

## Cash Out Review Working Group Minutes

### Meeting 07- 'Inputs' session 3

07 February 2005, 13:00 pm – 17:00 pm  
Ofgem, 9 Millbank, London

#### Attendees

Matt Buffey (chair)	Ofgem	Garth Graham	SSE
David Hunt	Ofgem	Ian Moss	APX Group
Ndidi Njoku	Ofgem	Mat Tyrell	Merrill Lynch
Simon Bradbury	Ofgem	Mark Manley	Centrica
Bill Reed	RWE	Tom Bowcutt	ELEXON
Libby Glazebrook	First Hydro	David Lane	Cornwall Consulting
Paul Dawson	Barclays Capital	Martin Mate	British Energy
Malcolm Taylor	The AEP	Paul Mott	EDF Energy
Mark Brackley	NGC		

All presentations delivered at this meeting are available on the Ofgem website [www.ofgem.gov.uk](http://www.ofgem.gov.uk) under Ofgem's Work > Cash Out Review

#### Inputs

##### ***Key points note of the last meeting***

- ◆ There were no comments on the notes of the last meeting.

##### ***Papers submitted since the last meeting***

- ◆ NGC followed up its paper on the practicalities of allocating standing reserve option fees, by presenting additional options for revised profiling of option fees. Mark presented an approach that allocates option fees in windows where utilisation has been forecast. The approach seeks to derive pots of money based on the standing reserve tender, per reserve window, and adjusts these pots of money according to contracted capability to derive a £/MWh figure. This would provide an uplift factor across each individual standing reserve window, which would then need profiling according to a measure of expected utilisation. In Mark's example, a proportion of the total pots of money were allocated according to a measure of utilisation, whilst the remainder would be smeared across the periods, reflecting that the probability of using certain standing reserve providers was near zero, and the value of holding the reserve was in having the MWs available. The group considered that because this mechanism uses a backward-looking measure of utilisation, it would not provide a tangible improvement over the current mechanism.
- ◆ An alternative mechanism explored by NGC was to create an "adder" that could be tagged onto the utilisation fee of each unit. This would divide the total availability payment by the expected hours of utilisation, to give a £/hr figure which could be added on to the price when the service is used. The group recognised that this may result in perversities in cash out, where NGC may instruct an offer at £300/MWh, without giving explicit consideration to the "adder" factor which may be substantial,

- and would feed into cash out. However, some of the group felt that in the event that an adder is attached to a price, NGC should consider the effect the adder would have on energy imbalance prices.
- ◆ A final approach for option fees that the group discussed was to create an adjustment to cash out prices scaled in proportion to a measure of likely reserve utilised.

### ***Approaches that remain viable and those that do not***

- ◆ The group initially considered that one option that was previously discussed by the group may still warrant further consideration. At the last meeting, the group considered that the approach of taking MELNGC minus the demand forecast may not be the most reliable indication of the expected utilisation of reserve. However it was recognised that a reserve function may not be possible based on expected utilisation, as some services are simply not expected to be used, and therefore MELNGC and demand forecast may be a reasonable approximation.
- ◆ Some members of the group considered that it may be more appropriate to develop a mechanism that reflects expected value of reserve rather than expected utilisation. One such member formed a view that if NGC is prepared to pay a certain maximum price for reserve in a given period, then that is the true indication of the value the service offers to NGC, and all reserve services in that period should receive this marginal price. One member of the group considered this may not provide that much of a price signal if they remain static. Another member contended that it may be desirable to revise the profile closer to real time as the value of reserve may change.
- ◆ One member considered that ultimately the purpose of the option fee mechanism is to reflect the value of capacity, which is a function of the value associated with not enough being available and load being lost, and the probability of there not being enough. In short this equates to the value of lost load and the loss of load probability, which brings the group back to a mechanism similar to MELNGC and the demand forecast.
- ◆ The group further considered that there needs to be a signal of the margin, and an accurate and timely reflection of this signal to the market. The group considered that there was a disjoint between the signal and how reserve fees feed into cash out
- ◆ One member of the group felt that there was a signal of a short margin in the form of NISMs published on the BMRS, but that these signals relied heavily on NGC, and would need to be more continuously updated to provide the desired effect.
- ◆ The group mentioned whether or not an approach based on the difference between MELNGC and the demand forecast would require physical notifications to be submitted prior to the day-ahead stage, without reaching a firm opinion.

**ACTION: The group to consider how to conceptualise and develop the mechanism of MELNGC and demand**

### ***Mapping approaches and interactions with warming contracts***

- ◆ NGC outlined the current structure of warming contracts. In short, warming contracts comprise of a £/hr capability fee to get a unit into a state of readiness and

reduce its NDZ time, and is only paid when a unit is stood down; a hot standby fee may be paid to maintain a unit at the warmed NDZ, which is paid regardless of whether or not a unit is stood down; and an offer payment should the unit be utilised. If a unit is actually used then the warming payment and the hot standby payment, which is not paid, should be reflected by the unit in its offer price. The purpose of warming a unit is to create a volume of reserve, between the stable export limit (SEL) and maximum export limit (MEL), which may then be used by NGC should it be necessary.

- ◆ The main issue relating to warming fees is whether the initial warming payment and hot standby fees are akin to an option fee, and if so whether this should therefore feed into cash out regardless of whether or not the unit is stood down.
- ◆ Some members of the group considered that for warming to be fed into cash out in a similar way to option fees, the contract itself may need restructuring.
- ◆ Some concern was voiced that if you were to feed warming and hot standby fees into cash out, whilst the offer price is unrevised, then there is a substantial degree of double counting. Some members of the group considered that this would provide a strong signal and would be beneficial, whilst others considered that double counting would not provide accurate signals and may be damaging.
- ◆ There was some support for allocating warming and hot standby fees into the periods for which the unit is instructed to be available, and would need this to be signalled to the market. NGC mentioned that they are currently working on a mechanism to inform the market as to when warming is initiated and cancelled.
- ◆ One member of the group considered that it may be possible to strip out the portion of the offer price that is bundled to reflect the initial warming and hot standby and allocate this on a volume basis to derive a £/MWh figure for the purposes of cash out. The BMU would still be subject to pay as bid, but cash out would be revised.
- ◆ Some members of the group considered that reflecting the warming and hot standby fees in cash out may be problematic should the offer be tagged out. It was argued that even if the action is tagged out, the associated warming and hot standby “option fees” should be reflected in cash out.
- ◆ The group considered a range of options including taking the warming and hot standby and converting them into option fees when a unit is synchronised; working out the revenue from the offer acceptance, removing warming and hot standby fees and calculating a new offer, with the option fees only reflected if the unit is called; and always adding on a calculated option fee regardless of the direction of system length.

**ACTION: NGC to consider the feasibility of the options for treating warming (and hot standby) fees.**

- ◆ Broadly, it was considered that the principles surrounding the treatment of option fees would inform the direction of the discussions of warming contracts as it would be beneficial to align the two.

***Preparation for BSAD***

- ◆ The group outlined that it intended to talk through a number of papers to inform discussions of the next meeting on inputs. The next meeting moves into the treatment of BSAD, and in particular:
  - Removing BSAD
  - Aggregated vs. disaggregated BSAD
  - Net vs. gross BSAD
  - Time constraining pre-gate actions
  - Treatment of non-BM reserve (time permitting)