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21 March 2003

The National Grid Company, BSC Signatories and
Other Interested Parties

Our Ref: MP No P100

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P100: "Extension of demand-side Trading Units in order to increase the competitiveness of the market for embedded benefits"

The Gas and Electricity Markets Authority (the "Authority")[1] has carefully considered the issues raised in the Modification Report[2] in respect of Modification Proposal P100, "Extension of demand-side Trading Units in order to increase the competitiveness of the market for embedded benefits".

The BSC Panel (the "Panel") recommended to the Authority that Modification Proposal P100 should be made, with an Implementation Date of 5 November 2003 if an Authority Decision is received by 25 April 2003 and an Implementation Date of 25 February 2004 if an Authority Decision is received after 25 April 2003 and before 15 August 2003.

Having considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives and the Authority's wider statutory duties, the Authority has decided to direct a Modification to the BSC in line with the Modification Proposal P100.

This letter explains the background and sets out the Authority's reasons for its decision. In addition, the letter contains a direction to The National Grid Company plc ("NGC") to modify the BSC in line with Modification Proposal P100, as set out in the Modification Report.

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

[2] ELEXON document reference P100RR, Version No. 1, dated 24 January 2003

This letter constitutes the notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

Background

If Embedded Licence Exempt Generators ("ELEGs")[3] are deemed to net off local demand they can be considered not to be making use of the Transmission System. In this situation it has been argued that they should not be liable for associated charges which could include Transmission Network Use of System ("TNUoS"), Balancing Services Use of System ("BSUoS"), transmission losses and BSCCo (Elexon) costs. These charges are collectively known as "embedded benefits".

Slough Energy Ltd submitted Modification Proposal P100, "Extension of demand-side Trading Units in order to increase the competitiveness of the market for embedded benefits" on 2 September 2002. At that time, embedded benefits could only be attained by grouping ELEGs and demand within a Trading Unit or through a netting-off agreement. In some Grid Supply Point ("GSP") Groups there are few Suppliers and it was asserted that this had left limited opportunity for the ELEG to obtain a competitive commercial agreement to net-off.

NGC subsequently proposed and is going to implement change UoSCM-M-07[4] to its charging methodology. It establishes that ELEGs whose meters are registered in the Central Meter Registration Service ("CMRS") will pay or be paid demand TNUoS charges on the basis of their metered volumes for the half hours used in calculating such charges and that such ELEGS do not have to be in a Trading Unit with demand or have a netting-off agreement with a Supplier to receive TNUoS benefit. The generation of ELEGs whose meters are registered in the Supplier Meter Registration Service ("SMRS") is still automatically netted off against their Supplier's demand. As a result of this change, Modification Proposal P100 will have the effect of addressing the remaining elements of embedded benefit:- BSUoS, transmission losses and BSCCo costs.

The Modification Proposal

Modification Proposal P100 addresses alleged shortcomings related to the trading of embedded benefits. The justification for the Modification Proposal was that it would better facilitate achievement of the Applicable BSC Objectives[5] C3 (3) (c) and (d).

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[3] Embedded Licence Exemptible Generators ("ELEG") are generators who are connected to the distribution system and who are not required to be licensed under the Electricity Act 1989.

[4] Use of System Charging Methodology Modification UoSCM-M-07: "Proposed change to the TNUoS Liability rules for Embedded Licence Exemptable Generations and Distribution Interconnectors" (to be implemented from 1 April 2003)

[5] The Applicable BSC Objectives, as contained in Condition C3 (3) of National Grid Company's Transmission Licence, 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
e) the undertaking of work by BSCCo (as defined in the BSC) which is:
(i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
(ii) relevant to the proposed GB wide balancing and settlement code;
and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

The Modification Proposal seeks to:

- create one default Trading Unit (a "Base Trading Unit") for each GSP Group, which would comprise all Supplier Balancing Mechanism Units ("BMUs") and all participating Exempt Export BMUs in the relevant GSP Group. Whilst each relevant BMU would by default belong to the relevant Base Trading Unit, an Exempt Export BMU should have the option of exiting at the behest of its Lead Party
- allow each Exempt Export BMU to choose its Production Consumption Status (P/C Status) irrespective of the Trading Unit to which it belongs
- allow for SMRS registered non-default Supplier BMUs composed of licence exemptable generation to be treated as Exempt Export BMUs.

