

Modification proposal:	<b>Balancing and Settlement Code (BSC) P285: 'Revised treatment of RCRC for Interconnector BM units'</b>		
Decision:	The Authority <sup>1</sup> directs that this modification be made <sup>2</sup>		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	23 January 2013	Implementation Date:	27 June 2013

## Background to the modification proposal

National Grid Electricity Transmission (NGET), in its role as the System Operator (SO), recovers the daily cost of balancing the national electricity transmission system through Balancing Services Use of System (BSUoS) charges. These consist of energy balancing costs which are incurred through resolving the imbalances created when Parties fail to balance their positions (the net imbalance volume), and system balancing costs which are incurred through other activities such as managing transmission constraints. BSUoS charges are governed by the Connection and Use of System Code (CUSC).

For each Settlement Period, each BSC Trading Party is charged System Buy Price (SBP) for any 'short' imbalances in their Energy Accounts, or paid System Sell Price (SSP) for any 'long' imbalances in their Energy Accounts. This is known as cash-out. Residual Cashflow Reallocation Cashflow (RCRC) is a cashflow which arises from the cash-out mechanism. The total amount of money paid to, and received from, Trading Parties in a given Settlement Period will not usually be equal, due to the dual cash-out price calculation<sup>3</sup> and the overall imbalance on the system (the net imbalance volume). However, in order that the net cost arising from Trading Charges is zero, the net of these trading charges is recovered from, or redistributed to, all Trading Parties through RCRC. Cash-out and RCRC are governed by the Balancing and Settlement Code (BSC).

### *How do RCRC and BSUoS interact?*

Both a proportion of RCRC and a proportion of BSUoS charges/payments arise from the need to overcome the net imbalance on the system. A proportion of BSUoS charges arise from actions that the SO has to procure to resolve imbalances created when Parties fail to balance their positions. Meanwhile, those Parties which fail to balance their positions are subject to the cash-out price, the net of which is redistributed or recovered by RCRC. Consequently, there is a relationship between these two charges. A simplified example of this is set out in the P285 Final Modification Report (FMR<sup>4</sup>).

RCRC does not comprise only of cashflows which relate to the net imbalance volume on the system (and therefore to BSUoS costs). RCRC also has a second component relating to offsetting imbalances. Offsetting imbalances are individual parties' imbalances which net off against each other and therefore do not require the SO to take any balancing actions. Although these imbalances cancel each other out physically, there is still a net charge associated with them due to the dual cash-out price.

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

<sup>2</sup> This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

<sup>3</sup> The calculation of SBP and SSP will differ depending on whether the system is long or short overall. If the system is short overall, the SBP will be the 'main' price, and will be calculated based on the Bids and Offers accepted by NGET in order to resolve the energy imbalance on the system. The other price is the 'reverse' price and is calculated using data on short-term trades. If the system is long overall, the opposite is true, and SSP will be the 'main' price.

<sup>4</sup> The P285 FMR is on Elexon's website here: <http://www.elexon.co.uk/wp-content/uploads/2012/05/P285-Final-Modification-Report.zip>

The distribution of both BSUoS costs and RCRC is based on Credited Energy Volumes. Parties will often be liable for both BSUoS charges/payments and RCRC charges/payments simultaneously and will pick up the same proportion of each<sup>5</sup>.

Approved CUSC Modification Proposal (CMP) 202 has removed BSUoS charges/payments from Interconnector Balancing Mechanism (BM) Units<sup>6</sup>. CMP202 was raised to better align the GB arrangements with those prevalent in other EU Member States, to remove a barrier to cross-border trading and to be consistent with the wider European objective of enabling the development of a single EU internal electricity market. CMP202 was approved by Ofgem on 15 August 2012 and was implemented on 30 August 2012.

### *Is RCRC impacted by European regulation?*

Directive 2009/72/EC (the Electricity Directive), which covers common rules for an internal European electricity market, recognises that "different types of market organisation will exist", and that Member States should take measures to ensure a level playing field. Recital 3 of Regulation (EC) No 714/2009 (the Electricity Regulation) acknowledges the existence of obstacles to the sale of electricity on equal terms and without discrimination or disadvantage within the European Union, and Article 1 states that one of the aims of the Electricity Regulation is to set fair rules for cross-border exchanges of electricity in order to enhance competition. The Electricity Regulation was introduced as part of the Third Package, which became legally binding on all EU Member States on 3 March 2011.

The Electricity Regulation is directly applicable in Great Britain, and supersedes national law. The GB trading arrangements set out in the BSC need to comply with the Regulation. In particular, applicable BSC Objective (e)<sup>7</sup> states that any changes proposed to the balancing and settlement arrangements set out in the BSC should facilitate compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or the Agency for the Co-operation of Energy Regulators (ACER).

