Responses from P78 Draft Report Consultation
Consultation issued 1 August 2002

Representations were received from the following parties:

No	Company	File Number	No. Parties Represented
1.	TXU Europe	P78_MR_001	21
2.	Powergen	P78_MR_002	3
3.	Edison Mission	P78_MR_003	1
4.	Aquila Networks	P78_MR_004	1
5.	SEEBOARD	P78_MR_005	1
6.	LE Group	P78_MR_006	1
7.	British Gas Trading	P78_MR_007	1
8.	Scottish Power	P78_MR_008	5
9.	Innogy	P78_MR_009	6
10.	Immingham CHP LLP	P78_MR_010	1
11.	Scottish and Southern	P78_MR_011	4
12.	Campbell Carr, Electricity Direct & British Sugar	P78_MR_012	2

P78_MR_001 – TXU Europe

Thank you for the opportunity to comment on Modification Proposals P74 and P78. The following comments are made on behalf of all TXU Europe companies (21 BSC Parties).

TXU does not believe that either of the modification proposals, or their alternatives, should be implemented at this stage. It is not entirely clear that either proposal will improve the separation of system and energy balancing actions. Further, we believe that both these proposals will severely reduce the incentives on participants to balance their positions ahead of gate closure by eliminating or greatly reducing the system buy/system sell spread. For these reasons we do not feel that P74/P74A/P78/P78A better achieve any of the applicable BSC Objectives.

Ofgem recently approved the reduction of the Balancing Reserve Level to 5 MWh and we believe that the market should allow sufficient time for the impact of this reduction to be fully realised and assessed before making any changes to the calculation of Energy Imbalance Prices.

Yours faithfully
Nicola Roberts
Market Development Analyst
TXU Europe Energy Trading Ltd.

P78_MR_002 – Powergen

I am writing in response to consultation on the modification reports for P74 and P78. This response is made on behalf of Powergen UK plc, Powergen Retail Ltd and Cottam Development Centre Ltd. We do not support the recommendation of the Panel that P74 Alternative and P78 Alternative should be implemented.

During the assessment consultation we stated that we did not believe that either P74 Alternative or P78 Alternative better met the relevant BSC objectives. For P74 Alternative we had concerns about whether a single price would provide enough of an incentive for parties to contract sufficiently ahead of gate closure. For P78 Alternative we felt the reverse price was somewhat arbitrary and not cost reflective. We also pointed out that Gate Closure had only recently been set to 1 hour, that BRL was just about to be reduced to 5MWh and that we felt it was too early to make amendments to cash-out prices until the industry had sufficient experience of operating in these circumstances. These views remain.

We believe that it is not possible to perfectly separate energy and system actions and that there are inevitably going to be some actions which have been taken for both purposes. Therefore, to aim to remove all potential system actions from the energy price is not realistic, as it simply means that more energy related actions would end up in BSUoS.

One benefit of the use of the Net Imbalance Volume (NIV) is that in theory it should provide a simpler way of deciding which actions go into energy prices, as it is not necessary to identify which individual trades were made for energy purposes. However, we do not believe that this potential for simplicity is being exploited sufficiently in alternative proposals P74 and P78 to warrant their implementation. They still require a separate identification of a volume of BSAD which is deemed to be for energy purposes and a volume which is deemed to be for system purposes, prior to the use of NIV.

In short, we do not believe that alternative proposals P74 and P78 are more cost reflective, or provide a simpler and more efficient method of setting price. We therefore do not agree with the recommendation that they better meet the relevant BSC objectives.

