



Direct Dial: 020-7901 7412
9 September 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref: MP No: P78

Dear Colleague

Modification to the Balancing and Settlement Code ("BSC") - Decision and Direction in relation to Modification Proposal P78: "Revised Definitions of System Buy Price and System Sell Price"

The Gas and Electricity Markets Authority (the "Authority") has carefully considered the issues raised in the Modification Report¹ in respect of Modification Proposal P78 "Revised Definitions of System Buy Price and System Sell Price".

The BSC Panel (the "Panel") recommended to the Authority that Alternative Modification Proposal P78 should be made. The Panel recommended that Alternative Modification Proposal P78 should have an Implementation Date of 25 February 2003 where an Authority decision is received by 6 September 2002. Where an Authority decision is received after this date, but before 19 February 2003, the Panel recommended that the Implementation Date should be 24 June 2003.

The Panel recommended that the Authority should reject Proposed Modification P78. However, if the Authority determines that the Proposed Modification should be made, the Panel recommended that the Implementation Date should be 25 February 2003 if an Authority decision is received by 6 September 2002. Where an Authority decision is made after 6 September 2002 but before 8 January 2003 the Panel recommended that the Implementation Date should be 24 June 2003.

¹ ELEXON document reference P078RR, Version No. 1, dated 16 August 2002.

The Authority has decided to direct a Modification to the BSC. This letter explains the background to the Modification Proposal and sets out the Authority's reasons for its decision. In addition, the letter contains a direction to The National Grid Company plc ("NGC") to modify the BSC in line with Modification Proposal P78 as set out in the Modification Report. This letter constitutes the notice by the Authority under Section 49A of the Electricity Act 1989 in relation to the direction.

Background to the proposal

The Balancing Mechanism was designed to enable NGC, amongst other things, as the System Operator ("SO"), to keep the transmission system (the "System") in Electricity Balance close to, and in, real time by adjusting levels of generation and demand in the light of the Bids and Offers submitted. The SO also uses the Balancing Mechanism to ensure that the System remains within safe operating limits² and that the pattern of generation and demand is consistent with any System transmission constraints. NGC, as SO, therefore incurs costs which can be divided between costs associated with "Electricity Balancing" and "System Balancing".

NGC can contract ahead of Gate Closure³ for the provision of balancing services where it is efficient and economic to do so. NGC is required to procure any balancing service contracts competitively via transparent processes. Therefore, NGC is required under special condition AA4 of its Transmission Licence to have in place Procurement Guidelines ("PGs") and a Balancing Principles Statement ("BPS"). The PGs outline the sort of balancing services that NGC may be interested in purchasing, together with the mechanisms envisaged for purchasing such balancing services. The PGs additionally state that NGC is prohibited from trading speculatively. The BPS defines the broad principles and criteria by which NGC will determine, at different times and in different circumstances, which balancing services will be used to assist in the operation of the System.

Gate Closure was reduced from 3.5 hours to 1 hour following the implementation of Approved Modification P12⁴ on 2 July 2002. The reduction in Gate Closure was accompanied by the creation of an additional contractual arrangement called a "Pre-Gate Closure Balancing Mechanism Unit Transaction" ("PGB Transaction"). This balancing service enables the SO to synchronise or desynchronise Balancing Mechanism Units with dynamics that extend outside the Balancing Mechanism with Gate Closure set at 1 hour.

Imbalance cashout ensures that any electricity not covered by contracts is paid for at or charged at a price that relates to the costs that the SO has incurred in undertaking Electricity Balancing actions. Imbalance cashout prices are designed to target the costs of Electricity Balancing onto Parties on whose behalf the SO has taken Electricity Balancing actions. Currently, a dual

² As prescribed by The Electricity Supply Regulations, 1988 (amended 1998) and consistent with its statutory duties and licence conditions.

³ Gate Closure is the last point at which Parties can notify their contract position to NETA Central Systems and at which Parties can resubmit their Physical Notifications to NGC.

