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Direct Dial: 020 7901 7389
Email: steve.smith@ofgem.gov.uk

BSC Signatories, National Grid Company
and Other Interested Parties

29 April 2005

Our Ref: MP No P171

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") – Decisions in relation to Modification Proposal P171: "Retrospective removal of Emergency Instructions taken for System reasons from Imbalance Price"

The Gas and Electricity Markets Authority (the "Authority")¹ has carefully considered the issues raised in the Final Modification Report² in respect of Modification Proposal P171 "Retrospective removal of Emergency Instructions taken for System reasons from Imbalance Price".

The BSC Panel (the "Panel") recommended to the Authority that Proposed Modification P171 should be made and that Alternative Modification Proposal P171 should not be made. In the event that the Authority determines that either Proposed Modification P171 or Alternative Modification Proposal P171 should be made, the Panel recommended an Implementation Date of five working days following an Authority Decision.

Having considered the Final Modification Report in respect of Modification Proposal P171, the Panel's recommendation and having regard to the Applicable BSC Objectives³, the Authority has decided not to direct a Modification to the BSC in respect of Modification Proposal P171.

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

² Elxon document reference P171DMR, Version No. Final/1.0, dated 18 January 2005.

³ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Company's ("NGC'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

This letter explains the background and sets out the Authority's reasons for its decisions.

Background

Cash out arrangements

The Balancing Mechanism ("BM") was designed as a tool to assist National Grid Company plc ("NGC"), as the System Operator ("SO"), to keep the transmission system in balance in real time by providing a mechanism to adjust levels of generation and demand through the acceptance of Bids and Offers submitted to the BM ("Electricity Balancing"). The SO also uses the BM, amongst other things, to ensure that the system remains within safe operating limits, and that the pattern of generation and demand is consistent with any transmission system constraints ("System Balancing"). System Balancing actions include, but are not limited to, frequency control and the alleviation of locational constraints. The SO also has commercial freedom to trade in the other short term markets and to contract with generators, suppliers and customers to balance the system.

Under the rules of the BSC, a Party is in a position of imbalance if its notified contract volume does not match its metered volume, i.e. the Party is producing (or consuming) electricity which has not been sold (or bought) and is therefore not covered by contracts. Imbalance settlement, or 'cash out', is designed so that any electricity produced or consumed that is not covered by contracts is paid for, or charged at, a cost reflective price. The arrangements are designed to target the costs that NGC has incurred in buying and selling electricity to match generation and demand onto those Parties that are in imbalance, i.e. those Parties on behalf of which the SO has taken Electricity Balancing actions.

Parties that are 'long' when the market as a whole is 'short' (i.e. generators whose physical output exceeds their contracted volume or suppliers whose customers' demand is less than their contract volume when total demand on the system is greater than the total supply of generation), are not, in any meaningful sense, contributing to balancing the system (except inadvertently). The converse is true for parties who are short when the market is long. Parties with imbalances in the opposite direction to the system can also impose costs on the system (these are the costs associated with the need for a generator or supplier to change its output at short notice) as their contribution to balancing is not guaranteed, requiring the SO to manage the resulting risks.

A dual cash-out mechanism exists, in which there are two Energy Imbalance Prices, or 'cash out prices': the System Buy Price ("SBP") and the System Sell Price ("SSP"). Parties that are short are generally charged the SBP for their imbalance volumes and Parties that are long generally receive SSP for their imbalance volumes. These prices apply whether the system itself is long or short. In reflecting the costs that parties in imbalance impose on the system, a dual cash-out mechanism provides incentives for parties to contract ahead to meet their customers' demands, as those Parties that are long are likely to receive a lower price for electricity via imbalance settlement than if they had been fully contracted. Similarly, parties that are short are likely to pay a higher price for electricity via imbalance settlement than if they had been fully contracted.

(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.

Since NETA Go-Live⁴, in the light of experience gained under the new arrangements, a number of modifications⁵ have been made to the way in which Energy Imbalance Prices are calculated as a result of concerns that the rules did not give rise to prices that reflected costs and market conditions on the grounds that the proposed changes would increase the likelihood of this happening⁶. These modifications include the introduction of the Continuous Acceptance Duration Limit ("CADL")⁷ and changes to the treatment of contracts in the calculation of the Energy Imbalance Price. Most recently, Approved Modification P78 was introduced to address a potential defect in the methodology for calculating Energy Imbalance Prices used at that time which resulted in high levels of SBP that did not reflect the costs that NGC was incurring to balance the system and were considered to be driving the market long, as discussed above.

Approved Modification P78⁸ was submitted by NGC on April 2002 in response to concerns expressed by both NGC and market participants that cash out prices were reflective of costs associated with both System Balancing and Electricity Balancing⁹. It was also suggested that SBP was being distorted by System Balancing costs more frequently than SSP and hence the spread between SBP and SSP was larger than would be the case if System Balancing costs were correctly excluded. This, in turn, was creating asymmetric risks for Parties, in response to which they were tending to go long to avoid exposure to a high SBP, with the result that the market itself was long overall.

