

Modification proposal:	<b>Balancing and Settlement Code (BSC) P282: 'Allow MVRNs from Production to Consumption or Vice Versa'</b>		
Decision:	The Authority <sup>1</sup> has decided to reject this proposal <sup>2</sup>		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	23 January 2013	Implementation Date:	n/a

## Background to the modification proposal

BSC Parties are required to keep their licensed Production (exports to the GB system) separate from their licensed Consumption (imports from the GB system) under the current market trading arrangements. Each party is allocated both a Production account and a Consumption account to which energy is credited. Parties are able to trade credited energy between accounts through two methods: Metered Volume Reallocation Notifications (MVRNs) and Energy Contract Volume Notifications (ECVNs)<sup>3</sup>.

The separation of trading accounts was introduced by the New Electricity Trading Arrangements (NETA) in 2001, in order to ensure a level playing field between parties operating on both sides of the market and those operating on one side of the market only, who may be smaller parties or new entrants.

Along with the energy credited to Production and Consumption accounts, any imbalances associated with energy volumes are also kept separate and independently face cash-out prices<sup>4</sup>. It is possible for a party to have opposing imbalances across its accounts (eg long in Production but short in Consumption). It would consequently face the cost of the spread between the main and reverse cash-out price on these imbalances.

## The modification proposal

Statkraft (the proposer) raised P282 (the proposed modification) in March 2012. P282 would allow BSC parties to reallocate their credited energy using MVRNs between Production and Consumption accounts and vice versa, rather than having to trade separately through ECVNs to do so. P282 would allow parties to use MVRNs to shift all credited energy into a single account, combining all imbalances across their portfolios into one volume exposed to the cash-out price. This would remove the risk that parties could face the cash-out price spread on opposing imbalances across different accounts.

The proposer believes that P282 would improve the current market arrangements as:

- the separation of accounts restricts smaller parties from having the flexibility to manage their imbalance risk in the most efficient way;

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision pursuant to section 49A of the Electricity Act 1989.

<sup>3</sup> MVRNs and ECVNs both must be made before gate closure of the applicable settlement period and there are key differences between the two types of trade. MVRNs are made between a lead and subsidiary party, and can be defined as a percentage or fixed volume of energy to be reallocated from one account to another. However, reallocation can only be made from one Production account to another Production account (and similarly for Consumption accounts); whereas ECVNs must define a fixed volume of energy to trade between accounts, but can trade that energy between Production and Consumption accounts.

<sup>4</sup> Cash-out prices are the key incentive to ensure parties meet their contracted positions. Any deviation in generation or supply from these contracts is known as the imbalance volume, which is subject to a cash-out price per MWh of imbalance.

- the original rationale for the separation of accounts to prevent vertically integrated companies from being able to net volumes of generation and supply has not been met as alternative options to reduce imbalance risk are available to these parties;
- the separation of accounts provides an implicit benefit to owners of embedded generation which can choose Production or Consumption status, giving them additional flexibility to manage imbalance risk, and;
- P282 may align the GB market arrangements more with those in other European countries, helping to facilitate a single European energy market.

### **BSC Panel<sup>5</sup> recommendation**

The majority of the Panel voted that P282 would not better facilitate Applicable BSC Objectives b), c) and d) and recommended that it is rejected. They considered that P282 could reduce the incentive for parties to balance their positions in line with their Physical Notifications, potentially increasing uncertainty for the System Operator (SO) in its balancing role, and rewarding those parties less effective at balancing their positions.

A minority of the Panel recommended approval of P282, noting that opposing imbalances across a party's accounts could be considered an 'accounting' rather than actual imbalance, and that the current arrangements may cause parties to go longer than necessary to hedge rather than balance their positions. The full views of the Panel can be found in the Final Modification Report (FMR).

### **The Authority's decision**

The Authority has considered the issues raised by the modification proposal and the FMR dated 18 December 2012. The Authority has considered and taken into account the responses to Elexon's<sup>6</sup> consultation on the proposal which are attached to the FMR<sup>7</sup>.

We have considered P282 in the context of the applicable BSC objectives, our statutory duties, and the Panel's recommendation. We agree with the recommendation of the majority of the Panel to reject P282. The case for whether the implementation of P282 would better facilitate the applicable BSC objectives is not proven *at this stage*.

We have also concluded that approval of P282 would be inconsistent with our statutory duties, especially our principal objective to protect the interests of consumers<sup>8</sup>. The separation of trading accounts needs further consideration in a holistic manner and is included within the scope of our Electricity Balancing Significant Code Review (EBSCR)<sup>9</sup>.

