



Electricity generation and/or supply licence holders, consumers and their representatives, and other interested parties

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Date: 1 August 2012

Dear Colleague,

Electricity Balancing Significant Code Review Launch Statement

Overview

This letter announces the launch of the electricity balancing Significant Code Review (SCR). It should be read alongside the initial consultation document¹, also published on 1 August 2012.

The key objectives of the SCR are to:

- incentivise an efficient level of security of supply
- increase the efficiency of electricity balancing
- ensure our balancing arrangements are compliant with the developing European Target Model and complement Department of Energy and Climate Change (DECC) work on Electricity Market Reform.

We believe that failing to consider potential reform to the existing balancing arrangements could harm future electricity security of supply and could unnecessarily increase costs of system balancing.

We expect to conclude the SCR process with publication of our final decision in early 2014. Following this we may issue directions for code modifications to be raised. Any proposal(s) raised would then be taken forward through the standard industry code modification process.

This letter outlines the SCR process which we intend to follow and sets out the scope of the electricity balancing SCR. The SCR mechanism allows us to undertake an open, accessible and consultative review of the codes relating to electricity balancing². This launch statement summarises why we consider an SCR of the electricity balancing arrangements is needed.

¹ The initial consultation document is available here:

<http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/electricity-balancing-scr/Documents1/Electricity%20Balancing%20SCR%20initial%20consultation.pdf>

² The Code Governance Review Final Proposals, published in March 2010, and subsequent licence changes introduced the SCR mechanism. It provides a leading role for Ofgem in facilitating code changes through a holistic review process. The Final Proposals document is available here:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=297&refer=Licensing/IndCodes/CGR>

We published an electricity cash-out issues paper in November 2011 that sought views on a range of concerns with existing electricity cash-out arrangements, whether we should conduct an SCR and the scope of a potential SCR³. Generally, there was agreement that the current arrangements could be improved. A summary of responses to our issues paper can be found in Chapter 1 of our initial consultation. After considering these responses we published an open letter in March 2012 signalling our intention to launch an SCR of electricity cash-out arrangements in summer 2012⁴.

We have decided to take forward the SCR with a wide scope. We agree with stakeholders who have previously mentioned (in response to our issues paper and at our stakeholder event held in April 2012) that elements of the scope are wider than the immediate electricity cash-out arrangements. As such we have decided to launch our review as the electricity *balancing* SCR.

Following the publication of this launch statement and the initial consultation document, we are now entering a twelve week period of consultation with stakeholders to seek views on the range of reform options we have identified. We will be holding an opening seminar and workshop in the week commencing 3 September 2012. The closing date for responses to the initial consultation is **24 October 2012**.

Scope

After careful consideration of stakeholder input, we have made a decision on the scope of the SCR. The scope is set out in this launch statement and in more detail in the initial consultation document. It comprises 'primary considerations' and 'secondary considerations'.

In our primary considerations is a range of policy options for changing the existing balancing arrangements, including:

- More marginal main cash-out price
- Single or dual cash-out prices
- Single or separate trading accounts
- Pay-as-bid or pay-as-clear for energy balancing services

There are also options for improving price inputs. This includes attributing a cost to non-costed actions and improving the way that the costs of procuring and using reserve are reflected in cash-out prices. Improvements to price inputs encompass options that we believe should be considered regardless of decisions taken on other primary and secondary considerations.

Our primary considerations also include new electricity balancing arrangements, such as consideration of a balancing energy market and alternative arrangements for renewable generation.

The secondary considerations are issues that rely on decisions about individual primary considerations or are related to less fundamental concerns. We will seek views on the following issues and options:

- Improved provision of information
- Creating a Reserve Market

³ Our Electricity cash-out issues paper can be found here:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=148&refer=Markets/WhIMkts/CompanEff/CashoutRev>

⁴ Our decision to launch an SCR of cash-out arrangements is available here:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=174&refer=Markets/WhIMkts/CompanEff/CashoutRev>

- Amending gate closure
- Residual cashflow reallocation cashflow (RCRC)
- Reverse price
- Setting an information imbalance charge

If in order to further our principal objective and statutory duties we consider that further consequential change to the scope of the SCR is necessary, we may bring additional elements of the arrangements into scope. This could be in line with developments in domestic and European legal requirements, industry developments, progress in our thinking and engagement with stakeholders.

