Responses from P136 Draft Modification Report Consultation

Consultation issued 21 November 2003

Representations were received from the following parties:

No	Company	File Number	No. BSC Parties Represented	No. Non-Parties Represented
1.	Powergen	P136_DMR_001	14	-
2.	Energywatch	P136_DMR_002	-	1
3.	Bizz Energy	P136_DMR_003	1	-
4.	ConocoPhillips (U.K.) Limited and Immingham CHP	P136_DMR_004	2	-
5.	AES Indian Queens Power Ltd	P136_DMR_005	1	-
6.	CECL, IETS, RPCL, SPAL	P136_DMR_006	4	1
7.	Corus Group Plc	P136_DMR_007	-	1
8.	ScottishPower	P136_DMR_008	6	-
9.	Gaz de France Marketing Limited	P136_DMR_009	1	-
10.	Entergy-Koch Trading Ltd	P136_DMR_010	1	-
11.	National Grid Transco	P136_DMR_011	1	-
12.	Aquila Networks Plc	P136_DMR_012	1	-
13.	RWE Limited	P136_DMR_013	9	-
14.	South Coast Power Ltd	P136_DMR_014	1	-
15.	EDF Energy	P136_DMR_015	9	-
16.	British Gas	P136_DMR_016	1	-
17.	Alcan Smelting and Power UK	P136_DMR_017	-	1
18.	BP Gas Marketing Limited, Great Yarmouth Power Limited	P136_DMR_018	2	-
19.	Barclays Capital	P136_DMR_019	1	-
20.	Scottish and Southern Energy	P136_DR_020		
21.	British Energy Power & Energy Trading Ltd	P136_DR_021		
22.	Teesside Power Limited	P136_DR_022		

P136_DMR_001 – Powergen

Respondent:	Powergen
No. of BSC Parties Represented	14
BSC Parties Represented	Powergen UK plc, Powergen Retail Limited, Cottam Development Centre Limited, TXU Europe Drakelow Limited, TXU Europe Ironbridge Limited, TXU Europe High Marnham Limited, Midlands Gas Limited, Western Gas Limited, TXU Europe (AHG) Limited, TXU Europe (AH Online) Limited, Citigen (London) Limited, Severn Trent Energy Limited (known as TXU Europe (AHST) Limited), TXU Europe (AHGD) Limited and Ownlabel Energy Limited
No. of Non BSC Parties Represented	-
Non BSC Parties represented	-
Role of Respondent	Supplier, Generator, Trader & Exemptable Generator

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	We continue to believe that the proposal has the potential to create unmanageable risk for some parties which would be detrimental to competition.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes	The legal text is consistent with the solution proposed for P136.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes	

Q	Question	Response	Rationale
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_002 – Energywatch

Respondent:	*Lesley Davies*
Non BSC Parties represented	*energywatch*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	energywatch supports the Panel's provisional recommendation to the Authority to reject P136. We agree with the Panel's view that P136 does not better facilitate applicable BSC objectives (b) or (c).
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	No comment	
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	No comment	
4.	Are there any further comments on P136 that you wish to make?	Not at the present time	

P136_DMR_003 – BizzEnergy

Respondent:	BizzEnergy
No. of BSC Parties Represented	1
BSC Parties Represented	BizzEnergy
No. of Non BSC Parties Represented	0
Non BSC Parties represented	0
Role of Respondent	*Supplier*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	The proposal will drastically increase risk. The incentives to manage risk are already very strong, increasing the strength of the signal is only of value if parties can react and change their behaviour in a manner that increases overall market efficiency. It is not clear that that this is so. In the absence of any clear indicators the increased prices are merely a penalty for doing something that could not be avoided in the first place. In tems of increased risk: 1. IPPs face bankruptcy if they trip when demand is high 2. Portfolio generators have an overwhelming incentive to self-insure even if it means breaching the Grid Code 3. Suppliers face an ongoing risk cost of imbalance, which especially impacts smaller portfolios that lack diversity. This favours the larger diverse incumbent portfolios and hence has a negative impact upon competition in supply. This ultimately increases consumer cost.

Q	Question	Response	Rationale
			4. Embedded generators face lower prices in their contracts because they are not able to offer suppliers firm delivery against contract if registered in SVA. The proposal threatens security of supply 1. IPPs will withdraw from the market when high prices are anticipated 2. Portfolio generators will increase part-loading 3. Although suppliers will go slightly longer, they are already considerably long and will not contract for sufficient generation to provide more than a 7% security cushion (not the 19% NGC wants to cover for generation failure) 4. The risk-cost of generation raises the cost of new entry. 5. No evidence has been produced that forward price signals will increase. In fact forward prices may reduce because suppliers will be trading at the marginal sell price, which will be even lower than the current SSP. Therefore the proposal will make operation of the transmission system more risky (Objective (b)) and competition will be damaged (Objective (c)) without any evidence that the marginal price is offering a better signal of the marginal cost of energy.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	There are substantial changes to the text of the Code. There is a risk that errors will have crept in.

Q	Question	Response	Rationale
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	No	Such a proposal should never be introduced over a winter. It should be delayed to the June 2005 release if it is approved.
4.	Are there any further comments on P136 that you wish to make?	Yes	It seems rather perverse that parties who are at no risk to the risk of imbalance prices can raise modifications that materially increase the imbalance costs and risks to other parties.

P136_DMR_004 – ConocoPhillips (U.K.) Limited and Immingham CHP

Respondent:	*Name Rekha Patel*
No. of BSC Parties Represented	2
BSC Parties Represented	*ConocoPhillips (U.K.) Limited and Immingham CHP*
No. of Non BSC Parties Represented	
Non BSC Parties represented	*Please list all non BSC Parties responding on behalf of (including the respondent company if relevant).*
Role of Respondent	*Trader and Generator*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	ConocoPhillips' agree with the BSC Panel that modification P136 would not better facilitate achievement of the Applicable BSC Objectives. The implementation of a 'marginal' energy imbalance price methodology has the detrimental impact of over-recovering the cost of balancing the system

Q	Question	Response	Rationale
			and therefore creating distortionary signals. ConocoPhillips' support Ofgem's view, 'that cash-out prices should be calculated from a volume weighted average of accepted offers and bids, as this better reflects the cost incurred by the SO in balancing the system and ensure that appropriate signals and incentives were created.'
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	No	The legal drafting assumes the retention of 'day ahead BSAD data'. However, NGT within its BSAD methodology consultation believes 'BSAD submissions at day ahead is no-longer used in the calculation of imbalance prices.' NGT seeks to gain market participants views' of ceasing the day ahead submissions of BSAD. ConocoPhillips would appreciate clarity on this issue.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	No	The implementation of modification P136 should not arise within Winter 2004. Firstly, it is vital to ensure adequate time has been allocated to allow central systems to implement the complex modification. Secondly, the implementation of marginal pricing within a Winter period, shall increase the materially of the amendment and therefore increasing the cost associated with failure of delivering the change.
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_005 – AES Indian Queens Power Ltd

