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**Title of Modification Proposal** *(mandatory by originator)*:
Energy Imbalance Incentive Band

**Submission Date** *(mandatory by originator)*:
7 June 2006

**Description of Proposed Modification** *(mandatory by originator)*

All supplier trading parties with consumption accounts under the BSC should be allowed an Energy Imbalance Tolerance Band in certain defined circumstances. The band should be 20MWh per half-hour trading period.

Imbalances within this narrow band should be cashed out at a different price to the current cashout price. The circumstances where this should be applied would be tailored to instances where the supplier is short of contracted power and the system is also short, in recognition of the fact that small parties cannot often contract for power either because of their size relative to the market or because of illiquidity in the traded markets. The price indicator in such circumstances should be linked to a market-based price, which would be the reverse price for the relevant trading period, rather than the main price which would otherwise have applied. To maintain incentives to trade, this figure should be adjusted to include a reasonable premium possibly a 10% adjustment to the market price for the appropriate settlement period to retain a differential against the short-term traded energy price ("tolerance price differential"). Thus:

Tolerance price = market price + 10% where a party is short.

There would need to be a cap so that the supplier paid no more than main price in circumstances where the main price was lower than the market price as adjusted.

As under P201, the tolerance price **would not apply** where the imbalance was against the direction of the system (that is, to parties that are short when the market is long or to parties that are long where the system is short). But unlike under P201 it is envisaged that the tolerance band would need to apply where the system is long and the supplier was long as well. In such circumstances the price would be constructed:

Tolerance price = market price - 10% where a party is long.

Imbalances outside of the Imbalance Tolerance Band would be cashed out at the appropriate SSP or SBP under the pricing rules as they stand. Thus the first 20MWh in a trading period where the supplier is short and the system is short is inside the band; likewise for circumstances where the system is long and the supplier long.

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

Trading parties have strong incentives under the current BSC rules to balance their positions (with positions being represented by energy contracts relative to their predicted metered output) and enabled by an ability to enter into energy contracts up until gate closure. There is a strong dependency on the ability of purchasers to trade energy, especially where a trading party does not have its own production or is not part of a wider corporate grouping. However, electricity spot markets have demonstrated very limited and declining liquidity in trades over a sustained and representative period of time, and this illiquidity tends to be greatest when the system is tighter.

Further, a high degree of liquidity and trading volume is required typically before products are offered on such markets that approximate the small volumes of energy needed to fine-tune smaller portfolios. This liquidity has declined materially with the exit of many independent generators from the market, a dynamic

that is poised to continue.

There are also important issues about the granularity of trades, with standard quantities only being available in minimum tranche, trades which are typically greater than the purchase requirements of many small suppliers and a new entrants total portfolio size. Further many products presently available on the market impose "shape" limitations that mean a small supplier may not be able to match its shape for long periods of the day against standard product offerings.

Furthermore, all suppliers are exposed to systematic forecasting error across all time periods as a function of among other things temperature and weather changes. An existing supplier with a 1% market share and a requirement for 3% extra energy in a half-hour - a not untypical quantity given short-run sensitivity of demand to temperature - would require about 7MWh in an average half-hour. It is not commonplace for such parties to have large or intensive energy customers, and their customer base tends to have very limited if any demand elasticity. In this respect suppliers are different from generators who can elect whether to generate or not.

In these circumstances, and because of the incentivising properties of imbalance cashout, which are due to be sharpened under P194 from November 2006, many smaller players have no alternative but to go systematically long where they can, to avoid occasionally extreme top-up prices when the system overall is short. Perversely lack of liquidity is contributing to some participants going longer because they cannot buy in quantities that would allow them to reach a position closer to balance or which matches their expected shape. In both these cases the strength of the incentives to avoid imbalance when the system is tight (and SBP the main price tends to be at its highest), can undermine the orderly balancing of the system, which in turn could possibly diminish security of supply.

A new entrant supplier would have much less that a 1% market share for some considerable time, and may not have sufficient volumes to trade in wholesale markets even where volumes are offered. In such circumstances the supplier faces the choice between full exposure to imbalance cashout or contracting with an intermediary for risk management services, for instance by contracting with a consolidator.

Currently, typical volumes of energy trading on power exchanges is 20MWh, with the transaction cost for acquiring smaller volumes being very high. Direct trading by small suppliers will see these costs directly where small strips of power are available. Where they use a supply consolidator, they will usually see them indirectly.

