



Direct Dial: 020-7901 7412

27 February 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref : MP No: P26

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") - Decision and Notice in relation to Modification Proposal P26: "Market-Driven Trading Neutrality Band"

The Gas and Electricity Markets Authority (the "Authority") has carefully considered the issues raised in Modification Proposal P26 "Market-Driven Trading Neutrality Band".

The Balancing and Settlement Code Panel (the "Panel") recommended to the Authority that Modification Proposal P26 be rejected.

The Authority agrees with the Panel's recommendation. This letter explains the background to the Modification Proposal and sets out the Authority's reasons for its decision.

Background to the proposal

NETA is designed to ensure that there is sufficient incentive on participants to balance their individual trading positions and minimise the costs to the National Grid Company plc (NGC) as System Operator ("SO") of balancing the Transmission System ("System"). Market participants can contract ahead in the forwards, futures and short-term markets to balance their contract position ahead of Gate Closure (3½ hours before real time). Gate Closure is the last point at which Parties can notify their contract position to NETA Central Systems. For each Settlement Period the metered volumes for each Trading Party are used to determine if the actual volumes taken from, or put onto the System match their notified contractual volumes. Parties with a position of energy imbalance will be exposed to the relevant Energy Imbalance Prices for the relevant Settlement Period. There are dual Energy Imbalance Prices: the System Sell Price ("SSP") and the System Buy Price ("SBP"). When generators are 'short' of electricity i.e. metered volumes are less than contracted volumes, the shortfall of generation is paid for at the SBP. When generators are 'long' of electricity i.e. contracted volumes are less than metered volumes, the spill is paid at the SSP. This creates an incentive for participants to balance their predicted metered output to their contract position.

On 25 June 2001 BizzEnergy submitted Modification Proposal P26: "Market-Driven Trading Neutrality Band". The Proposer argued that the smallest volume of energy traded on power exchanges is 20MWh and that the transaction cost for acquiring smaller volumes is very high. The Proposer suggested aggregation services, where a participant can buy a small portion of a power exchange trade, are available, but to date, the prices offered on such services have been uneconomic for new entrants. It was also suggested that due to granularity and a lack of liquidity in spot markets, new entrant suppliers and small generators cannot acquire or sell energy in volumes appropriate to their forecast balance position and this puts them at a competitive disadvantage relative to larger participants. The Proposer argued that by providing a Neutral Price for small imbalance positions, a barrier to entry into the market would be removed.

The Modification Proposal

Modification Proposal P26 seeks to better facilitate the achievement of the relevant BSC Objectives¹ by providing all participants in the market with a Trading Neutrality Band decided annually by the Panel. The intent of such a Trading Neutrality Band is to allow BSC Parties a defined volume of energy imbalance which would be cashed out for each Settlement Period at a Neutral Price, with the remaining energy imbalance cashed out under existing arrangements, i.e. subject to either the SSP or the SBP, as appropriate. The Modification Proposal suggested that the initial band should be 20MWh.

The Neutral Price would be a single price applied to the energy imbalance covered by the Trading Neutrality Band. It was proposed that the Neutral Price be a £/MWh variable and that amendments to the Neutral Price between settlement runs be supported by the settlement calculations. It is also proposed that ELEXON display the Neutral Prices for all Settlement Periods on the ELEXON website for information.

The Modification Proposal suggested that the Panel determine the methodology for determining the Neutral Price. The Modification Group ("the Group") recommended that, at least initially, the Neutral Price be the last traded price on the UKPX², for each Settlement Period. A last traded price was proposed, as opposed to a weighted average price to prevent Parties being able to predict the Neutral Price before real time and the subsequent arbitrage opportunities this would create.

It was proposed that the Panel would annually consult on the level of liquidity in spot markets and recommend to the Authority whether the level of granularity in the spot markets has sufficiently reduced to enable participants to trade out of residual imbalances at reasonable cost (with 'reasonable' being quantified as a cost at which smaller players are able to compete effectively³).