Respondent:	*Vic Danks*
No. of BSC Parties Represented	1
BSC Parties Represented	*AES Indian Queens Power Ltd*
No. of Non BSC Parties Represented	
Non BSC Parties represented	
Role of Respondent	*Generator*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	• Dramatic increase in risk of insolvency should generators fail in periods of high demand • Incentive to breach grid code and self balance (portfolio actions) • IPP's particularly at risk and may withdraw during times of system stress • Credit risk • Competition will be stifled as fewer participants will want to take immeasurable risk
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	No	Winter is not the time to introduce such modifications. Preference would be summer 2005
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_006 – CECL, IETS, RPCL, SPAL

Respondent:	*Chris Ridgway*
No. of BSC Parties Represented	4
BSC Parties Represented	*CECL, IETS, RPCL, SPAL*
No. of Non BSC Parties Represented	1
Non BSC Parties represented	*InterGen (UK) Ltd*
Role of Respondent	*Generator*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	We continue to believe that p136 does not better facilitate the applicable BSC objectives.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	No comment.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes	
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_007 - Corus Group Plc

Corus supports the Panel's recommendation that P136 should not be made as our response of 31 October 2003 to the previous consultation urged rejection. The rationale for supporting the Panel is best described in that response . This was as follows:-

"Corus responded to the initial consultation and nothing in the latest consultation leads us to change our view that these proposed modifications should be rejected. In fact, the list of reasons against P137/137 in the summary of responses to the initial consultation includes a number of drawbacks which we had not mentioned in our response. As a result we are even more convinced that these modifications should be rejected. Without repeating all the reasons for rejection, our main concerns are:-

1. P78 has not been given chance to run even for a full year. Constant change creates uncertainty and risk which ultimately is paid for by end-consumers. 2. The risk of high and volatile imbalance prices will create an unacceptable level of risk which will have a disproportionate effect on smaller generators and suppliers. Competition in these sectors will be hindered not facilitated. Companies may be bankrupted. 3. High marginal imbalance prices are hardly likely to be cost reflective and will swell the RCRC. 4. Generators may choose to avoid risk by withholding plant. 5. There may be further unintended consequences that arise from the scale of premature change being proposed in P136/137.

In summary, the risks inherent in P136/137 far outweigh the perceived benefits - in fact it is difficult from an end-user perspective to see what the benefits are - and we recommend that the modifications be decisively rejected."

P137_DMR_008 – ScottishPower Uk plc

Respondent:	*Name* John W Russell (SAIC Ltd)
No. of BSC Parties Represented	6
BSC Parties Represented	*Please list all BSC Parties responding on behalf of (including the respondent company if relevant).* Scottish Power UK plc; ScottishPower Energy Management Ltd.; ScottishPower Generation Ltd; ScottishPower Energy Retail Ltd.; SP Transmission Ltd; SP Manweb plc.
No. of Non BSC Parties Represented	
Non BSC Parties represented	*Please list all non BSC Parties responding on behalf of (including the respondent company if relevant).*
Role of Respondent	Supplier / Generator / Trader / Consolidator / Exemptable Generator / Party Agent

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	*Yes*	*While ScottishPower support the principle of sending clearer price signals to the market which would better facilitate BSC objective (b) "the efficient, economic and co-ordinated operation by the Transmission Company of the Transmission System", we believe that this is unlikely to happen with this modification.* *As with P135, this Mod does not encourage capacity to be made available at times of system stress and will increase the risk that less reliable plant will not be made available at all due to the potentially damaging imbalance charges associated with unexpected plant failure.* *Acceptance of the modification would greatly increase the risk of generators going out of business and also significantly increase the cost to participants in managing the risk exposure. This, as has already been highlighted in the P135 consultation, would be bad for promoting competition (Objective c), as potential new entrants would be more reluctant to participate in such market. It also does not better facilitate the efficiency objective (Objective d), as parties would be withholding capacities and there would be significant increase in cost of operations for all concerned. It would be far more efficient for the System Operator to utilise the capacity to balance the system. As indicated in the P135 consultation, the industry is quite happy to pay for this service by the System Operator. The current imbalance charging mechanism still ensures that "pollutants pay".* *In conclusion, we agree with the Panel's view that this modification should not be made.*
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	*We do not wish to comment on the legal text.*
3.	Do you agree with the Panel's provisional	*Yes*	*Not withstanding the fact that we do not support this Mod Proposal; we agree*

Q	Question	Response	Rationale
	recommendation concerning the Implementation Dates for P136? Please give rationale.		*that this date is appropriate.*
4.	Are there any further comments on P136 that you wish to make?	*Yes*	*ScottishPower believe an alternative, which would encourage generators to offer any potential spare capacity is required.* *Specifically, treatment of post Gate Closure plant loss needs to be addressed, as currently participants are prohibited from* *adjusting their position to maintain the* *balance, which they had achieved at Gate* *Closure. In this situation, either the shortfall should be treated as system balancing and removed from the price calculation or the generator should be able to self-balance after Gate Closure.* *There should be some dispensation for the generators in this circumstance.*

P137_Def_009 - Gaz de France Marketing Limited

Respondent:	
No. of BSC Parties Represented	1
BSC Parties Represented	Gaz de France Marketing Limited
No. of Non BSC Parties Represented	0
Non BSC Parties represented	*N/a*
Role of Respondent	*Supplier/Generator*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that	Yes	As stated in our previous responses we do not support a move to marginal pricing as proposed within this modification proposal. We are concerned that NGT have presented conflicting views regarding this winters security of supply

Q	Question	Response	Rationale
	Proposed Modification P136 **should not** be made? Please give rationale.		status throughout the life of this modification that may have distracted attention from the fact that the current pricing methodology appears to be working as expected. At the start of the summer NGT were warning of potential serious shortfalls this winter, however we now find that NGT are currently forecasting acceptable levels of plant margin. Generation is returning to production in response to the current pricing signals delivered under the P78 pricing regime. For this reason we believe that the panel decision to retain the current status quo is correct at this time. Consideration should also be given to the fact that since NETA Go Live we have seen significant change within the Pricing area of the BSC (There have been 151 modifications submitted to date with 29 of those specific to the Pricing area of the code) and there comes a time when it would be wise to adopt a more consistent, and stabilised approach. A move to a marginal price would be an indication of further regulatory tweaking. If we are to deliver the expected environmental enhancements outlined in the governments White Paper we need to introduce an element of certainty to potential investors and new entrants, not convey an impression of constant change and uncertainty. In approving P78 Ofgem stated that the incentives for individual Parties to balance their positions should improve. We believe that this is actually the case. Approval of this modification is perceived to be counter productive as Parties would be more inclined to self-hedge and/or adopt a 'long' position.

