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Date: 28 March 2012

Dear Colleague,

Open letter: Ofgem decision to launch a Significant Code Review (SCR) of the electricity cash-out arrangements

This letter informs stakeholders of our decision to launch a Significant Code Review (SCR) of the electricity cash-out arrangements in summer 2012. We will hold a stakeholder event on 30 April 2012 to discuss the SCR and its scope before its formal launch in the summer.

Background

Cash-out provides the principle incentive for demand and supply to be balanced in the short term and also provides longer term signals to invest in building and/or maintaining generation plant and potentially demand side response (DSR). We have repeatedly expressed concerns with current cash-out arrangements, and have suggested that incentives could be sharpened to improve security of supply and reduce balancing costs, both of which should benefit consumers.

In November 2011 we published our electricity cash-out issues paper¹, which described our main concerns with the existing cash-out arrangements. The issues paper set out the importance of cash-out for a secure and competitive electricity market, and highlighted a number of areas where the current cash-out arrangements could be improved. The issues identified were:

- Cash-out prices may not fully reflect scarcity at times of system stress
- Cash-out may not provide the right incentives for demand side response
- Cash-out prices suffer from a lack of transparency and predictability
- Dual cash-out prices have a large spread
- Participants are not incentivised to provide accurate Physical Notifications
- Reconciliation cashflows are large and opaque.

¹ Electricity cash-out issues paper, 2 November 2011, Ref: 143/11
<http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/CashoutRev/Documents1/Electricity%20cash-out%20issues%20paper.pdf>

We sought views on whether we should launch an SCR to allow Ofgem to take a lead role in considering improvements that could be made to the arrangements.

Stakeholder responses

We received 28 responses to the electricity cash-out issues paper. The non-confidential responses to our issues paper are published on our website alongside this letter.

The responses were diverse in relation to timing and scope of an SCR. Almost all respondents agreed that there are problems with the current cash-out arrangements. However, opinions differed widely as to what the key issues were and what the scope of the SCR should be. The diverse range of perspectives supports the case for exploring whether improvements could be made to the arrangements and for initially considering a broad range of areas.

The majority of respondents supported consideration of an SCR but raised issues with the sequencing of reforms to the electricity market considering other Ofgem and European work streams and the Government's Electricity Market Reform (EMR) package. We now explore these in more detail.

SCR timing and interactions with other electricity markets reforms

A number of respondents suggested that the launch of an SCR should be delayed to await further clarity on other industry developments. While we agree it is important to consider all the implications that other market developments might have for electricity cash-out, we believe that there is a balance between waiting for greater clarity and ensuring that any new arrangements deemed to be appropriate are in place promptly. We believe that by launching in the summer we will strike an appropriate balance. We consider that we will have sufficient clarity on the most closely related work streams to progress any necessary changes in such a way as to complement these wider reforms. The SCR process is intended to last no more than 12 months. In determining the length of the SCR, we will take into consideration the refined scope, the complexity of the project, and the industry's ability to resource and support the process. We may schedule the SCR to last for more than 12 months. Any resultant changes to codes and licences will then need to be progressed through the normal processes before they can be considered by Ofgem and implemented if they are approved.

Cash-out and EMR

We recognise the strong interactions that cash-out has with the Government's policy relating to the EMR Capacity Market proposal, and that some respondents suggested that the SCR should be delayed until there is further clarity on this and other EMR policy proposals. In December 2010 we informed stakeholders that we intended to delay the launch of an SCR until we had further clarity on EMR policy. We believe that we are now in a position whereby launching an SCR in the summer could mean that:

- The Capacity Market design could be made more effective and
- Irrespective of EMR, important short-term incentives for delivering the flexibility required to manage increasing volumes of intermittent generation (including DSR) can be enhanced.

We will continue to work closely with the Department of Energy and Climate Change to ensure consistency between the EMR policy proposals and the electricity SCR project, and will be able to consider the interactions between the EMR Capacity Market and any electricity cash-out reforms carefully. We believe launching the SCR in the summer should allow us to ensure that any changes to cash-out will be able to be aligned with the implementation of the Capacity Market.

Cash-out and the EU target model

Some respondents stated that the SCR should be delayed to allow for more clarity on the European framework guidelines and network codes² on capacity allocation and congestion management (CACM) and on cross border balancing (the "European target model"). The electricity balancing framework guideline in particular seeks to promote cross-border integration of balancing mechanisms. The Agency for the Cooperation of European Regulators (ACER) plans to finalise the development of the framework guideline this year. The European Network for Transmission System Operators for Electricity (ENTSO-E) is likely to finalise the associated network code in 2013.

Related to this, Ofgem's amended principal objective³ now includes promoting a competitive, secure and environmentally sustainable internal market in electricity within the Community and eliminating restrictions on trade in electricity between Member States. Any changes to existing arrangements will need to be consistent and compliant with these new responsibilities.

