

## TERMS OF REFERENCE FOR MODIFICATION PROPOSAL P78

There is significant overlap between a number of these Terms of Reference. However, they are kept separate for clarity.

### 1. DEFINITION ISSUES

- 1.1 Definition of an appropriate market price: Modification Proposal P78 requires that the Modification Group determine and define an appropriate market price. Any definition of market price should be based upon information available on a real time basis to enable prompt price reporting (see point 2.1), and on information that is stable. The Panel requested that the PIMG explore an alternative to an exchange based price, on the grounds that an exchange based price may not be available real time, and the definitions of the composition / constitution of exchange prices are subject to change, beyond the control of the BSC, therefore introducing an element of instability; and
- 1.2 Definition of the Settlement calculations to support Modification Proposal P78: Modification Proposal P78 provides a relatively high level view of the mechanism for calculating the main price. However, there are aspects of the calculation that need to be explored and defined further, for example, the exact nature of the inclusion of BSAD into the calculation.

### 2. ASSESSMENT ISSUES

- 2.1 Assessment of the Modification Proposal against the Applicable BSC Objectives: Consideration should be given as to whether, and how, Modification Proposal P78 better facilitates achievement of the Applicable BSC Objectives than the current baseline. Specific issues arising from the achievement of Applicable BSC Objectives may include (but are not limited to);
  - 3(b) – ‘The efficient, economic and co-ordinated operation by the Transmission Company of the Transmission System’. The basis for assessment could use:

The following points have been developed by the PIMG by considering certain views of the Authority, as expressed in a number of decision letters regarding previous Modifications.

- Provision of more accurate signals to the Transmission Company (System Operator) of the costs of balancing the system;
- More efficient incentives to achieve individual balance and overall system balance;
- The improved accuracy of (physical position) information given to the Transmission Company (System Operator) in advance of Gate Closure to ensure that it can make informed decisions about balancing the system, and the incentives on participants to provide such information.

- 3(c) – ‘Promoting effective competition in the generation and supply of electricity, and (so far as is consistent therewith) promoting such competition in the sale and purchase of electricity’. The impact of Modification Proposal P74 on all energy markets and mechanisms (including the Balancing Mechanism) should be assessed. The basis for assessment could use:

The following points have been developed by the PIMG by considering certain views of the Authority, as expressed in a number of decision letters regarding previous Modifications.

- The improvement of targeting of energy imbalance costs back to those participants that cause them, and the extent to which this promotes competition by preventing cross subsidies;
- Noting any change in the extent to which system balancing costs are targeted to all users of the system (via BSUoS), and the extent to which this promotes competition by preventing cross subsidies;
- The extent to which Energy Imbalance Prices are more reflective of the costs the Transmission Company (System Operator) has incurred in taking energy balancing actions; and
- The impact on the promptness of Energy Imbalance Price reporting and its effect on market transparency.

The following points are additional to those defined above, and have been defined by the PIMG as relevant to the assessment of the Modification Proposal against this Applicable Objective:

- The formation of Energy Imbalance Prices should not distort the forwards / spot markets in electricity; and
  - The extent to which participant imbalances may distort competition.
- 3(d) – ‘efficient administration’. An assessment of whether the potential improvements in the above Applicable Objectives outweigh the costs of administering the modified trading arrangements.

2.2 Assessment of the arguments that can be applied to the Modification Proposal. Consideration should be given as to whether Modification Proposal P78 is the most appropriate mechanism for addressing these issues, and to what extent the implementation of Modification Proposal P78 will mitigate / address these issues. Each issue will be assessed against the Applicable BSC Objectives and can be summarised as follows:

- The extent to which the Modification Proposal reflects the value which the Transmission Company (System Operator) places on passive and active actions by participants, such as Bid – Offer Acceptances as opposed to un-notified (to the System Operator) action;
- Asymmetric risk in the current mechanism, which is not reflective of the costs of balancing the system;

- Potential size of the buy – sell spread is leading to inefficient traded markets;
- Efficient peaking capacity is not being utilised as the predominant balancing action is to de-load flexible coal plant, thus increasing emissions;
- The continuing risk of exposure to the System Buy Price incentivises generators to part load plants to provide their own reserve, thus increasing emissions;
- The long market is distorting signals to generators to offer reserve to the Transmission Company (System Operator) rather than to maintain that reserve for their own portfolio; and
- The cost of imbalance borne by participants is not reflective of the costs incurred by the Transmission Company (System Operator) in managing these imbalances, thus distorting the market.

The potential benefits of implementing Modification Proposal will be assessed, analysed, and verified, as appropriate, by the PIMG as part of their assessment.

- 2.3 The assessment of the previously defined arguments will contribute to, but not constrain, the development of more detailed points for assessing the Modification against the current baseline. The PIMG will then consider how the Modification changes the incentives provided to different types of market participant and consequently draw qualitative conclusions on the likely impact of the Modification. If required, appropriate quantitative analysis may be performed in order to assess the likely range of outcomes, for example, cash-out prices, forward markets etc.

### **3. INTERACTION WITH OTHER MARKETS**

- 3.1 Transmission Company amendments: Any amendments to the Transmission Company processes, systems and documentation required to support this Modification Proposal will not be assessed by the PIMG. However, the Assessment Report for Modification Proposal P78 should highlight any dependencies between implementation of Modification Proposal P78 and consequential changes to the Transmission Company to ensure a consistent implementation approach. Also, amendments to the Transmission Company's documentation may require further changes to the BSC / Code Subsidiary documentation, and these need to be identified and assessed as part of the solution to the Modification Proposal; and
- 3.2 Balancing Services Adjustment Data: Following on from the above point (3.1), the Modification proposes that BSAD be reported and utilised as a net figure. There are two associated issues. The first is the impact on transparency; reporting of BSAD as a net figure could be considered to reduce transparency, therefore consideration should / could be given to amending BSAD such that the net figures are additional to that reported currently, or which address the transparency issues.

