

**Cash Out Review Working Group Minutes**  
**Meeting 09- 'Tagging' session 1**

21 February 2005, 1 pm – 5 pm  
Ofgem, 9 Millbank, London

**Attendees**

Simon Bradbury (chair)	Ofgem	Mark Manley	BGT
David Hunt	Ofgem	Mike Wilks	KEMA Consulting
Matthew Buffey	Ofgem	Martin Mate	British Energy
Fiona Lewis	Ofgem	Eddie Blackburn	NGT
Chris Day	Barclays Capital	Paul Jones	E.ON
Libby Glazebrook	First Hydro	Malcolm Taylor	The AEP
Mark Brackley	NGT	Stephen Woodhouse	ILEX
Bill Reed	RWE	David Lane	Cornwall Consulting
Thomas Bowcutt	ELEXON		

*All documents associated with this meeting will become 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 some minor points of interpretation raised by the group, and a correction of the definition of the equivalent price calculated from the net BSAD example.

***Assumptions behind NIV tagging***

- ◆ Ofgem outlined its interpretation of the rationale behind NIV tagging as the following:
  - Actions in the reverse stack are deemed to have been taken for system reasons.
  - An equal volume of actions are tagged from both the main stack and the reverse stack on the basis that system actions in the same direction as the system have to be "unwound" by actions in the opposite directions.
  - System actions are likely to be the most expensive and therefore tagging is off the stack (SBP main stack) or bottom of the stack (SSP main stack).
- ◆ Some members of the group explained that the concept behind the calculation of the NIV volume was to attain a net energy volume and a system length (as there can not be energy imbalance in both directions at the end of each settlement period).
- ◆ The group spent some time discussing the principles behind the system-energy split. It was not clear whether system actions were purely taken just for locational, constraint purposes. Other members of the group considered that every "system" action will deliver energy, and that the split was arbitrary. Members of the group also highlighted that there may be a split in the proportion of an action between

- system and energy, i.e. whether it was possible to say whether or not an action was 80% system and 20% energy. NGC considered that it would not be feasible to distinguish exact proportions of system and energy in each balancing action.
- ◆ NGC stated that it has broad guidelines with how to separate out system actions from energy actions for the purposes of BSAD, but noted that it was considerably easier to do this with pre-gate actions than it was with post-gate actions. NGC went on to discuss that its actions to address a NIV shortfall are categorised as energy, as are margin actions, and that constraints are categorised as system actions.
  - ◆ The group questioned whether or not the creation of reserve was a system or an energy action. However, it was noted that reserve itself may be created for different reasons, so it was not possible to say that it was used for solely system or energy, it depends on the circumstance. One member illustrated that there may be occasions where reserve is not expected to be held and the value of the service is in having the volume available. Where reserve is not associated with a probability of being used, it could be argued that it is being held for system reasons.
  - ◆ The group raised a point about the treatment of labelling actions system or energy when the length of the market is different at the point a contract is struck from the length of the market post gate closure. If NGC identifies a shortfall in NIV at the day-ahead stage and addresses this with an action it labels as being energy, if NGC gets the direction of the system wrong, so that an action to resolve NIV results in the creation of reserve, there is no process to change this action from energy to system (if reserve per se can be categorised as system). This served to highlight the deficiencies in the current mechanism for tagging actions.
  - ◆ The question of the duration and timing of actions was also raised with there being some concern that CADL tagging of trades of less than or equal to 15 minutes somewhat arbitrary. Standing reserve may be tagged as a system action, yet its equivalent CADL would be 20 minutes or greater. The group broadly considered that there needs to be a consistent approach adopted for deciding which actions were tagged as system or energy.
  - ◆ One member of the group observed that the NIV itself allows for a volume of priced energy actions to be created and serves as an indication of system imbalance. However, some of the group recognised the importance of getting this net energy volume priced at an appropriate level. To be able to price accordingly you need the following information:
    - The intent of the action.
    - The duration of the action, particularly where actions are taken pre gate closure.
  - ◆ Some of the group recognised the general principle for cash out is to create a mechanism as close to perfection as possible, whilst recognising that the market is not perfect. The majority of the group considered that the target was to get a cash out price as close to the marginal cost of energy as possible.
  - ◆ The group was interested in NGC's explanation at the Operational Forum that upward regulation was treated as energy BSAD, whilst downward regulation was treated as system (and therefore treated as unpriced in cashout). The group broadly did not consider that this was appropriate and felt that where downward regulation is pursued such that a volume of inflexible plant is taken off the system leaving more flexible plant, that this is equivalent to upward regulation (i.e. creating an energy 'option'). However, the underlying reason for taking a downward regulation

action is to maintain the required level of reserve for frequency response, i.e. generating plants operating in frequency responsive mode, rather than to increase 'options' for energy sells (Bids) for NIV energy balancing.

