



*Bringing choice and value
to customers*

Direct Dial: 020 7901 7412
Email: sonia.brown@ofgem.gov.uk

24 June 2005

Our Ref: MP No P173

BSC Signatories, National Grid Company
and Other Interested Parties

Dear Colleague

**Modification to the Balancing and Settlement Code (“BSC”) – Decisions in relation to
Modification Proposal P173: “Revised Settlement Arrangements for Emergency Instructions”**

The Gas and Electricity Markets Authority¹ (the “Authority”) has carefully considered the issues raised in the final Modification Report² in respect of Modification Proposal P173 “Revised Settlement Arrangements for Emergency Instructions”.

The BSC Panel (the “Panel”) recommended to the Authority that neither Proposed Modification P173 nor Alternative Modification Proposal P173 should be made. In the event that the Authority determines that either Proposed Modification P173 or Alternative Modification Proposal P173 should be made, the Panel recommended an Implementation Date of five working days following an Authority Decision.

Having carefully considered the final Modification Report in respect of Proposed Modification Proposal P173, the Panel’s recommendation and having regard to the Applicable BSC Objectives³ and the Authority’s wider statutory duties⁴, the Authority has decided not to direct a Modification to the BSC in respect of Modification Proposal P173.

¹ Ofgem is the Office of the Authority. The terms “Ofgem” and “the Authority” are used interchangeably in this letter.

² Elexon document references P173DMR10, Version No. Draft/1.0, dated 19 January 2005.

³ The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Company’s (“NGC’s”) Transmission Licence, 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;

This letter explains the background and sets out the Authority's reasons for its decisions.

Background

Cash out arrangements

The Balancing Mechanism ("BM") was designed as a tool to assist National Grid Company plc ("NGC"), as the System Operator ("SO"), to keep the transmission system in balance in real time by providing a mechanism to adjust levels of generation and demand through the acceptance of Bids and Offers submitted to the BM ("Electricity Balancing"). The SO also uses the BM, amongst other things, to ensure that the system remains within safe operating limits, and that the pattern of generation and demand is consistent with any transmission system constraints ("System Balancing"). System Balancing actions include, but are not limited to, frequency control and the alleviation of locational constraints. The SO also has commercial freedom to trade in the other short term markets and to contract with generators, suppliers and customers to balance the system.

Under the rules of the BSC, a Party is in a position of imbalance if its notified contract volume does not match its metered volume, i.e. the Party is producing (or consuming) electricity which has not been sold (or bought) and is therefore not covered by contracts. Imbalance settlement, or 'cash out', is designed so that any electricity produced or consumed that is not covered by contracts is paid for at, or charged at, a cost reflective price. The arrangements are designed to target the costs that NGC has incurred in buying and selling electricity to match generation and demand onto those Parties that are in imbalance, i.e. those Parties on behalf of which the SO has taken Electricity Balancing actions.

Parties that are 'long' when the market as a whole is 'short' (i.e. generators whose physical output exceeds their contracted volume or suppliers whose customers' demand is less than their contract volume when total demand on the system is greater than the total supply of generation), are not, in any meaningful sense, contributing to balancing the system (except inadvertently). The converse is true for parties who are short when the market is long. Parties with imbalances in the opposite direction to the system can also impose costs on the system (these are the costs associated with the need for a generator or supplier to change its output at short notice) as their contribution to balancing is not guaranteed, requiring the SO to manage the resulting risks.

A dual cash out mechanism exists, in which there are two Energy Imbalance Prices, or 'cash out prices': the System Buy Price ("SBP") and the System Sell Price ("SSP"). Parties that are short are generally charged the SBP for their imbalance volumes and Parties that are long generally receive SSP for their imbalance volumes. These prices apply whether the system itself is long or short. In reflecting the costs that parties in imbalance impose on the system, a dual cash out mechanism provides incentives for parties to contract ahead to meet their customers' demands, as those Parties that are long are likely to receive a lower price for electricity via imbalance settlement than if they had been fully contracted. Similarly, parties that are short are likely to pay a higher price for electricity via imbalance settlement than if they had been fully contracted.

d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements.

⁴ Ofgem's statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

Since NETA Go-Live⁵, in the light of experience gained under the new arrangements, a number of modifications⁶ have been made to the way in which Energy Imbalance Prices are calculated as a result of concerns that the rules did not give rise to prices that reflected costs and market conditions on the grounds that the proposed changes would increase the likelihood of this happening⁷. These modifications include the introduction of the Continuous Acceptance Duration Limit (“CADL”)⁸ and changes to the treatment of contracts in the calculation of the Energy Imbalance Price. Approved Modification P78 was introduced to address a potential defect in the methodology for calculating Energy Imbalance Prices used at that time which resulted in high levels of SBP that did not reflect the costs that NGC was incurring to balance the system and were considered to be driving the market long, as discussed above.