### **The modification proposal**

In May 2012, NGET (the proposer) raised BSC Modification P285, to exclude Interconnector BM Units from RCRC charges/payments. To achieve this, the Credited Energy Volumes from Interconnector BM Units (whether relating to an Interconnector User<sup>8</sup> or an Interconnector Error Administrator<sup>9</sup>) would be excluded from the calculation of each Party's Residual Cashflow Reallocation Proportion (RCRP<sup>10</sup>). As a result, Interconnector volumes would not be included in a Party's RCRP, and the share of the RCRC that would have been allocated to these Interconnector volumes would instead be reallocated across all other BSC Parties in proportion with their non-Interconnector Credited Energy Volumes.

The proposer considers that P285 would better facilitate applicable BSC Objectives (a), (c) and (e). It considers that P285 would allow NGET to account for developments in its transmission business arising from European legislation, and ensure that the appropriate

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<sup>5</sup> An exception will occur if the relevant BM Unit is the subject of a Metered Volume Reallocation Notification (MVRN).

<sup>6</sup> Ofgem's decision on CMP 202 can be found on our website here:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=83&refer=Licensing/ElecCodes/CUSC/Amend>

<sup>7</sup> As set out in Standard Condition C3(3) of NGET's Transmission Licence, see:

<http://epr.ofgem.gov.uk/EPRFiles/Electricity%20transmission%20full%20set%20of%20consolidated%20standard%20licence%20conditions%20-%20Current%20Version.pdf>

<sup>8</sup> An interconnector means in relation to an Interconnector, a Lead Party in respect of an Interconnector BM Unit other than the Interconnector Error Administrator;

<sup>9</sup> A Party which, in accordance with Section K5.4, is for the time being appointed in respect of an Interconnector by notice given by the Interconnected System Operator, and has agreed to act as such, or a Party which is otherwise required to act as such.

<sup>10</sup> The Residual Cashflow Reallocation Proportion is a fraction expressing the proportion of the RCRC to be allocated to an Energy Account in a given Settlement Period.

financial BSC arrangements are in place. In addition, it would ensure that trades across Interconnectors are based on price differentials, undistorted by RCRC charges/payments. As RCRC could be perceived as a charge on Parties trading across Interconnectors, the current arrangements could be viewed as contrary to the EU Third Package, and the overall goal of the creation of a single internal market for electricity. The proposer considers that P285 would also prevent Interconnector users from receiving 'windfall' gains or losses that would arise from being liable for RCRC but not liable for BSUoS.

P285 was raised alongside BSC Modification P286 'Revised treatment of RCRC for generation BM Units'<sup>11</sup>. P286 would also impact the allocation of RCRC, although the two solutions are independent of each other.

### **BSC Panel<sup>12</sup> recommendation**

The BSC Panel considered its final recommendation on P285 at its meeting on 13 December 2012. The Panel unanimously considered that P285 does better facilitate the Applicable BSC Objectives, and therefore recommended that P285 is approved. The views of the Panel are set out in full in the Final Modification Report (FMR).

### **The Authority's decision**

The Authority has considered the issues raised by the Modification proposal and the Final Modification Report (FMR) dated 18 December 2012. We have considered and taken into account the responses to Elexon's<sup>13</sup> consultation that are attached to the FMR<sup>14</sup>. We have concluded that:

1. implementation of the Modification will better facilitate the achievement of the applicable objectives of the BSC<sup>15</sup>; and
2. directing that the Modification be made is consistent with the Authority's principal objective and statutory duties<sup>16</sup>.

### **Reasons for the Authority's decision**

In our view, there are two issues relevant to our decision – whether RCRC could be perceived as a distortion to cross-border trading of electricity, and whether an unacceptable 'anomalous situation' would be created if Parties who do not currently pay BSUoS, are subject to RCRC charges or payments.

We note the majority view of the Workgroup that assessed P285 that RCRC could be perceived as a charge on Interconnector flows when negative and improper incentive to flow when positive. The majority view is that P285 will prevent a distortion to cross-border trades, and allow trades across Interconnectors to be based on market price differentials. Although RCRC is related to the imbalance arrangements, and imbalance charges are permissible under the Third Package, we agree with the majority view that this Modification is consistent with the wider European objective of enabling the development of a single internal electricity market. P285 will therefore allow NGET to account for developments in its transmission business arising from European legislation. The minority Workgroup view was that RCRC is a part of the imbalance mechanism and as such there are no relevant legally binding European regulations that would require the removal of RCRC from interconnectors.

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<sup>11</sup> Information regarding P286 is available on Elexon's website: <http://www.elexon.co.uk/mod-proposal/p286/>

<sup>12</sup> The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC.

<sup>13</sup> The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.

<sup>14</sup> BSC modification proposals, modification reports and representations can be viewed on the Elexon website at <http://www.elexon.co.uk/>.

<sup>15</sup> See footnote 7 above.