Yours sincerely,

Paul Jones
Strategy and Regulation

P78_MR_003 – Edison Mission

Edison Mission Energy does not support the rationale for recommending Modification P78. In the absence of supporting analysis of changes to behaviour there is no basis for asserting that P78 will better meet the applicable BSC Objectives. This modification proposal constitutes a material change to the B&SC that warrants more in-depth analysis before approval should be considered. The following issues have been overlooked:

1. P78 creates an artificial suppression of cashout prices. Cashout prices will be formulated from bids/offers and NGC's forward trades. Short duration bids and offers will undergo one arbitrary treatment (those less than 15 mins are deemed to have been taken for system reasons and are not included in the price calculation). NGC will split the forward trades into system and energy trades even though NGC admits that this judgment is very difficult to make. NGC's net forward energy trades will be placed in the relevant price stack an average price of all energy trades. Bids and offers (other than those that are of a short duration) feed into the stacks at the acceptance price. There is no consistency of treatment - too many arbitrary, overly complex judgments are being made which lead to cashout prices that cannot be said to represent the costs of energy balancing. Quite what they do represent is unclear. Such complexity does not promote efficiency in the implementation and administration of the balancing and settlement arrangements

2. The reduction in Gate Closure, the Balancing Reserve Level and Pre-Gate closure BMU Transactions may be sufficient to address the concerns that led to these modification proposals being raised. Further complex changes to the cashout mechanism should not be made until the effects of the reduced BRL, PGBTs and Gate Closure can be assessed - next spring at the earliest. This opinion should not preclude an earlier decision on P90 which simplifies the calculation of cashout prices and removes the need for arbitrary rules and non transparent judgements.

3. In an oversupplied market, with risk averse suppliers who over forecast their demand to avoid exposure to SBP and an asymmetric bid-offer price curve, the main cashout price will most often be set from accepted bids. Since the reverse price is based on the first non arbitraged acceptance on the main stack, the reverse price will also generally be set

from a bid. The resulting low cashout price provides only a weak incentive on parties to balance that will be detrimental to liquidity in short term markets and discriminate against owners of reliable flexible generation. The modification does not therefore promote competition in generation, instead it will reduce competition in generation.

4. Changing from gross to net reporting of NGC BSAD trades will further reduce the transparency of NGC's forward trading activities. As NGC's forward trades can have a potentially large effect on determining system direction (they could change a system that is apparently short as a result of Bid-Offer Acceptances to one which is long once NGC's forward trades are included) we maintain that an *increased* level of transparency associated with NGC's forward trades is required in order that all parties can verify published prices and respond appropriately to market signals. The proposals as described will only add to the opaqueness of the pricing calculation and create uncertainty over the need to balance in the short term markets. To improve transparency, NGC's trades should be disaggregated, reported prior to or at gate closure and each one included in the relevant stack at the traded price and volume.

5. It is proposed that NGC's forward energy trades are priced at the average of all forward energy trades. Using an average of NGC's forward buys and sells as the price of the net energy volume will not reflect those actions taken to achieve the net energy balance; if NGC is a net forward energy seller, the price will be too high; if a purchaser the price will be too low. The proposed methodology will therefore lead to cashout prices that are not reflective of the costs of energy balancing. It is also not clear which NGC trades are to be included. NGC has indicated at the PIMG that it trades forward up to a year in advance. Trades struck so far in advance should not be included as the cashout price is meant to represent the cost of short term balancing. Included trades should be restricted to those struck either day ahead or within day.

In summary, it is Edison Mission's view that P78 does not better facilitate the Applicable BSC Objectives.

Libby Glazebrook
Manager, Market Development

P78_MR_004 – Aquila Networks

Please find that Aquila Networks response to P78 Consultation on draft
Modification Report is 'No Comment'.

regards
Rachael Gardener

Deregulation Control Group &
Distribution Support Office
AQUILA NETWORKS

P78_MR_005 – SEEBOARD

With respect to above mentioned proposal and draft modification report dated 31st July. After considering all aspects of this proposal it is felt that recommendations in section 1.1 should be to reject both main and alternate versions of this proposal. There still seems to be some considerable doubt about both versions in terms of providing a valid value for reverse prices. Given that this is a key area of trading this doubt means that we cannot be fully convinced that this proposal will better facilitate BSC objectives.

Dave Morton
SEEBOARD Energy Limited

P78_MR_006 – LE Group

LE Group (EPN Distribution Ltd, London Electricity plc, London Electricity Group plc, Jade Power Generation Ltd, London Power Networks plc, Sutton Bridge Power, West Burton Ltd) welcomes the opportunity to comment on the draft modification report on P78: Revised Definition of System Buy Price and System Sell Price.