Approved Modification P78 introduced a mechanism into the BSC to remove a category of acceptances taken for System Balancing reasons from the calculation of cash out prices. Under Approved Modification P78 these acceptances were considered to be characterised by equal and opposite compensatory actions which, in general, were being taken by the SO for System Balancing reasons, for instance the alleviation of locational constraints. Approved Modification P78 also sought to change the derivation of cash out prices such that there would be a 'main' price and a 'reverse' price. It proposed that the reverse price would be derived from a market price based on short-term energy trades made in the forward and spot markets. The main price would be derived using a volume weighted average of all the eligible¹⁰ Electricity Balancing

⁴ NETA Go-Live occurred on 27 March 2001.

⁵ Approved Modification P10 "Eliminating Imbalance Price Spikes caused by Truncating Effects" was implemented in May 2001 to remove spurious Bid-Offer Acceptances ("BOAs") for small volumes that resulted in price spikes that did not reflect the costs incurred by NGC in achieving energy balance.

Approved Modification P18A "Removing/Mitigating the Effect of System Balancing Actions in the Imbalance Price" was made in September 2001 to remove actions taken for System Balancing rather than Electricity Balancing reasons from the calculation of Energy Imbalance Prices and to remove Bids and Offers with a duration of less than 15 minutes.

Approved Modification P8 "Introduction of a Price Adjuster to reflect Option Fees for Balancing Services Contracts in setting System Buy Price and System Sell Price" introduced an adjustment mechanism to reflect option fees for balancing services contracts in the calculation of Energy Imbalance Prices.

Approved Modification P78 "Revised Definitions of System Buy Price and System Sell Price" removed further System Balancing actions from the calculation of Energy Imbalance Prices.

⁶ In addition, on 2 May 2002, the Authority accepted BSC Modification Proposal P12 "Reduction of Gate Closure from 3.5 hours to 1 hour", which was implemented on 2 July 2002.

⁷ Approved Modification P18A: CID definition 1a.

⁸ The Authority's decision in respect of Approved Modification P78 "Revised Definitions of System Buy Price and System Sell Price" was published on 9 September 2002 and can be found on the Elexon website: www.elexon.co.uk.

⁹ Since System Balancing costs cannot currently be attributed to particular users they are excluded from the calculation of imbalance cash out prices.

¹⁰ Defined as actions that are not: Bids or Offers which have a Continuous Acceptance Duration of less than 15 minutes; De Minimis accepted Bids or Offers; Arbitrage accepted Bids or Offers; NIV Tagged Bids or Offers; or System actions identified in the BSAD methodology.

actions taken by the SO to alleviate the Net Imbalance Volume (“NIV”) ¹¹. Under the proposal the main price would apply to imbalances in the same direction as the overall system imbalance and the reverse price would apply to imbalances in the opposite direction. On 9 September 2002, the Authority decided to direct that Approved Modification P78 should be made. Approved Modification P78 was implemented on 11 March 2003.

In summary, the rules used to set cash out prices are designed to produce prices for each half hour settlement period that reflect the costs that NGC incurs in balancing generation and demand on the system. Cash out prices are crucial in sending appropriate price signals and creating the right commercial incentives on companies necessary to maintain security of supply. For suppliers, the potential to be exposed to high cash out prices during periods of peak demand provides the incentive to contract with generators in advance to meet their customers’ peak demand. For generators, the potential to be exposed to high cash out prices following, for example, a mechanical failure, during periods when margins are tight provides an incentive to maintain plant and to contract with other peaking plant to provide physical cover.

Current treatment of Emergency Instructions

Under the Grid Code, NGC can issue Emergency Instructions, which may require BM Units to operate outside their submitted parameters, in order to preserve the integrity of the transmission system¹². NGC can issue an Emergency Instruction to increase or decrease generation or demand in certain circumstances¹³. An Emergency Instruction can only be rejected by the relevant transmission system user on safety grounds¹⁴. The Grid Code states that an Emergency Instruction issued to a BM Unit is treated as a Bid-Offer Acceptance (“BOA”), unless it is rejected by the transmission system user or the Grid Code explicitly states to the contrary¹⁵.

The BSC specifies that an Emergency Instruction issued to a BM Unit under the Grid Code is classed as an Acceptance for the purpose of settlement¹⁶. At present, Acceptances resulting from Emergency Instructions issued to BM Units under the Grid Code are handled within settlement consistent with other Acceptances. Therefore, as for other Acceptance Volumes, an Emergency Instruction Acceptance has the following effect:

- ◆ the Lead Party¹⁷ of the affected BM Unit will be paid (or pay) for the Acceptance at the prevailing Bid or Offer price;
- ◆ a payment will be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance, with an associated impact on Balancing Services Use of System (“BSUoS”) charges for all Parties; and
- ◆ the Acceptance Volume feeds into the cash out price calculation at the prevailing Bid or Offer price, which may, subject to the tagging rules, impact imbalance payments and the Residual Cashflow Reallocation Cashflow (“RCRC”) for all Parties.