<sup>16</sup> The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

We further note the Workgroup's majority view that RCRC and BSUoS are 'two sides of the same coin' and that, as a result of this relationship, an 'anomalous situation' would be created if Parties who do not currently pay BSUoS, are subject to RCRC charges or payments. We note the view that this would create windfall gains or losses for interconnector users. For this reason, supporters of P285 believe that the Modification allows NGET to ensure that appropriate financial balancing and settlement arrangements are in place in light of Approved CUSC Modification CMP202.

One Workgroup member's view was that RCRC arises from the imbalance charging mechanism under the BSC, which is separate from the cost-recovery mechanism under the CUSC, and for this reason the removal of RCRC from interconnectors in response to CMP202 is inappropriate. One Impact Assessment respondent considered that the real relationship is between RCRC and cash-out; if a Party is subject to one then they should also be subject to the other.

While we agree that there is a relationship between the two cashflows (insofar as a proportion of both is derived from the costs incurred by the SO in resolving energy imbalances on the system), we note the view that RCRC arises from the imbalance charging mechanism under the BSC, which is separate from the cost-recovery mechanism under the CUSC. Further, there is a second component of RCRC that is related to offsetting imbalances, and therefore is not related to BSUoS. We consider that whether those subject to BSUoS charges and RCRC charges/payments should be aligned is a finely balanced argument.

However, we agree with the majority view of the P285 Workgroup in relation to the potential effects of RCRC on cross-border competition. Accordingly, on balance we agree with the unanimous view of the Panel that P285 would better facilitate BSC Applicable Objectives (a), (c) and (e) and has no or a neutral impact with respect to the other Applicable Objectives.

***Applicable Objective (a) 'the efficient discharge by the Transmission Company of the obligations imposed upon it by the Transmission Licence'***

As set out above, it is a finely balanced argument as to whether P285 will allow NGET ensure that appropriate financial balancing and settlement arrangements are in place in light of Approved CUSC Modification CMP202.

We agree that RCRC charges/payments could be perceived as a distortion to flows on the interconnectors. Removing RCRC from interconnectors will better align the GB arrangements with those prevalent in other EU Member States, remove a distortion to cross-border trade and be consistent with the wider European objective of enabling the development of a single internal electricity market. We therefore believe that Modification P285 facilitates BSC Objective (a) as it allows NGET to account for developments arising from European legislation.

***Applicable 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'***

We acknowledge the view that P285 prevents windfall gains and losses. We consider this argument is not straightforward, given that the second component of RCRC is related to offsetting imbalances, and therefore is not related to BSUoS.

In our view, P285 would remove the potential for RCRC to be perceived as a charge on Interconnector flows when negative and an improper incentive to flow when positive. P285

should therefore ensure that trades across Interconnectors are based on price differentials, thereby improving competition within the single EU internal electricity market.

***Applicable Objective (e) - Compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or the Agency [for the Co-operation of Energy Regulators]***

Although RCRC is related to the imbalance arrangements, and imbalance charges are permissible under the Third Package, we agree that RCRC is a 'grey' area, due to its application to all Parties, including Interconnector Users. We agree with the majority view of the Workgroup that the allocation of RCRC to Interconnector Users could be perceived as a charge when RCRC is negative and could provide an improper incentive to flow when positive. Therefore allocation of RCRC to Interconnector Users carries the perceived risk of being contrary to the aims of the Electricity Regulation, and that P285 is in keeping with the principle of the European regulations. For this reason we agree that P285 would better facilitate this objective.

**Assessment against the Authority's statutory objectives and duties**

The Authority's principal objective is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems. While these interests are to be taken as a whole, they include consumers' interests in the security of supply of electricity to them, and the fulfilment by the Authority of the objectives set out in Article 36(a) to (h) of Electricity Directive.

Article 36(a) of the Electricity Directive relates to the development of a '*competitive, secure and environmentally sustainable internal market in electricity*'. Article 36(c) relates to '*eliminating restrictions on trade in electricity between Member States, including developing appropriate cross-border transmission capacities*'.

As set out above, we consider that whether there is a link between RCRC and BSUoS is a finely balanced argument. However, in respect of our principal objective, our view is that removing a potential barrier to cross-border trading would support more effective competition between domestic and cross border users of the national electricity transmission system and also improve access to other markets, which could improve security of supply and facilitate the development of a single European electricity market.

Some members of the P285 Workgroup considered that the issue raised by P285 ought to be discussed in a broader context as part of the Electricity Balancing Significant Code Review (EBSCR). We may consider changes to RCRC as part of the EBSCR, especially if other considerations have an impact on the nature and volume of RCRC. However, in our view, P285 already better facilitates the Applicable Objectives and conforms to our principal statutory objective. We consider that approving P285 now is appropriate to achieve appropriate alignment of the GB arrangements with EU objectives.

**Decision notice**

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority, hereby directs that modification proposal P285 '*Revised treatment of RCRC for Interconnector BM Units*' be made.

**Emma Kelso**

**Associate Partner, Wholesale Markets**

Signed on behalf of the Authority and authorised for that purpose