Q	Question	Response	Rationale
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	No	We do not support a move to marginal pricing as proposed within this modification proposal
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	No	We do not support a move to marginal pricing as proposed within this modification proposal
4.	Are there any further comments on P136 that you wish to make?	Yes	The final report includes estimates of the forecast implementation costs that would result from adoption of this modification. £1,562,000 +/- 20% has been quoted but in addition there would be the overhead of 750 additional Elexon man-days and the implementation costs incurred by market participants themselves. This modification proposal is estimated to require between 40 to 45 weeks to implement, with delivery scheduled for late November 2004 or late February 2005, depending on the timing of an Ofgem determination. It is difficult therefore to believe that adoption of this modification is guaranteed to improve increased plant margin for winter 2004/5. This modification carries with it additional impacts around the significant level of credit cover required. Forecasting the required levels would difficult and therefore participants will be faced with a decision of either lodging significantly higher levels of credit than at present or risk a credit breach. It is possible that circumstances may occur which mean that post event Parties may discover significant shortfalls in their credit cover provisions. In the circumstances it would be prudent to initiate a full review of the current credit cover calculation methodology. In this case Elexon would be required to

Q	Question	Response	Rationale
			ensure budget provision for this activity.

P137_DMR_010 – Entergy-Koch Trading Ltd

P136 DRAFT MODIFICATION REPORT CONSULTATION QUESTIONS

BSC Parties and other interested parties are invited to respond to this consultation expressing their views or provide any further evidence on any of the matters contained within this document. In particular views are sought in respect of the following questions. Parties are invited to supply the rationale for their responses.

Respondent:	*Adam Cooper*
No. of BSC Parties Represented	1
BSC Parties Represented	*Entergy-Koch Trading Ltd*
No. of Non BSC Parties Represented	
Non BSC Parties represented	
Role of Respondent	*Trader*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	No	EKT considers that there is still a need to increase the level of transparency in the way that NGT operates in the market, particularly as its actions have a strong influence on price outcomes. The effectiveness of a marginal pricing approach will be determined by the amount of market information that parties can gather and assess. P136 does not address many of these transparency issues, however EKT considers that on balance the proposal better facilitates the relevant objectives by improving the quality of market signals. Improved market signals are essential for creating an environment that is conducive to efficient investment

Q	Question	Response	Rationale
			decisions. Better price signals and also improves competition between different parties and provides a better valuation of the quality of supply.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No Yes	
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes / No Yes	The dates seem to reflect the level of system changes required.
4.	Are there any further comments on P136 that you wish to make?	Yes / No No	

P136_DMR_011 – National Grid Transco

ed within this document. In particular views are sought in respect of the following questions. Parties are invited to supply the rationale for their responses.

Respondent:	*National Grid Transco*
No. of BSC Parties Represented	1
BSC Parties Represented	*National Grid*
No. of Non BSC Parties Represented	
Non BSC Parties represented	
Role of Respondent	*BSC Party*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that	No	We believe that the balance of substantiated and robust arguments contained within the Modification Report is in favour of marginal pricing, We also believe that the arguments and views expressed against marginal pricing are largely

Q	Question	Response	Rationale
	Proposed Modification P136 **should not** be made? Please give rationale.		unsubstantiated. It is our view that the recommendation of the BSC Panel is not consistent with the balance of valid arguments contained within the report (noting however, that it is consistent with the recommendation of the modification group). Please see further comments below.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes	As proposer of P136, we believe that the legal text does address the proposed defect, and is reflective of the solution that has been developed and consulted upon. We further note that the legal text is compatible with the proposed BSAD Methodology Statement changes that have been consulted upon in parallel to the BSC process and which have been submitted to Ofgem for determination.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes	We believe that it is important to implement marginal pricing ahead of winter peak 2004/05. We note that P136 can be implemented co-incident with a planned BSC systems release in order to achieve this and therefore fully support the implementation of P136.
4.	Are there any further comments on P136 that you wish to make?	Yes	We welcome the opportunity to expand on our comments made in answer to question 1.

We stand by all our previous comments made during the assessment of P136 and remain fully supportive of the modification proposal. The Modification Report is a true and accurate representation of the deliberations of the PSMG in assessing Modifications Proposals P136/P137. The Report contains a number of substantiated arguments in favour of marginal pricing – supported by analysis and two papers submitted by the Proposers. The report also contains a number of views against marginal pricing. In some instances these views could be considered as being unsubstantiated, or even contradictory. We would like to take the opportunity to highlight what we believe to be inconsistencies in these arguments, which are apparent from our examination of the Modification Report. In order to do this the arguments against marginal pricing, taken directly from the Modification Report, are presented below in italics. Our commentary is provided in bold text.

Arguments made <u>against</u> marginal pricing in the report as to why it will not better facilitate applicable BSC objective (b)

- *A higher (main) Energy Imbalance Price (a postulated outcome of a marginal Energy Imbalance Price) will drive the market excessively and inefficiently long, by collective over contracting.*
- *A higher (main) Energy Imbalance Price will incentivise Parties to breach the Grid Code by self insuring / self balancing (i.e. deviating from FPN on other plants in the event of a plant trip in order to meet contracted levels and mitigate exposure to imbalance). Plant may also withhold capacity for self insuring, or to try and avoid trip. Both actions will degrade the ability of the Transmission Company to balance the system.*
- *Exposure to (large) imbalance (say plant trip) at the time of a higher Energy Imbalance Price increases the (potentially unmanageable) risk of exposure to imbalance, and may put smaller Parties out of business, creating capacity issues.*

These arguments/views are predicated on the belief that marginal prices mean higher prices, and higher prices are undesirable. The costs and volumes that feed into the calculation of imbalance prices comprise the balancing actions purchased by National Grid to balance generation and demand. Thus a marginal price can only be set by the price of one of these actions, (after tagging) therefore the only way imbalance prices can become "high" is if participants submit "high" prices for balancing services that are subsequently accepted. In the assessment of this modification, as noted in the Assessment Report section 2.2.1.3 para 3, the PSMG were of the view that Balancing Mechanism Bid-Offer pricing strategies are independent of imbalance prices – i.e. Participants do not vary their Bid-Offer prices in response to imbalance prices. So if the prices that feed into energy imbalance prices are unlikely to change as a result of imbalance prices, and these are the prices used in the imbalance price calculation, w*here do these postulated inappropriately high prices come from?* We are disappointed that the PSMG concluded that the prices that feed into the calculation of energy imbalance prices (e.g. Bid-Offer prices) are unlikely to change in response to imbalance prices, but at the same time arrived at the contradictory and unsubstantiated view that marginal imbalance prices will become "high" or "extreme".

We have provided the industry with indicative analysis which compares "average" and marginal imbalance prices (using the P78 NIV tagging methodology) for over 20000 settlement periods. This shows that prices do not rise to inappropriate magnitudes. We recognise that analysis of historic data is no guarantee of the future. However, given the disconnect between imbalance prices and Bid-Offer pricing strategies referred to above, we believe the claim that marginal imbalance prices will be inappropriately "high" or "extreme" is unsubstantiated and therefore arguments that are predicated on this assumption should be discounted.