⁴ Modification P12: 'Reduction of Gate Closure From 3.5 Hours To 1 Hour' was approved by the Authority on 2 May 2002.

cashout system exists under which there are two Energy Imbalance Prices: the System Buy Price ("SBP") and the System Sell Price ("SSP"). Parties who are 'short' (generators whose output is less than their contract volume or suppliers whose demand exceeds their contract volume) are charged the SBP for their imbalance volumes. SBP is intended to represent the average price at which electricity is bought for the System. It is calculated as the volume-weighted average of the Offers accepted in the Balancing Mechanism for Electricity Balancing purposes (plus the costs of electricity bought by the SO outside the Balancing Mechanism for Electricity Balancing purposes). Parties who are 'long' (generators whose output exceeds their contract volume or suppliers whose demand is less than their contract volume) receive the SSP for their imbalance volumes. SSP is intended to reflect the average price at which electricity is bought from the System. It is calculated as the volume-weighted average of the Bids accepted in the Balancing Mechanism for Electricity Balancing purposes (plus the costs of electricity sold by the SO outside the Balancing Mechanism for Electricity Balancing purposes).

Some market participants, including NGC, have expressed concerns in relation to the methodology by which Energy Imbalance Prices are calculated. They argue that the Energy Imbalance Prices do not only reflect Electricity Balancing costs but can also include costs associated with System Balancing. Moreover, they suggest that SBP tends to be distorted by System Balancing costs more frequently than SSP and hence that the spread between SBP and SSP is larger than would be the case if System Balancing costs were correctly excluded. This, in turn, creates asymmetric risks for Parties in response to which they have tended to go long to avoid exposure to high SBP, with the result that the market itself is being driven long.

In response to its concerns about imbalance prices, on 5 April 2002, NGC submitted Modification Proposal P78: "Revised Definitions of System Buy Price and System Sell Price".

The Modification Proposal

Modification Proposal P78 seeks to further the achievement of the applicable BSC Objectives⁵ by modifying the BSC to revise the definitions of SBP and SSP. Modification Proposal P78 proposes that the derivation of Energy Imbalance Prices be amended such that only one of the cashout prices would be derived directly from the costs incurred by the SO in undertaking balancing actions in the Balancing Mechanism. This price, the "main price" would apply to Parties whose imbalances are in the same direction as the overall imbalance on the system, ie, if the System was long overall, it would apply to Parties who are long. The other price, the "reverse price" would be derived from a "market price", based on short-term energy trades on the forwards and spot markets.

⁵ The applicable BSC Objectives are contained in Condition C3.3 of NGC's Transmission Licence and are:

- (a) the efficient discharge by the licensee of the obligations imposed upon it by this licence;
- (b) the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system;
- (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;
- (d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

Under Modification Proposal P78, the direction of the overall imbalance on the System for a settlement period would be based upon the volume of Electricity Balancing actions taken by the SO. This would be determined by creating separate purchase and sale stacks and then subtracting the sale stack volume from the purchase stack volume to produce a Net Imbalance Volume ("NIV"). The purchase stack would include the volumes of all Offers accepted by NGC and NGC's forward purchases for that Settlement Period while the sale stack would include accepted Bid volumes and NGC's forward sales. The NIV would be deemed to be the overall energy imbalance of the System and the main price would be derived from the balancing actions associated with the NIV. The remaining balancing actions would be deemed to have been taken for System Balancing purposes.

When the sale stack is larger than the purchase stack, the NIV would be negative. Conversely, when the purchase stack is larger than the sale stack, the NIV would be positive. Under Modification Proposal P78, when the NIV for a Settlement Period is:

- Negative, then the main price is SSP and the reverse price (SBP in this case) is based on the market price;
- Positive, then the main price is SBP and the reverse price (SSP in this case) is based on the market price.
- Zero, then both the main price and the reverse price SSP and SBP will be set to the market price.

