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08 January 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref: MP No: P15/P18B

Dear Colleague

Modification to the Balancing and Settlement Code (“BSC”) – Decision and Notice in relation to Modification Proposal P15: “Removal of Price Spikes Associated with System Balancing From System Prices” and Modification Proposal P18B: “Removing/Mitigating the Effect of System Balancing Actions in the Imbalance Price Calculations”

The Gas and Electricity Markets Authority (the “Authority”) has carefully considered the issues raised in Modification Proposal P15: “Removal of Price Spikes Associated with System Balancing From System Prices” and in Modification Proposal P18B: “Removing/Mitigating the Effect of System Balancing Actions in the Imbalance Price Calculations”.

The BSC Panel (the “Panel”) recommended to the Authority that Modification Proposals P15 and P18B should be rejected.

The Authority agrees with the Panel’s recommendation and has decided not to direct a modification to the BSC. This letter explains the background to the Modification Proposals and sets out the Authority’s reasons for its decision.

Background to the proposals

The Balancing Mechanism was designed, amongst other things, to enable NGC as the System Operator (“SO”), to keep the transmission system (the “System”) in Electricity Balance close to, and in real time, by adjusting levels of generation and demand in the light of the Bids and Offers submitted. The SO also uses the Balancing Mechanism to ensure that

the System remains within safe operating limits¹, and that the pattern of generation and demand is consistent with any System transmission constraints. NGC, as SO, therefore incurs costs which can be approximately divided between costs associated with 'Electricity Balancing' and 'System Balancing'.

In the first two months of operation of NETA, participants became concerned that some costs associated with System Balancing actions were included in the calculation of Energy Imbalance Prices. Participants were concerned that this was leading to Energy Imbalance Prices that did not reflect the costs of Electricity Imbalances.

On 23 May 2001, Vattenfall AB proposed a modification to the BSC, Modification Proposal P15, which sought to remove Price Spikes associated with System Balancing from Energy Imbalance Prices. NGC, also on 23 May 2001, proposed two modifications to the BSC: Modification Proposal P18 option A and Modification Proposal P18 option B which sought to remove/mitigate the effect of System Balancing action in the Energy Imbalance Price Calculations. Ofgem² considered that, although contained in a single application, Modification Proposal P18A and Modification Proposal 18B were properly considered to be two separate Modification Proposals.

The Panel combined Modification Proposal P15 with Modification Proposal P18A and Modification Proposal P18B for joint assessment. Following the recommendation from the BSC Panel Chairman, supported by the BSC Panel, the Authority consented to Modification Proposals P15, P18A and P18B being treated as Urgent Modification Proposals and agreed the process and initial timetable in accordance with Section F2.9 of the BSC on 25 May 2001.

The initial Consultation Document on Modification Proposals P15, P18A and P18B was issued for comment on 5 June 2001. After consideration of the consultation responses, the Modification Group (the "Group") issued an Interim Report for consideration by the Panel at its meeting on the 14 June 2001. The Group discussed the merits of the proposals and considered that as the proposals seek to address similar issues and recognising that each proposal is to be treated as an Urgent Modification Proposal, the Modification Group sought to ensure that resources were not diluted by progressing each proposal in parallel. The Group instead recommended that proposal P18A should be progressed whilst proposals P15 and P18B should be deferred awaiting confirmation of the feasibility of P18A. The Panel agreed with this recommendation and sought the approval of the Authority. On 20 June 2001, the Authority consented to defer the consideration of Modification Proposal P15 and

¹ As prescribed by The Electricity Supply Regulations, 1988 (amended 1998) and consistent with its statutory duties and licence conditions.

² Ofgem is the office of the Authority. The terms "Ofgem" and "Authority" are used interchangeably in this document.

Modification P18B in favour of Modification P18A, given the Urgent status of the Modification Proposals.

On 22 August 2001, the Authority determined, having had regard to its statutory duties, that Modification Proposal P18A better facilitated the relevant objectives of the BSC and approved the implementation date of 25 September 2001. In its decision letter for Modification Proposal P18A, the Authority stated that it expected that Modification Proposals P15 and P18B should complete their respective modification procedures.

