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Promoting choice and value for all gas and electricity customers

Cash-out review
Open industry meeting

30th March 2007

Agenda

1. Objectives of review
2. Feedback from industry meetings
3. Summary of main options
4. Discussion and debate
5. Programme plan/next steps

Objectives

Objectives of the review

To identify and implement a set of electricity cash out arrangements which:

- Are simple and transparent
- Provide appropriate signals
- Are non-discriminatory
- Promote competition in the electricity market

Context

Modifications	▪ Experience of market operating under different cash-out price regimes ▪ Shorter gate closure
SO Incentives	▪ Built up some history of regime working with and without SO incentives
Regional Initiatives	▪ Market coupling/new interconnectors
Environment	▪ EU targets (20% energy from renewables by 2020) ▪ Impact of intermittency on the grid ▪ Impact of LCPD on coal plant load factors
Logica contract	▪ Timing is a constraint on cash out review

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Feedback from industry meetings to date

30 March 2007

Key concerns raised

Cash-out prices **random/ volatile** for

Parties **don't know** their **position** in run-

Difficult for small players to source required shape

RCRC has distortive effect and favours VI players

Difficult to balance simplicity and cost-reflectivity

Incentive on parties to contract with SO rather than self-balance in highest price periods

RCRC is appropriate – just a refund on BSUoS charges

Greater role for SO than envisaged at

NG is **taking liquidity out** of the market

Locational BSUoS to address locational market

Cash out prices have a small impact on investment decisions

...so what is needed?

Arrangements are very complex

More simplistic calculation of prices?

Pollution of energy signal in prices

Effective mechanism to extract non-energy actions?

Lack of transparency in NG's actions

More information on actions taken by NG

Two Cash out models

Two main options for discussion based on ideas that have emerged

- **Need more simplistic calculation of prices**

- **Effective mechanism to extract non-energy actions**
- **More information on actions taken by NG**

Model 1

Market price +/- **X**%

X reflects 'inefficiency premium' of SO balancing

Model 2

SO creates ex-post unconstrained stack

Cash out price based on pure energy actions

Pros/Cons – Model 1
Simplified Cash-out

Pros

- Simplifies cash-out pricing leading to improved predictability and consistency
- Issue of system action pollution goes away
- Relatively simple to implement
- May encourage liquidity by creating a single within-day price reference

Cons

- May be moving too far from cost-reflective pricing
  - Market, and hence SO, may not carry out efficient level of balancing
- Premia/discounts would not reflect short notice changes in supply/demand
- Long term signals may still not be correct