We have the following comments to make.

We agree with the recommendation that P78 original should not be made. We agree with the recommendation that P78 alternative should be made. Our rationale is outlined below.

P78 original is flawed because:
* a lack of liquidity in short term markets will create a gameable reverse price
* there is no evidence to suggest that the pre-gate closure trades that would be used to create the market index reflect the cost of NGC actions taken to balance the system
* there is no guarantee that any 'price reporters' will be able to provide suitable information to construct a market index at the time this modification is implemented

P78 alternative better meets the relevant BSC objectives than the current baseline because:
* the methodology for deriving the main price in P78A better separates system and energy balancing actions through the inclusion of BSAD and CADL'ed Bid-Offer volumes attributable to system balancing in the calculation of the Net Imbalance Volume
* the reverse price is the closest available proxy to the price that NGC would have paid to remove an energy imbalance in the opposite direction to the market imbalance and is based on an action taken by NGC
* the reverse price is robust and not easily manipulated due to the

large number of bids and offers submitted to the Balancing Mechanism and the transparency of the Balancing Mechanism

* the reverse price values participant actions by rewarding spill at the smallest, in absolute terms, energy imbalance-removing accepted Bid-Offer / BSAD price in the Settlement Period and therefore offers no benefit to the participant above the value it would have received had it submitted a bid or offer into the Balancing Mechanism
* this alternative modification maintains a price spread and therefore retains a strong incentive for participants to contract ahead of gate closure

Further detail on these points was given in our response to the second assessment consultation.

Yours sincerely,

Liz Anderson,
General Manager,
Energy Strategy and Regulation

P78_MR_007 – British Gas Trading

Thank you for the opportunity of responding to this final modification report considering Modification Proposals 78 and 78 Alternative (P78A). British Gas Trading (BGT) support Alternative Modification Proposal 78 subject to the comments below.

BGT welcomes these proposals and is aware of the detailed discussions that have taken place in consideration of them. We believe that before discussing the detail of these proposals that we identify the criteria necessary for a successful regime. We believe these to be:

- a strong incentive on every individual party to balance their own supply and demand.
  - a consequentially small residual balancing role for the SO
  - overall minimisation of balancing costs
  - maintenance of liquidity in the forward OTC and PX markets
- where parties are out of balance, that the imbalance costs incurred are reflective of the costs incurred by the SO in resolving that imbalance.

Looking at the detail, we agree that the current energy imbalance cashout regime is not cost reflective and is arguably penal. However, we believe that the principles of cost reflectivity, cost targeting and provision of an incentive to balance underlying the current price calculations are sound and should be retained in any changes that are made.

P78A has a number of advantages over the other modifications that have been considered in detail during the course of the discussions by the Pricing Issues Modifications Group. The following are key points we believe should be highlighted at this stage.

- The use of the Net Imbalance Volume is more cost reflective of the actions taken by NGC to rectify overall energy imbalance. The limited analysis of historical data that has been undertaken to support this proposal shows that there will be some dampening of energy imbalance prices if this proposal is implemented. A less severe SBP will reduce the incentive on participants to maintain a long position, improving the overall balance and efficiency of system balancing by the SO.
- P78A retains a dual price which maintains a price spread and provides strong incentives on Parties to balance their positions for Gate Closure. A dual price mechanism will retain the incentive on parties to contract bilaterally for energy through forward contracts as opposed to spilling energy onto the system.
- We believe P78A targets costs appropriately to those who cause them. There is no reward for participants who are 'favourably' out of balance thereby reducing the incentive to second guess overall system direction.
- The use of the first non-arbitrage bid or offer on the main stack ensures a promptly reported second price that is an acceptable reflection of energy balancing actions costs given the practicalities with the use of a market price (see below).

