



Direct Dial: 020-7901 7412
2 May 2002

The National Grid Company, BSC Signatories and
Other Interested Parties

Your Ref:
Our Ref : MP No: P12

Dear Colleague,

**Modification to the Balancing and Settlement Code - Decision and Direction in relation to
Modification Proposal P12: "Reduction of Gate Closure From 3.5 Hours To 1 Hour"**

The Gas and Electricity Markets Authority (the "Authority") has carefully considered the issues raised in the Modification Report P12 "Reduction of Gate Closure From 3.5 Hours To 1 Hour".

The Balancing and Settlement Code Panel (the "Panel") recommended to the Authority that the Proposed Modification P12 should be made with an Implementation Date of 2 July 2002 (Settlement Period 31).

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 Balancing and Settlement Code ("BSC") 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 New Electricity Trading Arrangements ("NETA") are designed to ensure that there are sufficient incentives on participants to balance their individual trading positions and minimise the costs to NGC as System Operator ("SO") of balancing the Transmission System ("System"). Market participants can contract ahead in the forwards, futures and short-term markets to balance their contract position ahead of Gate Closure (three-half hours before real time). 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.

At Gate Closure NGC use the Balancing Mechanism to enable them, amongst other things, to keep 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. For each Settlement Period the metered volumes for each Trading Party are used to determine if the actual volumes taken from, or put onto the System match their notified contractual volumes. Parties with a position of energy imbalance will be exposed to the relevant Energy Imbalance Prices for the relevant Settlement Period.

On 9 May 2001 Damhead Creek Limited proposed Modification P12 to the BSC to reduce Gate Closure from 3.5 hours to 1 hour. The Proposer argued that if Parties were able to adjust their contract positions closer to real time, it would reduce participants' imbalance risk and therefore reduce the need to mitigate the risk by over/under contracting. The Proposer also suggested that the current Gate Closure and the associated greater imbalance risk is also having a negative impact on liquidity in the short-term markets. The Proposer argued that the SO had demonstrated a preference for 'just-in-time' balancing action, which runs counter to the rationale originally used to justify the Gate Closure period and the current Gate Closure period is stifling competition in the generation and supply of electricity.

The Modification Proposal

Modification Proposal P12 seeks to further the achievement of the relevant BSC Objectives¹ by modifying the BSC to reduce Gate Closure from three and half hours to one hour.

In the Definition Report the Modification Group (the "Group") recommended that the Modification Proposal be progressed to a nine month Assessment Phase, which would provide NGC with the operational experience of a full winter period that NGC believed was necessary before reducing Gate Closure. The Panel endorsed this approach.

In the Assessment Phase the Group assessed whether or not the Modification Proposal better facilitates the achievement of the relevant BSC Objectives. Subsequently, the Group established a set of three assessment criteria against which to assess the merits of the Modification Proposal, which the Panel approved. The assessment criteria are: Impact on Trading; Impact on System Management; and "Cost-Benefit Analysis". In the Assessment Phase analysis and consultations

¹ The relevant 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.

were undertaken with NGC, BSC Agents and Parties to assess the Modification Proposal against these criteria.

Impact on Trading

To assess the impact on trading the Group sought to determine the impact of the Modification Proposal on the accuracy of generation and demand forecasting at Gate Closure, market liquidity and Energy Imbalance Prices.

The majority of Parties believed that both demand and generation forecasting would improve under a one hour Gate Closure. In addition the majority of Parties believed that liquidity in short-term markets would improve under a one hour Gate Closure. Increased short-term market liquidity (i.e. taken to be the final 24-hour period prior to Gate Closure) was seen as one of the key benefits of the Modification Proposal.

The Group concluded that the pricing analysis carried out as part of the assessment was sufficient to anticipate that reducing Gate Closure would not have a dramatic negative impact on Energy Imbalance Prices. The Group also believed that Energy Imbalance Prices would probably either be unchanged or reduced.

Impact on System Management

To establish the impact on System Management, NGC as the SO was consulted upon their view. NGC reported that it anticipated that reducing Gate Closure to one hour would not have a significant impact on the Balancing Mechanism, either in terms of the price, volume or transparency of actions taken. However NGC noted that, based on their experience of NETA Go-Live, there might be a transition period in which efficiency temporarily decreases and balancing costs temporarily increase. NGC expect that as with NETA Go-Live, the greater uncertainty associated with balancing the system under new conditions will lead NGC, initially, to hold higher levels of reserve and response.

In the Assessment Phase, NGC identified their requirement for additional contractual arrangements for pre Gate Closure actions as a result of reducing Gate Closure to one hour. Additional contractual arrangements are required as there is no current effective alternative to Bid/Offer Acceptances for plant that would not have the dynamics to participate in the Balancing Mechanism under a one hour Gate Closure. To ensure enough plant is available to provide balancing services, NGC is currently in the process with market participants of developing a generic balancing service contract called a 'Pre-Gate Closure Balancing Mechanism Unit Transaction' ('PGB Transaction'). In addition, NGC identified that core documents (such as the Grid Code, Balancing Principles Statement ("BPS"), Procurement Guidelines ("PGs") and

Balancing Services Adjustment Data ("BSAD") Methodology Statement) would need to be changed to reflect the introduction of PGB Transaction contracts².