Another argument against marginal pricing is that it would "drive the market excessively and inefficiently long". We do not understand the rationale behind this argument. The marginal methodology proposed would apply to both SBP and SSP when they are the 'main' price. A marginal SSP is likely to result in a lower payment to participants who are long when compared with the current arrangements,

hence there will be less of an incentive to go excessively long and more of an incentive to balance. This better facilitates applicable BSC objective (b).

We believe it is inappropriate to assume that Participants will breach the obligations placed on them via core industry documents (such as the Grid Code) when assessing modification proposals. We note that this was also the view of the PSMG as documented in the Assessment Report section 2.2.1.2 para 4. However, again it is disappointing that the majority of the PSMG can hold this view at the same time as postulating that Participants will breach their Grid Code obligations, by withholding plant to "self-insure" against the risk of plant failure and subsequent exposure to imbalance charges, and use this as an argument against applicable BSC objective (b).

One of the arguments above suggests that marginal imbalance prices will incentivise Generators to withhold plant in case of trip. We believe that marginal imbalance prices will ensure forward prices value generation capacity more appropriately, hence incentivising generators to make plant available in response to market demand.

Arguments made against marginal pricing in the report as to why it will not better facilitate applicable BSC objective (c)

- As a consequence of imperfect information and the inability to accurately differentiate between system and electricity balancing, a volume weighted average price methodology is more cost reflective than a marginal price methodology;

This is a statement or view, rather than a substantiated argument. It is true to say that the current tagging methodology makes a number of assumptions as to the "system / energy" split, but it does not follow that this means a weighted average price is more cost reflective. Hence the question should be whether the tagging that is currently performed is sufficiently robust to ensure that the marginal price is set at a price which is reflective of actions taken for energy reasons, rather than for system reasons. Our view, which is substantiated with pricing analysis, is that the current tagging methodology is sufficient to ensure this happens and, furthermore, it will be improved by the BSAD changes that are associated with the modification.

- A marginal Energy Imbalance Price may consistently over or under recover the costs incurred in electricity balancing the system, and so it does not appropriately target the costs of electricity balancing, whereas a volume weighted average price is unlikely to consistently over or under recover the costs and is therefore a more appropriate cost targeting mechanism;

<u>Imbalance prices are not about recovering costs.</u> Costs of Balancing Services are recovered by the Balancing Service Use of System charge. Imbalance prices provide valuable price signals to the forwards markets and should incentivise Participants to contract forward for energy. The argument above is suggesting that as long as imbalance charges recover balancing costs, the incentives to trade forward must be correct. We strongly disagree with this, as the Balancing Mechanism is designed as a mechanism for calling off a number of balancing services (or 'products') in real time in order to maintain security and quality of supply. It is not solely for balancing the residual energy position presented to us by the market.

- Small volumes of extremely priced Bids or Offers could set the marginal Energy Imbalance Price, especially at times of system stress, which are not cost reflective of market conditions, nor reflective of the Transmission Company costs of electricity balancing the system;

If National Grid accept expensive Bids / Offers in times of system stress, when energy is scarce, then this is done because they are necessary and therefore imbalance prices should reflect the prevailing situation. Currently 'market conditions' will not adequately reflect these situations, as the price signals sent by imbalance prices are diluted and therefore inappropriate. If a Bid or Offer is accepted in the BM, it is required and therefore is by definition entirely reflective of the "*Transmission Company costs of electricity balancing the system*".

- The current methodology sends adequate price signals to the forwards and spot markets, encouraging an appropriate response from Parties in respect of forward contracting to balance;

There is evidence to suggest that this is not the case in all circumstances. When available generation capacity is scarce, (examples being over the winter peak 2002/03 or summer 2003) imbalance prices do not provoke an appropriate market response. An example of this is 10 December 2002 when imbalance prices peaked at £270/MWh (even though Offers priced up to £9999/MWh were accepted). The short term power exchange price (for EFA block 5) on that day was only circa £50/MWh. We believe that marginal pricing will not significantly change the incentives on Market Participants in most circumstances, but will provide more appropriate signals in times of energy scarcity and provoke an efficient market response.

- *Volatile, inappropriately high Energy Imbalance Prices will incentivise excessive and inefficient length in the market, which in turn causes volatility in the forwards and spot markets. Such length may also stifle liquidity in the forwards and spot markets, as will withholding of capacity for the purposes of self balancing / self insurance;*

- Increased risk of exposure to inappropriately high Energy Imbalance Prices (if a marginal Energy Imbalance Price is not considered to be cost reflective, then it could be considered to be setting an inappropriate Energy Imbalance Price) is considered to be unmanageable, as events such as plant trip or demand forecast error occur within the Settlement Period and therefore cannot be insured against;

- *Thus a marginal Energy Imbalance Price will result in inappropriately higher Energy Imbalance Prices which increases the risk of exposure to imbalance, and consequently increases the cost of managing that risk. This could also present a barrier to entry for smaller Parties in terms of the disproportionate costs of risk management;*

- *The risk of exposure to imbalance should be factored into Bid – Offer prices and contract prices, however, a large exposure to the marginal Energy Imbalance Price at a time of system stress could lead to catastrophic imbalance exposure, for which there is no way of adequately factoring the risk into Bid – Offer prices and contract prices; and*

- *Furthermore, a large exposure to an extreme marginal Energy Imbalance Price could lead to a Party incurring imbalance charges far in excess of its Credit Cover, creating consequential risk for all other BSC Parties.*

Again, these arguments are predicated on marginal imbalance prices being high and volatile and, as indicated above, we believe this to be unsubstantiated. Imbalance prices provide a level of risk upon which Market Participants base their commercial decisions. Procurement and pricing strategies, and developing products in order to manage market risk is, by definition, the role of the market. Risk management is core to NETA, and it is crucial that the correct signals are sent to the market to enable Participants to manage risk effectively and efficiently.