Whilst theoretically we would prefer the P78 approach of using a market price as the "reverse price", in our opinion the use of a market price derived from power exchanges in this proposal presents a number of practical problems. Our principal concerns are as follows:

- The prompt availability of the prices cannot be guaranteed which may have implications for settlement and the positions taken by Parties.
- Using a power exchange market price means that there is a risk of some participants attempting to set the energy imbalance price in their favour e.g. generation only participants.
- Liquidity in the power exchanges can be low at times and this increases the potential for use of default prices. It is recognised that the current default rules are not robust and this is not a desirable outcome.
- The implementation costs associated with this proposal are significantly higher than those for other proposals. Furthermore, these costs are not final costs as they do not include those for the provision of information from the power exchanges.

We remain concerned that a fundamental underlying issue that remains to be resolved in reforming the energy cashout regime is the proper separation of system balancing actions from the calculation of energy prices. Ideally we would like to see a clear and transparent mechanism of tagging system trades out of the price stacks but, recognising the difficulties associated with achieving this within the BSC, we support P78A as an improvement over the current baseline. Notwithstanding this we are of the opinion that this may only be the first step towards development of the best possible solution

We hope these comments are useful. Should you wish to discuss any of these issues in more detail please do not hesitate to contact me on the number above.

Yours faithfully,

Danielle Lane
Transportation Analyst

P78_MR_008 – Scottish Power

Thanks for the opportunity to respond to this consultation on the P78 Modification Report.

We would reiterate the views, which we expressed in respect of the second Assessment Phase consultation. We continue to support the view that, if we were required to indicate a preference for one of the options presented as solutions, we would choose the P78 Alternative modification. We believe that this option best meets the Applicable BSC Objectives and would agree with the rationale for this as identified by the majority of the Pricing Issues Modification Group.

However, our previous views also indicated concern that these modification proposals did not undergo a more thorough analysis because of their expeditious treatment in terms of the Assessment timetable. We also identified valid reasons why further analysis requires to be undertaken. We believe that our argument for a more thorough consideration of the issues relating to imbalance pricing has been given more credence in two ways. Firstly, because there are now two further modifications being considered in this area, viz. P90 and P95. Secondly, because there is now an opportunity, as a result of the Authority decision on P28, to establish a Pricing Issues Standing Group, which could assess all the relevant issues and present a holistic solution to the problems identified. In our view, this would provide a more efficient and cost-effective method of dealing with market participants' concerns than the current piecemeal approach, which leads to greater uncertainty in the market. It would also allow for a proper perspective to be adopted in respect of the two main recent changes which might impact on imbalance pricing, viz. reduction in Gate Closure to one hour and the revision to the BRL value.

We note that the Modification Report highlights changes to the BSAD Methodology Statement, which will be required to provide consistency between the Statement and the proposed changes to the BSC. We would dispute the view expressed in the Report that the BSC changes should be "dependent upon the results" of the BSAD consultation. We are concerned that the changes being made to the BSAD Methodology are being undertaken prematurely, when the P78 legal drafting has not been finalised. We contrast this with previous changes made to the BSAD Methodology in respect of BSC modifications, when these were consulted upon once the final BSC changes had been identified. It is conceivable, for instance, that the Authority may reject the Panel's recommendations and decide to persevere with the current baseline. This would render the BSAD changes unnecessary. Furthermore, it is clear from the Panel recommendations that none of the proposed solutions can be implemented prior to 25 February 2003 at the earliest. The period between the submission of the final Modification Report to the Authority and the earliest proposed implementation date would allow ample time for a consistent set of changes to the BSAD Methodology to be made and consulted upon.

We note the proposed legal drafting changes in respect of this modification and would agree that they are generally appropriate. However, we would wish to highlight the need to make explicit that the BSAD data to be provided by NGC is net. This would avoid confusion for market participants and could be done simply by inserting the word "Net" in the description of the BSAD cost and volume adjustment variables in Section Q6.3. This is how the same variables are described in the corresponding BSAD changes.

I trust that you will find these comments helpful. Nonetheless, should you require further clarification of any of the above, please do not hesitate to contact me.

Yours Sincerely,

Man Kwong Liu
Calanais Ltd.
For and on behalf of: - *Scottish Power UK Plc.; Scottish Power Energy Trading Ltd.; Scottish Power Generation Ltd.; Scottish Power Energy Retail Ltd.; SP Transmission Ltd.*

P78_MR_009 – Innogy

This submission represents the views of Innogy plc, npower Limited, Innogy Cogen Trading Limited, npower Direct Limited, npower Northern Limited, npower Yorkshire Limited.