¹¹ The NIV is calculated by netting off all purchase actions against all sell actions to give the imbalance of the overall System.

¹² See Grid Code BC2.9.1 and BC2.9.2.

¹³ See Grid Code BC2.9.1.2.

¹⁴ See Grid Code BC2.9.2.1.

¹⁵ Grid Code BC2.9.2.3 states that a BOA will not be issued for provision of the Maximum Generation Service, during the Black Start process or the re-synchronisation of a de-synchronised island.

¹⁶ See BSC Q5.1.3 (b) and Q5.1.5.

¹⁷ The Lead Party is the Party registered to the BM Unit pursuant to Section K3 of the BSC.

Damhead Creek incident

On 19 May 2004, NGC determined that a piece of high voltage equipment was showing signs of distress and needed to be taken out of service as soon as possible in order to prevent an unsafe situation. The location of the distressed equipment meant that it was necessary to stop Damhead Creek Power Station exporting to the transmission system. At 12:51 BST on 19 May 2004, NGC issued an Emergency Instruction to Damhead Creek to perform a controlled shutdown and desynchronise the BM Unit as quickly as possible. The power station complied with the instruction and the equipment was isolated safely.

As outlined earlier, Acceptances resulting from Emergency Instructions are not distinguished within Settlement from other Acceptances. In this case, Damhead Creek's prevailing Bid price for a large proportion of the Acceptance Volume was -£9,999/MWh. Elexon has estimated that the inclusion of the Acceptance data¹⁸ associated with the Emergency Instruction would result in SSP being:

- ◆ -£96.68/MWh¹⁹ for Settlement Period 27; and
- ◆ -£5,870.82/MWh for Settlement Period 28.

Following the implementation of Approved Modification P181²⁰, the inclusion of this Bid Acceptance within settlement has been delayed until the Final Reconciliation Run for the affected Settlement Periods. The Final Reconciliation Run is due to take place on 8 July 2005 at which point, under the existing baseline, the imbalance exposure of those Parties with long positions in the relevant Settlement Periods will be altered on the basis of the revised SSPs.

In response to its concerns about the impact of the Damhead Creek incident on cash out prices in the affected Settlement Periods and the potential for cash out prices to be affected by Emergency Instructions in the future, on 25 August 2004 British Gas Trading ("BGT") submitted Modification Proposal P171: "Retrospective removal of Emergency Instructions taken for System reasons from Imbalance Price".

The Modification Proposal

Modification Proposal P171 seeks to revise the way in which Acceptances linked to Emergency Instructions are included in the calculation of cash out prices. Under the proposal, NGC, as SO, would have the discretion to identify whether an Emergency Instruction was issued for Electricity Balancing reasons or for System Balancing reasons. In the event that an Emergency Instruction is flagged by NGC as being an Electricity Balancing action, it would be treated no differently from any other Acceptance within settlement, as is currently the case. However, in the event that an Emergency Instruction is flagged by NGC as being a System Balancing action, it would be

¹⁸ The acceptance data was not initially included in settlement. The Trading Disputes Committee subsequently heard a Trading Dispute and directed that a Bid Acceptance should be entered into Settlement in the R3 Reconciliation Run on 15 December 2004.

¹⁹ NB: A negative SSP will mean that a Party who was 'long' during the Settlement Period will pay the absolute value of SSP for its imbalance volume (rather than receive it).

²⁰ Approved Modification P181 "NGC Emergency Instruction re Damhead Creek 19.5.04: Deferral of Settlement Process".

distinguished within settlement. Under the proposal a System Balancing Emergency Instruction Acceptance would be treated as follows within settlement:

- ◆ the Lead Party of the affected BM Unit would be paid (or pay) for the Acceptance at the prevailing Bid or Offer price (as is currently the case);
- ◆ a payment would be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance with an associated impact on BSUoS charges for all Parties (as is currently the case); and
- ◆ the Acceptance Volume would feed into the cash out price calculation as an unpriced volume.

Therefore, Modification Proposal P171 seeks to revise the treatment of System Balancing related Emergency Instructions Acceptances by making them unpriced Acceptance Volumes for the purposes of calculating cash out prices.

Modification Proposal P171 also seeks to apply the proposed solution on a retrospective basis with effect from 19 May 2004. This would, if approved, unwind the effect of the Damhead Creek incident on cash out prices in the affected Settlement Periods.

The Proposer considers that this Modification Proposal better facilitates the achievement of Applicable BSC Objective (c) ("Promoting effective competition in the generation and supply of electricity and promoting such competition in the sale and purchase of electricity") in that the Emergency Instruction issued on 19 May 2004 undermined the intent of imbalance prices which are meant to be based upon Electricity Balancing actions taken by the SO. The Proposer considers that this led to a number of Parties being exposed to erroneously large imbalance prices that are unrepresentative of the SO's Electricity Balancing actions. The Proposer was also of the view that retrospection could be justified in this case against the criteria against which Ofgem has previously considered retrospective Modification Proposals²¹. The Proposer considered that allowing retrospection would provide assurance to both existing and prospective market participants and thus would encourage active participation in electricity trading thereby promoting effective competition.