Approved Modification P78⁹ was submitted by NGC on 5 April 2002 in response to concerns expressed by both NGC and market participants that cash out prices were reflective of costs associated with both System Balancing and Electricity Balancing¹⁰. It was also suggested that SBP was being distorted by System Balancing costs more frequently than SSP and hence the spread between SBP and SSP was larger than would be the case if System Balancing costs were correctly excluded. This, in turn, was creating asymmetric risks for Parties, in response to which they were tending to go long to avoid exposure to a high SBP, with the result that the market itself was long overall.

Approved Modification P78 introduced a mechanism into the BSC to remove a category of acceptances taken for System Balancing reasons from the calculation of cash out prices. Under Approved Modification P78 these acceptances were considered to be characterised by equal and opposite compensatory actions which, in general, were being taken by the SO for System Balancing reasons, for instance the alleviation of locational constraints. Approved Modification P78 also sought to change the derivation of cash out prices such that there would be a ‘main’ price and a ‘reverse’ price. It proposed that the reverse price would be derived from a market price based on short-term energy trades made in the forward and spot markets. The main price

⁵ NETA Go-Live occurred on 27 March 2001.

⁶ Approved Modification P10 “Eliminating Imbalance Price Spikes caused by Truncating Effects” was implemented in May 2001 to remove spurious Bid-Offer Acceptances (“BOAs”) for small volumes that resulted in price spikes that did not reflect the costs incurred by NGC in achieving energy balance.

Approved Modification P18A “Removing/Mitigating the Effect of System Balancing Actions in the Imbalance Price” was made in September 2001 to remove actions taken for System Balancing rather than Electricity Balancing reasons from the calculation of Energy Imbalance Prices and to remove Bids and Offers with a duration of less than 15 minutes.

Approved Modification P8 “Introduction of a Price Adjuster to reflect Option Fees for Balancing Services Contracts in setting System Buy Price and System Sell Price” introduced an adjustment mechanism to reflect option fees for balancing services contracts in the calculation of Energy Imbalance Prices.

Approved Modification P78 “Revised Definitions of System Buy Price and System Sell Price” removed further System Balancing actions from the calculation of Energy Imbalance Prices.

⁷ In addition, on 2 May 2002, the Authority accepted BSC Modification Proposal P12 “Reduction of Gate Closure from 3.5 hours to 1 hour”, which was implemented on 2 July 2002.

⁸ Approved Modification P18A: CID definition 1a.

⁹ The Authority’s decision in respect of Approved Modification P78 “Revised Definitions of System Buy Price and System Sell Price” was published on 9 September 2002 and can be found on the Elexon website: www.elexon.co.uk.

¹⁰ Since System Balancing costs cannot currently be attributed to particular users they are excluded from the calculation of imbalance cash out prices.

would be derived using a volume weighted average of all the eligible¹¹ Electricity Balancing actions taken by the SO to alleviate the Net Imbalance Volume (“NIV”)¹². Under the proposal the main price would apply to imbalances in the same direction as the overall system imbalance and the reverse price would apply to imbalances in the opposite direction. On 9 September 2002, the Authority decided to direct that Approved Modification P78 should be made. Approved Modification P78 was implemented on 11 March 2003.

In summary, the rules used to set cash out prices are designed to produce prices for each half hour Settlement Period that reflect the costs that NGC incurs in balancing generation and demand on the system. Cash out prices are crucial in sending appropriate price signals and creating the right commercial incentives on companies necessary to maintain security of supply. For suppliers, the potential to be exposed to high cash out prices during periods of peak demand provides the incentive to contract with generators in advance to meet their customers’ peak demand. For generators, the potential to be exposed to high cash out prices following, for example, a mechanical failure, during periods when margins are tight provides an incentive to maintain plant and to contract with other peaking plant to provide physical cover.

Emergency Instructions

Treatment of Emergency Instructions under the Grid Code

Under the Grid Code, NGC can issue Emergency Instructions, which may require BM Units to operate outside their submitted parameters, in order to preserve the integrity of the transmission system¹³. NGC can issue an Emergency Instruction to increase or decrease generation or demand in certain circumstances¹⁴. An Emergency Instruction can only be rejected by the relevant transmission system user on safety grounds¹⁵. The Grid Code states that an Emergency Instruction issued to a BM Unit is treated as a Bid-Offer Acceptance (“BOA”), unless it is rejected by the transmission system user or the Grid Code explicitly states to the contrary¹⁶.

Treatment of Emergency Instructions under the BSC when Modification Proposal P173 was raised

The BSC specifies that an Emergency Instruction issued to a BM Unit under the Grid Code is classed as an Acceptance for the purpose of Settlement¹⁷. When Modification Proposal P173 was raised, the BSC specified that Acceptances resulting from Emergency Instructions issued to BM Units under the Grid Code were to be handled within Settlement consistent with other Acceptances. Therefore, as for other Acceptance Volumes, Emergency Instruction Acceptances had the following effect:

¹¹ Defined as actions that are not: Bids or Offers which have a Continuous Acceptance Duration of less than 15 minutes; De Minimus accepted Bids or Offers; Arbitrage accepted Bids or Offers; NIV Tagged Bids or Offers; or System actions identified in the BSAD methodology.