NGC have developed a number of 'Go-Live criteria' and 'confidence criteria' that they believe need to be met prior to a reduction in Gate Closure.

In summary, the Go-Live criteria relate to having made the necessary changes to core documentation; having the minimum number of PGB Transaction contracts in place; having made the necessary changes to internal systems and processes; having completed successful testing of PGB Transactions with market participants; and having contingency arrangements in place. NGC have been working with the industry to ensure that the Go-Live criteria will be met by the proposed Implementation Date.

The confidence criteria are: imbalance volumes resolved in the Balancing Mechanism are low; Physical Notifications are accurate; sufficient Bids and Offers available in the Balancing mechanism (with short notice times); generator dynamics are rational; and NETA has operated successfully through periods where the system is under stress. In NGC's Detailed Level Impact Assessment they were satisfied that the confidence criteria have been broadly met.

The Group believed that NGC's ability to manage the system and balance the market efficiently would not be diminished by movement to a one hour Gate Closure.

Consideration of Potential Costs

The Group identified that the Modification Proposal could have costs as a result of changes to Party, NGC, ELEXON and BSC Agent systems. In addition, costs could be caused by the development of new balancing services contracts (i.e. PGB Transactions). The impact on transparency under the BSC was also considered. Market participants were consulted on the costs and lead times they anticipate would be associated with a move to a one hour Gate Closure.

² Following a process of consultation on 19 March 2002 NGC submitted a Report to the Authority containing proposed revisions to the BPS and the PGs. The proposed revisions made provisions for the use of PGB Transactions. Having considered the consultation responses and NGC's Report, the Authority directed that the proposed changes should not be made. Ofgem considered that respondents' views on the proposals to make provision for the use of PGB Transactions warranted further consideration by NGC in consultation with market participants. Ofgem therefore suggested that the documents be further reviewed. Following a further consultation NGC submitted a Report to the Authority on the 23 April 2002 containing amended proposed revisions to the BPS and the PGs. The Authority approved the proposed revisions on the 1 May 2002. Current versions of the PGs and the BPS can be found on the NGC web site at http://www.nationalgridinfo.co.uk/balancing/mn_transmission. After further consideration NGC considers that it is not necessary to make revisions to the Grid Code or the BSAD to accommodate PGB Transactions.

The Group anticipated that one hour Gate Closure would deliver real benefits to market participants and that a secure and balanced system could be maintained with relatively small implementation costs. The Group anticipated that the costs of implementing the Modification Proposal would be minor compared with the benefits delivered. The Group also considered that trading closer to real time would be an option open to market participants and not compulsory as those market participants that did not want to deal as close to real time as one hour could continue to operate three and half hours ahead of Gate Closure.

To implement a reduction in Gate Closure the Party that would require the majority of system changes necessary is NGC. NGC need to develop changes to reflect a change in Gate Closure time, to increase the robustness of existing systems and to develop systems to support pre-Gate Closure activity. Having considered the changes required to their systems, NGC recommended that the Implementation Date be for 2 July 2002 (Settlement Period 31). The majority of Parties reported that only minor changes would be required to their systems and indicated that they would require 3 months or less.

The Panel sought the Authority's provisional thinking on the Implementation Date for the Modification Proposal. On the 14 March 2002 the Authority indicated in their response that, without prejudice to the Authority's considerations after receipt of the Final Modification Report for P12, on the basis of the respondent's views received by the Group during the Assessment Procedure, an Implementation Date of 2 July 2002 for Modification Proposal P12 would be appropriate.

The Group believed that NGC's recommended Implementation Date was compatible with Industry needs. The Group noted that, in order to implement Modification Proposal P12, an outage of the Energy Contract Volume Allocation Agent ("ECVAA") system will be required for approximately two and half hours, finishing approximately 15 minutes before Gate Closure for Settlement Period 31 on 2 July 2002.

The Group considered whether the Modification Proposal would better facilitate the achievement of the relevant BSC Objectives taking into account the analysis and consultation responses undertaken against the assessment criteria. The potential benefits of the Modification Proposal were considered to be greater forecasting accuracy, increased market liquidity in short-term markets and reduced imbalance risk. The Group considered that implementation of the Modification Proposal would improve competition in the generation and supply of electricity (i.e. relevant BSC Objective (c)). In addition, the Group agreed that the Modification Proposal would not compromise any of the other relevant BSC Objectives.

The Panel met on the 14 March 2002 and considered the recommendations of the Group in the Assessment Report. The Panel endorsed the Group's recommendations and decided to proceed

to the Report Phase. ELEXON published a Draft Modification Report on 25 March 2002 which invited respondents' views.

Respondents' views

In total, ELEXON received 15 responses to the consultation on Modification Proposal P12. Of the responses, 12 expressed support for the recommendations in the Draft Modification Report, one did not support the recommendations in the Draft Modification report and the remaining two were neither in favour nor opposed.