Alternative Modification Proposal

Alternative Modification Proposal P171 seeks to reflect within cash out prices any consequential Electricity Balancing which may be delivered by an Emergency Instruction issued for System Balancing reasons.

²¹ In, for example, the decision letter for BSC Modification Proposal P37 ("To provide for the remedy of past errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications"), Ofgem outlined that the particular circumstances which could give rise to the need for a retrospective rule change could, for instance, include:

- ◆ where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect;
- ◆ a situation where the fault or error occasioning the loss was directly attributable to central arrangements; or
- ◆ combinations of circumstances that could not have been reasonably foreseen.

In any event, the loss sustained would need to be material.

Like Proposed Modification P171, Alternative Modification Proposal P171 seeks to apply the proposed solution on a retrospective basis with effect from 19 May 2004 and to provide NGC with the discretion to identify whether an Emergency Instruction was issued for Electricity Balancing reasons or for System Balancing reasons. Alternative Modification P171 also proposes no revisions to the treatment within settlement of any Emergency Instruction Acceptances which are flagged as being Electricity Balancing actions. However, a different approach is proposed for the treatment of Emergency Instructions taken for System Balancing reasons. Under Alternative Modification Proposal P171, a System Balancing Emergency Instruction Acceptance would be treated as follows within settlement:

- ◆ the Lead Party of the affected BM Unit would be paid (or pay) for the Acceptance at the prevailing Bid or Offer price (as is currently the case);
- ◆ a payment would be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance with an associated impact on BSUoS charges for all Parties (as is currently the case); and
- ◆ replacement Bid/Offer Acceptances, derived on the basis of the Bids and Offers that would have been taken had the Emergency Instruction not been issued, would be included within settlement for the purposes of calculating cash out prices. This is effectively akin to applying a replacement price to the System Balancing Emergency Instruction volume based on an equivalent overall volume of Bids/Offer which would have been taken in the absence of the Emergency Instruction. The BSC Panel or a delegated sub-committee would have responsibility for approving the replacement price.

Therefore, as with Proposed Modification P171, Alternative Modification Proposal P171 has no impact on the payments between the Lead Party of affected BM Units and the Transmission Company relating to the Emergency Instruction Acceptance. The impact is confined to the way in which System Balancing Emergency Instruction Acceptances feed into and affect the calculation of cash out prices. As outlined above, such Acceptances will effectively be priced at a replacement price for the purpose of calculating cash out prices under Alternative Modification Proposal P171.

Related Modification Proposals

Several related Modification Proposals were considered by the Pricing Standing Modification Group (“PSMG”) alongside Modification Proposal P171. However, the decision in relation to Modification Proposal P171 has been made independently of these related Modification Proposals.

Modification Proposal P172 “Removal of Emergency Instructions taken for System reasons from Imbalance Price”

Modification Proposal P172 was also submitted on 25 August 2004 by BGT. The solutions proposed under Original Modification Proposal P172 and Alternative Modification Proposal P172 are identical to those proposed under Original Modification Proposal P171 and Alternative Modification Proposal P171 respectively in all but one respect. Consequently, the details of the proposed solutions under Modification Proposal P172 are not repeated here.

Modification Proposals P171 and P172 differ in terms of the proposed implementation approach. While Modification P171 entails retrospective implementation, the solutions proposed under Original Modification Proposal P172 and Alternative Modification Proposal P172 would, if approved, be implemented on a prospective basis.

Modification Proposal P173 “Revised Settlement Arrangements for Emergency Instructions”

Modification Proposal P173 was submitted by National Grid Transco on 25 August 2004. It proposes to amend the way in which Emergency Instructions are distinguished within settlement as follows:

- ◆ the Lead Party of the affected BM Unit would be paid (or pay) for the associated Acceptance at a replacement price rather than the prevailing Bid or Offer price. The replacement price would be calculated for the affected BM Unit and agreed by the Panel post event. The proposal is that the replacement price should represent Avoidable Costs, as currently defined in Section G.2 of the BSC, with the intention that the Lead Party of the affected BM Unit would be ‘cost neutral’ as a result of responding to an Emergency Instruction;
- ◆ a payment would be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance on the basis of the replacement price based on Avoidable Costs rather than the prevailing Bid or Offer price. BSUoS payments for all Parties would reflect the replacement price rather than the prevailing Bid or Offer price; and
- ◆ the Acceptance Volume would feed into the cash out price calculation at the replacement price based on Avoidable Costs rather than the prevailing Bid or Offer price.

Alternative Modification Proposal P173 proposes the same solution in terms of the treatment of Emergency Instructions within settlement but proposes a wider definition of Avoidable Costs upon which to base the replacement price. The wider definition proposed under Alternative Modification Proposal P173 includes additional cost categories which are specifically excluded under the existing Avoidable Costs definition included in Section G.2 of the BSC. Under the wider definition the following cost categories can be included where demonstrably incurred:

- ◆ costs or losses in respect of damage to property (including plant or apparatus) or death or injury to persons;
- ◆ increases in insurance premia; and
- ◆ increases in financing costs and overhead costs.