Pros/Cons – Model 2
Ex-post Unconstrained Schedule

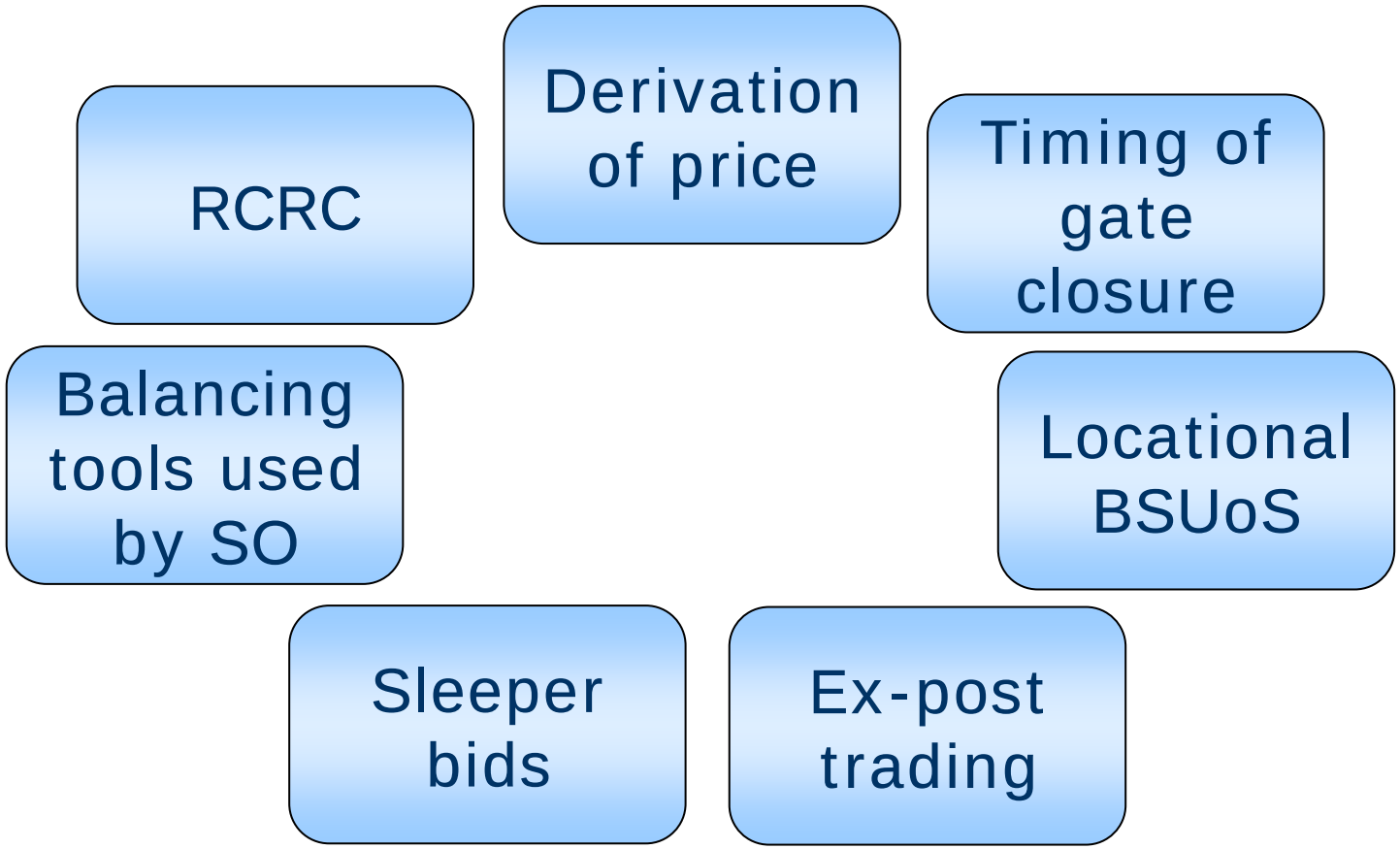
Pros

- More closely reflects costs of balancing the system
- Would create pure energy price
- Improves transparency

Cons

- Implementation would require new methodology for unconstrained energy schedule to be defined
- Pricing is ex-post
- Still need to consider how balancing services contracts are fed into cash-out prices

Additional issues for consideration



Evaluation criteria (for discussion)

(b) Efficient, economic and coordinated operation of the transmission system

e.g.

- Providing appropriate incentives to balance
- Providing LT investment signals
- Transparency
- Consistency and predictability

(c) Promoting effective competition in the generation and supply of electricity

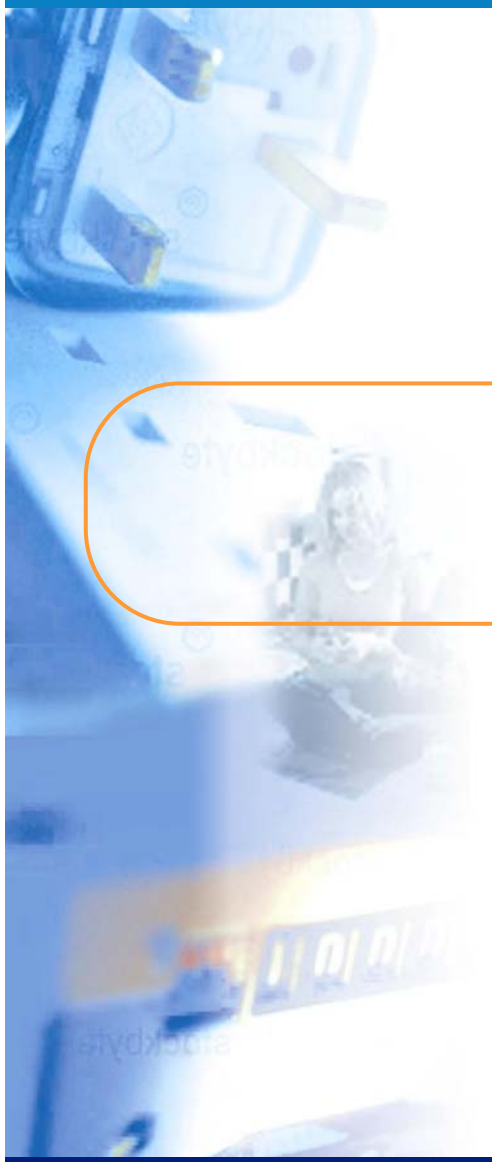
e.g.

- Effective cost targeting
- Lower entry barriers
- Encouraging liquidity
- Non-discriminatory
- Difficult to game

Other objectives and duties

e.g.

- Ease of implementation
- Robustness to change
- Minimise environmental impact



Discussion and debate

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Programme plan/next steps

Process

- Changes have to be made through mods process
- Important that cash out review does not delay the raising of – commercially important - mods
- We encourage parties to bring forward mods at any time
- Potential need to carry out IA on any mod (or mods) that are raised

Cash out review process will be flexible in response to any mods that are raised

High level programme plan