The effect of implementing Modification Proposal P100 would be that each GSP Group would have a Base Trading Unit which by default comprises all Supplier BMUs and all Export Exempt BMUs. Those ELEGs whose meters are registered in CMRS would not need to negotiate for membership of a Trading Unit. If the GSP Group has a net demand for electricity, the CMRS registered ELEG could then access embedded benefits directly, without the need for a contractual relationship with a Supplier within that GSP Group. The realisation of embedded benefits attributable to generation by ELEGs whose meters are registered in SMRS would still be the subject of contractual arrangements between the generator and Supplier.

The Proposer of P100 suggested that implementation of this Modification Proposal would provide for a greater choice of Parties with whom embedded generators could contract, so it would be expected that by increasing competition, energy exported from ELEGs could be more efficiently and competitively traded.

The Panel considered the Initial Written Assessment at its meeting of 12 September 2002 and agreed to submit Modification Proposal P100 to the Assessment Procedure. The Settlement Standing Modification Group (the "Group") considered the Modification Proposal during four meetings (on 25 September, 16 October, 11 November and 28 November 2002) and issued a consultation on 13 November 2002 to all BSC Parties and certain non-BSC Parties representing ELEGs. Responses were also invited from other interested persons and entities via the ELEXON web site.

The Group was unable to come to a majority decision on whether the Proposed Modification better facilitated the Applicable BSC Objectives. The Assessment Report was submitted for consideration at the Panel meeting of 12 December 2002 and the Panel decided by a majority that the Modification Proposal should be submitted to the Report Phase with a recommendation that the Proposed Modification be made.

ELEXON published a draft Modification Report on 17 December 2002, which invited respondents' views by 27 December 2002.

Respondents' views

ELEXON received ten responses to the consultation on Modification Proposal P100. Three responses (representing 1 Party and 2 non-Parties) expressed support for the Proposed Modification, six responses (representing 25 Parties) were against the Proposal and one response (representing 1 Party) replied with "no comment".

Respondents in favour of the Modification Proposal stated that the contracting options available to both ELEGs and those tendering for their output would be increased, as those Parties possessing sufficient demand to permit "netting off" in the GSP Group would no longer be competitively advantaged over those lacking such demand. One respondent in favour of the Modification Proposal expressed a concern that the Modification Proposal would incentivise ELEGs whose meters are registered in the SMRS to transfer their registration to the CMRS to such an extent that unsupportable demands could be made on the existing arrangements for such transfers.

Respondents against the Modification Proposal put forward three main arguments:

- Suppliers would face increased costs for contracting with ELEGs, to the extent that such contracts would become commercially unsound propositions
- the Proposal introduces a direct cross subsidy of ELEGs by Suppliers
- implementation would result in higher prices to the end consumer.

One respondent against the Modification Proposal commented that the premise against which the Modification Proposal was originated was mistaken, ie that there was insufficient competition between Suppliers contracting with ELEGs within GSP Groups. A number of respondents commented on the Panel's decision to recommend that the Modification Proposal should be made despite the majority of Party responses expressing the contrary opinion.

The respondents' views are summarised in the Modification Report for Modification Proposal P100, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 16 January 2003 and considered the Modification Proposal P100, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Proposed Modification and that, if approved, the Proposed Modification should be made with an Implementation Date of 5 November 2003 if an Authority Decision is received by 25 April 2003 and an Implementation Date of 25 February 2004 if an Authority Decision is received after 25 April 2003 and before 15 August 2003.

Ofgem's view

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem takes the view, having regard to the Applicable BSC Objectives and its statutory duties[6], that Modification Proposal P100 will better facilitate achievement of Applicable BSC Objective (c) as the Proposal is likely to improve liquidity and transparency in energy trading by ELEGs.

The current arrangements require an ELEG to be both connected to a distribution system and participating in a Trading Unit with a net demand in order for it to obtain the full range of embedded benefits. In these circumstances, the presence of the embedded generator is reducing the GSP Group's requirement for use of the Transmission System. However, the extent to which embedded generators can realise the available benefits is dependent on the generator's ability to strike a contractual agreement with a Supplier or Suppliers in the GSP Group and as a result form a Trading Unit.