Modification Proposal P175 “Development of Provisions related to certain Bid-Offer Acceptances issued pursuant to the Grid Code (e.g. BC2.9 and BC2.10)”

Modification Proposal P175 was submitted by RWE Npower plc on 1 October 2004. It proposes to amend the way in which Emergency Instructions and intertrips are distinguished within settlement as follows:

- ◆ the Lead Party of the affected BM Unit would not be paid (or pay) for the associated Acceptance at either the prevailing Bid or Offer price or any replacement price. The Lead Party would be able to apply under the BSC for compensation for any costs

incurred in responding to the instruction, including costs associated with plant damage but excluding any amounts received or paid under the Connection Use of System Code ("CUSC") or any other bilateral agreement with NGC. The Panel would make a determination on each cost claim received. The Lead Party would be paid (or pay) any upheld compensation claim;

- ◆ a payment would not be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance on the basis of the prevailing Bid or Offer price or any replacement price. However a payment would be made from (or to) the Transmission Company on the basis of any upheld compensation claim; and
- ◆ replacement Bid/Offer Acceptances, derived on basis of the Bids and Offers that would have been taken had the Acceptance not been issued, would be included within settlement for the purposes of calculating cash out prices. This is effectively akin to applying a replacement price to the Acceptance volume based on an equivalent overall volume of Bids/Offer which would have been taken in the absence of the Acceptance. The Panel or a delegated sub-committee would have responsibility for approving the replacement price.

Respondents' views

Assessment Consultation

Elxon published an Assessment Consultation in relation to Modification Proposal P171 on 28 October 2004, which invited respondents' views by 9 November 2004. Elxon received 14 responses to the Assessment Consultation. The views received can be summarised as follows:

- ◆ six respondents considered that Proposed Modification P171 better facilitated the achievement of the Applicable BSC Objectives, while seven respondents did not;
- ◆ three respondents considered that Alternative Modification Proposal P171 better facilitated the Applicable BSC Objectives (although all three explicitly favoured Proposed Modification P171 over Alternative Modification Proposal P171), while six respondents did not. A further respondent supported Alternative Modification Proposal P171 over Proposed Modification P171; and
- ◆ one respondent did not provide a view.

Respondents' views in respect of Proposed Modification P171

Those in support of Proposed Modification P171 considered that the process for calculating Energy Imbalance Prices should be designed so that it clearly distinguishes between Electricity and System Balancing actions for the purposes of cash out. Several respondents noted that the potential for an event such as that which occurred on 19 May 2004 to distort Energy Imbalance Prices creates a large and unmanageable risk for all market participants, and considered that Proposed Modification P171 provided a mechanism to address this. One respondent considered that not only did the events surrounding 19 May 2004 adversely affect current BSC signatories but also that a failure to address this perceived defect may have a negative effect on encouraging new entry.

Several respondents considered that it is not appropriate for parties to be exposed to Energy Imbalance Prices that are unrepresentative of the Electricity Balancing actions taken by the SO.

One respondent noted that it is not appropriate that parties should make windfall losses or windfall gains as a result of Emergency Instructions. This respondent considered that on balance, Proposed Modification P171 would better facilitate Applicable BSC Objective (c) than the current baseline. One further respondent echoed this view, stating that Proposed Modification P171 would reduce the potential exposure to unrepresentative Energy Imbalance Prices, give confidence and certainty to the market and therefore better facilitate the achievement of Applicable BSC Objective (c).

Several respondents noted that in relation to retrospective implementation of Proposed Modification P171, it is appropriate for Energy Imbalance Prices to be calculated on the basis of the Electricity Balancing actions taken by the System Operator and not System Balancing actions, which respondents considered the events of 19 May 2004 to be. One respondent considered that retrospective correction of this anomaly would be the first step in a process that should ultimately result in the removal of the current effect of an Emergency Instruction upon Energy Imbalance Prices from within the BSC. Several respondents noted that Ofgem has previously expressed that retrospection may be considered in limited circumstances, and were of the view that the events of 19 May 2004 were sufficient to be considered within the scope of these limited circumstances.

However, the remaining respondents generally considered that retrospection could not be justified and that allowing Energy Imbalance Prices to change retrospectively would not promote competition in the generation and supply of electricity and would therefore not better facilitate Applicable BSC Objective (c). One respondent considered that retrospective modifications should be avoided wherever possible. This respondent stated that, specifically in this case, it is clear that Proposed Modification P171 does not meet any of the criteria against which Ofgem has stated that retrospective modifications may be appropriate. Should Proposed Modification P171 be approved, this respondent considered that it would set a precedent which would significantly widen the scope for retrospective modifications in the future. This respondent thought that this would represent a considerable increase in regulatory risk in the market which would be detrimental to the achievement of Applicable BSC Objective (c). Another respondent noted that having certainty over the market rules and basing operational or commercial decisions upon the rules at the time is a fundamental principle which underpins the industry.