NGC did not 'hardwire' a definition of the market price into Modification Proposal P78, considering that it was more appropriate for the Pricing Issues Modification Group (the "Group") to develop an appropriate definition. However, it suggested the Single Price Net Imbalance Reference Price, as defined in the Transmission Licence in relation to NGC's external SO incentive scheme, as a starting point for the Group's considerations.

The Group agreed that a market-based reverse price should, in principle, reflect the costs of short term energy, be representative of a liquid traded market and be available for publication/calculation close to real time. However, the Group considered that none of the currently available indices were reflective of short-term energy costs as they include trades undertaken up to 48 hours in advance of the relevant Settlement Period. Additionally, the Group was concerned that the indices are not published until some time after real time. Consequently, the Group suggested that "bodies" who trade within-day with "sufficient" liquidity close to real time should be requested to provide data on their traded prices and volumes from which the reverse price would be calculated. The Panel would determine which bodies would be designated as Market Data Index Provider(s) ("MIDPs") for these purposes.

The Panel would be required to define and maintain a Market Index Definition Statement ("MIDS"), approved by the Authority, containing the principles underlying the calculation of the reverse price, the detailed definition of how MIDPs should calculate their traded prices and volumes, and any liquidity thresholds that the MIDP are required to meet for the provision of data. The Panel would be supported by ELEXON when undertaking these roles.

Each MIDP would be expected to provide traded price and traded volume data to the Balancing Mechanism Reporting Agent ("BMRA") for each Settlement Period no later than the end of the Settlement Period to which the data pertained and the BMRA would publish these data on the Balancing Mechanism Reporting Service.

At the end of a Settlement Period the BMRA would calculate the NIV and the main price (based on the NIV). The BMRA would also calculate the reverse price based on the volume-weighted average of the traded prices provided by the MIDPs. In the event that no MIDPs provided traded price and volume data (or all the data received had zero values), the reverse price would default to the main price.

Alternative Modification Proposal

The Group considered that, while basing the reverse price on a market price might be desirable in principle, there might be a number of issues in relation to such a solution. For example, the Group suggested that there might be insufficient liquidity in within-day trades and questioned whether it would be appropriate in such circumstances to use a market index since it could be unrepresentative of short-term energy costs. An additional issue raised by the Group relates to the procurement process for obtaining the market data. In addition, information relating to procurement costs and timescales involved in creating a market index was not available during the Assessment Phase. In light of these concerns the Group considered the development of alternative options for calculating the reverse price.

The criteria that the Group took into account when considering alternative methods of calculating the reverse price were that it should have the ability to be reported promptly, be robust against manipulation and be reflective of the cost of short-term energy. After consideration of several options, the Group developed Alternative Modification Proposal P78 in which the reverse price is based on the first non-arbitrated Bid-Offer Acceptance ("BOA") in the main stack. The majority of the Group considered that this formulation of the reverse price met the criteria set out above.

Related decisions

Modification Proposal P74

In addition to the Group's consideration of Modification Proposal P78, the Panel deemed that the Group should consider in parallel Modification Proposal P74: "Single Cost-Reflective Cash-out Price", as they both addressed similar perceived defects in the BSC.

Modification Proposal P74 was submitted by Electricity Direct on 4 April 2002. It proposes the amendment of the application of Energy Imbalance Prices such that a single price cashout mechanism is in operation. Under Modification Proposal P74, the single cashout to apply in a Settlement Period is dependent upon the Total System Energy Imbalance Volume ("TQEI"). The Group developed Alternative Modification Proposal P74 which uses a different method for

determining the energy imbalance of the System which does not rely on TQEI. Under Alternative Modification Proposal P74, the direction of the energy imbalance of the System is based on the volume balancing actions taken by the SO to alleviate based on NIV. Under Alternative Modification Proposal P74, NIV is calculated in the same manner as under both original and Alternative Modification Proposal P78.

The Authority's decision in relation to Modification Proposal P74 has been issued concurrently with this letter.