In light of our new duties and the European developments we also published an open letter today (28 March 2012) on implementing the European target model in GB. The letter explains the European target model and the ongoing initiatives to implement it by 2014. The letter seeks market participants' views on the implications of implementing the European target model on GB wholesale market arrangements and any interaction with the ongoing Electricity Market Reform. We believe that by launching an SCR in the summer we will be able to take into account all of these European developments.

Cash-out and wholesale liquidity

Some respondents stated that we should delay the SCR to await further clarity on Ofgem's liquidity proposals. Ofgem has now published its consultation document on a potential intervention to enhance liquidity in longer-dated products in the GB wholesale electricity market⁴. The document concluded that there is not a strong rationale for intervening in near-term markets at present. This consultation also notes that changes to the cash-out arrangements could have an impact on near-term liquidity. Assessment of the impact of any potential reforms to cash-out will include consideration of their possible implications for liquidity.

Reasons for our decision to launch

As illustrated above, we do not believe that the ongoing electricity market developments mean we should delay the SCR. We believe that the reforms under consideration could make it more important that we explore our cash-out arrangements to ensure that they compliment any other reforms that are made. Furthermore, we believe that failing to consider reform to the existing cash-out arrangements may harm future electricity security of supply and unnecessarily increase the costs of balancing the system, to the detriment of consumers. We believe it is appropriate to investigate these concerns further, and consider options to address them. Opinions as to which issues are most significant varied significantly between respondents. Because of this, and because of the highly complex nature of cash-out, we believe that an SCR is the best means for investigating these issues. We will refine the scope with input from stakeholders to allow the SCR to be as focused as possible without ruling out options that could ultimately benefit consumers.

² The European network codes will be legally binding legislation, directly applicable in each Member State.

³ The Domestic Regulations have amended Ofgem's principal objective under the Electricity Act 1989 (the Electricity Act) of protecting the interests of existing and future consumers. The interests of consumers now include their interests in the fulfilment by the Authority, when carrying out its functions as designated regulatory authority for GB, of the objectives set out in Article 36(a) to (h) of Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC.

⁴ Retail Market Review: Intervention to enhance liquidity in the GB power market, 22 February 2012, Ref: 21/12 <http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Liquidity%20Feb%20Condoc.pdf>

Developing the scope with stakeholders

We currently consider that the scope of the SCR should remain sufficiently wide to allow for investigation of some of the options described as part of the "wide scope" outlined in the issues paper⁵. However, we remain open minded as to whether this will be the case and intend to refine the scope and the principles of the SCR before launching the SCR this summer. This could involve ruling out some of the options considered in the issues paper under both the narrow scope and the wide scope. We will hold a stakeholder event on 30 April 2012 to gain stakeholders' views on the SCR's scope, alongside a stakeholder event on implementing the European Electricity Target Model in Great Britain. We invite parties who wish to attend this event to register their interest by 6 April 2012 (email address below). We will provide further details of the event in due course.

P217A preliminary analysis

In preparation for the launch of the SCR we plan to conduct preliminary analysis of the most recent modification to the cash-out arrangements, Balancing and Settlement Code (BSC) Modification P217A '*Revised Tagging Process and Calculation of Cash-out Prices*'. We expect to conduct further analysis of the current arrangements throughout the SCR process but accept respondents' views that the provision of some analysis of the impact of P217A would be useful prior to the launch of the SCR. Further detail on P217A and our proposals for preliminary analysis can be found in Annex 1. We would like to invite interested parties to contribute to our approach to undertaking the P217A analysis in an independent process from the stakeholder event. Depending on the level of interest we will determine how best to engage with interested parties. We would also appreciate expressions of interest in contributing to this work by 6 April 2012.

To register your interest in participating in the development of the scope and/or the development of analysis of P217A please email gb.markets@ofgem.gov.uk.

We look forward to your continued positive engagement in the electricity SCR process. If you have any comments or questions on the content of this letter, please contact Jamie Black at jamie.black@ofgem.gov.uk.

Yours sincerely,

Emma Kelso
Associate Partner, Wholesale Markets

⁵ These include consideration of an energy balancing market, a reserve market and alternative arrangements for intermittent generation.

Annex 1- Overview of BSC Modification Proposal P217A and summary of analysis proposals

BSC Modification Proposal P217A, '*Revised Tagging Process and Calculation of Cash-out Prices*,' was the most recent modification to the electricity cash-out arrangements.

P217A sought to improve the main imbalance price. It introduced a mechanism for "flagging" actions taken by the system operator to address transmission constraints. The price of flagged actions is removed from the cash-out calculation to prevent them from "polluting" the cash-out price. Under P217A, any flagged actions which would otherwise "pollute" the cash-out price are assigned a 'replacement' price. P217A also sought to improve the cost-reflectivity of the cash-out price by disaggregating Balancing Services Adjustment Data (BSAD)⁶.

P217A was proposed as an alternative to the original modification P217. The original was identical to P217A except that it proposed reducing the Price Average Reference (PAR) to 100MWh⁷. The alternative proposed no change to the 500MWh PAR. When P217A was accepted, we considered that it was appropriate that the PAR level stayed at 500MWh but that this value should be kept under review.

Post-implementation review

Ofgem approved the alternative P217A in October 2008 and it was implemented in November 2009. In our decision letter we committed to conducting a post-implementation review of the Modification after 12 months⁸. We noted that a review of P217A would be appropriate to understand the modification's impact on prices. We also stated the case for reducing the PAR would be kept under review.

In August 2010 we issued an open letter consultation on potential SCRs⁹, and sought views on whether it would be appropriate to develop the cash-out arrangements through an SCR. We stated that if an SCR of the electricity cash-out arrangements was launched, it would be appropriate to progress the P217A post-implementation review as part of this. After considering the responses to this letter, we decided not to launch an electricity cash-out SCR at that time. Similarly, the post-implementation review was not progressed at that time. As we have now decided to conduct an SCR of the cash-out arrangements we consider it appropriate to commence a post-implementation review of P217A as part of this process.

Our analysis

Ahead of launching an SCR in summer 2012, we plan to undertake preliminary analysis of the impacts of P217A on electricity cash-out arrangements. We expect to conduct further analysis of the current arrangements throughout the SCR process, but accept the views of respondents to the cash-out issues paper that some analysis of P217A would be useful prior to the launch of the SCR.

⁶ Before P217A, BSAD was treated as a single volume for each settlement period. Disaggregation created a consistent approach all balancing actions (forward trades and bid offer acceptances in the balancing mechanism).

⁷ PAR is the volume of NGET actions averaged in order to calculate the cash-out price. The lower the PAR value, the closer the cash-out price would be to the price of the marginal qualifying balancing action.

⁸ Ofgem decision letter on modification proposals P211 and P217, 16 October 2008

http://www.elexon.co.uk/ELEXON%20Documents/p211_p217_authority_decision_.pdf

⁹ Open letter consultation: Potential Significant Code Reviews (SCRs), 12 August 2010

http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/SCR%20open%20letter%20consultation_Aug10_final.pdf

We are currently minded to undertake preliminary analysis of the following areas:

1. Impact of P217A on cash-out prices

The Impact Assessment (IA) which supported the decision around P217A assessed the potential impacts of the proposed modification on cash-out prices and annual imbalance charges¹⁰.

We propose to investigate what impact the modification has had on cash-out prices, in particular assessing volatility and the spread between the main and reverse prices, relative to previous arrangements for calculating cash-out prices. Further, we will look at what impact the modification has had on overall imbalance charges and redistribution through the Residual Cashflow Reallocation Cashflow (RCRC).

2. Risks under P217A and Accuracy of Implementation

We also highlighted in the IA that there is a risk that the cash-out price methodology under the structure set out by P217A could, in particular circumstances, produce unexpected prices as a consequence of flagging and disaggregating BSAD.

Further, we announced in our decision letter for P217A that we would request that National Grid Electricity Transmission (NGET) provides interim reports on the effectiveness of the flagging process during the year. NGET has produced two reports to date setting out this analysis¹¹. We will use the information contained in these reports to consider the System Operator's accuracy in implementing the flagging procedure, and the impact of any inaccuracies on cash-out prices.

3. The impact of PAR level

When P217A was accepted, we considered that it was appropriate that the PAR level stayed at 500MWh but that this value would be kept under review. We propose to investigate what the cash-out prices would have been under different levels of PAR since the introduction of P217A. We will assess what impact varying the level of PAR would have had on cash-out prices, in particular on the volatility and spread between main and reverse price, and on annual imbalance charges and redistribution through the RCRC.

We are interested to hear interested parties' views on our proposals for the preliminary analysis to be published ahead of the SCR. We invite comments on the scope of proposals and other pieces of analysis interested parties would consider worthwhile as part of the preliminary analysis and/or subsequent analysis as part of the SCR.

¹⁰ BSC Modification Proposal P217 'Revised Tagging Process and Calculation of Cash-out Prices, 11 August 2008, Ref: 122/08

www.ofgem.gov.uk/Markets/WhIMkts/CompanEff/CashoutRev/Documents1/P217%20IA_FINAL.pdf

¹¹ Report on the Accuracy of the System Management Action Flagging Methodology: Report Covering November 2009 to April 2010, 24 June 2010

www.nationalgrid.com/NR/rdonlyres/0C22610E-C8D4-4DAF-955D-2CE77D00BADB/41912/P217FlaggingAccuracyReport.pdf; and:

Report on the Accuracy of the System Management Action Flagging Methodology: Report Covering May 2010 to April 2011 Inclusive

www.nationalgrid.com/NR/rdonlyres/BBDBD374-634A-4FAC-9AAE-8AF67A0A98B8/47733/P217AFlaggingAccuracyReport.pdf