Reasons for launching the SCR

Our published guidance on the launch and conduct of SCRs suggests a number of factors that might trigger Ofgem to launch an SCR⁵.

We believe that failing to consider reform options in respect of the existing electricity balancing arrangements could harm future electricity security of supply and unnecessarily increase the cost of balancing the system.

Project Discovery⁶ and our electricity cash-out issues paper set out our concerns with the current electricity cash-out arrangements and highlighted the importance of cash-out for a secure and competitive electricity market. Our key concerns are:

- Cash-out prices may not fully reflect scarcity at times of system stress and may have adverse consequences for security of supply.
- Cash-out may not provide the right incentives for demand side participation and this may lead to higher overall balancing costs than necessary.
- Cash-out prices suffer from a lack of transparency and predictability and this may impede the ability of market participants to react to signals being delivered, and may discourage new participants from entering the market.
- Dual cash-out prices have a large spread between the price paid to long participants and the price paid by short participants and this may place a significant cost on some participants.
- Participants are not incentivised to provide accurate physical notifications and this may lead to the SO taking inefficient balancing decisions as a result of inaccurate information.
- Reconciliation cashflows are large and opaque and this may be leading to an inefficient allocation of costs.

Almost all respondents to our issues paper agreed that there are concerns with the current arrangements though opinions differed on which concerns are of highest priority. The initial consultation document summarises these responses. They are also available on our website⁷. Our objectives for undertaking an SCR of the electricity balancing arrangements are also outlined in our initial consultation document.

⁵ Ofgem guidance on the launch and conduct of Significant Code Reviews (SCRs) can be found here: http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Guidance_intiating%20and%20conducting%20SCRs_final%20draft_110810.pdf

⁶ Project Discovery was our assessment of the risks to GB electricity and gas security of supply and our appraisal of whether market arrangements remained fit for purpose. It can be found here: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=73&refer=Markets/WhIMkts/monitoring-energy-security/Discovery>

⁷ Responses to our Electricity cash-out issues paper can be found here: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=148&refer=Markets/WhIMkts/CompanEff/CashoutRev>

Interactions

The electricity balancing SCR has interactions with a number of ongoing developments in the electricity market, most notably with the development of a European Target Model, DECC's work on EMR, and our work on improving liquidity in wholesale markets.

The European Target Model takes a long-term strategic look at EU electricity generation and transmission with the aim of integrating European electricity markets. The integration of European electricity markets should allow consumers in GB and across Europe to benefit from lower balancing costs as a result of simplified conditions for trading, efficient dispatch of plant and sharing of resources such as reserve.

There are significant interactions between the considerations in scope of the SCR and elements of the European Target Model. The European Target Model will become more clearly defined as the SCR process continues. To ensure our policy choices will be compliant with the European Target Model we will keep these interactions under review throughout the SCR process. We may for example consider progressing certain aspects of the SCR at a different pace to help ensure that we will be compliant. We will also consider carefully the appropriate timing of implementing reform to avoid unnecessary additional costs from repeated market changes.

There are also strong links between a review of electricity balancing arrangements and DECC's work on EMR, particularly consideration of a capacity mechanism (CM). EMR and potential reform of balancing arrangements are complementary but interacting, with the level of interaction depending on the choice of CM design.

DECC has welcomed our work on cash-out and our plans to launch an SCR. We will keep interactions between the two projects under close review as the CM design develops further. In our policy design and before implementing any balancing reforms, we will consider the impact on the effectiveness and cost of the CM carefully.

Interactions between the electricity balancing SCR and other work streams are further outlined in our initial consultation document.

Reasons for using the SCR process

Past modifications to the Balancing and Settlement Code (BSC) have made incremental improvements to the electricity balancing arrangements⁸. However, relying solely on an industry-led piecemeal approach has not alleviated our ongoing concerns with the current electricity balancing arrangements.