Respondents' views in respect of Alternative Modification Proposal P171

Several respondents noted that although Alternative Modification Proposal P171 may be an improvement over the current BSC baseline, it was inferior to Proposed Modification P171 when assessed against the Applicable BSC Objectives. One respondent noted that, whilst it considered that Alternative Modification Proposal P171 is better than the current baseline in terms of Applicable BSC Objective (c), it was of the view that, as Emergency Instructions should be mostly System Balancing related and occur infrequently, the need for a post-event adjustment would only complicate the process which would be detrimental to the Applicable BSC Objective (d). Any post-event adjustment requiring the judgement or discretion of the SO was also considered to add uncertainty to the arrangements.

One respondent expressed that Alternative Modification Proposal P171 appears to introduce an additional and unnecessary process into the calculation of imbalance prices. This respondent considered that the process would require involvement from a number of entities and, on the grounds of operational efficiency, did not consider that the additional time and resource in

calculating a replacement price would achieve very much more than simply including a zero price.

A further respondent considered that the approach under Alternative Modification Proposal P171 would enable the NIV tagging process to determine the System and Electricity Balancing split and remove the need for determination of this split by the System Operator.

Several respondents took the opportunity to reiterate views on the issue of retrospection. One respondent noted that it was neutral as to the form of a potential alternative, provided that it was more efficient than Proposed Modification P171 and led to the removal of the impact associated with the events of 19 May 2004. One respondent stated that it did not consider that retrospective Code changes are appropriate but expressed a view that when anomalous events occur, retrospection should be considered on a case-by-case basis. This respondent considered that there is insufficient justification to override its general view on retrospective Code changes in this case, and that the retrospective nature of Alternative Modification Proposal P171 outweighs benefits brought by the solution. Consequently this respondent did not consider that Alternative Modification Proposal P171 would better facilitate the achievement of Applicable BSC Objective (c).

Draft Modification Report

Subsequently, Elexon published a Draft Modification Report in relation to Modification Proposal P171 on 15 December 2004, which invited respondents' views by 23 December 2004. Elexon received 15 responses to the consultation on the Draft Modification Report for Modification Proposal P171. Seven respondents considered that Proposed Modification P171 would better facilitate the achievement of the Applicable BSC Objectives relative to the current baseline. Four respondents considered that Alternative Modification Proposal P171 would better facilitate the achievement of the Applicable BSC Objectives relative to the current baseline, although three of these respondents expressed a preference for Proposed Modification P171. Seven respondents considered that neither Proposed Modification P171 nor Alternative Modification Proposal P171 would better facilitate the achievement of the Applicable BSC Objectives. The remaining respondent offered no comment.

Several respondents in favour of Proposed Modification P171 (in disagreement with the BSC Panel) considered that, in general, retrospective changes should not be made, but suggested that on balance, retrospection could be justified in this case. One respondent considered that retrospection in this case could serve to increase the confidence that the market could rectify errors, and as such Proposed Modification P171 would better facilitate Applicable BSC Objective (c). Another respondent noted that Proposed Modification P171 or Alternative Modification P171 would serve to remove actions that are clearly taken for System Balancing reasons from the calculation of Energy Imbalance Prices. One respondent noted that the PSMG implicitly acknowledged that not all the guidelines for approving modifications with retrospective effects²² were satisfied particularly regarding whether the issue was clearly flagged in advance. The views expressed, however, in relation to the remaining two criteria by those in favour of Proposed Modification P171 at the PSMG, the respondent believes, ultimately

²² The Draft Modification Report referenced the Authority's decision letter on Approved BSC Modification P37, which can be found at the following location:

<http://www.elexon.co.uk/documents/modifications/37/P37D.pdf>

outweigh this concern. This respondent stated that developing appropriate criteria that encompass all circumstances in advance, for approving retrospective proposals, is fraught with difficulties. This respondent went on to state that the guidelines should be treated as just that and not constrain sensible decision making i.e. they should recognise the highly unusual nature of this event and potentially damaging effect of this defect in the central arrangements.

Several respondents against Proposed Modification P171 noted that it is clear that the events of 19 May 2004 do not meet the retrospection criteria laid down by the Authority in its decision letter on Approved BSC Modification P37, and as such do not consider there is sufficient justification to warrant approval of a retrospectively applied modification to the BSC in this situation. Several respondents noted that their views had not changed since the Assessment Consultation. One respondent added that, in addition to its views on retrospection, it agreed with the Panel that the potential benefits brought about by Alternative Modification Proposal P171 are outweighed by the complexity of the solution, and the detrimental impact on the efficiency of the arrangements. This respondent also supported the Panel's view that the proposed treatment of Emergency Instructions taken for System Balancing reasons introduces an inconsistency in the cashout arrangements.

Panel's recommendation

The Panel met on 13 January 2005 and considered Original and Alternative Modification Proposals P171, the Draft Modification Report, the views of the PSMG and the consultation responses received.