¹² The NIV is calculated by netting off all purchase actions against all sell actions to give the imbalance of the overall System.

¹³ See Grid Code BC2.9.1 and BC2.9.2.

¹⁴ See Grid Code BC2.9.1.2.

¹⁵ See Grid Code BC2.9.2.1.

¹⁶ Grid Code BC2.9.2.3 states that a BOA will not be issued for provision of the Maximum Generation Service, during the Black Start process or the re-synchronisation of a de-synchronised island.

¹⁷ See BSC Q5.1.3 (b) and Q5.1.5.

- ◆ the Lead Party¹⁸ of the affected BM Unit will be paid (or pay) for the Acceptance at the prevailing Bid or Offer price;
- ◆ a payment will be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance, with an associated impact on Balancing Services Use of System (“BSUoS”) charges for all Parties; and
- ◆ the Acceptance Volume feeds into the cash out price calculation at the prevailing Bid or Offer price, which may, subject to the tagging rules, impact imbalance payments and the Residual Cashflow Reallocation Cashflow (“RCRC”) for all Parties.

This treatment applied in the case of the Damhead Creek incident, which is outlined below.

Damhead Creek incident

On 19 May 2004, NGC determined that a piece of high voltage equipment was showing signs of distress and needed to be taken out of service as soon as possible in order to prevent an unsafe situation. The location of the distressed equipment meant that it was necessary to stop Damhead Creek Power Station exporting to the transmission system. At 12:51 BST on 19 May 2004, NGC issued an Emergency Instruction to Damhead Creek to perform a controlled shutdown and desynchronise the BM Unit as quickly as possible. The power station complied with the instruction and the equipment was isolated safely.

As outlined earlier, under the then prevailing BSC baseline, Acceptances resulting from Emergency Instructions were not distinguished within Settlement from other Acceptances. In this case, Damhead Creek’s prevailing Bid price for a large proportion of the Acceptance Volume was -£9,999/MWh. Elexon has estimated that the inclusion of the Acceptance data¹⁹ associated with the Emergency Instruction would result in SSP being:

- ◆ -£96.68/MWh²⁰ for Settlement Period 27; and
- ◆ -£5,870.87/MWh for Settlement Period 28.

Subsequent revision to the treatment of Emergency Instructions under the BSC

However, the way in which Acceptances linked to Emergency Instructions are treated in the calculation of cash out prices has been revised since Modification Proposal P173 was raised due to the Authority’s approval of Modification P172 (“Removal of Emergency Instructions taken for System reasons from Imbalance Price”).

Modification P172 was submitted on 25 August 2004 by British Gas Trading (“BGT”) and it revised the way in which Acceptances linked to Emergency Instructions are included in the calculation of cash out prices. Modification P172 gives NGC, as SO, the discretion to identify whether an Emergency Instruction was issued for Electricity Balancing reasons or for System

¹⁸ The Lead Party is the Party registered to the BM Unit pursuant to Section K3 of the BSC.

¹⁹ The acceptance data was not initially included in Settlement. The Trading Disputes Committee subsequently heard a Trading Dispute and directed that a Bid Acceptance should be entered into Settlement in the R3 Reconciliation Run on 15 December 2004.

²⁰ NB: A negative SSP will mean that a Party who was ‘long’ during the Settlement Period will pay the absolute value of SSP for its imbalance volume (rather than receive it).

Balancing reasons. In the event that an Emergency Instruction is flagged by NGC as being an Electricity Balancing action, it would be treated no differently from any other Acceptance within Settlement, as outlined above. However, in the event that an Emergency Instruction is flagged by NGC as being a System Balancing action, it would be distinguished within Settlement. As a result of Modification P172, a System Balancing Emergency Instruction Acceptance will be treated within Settlement as follows:

- ◆ the Lead Party of the affected BM Unit will be paid (or pay) for the Acceptance at the prevailing Bid or Offer price (as was previously the case);
- ◆ a payment will be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance with an associated impact on BSUoS charges for all Parties (as was previously the case); and
- ◆ the Acceptance Volume will feed into the cash out price calculation as an unpriced volume.

Therefore, Modification P172 has revised the treatment of System Balancing related Emergency Instructions Acceptances by making them unpriced Acceptance Volumes for the purposes of calculating cash out prices.

Modification P172 was approved by the Authority on 29 April 2005 and it was implemented on 9 May 2005. Therefore, this decision on Modification Proposal P173 is made against the BSC baseline following the approval of Modification P172.

The Modification Proposal

In response to its concerns about the potential for cash out prices and BSC cashflows to be affected by Emergency Instructions in the future, on 25 August 2004 National Grid Transco ("NGT") submitted Modification Proposal P173: "Revised Settlement Arrangements for Emergency Instructions".