**ACTION: The group to report back with what it considers to be the deficiencies and/or inconsistencies in the current methodology.**

### ***Removing Tagging***

- ◆ First Hydro presented a paper that outlined that there are a considerable volume of actions tagged out of the pricing calculations via the NIV mechanism. Some of these actions may not be system actions, and so therefore should not be tagged out. First Hydro considers that the current mechanism is not consistent with the cash out objectives which are intended to be cost-reflective. As identified earlier, there was some support from the group that the cash out price should be the marginal cost of energy, and that the current mechanism is significantly divergent from this. It was again highlighted that every system action delivers energy. First Hydro also questioned the belief that system actions are the most expensive and are tagged from the top of the stack. An opposing view is that where a system action can be identified pre gate closure, then the reason for taking a system action pre gate closure is that it is cheaper than taking the action in the BM. It is therefore feasible that a pre gate system action can be cheaper than a post gate energy action. Where this is the case, the NIV tagging methodology may tag an energy action and leave a system action in the pricing calculation. First Hydro espoused that the current mechanism therefore over-tags relevant actions, and that NIV tagging should be abolished. First Hydro was less concerned about CADL and the reverse price, but considered that it would be desirable for them to both be removed.
- ◆ Some members of the group expressed sympathy for First Hydro's position.

**ACTION: ELEXON to assess the feasibility of recreating pre-P78 prices.**

- ◆ There was some support from the group for the concept of there being a volume designed to reflect the net energy imbalance of the system, but that the resulting prices may not be appropriate.
- ◆ A specific defect of the NIV was that the concept of the reverse price may generate windfall gains and losses over the main price, simply because of a participant that is out of balance being on the opposite side of the market imbalance. Whether you receive or pay a windfall gain or loss was considered to be largely down to luck.
- ◆ The group broadly considered that if the NIV was accurate then we need to focus on the prices that result from the calculation. If the NIV is inaccurate then perhaps it should be abandoned or changed so that it is more accurate.
- ◆ One member of the group questioned the current mechanism of leaving system actions in the stack but unpriced for the purposes of cash out. A potential mechanism for addressing this may be to include gross energy and system BSAD in the stacks and rely on the tagging mechanisms to remove system actions from cash out.
- ◆ Again the group returned to the concept of system actions erroneously being tagged from the main stack on the basis of their price. By tagging the highest priced actions

as system, actions identified as system actions pre-gate may be cheaper than energy actions. Tagging may therefore remove post gate closure energy actions and leave in pre gate closure system actions.

- ◆ There was a range of potential mechanisms to address the defect in the NIV methodology. These options included:
  - Remove the NIV calculation and have WAP of each stack (pre-P78)
    - A potential variant of this mechanism is to retain the reverse (market) price concept.
  - Each potential mechanism could include gross energy BSAD at a WAP price. This would retain the system actions distinction, by including the gross priced energy actions and gross system actions unpriced. The group broadly agreed that the gross volume of actions would need to be calculated in each direction to get market direction.
  - Another option was removing system volume in each approach or leaving it out. Some members of the group felt that you would only be interested in system volumes if you care about the value of NIV and the reverse price.
- ◆ One member of the group considered that it would be useful for there to be clear reasons why the current mechanism is not working before considering potential options for its revision. In response, one member suggested that the current mechanism overstates the volume of system actions purported to be in the stack, which are then tagged out.
- ◆ This was followed up by a request for more understanding of to what extent prices are actually affected by system prices. In other words comparing the ex-post unconstrained schedule (EPUS) with the prices that actually out turned in a given period. One member of the group stated that you can not identify with 100% accuracy that an action is taken for system reasons. In this context comparing the EPUS with the actual prices may not mean much. Again the group echoed reasserted concerns that system actions are not always the most expensive and that the current mechanism may be tagging out the wrong actions. The group was therefore interested in the relative sizes of the two stacks, in part because if in a long period there are lots of reverse actions, is it really likely that these have been taken for system reasons?

**ACTION: ELEXON to conduct some analysis of the relative sizes of the main and reverse stacks to illustrate the extent of “system actions” being tagged from the main stack.**

- ◆ In addition to this, one member of the group felt it would be useful to look at gross BSAD in each direction for both system and energy. As system BSAD is not currently priced, it would be desirable to have an indication of priced system BSAD.

**ACTION: NGC to produce gross BSAD (both system and energy) for a particular period (at NGC's discretion).**

**ACTION: RWE to use gross BSAD to model the effects of its inclusion in prices.**

***Proportional tagging and offset tagging***

- ◆ One member of the group outlined that the difference between proportional NIV tagging and having no tagging was that the former keeps the concept of the reverse price, and maintains an element of system tagging via the reverse stack. However, it was noted that the resulting price from no NIV tagging and from proportional NIV tagging will be the same, providing other tagging mechanisms remain the same.

**ACTION: The group is to provide feedback on the concept of gross BSAD for the purposes of tagging, and comment on the proportional and offset tagging mechanisms outlined by Ofgem in its note.**

**Next meeting: Tagging/Review on 2 March 2005 from 10:30am to 4:30pm at ELEXON's offices**