Generally we believe that the draft Modification Reports for P74 and P78 represent a fair summary of the rationale for the recommendations, and the description of the processes that have been proposed.

The draft report for P74 indicates that the Modification Group failed to reach a clear view that P74A better achieves the relevant BSC objectives. Given the importance of this Modification to the functioning of the market it seems somewhat unfortunate that the PIMG could not be given the additional time that was requested. This would have enabled them to undertake the relevant modelling that was proposed and thus give them greater confidence in formulating a definite conclusion to their deliberations.

We note that the summary of the representations made by parties has not yet been included in the report. Given past difficulties we would wish to reserve our position concerning any issues that might emerge from these summaries until this part of the drafting is complete. We would trust that the report will faithfully record our support for P74A as a pragmatic single cash-out price model, and note that P74, P78 and P78A are, in our view, inappropriate.

P78_MR_010 – Immingham CHP LLP

Thank you for the opportunity for commenting on the P74/P78 draft Modification reports. Please treat this reply as a response to both draft reports.

The current imbalance price setting rules fail to deliver the intended outcomes. In particular, they load energy imbalance charges, including some associated with system balance, on out of balance parties and unnecessarily increase market risk. The methodology is therefore punitive and penal to parties in imbalance.

As a general remark, we consider that P74 and P78, both original and alternative formulations, better meet the applicable objectives than the existing imbalance pricing rules, and **we support the recommendations in both the draft reports** as endorsed by the

BSC Panel. Of the four choices, **we strongly believe P78 Alternative <u>best</u> facilitates the applicable objectives**. The primary reason for this judgement relates both to efficiency as it provides the most cost reflective approach and to facilitating competition in the market by removing barriers to intermittent technologies. In addition we believe this is the modification most likely to incentivise parties to balance their position.

We have previously provided full responses to the initial and full assessment phases on both modifications that lay out our views in greater detail, and these are remain generally applicable to the draft reports.

Maureen McCaffrey
For Immingham CHP LLP

P78_MR_011 – Scottish and Southern

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

Further to your note of 1st August 2002, and the associated Modification Report for P78, we agree with the proposed BSC Panel recommendation to the Authority that the Original Modification Proposal P78 should not be made and we agree with the proposed BSC Panel recommendation to the Authority that the Alternative Modification Proposal P78 should be made.

For the avoidance of doubt, we would prefer that the Authority approve the Alternative Modification Proposal P78, rather than the Alternative Modification P74.

If the Modification Proposal P78 is approved, we agree with the proposed BSC Panel recommendation on the timing for the Implementation Date, as outlined in Section 1.1 of the Modification Report.

P78_MR_012 – Campbell Carr, Electricity Direct & British Sugar

Although the PIMG could not come to a definitive conclusion on every proposition posed in these two Modifications, there has been an impressive degree of progress on several points. These must have been crucial in the Panel's unanimous recommendation in favour of both of the Alternative Modifications. This response addresses both Modifications together because so many of the areas covered are common.

This response is in two main parts. In the first, we discuss some of the key issues where there is scope for confusion or disagreement in order to offer a clear considered view on the point. In the second, the proposals are assessed against the BSC Objectives.

