

Gas market participants, electricity
market participants, National Grid
Transco, Elexon and other
interested parties

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Dear Colleague

Gas and electricity cash out review: the way forward

Introduction

In May 2004, Ofgem initiated a review of the electricity and gas cash out arrangements. This letter sets out the approach that Ofgem considers, in the light of responses to this review, should be adopted to progress the next phase of the review.

Background

On 17 May 2004, Ofgem published a consultation document which initiated the review of the gas and electricity cash out arrangements¹. In the May 2004 document, Ofgem identified several areas of the cash out arrangements that it considered to be most relevant when considering incentives to balance and security of supply. The document focussed in particular on areas where changes could potentially be implemented ahead of winter 2004/05.

All non-confidential responses, together with a brief summary of the responses received, can be found on our website at www.ofgem.gov.uk. The majority of respondents considered that it was unlikely that the cash out arrangements could be significantly revised ahead of winter 2004/05 and that the need to do so was not, in their view, as urgent as some market participants, notably National Grid Transco, had suggested. Respondents were, therefore, generally of the view that the review should extend its focus beyond winter 2004/05. They also thought that there would be benefit in having wider discussions within an extended timetable to allow more thorough analysis of the issues.

¹ 'Electricity and gas cash out review. A consultation document', Ofgem, May 2004.

Process going forward

Revised approach

Ofgem agrees that it is appropriate to revise the approach to the review. Ofgem also agrees that it would be sensible to lengthen the timetable for the review to allow fuller consideration of the issues and more analysis.

Many respondents have expressed concerns about their ability to look at the current arrangements in a systematic way as they are split between a number of different documents and codes. Ofgem accepts this concern and considers that it would be better if the industry could consider these issues in a combined forum. Ofgem is therefore proposing to establish and chair a working group to enable consideration of issues relating to both the gas and electricity cash out arrangements.

It is important to note, however, that establishing this working group does not preclude any relevant party from raising modification proposals in relation to the cash out arrangements if they have concerns about the current rules.

Issues to be addressed by the working group

The gas and electricity cash out arrangements are set out in several distinct documents and codes², each with its own governance structure. The working group, chaired by Ofgem, will be able to consider and analyse cash out issues across all the relevant documents and codes. Therefore, the working group will be able to consider cash out issues holistically, regardless of the differing governance arrangements which exist for different elements of the arrangements.

There are a number of high-level objectives, which are set out below, that the cash out arrangements in both the gas and electricity markets are designed to meet. These objectives, which stem from the wider regulatory framework³, are presented to assist the working group in carrying out the review. The two main objectives are:

- ◆ to provide appropriate commercial incentives for market participants to balance their own positions and therefore deliver security of supply; and
- ◆ to reflect the costs incurred by the relevant System Operator when undertaking energy balancing actions as residual balancer and therefore provide appropriate signals to market participants as to the costs of supplying balancing energy in the relevant balancing period.

In addition, there are a number of secondary objectives of cash out arrangements, such as:

- ◆ not being easily open to manipulation or gaming;
- ◆ transparency; and

² The Balancing and Settlement Code (BSC) and the Balancing Services Adjustment Data (BSAD) Methodology Statement in the case of electricity cash out. Transco's network code and the System Management Services Adjustment Data (SMSAD) Methodology Statement in the case of gas cash out.

³ These objectives are consistent with Ofgem's interpretation of its statutory duties under the Gas Act 1986 and the Electricity Act 1989 and the relevant objectives of the BSC and Transco's network code.

- ◆ prompt (or real time) reporting of prices.

At present, Ofgem has not been persuaded, on the basis of its own analysis and that provided by market participants, that the existing arrangements are failing to meet these objectives. However, Ofgem considers that it is sensible for the working group considerations to begin with an assessment of the appropriateness of the existing arrangements in the context of these objectives. Having carried this out, the group's assessment should move on to consider potential revisions to the arrangements that could potentially be more effective in meeting these objectives.

To aid the group in carrying out the review, Ofgem has developed a proposed terms of reference for the working group. This outlines the issues that Ofgem considers should be addressed by the working group and the scope of its assessment. This is based on the issues set out in the May 2004 consultation document and responses to it. Additionally, Ofgem considers that the working group should examine and assess the cash out arrangements in emergency situations. Ofgem proposes that the working group's terms of reference should not include those issues which were excluded from consideration in the May 2004 document but this can be reviewed, if necessary, when the group first meets. The proposed terms of reference are provided in Annex 1. Finalising the terms of reference is likely to represent one of the first agenda items of the working group.

Operation of the working group

As mentioned above, it is Ofgem's intention that a single group will consider both the electricity and gas cash out arrangements⁴. Ofgem proposes to facilitate the working group, carrying out both the chair and secretariat functions. It is Ofgem's intention for both Elexon and NGT to provide support to the working group, particularly by carrying out any analysis required by the group⁵. Both Elexon and NGT have kindly agreed to provide this support.

Ofgem expects the working group to begin in September 2004 and meet every 2 – 3 weeks for about 3 or 4 months. Following the assessment of the group and consideration of these discussions and the analysis undertaken, Ofgem expects to publish a report in January 2005 to conclude the review. The document will:

- ◆ summarise the group's assessment of the issues and the views reached by the group on the basis of this assessment; and
- ◆ outline Ofgem's views on the basis of the group's assessment.