This proposal seeks to ensure that existing suppliers and new entrant suppliers can, for a small but proportionate portion of their energy, avoid the excessive transaction costs required for a full imbalance avoidance strategy.

The tolerance band proposed at 20MWh takes into account the volumes of energy typically trading on power exchanges, especially during tight days.

As with P201, the current proposal has a number of important differences to P26 (Energy Neutrality Band), which was rejected by Ofgem in 2002. The proposal

- takes into account and builds on P78, which created a market based reverse price, and it uses this as its starting point for derivation of a market-based price that is applied to tolerance quantities
- retains an incentive to contract through the reverse price differential
- recognises the documented problems of smaller suppliers under Neta/Betta in purchasing contracts on short-term forward markets

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- is limited to suppliers who are to all intents and purposes price takers after gate closure.

The nature of the defect has also changed since 2001 because of:

- the high levels of increasing concentration in the electricity market which has seen many independent sellers of imbalance product exit the market through acquisition by the main players in the market
- the withdrawal of physical risk management products in the market as a consequence
- reductions in general liquidity levels in traded electricity markets more generally
- increased imbalance risk from November 2006 as a consequence of the scheduled implementation of P194.

As we have noted, in circumstances where volumes are available many suppliers aim to over-cover their positions to avoid exposure to the main price, which can be volatile. This leads smaller players like Bizz Energy to have to spill back into the system surplus power above their physical requirements. In such circumstances, and because the system is ordinarily long, the supplier will take the main price. This situation also creates inefficiencies and competitive distortions in addition to the main defect identified above. In contrast to P201, and it is for consideration whether the proposed solution might be extended to cover circumstances also where the supplier is long coincident with the system being long.

A further point is that the proposal is not intended to be prescriptive in terms of the detail of the solution. A 10% premium has been proposed over the market price to derive the tolerance price. An alternative approach might be to form the tolerance price by reference to reverse price ± 50% of APX spread. The merits of this, or similar alternatives to the price marker, might be explored.

An element of an alternative might also be to develop a total daily limit for the tolerance, of, say 24*10MWh, which mitigates the total volume and can create incentives to balance in higher priced periods, rather than adopting a flat 20MWh per settlement period.

**Impact on Code** *(optional by originator)*

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**Impact on Core Industry Documents or System Operator–Transmission Owner Code** *(optional by originator)*

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

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**Impact on other Configurable Items** (*optional by originator)*

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

Small participants and new entrant suppliers cannot acquire energy in volumes appropriate to their forecast balance position because of the granularity of the traded markets and because of their now characteristic illiquidity. This puts them at a competitive disadvantage relative to larger participants. By providing a market-based price for small imbalance positions in defined circumstances, a major barrier to entry into supply markets is removed. The proposal therefore satisfies Applicable BSC Objective (c) of facilitating competition between generators and between suppliers, but also between different types of supplier.

The proposal counteracts dis-efficiencies for smaller players based on their systematically greater exposure to imbalance cashout as they do not ordinarily have access to generation production. It also removes a barrier to entry for new suppler entrants by providing a proportionate and modest safety net commensurate with exposure to an unmanageable risk, again supporting delivery of objective (c).

The change provides for small suppliers a linkage with a market-based price, not a mechanism, providing a market indicator and price settlement mechanism for limited quantities that are ordinarily too small to be traded on the market or for which the transaction costs are disproportionate without the shape or volume limitations routinely imposed by scale participants, further supporting objective (c).

Where volumes are available, forcing small suppliers to try to contract in circumstances where the system might be tight and where they will spill unwanted quantities could potentially undermine security of supply as they will displace quantities otherwise available to other trading parties. By eliminating uncertainties at the margin over how small suppliers will react during periods of system stress, it will also support NG to better deliver objective (b) in circumstances where the system is tight.

**Urgency Recommended: Yes / No** *(delete as appropriate) (optional by originator)*

Yes – see separate confidential letter to for justification.

**Justification for Urgency Recommendation** *(mandatory by originator if recommending progression as an Urgent Modification Proposal)*

1. Material commercial effect, on proposer and small suppliers as a class
2. Time dependency given implementation of P194 on 4 November 2006.

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Attachments: No *(mandatory by originator)*

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