Balancing Services Adjustment Data ("BSAD") Methodology Statement consultation

Modification Proposal P78 and Alternative Modification Proposal P78, should either be approved, require complementary revisions to be made to the BSAD Methodology Statement⁶. In particular, Modification Proposal P78 and Alternative Modification Proposal P78 require an amendment to the formulation and utilisation of the BSAD variables submitted by NGC. The BSAD variables are currently formulated and reported on a gross basis and only Electricity Balancing actions are included. However, the volumes of both Electricity and System Balancing actions are required in order to calculate NIV and there is a requirement for net BSAD to be reported. With this in mind, on 23 July 2002 NGC initiated a 14-day consultation process in relation to proposed amendments to the BSAD Methodology Statement. The Authority's decision in relation to the BSAD Methodology Statement consultation has been issued concurrently with this letter.

The Panel considered the P78 Assessment Report on 18 July 2002. The Panel recommended that Modification Proposal P78 be submitted to the Report Phase, with a recommendation that the Proposed Modification should not be made and that the Alternative Modification Proposal should be made. ELEXON published a Draft Modification Report on 1 August 2002 which invited respondents' views by 7 August 2002.

Respondents' views

In total, ELEXON received 13 responses to the consultation on the Draft Modification Report for Modification Proposal P78. Of the responses, seven expressed support for the provisional recommendations in the Draft Modification Report, five were opposed to the provisional recommendations and the remaining respondent made no comments in respect of the Draft Modification Report.

The seven respondents in favour of the provisional recommendations accepted that the costs of System Balancing actions were distorting Energy Imbalance Prices and considered that the cost reflectivity of imbalance prices would be improved if more System Balancing actions could be

⁶ NGC has produced and maintains the BSAD Methodology Statement in accordance with special condition AA4 of the Transmission Licence. The purpose of the BSAD Methodology Statement is to set out the information on relevant balancing services that will be taken into account under the BSC for the purpose of determining Energy Imbalance Prices.

removed from the calculation of the Energy Imbalance Prices. They believed that the NIV mechanism would achieve this and preferred the methodology contained in Alternative Modification Proposal P78 for calculating the reverse price to the original suggestion of a market price. Their concerns over a market-based reverse price reflected those raised by the Modification Group. Several respondents also expressed concerns in relation to the procurement and implementation processes required to develop the market-based index. However, two of the respondents stated that whilst they supported Alternative Modification Proposal P78 because they believed it would be easier to implement and would not suffer from liquidity problems, they would prefer the use of a market-based reverse price if these shortcomings could be overcome.

The five respondents not in support of the provisional recommendations considered that both Proposed Modification P78 and Alternative Modification Proposal P78 should be rejected. Several of these respondents considered that neither proposal improved the cost reflectivity of imbalance prices. Several specific comments were provided which outlined respondents' opposition to Alternative Modification Proposal P78. These included the concern that use of the first non-arbitrated BOA as the reverse price is an arbitrary solution and hence is not cost reflective. A further comment on the reverse price calculation under Alternative Modification Proposal P78 was that it would result in a low cashout price with only a weak incentive for Parties to balance.

Several respondents considered that it was too soon to make any changes to the calculation of imbalance cashout prices following both the reduction of Gate Closure to 1 hour on 2 July 2002 and the reduction of the Balancing Reserve Level ("BRL") to 5MWh on 19 July 2002.

Panel's recommendation

The Panel met on 15 August 2002 and considered Draft Modification Report for Modification Proposal P78, the views of the Group and the consultation responses received.

The Panel recommended that the Authority should accept Alternative Modification Proposal P78. The Panel recommended that Alternative Modification Proposal P78 should be implemented on 25 February 2003 if an Authority decision is received by 6 September 2002. Where an Authority decision is made after 6 September 2002 but before 19 February 2003 the Panel recommended that the Implementation Date should be 24 June 2003.

