Modification Proposal

MP No: 26
(mandatory by BSCCo)

Title of Modification Proposal *(mandatory by proposer)***:**

Market-Driven Trading Neutrality Band

Submission Date *(mandatory by proposer)***:** 25th June 2001

Description of Proposed Modification *(mandatory by proposer)***:**

All participants in the market should be allowed a Trading Neutrality Band decided annually by the Panel. The initial band should be 20MWh per half-hour.

Imbalances within this band should be cashed out at a single neutral price. This could be either:

1 The closing (last-traded) price in an approved power exchange;

2 The average exchange traded price in the the preceeding 24 hours (which reduces the possibility of market manipulation and incorporates the period when the market will have traded most liquidly);

3 Any other neutral price that represents the value of short-term energy.

Imbalances beyond the Trading Neutrality Band would be cashed out at the appropriate SSP or SBP.

Annually, the Panel will consult on the level of liquidity in spot markets and will then recommend to the Authority as to whether there is a reduced level of granularity in such markets sufficient to enable participants to trade out of residual imbalances at reasonable cost. With approval of the Authority, such smaller Trading Neutrality Band will apply with 1 month's notice.

Description of Issue or Defect that Modification Proposal Seeks to Address *(mandatory by proposer)***:**

Participants have a strong incentive to balance their portfolio of contracts to their predicted metered output. This is made feasible by an ability to contract up until gate closure in spot markets. There is therefore a strong dependency on the liquidity and efficiency of the spot markets. This will take time to develop and, to an extent, is hampered by the degree to which flexible generation is in the control of a limited number of portfolio and vertically integrated participants.

In particular, a high degree of liquidity and trading volume is required before products are offered on such markets that represent the small volumes of energy needed to fine tune small portfolios (be they supply or embedded generator type portfolios). A supplier with a 1% market share and a requirement for 3% extra energy in a half-hour would require 7MWh on an average half-hour. A new-entrant supplier would have much less that a 1% market share for some considerable time. Currently, the smallest volume of energy normally trading on current power exchanges is 20MWh, with the transaction cost for acquiring smaller volumes being very high. It is the lack of such liquidity that may be contributing to some participants going long because they cannot buy in quantities that would allow them to reach closer to balance.

To an extent, parties are offering an aggregating service whereby suppliers can buy a portion of an aggregated power exchange trade. But, to set up such a function requires either a significant portfolio of flexible generation or else the development of a market-making function, which entails the absorption of imbalance risk. To date, the prices offered on such services have been uneconomic for new entrants.

This Proposal seeks to ensure that, until such time as spot markets can provide the required variety and precision of energy contracts, new entrants and other niche players can, for an appropriate portion of energy, avoid the excessive transaction costs required for a full imbalance avoidance strategy.

In providing a neutral cash-out price for these residual imbalances, all players are able to contract to a reasonably tight level of balance at reasonable cost, without imposing excessive costs on other participants.

Impact on Code *(optional by proposer)***:**

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Impact on Core Industry Documents *(optional by proposer)*:

Impact on BSC Systems and Other Relevant Systems and Processes Used by Parties *(optional by proposer)*:

Impact on other Configurable Items *(optional by proposer)*:

Justification for Proposed Modification with Reference to Applicable BSC Objectives *(mandatory by proposer)*:

Due to granularity and 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. This puts them at a competitive disadvantage relative to larger participants. By providing a neutral price for small imbalance positions, a barrier to entry into the supply market is removed. This therefore satisfies the Applicable BSC Objective of facilitating competition between generators and between suppliers.

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Attachments: NO

If Yes, Title and No. of Pages of Each Attachment: