

Modification proposal:	Balancing and Settlement Code (BSC) P212: Main Imbalance Price based on Market Reference Price		
Decision:	The Authority ¹ has decided to reject the Modification proposal ²		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	29 February 2008	Implementation Date:	n/a

Background to the modification proposal

In February 2007 Ofgem launched a review of the electricity cash-out arrangements, after concerns were identified with the existing arrangements. The objective of the Review was to identify cash-out arrangements which are simple and transparent, provide appropriate economic signals and commercial incentives, are non-discriminatory, and promote effective competition in the electricity market.

The modification proposal

One of the perceived defects discussed during the Cash-out Review was 'system pollution', where cash-out prices reflect some of the costs of 'system' balancing actions rather than purely 'energy' balancing actions. Bizz Energy raised modification proposal P212 (P212) in April 2007 seeking to address this defect. P212 proposes that cash-out prices be based on market prices rather than System Operator (SO) actions. System Buy Price (SBP) would be set at a 5% premium to the Market Index Price (MIP) when the system is short and System Sell Price (SSP) set at a 5% discount to the MIP when the system is long.

Elxon³ published its Initial Written Assessment of the proposal on 4 May 2007. The 14 December Final Modification Report (FMR) outlined the Balancing and Settlement Code (BSC) Panel's recommendation⁴. We published our Impact Assessment of the Modification on 20 December 2007⁵.

BSC Panel⁶ recommendation

At its meeting on 13 December 2007 the Panel recommended unanimously (aside from one abstention) that P212 should not be implemented.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the FMR and responses to Elxon's consultation, attached to the FMR. We considered all responses to our Impact Assessment, which can be found on Ofgem's website. The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the applicable objectives of the BSC⁷, and therefore does not direct that it be implemented. The reasons for this decision are outlined below.

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

³ The role and powers, functions and responsibilities of ELEXON are set out in Section C of the BSC.

⁴ BSC modification proposals, modification reports and representations can be viewed on the Elxon website at www.elxon.com

⁵ Available at the following link

<http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/CashoutRev/Pages/CashoutRev.aspx>

⁶ The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC.

⁷ As set out in Standard Condition C3(3) of NGET's Transmission Licence, see:

http://epr.ofgem.gov.uk/document_fetch.php?documentid=4151

Reasons for the Authority's decision

Objective (b) – the efficient, economic and co-ordinated operation of the GB transmission system

Our IA outlines our analysis and explains why we concluded that P212 would not lead to cash-out prices that reflect sufficiently the costs the SO incurs in balancing energy on the system in each balancing period. Analysis shows that it is difficult to forecast accurately the Net Imbalance Volume (NIV)⁸ (for parties and the SO) at gate closure (currently 1 hour ahead of the settlement period) due to uncertainties in the demand forecast and the risk of generator trips. This means that cash-out prices set 1 hour ex-ante may not reflect energy demand and supply in the relevant balancing period, or outturn imbalance volumes. Furthermore, the MIP is calculated based on trades undertaken on the APX exchange over a twenty hour period in the run up to gate closure, further diminishing the relationship between the MIP and actual energy balancing costs.

We also agree with analysis presented by the Modification Group in its FMR, that incentives on parties to balance would be weakened by cash-out prices that did not closely reflect the actual costs the SO incurs to keep the system in energy balance in each balancing period. The reduction in cost-reflectivity and in incentives to balance, as supported by the analysis presented in the IA, is likely to result in higher balancing costs and an increased role for the SO thereby reducing the efficient operation of the GB transmission system.

All respondents to our IA agreed with our assessment that P212 would lead to much less cost reflective cash-out prices and so would not promote the economic and efficient operation of the transmission system.

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

We recognise there are benefits in seeking to reduce the complexity of cash out, particularly in terms of potentially reducing barriers to entry, and consider that P212 achieves this to some extent.

However, the analysis in the IA demonstrated that P212 could lead to companies with better balancing performance effectively cross-subsidising those companies with poorer balancing performance due to the inaccurate targeting of imbalance costs under P212. The FMR also set out the modification group's belief that P212 might incentivise parties to manage their imbalance exposure through trying to influence the MIP rather than attempting to balance their own positions. This could lead to instability in the overall balance of the system and erratic market pricing. We agree that the risk of such unintended consequences is high and therefore conclude that P212 could be harmful to competition in the market, which therefore does not further BSC objective (c).

All respondents to our IA agreed with our assessment that the effectiveness of competition in the market for electricity would not be increased by P212.

⁸ The NIV is the imbalance volume over each half-hourly settlement period quoted in MWh. It is calculated from the net difference between the volume of buy and sell actions taken by the SO for each settlement period. A positive NIV indicates a short system, a negative NIV a short system.

Objective (d) - promoting efficiency in the implementation and administration of the balancing and settlement arrangements

The FMR outlines total central costs for implementing P212 at £258,637. The modification does not in any case further objectives (b) or (c) and therefore we believe this cost would not be justified. Furthermore, as we have outlined in our IA, the decreased incentive for parties to balance could significantly increase the costs of the system operator.

Other points raised by respondents

Three respondents expressed their preference for another variant of the market based price methodology. The first believes a different methodology, based on a dynamic premium/discount to the MIP relating to a measure of “system stress”, which was discussed during the Modification Process, would further the applicable objectives. The second believes the methodology chosen for detailed analysis at definition stage was not the best available. It therefore maintains that cash-out prices should be calculated by some method of reference to market price, but nonetheless agrees with rejection of P212. Another respondent suggested that a two tier methodology for cash-out could be developed, which applies a P212-type price ($MIP \pm [X]\%$) to the first [Y] MWh of a party’s imbalance, and a different price (e.g. using the existing methodology) to any imbalance above [Y] MWh.

We welcome and have considered these views in making our final decision. However, it is the role of the Modification Group to agree the exact form the final modification proposals should take.

We are disappointed that the Modification Group was unable to evolve the initial proposal for P212 into a workable solution, or to provide an alternative within the assessment phase timeframe, which was itself extended. We intend to consider the effectiveness of the governance processes surrounding the development of P212 more broadly in the context of the governance review.

We believe that there are merits in establishing cash-out prices derived from markets which parties can themselves access. This is after all the solution that works effectively in the gas market. The notable difference is that the SO can also trade in the gas on-the-day commodity market thus maintaining the link between energy balancing costs and cash-out prices, the absence of which is the greatest weakness of P212.

We welcome the fact that a party brought forward an innovative proposal to simplify the cash-out arrangements, and believe that the debate and analysis involved in the P212 Assessment Phase has furthered our understanding within the Cash-out Review.

Since we must assess each modification in its final form, and having considered all responses to our Impact Assessment, our view is that the applicable objectives of the BSC would not be better facilitated by Modification Proposal P212. We therefore reject Modification Proposal P212.

Signed on behalf of the Authority and authorised for that purpose.

Andrew Wright
Managing Director, Markets