P136_DMR_012 – Aquila Networks Plc

Please find that there is no impact to Aquila Networks Plc systems and/or processes.

regards
Rachael Gardener

P136_DMR_013 – RWE

Respondent:	*Name Bill Reed*
No. of BSC Parties Represented	9
BSC Parties Represented	*Please list all BSC Parties responding on behalf of (including the respondent company if relevant).* Innogy plc, Innogy Cogen Limited, Innogy Cogen Trading Limited, Npower Limited, Npower Direct Limited, Npower Northern Limited, Npower Northern Supply Limited, Npower Yorkshire Limited, Npower Yorkshire Supply Limited
No. of Non BSC Parties Represented	None
Non BSC Parties represented	*Please list all non BSC Parties responding on behalf of (including the respondent company if relevant).*
Role of Respondent	*(Supplier/Generator/ Trader / Consolidator / Exemptable Generator / BSC Agent / Party Agent / other – please state [1])* Supplier/Generator/ Trader / Consolidator / Exemptable Generator / Party Agent

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	We support the recommendation of the Panel to reject P136. Although we support marginal pricing in principle, we are concerned that the methodology in P136 may not accurately reflect the costs of energy balancing. Until a methodology can be defined that properly reflects the resource cost associated with energy balancing, marginal pricing will not better facilitate

Q	Question	Response	Rationale
			Objective (c) in relation to competition or Objective (b) in relation to the economic and co-ordinated operation of the system.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	We note that the P136 implementation envisages the use of options fees as set out in P137. It is also worth noting that the BSC legal drafting can only make sense when the BSAD consultation is considered. This raises issues associated with governance of BSC changes.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes	This appears to be the only practical date for implementation of this modification.
4.	Are there any further comments on P136 that you wish to make?	Yes	We note that the Transmission Company has not provided any estimate of costs associated with implementing P136.

P137_DMR_014 – South Coast Power Ltd

Respondent:	South Coast Power Ltd
No. of BSC Parties Represented	1
BSC Parties Represented	South Coast Power Ltd
No. of Non BSC Parties Represented	-
Non BSC Parties represented	-
Role of Respondent	Generator

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	The proposal will drastically increase risk: 1. IPPs face bankruptcy if they trip when demand is high 2. Portfolio generators have an overwhelming incentive to self-insure even if

Q	Question	Response	Rationale
			it means breaching the Grid Code 3. Suppliers face an ongoing risk cost of imbalance, which especially impacts smaller portfolios that lack diversity. This ultimately increases consumer cost. 4. Embedded generators face lower prices in their contracts because they are not able to offer suppliers firm delivery against contract if registered in SVA. The proposal threatens security of supply 6. IPPs will withdraw from the market when high prices are anticipated 7. Portfolio generators will increase part-loading 8. Although suppliers will go slightly longer, they are already considerably long and will not contract for sufficient generation to provide more than a 7% security cushion (not the 19% NGC wants to cover for generation failure) 9. The risk-cost of generation raises the cost of new entry. 10. No evidence has been produced that forward price signals will increase. In fact forward prices may reduce because suppliers will be trading at the marginal sell price, which will be even lower than the current SSP. Therefore the proposal will make operation of the transmission system more risky (Objective (b)) and competition will be damaged (Objective (c)) without any evidence that the marginal price is offering a better signal of the marginal cost of energy.

Q	Question	Response	Rationale
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	There are substantial changes to the text of the Code. There is a risk that errors will have crept in.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	No	Such a proposal should never be introduced over a winter. It should be delayed to the June 2005 release if it is approved.
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_015 – EdF Energy

Respondent:	Tony Dicicco
No. of BSC Parties Represented	9
BSC Parties Represented	EDF Energy Networks (EPN) plc; EDF Energy Networks (LPN) plc EDF Energy Networks (SPN) plc; EDF Energy (Sutton Bridge Power) EDF Energy (Cottam Power) Ltd; EDF Energy (West Burton Power) Ltd; EDF Energy plc; London Energy plc; Seeboard Energy Limited
No. of Non BSC Parties Represented	0
Non BSC Parties represented	N/A
Role of Respondent	Supplier/Generator/ Trader

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority	Yes	EDF Energy believes that P136 does not better facilitate achievement of the Applicable BSC Objectives and concur with the Panel's view that P136 should

Q	Question	Response	Rationale
	contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.		not be made. EDF Energy states that P136 will deter new entrants as well as increasing operational risks to existing players, to the clear detriment of competition.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	No	EDF Energy has reviewed the legal drafting but has concerns regarding BSC Section Q6.3. We would prefer that the Transmission Company does not resubmit BSAD after the Energy Imbalance Prices have been calculated by the BMRA. P136 proposes a sensitive marginal cashout price mechanism, and allowing ex-post changes to the data affecting cashout prices is undesirable. The Transmission Company should not resubmit BSAD except in the rare case of manifest error and the BSC legal drafting should reflect this.
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes and No	EDF Energy notes the lead times required to amend the BSC Systems. However, EDF Energy is not in favour of a new pricing methodology being implemented at the start of winter.
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_016 – British Gas

Re: Modification Proposal P136 – Marginal Definition of the 'main' Energy Imbalance Price

Thank you for the opportunity of responding to this draft modification report considering Modification Proposal P136. British Gas Trading (BGT) agrees with the Panel's recommendation that this Modification Proposal will not better facilitate Applicable BSC Objectives (b) and (c). Whilst BGT does not support the principle of P136 we also have concerns about the proposed implementation solution and the significant cost implications of implementing this modification proposal.

BGT believes this modification will be detrimental to the economic, efficient and co-ordinated operation of the Transmission System by the Transmission Company. Parties will be incentivised to go long and hold excessive levels of reserve, this is inefficient and will have a negative impact on Applicable BSC

Objective (b). BGT also believes this modification may encourage Parties to self-insure, which may result in Parties breaching the Grid Code. At the Panel it was suggested that this was a non-issue. However there is a precedent for this occurring, at the start of NETA, when Parties were faced with high volatile imbalance prices there were some self-balancing actions undertaken.

BGT also concur with the Panel's recommendation that this modification will not promote effective competition in the generation and supply of electricity. BGT believes this modification introduces an unmanageable level of risk and as such may have a detrimental effect on competition amongst existing industry participants. The increased risks associated with a marginal cash-out regime may also result in a barrier to entry for potential new players.

The assessment consultation provided a number of options in respect of the publication and status of imbalance prices. BGT supported the requirement for prompt price reporting and favoured the freezing of imbalance prices in real time. The group preferred to maintain the status quo and allow prices to be fluid and subject to change through reconciliation. However due to the sensitivities of marginal pricing, any resubmission of data could significantly change the main cash out price. BGT is concerned that the option selected was on the basis of assurances provided by NGT of their ability to provide accurate real-time BSAD submissions. However since the last modification meeting there have been two instances of erroneous BSAD submissions that have needed amendment at the next reconciliation run. If this had occurred under a marginal regime BSC Parties cash out liabilities could have been subject to significant change. Trading decisions are based on real time information and it is not possible to react to retrospective changes. Therefore BGT are unsure of the value of having imbalance prices that are subject to change, unless the initial submission is manifestly wrong and the amendment process is supported by a robust process like the Disputes service.

BGT note the significant BSC development and implementation costs of implementing P136. In addition to BSC costs, which are in the region of £1 to 1.5 million there, are NGT costs of approximately £1.2 million, which are required to make the appropriate BSAD changes. P136 is a very expensive modification to implement especially when considering the costs the industry has incurred in implementing P78. P78 has not been tested under a winter environment and the need for a change in the imbalance cash out methodology has yet to be proved.