The Panel recommended that the Authority should reject Proposed Modification P78. However, if the Authority determines that the Proposed Modification should be made, the Panel recommended that the Implementation Date should be 25 February 2003 if an Authority decision is received by 6 September 2002. Where an Authority decision is made after 6 September 2002 but before 8 January 2003 the Panel recommended that the Implementation Date should be 24 June 2003.

Both original and Alternative Modification Proposal P78 required a decision to be issued by 6 September 2002 in order for implementation to take place in February 2003, should either be

approved. On 6 September 2002, Ofgem contacted ELEXON and requested an extension to this deadline. ELEXON agreed to an extension and the deadline was revised to 9 September 2002.

Ofgem's view

Ofgem⁷ considers, having had regard to its statutory duties, that original Modification Proposal P78 will better facilitate the achievement of the Applicable BSC Objectives.

Ofgem considers that the principle behind the current dual cashout mechanism continues to be appropriate. A Party whose metered position differs from their contracted position imposes additional costs on the System Operator who is seeking to balance the System in real time. Ofgem continues to consider that it is important for these costs to be targeted onto the Party concerned to act as an incentive to balance their position. While it is difficult to value the actual cost imposed by the Party being out of balance, to assume that the cost is zero by adopting a single cashout price would be even more arbitrary. Consequently, it is appropriate that participants who are spilling electricity should receive a lower price for their electricity than if they had been fully contracted since they may be imposing costs on the system. Conversely, participants on whose behalf the SO has to procure the flexible delivery of electricity at short notice should pay the full cost of power delivered over short timescales. The use of a dual cashout price regime incentivises participants to balance their own positions by Gate Closure and hence the actions that the SO has to take are minimised. Ofgem recognises that there are concerns relating to the calculation of Energy Imbalance Prices which apply within the dual cashout mechanism, but Ofgem continues to consider that a dual cashout mechanism is appropriate and that the calculation of Energy Imbalance Prices can be improved.

During its consideration of Modification Proposal P78, Ofgem requested additional information from NGC in its role as SO. Firstly, Ofgem requested NGC's views as to whether or not System Balancing actions continue to affect Energy Imbalance Prices following the reduction in both BRL and Gate Closure. NGC stated that System Balancing costs can and do affect Energy Imbalance Prices under the current regime. In relation to the reduction in BRL, NGC considered that this had reduced the frequency with which System Balancing actions affect the reverse price and the impact that they have on Energy Imbalance Prices. NGC considered that reducing Gate Closure has had a lesser effect. With shorter Gate Closure, more actions are being taken pre-Gate Closure where System Balancing actions can be tagged via the BSAD process. However, System Balancing actions are still being taken post Gate Closure, so NGC considers that the issue still exists. Overall therefore, NGC considered that this issue could only be fully resolved by implementing a more fundamental change to the imbalance price calculation, such as Modification Proposal P78.

Secondly, Ofgem requested NGC's views as to the appropriateness of making an amendment to the cashout price calculation methodology at this time given the recent changes to BRL and Gate Closure. Ofgem also asked whether NGC had any operational concerns linked to the

⁷ Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

implementation of any changes to the cashout price calculations in the winter months. NGC stated that it has not experienced any adverse effects on the behaviour of market participants since the changes to BRL and Gate Closure. NGC also stated that the implementation of a change to Energy Imbalance Prices on 25 February 2003 presents it with no operational concerns.

Ofgem accepts NGC's advice that the costs of System Balancing actions are being included in the calculation of Energy Imbalance Prices, particularly the reverse cashout price (typically SBP). Modification Proposal P78 and Alternative Modification Proposal P78 both seek to improve the differentiation between System and Electricity Balancing actions for the purposes of calculating Energy Imbalance Prices. Based on NGC's advice, Ofgem considers that calculating NIV, and basing the cashout price for imbalances in the same direction as the overall System imbalance (the main price) on the actions associated with the NIV volume should result in a price that is more reflective of the costs of Electricity Balancing than the current price, thereby allowing the costs of Electricity Balancing actions to be more correctly targeted at those causing the imbalance. Ofgem considers that this will facilitate the achievement of the applicable BSC Objective of "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".