The implementation of Modification Proposal P100 would ensure that under the current GSP Group demand capacities, all ELEGs will have a means by which they can realise embedded benefits without necessarily having contractual arrangements with Suppliers, ie through becoming a Party to the BSC and registering their meter in CMRS. The potential to choose to register in CMRS rather than SMRS to obtain better terms should in turn influence the contractual terms available for those generators who remain registered in SMRS.

Additionally, Suppliers without sufficient demand in the particular GSP Group would be able to realise the full embedded benefit for SMRS registered ELEGs without having to negotiate contracts with other Suppliers who do have the requisite demand. Also, increasing the ability for non-physical trading parties to trade the output from ELEGs should, over time, increase liquidity at the smaller volume end of the NETA markets.

The combined effect of these changes should be to ensure a more competitive and transparent marketplace for the trading of energy from ELEGs, therefore facilitating the achievement of Applicable BSC Objective (c).

Parties against the Modification Proposal stated that ELEGs already benefit from non-usage of the Transmission System through avoidance of generation TNUoS and BSUoS charges, so any subsequent allocation of benefits represents a cross-subsidy by Suppliers to ELEGs. Ofgem is concerned that all charges on Parties should be cost reflective. As a result of the implementation of Modification proposal P100, Suppliers will still be subject to the same quantity of demand TNUoS and BSUoS charges as before, in line with the cost to the Transmission System Operator ("TSO") for providing for that demand in the GSP Group. It is consistent with the Ofgem view that any ELEG which offsets that demand, thereby saving TSO costs, should be rewarded accordingly (so far as contractual relationships between the ELEG and the TSO allow).

[6] Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things social and environmental guidance provided to Ofgem by the government.

Ofgem notes that some Suppliers consider that they may find dealing with ELEGs, particularly those registered in CMRS, to be financially less attractive as a result of this Modification Proposal. Ofgem understands that a proportion of the current sharing arrangements for embedded benefits is due to the costs incurred by Suppliers in administration, transaction costs and the imbalance risks they assume. This Modification Proposal will not reduce the needs of ELEGs for the provision of such services, so it would be expected that Suppliers and ELEGs would still contract for these. However, the Proposal should make this market more competitive and transparent by increasing the options for contracting routes.

Certain respondents argued that the implementation of this Modification Proposal would result in higher prices for Suppliers and possibly for the end consumer. Whilst those Suppliers who are taking a significant proportion of embedded benefit from ELEGs they have contracts with may feel an impact, in the longer term, a more cost-reflective regime should improve efficiency to the benefit of customers.

In carrying out its functions, Ofgem is required by the Electricity Act 1989 to have regard to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity. The government has issued guidance on the subject[7]. Ofgem is satisfied that this Proposal will bring environmental benefits through the encouragement of renewable and combined heat and power generation (these generators are typically ELEGs) and the avoidance of wasted energy through transmission losses.

In summary, Ofgem is satisfied that this Proposal will reduce the barriers to freely traded energy from ELEGs and as a consequence improve competition in the electricity markets. In addition the Proposal is likely to have environmental benefits in encouraging embedded generation.

The Authority's decision

The Authority has therefore decided to direct that the Proposed Modification P100, as set out in the Modification Report, should be made and implemented.

Direction under Condition C3 (5) (a) of NGC's Transmission Licence

Having regard to the above, the Authority, in accordance with Condition C3 (5) (a) of the licence to transmit electricity granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the BSC as set out in the Modification Report.

The Implementation Date for Modification Proposal P100 is 5 November 2003.

In accordance with Condition C3 (5) (b) of NGC's Transmission Licence, NGC shall modify the BSC in accordance with this direction of the Authority.

[7] The guidance says: "There are significant greenhouse gas emissions as a result of losses in both gas and electricity. More extensive embedded generation and CHP, as outlined above, may help to reduce those losses. In addition, the Authority, in exercising its functions, should have regard to the desirability of reducing those losses through other means, given the contribution that this would make to meeting the government's Climate Change commitments and objectives" (Social and Environment Guidance, November 2002).

If you have any questions, please contact me on the above number.

Yours sincerely,

Nick Simpson
Director of Industry Code Development
Signed on behalf of the Authority and authorised for that purpose by the Authority