



Making a positive difference  
for energy consumers

BSC Parties, ELEXON, National  
Grid Electricity Transmission plc,  
interested parties

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Dear Colleague,

### **Statement on our commitment to the Electricity Balancing Significant Code Review reforms**

In this letter we<sup>1</sup> reiterate our strong commitment to the package of reforms resulting from the Electricity Balancing Significant Code Review (EBSCR)<sup>2</sup>. These changes to the cash-out arrangements are vital for ensuring the electricity market operates efficiently in the interest of consumers. They have been informed and tested by rigorous analysis and extensive stakeholder engagement over a three year period. The Authority approved the Final Policy Decision for the EBSCR earlier this year.

The substantial work undertaken during the EBSCR has given us confidence that this package of reforms, which is currently being progressed through Balancing and Settlement Code (BSC) modification P305, drives significant benefits for consumers. We therefore have a strong resolve to see the reforms implemented. We strongly urge the industry to fully consider and acknowledge the significant analysis and consultation that has been conducted during the EBSCR in order to ensure that P305 is progressed in an efficient and expeditious manner.

We also strongly advise market participants to fully account for the potential impact of the EBSCR reforms on their businesses now, particularly those bidding into the Capacity Market auctions this December.

#### *Background to BSC modification P305 and the rejection of P304 and P314*

On 15 May 2014 we announced our EBSCR Final Policy Decision and issued directions to National Grid Electricity Transmission plc (NGET) to raise two code modification proposals to the BSC to give effect to our conclusions. The full package of EBSCR reforms has been taken forward through BSC modification P305, with an intended implementation before winter 2015/16.

We also directed NGET to raise BSC modification P304. This was intended to be a small, discrete step through a distinct, stand-alone modification ahead of the full package of

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

<sup>2</sup> For more information about the EBSCR please visit: <https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-balancing-significant-code-review>

reforms included in P305. It proposed reducing the Price Average Reference volume (PAR) in the cash-out calculation from 500MWh to 250MWh in time for this winter.<sup>3</sup>

We directed this modification as we recognised the possibility for PAR reform by early winter. We considered that P304 would provide additional benefits by promoting the efficient market delivery of secure electricity supplies to consumers this winter, whilst presenting a very manageable change for market participants. We also considered this would give market participants an opportunity to assess whether a first step for this winter would be beneficial by helping them gain some experience of the more marginal cash-out prices due to be introduced under P305 next winter. This was in part because a phased introduction of our reforms had been suggested by a number of respondents through our public consultation during the EBSCR (and which is also reflected in the proposal for the full package of reforms for P305).

During the modification process for P304, a BSC party raised modification P314. This was similar to P304 apart from the fact that it proposed a lower PAR value of 350MWh and a later, mid-winter implementation date. The proposer of P314 considered that P304 presented an unmanageable change for smaller parties, particularly in the timescales set out. They viewed P314 as a better alternative to P304 although they still did not ultimately support either modification.

The industry had mixed views on the modification proposals. Some supported PAR reduction this winter, with a general preference for P304. Others considered any PAR reduction in the absence of a single cash-out price<sup>4</sup> to be unfair and unmanageable for smaller parties, particularly in the timescales proposed. Ultimately the BSC Panel voted to reject both modifications. Panel members also had mixed views, but broadly considered that any potential benefits were too small relative to the potential downsides. They also believed that the short period of time before the proposed introduction of P305 made the implementation of P304 and P314 hard to justify.

Today we announced our decision to reject both BSC modification P304 and P314.<sup>5</sup> This follows consultation with industry and analysis conducted during the BSC modification process, which suggests that the benefits of this separate step are likely to be too small to warrant the potential downsides of introduction. In particular, the analysis and feedback suggest that any benefits in relation to promoting the efficient market delivery of secure supplies of electricity this winter may be limited.

Although the analysis suggests that the magnitude of any distributional impacts would also likely be small, there may be legitimate concerns about the ability of some parties to react within the proposed timescales (potentially within two weeks), and also the extent to which sharper cash-out prices in the absence of a single price could contribute to unfair disadvantages and risks for certain types of market participants. All these factors suggest that P304 or P314 are unlikely to provide significant or appropriate learning benefits for market participants in preparation for P305.

#### *Implications for P305 and wider interactions*

The Authority's decision in May 2014 on its intention to implement the full package<sup>6</sup> of EBSCR reforms still stands. **We are fully committed to the progression of this package of reforms.** We consider that the proposals in P305 are fundamental to resolving defects in the market that have been known for many years. This includes market signals insufficiently reflecting the value consumers place on flexible electricity sources. Correcting

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<sup>3</sup> The Price Average Reference volume (PAR) is the volume of the most expensive energy balancing actions from which a weighted average is taken to calculate the main imbalance price.

<sup>4</sup> A single cash-out price is being brought forward by P305. Unlike a PAR reduction, this change was unable to be implemented in time for this winter.

<sup>5</sup> <https://www.ofgem.gov.uk/publications-and-updates/ofgem-decision-p304-and-p314-reduction-par-500mwh-250mwh-and-reduction-par-500mwh-350mwh>

<sup>6</sup> As being progressed through modification P305

these defects will be increasingly important for ensuring market efficiency as the share of intermittent generation grows.

The proposals set out in P305 have been informed and tested by very rigorous analysis and extensive stakeholder engagement over a three year period. This has provided us with confidence that they drive significant benefits for consumers. We strongly urge industry to progress modification P305 to the timelines set out at the EBSCR Final Policy Decision in order to deliver these benefits.

We also note the interactions between the EBSCR and the government's Capacity Market. These policies have distinct but complementary roles in ensuring the electricity market delivers in the interests of consumers. The EBSCR should increase electricity market revenue expectations for flexible capacity to a level more in line with the value consumers assign to this flexibility. The Capacity Market aims to provide an efficient level of security of supply by providing payments to market participants for reliable sources of capacity alongside their electricity market revenues.

As a result of the EBSCR reforms, participants should need to recover less 'missing money'<sup>7</sup> through capacity payments and therefore lower their bids in the Capacity Market auctions. Given the EBSCR's high likelihood of introduction, we strongly advise participants bidding into the Capacity Market auctions in December 2014 to factor in the expected impact of EBSCR. This will ensure efficient auction results and the avoidance of unnecessary costs for consumers in winter 2018/19.

If you have any questions about this letter please contact [EBSCR@ofgem.gov.uk](mailto:EBSCR@ofgem.gov.uk)

Yours sincerely,

Rachel Fletcher  
Senior Partner, Markets

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<sup>7</sup> The concept of missing money is used to describe a shortage of available revenue streams to allow capacity providers to cover their costs. Averaging of the cash-out price reduces the signal of scarcity passed through to forward markets, creating missing money in particular for flexible capacity providers.