BGT do not agree with the proposed implementation date of November 2004. Should P136 be approved BGT believe a change as fundamental as this should not be deployed in a winter and therefore would propose the June 2005 release program.

Mark Manley
Contract Manager

P136_DMR_017 – Alcan Smelting and Power

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Respondent:	*Jonathan Scott*
No. of BSC Parties Represented	0
BSC Parties Represented	*N/a*
No. of Non BSC Parties Represented	1
Non BSC Parties represented	*Alcan Smelting and Power UK*
Role of Respondent	*Other – Licence Exempt Generator*

Q	Question	Response [1]	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	The Panel's recommendation reflects the balance of views expressed in previous consultations and of the strength of the arguments against implementation of Modification P136.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes / No	
4.	Are there any further comments on P136 that you wish to make?	No	Alcan has no further comments to make which are additional to those expressed in previous consultations

P136_DMR_018 – BP Gas Marketing Limited

Respondent:	*Name*
No. of BSC Parties Represented	2
BSC Parties Represented	*BP Gas Marketing Limited, Great Yarmouth Power Limited*
No. of Non BSC Parties Represented	0
Non BSC Parties represented	-
Role of Respondent	*Generator / trader*

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	It is BP's view that the modification proposal might introduce the risk of a cascade in credit default and liquidity squeeze resulting from a single player administration occurring at a time when administration would exacerbate the situation when the system demand is high. We believe that the effect on trading liquidity could be severe.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes / No	As we agree with the recommendation not to implement, we do no believe it appropriate to fully analyse the legal text proposed in order to provide a definitive answer to this question
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes /No	
4.	Are there any further comments on P136 that you wish to make?	No	

P136_DMR_019 – Barclays Capital

Respondent:	**Paul Dawson**
No. of BSC Parties Represented	**1**
BSC Parties Represented	**Barclays Capital**
No. of Non BSC Parties Represented	**0**
Non BSC Parties represented	**NA**
Role of Respondent	**Trader**

Q	Question	Response	Rationale
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	No	See attached paper "Draft Modification Reports for Proposals P136 and P137, Comments by Barclays Capital, 3 December 2003"
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	Yes	The legal text is an accurate interpretation and representation of the proposed modification
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Qualified Yes	We assume that the recommended implementation dates are reasonable given the constraints on delivering the proposed changes. However, every effort should be made to implement this proposal in time for next Winter 2004. A delay to February 2005 would mean that the benefits of the modification proposal in ensuring a more secure system would largely be delayed to Winter 2005-6. We would therefore urge the Panel to reconsider whether an Autumn 2004-5 delivery would still be possible even if the Authority decision is not received by 23 January 2004 (but say shortly thereafter).

Q	Question	Response	Rationale
4.	Are there any further comments on P136 that you wish to make?	No	

Draft Modification Reports for Proposals P136 and P137

Comments by Barclays Capital

3 December 2003

The recommendations of the PSMG – subsequently endorsed by the Panel – on Modifications P136 and P137 have emerged from a process that has systematically understated the benefits of the proposed modifications while placing undue weight on a list of highly questionable arguments against the proposals. The major arguments against the proposals either have serious logical flaws or significantly overstate the risks associated with the proposals. The Panel's recommendation is therefore based on an incorrect weighting of the arguments for and against the proposals and, consequently, we cannot support that recommendation. We will not reiterate the arguments for the proposals again here since the modification proposals themselves included good theoretical and analytical backing for the proposed changes. However, in the following we respond to the specific arguments against the modification proposals that are featured in the Draft Modification Reports.

Marginal Cash Out Will not Lead to Unjustifiably High and Volatile Cash-Out Prices

The benefits of Modifications P136 and P137 in improving market incentives and security of supply are clear and soundly based in economic theory. Indeed, at no stage during the modification process has the theoretical justification for marginal cash out prices been challenged. Instead, the main source of opposition has been unsubstantiated assertions relating to "inappropriate" levels and volatility in prices. This position is both inconsistent and highly questionable in practice. It is inconsistent because marginal cash-out prices either provide the correct economic signals or they do not. One cannot concede that they provide the correct incentives in theory, but then reject the modification proposal solely because the practical consequences on price levels and volatility are unpalatable. Moreover, it is practically misleading since the likely level and volatility has been significantly "talked up". The working assumption that marginal cash-out pricing automatically equates to frequent instances of cash-out prices in the tens of thousands is highly misleading and is unlikely to reflect the competitive and practical constraints on behaviour under a marginal cash-out regime and, in particular:

- Market participants compete in the balancing mechanism and offer and bid prices should therefore tend to participants' expectation of the marginal cost of producing additional power (or consuming less demand). Prices will therefore typically only rise to high levels in response to the underlying market supply and demand fundamentals. In these circumstances, while cash-out prices may occasionally rise to high levels, these will be justifiably high price levels and, consequently the level of risk faced by participants – and their responses to those risks - will be efficient.

- On those occasions when generation is very scarce, prices may rise above marginal cost to capture the scarcity rents associated with inflexible demand. However, the exercise of excessive market power at these times is subject to several practical, regulatory and legal constraints on the abuse of market power. Moreover, any market participant who became responsible for setting the price at unjustifiably high levels does so at the risk of potentially serious consequences to their own business including the indirect credit, financial and reputational consequences associated with the high prices and the potential exit of other market participants. This indicates that underlying market fundamentals rather than frequent, inexplicable and unmanageable deviations from the underlying economics will typically justify incidences of high prices.
- Analysis performed by NGT on the practical impact of modification P136 indicates that anomalous prices are unlikely to occur (this analysis is also relevant to P137). While this is based on historic analysis, we believe that the conclusions can be extrapolated forwards. To the extent that behaviour does change, we would expect it to be toward mitigating offers that may have led to anomalous cash-out prices. We have discussed many of the reasons for this in the previous section which indicates that there are strong grounds to believe that offers and bids will continue to be based on expected supply and demand fundamentals.
- The requirement for marginal cash-out pricing is driven off the need to ensure correct long-term generation investment signals. The adoption of marginal cash-out pricing will reduce the frequency of those occasions when generation is very scarce and hence when market participants can exert short-term market power with excessive offer prices.
- Sleeper offers, rather than dynamic parameters, have been used in the past to signal unavailability. There is no reason to suppose that sleeper offers at very high prices continue to be used with a marginal cash-out calculation since they are both unnecessary and run the risk of setting the marginal price (together with the attendant reputational, regulatory and financial consequences should that offer not be a genuine one).

These considerations do not rule out the possibility that prices may occasionally be very high and/or highly volatile. However, they demonstrate that there should be no underlying presumption that prices will be systematically be <u>inappropriately</u> high or <u>unduly</u> volatile. The modification has therefore been rejected based on a prevailing assumption about prices that has not been substantiated either in theory or practice.