The second is that this Modification clearly requires amendment to the Transmission Company owned 'BSAD Methodology Statement', and consequentially to the BSC Systems that receive, publish and utilise BSAD. Therefore these amendments have an impact on the BSC and BSC Systems which needs to be understood and assessed as part of the solution to Modification Proposal P78.

#### 4. INTERACTION WITH OTHER MODIFICATION PROPOSALS

- 4.1 Interaction with Modification Proposal P12 'Reduction of Gate Closure from 3.5 hours to 1 hour': Consideration of the impact of the implementation of Modification P12 on the solution to Modification Proposal P78 should be assessed. Modification P12 has the potential to increase bilateral trading in the forwards and spot markets by allowing trading closer to real time, and also reduces the risk of exposure to imbalance from plant failure, by enabling a party to adjust their physical position, portfolio or trade to counter the failure, resulting in a smaller period of potential exposure to imbalance;
- 4.2 Interaction with Modification Proposal P27 'Amendment to the Derivation of Energy Imbalance Prices': Modification Proposal P27 sought to address similar issues by amending the calculation of Energy Imbalance Prices. The Authority rejected the Modification and provided their rationale for doing so, therefore any consideration of Modification Proposal P78 should ensure that any issues raised in the Authority Decision letter are addressed in the assessment of Modification Proposal P78;
- 4.3 Interaction with Modification Proposal P74 'Single Cost – reflective Cash-out Price': Modification Proposal P74 seeks to address similar issues to Modification Proposal P78, but via a different mechanism. Therefore the assessment of Modification Proposal P74 is to be undertaken in parallel with that for Modification Proposal P78. It is pertinent that the assessment of both Modification Proposals 'keeps an eye' on the other, but it may not be appropriate for there to be further interaction; and
- 4.4 Interaction with other relevant Modification Proposals: For example, Modification Proposal P79 'Revised Rules for Default Energy Imbalance Pricing' was raised on 12 April 2002 by London Electricity Group, and has yet to be considered by the Panel. This Modification Proposal has an obvious interaction with Modification Proposal P78, and therefore any interaction should be considered, if appropriate, once the Panel have considered the Initial Written Assessment for Modification Proposal P79.

Modification Proposal P38 is also relevant to the consideration of certain aspects of Modification Proposal P78, as set out in point 5.1.

#### 5. TECHNICAL IMPLEMENTATION ISSUES

- 5.1 'Prompt Pricing': Modification Proposal P78 requires that a market price be defined and utilised. Depending upon the composition of the market price, it may not be possible to report it promptly, and indeed, the definition of the market price may dependent upon the requirement for it be calculated and reported promptly. Therefore some consideration of prompt pricing aspects is required. Modification Proposal P38 'Redefined Definition of CAD (Continuous Acceptance Duration) to allow Prompt Price Reporting' considered the issues and requirements surrounding prompt price reporting and the associated consultation responses (indicating the importance of prompt pricing) could / should be considered when addressing Modification Proposal P78;
- 5.2 Impact on other Settlement calculations: The impact of the implementation of Modification Proposal P78 on other aspects of Settlement should be considered, as examples, the effect on Residual Cashflow Reallocation Cashflows and the effect of the redundancy of the Balancing

Reserve Limit (BRL). This should ensure a complete and consistent solution to the Modification Proposal; and

- 5.3 Settlement Day implementation: A Settlement Day implementation leads to an overlap of Settlement calculations for a period after implementation. Issues may arise from this implementation and these should be considered and addressed, for example, BSC Parties, ELEXON and the Transmission Company will be required to support two versions of the Settlement Report (SAA-I014), one for Settlement Days prior to the Implementation Date and one for Settlement Day post implementation, as a consequence of the amended reporting requirements of Modification Proposal P78.

#### **ANNEX 1: SPECIFIC ISSUES TO BE ADDRESSED BY THE ASSESSMENT OF MODIFICATION PROPOSAL P78**

The following are a more detailed consideration of the assessment issues defined in section 2 of this Terms of Reference paper and represent an indication of the type of analysis, assessment and consideration that the PIMG could undertake in respect of Modification Proposal P78. This is not an exhaustive list of such issues, but provides an indicative list, which will be added to in accordance with the process defined in paragraph 2.3 of this paper:

- What the most appropriate form of market price for the reverse price associated with this Modification Proposal is;
- The extent to which the Modification Proposal reflects the value which the Transmission Company (System Operator) places on passive and active actions by participants, such as Bid – Offer Acceptances as opposed to un-notified (to the System Operator) action;
- The extent to which Modification Proposal P78 provides incentives to deviate from Final Physical Notification (FPNs) or alter IPNs at short notice. If there is sufficient incentive to deviate, can this effect be countered, and how will this be achieved;
- The impact from Modification Proposal P78 on the risk profiles of different types of participant, and the consequential effect / impact on competition;
- If the Modification significantly weakens the incentive of participants to balance, would this have an impact on the resultant market price levels compared to competitive market price levels;
- The extent to which Parties are incentivised to balance the system as a whole, pre-Gate Closure, (even if individual parties are not); and
- The extent to which any Alternative Modification Proposal better facilitates achievement of the Applicable BSC Objectives than the original Modification Proposal.