Main Issues
Cost-reflectivity

The transmission company has clearly stated that no action taken by it in the reverse direction of the system's overall balance is for energy balancing reasons – they are all for systems reasons.
o There is therefore no energy cost to reflect in the reverse price. The current pricing mechanism for the reverse price must therefore be penal and cannot be cost-reflective.
o The only energy reason for reverse-flow actions over a full trading period is to prepare plant to carry reserve. Given the extent of option contracting by NGC and the extent of part-loading of plant (even without actions taken to buy the market back from its hitherto habitual long position), there seems no foreseeable need for NGC to procure reserve in forward markets or in the balancing mechanism.
o There can still be actions for within-period energy imbalances (not all of which will be removed by CADL). Participants cannot trade out of such positions. The within-period imbalance cannot be accurately attributed to any party because a party causing/contributing to the within-period reverse-flow imbalance may have a net imbalance in the opposite direction over the whole of the trading period.
o Although the point was exhaustively debated at the time of Modification P18A, there remains considerable confusion about the role of imbalance prices. They are not designed for cost allocation but for cost reflection. It is therefore irrelevant whether particular actions for energy purposes have been excluded from the calculation of the energy price if the inclusion or otherwise of such an action does not significantly move the resulting imbalance price.
A participant imbalance in the reverse direction allows the transmission company to avoid taking a balancing action and so its cost-reflective value should be that of the action avoided. This tends to favour the single-price proposed in P74 (although the reverse-flow price proposed in P78 may be favoured for other reasons).
From a pure economic perspective, the market can only be out of balance in one direction and so there can only be one marginal value of imbalance energy.

Incentive to balance

The current regime is an incentive on suppliers to spill (this is supported by the algebra presented in the Assessment Reports – P74 Annex 6b, 78 Annex 5). This is related to the fundamental nature of price-setting in the balancing mechanism whereby the range of prices of Bid Acceptances will usually be less than the range of Offer Acceptance prices. Even with BSAD adjustments, trade tagging and CADL, the probability of price spikes in the buy direction is considerably higher, hence a supplier incentive to over-contract.
Both proposals reduce the penalty for being out of balance in the reverse direction and so will tend to reduce the incentive on suppliers to spill.
o This will lead to a more balanced market.
o The frequency of NGC energy purchases (both before and after gate closure) will increase and its energy sales will reduce. BSUoS will inevitably increase but this should not be regarded as an increase in the cost of balancing because that cost is currently being borne by suppliers through excess contracting, the cost of which feeds through to customers. In reality, in a balanced market, there will only be central purchase of residual balancing services and the overall cost should be lower to the customer.
As indicated by the algebra, the incentive to balance in P74 is based purely on the direction of the market but the incentives in P78 are more complex. Both improve on the current mechanism whereby market balance is irrelevant.
Both proposals incentivise suppliers to balance to their own forecasts of demand. This is not fully obvious in P74 because there is an apparent incentive to take a position opposite to the market. In reality, this incentive is a chimera because no party (including NGC) will have

sufficient information about the intentions of other parties before gate closure. Any out of balance position taken is therefore a gamble and, to the larger the gamble taken, the greater the risk that the gambler will tip market balance against himself.

- Nevertheless, the incentive to take a contrary position is lower in P78 because the potential reward is less. Whether this leads to a more balanced net position cannot be judged – it depends on the extent to which such "voluntary" imbalances offset involuntary ones (when generators trip or else when suppliers mis-forecast).

Incentive to spill

- NGC's main contention against P74 is a belief that parties will be happier to take the "average" imbalance price rather than to contract ahead of gate closure or else to submit bids and offers. This is mistaken for the following reasons:
  - As demonstrated by the algebra already mentioned, the incentive on suppliers is to contract to avoid expected imbalance prices. In a free market, the spot price will adjust up to the point where suppliers are indifferent as between exposure to expected imbalance prices in both directions and taking that spot price. At this point, suppliers will be fully contracted provided that generators are offering energy at that price.
  - Annex 6c of the P74 Assessment Report demonstrates that generators will be likely to be offering spot contracts at their risk-adjusted expected spill price (and will contract at that price for price certainty rather than spilling at risk of only getting SSP) but will also be better off offering the energy to NGC rather than spilling because their risk-adjusted position is better.
- Although the Transmission Company believes that it is wrong that any imbalance should earn more than has been earned from a BM Acceptance, this is a moral position rather than an economic one:
  - An intentional imbalance is a risk position whose ex ante value must reflect both the expected system prices, whereas a BM Acceptance is a contract at a defined price;
  - An unintentional balance is also a risk position but one that, by definition, is not in the control of the out-of-balance party. Therefore, in an incentive regime, there is in perverse incentive in rewarding this position at the value of system imbalance.

