

Cash Out Review Working Group Minutes

Meeting 08- 'Inputs' session 4

14 February 2005, 10:30 pm – 16:30 pm

Elexon, 350 Euston Road, London

Attendees

Jo Witters (chair)	Ofgem	Ian Moss	APX Group
David Hunt	Ofgem	Martin Mate	British Energy
Ndidi Njoku	Ofgem	Paul Jones	E.ON
Mark Brackley	NGC	Paul Mott	EDF Energy
Bill Reed	RWE	Mark Manley	Centrica
Libby Glazebrook	First Hydro	Steven Woodhouse	ILEX
Paul Dawson	Barclays Capital	Mark Manley	BGT
Anna Kneafsey	ELEXON	Eddie Blackburn	NGT
David Lane	Cornwall Consulting		

All documents associated with this meeting will become available on the Ofgem website www.ofgem.gov.uk under Ofgem's Work > Cash Out Review

Inputs

Key points note of the last meeting

- ◆ There were some minor points of interpretation raised by the group, and a correction of the treatment of hot standby payments.

Removing BSAD

- ◆ RWE presented a paper on the treatment of BSAD in cash out. Several potentially defective areas were identified, including:
 - NGC's forward trades do not represent the cost of energy in the Balancing Mechanism (BM), and will influence cash out prices such that they become more aligned with forward prices;
 - Net energy BSAD can set the main price if the volume is greater than the NIV. Where this occurs, the cash out price will be set by NGC's forward trades, and may dampen incentives to balance;
 - NGC's pre-gate actions influence the market price by removing or creating capacity in the forward market and do not need to be reflected in the calculation of the main price;
 - The volume of NGC trades will either directly or indirectly be reflected in final physical notifications submitted to NGC at Gate Closure. These actions affect the need for NGC to take actions in the BM, without the need to add back NGC's trades;
- ◆ Bill suggested that the defects addressed in his note may result in inadequate incentives for parties to balance and reducing the effectiveness of market signals. By removing BSAD, greater volatility and higher values for SBP would be introduced, whilst reducing the volatility and magnitude of SSP.

- ◆ One member of the group questioned whether it would be necessary to have two prices in each direction of system length, such as an information imbalance price to top up the cash out price, which indicate the differing effects of pre and post gate closure actions.
- ◆ Some members of the group considered that the concept of gate closure was partly responsible for creating anomalies in cash out prices as a consequence of NGC's, forward actions being reflected. One member of the group felt that if gate closure was a firm event where system conditions were crystallised then only post gate closure actions should be included in the calculation of cash out prices.
- ◆ A potential option for preventing NGC from inadvertently influencing the value of NIV may be to simply remove the BSAD volumes and set the price to zero. The group did not come to agreement as to whether volume and price should be set to zero, or just price, or just volume.
- ◆ NGC outlined that its BSAD actions can broadly be separated into three categories:
 - forward trades in the power exchange;
 - PGBTs where NGC needs to create reserve; and
 - SO to SO trades, taken for post gate closure reasons.

NGC went on to consider that it may be possible to address the potential defect identified by RWE by separating out NGC's trades that are used to create reserve, and allocate these as option fees, and leave the remaining energy actions in the stack.

- ◆ The approach above highlighted the importance of being able to identify separate actions in BSAD.
- ◆ One member of the group considered that if NGC is trading accurately then BSAD actions should be used for the calculation of the reverse price, whilst BM actions should be used for the main price.
- ◆ One member of the group reiterated that cash out prices should only reflect the actions taken by NGC post gate closure as those taken prior to gate closure are a normal function of the market, whilst those after gate closure are taken where there is no liquid dynamic market.
- ◆ Another member considered that NGC may take actions that are not related to NIV, but by adding these actions back in to cash out would distort the price signal.
- ◆ A further point was made on whether or not energy BSAD is that, or whether it incorporates an element of marginal capacity.