Modification Proposal P173 seeks to amend how Acceptances linked to Emergency Instructions would feed into Settlement. Under the proposal, all Emergency Instruction Acceptances would be treated as follows within Settlement:

- ◆ the Lead Party of the affected BM Unit would be paid (or pay) for the associated Acceptance at a replacement price rather than the prevailing Bid or Offer price. The replacement price would be calculated for the affected BM Unit and agreed by the Panel post-event. The proposal is that the replacement price should represent Avoidable Costs, as currently defined in Section G.2 of the BSC²¹, with the intention that

²¹ The definition of Avoidable Costs within Section G.2 of the BSC includes the following:

- (a) costs incurred include loss of revenues, whereas costs saved include revenues earned;
- (b) in the case of a BM Unit comprising premises of a Customer, the costs which are counted are the costs incurred by the Customer;
- (c) costs are not to be counted unless they are demonstrably:
 - costs directly incurred in the operation of the Plant and Apparatus comprised in the BM Unit;
 - costs which were reasonably and prudently incurred, and incurred pursuant to commitments reasonably and prudently made;
 - costs the amount of which would be expected to differ according to whether there occurred the relevant changes in Exports and/or Imports in the relevant Settlement Period alone;
- (d) costs include costs (incurred or saved) of consumption of electricity or fuel;

the Lead Party of the affected BM Unit would be 'cost neutral' as a result of responding to an Emergency Instruction. The Panel or a delegated sub-committee would have responsibility for approving the replacement price;

- ◆ a payment would be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance on the basis of the replacement price based on Avoidable Costs rather than the prevailing Bid or Offer price. BSUoS payments for all Parties would reflect the replacement price rather than the prevailing Bid or Offer price; and
- ◆ the Acceptance Volume would feed into the cash out price calculation at the replacement price based on Avoidable Costs rather than the prevailing Bid or Offer price.

Therefore, Modification Proposal P173 seeks to revise the treatment of Emergency Instruction Acceptances by pricing them at Avoidable Costs for the purposes of payments between the affected BM Unit and the Transmission Company and for the purposes of calculating cash out prices. Given the changes to these elements of Settlement for Emergency Instruction Acceptances, Modification Proposal P173 is also likely to impact upon BSUoS payments and on RCRC cashflows for all Parties.

The Proposer considers that this Modification Proposal better facilitates the achievement of Applicable BSC Objective (b) "the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system" as it would ensure that the Lead Party of the affected BM Unit will remain cost neutral as a result of responding to an Emergency Instruction, removing any potential commercial disincentive to respond to the Emergency Instruction which may arise if its prevailing Bid-Offer price did not adequately compensate it for the actions requested by NGC.

The Proposer also considers that this Modification Proposal better facilitates the achievement of Applicable BSC Objective (c) "promoting effective competition in the generation and supply of electricity and promoting such competition in the sale and purchase of electricity" because this modification would remove any potential distortion to Balancing Mechanism prices brought about by Lead Parties attempting to factor the costs of responding to an Emergency Instruction into their Bid or Offer prices. The Proposer also considers that, by removing the potential for windfall gains or losses as a result of complying with the Emergency Instruction, this Modification Proposal will promote effective competition in the generation and supply of electricity and (so far as consistent therewith) promote such competition in the sale and purchase of electricity. The Proposer also considers that the wider industry should similarly not be exposed to losses or gains resulting from an Emergency Instruction through any consequential impact on industry cashflows.

-
- (e) the following costs are not to be counted:
 - costs or losses in respect of damage to property (including Plant or Apparatus) or death or injury to persons;
 - insurance premia;
 - financing costs and overhead costs;
 - (f) amounts payable (other than by way of rebate of payment for supply), under any contract or otherwise, by way of compensation for loss of supply or otherwise in consequence of relevant changes in Exports and/or Imports, by the Lead Party to the person referred to in paragraph (b), are to be disregarded;
 - (g) amounts payable or receivable under the Code in respect of Trading Charges or BSCCo Charges are to be disregarded.

Alternative Modification Proposal

Alternative Modification Proposal P173 proposes a variation to the Proposed Modification P173 solution which entails a wider definition of Avoidable Costs. Under Alternative Modification Proposal P173, the wider definition of Avoidable Costs includes the following cost categories (which are explicitly excluded from the definition of Avoidable Costs within Section G.2 of the BSC):

- ◆ costs or losses in respect of damage to property (including Plant or Apparatus) or death or injury to persons;
- ◆ insurance premia; and
- ◆ financing costs and overhead costs.

Alternative Modification Proposal P173 was developed with the intention of enabling Parties affected by Emergency Instructions to receive fuller and more cost reflective compensation.

Related Modification Proposals

Several related Modification Proposals were considered by the Pricing Standing Modification Group ("PSMG") alongside Modification Proposal P173.

Modification Proposal P171 "Retrospective removal of Emergency Instructions taken for System reasons from Imbalance Price" and Modification P172 "Removal of Emergency Instructions taken for System reasons from Imbalance Price"

Modification Proposals P171 and P172 were also submitted on 25 August 2004 by BGT. The intended effect of Modification P172 has been outlined above. As the solutions proposed under Modification Proposals P171 and P172 are identical in all but one respect, the details of the proposed solutions under Modification Proposal P171 are not repeated here. Modification Proposals P171 and P172 differ in terms of the proposed implementation approach in that Modification Proposal P171 proposed retrospective implementation while Modification P172 proposed prospective implementation.

As outlined above, Modification P172 was approved on 29 April 2005 and implemented on 9 May 2005. Modification Proposal P171 was rejected on 29 April 2005. This decision in relation to Modification Proposal P173 has therefore been considered in the light of the revised BSC baseline following the approval of Modification P172.

Modification Proposal P175 "Development of Provisions related to certain Bid-Offer Acceptances issued pursuant to the Grid Code (e.g. BC2.9 and BC2.10)"

Modification Proposal P175 was submitted by RWE Npower plc on 1 October 2004. It proposes to amend the way in which Emergency Instructions and intertrips are distinguished within Settlement as follows:

- ◆ the Lead Party of the affected BM Unit would not be paid (or pay) for the associated Acceptance at either the prevailing Bid or Offer price or any replacement price. The Lead Party would be able to apply under the BSC for compensation for any costs incurred in responding to the instruction, including costs associated with plant damage

but excluding any amounts received or paid under the Connection and Use of System Code ("CUSC") or any other bilateral agreement with NGC. The Panel would make a determination on each cost claim received. The Lead Party would be paid (or pay) any upheld compensation claim;

- ◆ a payment would not be made from (or to) the Transmission Company to (or from) the Lead Party of the affected BM Unit as a result of the Acceptance on the basis of the prevailing Bid or Offer price or any replacement price. However a payment would be made from (or to) the Transmission Company on the basis of any upheld compensation claim; and
- ◆ replacement BOAs, derived on the basis of the Bids and Offers that would have been taken had the Acceptance not been issued, would be included within Settlement for the purposes of calculating cash out prices. This is effectively akin to applying a replacement price to the Acceptance volume based on an equivalent overall volume of Bids/Offeres which would have been taken in the absence of the Acceptance. The Panel or a delegated sub-committee would have responsibility for approving the replacement price.

The decision in relation to Modification Proposal P173 has been made independently of Modification Proposal P175.

Respondents' views

Assessment Consultation

Exxon published an Assessment Consultation in relation to Modification Proposal P173 on 28 October 2004, which invited respondents' views by 9 November 2004. Exxon received 11 responses to the Assessment Consultation. The views received can be summarised as follows:

- ◆ three respondents considered that Proposed Modification P173 better facilitated the achievement of the Applicable BSC Objectives, while eight respondents did not;
- ◆ one respondent considered that Alternative Modification P173²² better facilitated the achievement of the Applicable BSC Objectives, whilst nine respondents did not. One respondent did not provide a view as to whether Alternative Modification P173 better facilitated achievement of the Applicable BSC Objectives.

Respondents views in respect of Proposed Modification P173

A number of respondents in support of Proposed Modification P173 noted that under the proposal a BM Unit affected by an Emergency Instruction would remain cost neutral, thereby removing any commercial disincentive to respond to such an instruction. One respondent noted that Proposed Modification P173 would remove distortions in Energy Imbalance Prices by removing the incentive to factor a BM Unit's perceived cost of potentially responding to Emergency Instructions into its Bid and Offer prices. This respondent considered that it was inappropriate for a BM Unit responding to an Emergency Instruction to make a windfall gain or loss or for wider industry to be exposed to losses or gains as a result of an Emergency

²² Whilst two alternatives for Modification Proposal P173 were raised, only one proceeded. Therefore the respondents' views detailed in this letter do not make mention of the alternative based on calculating Avoidable Costs on the basis of using replacement Bids and Offers.

Instruction. This respondent considered that Proposed Modification P173 would therefore promote effective competition in the generation and supply of electricity and would therefore better facilitate achievement of Applicable BSC Objective (c). This respondent also considered that, by ensuring that the affected Party would be cost neutral as a result of responding to an Emergency Instruction, Proposed Modification P173 would remove any potential commercial disincentive to respond to an Emergency Instruction in the event that Bid-Offer Prices did not provide adequate compensation. One respondent offered qualified support for Modification Proposal P173, providing caveats pending further clarity as to the circumstances under which an Emergency Instruction may be issued, to prevent the suggestion that these may be used more frequently in order to reduce the costs of balancing the system.