Liquidity

- It has been asserted that liquidity will be drained from the spot and forward markets and replaced by CfDs. It is not certain whether parties will use CfDs rather than spot trading to manage imbalance risk but it should be noted that any long-term contract (base load or shaped) can remove liquidity from shorter-term markets and the fact that the long-term contract is in the form of a CfD is not particularly relevant. A CfD is just another form of long to medium-term contract.
- In addition P74 (but not P78) removes notification risk from the market because of the fallback of CfD terms in the event of notification failure. This must increase the potential for liquidity in prompt markets.
- Notified contracts are likely to predominate even so for the following reasons:
  - Once a contract has been notified, only residual credit risk need be allowed for under BSC terms – market credit terms are likely to be less onerous and hence cheaper.
  - Parties will prefer notified contracts because delivery is made at gate closure rather than on delivery of meter reads (at settlement). This is of particular benefit to suppliers.
- Non-physical Traders will be able to take a fallback physical position and so will be in a better position to offer risk management "across the system". This increases the competition for provision of risk management and is more efficient than reliance solely on Consolidators.

Assessment against the BSC Objectives

Modification P74

This proposal incentivises better balance of the system. As such, NGC only needs to take a residual balancing position rather than habitually needing to dispose of significant volumes of excess energy. This therefore allows more efficient and economic operation of the balancing mechanism.

The Original Proposal priced imbalances in the main direction in the same way as the current mechanism and so, in this respect is at least as good as the current baseline. The Alternative Modification utilises NGC's assessment of those balancing actions taken for energy balancing reasons and therefore provides a more cost-reflective price than the baseline – again in the main direction.

Both the Original Proposal and the Alternative value reverse-flow imbalances at approximately NGC's avoided cost of managing energy imbalances and so are both significantly more cost-reflective than the base line. This cost-reflective position therefore facilitates competition in generation and supply by correctly pricing imbalance positions.

Modification P78

This proposal also incentivises better balance of the system, which allows more efficient and economic operation of the system.

The proposal removes more systems-balancing actions from the calculation of the main price and so is more reflective of the cost of energy imbalance than is the baseline.

The principle behind calculation of the reverse price differs from that of P74. The price used is intended to represent the cost that the out-of-balance party could have incurred before gate closure had that party traded out its position then. The price must therefore reflect some form of pre-gate closure market price. Because NGC will not have taken any energy actions in the reverse direction for energy reasons, there is no cost that such a price can reflect. The resultant price is therefore more cost-reflective than the current position, which erroneously reflects the cost of systems actions (and not energy actions).

However, there remains a debate between whether a market index should be used for this reverse price or whether some form of proxy is preferable. The Transmission Company adheres to its original proposal that a market index should be used and this is to be preferred on theoretical grounds. However, the proposed proxy price remains better on practical grounds as is exhaustively explained in the Assessment Report. We therefore support the Panel in recommending the Alternative, noting that the price used is meant to "reflect" the cost that the individual party avoided by going into imbalance rather than seeking to precisely measure that cost and so this proxy seems a sufficiently close approximation for the intended price.

Conclusion

The current price-setting mechanism has serious flaws that distort the market and needs to be improved to facilitate competition. Such distortions will not be improved significantly by the introduction 1-hour gate closure or by the recent reduction in BRL. By punishing all imbalances, parties are led down a "least-bad" route rather than an efficient one that optimises the cost of managing imbalance risk.

Both Modifications and their Alternatives improve the situation by removing distortions and perverse incentives. It is unfortunate that the situation cannot be remedied before the coming winter.

The Panel is correct to recommend the Alternatives of both Modifications. The P74 Alternative improves the cost-reflectivity of the "Main Price" and ensures the promptness of price reporting (although this could have been easily accommodated by a minor change to the Original Proposal).
The case for the P78 Alternative is less clear-cut relative to the Original but is to be preferred because it is close to the Original but with lower implementation risks and costs.
P74 Alternative is to be preferred over P78 Alternative because it is more likely to stimulate market liquidity but both proposals are a significant improvement on the status quo.

Yours sincerely

Robert Barnett
Economics Consultant
Campbell Carr Limited