units. Applying the existing criteria to Interconnector BM Units could make it possible for electrically remote BM Units to be party to the same Trading Unit, even if that Trading Unit also included a multi circuit interconnector with electrically remote boundary points on the Total System.

Settlement Standing Modification Group considerations

By forming a Trading Unit including Interconnector BM Units, BM Units which are not linked by contiguous or dedicated assets would be able to join the same Trading Unit. The Group noted that this could undermine the physical proximity principle of Trading Unit status. Furthermore, an element of discrimination could be introduced because:

- ◆ electrically remote BM Units not connected by contiguous or dedicated assets and not connected to Interconnector BM Units by contiguous or dedicated assets **would not** be able to form Trading Units; whereas
- ◆ electrically remote BM Units not connected by contiguous or dedicated assets, but connected to Interconnector BM Units associated with electrically remote Interconnector circuits by contiguous or dedicated assets **would** be able to form Trading Units.

The Group considered three possible approaches to address this deficiency. It concluded that the preferable option would be to create a new class of Trading Unit which would limit Interconnector BM Units to forming Trading Units with other Interconnector BM Units on the same Interconnector.

No Alternative Modification was developed by the Group. An alternative solution, suggested by one consultation respondent, whereby all Interconnector BM Units on the same Interconnector would be mandated as forming a Trading Unit, was considered by the Group. However, the Group agreed that mandating Trading Unit status to Interconnector BM Units was undesirable. Furthermore, the Group considered that apportioning net benefits via the underlying contractual arrangements between Trading Unit members helps to facilitate competition. If Trading Unit status were mandated these underlying contractual arrangements may cease to be made. Therefore, the Group agreed that this alternative solution would not better facilitate achievement of the Applicable BSC Objectives as compared to the Proposed Modification, and as such did not constitute an Alternative Modification.

Responses to ELEXON Consultation

ELEXON published a draft Modification Report on 17 December 2003, which invited respondents' views by 5 January 2004. Nine responses were received. Five responses expressed support for the Proposed Modification, two responses opposed the Proposed Modification and the remaining two responses provided a "no comment" response.

Several respondents indicated that the Proposed Modification would better facilitate achievement of Applicable Objective (c) by allowing Interconnector Users to form Trading Units in the same way as other classes of User which are electrically proximate and thus removing an anomaly in the market. One respondent commented that allowing Interconnector BM Units to form Trading Units that included more than one BM Unit would remove an element of discrimination in the charges levied upon them and afford Interconnector Users the same opportunities for the formation of Trading Units available to other Users. As a consequence they considered that Proposed Modification P139 would facilitate more effective and efficient competition in the market.

One respondent, although in support of removal of the current Trading Unit restriction for some Interconnector types, did not support the Proposed Modification. This respondent considered that it would be inappropriate for Interconnector BM Units associated with Interconnector circuits, where flows onto or off of the Interconnector are at geographically separate points, to form a Trading Unit (as would be the case for multi circuit Interconnectors). It was the view of this respondent that such an approach would set a precedent in terms of allowing assets which connect to the Transmission System at points geographically separate from each other to be treated as one site for Trading Unit purposes. As such, this respondent did not support criteria

which would allow Interconnector BM Units associated with multi circuit Interconnectors to form Trading Units and therefore did not support Proposed Modification P139.

The second respondent opposing the Proposed Modification presented the view that, if there is an inappropriate or inconsistent methodology for calculating BSUoS liabilities for Interconnector Users, the issue should be resolved outside the BSC. It was the view of this respondent that the other benefits delivered by the proposal were negligible and would not better facilitate competition in the generation and supply of electricity.

The complete text of all respondents' views can be found on ELEXON's website⁷.

Panel's recommendation

The Panel met on 15 January 2004 and considered Modification Proposal P139, the views of the Modification Group, the draft Modification Report and the consultation responses received.

The Panel recommended that the Authority should approve the Proposed Modification and that, if approved, the Implementation Date for Proposed Modification P139 should be:

- ◆ 30 June 2004, should the Authority determination be received before 19 March 2004;
or
- ◆ 3 November 2004, should the Authority determination be received on or after 19 March 2004, but prior to 20 July 2004.

Responses to Ofgem's GB Consultation

On 5 December 2003 Ofgem undertook to formalise the process it would follow when consulting on a GB wide basis when proposing changes for consideration under the BSC and the CUSC.

In order to discharge this undertaking, Ofgem published a GB Consultation Paper on 7 January 2004⁸, inviting respondents to consider whether there are any additional implications that Proposed Modification P139 may have, were it to be applied on a GB wide basis as opposed to being limited to England and Wales. One response was received. The response opposed the Proposed Modification with no new arguments than were presented in the responses to the England and Wales consultation.

The Consultation Paper, the response to it and other related documents can be found on the BETTA GB Consultation section of the Ofgem website⁹.

Ofgem's view

Having carefully considered the 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 P139 would not better facilitate achievement of the Applicable BSC

⁷ http://www.elexon.co.uk/documents/modifications/139/P139MR_Attachment2.pdf

⁸ Respondents' views were requested by 5pm on Tuesday 3 February 2004

⁹ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

Objectives. In addition, Ofgem considers that this decision is consistent with its wider statutory duties.¹⁰

As detailed in the BSC, a Trading Unit is a group of BM Units that are electrically close to each other on the transmission system. Because of this proximity, Trading Units are afforded net treatment, such that the overall commercial effect is the same as if demand were directly satisfied by on-site generation, and vice versa. Ofgem is concerned that allowing Interconnector BM Units to form non-sole Trading Units, would undermine the original purpose of Trading Unit status, which is to net off on-site demand and generation. The BSC directly specifies that Interconnector Users are not able to form Trading Units. This is because Interconnector BM Units can be separated from each other by many miles, and do not therefore meet the intended criteria of Trading Units. Ofgem notes that for the purposes of BSC Modification Proposal P139 the Scottish Interconnector would equally be afforded the same treatment, despite this being a multi-circuit Interconnector, containing BM Units that are geographically separated. This principle would equally be applied to any new Interconnectors. Ofgem is therefore concerned that Modification Proposal P139 would undermine the primary purpose of allowing proximate demand and supply assets to form Trading Units. This principle is important as it seeks to ensure that, where practicable, energy is available to the traded markets and is not withdrawn. Wherever possible, making energy available is desirable to ensure the efficient and competitive functioning of the traded markets by maintaining liquidity.