An SCR allows us to address our long-standing concerns and to undertake a more coordinated and holistic review of the electricity balancing arrangements with active stakeholder involvement, recognising the complex nature of these arrangements.

Timeline of process

We would normally expect that the SCR process would take approximately 12 months from the publication of the launch statement to the publication of our final decision. However, due to the complex nature of issues considered under our electricity balancing SCR we anticipate that the process will last around 18 months. We anticipate that it will run from August 2012 to early 2014, but the process may take longer if issues we encounter are complex or if certain issues rely on interactions with other ongoing areas of reform.

After considering responses following this initial consultation period, we will further develop our policy thinking with the aim of publishing our draft policy decision in spring 2013.

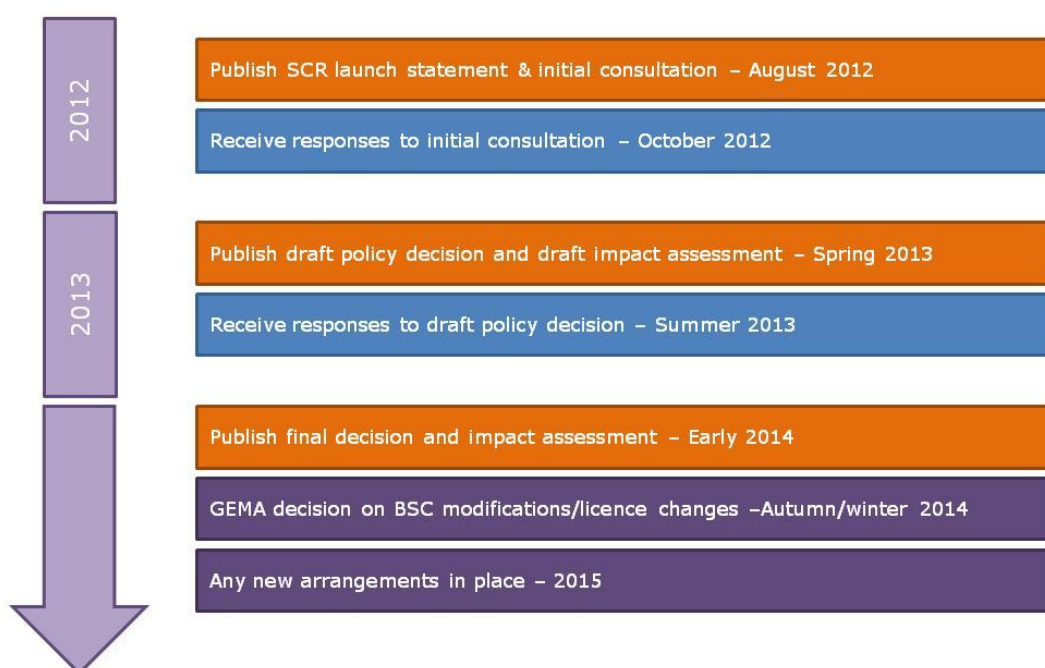
⁸ Past modifications of the cash-out arrangements relevant to the scope of the SCR are discussed in Appendix 3 of the initial consultation document.

Following further consultation on our draft policy decision we intend to publish our SCR final decision in early 2014.

Following the publication of our SCR final decision we may issue directions for code modifications to be raised. Any proposal(s) raised would then be taken forward through the standard industry code modification process and, following this process, the Gas and Electricity Markets Authority would make a decision on any proposed modification(s). It would then be the role of the relevant parties, eg in the case of the BSC central systems, Elexon, to facilitate the implementation of any system changes necessary as a result of any approved code modifications. Should any licence changes be necessary to implement the reform proposals, Ofgem will consider how to take these forward in a manner consistent with code developments.

We set out a high-level indicative timeline of our proposed process below.

Indicative electricity balancing SCR timetable



Project Considerations

As noted in our published guidance on the launch and conduct of SCRs, new modification proposals covering similar issues to those within the scope of an SCR may be suspended if they are raised after the publication of a launch statement. We will consider each modification proposal individually. If a proposal falls within the scope of this SCR we will direct that it is suspended whilst the SCR process is ongoing. Otherwise we may direct that the proposal should continue through the industry process. Proposals that we consider meet the relevant urgency criteria can also be progressed. Any modification proposals raised prior to the launch of the SCR may continue through the normal modifications process.