Aggregated vs. Disaggregated BSAD

- ◆ NGC threw open the debate to the group, by questioning whether the motivation for the weight of feeling towards disaggregation was for the purposes of setting a differing imbalance price or whether it was simply to acquire more information on NGC's trades. Should the motivation be the former, NGC showed that on the basis of previous analysis, disaggregating BSAD would have very little effect on the resulting cash out prices in a volume-weighted average price calculation. Should the latter be the motivation, NGC suggested it may be able to develop something less costly and labour intensive than BSAD disaggregation.
- ◆ NGC outlined that the costs of disaggregating BSAD as part of the P136/7 project were around £250,000 to NGC and considerably more for ELEXON, so without a marginal price mechanism for cash out the cost benefit analysis would be difficult to

- justify. However, the group generally felt that disaggregation of BSAD was desirable and would be an improvement over the current market mechanism.
- ◆ The group questioned the reasons why NGC did not support disaggregated BSAD, and specifically whether this was due to commercial issues with the contracts. NGC stated that it was not reluctant to develop disaggregated BSAD because of commercial contracts, except perhaps those that are treated as system BSAD. NGC stated that there were no confidentiality reasons why it could not release energy BSAD in a disaggregated manner.
 - ◆ The group cogitated over whether when NGC takes a system trade which is unwound by an energy action, this second action should also be tagged out of the pricing calculation.
 - ◆ One member of the group considered that CADL was introduced because it seemed like the right thing to do, and that introducing disaggregated BSAD should take place for the same reason. Another member of the group considered that although NGC considered that BSAD would not have a substantial effect on the magnitude of the cash out price, it would improve the structure of the price.

ACTION: Ofgem to ascertain the costs of disaggregating BSAD from the P136/7 material.

Net vs. Gross BSAD

- ◆ First Hydro highlighted the flaw with the current net BSAD calculation in that the following may occur:

Buy: 100MW @ £50/MWh

Sell: 200MW @ £30/MWh

ESVA: 100MW

$$\text{ESCA: } 100 * \frac{(100 * 50 + 200 * 30)}{300} = £3666.67$$

Equivalent price: £36.67/MWh

- In this example NGC has in reality sold 100MW for £1000, so there is an argument to suggest that the price should be £10/MWh.
- However, there is another way of treating these actions, such that the net volume of 100MW is features in cash out at the same price as the dominant action, i.e. £30/MWh.
- The current mechanism would result in a volume weighted aggregate average of all the actions.
- One member of the group considered that using a mechanism that takes the gross buys and sells independently would be an improvement over the current mechanism.
- Several members of the group considered that the different approaches for net and gross BSAD simply make a strong argument for disaggregating BSAD.

- ◆ Overall the group considered that disaggregation would be the best mechanism, and in which case, the mechanism would be a gross system for each individual trade.

Time constraining pre-gate actions

- ◆ One member of the group did not think that each trade within BSAD should be given the same weighting, but rather that an approach more akin to the MIDS may be appropriate. A further view was expressed that by limiting the duration of the trades to 4 hours and excluding any trades from BSAD that were struck beyond 20 hours of gate closure, would be a positive and consistent step. Plant dynamics would need to be observed in the context of only including trades procured within 20 hours of gate closure.
- ◆ There was a considerable weight of feeling that the cash out price should better separate the energy cost from the capacity cost. The cashflow that is derived from cash out prices is less of an issue, as BSUoS will recover NGC's costs.
- ◆ The group expressed interest in better understanding NGC's actions in the context of the reverse price.

ACTION: NGC to look at the proportion of NGC actions in forward trade.

- ◆ One member of the group continued to express that NGC's trades being in the reverse price via the influence it exerts over the power exchanges, and also directly into the main price, may result in an element of double-counting.
- ◆ However, one member of the group considered that intuitively it seemed wrong to exclude NGC's trades from the pricing calculation, as would be the case under RWE's potential mechanism, whilst another member felt that it seemed wrong to include BSAD with too much weight.
- ◆ One member of the group considered that to a certain extent, NGC's pre gate closure actions determined the length of the market. NGC suggested that it can not affect a party's imbalance position, and that any shortfall or spill is entirely the party's responsibility.
- ◆ Another member of the group reiterated that NGC has a direct influence on price, as when it is buying energy of the exchanges it is reducing the pool of available plant and thereby increasing the price of the remaining energy (the converse is true).
- ◆ The group considered that more information on NGC's trades was needed, and in particular an indication of NGC's activity in schedule 7 trades.

ACTION: Ofgem to work with RWE to further explore the mechanism laid out in its paper.

Next meeting: Tagging on 21 February 2005 from 1pm to 5pm at Ofgem's offices