As outlined above, the majority of respondents did not support Proposed Modification P173. Several of these respondents noted that they had sympathy with the principle of removing the financial impact of Emergency Instructions from cash out, however, they expressed concern that the approach for achieving this under Proposed Modification P173 entails a departure from the pay-as-bid principle, which is regarded as a fundamental characteristic of the Balancing Mechanism and NETA. These respondents considered that the Bid-Offer Prices submitted by market participants are appropriate as they are based on the costs and risks of a plant being removed from the system as a result of complying with a BOA. Respondents were concerned that payments based on Avoidable Costs may not reflect these costs adequately and so may not provide reasonable reward or compensation for the affected Party. Respondents stated that Parties submit their Bids and Offers in the context of a competitive market and considered that it was not clear why these prices are inappropriate for the purposes of Emergency Instructions. It was also stated that Parties are not able to change these Bids and Offers in reaction to the Emergency Instruction and so respondents considered that there is no question that the System Operator can be exploited as a distressed buyer. The majority view, therefore, was that deviating from pay-as-bid and basing payment for Emergency Instructions upon Avoidable Costs would be inappropriate and could have a detrimental impact on competition in the supply and generation of electricity, which would not better facilitate Applicable BSC Objective (c).

In addition, one respondent considered that basing the payment for responding to an Emergency Instruction on the notion of cost neutrality could be a contravention of the European Convention of Human Rights and the Human Rights Act 1998. This respondent considers that the SO can only legitimately interfere with a market participant's use of their property where compensation is provided. However, given that the notion of cost neutrality may mean that the affected Party has to make a payment for responding to an Emergency Instruction (rather than receiving payment), this respondent was of the opinion that Proposed Modification P173 did not comply with the requirements of Article 1 of the First Protocol of the European Convention of Human Rights. This is on the basis that the affected Party would have to pay when denied free enjoyment of its possessions.

Several respondents also considered that the post-event compensation claims process associated with Proposed Modification P173 introduced additional complexity, uncertainty and costs to the Settlement process, which could operate to the detriment of Applicable BSC Objective (d). One such respondent considered that the mandatory nature of the claims process could create an unnecessary burden for market participants and the BSC Panel, particularly in the event that the changes to BOA prices were not material. This respondent considered that this may result in delays that could negatively impact on the integrity of the Settlement process. Furthermore this

respondent considered that the avoided cost claim route would imply that at least one cash out price would remain provisional until the claims process has been exhausted.

Several respondents also raised concerns in relation to the impact on the calculation of Energy Imbalance Prices of basing the replacement price on Avoidable Costs. One respondent considered that pricing an Emergency Instruction at Avoidable Costs could retain the potential distortion of Energy Imbalance Prices that exists under the current baseline. Another respondent considered that in cases where an Emergency Instruction was taken for System Balancing reasons, it would be inappropriate, as under Proposed Modification P173, to feed this System Balancing action into the calculation of Energy Imbalance Prices at Avoidable Costs rather than attempt to remove it.

Respondents' views in respect of Alternative Modification Proposal P173

Only one respondent expressly considered that Alternative Modification Proposal P173 would better facilitate achievement of the Applicable BSC Objectives. This respondent stated that it is appropriate for Avoidable Costs to be calculated to account for damage to plant and apparatus arising from an Emergency Instruction. Several other respondents did, however, consider that the wider definition of Avoidable Costs under Alternative Modification Proposal P173 would better reflect the costs and risks associated with responding to an Emergency Instruction.

The majority of respondents that did not support Alternative Modification P173 did so for the same reasons as outlined above with respect to Proposed Modification P173, namely the opinion that the proposed solution entailed a lack of appropriate financial reward, the abandonment of pay-as-bid and the additional complexity that it would introduce into the cash out arrangements.

One respondent stated that extending the compensation beyond the existing BSC definition of Avoidable Costs to include plant damage would in its view be inappropriate and could be seen as a replacement for plant insurance, underwritten by the rest of the industry. This respondent considered that this would not promote competition, and would not better facilitate Applicable BSC Objective (c). Furthermore, this respondent did not consider that a Party issued with an Emergency Instruction should be able to claim lost opportunity costs associated with Trading Charges or BSCCo charges. A further respondent provided a similar view, stating that the BSC is not the correct arena to consider compensation for plant damage.

Draft Modification Report

Subsequently, Elexon published a draft Modification Report in relation to Modification Proposal P173 on 16 December 2004, which invited respondents' views by 23 December 2004. Elexon received 10 responses to the consultation on the draft Modification Report for Modification Proposal P173. One respondent considered that Proposed Modification P173 would better facilitate the achievement of the Applicable BSC Objectives relative to the current baseline. Eight respondents did not consider that Proposed Modification P173 would better facilitate the Applicable BSC Objectives. No respondents considered that Alternative Modification Proposal P173 would better facilitate the achievement of the Applicable BSC Objectives relative to the current baseline. The remaining respondent offered no comment.