Under Alternative Modification Proposal P78, the reverse price is based on the first non-arbitrated BOA in the main stack. While this price is based on the cost of a balancing action taken by the SO in the relevant half-hour, it is an action taken in the opposite direction to the imbalances to which the reverse price will be applied. For example, any shortfall in a long market will be cashed out at a price based on an accepted Bid to reduce generation/increase demand while any spill in a long market will be cashed out at a price based on an accepted Offer to increase generation/reduce demand. Moreover, Alternative Modification Proposal P78 assumes that the first BOA in the main stack will be an Electricity Balancing action, as it will be the lowest price BOA. However, it is possible that the first BOA could be a Bid or Offer which has been submitted in relation to a Balancing Services contract for System Balancing purposes. For these reasons, Ofgem considers that this approach could result in arbitrary reverse prices, particularly since they will be calculated from a single BOA.

Basing the reverse price on the first non-arbitrated BOA could also unduly over-reward Parties whose imbalances are in the opposite direction to the System as a whole. For example, if the System is short, Parties who are long will receive SSP based on an Offer price. Equally if the System is long, Parties who are short will pay SBP based on a Bid price. Analysis conducted by the Group suggested that the cashout price is likely to be more favourable than under the current arrangements. Ofgem does not consider that such a system would result in a reverse Energy Imbalance Price which represents the costs of Electricity Balancing.

Ofgem considers that unduly over-rewarding reverse imbalances may have detrimental effects on the incentives for Parties to balance their positions. To date, the System has tended to be long, with Parties spilling to avoid being cashed out at SBP for any shortfall. Ofgem considers that this perceived incentive to spill will be strengthened if the reverse price is based on the first

non-arbitrated BOA because any spill is likely to be cashed out at a higher price than currently. Therefore, although the disincentive to be short will be reduced (since the new calculation of top-up prices – SBP – is likely to result in lower values), the shortfall between spill and market prices will be reduced so that, overall, Parties may be even more likely to go long. Consequently, Ofgem considers that basing the reverse price on the first non-arbitrated BOA in the main stack could weaken the incentives for Parties to balance their individual positions. This, in turn, might potentially move the System further out of balance leading to the SO having to take additional balancing actions and so incur higher costs. Ofgem does not believe that this would facilitate the achievement of the applicable BSC Objectives of ensuring “the efficient, economic and co-ordinated operation by the licensee of the licensee’s transmission system” and “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”.

Under original Modification Proposal P78, the reverse price is based on a market price. This approach values any imbalance in the opposite direction to the overall System imbalance at a price that NGC intended should be generally reflective of the cost of short-term Electricity Balancing. The market price is designed to represent a “neutral price” in the sense that it is a price agreed between a willing buyer and a willing seller and hence is equally applicable to Parties who are long or short. The fact that SBP and SSP are generally different indicates the fact that the prices for buying and selling electricity diverge in the Balancing Mechanism in a way that is not possible in a traded market. Consequently, Parties cashed out at a market-based reverse price are less likely to be unduly over-rewarded than if the reverse price is based on a balancing action taken in the opposite direction.

Overall, the incentives for individual Parties to balance their positions under Modification Proposal P78 should improve. The current perception in a predominantly long market is that the reverse price, SBP, is unduly high and Parties are going long in order to avoid exposure to SBP. In such a situation, setting SBP to a market price will reduce the risk faced by Parties should they be short. Thus, the tendency for Parties to go long should be reduced and the overall balance of the System should improve. Equally, if the System is short, using a market-based reverse price is unlikely to result in SSP being as high as would be the case under the Alternative Modification Proposal (although it might be higher than under the current methodology). The result is that Parties should have less of an incentive to speculate on the direction of the System imbalance and then position themselves in the opposite direction. Therefore, the incentives for Parties to balance their individual positions should be enhanced when using a market price to set the reverse price.