These observations on prices also invalidate many of the concerns related to individual participant or market length. Specifically, if cash-out prices are set at efficient levels, market participants will be taking efficient contracting decisions in trading off the probability of being short (long) against the likely SBP (SSP). Put another way, there is no way in which efficient cash-out prices can result in "excessive and inefficient length in the market" or in which parties face "disproportionate costs of risk management". Any market length in response to high expected cash-out prices would actually be an efficient market response at times of system shortage.

Prices will not be set by system actions

Efficient imbalance settlement requires that cash-out prices be based on the marginal cost of energy actions taken to balance the system. The basic commodity traded in England and Wales is a "plain vanilla" MWh which is delivered flat within a settlement period onto the NGT system. It is crucial that cash-out prices are set on a consistent basis and hence that the rules to separate system from energy actions prevent short-duration or location-specific actions from setting cash-out prices and thereby distorting the energy market.

In moving to marginal pricing, there is a concern that flaws in the tagging rules may mean that system rather than energy actions may occasionally set prices. This can be seen as less of a concern with average pricing because of the "diluting" effect of the averaging process. While we share the objective to ensure that system actions do not set energy cash-out prices, this concern is not sufficient to prevent the adoption of the marginal determination of cash-out prices for the following reasons:

- There is no unique theoretical dividing line between system and energy actions given that "system" actions have energy consequences and vice versa. The best that we can achieve is a pragmatic separation of these actions. In England and Wales, the current tagging process via CADL and NIV-tagging is very robust and separates out the majority of actions that can be deemed due to dynamic or locational constraints. (Arguably, the current process is too robust in that it tags out many actions that could be deemed to relate to energy balancing.) The retention of the tagging rules within P136 and P137 therefore provides extremely high degrees of comfort that system actions will not typically set cash-out prices.
- While we believe the tagging arrangements are already sufficiently robust, the modification process – including the urgent procedures – can be used to correct any unforeseen anomalies that emerge in future (whether under P136 or 137 or the current system);
- To the extent that a "system" action is not tagged out, this is highly likely to relate to a single action which has been accepted for both system and energy reasons. In these circumstances, the current weighted average calculation and the marginal calculation would actually calculate a very similar price. Marginal price cash-out should therefore not materially increase the incidence of "anomalous" prices for "system" reasons over and above the current baseline.
- In circumstances where an action is accepted for system and energy reasons, the marginal cost can be assigned either solely to system or solely to energy. There is no unique theoretically correct answer here since the action is effectively a joint product of system and energy. In these circumstances, it would be entirely reasonable to err on the side of caution and to treat this as an energy action. (This is a cautious approach since it jumps on the side of not understating the cost of energy cash-out, ie, errs on the side of a slightly stronger rather than weaker signal of shortage.)
- One of the main reasons for the proposed modification is the fact that generators do not consistently pitch their offers at the level of the marginal energy acceptance. We believe that this is in part due to imperfect information on the likely level of that acceptance which in part reflects uncertainty

over whether offers are being accepted for system or energy reasons. This uncertainty is likely to mitigate the extent to which "system acceptances" can be anticipated in advance. In turn, this means that any pure "system" actions that do get through the net are unlikely to have been accepted at unreasonably high price levels.

Overall, therefore, concerns about the separation of system and energy actions are not sufficient to justify the rejection of these modifications. The modifications are designed to address a major defect in the current arrangements at times of system shortage and the expected cost of this defect - in terms of degraded security of supply - is extremely large when compared to the very low likelihood of stray system actions feeding into energy cash-out prices.

"Cost reflective" prices reflect marginal costs not average costs

The "cost reflectivity" of marginal cash-out prices has been a major feature of the assessment process and the associated Modification Report. However, the "cost reflectivity" arguments against the modifications seem to have several interrelated strands that have not been particularly well articulated. This makes it difficult to offer a reasoned response. However, we would offer the following observations on the issue of "cost-reflectivity":

- "Cost-reflectiveness" is not a BSC objective and should never be used directly as an assessment criterion. This is the source of a significant flaw in the assessment of these modifications. The only area where a form of "cost reflectiveness" is relevant is in the promotion of competition in the production and supply of electricity and the sale and purchase of electricity (ie, BSC objective (c)). Competitive markets secure an economically efficient outcome in which market prices should reflect the underlying marginal or "opportunity" costs of production and supply. A modification proposal can therefore be said to improve competition and efficiency if it improves the extent to which imbalance prices and market prices "reflect" the underlying marginal costs (a criterion met by both modifications 136 and 137).
- The fact that cash-out prices raise a surplus – which is redistributed via RCRC - is a function of the dual nature of cash-out rather than marginal pricing being inherently less "cost-reflective" than weighted average pricing.
- The balancing mechanism's original design was based on the underlying assumption that with "pay-as-bid" pricing (to mitigate gaming) offers – and bids – would migrate to the marginal offer or bid price. In this way, the weighted average cash-out price would – on average - reflect the marginal costs of balancing. If the current system worked as intended, therefore, the weighted average cash-out prices would reflect the marginal cost of balancing actions and that would be an efficient outcome.
- Cash-out prices are not cost reflective currently since generator bids/offers fail to consistently track the marginal bid/offer. Weighted average cash-out prices therefore persistently understate the opportunity costs of balancing the system. By addressing this flaw in the current cash-out arrangements, marginal cash-out pricing is therefore significantly more cost-reflective than the current arrangements.

- To argue that marginal cost cash-out is less cost-reflective than weighted average price cash-out therefore amounts to a claim that offer prices should be consistently pitched below the marginal offer price. This is completely unsustainable and impractical in any competitive process and we are aware of no other market where prices are expected to reflect average production or procurement costs; competition ensures that prices rise to reflect the marginal cost of securing additional production to meet the last – or marginal – unit of demand. (Essentially more efficient producers do not typically give away the competitive benefits of being able to produce more cheaply than the least efficient company in the industry.)
- Alternatively, opponents of marginal pricing may be arguing that only a weighted average price calculation could be cost reflective by definition. This is a circular argument without an independent justification as to why average pricing is more reflective and is therefore entirely without merit.

In summary, arguments relating to cost-reflectivity - if they are to have any validity at all - strongly support a move to a marginal definition of cash-out prices. The use of "cost-reflectivity" arguments in support of average price cash-out either rely on a bogus definition of cost-reflectivity or the logically flawed and circular assertion that average cash-out prices *must be* more cost-reflective than marginal price cash-outs. These arguments should play no role in a valid appraisal of these modifications.

P136_DMR_020 – Scottish and Southern Energy

Dear Sirs,

This response is sent on behalf of Scottish and Southern Energy, Southern Electric, Keadby Generation Ltd. and SSE Energy Supply Ltd.

In relation to the four listed in the Consultation Paper, contained within your note of 21st November 2003 concerning Modification Proposal P136, we have the following comments to make:-

Please note our response to any of the following questions should not be construed to lend support whatsoever to this Modification.