### **Reasons for the Authority's decision**

We consider Applicable BSC Objectives b), c) and d) are relevant to our decision. We agree with the majority Panel view that the impact on Objectives a) and e) is neutral.

<sup>5</sup> The BSC Panel is established and constituted pursuant and in accordance with Section B of the BSC.

<sup>6</sup> The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.

<sup>7</sup> BSC modification proposals, modification reports and representations can be viewed on the Elexon website at <http://www.elexon.co.uk/>

<sup>8</sup> The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

<sup>9</sup> Ofgem (2012); 'Electricity Balancing Significant Code Review (SCR) – Initial Consultation'; [www.ofgem.gov.uk/Markets/WhIMkts/CompandEff/electricity-balancing-scr/Documents1/Electricity%20Balancing%20SCR%20initial%20consultation.pdf](http://www.ofgem.gov.uk/Markets/WhIMkts/CompandEff/electricity-balancing-scr/Documents1/Electricity%20Balancing%20SCR%20initial%20consultation.pdf)

***Applicable Objective b) – the efficient, economic and co-ordinated operation of the National Electricity Transmission system***

If parties could net opposing imbalances across Production and Consumption accounts by consolidation as proposed by P282, this would reduce the total amount of imbalance charges and the Residual Cashflow Reallocation Cashflow (RCRC)<sup>10</sup>. The Workgroup estimated the impact to be a reduction of around 3%. The Workgroup's investigation of the impact on net flows to different parties concluded that P282 would benefit<sup>11</sup> parties which generally have wider spread of, or higher than average, imbalance volumes. P282 therefore appears to reward those less effective at balancing, as concluded by a majority of the Panel.

We agree that total imbalance charges could reduce if parties opt to consolidate imbalances. However, we consider that the impact on overall incentives for parties to balance, and the consequent impact on the SO as the residual system balancer, is less clear. The arguments as to whether P282 would further objective b) are finely balanced.

Although total imbalance charges could reduce under P282, parties would still have an incentive to balance their positions due to the cash-out price and uncertainty around their potential imbalance exposure before Gate Closure. Also, the impact on total imbalance charges (and hence imbalance risk) resulting from P282 is relatively small. Under the current market arrangements, it is considered that there is an implicit restriction on undertaking trades close to Gate Closure due to the administrative risk of doing so. P282 would overcome this, increasing the ability of parties to self-balance closer to Gate Closure, reducing the costs to the SO, and to consumers, of balancing the system.

We note the views of some of the Panel that current arrangements encourage parties to take up 'long' positions to hedge against imbalance risk. A reduction in imbalance charges as a result of P282 could reduce the extent to which parties hedge long ahead of Gate Closure, potentially reducing the costs to consumers. However, this in turn could also reduce the level of 'free'<sup>12</sup> reserve such positions provide to the SO with which it can balance the system, requiring the SO to procure more reserve in response. This could increase overall SO costs of managing the system and increase costs to consumers.

We agree that there is a risk that a reduction in overall imbalance risk may also reduce the incentive for parties to invest in other ways to improve their ability to balance, for example, by improving or maintaining plant reliability or developing improved forecasting abilities. We also note the concern of one Panel member that P282 could incentivise parties to change their behaviour after Gate Closure, increasing uncertainty for the SO, although such behaviour could also violate existing Grid Code obligations.

***Applicable Objective c) – Promoting effective competition in generation and electricity and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity***

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<sup>10</sup> RCRC is the reallocation of total imbalance charges between BSC Parties. A BSC Party's share of RCRC is determined by the proportion of total gross Credited Energy volumes allocated to their energy accounts.

<sup>11</sup> Where benefit is defined as an overall reduction in the net outflow from a party over the given period as a consequence of changes in imbalance charges and RCRC.

<sup>12</sup> This reserve is free from the perspective of the SO but has an associated cost for the parties that hedge long and provide this reserve.

The arguments as to whether P282 better facilitates this objective are also finely balanced. One of the key reasons for raising P282 is that the current arrangements prevent smaller parties from managing their imbalances in the most efficient way. We agree that P282 would provide all parties with an additional tool with which they can manage their imbalance risk. Furthermore, P282 could improve the simplicity of the balancing arrangements, reducing compliance costs, and potentially improving the ability of smaller players and new entrants to compete.

However, the benefits of netting imbalances through P282 may be limited to parties operating on both sides of the market and would not include those operating on one side of the market only. Any additional benefit to vertically integrated participants may impact on the competitiveness of parties operating on one side of the market only. Some Workgroup members suggested that any differential impact may be dampened. We also note a potential secondary differential impact on these parties through changes in the distribution of contracting charges associated with ECVNs<sup>13</sup>. Where parties replace the use of ECVNs with MVRNs, this reduces the proportion of the total notified volume charge these parties face relative to parties operating on one side of the market only.