These enhanced incentives to balance will increase the level of competition by encouraging Parties to trade ahead of Gate Closure. Ofgem considers that this will facilitate the achievement of the applicable BSC Objective of “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”. Ofgem considers that this should also reduce the costs incurred by the SO in balancing the System, since fewer Electricity Balancing actions should be required, and this would benefit customers.

Ofgem notes that the majority of the representations made in opposition to the use of a market price for the reverse price were based on perceived concerns in relation to the procurement of MIDPs and the implementation of this solution. Ofgem also notes that two such respondents to the Draft Modification Report stated that in theory they supported basing the reverse price on a market price and it was only the perceived practicality issues that concerned them.

One particular concern that was raised regarded the illiquidity of within-day trading. However, Ofgem notes that the proposal is for the market-based reverse price to be defined within a MIDS. The Panel will be responsible for establishing and reviewing the MIDS and it will include a full definition of the particular data and methodology to be used by each MIDP. Additionally, the MIDS will contain a definition and determination of a minimum liquidity requirement ("Individual Liquidity Threshold") for each MIDP. The Panel will have responsibility for defining these aspects of the MIDS, in consultation with Parties and other interested parties, and the Panel will review the MIDS if there is a change in circumstances which affects the provision of data from any MIDP. Ofgem considers that these measures should provide sufficient safeguards against illiquidity and that the Panel should take the appropriate steps to provide the appropriate market-based price.

Parties have expressed concern about the lack of information in relation to costs and timescales of putting in place a suitable set of MIDPs. Parties have commented on the perceived risk that this uncertainty presents. Whilst Ofgem notes this concern, in light of NGC's response it does not consider that it is sufficiently material to warrant impeding the progression of Modification Proposal P78.

Ofgem notes that several Parties considered that it was too soon to make an amendment to imbalance cashout prices following the reduction of BRL to 5MWh and the reduction of Gate Closure to 1 hour. However, Ofgem also notes that some Parties, and notably NGC, consider that System Balancing actions are currently being included within Energy Imbalance Prices. Ofgem considers that System Balancing actions should be excluded from the calculation of Energy Imbalance Prices, and as such considers that it is appropriate to make amendments in line with Modification Proposal P78. In reaching its decision, Ofgem has taken careful account of the views of NGC, who, as SO, is best placed to be able to analyse the extent to which the costs of System Balancing actions are affecting Energy Imbalance Prices. NGC has made it clear, not least by submitting Modification Proposal P78, that it considers that this change to Energy Imbalance Prices should not be delayed. Ofgem has stated previously that System Balancing costs should not be included in Energy Imbalance Prices. Ofgem therefore considers that it would be inappropriate to delay the implementation of Modification Proposal P78. In making this recommendation, Ofgem also notes that the SO has no operational concerns regarding the implementation of Modification Proposal P78 on 25 February 2002.

The Authority's decision

The Authority has therefore decided to direct that Modification Proposal P78 should be made and implemented.

In addition, the Authority, in accordance with special condition AA4.6 (b) (iii) of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), agrees that NGC may modify the BSAD Methodology Statement as set out in Appendix F of the Authority Report.

Direction under Condition C3.5(a) of NGC's Transmission Licence

Having regard to the above, the Authority, in accordance with Condition C3.5(a) of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the BSC as set out in Modification Report P78. A copy of the text of the modification to the BSC is attached to this letter.

The modification is to take effect from 25 February 2003.

In accordance with Condition C3.5(b) of NGC's Transmission Licence, NGC shall modify the BSC in accordance with this direction of the Authority.

Please do not hesitate to contact me on the above number if you have any queries in relation to the issues raised in this letter or alternatively contact Anthony Doherty on 020 7901 7159.

Yours sincerely



Sonia Brown

Head of Electricity Trading Arrangements

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