The respondent that considered Proposed Modification P173 should be made considered that it may be necessary to depart from normal Balancing Mechanism operation when issuing Emergency Instructions. This respondent noted that Emergency Instructions are not issued under normal market conditions or for standard operational purposes and as such warrant a different treatment in Settlement from standard Acceptances, involving a deviation away from the pay-as-bid principle.

The respondents who opposed both the Proposed and the Alternative Modification reiterated their views that it is inappropriate to move away from the principle of pay-as-bid, which some considered was a fundamental part of the competitive functioning of the market under NETA. These respondents continued to consider that it would not be appropriate to base payments for Emergency Instructions on Avoidable Costs rather than prevailing Bid-Offer prices. One respondent additionally expressed that it remained concerned that the replacement price derived may distort Energy Imbalance Prices in some circumstances and that the mandatory disclosure of commercially confidential information may place parties in breach of contract or breach of the Code.

Panel's recommendation

The Panel met on 13 January 2005 and considered the Proposed and the Alternative Modification, the draft Modification Report, the views of the PSMG and the consultation responses received.

The majority of Panel members considered that neither Proposed Modification P173 nor Alternative Modification P173 would better facilitate achievement of the Applicable BSC Objectives. These Panel members were of the opinion that departing from the pay-as-bid principle for BOAs would work to the detriment of Applicable BSC Objective (c), and considered that it was generally desirable for prices to be set by the market and that intervention is kept to a minimum.

A minority of Panel members considered that both Proposed Modification P173 and Alternative Modification P173 would better facilitate achievement of the Applicable BSC Objectives. These Panel members were of the opinion that, by ensuring Energy Imbalance Prices and consequential cash flows were not distorted by emergency system actions, that P173 would better facilitate achievement of the Applicable BSC Objectives. Moreover, these Panel members considered that responding to an Emergency Instruction should not create excessive windfall gains and losses for market participants, and that both Modification Proposal P173 and Alternative Modification P173 would prevent this from occurring. These Panel members considered that Emergency Instructions were not issued under normal market conditions or for standard operational purposes and as such warrant different treatment in Settlement to standard Acceptances issued within the Balancing Mechanism.

Therefore, the Panel recommended to the Authority that neither Proposed Modification P173 nor Alternative Modification P173 should be made. In the event that the Authority determines that either Modification Proposal P173 or Alternative Modification P173 should be made, the Panel recommended an Implementation Date of five working days following an Authority Decision.

Ofgem's view

Having carefully considered the final Modification Report, the respondents' views and the Panel's recommendation, Ofgem, having regard to the Applicable BSC Objectives, is of the view that neither Proposed Modification P173 nor Alternative Modification P173 would better facilitate achievement of the Applicable BSC Objectives. Ofgem considers this to be the case against the BSC baseline at the time Modification Proposal P173 was raised and against the revised BSC baseline following the approval of Proposed Modification P172.

Applicable BSC Objective (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

Pricing Emergency Instructions for cash out purposes

In order to avoid the potential for the cost of System Balancing related Emergency Instructions to distort Energy Imbalance Prices, both Proposed and Alternative Modification P173 propose that all Emergency Instructions would be priced at a replacement price based on Avoidable Costs rather than at the prevailing Bid-Offer price²³. Ofgem agrees that it is appropriate to reduce the risk that System Balancing related Emergency Instructions lead to unrepresentative Energy Imbalance Prices. However, Ofgem agrees with the respondents who considered that pricing all Emergency Instructions at Avoidable Costs may in itself lead to Energy Imbalance Prices which are not representative of the costs of Electricity Balancing. Ofgem, therefore, considers that this would not better facilitate the achievement of Applicable BSC Objective (c). Furthermore, while Emergency Instructions are infrequent events, Ofgem notes the concern that the potentially lengthy process for determining the replacement price could delay the calculation of Energy Imbalance Prices, which could create uncertainty for market participants which may be to the detriment of Applicable BSC Objective (c).

Pricing Emergency Instructions for payments to/from affected Parties

Under both Proposed and Alternative Modification P173, the replacement price, rather than the prevailing Bid-Offer price, would form the basis of the payments to/from the Party responding to an Emergency Instruction. Therefore, Parties would not be paid-as-bid for Emergency Instructions. During the development of NETA, it was considered appropriate for all Balancing Mechanism trades to be settled at the prices included in the accepted Bid or Offer i.e. under a pay-as-bid system. Ofgem continues to consider that, in general, the pay-as-bid approach is the appropriate method by which to settle energy procured via market arrangements.

However, Ofgem acknowledges the concern that it may be inappropriate for the pay-as-bid approach to apply in certain circumstances when actions are taken outside the normal operation of the market. Ofgem notes that Emergency Instructions are only issued in limited circumstances in order to ensure the integrity of the system and that they can represent a departure from normal Balancing Mechanism operation. Given this, Ofgem considers that different treatment of Emergency Instruction Acceptances in Settlement in terms of the payments made to/from

²³ Following the approval of Modification Proposal P172, System Balancing related Emergency Instructions will be unpriced for the purposes of calculating cash out prices, rather than being priced at the prevailing Bid-Offer Price, as was the case under the BSC baseline when Modification Proposal P173 was raised.

affected Parties may be warranted. This is particularly the case given the potential for “sleeper” Bids, which may be submitted as a signal of a market participant’s unwillingness to be flexible, to be accepted as Emergency Instructions with potentially significant implications for Settlement and associated cashflows.