ELEXON submitted a paper in relation to the progression of Modification Proposals P15 and P18B for consideration at the Panel meeting on 20 September 2001. The paper suggested that the Modification Proposals should continue to be progressed concurrently and provided a timetable based on the existing Urgent status of these Modification Proposals. The Panel sought the Authority's approval of the proposed procedure and timetable. On 27 September 2001, the Authority approved the proposed procedure and timetable for the Urgent Modification Proposals.

The Modification Proposals

Modification Proposal P15 seeks to tag and remove Bid Offer Acceptances ("BOAs") with an acceptance time less than 30 minutes before the start of the real time half-hour period from the calculation of the System Buy Price ("SBP") and System Sell Price ("SSP").

Under Modification Proposal P15, the removal and/or truncation of BOA's is based upon the lead-time between the Acceptance Time and the first minute of the Settlement Period(s) over which the BOA applies. Truncation applies to any section of a BOA for which the applicable Settlement Period begins before or within 30 minutes of the Acceptance Time. The truncation of the BOA continues until a Settlement Period begins that is more than 30 minutes after the Acceptance Time.

Modification Proposal P18B proposes that the Balancing Reserve Level ("BRL") should be set as a minimum volume of balancing actions from which the Energy Imbalance Prices can be set. When there is a smaller volume of actions, the imbalance price would be set as a weighted average of the price derived from the current rules and the default price that would apply if no balancing actions had been taken. The weighting would be in proportion to the volume of balancing actions, and BRL minus this volume, respectively.

Modification Proposal P18B aims to amend the Energy Imbalance Prices calculations in instances when there is a small number of system balancing actions. In these instances, it is argued that System Balancing BOAs may have an increased effect.

The timetable agreed by the Authority for completion of the modification process included data analysis of the effect of each Modification Proposal. The Group determined that further analysis should take place against a baseline of the BSC that included the effects of the

implementation of Modification Proposal P18A, as the analysis undertaken on Modification Proposals P15 and P18B before they were deferred did not take the presence of Modification Proposal P18A into account. The effect of Modification Proposal P18A is that it excludes from the Electricity Imbalance Prices calculations all BOAs with duration of up to 15 minutes. Consequently, the potential effects of Modification Proposals P15 and P18B needed to be assessed taking into consideration that there are fewer BOAs contributing to Energy Imbalance Prices than when the Modification Proposals were initially put forward in May 2001.

The Group, mindful of the Authority's decision on the 26 September 2001 to reject the Panel's recommendation to reset the BRL from 180 MWh to 5 MWh, directed ELEXON to concentrate its analysis on Modification Proposal P15 and its impact.

The analysis concluded that there is little evidence that Modification Proposal P15, in any of its forms, is better at identifying System Balancing actions than Modification Proposal P18A on its own.

A Consultation Document including the data analysis was issued to the market participants on 19 October 2001 with responses requested by 30 October 2001 to determine whether the BSC Objectives would be better facilitated by the implementation of either Modification Proposal. Previous consultations have been held in respect of Modification Proposals P15 and P18, however, they were against a different baseline of the BSC.

Respondents' views

ELEXON received 16 responses to the Consultation Document on Modification Proposals P15 and P18B. In regards to Modification Proposal P15, of the respondents 13 believed that P15 should be taken to the Report Stage with a recommendation to reject the Modification Proposal and 3 respondents did not agree with this approach. In regards to Modification Proposal P18B, of the respondents 10 believed that P18B should be taken to the Report Stage with a recommendation to reject the Modification Proposal and 6 respondents did not agree with this approach.

Comments received by respondents that recommended rejecting Modification Proposal P15 included concern that NGC would be able to choose which Balancing Mechanism actions to include in the calculation of imbalance prices if Modification Proposal P15 were introduced. It was also commented that there seems to be little correlation between the notice period and the purpose of the BOA. In contrast, one respondent that supported Modification Proposal P15 commented that actions taken after the start of a half-hour are made to ensure System security.