In general, respondents believed that the Modification Proposal would increase within day trading and therefore will reduce imbalance exposure. One respondent considered that reducing Gate Closure should enable generators to reduce their exposure to imbalance as a result of plant breakdowns. One respondent commented that they do not believe that the average forecasting accuracy will be materially increased. Most respondents considered that if NGC believe that they can operate the system safely as they have stated, then the Modification Proposal will better facilitate the achievement of the relevant BSC Objectives.

Whilst not within the remit of the BSC, some respondents expressed concerns surrounding the PGB Transaction contractual arrangements. Respondents believe it is essential that any PGB Transactions taken by the SO are transparent to all Parties. Some respondents are concerned that without proper reporting via the Balancing Mechanism Reporting Service ("BMRS") of PGB Transactions that there will be a reduction in the transparency in the reporting of Balancing Services. In addition some respondents are seeking clarity on the treatment of PGB Transactions costs in BSAD which has an impact on Energy Imbalance Prices. Some participants expressed concern that the proposed Implementation Date for the Modification Proposal may not allow enough time for these issues to be fully addressed and appropriate mechanisms to be put in place for PGB Transactions because of the significant commercial and technical issues involved.

Panel's Recommendation

The Panel met on the 18 April 2002 and considered the Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Modification Proposal and that, if approved, the Proposed Modification should be implemented on 2 July 2002 (Settlement Period 31). The Modification Report was submitted to the Authority for decision on the 25 April 2002.

Ofgem's view

Ofgem³ considers, having had regard to its statutory duties, that Modification Proposal P12 will better facilitate the achievement of the relevant BSC Objective (c) of promoting effective competition in the generation and supply of electricity.

During the development of NETA, Ofgem envisaged that over time, as the new trading arrangements develop, it would be possible to move Gate Closure closer towards real time⁴. NGC have had over a year's experience under the new trading arrangements of operating the System.

Ofgem agrees with the Group's and the Panel's recommendation that reducing Gate Closure can lead to greater forecasting accuracy as Parties will have access to more accurate real time information. Ofgem additionally agrees with respondents that reducing Gate closure will assist Parties by reducing the risk of exposure to imbalance prices in the event of plant breakdown and also considers that moving Gate Closure may help smaller generators, particularly those with less predictable output, to mitigate risk of imbalance exposure. Ofgem believes that greater forecasting accuracy and the option to all Parties to be able to fine tune positions through trading out any potential imbalance closer to real time will better facilitate the achievement of the relevant BSC Objectives.

Ofgem notes NGC's view that moving Gate Closure from three and half-hours to one hour will not have a negative impact on the operation of the Balancing Mechanism or compromise security of supply. In addition, Ofgem notes NGC's view that, apart from a transitional period the Modification Proposal should not increase the cost of balancing the System.

Ofgem notes respondents' concerns with the transparency and reporting of the proposed PGB Transactions. Ofgem considers that the clarification of the arrangements for PGB Transactions within the BPS and the PGs has been addressed through the appropriate governance structure. On the 1 May 2002 Ofgem approved NGC's proposed revisions to the BPS and PGs. Ofgem notes NGC's statement in these documents that detailed market design for PGB Transactions will take place when they have sufficient operational experience of operating within one hour Gate Closure. NGC envisage developing a screen based system that will provide further transparency and enhance the reporting of PGB Transactions.

Ofgem has noted that respondents to NGC's consultations are seeking clarity on the treatment of PGB Transactions costs in BSAD. Ofgem considers that PGB Transactions will be treated in BSAD in the same way as other Balancing Services. Ofgem has noted that each PGB Transaction will be assessed by NGC as to whether it has been taken for an Electricity Balancing or System Balancing purpose. Ofgem considers that any PGB Transaction that has been taken for

³ Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

⁴ See the Ofgem July 1999 document 'The New Electricity Trading Arrangements'.

Electricity Balancing Purpose should be taken into account under the BSC for the purposes of determining Energy Imbalance Prices.

Some respondents expressed concern that the proposed Implementation Date for the Modification Proposal may not allow enough time for NGC's Go-Live criteria to be fully addressed and appropriate mechanisms to be put in place for PGB Transactions. Ofgem considers that the Implementation Date does allow sufficient time for NGC's Go-Live criteria to be fully met. Ofgem notes the commitment by NGC to report any complications or difficulties arising in the run-up to implementation to the Authority.

The Authority's decision

The Authority agrees with the Panel's recommendation that Modification Proposal P12 should be made and implemented on 2 July 2002 (Settlement Period 31).

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 the Modification Report for Modification Proposal P12. A copy of the text of the modification to the BSC is attached to this letter.

The modification is to take effect from 2 July 2002 (Settlement Period 31).

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

Attachment 1

Legal Text to give effect to the Modification Proposal

Implementation of the Modification Proposal would require the following changes to the Code:

- Section T3.1A.1 (a): change 'eight Settlement Periods' to 'three Settlement Periods'
- Section T3.1A.1 (b): change 'eight Settlement Periods' to 'three Settlement Periods'
- Annex X-1: under Gate Closure entry, change '3 ½' to '1'
- Table X-2 in Annex X-2: under 'Balancing Mechanism Window Period' entry, change '3 ½' and '4' to '1' and '1 ½' respectively