A more detailed timetable for the working group meetings and its assessment process will be provided in advance of the initial meeting.

Ahead of this, all parties interested in participating in the working group should register their interest by the end of August 2004 with David Hunt at david.hunt@ofgem.gov.uk or by phone

⁴ Ofgem considers that this is appropriate in the initial stages of the working group, but recognises that the creation of separate sub-groups may become appropriate over time.

⁵ Elexon will be called on to provide analytical support in relation to the electricity cash out arrangements only as appropriate. However, NGT will be called upon to provide analytical support in relation to both the gas and electricity cash out arrangements as appropriate.

on 020 7901 7429. In order to ensure that the working group is of a manageable size to facilitate discussions, Ofgem requests that each interested company provides the name of just one main representative and one alternate attendee.

Please feel free to contact me on the above contact details, or alternatively Simon Bradbury on 020 7901 7249, if you have any questions.

Yours sincerely

A handwritten signature in black ink, consisting of several overlapping, stylized loops and strokes, likely representing the name Steve Smith.

Steve Smith
Managing Director, Markets

Annex One

DRAFT

Proposed terms of reference for cash out review working group

Introduction

This paper outlines the working arrangements and terms of reference for the cash out review working group (CORWG).

The CORWG shall be established as a working group to consider the issues specified below in relation to:

- ◆ the gas cash out arrangements contained within Transco's network code and the System Management Services Adjustment Data (SMSAD) Methodology Statement; and
- ◆ the electricity cash out arrangements contained within the Balancing and Settlement Code (BSC) and the Balancing Services Adjustment Data (BSAD) Methodology Statement.

Meeting administration

Ofgem will chair the working group meetings and provide a secretariat function.

Elxon and NGT will provide analytical support as defined necessary by the chair to facilitate the assessment of the working group in accordance with the scope and timescales outlined below. Elxon will be called on to provide analytical support in relation to the electricity cash out arrangements only as appropriate. However, NGT will be called upon to provide analytical support in relation to both the gas and electricity cash out arrangements as appropriate.

Scope

Timescale for consideration

The original focus of the review was on areas of the cash out arrangements which had implications for security of supply and incentives to balance that could be revised ahead of winter 2004/05. However, the CORWG's assessment should have a wider focus and consider issues relating to the cash out arrangements beyond winter 2004/05. The CORWG's assessment should focus on issues in relation to which revisions could be made, if appropriate, ahead of winter 2006/07.

Issues for consideration

There are a number of high-level objectives that the cash out arrangements in both the gas and electricity markets are designed to meet. The two main objectives are:

- ◆ to provide appropriate commercial incentives for market participants to balance their own positions and therefore deliver security of supply; and

- ◆ to reflect the costs incurred by the relevant System Operator when undertaking energy balancing actions as residual balancer and therefore provide appropriate signals to market participants as to the costs of supplying balancing energy in the relevant balancing period.

In addition, there are a number of secondary objectives of cash out arrangements, such as:

- ◆ not being easily open to manipulation or gaming;
- ◆ transparency; and
- ◆ prompt (or real time) reporting of prices.

The CORWG should evaluate the existing cash out arrangements in terms of their performance against these objectives. When the CORWG has completed this assessment, it should move on to consider possible revisions to the cash out arrangements and whether or not they offer any improvements over the existing arrangements in respect of the objectives set out above.

Ofgem considers that the following should be the key areas for consideration during the CORWG's assessment:

- ◆ the basis upon which dual cash out prices are calculated (e.g. weighted average methodology as at present for electricity, marginal methodology as at present for gas), including the reverse price in the case of electricity and the default differentials in the case of gas;
- ◆ the methodologies for separating the system and energy balancing actions and then including the latter in the calculation of cash out prices;
- ◆ the methodologies for redistributing imbalance cash flows; and
- ◆ the methodologies for determining cash out prices in emergency circumstances.

Consistent with paragraph 3.5 of Ofgem's May 2004 consultation document⁶, it is Ofgem's current view that the following issues are not to be considered by the CORWG, although they can form the subject of discussions in other relevant forums:

- ◆ single versus dual cash out prices;
- ◆ pay-as-bid versus cleared price;
- ◆ ex post trading in electricity and gas;
- ◆ Gate Closure;
- ◆ system balancing/energy balancing split principle;
- ◆ balancing periods; and
- ◆ separate production and consumption accounts for electricity imbalance volumes.

Analysis/assessment to be undertaken

The CORWG will undertake its assessment of the existing arrangements and potential revisions to the arrangements against the objectives outlined above using historic data and where appropriate, hypothetical or synthesised data to look at the potential impact of changes to the

⁶ 'Electricity and gas cash out review. A consultation document', Ofgem, May 2004.

current arrangements on prices and incentives. The nature of the analysis to be completed to undertake this assessment will be decided by the CORWG.

Timescales and deliverables

The CORWG shall make an assessment of the issues outlined above within its 3 – 4 month lifespan, beginning in September 2004. Following the completion of the CORWG's assessment and consideration of these discussions and the analysis undertaken, Ofgem expects to publish a report in January 2005 to conclude the review. The document will:

- ◆ summarise the CORWG's assessment of the issues and the views reached by the CORWG on the basis of this assessment; and
- ◆ outline Ofgem's views on the basis of the CORWG's assessment.