During the Assessment phase, the Group developed an Alternative Modification Proposal. A view was expressed that the Trading Neutrality Band should be a proportion of total output given that a fixed MWh volume disproportionately advantages smaller players. The Alternative Modification proposed that the amount of energy imbalance to be cashed out at a Neutral Price for each Settlement Period to be the lower of a percentage of BSC Parties' Account Credited Energy Volume or a fixed MWh value for the Trading Neutrality Band. After further assessment, the Group determined that the Alternative Modification Proposal should be rejected, given that it was not in accordance with the principle objective of the Modification, which is to overcome the issues of granularity. The Group considered that if a percentage of a small amount of Credited Energy is subject to the Trading Neutrality Band, then there is the potential for the Party to have to obtain even smaller volumes of trades in the prompt market, thus defeating the objective of the Modification Proposal.

The Group identified a number of issues relevant to whether the Modification Proposal better meets the relevant BSC Objectives. However, the Group was unable to reach a consensus. Some members of the Group believed the Modification Proposal reduces the incentives on Parties to balance, which would potentially increase Balancing Mechanism costs. A contrasting view was that the Modification Proposal improves the incentive to balance rather than being long. Some members of the Group argued that the Modification Proposal may encourage the splitting of companies into affiliates in order to maximise the benefits of the Trading Neutrality Band, thus reducing the administrative efficiency of the BSC. Some members of the Group also argued that the Modification Proposal reduces the incentives to develop sub-20MWh products and would limit competition in demand forecasting products.

The Group agreed that if granularity and liquidity of the forwards/spot markets is insufficient to enable a smaller player to trade effectively and economically then this Modification Proposal would better facilitate promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity. However, the Group was unable to determine the granularity/liquidity and costs in the forwards/spot markets for

¹ The relevant BSC Objectives are contained in Condition C3.3 of NGC's Transmission Licence and are:

- (a) the efficient discharge by the licensee of the obligations imposed upon it by this licence;
- (b) the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system;
- (c) promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity;
- (d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

² United Kingdom Power Exchange

³ The effective cost of energy includes transaction costs, system costs and trading desk costs.

small players and associated smaller volume trades. Therefore the Group could not reach consensus as to whether the Modification Proposal better facilitated achievement of the relevant BSC Objectives. The Group recommended that the Panel should determine if the Modification Proposal better meets the achievement of the relevant BSC Objectives based on the analysis, consultation and assessment undertaken and the resultant findings outlined in the Assessment Report.

The Panel considered the Group's Assessment Report at their meeting of 18 October 2001 and decided that the Modification Proposal better facilitated achievement of the relevant BSC Objectives subject to further analysis to support the determination of the value of the Trading Neutrality Band and Neutral Price methodology. The Panel decided to proceed to the Report Phase, with the proposed implementation date to be determined and consulted upon by ELEXON during the Report Phase.

Further detailed analysis was sought by ELEXON from power exchanges and Settlement Reports. The analysis revealed that across all Parties, 40 percent of instances of Energy Imbalance are for volumes of less than 1MWh, and 52 percent are for less than 2MWh. The analysis also revealed that the Modification Proposal would decrease the Residual Cashflow Reallocation Cashflow to an extent that it might be negative for some Settlement Periods. In addition, the analysis revealed that there are small volumes available to trade and a comparison of prices against traded volumes over time indicates that there appears to be relatively little correlation between price and volume.

ELEXON published a draft Modification Report on 27 November 2001 which invited respondents' views. The draft Modification Report included the further detailed analysis.

Respondents' views

In total, ELEXON received 12 responses to the consultation on Modification Proposal P26. Of the responses, four expressed support for the original Modification Proposal and the remaining eight did not support the original Modification Proposal or the Alternative Modification Proposal.

The respondents that supported the original Modification Proposal argued that a Trading Neutrality Band offers a degree of protection to smaller Parties, which is needed if these smaller Parties are to compete in the market. One respondent suggested that medium and large sized Parties would still seek to minimise their imbalance to gain price certainty through traded contracts in preference to an uncertain Neutral Price.

One respondent supporting the original Modification Proposal believed that the data analysis carried out by ELEXON supports the introduction of a Trading Neutrality Band set at 20MWh. Other respondents suggested that the Trading Neutrality Band should be between 1MWh and 5MWh.

Some of the respondents that did not support the original Modification Proposal or the Alternative Modification Proposal suggested that the analysis carried out by ELEXON demonstrates that there is sufficient granularity in the markets for all Parties to trade out of residual imbalances at a reasonable cost and that the justification for the Modification Proposal is therefore invalid.