On a related point, Ofgem notes that, following the approval of CUSC Amendment Proposal CAP076²⁴ and BSC Modification Proposal P177²⁵, operational intertrips are no longer treated as BOAs within the Balancing Mechanism and that different compensation arrangements are now in place for such actions. On the basis that Emergency Instructions are generally issued outside the normal operation of the market, Ofgem considers that it may be appropriate for alternative compensation arrangements to be put in place for Emergency Instructions under which, as is now the case for operational intertrips, Emergency Instructions are not remunerated in the same manner as BOAs in the Balancing Mechanism. Ofgem considers that this issue may merit further consideration by market participants, including NGC.

Finally, Ofgem notes that one respondent raised concerns that Modification Proposal P173 could contravene the European Convention on Human Rights. Ofgem notes that the legal advice provided to the PSMG indicated that as Modification Proposal P173 is intended to place a generator in a cost neutral position in the event of an Emergency Instruction it is unlikely to amount to an infringement of Article 1 of the First Protocol of the European Convention on Human Rights. Ofgem’s current view is that in such a situation deprivation of the use of possessions, such as a power station, can be a legitimate aim under the Convention but that any resulting cost neutrality should be proportionate.

Applicable BSC Objective (d) – promoting efficiency in the implementation and administration of the balancing and settlement arrangements

Ofgem notes that concerns have been raised during the progression of Modification Proposal P173 in relation to the complexity of the solution, particularly the post-event process for deriving a replacement price based on Avoidable Costs. Ofgem agrees that this process could indeed be lengthy and complex for both market participants and the Panel, given the need to provide and assess information upon which to determine Avoidable Costs, potentially introducing considerable complexity to the arrangements relative to the existing baseline. Ofgem considers that this could be to the detriment of Applicable BSC Objective (d).

Furthermore, as previously outlined in its decision letter in relation to Modification Proposal P80²⁶ in the context of disconnections from the transmission system, Ofgem does not consider it is appropriate in this situation for the BSC Panel to determine compensation claims. Ofgem therefore considers this to be an additional reason why Modification Proposal P173 would be detrimental to the achievement of Applicable BSC Objective (d).

Summary

Overall, Ofgem considers that neither Proposed Modification P173 nor Alternative Modification P173 would better facilitate the achievement of the Applicable BSC Objectives, notably

²⁴ CUSC Amendment Proposal CAP076: “Treatment of System to Generator Intertripping Schemes”.

²⁵ Modification Proposal P177: “Removal of Intertrip Provisions from the BSC”.

²⁶ Modification Proposal P80: “Deemed Bid/Offer Acceptance for Transmission System Faults”.

Applicable BSC Objective (c). Ofgem considers this to be the case against both the BSC baseline which existed at the time that Modification Proposal P173 was raised and the revised BSC baseline following the Authority's approval of Modification Proposal P172. This is because pricing all Emergency Instructions at Avoidable Costs for the purpose of calculating cash out prices may lead to unrepresentative Energy Imbalance Prices. However, Ofgem considers that there is merit in further considering whether, in the case of Emergency Instructions, deviation from the pay-as-bid approach may be appropriate.

Sleeper Bids

The Damhead Creek incident has highlighted the issue of the potential effects of high priced "sleeper" Bids on the operation of the market and market participants. NGC has provided analysis which suggests that in the Settlement Periods affected by the Damhead Creek incident around 30 per cent of Bids submitted may be "sleeper" Bids and has stated that high, negative Bid prices are not uncommon. Ofgem has previously expressed in the consultation document relating to the guidelines for applying the Market Abuse Licence Condition under NETA²⁷ concerns about the potential for "sleeper" Bids, if accepted, to distort competition, which could be to the detriment of customers. Ofgem has also published guidance in relation to the application of competition law in the energy sector²⁸, which is intended to help market participants assess their conduct to avoid potential breaches of competition law. This guidance applies to the bidding strategies of market participants in the Balancing Mechanism. Ofgem considers that the issue of "sleeper" Bids may merit further consideration and is of the view that this could be a topic for consideration at a forthcoming NGC Operational Forum.

If you would like to discuss any aspects of this letter, please contact me on the above number or Simon Bradbury on 020 7901 7249.

Yours sincerely



Sonia Brown
Director, Markets

²⁷ 'The Market Abuse Licence Condition under NETA: Guidelines, A consultation document', Ofgem, September 2000.

²⁸ 'Competition Act 1998 – Application in the Energy Sector, OFT and Ofgem, January 2005.