Guidance on our internal resourcing and on how we intend to engage with industry throughout the SCR can be found in Appendix A.

Next steps

This letter has been published alongside our electricity balancing SCR initial consultation document and our preliminary analysis of P217A⁹, the most recent change to cash-out arrangements. We invite responses to the questions presented in our initial consultation document and request that these are sent to gb.markets@ofgem.gov.uk. The closing date for responses to the consultation is **Wednesday 24 October 2012**.

We will be holding a number of events alongside the initial consultation to give stakeholders an opportunity to engage with us on the content of the SCR and discuss the issues raised in more detail. Our first stakeholder event will consist of a brief opening seminar and a full-day workshop. This event will be held in the week beginning 3 September 2012. We invite stakeholders to register their interest by 15 August 2012. We will then hold a further three workshops before the close of the consultation period on 24 October 2012. We will provide further detail on all of these events shortly.

If you have any questions or comments on the content of this letter please contact gb.markets@ofgem.gov.uk in the first instance.

Yours sincerely,

Emma Kelso
Associate Partner, Wholesale Markets

⁹ The P217A Preliminary Analysis document can be found here:
<http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/electricity-balancing-scr/Documents1/P217A%20Preliminary%20Analysis.pdf>

Appendix A: Internal resourcing and stakeholder engagement throughout the SCR process

Internal

There will be an in-house project team working on the electricity balancing SCR. We will seek input on links and dependencies from other teams across Ofgem, and will engage with stakeholders and with consultants where appropriate throughout the SCR process.

If, upon publication of our final decision at the end of the SCR period, we consider that code changes are required we will issue an SCR direction(s) to the relevant licensee, setting out matters to be addressed in a code modification proposal(s) by the licensee. It is then for the licensee to take these forward through the normal code modifications processes.

External

In order to enable us to meet our SCR objectives as set out in the initial consultation, we welcome stakeholder input throughout the SCR. We initially propose a number of methods for engagement with stakeholders:

- **Published documents:** We intend to publish an initial consultation document and two decision documents (our draft policy decision and final decision). These will allow interested parties to formally express their views on our position. We may publish further documents if we consider this to be necessary.
- **Seminars:** We are proposing to run two seminars to start and close our consultation period. The first will aim to give interested parties an overview of our initial consultation document and our initial options for potential reform. It will precede our first workshop on the same day. At the second seminar we will discuss our emerging thinking after the initial consultation period has closed.
- **Workshops:** We intend to hold four workshops throughout the initial consultation period to allow stakeholders to input into the various considerations as our thinking develops. The workshops will be divided into groups of specific policy issues, with each workshop aiming to develop thinking in the given areas.

Seminars and workshops will be open to all interested parties. However, to maximise the productivity of the workshops we request that attendance is limited to one participant per organisation. Wherever possible we would ask that the same participant from the organisation involved attends the stakeholder events. Interested stakeholders will be required to register their interest in attending events in advance. Where we require circulation of materials prior to workshops, we will aim to circulate these at least three full working days before the date of the event. We will also aim to circulate a high-level summary of workshops after the event.

We will be hosting our opening seminar alongside the first workshop in the week commencing 3 September 2012. More information on the event will be circulated closer to the time. If you are interested in attending this seminar and workshop, please register your interest by emailing gb.markets@ofgem.gov.uk by 15 August 2012.

If our timetable for the SCR, as shown above, falls back for any reason then we will seek to publish an updated timetable as soon as possible. This will be published on the electricity balancing SCR section of our website¹⁰.

We will continue to engage with stakeholders outside of the events outlined above, including through regular communication with parties carrying out interacting work.

¹⁰ The electricity balancing SCR section of our website can be found here:
<http://www.ofgem.gov.uk/Markets/WhlMkts/CompanEff/electricity-balancing-scr/Pages/index.aspx>