Applicable BSC Objective (c) – promoting effective competition in the generation and supply of electricity, and (so far as is consistent therewith) promoting such competition in the sale and purchase of electricity

Ofgem does not consider that, at present, the absence of Trading Unit benefits for Interconnector BM Units hinders their competitiveness. Modification Proposal P139 only allows Trading Unit status for Interconnector BM Units on the same Interconnector. The proposal does not allow other BM Units to join the Trading Unit, nor is there scope to extend this status for other generation and demand BM Units. Ofgem is of the view that because the Modification Proposal, if implemented, could prevent Interconnector BM Units from forming Trading Units with non-Interconnector BM Units, the Modification Proposal is unduly discriminatory in certain circumstances. This feature of the Modification Proposal therefore has the potential to be unduly discriminatory and would therefore be to the detriment of Applicable BSC Objective (c).

Ofgem notes the proposer's view that removing the restriction on Interconnector BM Units forming Trading Units would lift "an unnecessary and unfair financial burden" on existing and new Interconnector Users on the grounds of discrimination. However, Ofgem does not consider that this Modification Proposal would necessarily result in an overall improvement in conditions for effective competition. Ofgem has concerns over propagating conditions for discrimination, as the legal drafting for this proposal put forward by the SSMG remedies only the perceived defect in respect of Interconnectors that have a single Boundary Point on the transmission system. Ofgem considers that Modification Proposal P139 could therefore be unduly discriminatory by attempting to address a perceived form of discrimination that exists in the current arrangements by introducing another. Ofgem considers this could be to the detriment of Applicable BSC Objective (c).

¹⁰ Set out in Section 3A of the Electricity Act 1989, as amended by the Utilities Act 2000. Ofgem's statutory duties are wider than the matters 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.

Ofgem is concerned that enabling intra-party trading by Interconnector Users could have an adverse effect on the liquidity of the traded markets. Ofgem considers that liquidity in the wholesale markets underpins the competitive nature of the trading arrangements. Modification Proposal P139 could enable a significant volume of energy that would otherwise be traded at the notional National Balancing Point (NBP), to be traded via a secondary Interconnector equivalent of the NBP and therefore removed from the wider market. Ofgem is concerned that by preventing this potential volume of trade from being available, the Modification Proposal could reduce the competitive nature of the arrangements. Ofgem considers that this would be to the detriment of Applicable BSC Objective (c).

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

Ofgem considers that there may be some benefit in revising the treatment of Interconnector BM Units going forward, but considers that at this point, the provisions contained within Modification Proposal P139 are not appropriate. As mentioned previously, Ofgem is concerned that the Modification Proposal includes bestowing Trading Unit benefits to the Scottish Interconnector, and other Interconnectors going forward. Ofgem considers that it may be useful for these issues to be considered on a GB wide basis by industry standing groups. Ofgem considers that bestowing Trading Unit status to Interconnector Users would be better suited to consideration under a GB market, rather than incurring unnecessary development costs as part of the Modification Proposal. In particular, the Scottish Interconnector will be subsumed into the BETTA arrangements upon implementation. Ofgem considers this would be to the detriment of Applicable BSC Objective (d).

Although Ofgem does recognise the potential benefits arising from Modification Proposal P139, the most tangible of which would be a reduction in BSUoS exposure, on balance, Ofgem does not consider that these prospective benefits outweigh the potential for undue discrimination associated with the proposal and importantly, the sunk costs involved in its implementation, and therefore that the proposal would not better facilitate achievement of Applicable BSC Objectives (c) and (d).

Other issues

Ofgem recognises that it may be desirable at a future point in time to review the Interconnector arrangements such that they continue to be compatible with European Directives and with arrangements in other markets. Moreover, the Interconnector arrangements need to be consistent with the requirement to not hinder cross-border trade. Furthermore, Ofgem considers that although the principle of allowing Interconnector Users with single Boundary Point connections the ability to net their exposure to the various charges may be worthy of consideration going forward, the provisions within Modification Proposal P139 go beyond this principle.

Ofgem notes that it is also questionable whether developing a new class of Trading Unit mainly for the purposes of avoiding gross BSUoS (amongst other) charges should be undertaken via the BSC. As part of the discussions surrounding Approved Modification P100¹¹, the SSMG noted that both BSUoS and TNUoS charges were “outside the vires of the BSC and that Ofgem is

¹¹ Approved BSC Modification P100 - Extension of demand-side Trading Units in order to increase the competitiveness of the market for embedded benefits

responsible for ensuring the consistency of NETA charging across different governance arrangements".

The Authority's decision

Following consideration of the views of the Panel and respondents to the various consultations, and having regard to the views above, Ofgem considers that Proposed Modification P139 would, overall, not better facilitate achievement of the Applicable BSC Objectives, in particular Applicable BSC Objectives (c), and should therefore not be made.

If you have any queries please contact me on the number above, or David Hunt on 020 7901 7429.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Kyran Hanks", is written over a stylized, downward-pointing triangle outline.

**Kyran Hanks
Director, Wholesale Markets**

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