#### ***Objective d) – promoting efficiency in the implementation of the balancing and settlement arrangements***

Allowing parties to use MVRNs to reallocate credited energy between accounts could reduce the resulting volume of ECVNs submitted. This could reduce the overall level of contracting charges faced by parties associated with ECVNs, but may increase any administrative costs associated with MVRNs, as parties submit a single 'evergreen' MVRN instead, potentially improving the efficiency of the trading arrangements.

We note that the use of MVRNs to reallocate credited energy could reduce the risk of errors associated with ECVN-related administration as noted by the P282 Workgroup.

The Workgroup also discussed the possible impact of P282 on transparency in the market. We note that the majority of the Workgroup considered that any impact is unlikely to be material, and it is unproven whether the current level of transparency is useful to market participants. We also note that the SO's consultation response did not set out any concerns about its ability to balance the system effectively with the information available if P282 were to be implemented.

#### **Our wider statutory duties**

In August 2012, Ofgem launched the EBSCR. The EBSCR seeks to address Ofgem's long-standing concerns with the current balancing and settlement arrangements identified by Project Discovery<sup>14</sup>. One of our main concerns is that dampened and inaccurate price signals have an adverse impact on the incentives for parties to balance and provide flexible capacity. Failing to consider reform could harm future electricity security of supply and unnecessarily increase system balancing costs.

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<sup>13</sup> In particular through the notified volume charge which is used to recover the costs of the Energy Contract Volume Aggregation Agent (ECVAA) service, and levies a charge on Parties based on the absolute volume of energy traded by each Party through ECVNs and fixed volume MVRNs.

<sup>14</sup> Ofgem (2010): 'Project Discovery: Options for delivering secure and sustainable energy supplies'; [www.ofgem.gov.uk/Markets/WhIMkts/monitoring-energy-security/Discovery/Documents1/Project\\_Discovery\\_FebConDoc\\_FINAL.pdf](http://www.ofgem.gov.uk/Markets/WhIMkts/monitoring-energy-security/Discovery/Documents1/Project_Discovery_FebConDoc_FINAL.pdf)

There are strong links between the content of P282 and the scope of the EBSCR. Two of the issues we are considering under the scope of the SCR are implementing single trading accounts and a single cash-out price. The objectives of a single trading account and P282 are closely related. Both a single trading account and a single cash-out price would capture the benefits of P282 by consolidating imbalances across party's accounts.

We aim to publish a draft decision on the EBSCR in spring this year and a final decision early in 2014. We are still considering and developing our proposals based upon the issues within the scope of the EBSCR. Notwithstanding our view that the case for P282 is not proven *at this stage*, we consider that there would be a significant risk associated with approving P282 at this time before we have developed our EBSCR proposals fully due to the strong links between P282 and the EBSCR. P282 could:

- be inconsistent with any wider changes we subsequently propose under the EBSCR, which may make the costs of implementing P282 nugatory; or
- deliver a solution to the issue of single trading accounts but at a greater cost or smaller benefit relative to any alternatives considered under the EBSCR.

### **Overall decision**

Having considered P282 against the applicable BSC objectives above, against our wider statutory duties and the majority Panel recommendation to reject, we have decided to reject P282. We consider that the case for approving P282 as better facilitating the applicable BSC objectives is not proven *at this stage*. There is significant uncertainty around the possible impacts and the arguments to approve or reject are finely balanced.

We also consider that a decision to approve P282 would be inconsistent with our wider statutory duties, in particular, our principal objective to protect the interests of consumers. We have reached this decision in light of the current context where we have launched the EBSCR after P282 was raised.

The EBSCR will consider a wide range of issues regarding potential improvements to the current balancing arrangements and seek to address our long-standing concerns. This includes the issues raised by P282. We consider that these issues require fuller, more holistic, consideration as part of the EBSCR process, to ensure overall consistency of outcomes and to avoid the potential risk of unnecessary implementation costs to industry and consumers. Furthermore, we consider that the case in support of P282 as the most appropriate solution to the issues raised is not proven *at this stage*.

It would be, in our view, in consumers' interests for the EBSCR, which is at a very early stage in development, to run its course and for it to address the issues raised by P282 as part of the wide range of concerns which the EBSCR seeks to address.

**Emma Kelso**

**Associate Partner, Wholesale Markets**

Signed on behalf of the Authority and authorised for that purpose