In the Draft Modification Report, the Panel recommended that both Proposed Modification P171 and Alternative Modification Proposal P171 should not be made. However, at its meeting on 13 January 2005 when the Panel met to finalise its recommendations for the Final Modification Report, the Panel revised its views in relation to Proposed Modification P171 and recommended that it should be made. The Panel remained of the view that Alternative Modification Proposal P171 should not be made. While views on the issue were split, the majority of the Panel considered that a retrospective change could be justified in the circumstances addressed by Modification Proposal P171 and would be beneficial to competition. The split in views concerning retrospection existed for both Proposed Modification P171 and Alternative Modification Proposal P171. However, in comparing the other elements of Proposed Modification P171 with Alternative Modification Proposal P171, the majority view of the Panel was that Alternative Modification Proposal P171 would not better facilitate the achievement of the Applicable BSC Objectives when compared to Proposed Modification P171. This was on the basis that any competitive benefits offered by the potential for more representative Energy Imbalance Prices under Alternative Modification Proposal P171 would not justify any detrimental impact associated with the reduced efficiency of the solution compared to Proposed Modification P171.

Therefore, in the Final Modification Report the Panel recommended to the Authority that Proposed Modification P171 should be made and that Alternative Modification Proposal P171 should not be made. In the event that the Authority determines that either Proposed Modification P171 or Alternative Modification Proposal P171 should be made, the Panel recommended an Implementation Date of five working days following an Authority Decision.

Ofgem's view

Having carefully considered the Final Modification Report, the respondents' views and the Panel's recommendations, Ofgem, having regard to the Applicable BSC Objectives, is of the view that neither Original Modification Proposal P171 nor Alternative Modification Proposal P171 would better facilitate achievement of the Applicable BSC Objectives.

Applicable BSC Objective (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

Retrospection

Several previous Modification Proposals have sought retrospective implementation²³. In decision letters relating to these retrospective Modification Proposals, Ofgem has outlined that it considers that there should be a presumption against retrospective changes to the codes as they are likely to damage market confidence in, and the efficient operation of, the trading arrangements. Rather than protecting market participants from “unforeseen unfairnesses”, Ofgem has taken the view that market participants would generally prefer the assurance of rules that are unlikely to be changed retrospectively.

Ofgem has outlined that there are generally accepted and well understood legal reasons why retrospective modifications are to be avoided. In doing so, Ofgem has highlighted that it is a general principle of law that rules ought not to change the character of past transactions completed on the basis of the then existing rules. There are, therefore, sound legal and commercial reasons for having a strong presumption that retrospective modifications will not be made.

However, despite the general principle against retrospective rule changes, Ofgem has outlined²⁴ that it considers that there may be a small number of particular circumstances that could give rise to the need for a modification which would have a retrospective effect. The particular circumstances which could give rise to the need for a retrospective rule change could, for instance, include:

- ◆ where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect;
- ◆ a situation where the fault or error occasioning the loss was directly attributable to central arrangements; or
- ◆ combinations of circumstances that could not have been reasonably foreseen.

In any event, the loss sustained would need to be material.

²³ See, for example, BSC Modification Proposal P19 “To provide for the remedy of errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications”, BSC Modification Proposal P37 “To provide for the remedy of past errors in Energy Contract Volume Notifications and in Metered Volume Reallocation Notifications” and CUSC Amendment Proposal CAP001 “Frequency Response Imbalance Payments”.

²⁴ See, for example, the decision letter in relation to Modification Proposal P19.

As discussed below, Ofgem has considered whether or not the specified retrospective criteria are met in the case of Original and Alternative Modification Proposals P171. In doing so, Ofgem has considered the views expressed by the PSMG, consultation respondents and the Panel.

In relation to the first of the criteria outlined above, Ofgem agrees with PSMG and the Panel that the circumstances addressed under Original and Alternative Modification Proposals P171 are not an example of a situation where the possibility of retrospective action had been clearly flagged to market participants in advance. Therefore, Ofgem does not consider that this criterion has been met in this case.

Ofgem notes that differing views have been expressed in relation to the second of the criteria. One view was that the central arrangements had worked as anticipated because the Emergency Instruction Acceptance had been processed in accordance with the BSC and there had been no fault or error in the application of the central systems or processes in this respect. A different view was that the central arrangements had a wider scope and it could be considered that these arrangements had failed because a System Balancing action had influenced Energy Imbalance Prices. Having considered the views provided, Ofgem considers that a fault/error attributable to central arrangements refers to a situation where processes and/or systems associated with the BSC do not operate in accordance with the existing baseline. On the basis that, in this case, the Emergency Instruction was processed in accordance with the BSC, Ofgem does not consider that there was a fault or error which was directly attributable to the central arrangements. Therefore, Ofgem does not consider that this criterion has been met for Original and Alternative Modification Proposals P171.

The final consideration is whether or not the combinations of circumstances that Original and Alternative Modification Proposals P171 seek to address could have been reasonably foreseen. Ofgem notes that arguments were identified for and against this criterion. There are several contributing factors to the argument that the combination of circumstances in question could not have been reasonably foreseen:

- ◆ Emergency Instructions are rare events and the Damhead Creek incident was the first such event under NETA;
- ◆ the Emergency Instruction resulted in a Bid acceptance of which a substantial volume was priced at -£9999/MWh (a “sleeper” bid); and
- ◆ that SSP should be set at -£96.68/MWh and -£5,870.82/MWh as a result of the Emergency Instruction and the acceptance of a sleeper bid is both unexpected and inappropriate.

