

Cash-out Review Meeting 2 – Discussion Points

This memo summarises the open session discussions at the industry Cash-out Review Meeting organised by Ofgem on 26th September 2007.

Ofgem would like to thank all participants for contributing to an interesting and valuable discussion. It was useful to hear reaction to the presentations and views on the way forward for cash out. The discussion raised some challenges for the review and we are now considering the best way to move forward. We would welcome any further views from market participants on the presentations and on the challenges identified.

Reaction to Ofgem and Professor Littlechild presentations

- 1.1. An attendee questioned whether investors preferred incremental or step changes. He believed that investors would prefer evolution to radical reforms, and that long term signals were needed if significant changes were envisaged.
- 1.2. Another attendee questioned what Ofgem meant by the SBP / SSP spread being too large. He also commented that the spread may need to be larger for RCRC to match energy balancing costs.
- 1.3. An attendee commented on the issue of within-day liquidity raised in the presentations. In her view, within-day trading was limited by notification risk rather than by the cash-out prices *per se*. She also asked whether Professor Littlechild's proposed balancing market would be voluntary. He replied that he saw no reason for it to be mandatory.
- 1.4. One attendee suggested that bringing gate closure closer to real time could achieve the same results as the proposed balancing market. Professor Littlechild noted that his proposal also incorporated the System Operator (SO)'s system-wide viewpoint on imbalance, although the merits of this approach would depend on the accuracy of ex-ante NIV forecasts.
- 1.5. A SO representative commented that NIV could be very unpredictable in the short term. Referring to Ofgem's slides on post Gate Closure changes, he stated that uncertainty was inherent in the physical system. In turn this led to uncertainty in both imbalance volumes (NIV) and cash-out prices, regardless of the precise arrangements (dual or single, average or marginal).

The case for change

- 1.6. An attendee observed that there had been multiple discussions on cash-out over the last three years and that different views remained within the industry. However, he believed that a commonly held viewpoint is that the present arrangements are not perfect but do not require fundamental change.
- 1.7. Another attendee disagreed about the scale of deficiency and hence the need for change.
- 1.8. An attendee said that the industry was still struggling to define and agree the scale of the problem after nine months of review. For example:

- What SSP/SBP spread would the industry expect to see if imbalance prices were cost-reflective?
- Who should bear the costs of within half-hour balancing?
- Do SO actions help or hinder?

1.9. This attendee stated his belief that there is a significant deficiency with material divergences between current imbalance costs and true energy cash-out costs. Referring to Professor Littlechild's presentation, he questioned whether the current arrangements are facilitating or distorting the market. He believed the costs of uncertainty are being allocated to smaller players and renewable generators, and stated that the industry needs to identify the path for change given the unavoidable case for change.

1.10. However, another attendee called for Ofgem to look carefully at the analysis undertaken by the Modification Groups. He believed that evidence presented on the case for change had not been robust to detailed scrutiny and stated that change must be based upon "sound analysis not sound bites".

1.11. An attendee stated that the industry needed to agree on the objectives of the cash-out arrangements before clarifying the defects and proposing changes. Another attendee agreed that the industry needed to define the problem before analysing solutions.

1.12. An attendee provided three examples that he believed illustrated the deficiencies of the current arrangements:

- Negative prices can arise due to quirks in the market rules;
- Transmission constraints had been left in the Balancing Mechanism (BM) after six years of NETA;
- The pricing arrangements are incomprehensible to new entrants and many industry insiders, and therefore comprise a barrier to entry.

1.13. Many commented that there were legitimate reasons for the cash-out price to become negative. One attendee also challenged the perception that few in the industry understood the cash-out arrangements.

Transmission constraints and cross-governance concerns

1.14. An attendee commented on the cross-governance issues concerning the cash-out arrangements. The Modification Groups can only focus on BSC issues and not on SO issues such as incentives, reserve and constraint management. A BSC Issues Group would therefore lack the scope to take a holistic view of cash-out.

1.15. This attendee noted that constraints are to be considered by the BERR/Ofgem Transmission Access Review. He stated that participants can only deal with the industry codes and have to work within the policy framework set by Ofgem and government. As an example, the previous cash-out review raised issues around the role of the SO but participants did not have the ability to develop modifications to address these issues.

1.16. One attendee called for volunteers to evaluate and take forward proposals such as Professor Littlechild's balancing market concept. She stated there was a need to address a wider scope beyond the limitations of a BSC Issues Group.

1.17. Another attendee said the industry needed guidance on Ofgem's view of transmission constraints given that the current arrangement of resolving constraints in the BM was believed to be a legacy of Ofgem's pre-NETA position.

1.18. A SO representative noted that were issues concerning the appropriate allocation of reserve availability fees and that National Grid would welcome discussions on BSAD by an Issue Group or similar forum.

Defining energy balancing costs

1.19. An attendee stated that his organisation was clear on what should be in the cash-out price but that more information on the SO's actions was needed.

1.20. An attendee commented that agreeing energy balancing costs should be limited to half-hourly blocks would be a step forward, since it would confirm the intention to exclude real time balancing costs from cash-out. Another attendee thought that Ofgem had previously stated that real time balancing costs should be included in cash-out.

1.21. An attendee observed that the physical system was inherently complex, being subject to technical generator parameters and other constraints.

1.22. Another attendee commented that the P211 Alternative had illustrated the complexity of generator dynamic constraints. He believed that the majority had concluded that such an approach could not be achieved simply and would need a fundamental change to model generator constraints fully (per the SuperGOAL algorithm developed for the Pool).

1.23. An attendee suggested that it may be worthwhile revisiting the DISG papers that were discussed during the NETA project. Issues such as supplier balancing, auctions and the "gas shipper concept" had been extensively debated at the time and may be relevant to the current process.