Some of the respondents argued that the Modification Proposal would reduce the incentive on Parties to balance by reducing the incentive to forecast correctly and contract accordingly. It was suggested that if a neutrality band of 20MWh existed the average amount of imbalance would increase towards this figure. It was also argued that this would mean a significant increase in the cost of balancing actions taken by the SO which would be detrimental to the BSC objective of the efficient and economic operation by the Transmission Company of the Transmission System.

One respondent commented that the development of consolidation, aggregation and similar services would be a better way to address the difficulties of small players with respect to the issues highlighted in the Modification Proposal. Some of the respondents commented that this Modification Proposal would inhibit the development of products with a volume smaller than the neutrality band and would reduce liquidity in the short-term forward markets.

Panel's Recommendation

The Panel met on 13 December 2001 and considered the Modification Report, the views of the Modification Group and the consultation responses received. In addition the Panel considered the

further analysis undertaken in the Report Phase on the Trading Neutrality Band and the associated Neutral Price. The Panel amended the recommendation to support the Modification Proposal contained in the draft Modification Report and recommended that the original Modification Proposal and the Alternative Modification Proposal be rejected.

The Panel argued that the additional analysis did not appear to support the assertions of the Modification Proposal regarding the granularity and liquidity of the forwards/spot markets, or the assertion that it is uneconomic to trade smaller volumes. The Panel argued that the Modification Proposal could result in a decrease in liquidity and granularity of the forwards/spot markets as it could negate the requirement to trade and to develop risk management products for volumes smaller than the value of the band.

The Panel concluded that neither the Modification Proposal nor the Alternative Modification Proposal would better facilitate the achievement of the relevant BSC Objectives. In particular, the Panel argued that it would not further the BSC Objective of promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity.

Ofgem's view

Ofgem⁴ considers that Modification Proposal P26 does not better facilitate the relevant BSC Objectives. Ofgem agrees with the Panel that the Modification Proposal is not consistent with the achievement of the relevant BSC Objective of promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity.

Ofgem believes that the costs of Electricity Balancing should be targeted to participants who are out of balance and should reflect the cost to NGC of keeping the System in Electricity Balance during that period. The introduction of a Trading Neutrality Band and an associated Neutral Price would result in imbalance charges that do not reflect the cost of all Energy Balancing actions taken by the SO. This could result in the introduction of cross-subsidies between Parties as Electricity Balancing costs would only be targeted on those Parties in excess of the Trading Neutrality Band. In particular small Parties whose total production/consumption is less than or close to the value of the Trading Neutrality Band would have no or minimal exposure to Energy Imbalance Prices. The incentives upon them to balance would be unreflective of the Electricity Balancing costs they impose which could be significant when combined across a number of small Parties.

Ofgem considers that the introduction of a Neutral Price and a Trading Neutrality Band will decrease transparency in the operation of the BSC and create uncertainty and risk for market participants.

Ofgem agrees with the conclusion of the Panel that there is sufficient granularity and liquidity in the forwards/spots markets for small players to be able to manage their imbalance exposure economically. Ofgem has noted that smaller players believe that they have found it harder than larger players to access the wholesale markets under NETA. Ofgem considers that through the development of aggregation or consolidation services smaller players will have further options for accessing the wholesale markets and mitigating the risk of exposure to imbalance cash-out prices. Ofgem agrees with some respondents and the Panel that the Modification Proposal would inhibit the development of such services and other risk management products.

Ofgem agrees with the views of some respondents that the Modification Proposal would reduce the incentive on Parties to balance. Ofgem considers that a reduction in the incentive to balance may lead to an increase in the cost of balancing actions taken by NGC. Ofgem considers that this situation would therefore not further the BSC Objective of the efficient and economic operation by the Transmission Company of the Transmission System.

The Authority's decision

⁴ Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

The Authority agrees with the Panel's recommendation that Modification Proposal P26 should be rejected.

Having regard to the above, the Authority, in accordance with Section F1.1.4 of the BSC, hereby notifies NGC that it does not intend to direct NGC to modify the BSC as set out in Modification Proposal P26.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number, or alternatively contact Anthony Doherty on 020 7901 7159.

Yours sincerely



ng Arrangements

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