From the opposing perspective, there are several components to the argument that the combination of circumstances in question could have been reasonably foreseen:

- ◆ the provisions outlining the treatment of Emergency Instructions in the BSC are clear and have been in place for a number of years, meaning that there is no uncertainty as to how an Emergency Instruction would be treated and on 19 May 2004 the process worked as anticipated;
- ◆ the submission of high-priced “sleeper” Bids and Offers to the Balancing Mechanism is common; and
- ◆ the potential for sleeper bids to result in extreme cash out prices given the provisions in the BSC is known. Furthermore, this possibility was discussed in Modification Proposal

P87²⁵, further enhancing awareness of the possible impact of sleeper bids on SSP. Therefore, it is clear under the BSC baseline that in cases where an Emergency Instruction is issued it could have a significant impact on cash out prices.

Having considered the arguments made in the responses and the relevant documents, on balance Ofgem is of the view that this criterion is not met in this case. Ofgem considers that the BSC is clear in respect of the treatment of Emergency Instructions and that sleeper bids are common place. The potential for extreme Energy Imbalance Prices is, therefore, clear on the basis of the defined BSC provisions. This was acknowledged in the decision letter for Modification Proposal P87 in the context of intertrips where Ofgem noted that the arrangements currently in place in the Grid Code and the BSC could, in extreme circumstances, lead to some generators being paid very significant compensation which could also lead to extremely negative SSPs. While a number of parties were of the view that this was not reasonably foreseeable, Ofgem notes that a considerable proportion of respondents, PSMG members and Panel members shared the view that this possibility could be reasonably foreseen. Therefore, Ofgem considers that the combination of circumstances which led to the observed SSPs in the affected Settlement Periods on 19 May 2004 could have been reasonably foreseen by market participants.

Therefore, Ofgem does not consider that any of the listed criteria have been met in this case. In Ofgem's view, in order for retrospection to be directed, not only would at least one of the criteria (or additional criteria identified, recognising that the list of criteria is non-exhaustive²⁶) have to be met, but the matter would also have to be material. However, as Ofgem does not consider that any of the criteria have been met, the question of materiality is not relevant in isolation. Given the concern, which Ofgem shares, that retrospective changes to the codes will damage market confidence in, and the efficient operation of, the trading arrangements, Ofgem considers that approval of a retrospective rule change in this case would be to the detriment of the achievement of Applicable BSC Objective (c). Ofgem considers that to approve this modification with retrospective effect would also be to the detriment of its principal objective and general duties²⁷. Therefore, Ofgem is of the view that retrospection cannot be justified for Original and Alternative Modification Proposals P171.

Ofgem considers that the retrospective element of both Original and Alternative Modification Proposals P171 operates to the detriment of the achievement of Applicable BSC Objective (c). Therefore, Ofgem considers that neither Original nor Alternative Modification Proposals P171 would better facilitate the achievement of the Applicable BSC Objectives.

Sleeper Bids

The Damhead Creek incident has highlighted the issue of the potential effects of high priced "sleeper" Bids on the operation of the market and market participants. NGC has provided analysis which suggests that in the settlement periods affected by the Damhead Creek incident around 30 per cent of Bids submitted may be "sleeper" Bids and has stated that high, negative

²⁵ Modification Proposal P87: "Removal of market risk associated with the operation of a generator intertrip scheme". P87 was raised to address the possibility that sleeper bids could result in extreme cash out prices in the context of a BOA derived following the operation of an intertrip. The creation of a derived BOA for an intertrip is the same as for an Emergency Instruction.

²⁶ As outlined in the decision letter for Modification Proposal P19.

²⁷ Set out in Sections 3A to 3C of the Electricity Act 1989, as amended by the Energy Act 2004.

Bid prices are not uncommon. Ofgem has previously expressed in the consultation document relating to the guidelines for applying the Market Abuse Licence Condition under NETA²⁸ concerns about the potential for sleeper Bids, if accepted, to distort competition, which could be to the detriment of customers. Ofgem has also published guidance in relation to the application of competition law in the energy sector²⁹, which is intended to help market participants assess their conduct to avoid potential breaches of competition law. This guidance applies to the bidding strategies of market participants in the Balancing Mechanism. Ofgem considers that the issue of sleeper bids may merit further consideration.

If you would like to discuss any aspects of this letter, please contact Sonia Brown on 020 7901 7412 or Simon Bradbury on 020 7901 7249.

Yours sincerely

Steve Smith
Managing Director, Markets

²⁸ 'The Market Abuse Licence Condition under NETA: Guidelines, A consultation document', Ofgem, September 2000.

²⁹ 'Competition Act 1998 – Application in the Energy Sector, OFT and Ofgem, January 2005.