Comments received by respondents that recommended rejecting Modification Proposal P18B included concern that it aims to establish a 'reasonable' price. The respondent argued that the concept of a reasonable price is arbitrary and may be discriminatory. Another respondent

was concerned with the complexity of Modification Proposal P18B and argued that its impact would vary significantly with the level at which BRL is set. The respondent therefore did not think Modification Proposal P18B would lead to an economically rational cash-out price calculation. One respondent commented that Modification Proposal P18B is superfluous given that the existing BSC baseline includes Modification Proposal P18A.

Panel's Recommendation

The Panel met on 15 November 2001 and considered the Urgent Modification Report, the views of the Group and the consultation responses received.

The Panel agreed with the views of the Group that neither Modification Proposal P15 nor P18B would better facilitate the BSC objectives. Therefore, the Panel recommended that the Authority should reject Modification Proposals P15 and P18B.

Ofgem's view

Ofgem considers, having had regard to its statutory duties, that Modification Proposals P15 and P18B do not better facilitate the relevant objectives of the BSC. In its decision on Modification Proposal P15 and P18B, the Authority has considered the interaction these Modification Proposals would have with Modification Proposal P18A.

Ofgem believes that the costs of Electricity Balancing should be targeted to participants who are in electricity imbalance (i.e. where the BSC Parties' notified generation/demand does not equal their actual generation/demand) and should reflect the prices at which NGC buys and sells energy to keep the System in Electricity Balance during that period. The Energy Imbalance Prices were designed to remove System Balancing costs from these calculations. System Balancing costs, which are not caused directly by any particular users are then targeted back to all users of NGC's System through Balancing Services Use of System ("BSUoS") charges. Ofgem believes that, consistent with the relevant objectives of facilitating competition (by preventing cross subsidies), it is important that electricity imbalance costs are targeted back to those participants that cause them. Similarly, System Balancing costs should be targeted back to all System users. Ofgem accepts that it may be difficult to establish a rule that clearly determines when acceptances relate to System Balancing rather than Electricity Balancing, especially in real time.

Urgent Modification Proposals P15 and P18B seek to improve the separation of Bids and Offers accepted for Electricity Balancing purposes from those accepted for System Balancing purposes. Ofgem believes that neither Urgent Modification Proposal P15 nor Urgent Modification Proposal P18B improves the separation of System Balancing actions from Electricity Balancing actions so that the costs of Electricity Balancing can be better targeted to those who are out of balance. It is therefore Ofgem's view that Urgent Modification Proposal P15 and Urgent Modification Proposal P18B do not better facilitate the Applicable 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 notes the views of market participants that Modification Proposal P15 would arbitrarily separate out additional acceptances to those already tagged out as System Balancing by Modification Proposal P18A.

Ofgem recognises that the separation of System and Electricity Balancing actions, as augmented by Urgent Modification Proposal P18A, was considered and developed in a short time-scale. Ofgem recognises that there may be alternatives to the current methodology for separating System Balancing from Electricity Balancing that better facilitate the applicable BSC Objectives.

Further to a request from the Imbalance Settlement Group, the Panel agreed at their meeting on 15 October 2001 to undertake a review of Urgent Modification P18 Option A as permitted under Section F 2.9.7 of the Balancing and Settlement Code (BSC). The Panel determined that it should be conducted to the same timetable as Modification Proposal P38: ‘Redefined Definition of CAD to Allow Prompt Price Reporting’ Assessment Procedure.

The Authority’s decision letter on Modification Proposal P18A recommended that the Continuous Acceptance Duration Limit be reviewed at frequent and regular intervals by the Panel with guidance from NGC regarding operational experience.

The Authority’s decision

The Authority has therefore decided not to direct implementation of Modification Proposals P15 or P18B. 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 to implement Modification Proposal P15 or Modification Proposal P18B.

Please feel free to contact me on the above number if you have any queries in relation to the issues raised in this letter.

Yours sincerely

Sonia Brown

Head of Electricity Trading Arrangements

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