Q1 Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 should not be made? Please give rationale.

Yes.

As has been note in our response to P144, it is not 100% clear that ALL system balancing actions (based on the P18 CADL approach) will be excluded from NIV tagging and therefore some system balancing actions could feed through to the energy imbalance price. We believe that in light of this the definition of marginal price for P136 has to explicitly exclude ALL NIV and CADL tagging actions; i.e. those considered to be for system balancing purposes.

Given that the proposition is that the marginal price should explicitly reflect those actions taken for electricity balancing purposes, we believe that the energy imbalance price should be derived from the latest information and that this should be refined over time as volumes and associated information becomes more accurate. We believe, given that the principle of 'reconciliation' between initial and final data is well established within the Code (in some case months after the settlement period/day in question) that there is no reason why this should not be applied in this case. Clearly, in our view, there should be no compromise between accuracy of the price and the timing of its publication. For this reason we believe that if an action cannot be determined within the timeframe currently taken to publish the information to the market that it should be assumed to be a system balancing action and specifically excluded from the energy imbalance price. This is an appropriate approach (akin to that applied with regard to CADL) for ensuring that the broad signal is given to the market, whilst ensuring that uncertain prices are not falsely fed through to the market, which would leave to a perverse market signal as the market responded to a system (rather than an electricity) balancing action.

We believe that the incentives should be on each Party to 'insure' themselves by forward contracting in sufficient volumes to cover peak periods, with the Transmission Company undertaking the residual balancing in real time, i.e. striking an efficient balance between the two extremes. We believe that the current pricing mechanism provides adequate price signals which adequately incentives Parties to cover their own positions, and therefore do not believe that the extreme price signals that will arise from this Modification are either efficient, necessary or appropriate.

Furthermore, we believe that this Modification, with its inherent risk of exposure to extreme Energy Imbalance Price will, for example, at times of system stress where the system is short, and there is increased likelihood of extreme (i.e. high) System Buy Price, incentivesing Parties to withhold generation in order to avoid the risks associated with plant trip (potentially negating, for example, many of the benefits that are envisaged from the introduction of a Maximum Generation Service).

Therefore we believe that this Modification will have the effect of endangering (rather than enhancing or improving) the security of supply situation.

For the reasons we have outlined briefly above (and detailed extensively in our response to the P135 consultation which we would refer you too), we believe given the significant increase in risk (and associated cost that will inevitably be passed on by the market to customers) that P136 will lead to parties self insuring (resulting in a reduction in plant available to the Transmission Company). This will have the effect of increasing the Bid-Offer Prices being 'bid' into the Balancing Mechanism in order to adjust the Bid-Offer prices to reflect the increase in risk in the exposure to imbalance charges. This in turn may have the circular effect of increasing the marginal Energy Imbalance Price, which in turn raises Bid-Offer prices submitted into the Balancing Mechanism.

Given that it is not possible to apportion the cost of each individual MWh taken to the individual Party that incurred that cost and as a consequence of there being imperfect information and the inability to differentiate between system and electricity balancing actions, we believe that an average methodology is a more cost reflective methodology than a marginal price methodology.

We believe that this Modification will increase the potential for extreme (i.e. high) Energy Imbalance Prices (as a result of using the marginal energy balancing action) which in turn increases the risk for Parties from exposure to these extreme Energy Imbalance Price. We believe that a marginal imbalance price could reach extreme levels which could have the effect of bankrupting a Party exposed to the imbalance price, and therefore impose such an extreme risk that it cannot be (adequately) factored into the contract / Bid-Offer prices or the Credit arrangements that currently exist within the Code.

Furthermore, we believe that this risk (of exposure to extreme marginal prices) is unmanageable, because there are currently no insurance products available to mitigate the risk of exposure to imbalance charges resulting from a failure of some description after Gate Closure. In addition, we believe that the potential for more extreme Energy Imbalance Prices may prevent the development of such products.

We concur with the comments regarding the distortion of competition that will arise if this Modification proceeds as some Parties will have disproportion benefits (from the RCRC payments) whilst others, such as single site generators that fails, will not receive any benefits. Such an approach is discriminatory.

We believe that a major issue, should this Modification be approved, will be its impact on the credit arrangements. It will dramatically raise the likelihood of Parties going out of business. It will introduce significantly increased risk into the energy imbalance equations (which are more than under the current arrangements).

We believe that this Modification will have a damaging effect on many types of Parties, depending on their particular circumstances, and that this will have a distorting effect on competition.

We believe that this Modification, in so clearly leading to the distortion of competition, cannot be said to better achieve the Applicable BSC Objective 3(c).

Q2 Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.

Yes.

Q3 Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.

If the Modification Proposal P136 is approved, we agree with the proposed BSC Panel recommendation on the timing for the Implementation Date, as outlined in the Modification Report.

Q4 Are there any further comments on P136 that you wish to make?

Nothing further at this time.

regards

Garth Graham
Scottish and Southern Energy plc

P136_DMR_021 – British Energy Power & Energy Trading Ltd

British Energy has the following comment on P136 and P137 which we hope will be included in the report to the Panel.

We do not support marginal imbalance pricing in the form proposed by P136/P137. In the absence of suitable insurance products, the mechanism proposed would create an unmanageable risk for many market participants and would be susceptible to anomalous prices and market power, particularly in situations of shortage of energy. We are concerned that the current market with NGT as balancer of last resort at virtually any price does not lend itself to efficient bilateral insurance, and are not convinced that implementation of P136/137 will create such a market. We believe that capacity and security issues should be considered in the whole, and the most efficient balance between the procurement of capacity by NGT and bilaterally by parties examined further before fundamentally changing the imbalance pricing regime. We support the procurement of capacity by NGT and mild sharpening of pricing signals in response to short-term shortages of spare capacity for this winter, but expect a wider review and more transparent procurement for the future.

P136_DMR_022 – Teesside Power Limited

P136 DRAFT MODIFICATION REPORT CONSULTATION QUESTIONS

Respondent:	*Teesside Power Limited*
No. of BSC Parties Represented	One
BSC Parties Represented	*Teesside Power Limited*
No. of Non BSC Parties Represented	Zero
Non BSC Parties represented	
Role of Respondent	Generator

1.1	**Question**	**Response**	**Rationale**
1.	Do you agree with the Panel's views on P136 and the provisional recommendation to the Authority contained in the draft Modification Report that Proposed Modification P136 **should not** be made? Please give rationale.	Yes	For all of the reasons the Panel has listed as 'Against'.
2.	Do you agree that the legal text provided in the draft Modification Report correctly addresses the defect or issue identified in the Modification Proposal? Please give rationale.	N/A	

1.1	Question	Response	Rationale
3.	Do you agree with the Panel's provisional recommendation concerning the Implementation Dates for P136? Please give rationale.	Yes	This appears to be adequate preparation time for all parties concerned.
4.	Are there any further comments on P136 that you wish to make?	No	