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By email to gb.markets@ofgem.gov.uk

31st October 2012

Dear Andreas,

Re: Electricity balancing significant code review – initial consultation

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response, which represents the view of the Centrica group of companies, excluding Centrica Storage Ltd.

The annex to this letter provides detailed answers to the questions set out in the consultation document. In summary:

- We support in principle a review of the electricity balancing arrangements, however we are concerned on the approach taken by Ofgem and suggest that further work should be undertaken and shared with the industry prior to any initial decisions being published in the spring.
- We suggest that Ofgem should place a greater emphasis on quantitative analysis rather than only qualitative analysis based on economic theory which may not be easily applied to the electricity sector with its technical imperatives.
- We continue to believe that the key to achieving long term security of supply is via the introduction of a Capacity Mechanism as proposed by DECC.
- We suggest that Ofgem needs to clarify the significant code-based issues this process is trying to address and the objectives of undertaking this review.
- We suggest that the work undertaken by DECC and Ofgem on the interactions between the Capacity Mechanism and the Gas SCR should be shared with industry as soon as possible, to enable industry discussion and debate.

- It is vital that any changes made under this review are in accordance with the European Target Market to be implemented by 2014.

We hope these comments are helpful. If you have any questions or would like to discuss our response, please do not hesitate to contact me.

Yours sincerely,

Sarah Owen
Commercial Manager, Regulatory Affairs
Centrica Energy

ANNEX – Answers to consultation questions

Chapter 2 – Approach

Q1 – Do you agree with the approach and the proposed stakeholder engagement throughout the SCR?

We welcome Ofgem's recent stakeholder seminar and the workshops which accompanied this consultation, and we support the proposed methods for future engagement with stakeholders. We are, however, concerned about the SCR process, in particular the proposal to publish a draft policy decision in spring 2013. We believe that, following this consultation, further work needs to be undertaken and shared with the industry, before (initial) conclusions can be drawn, as explained below.

Significant code issues

It is our understanding that the SCR process is designed to resolve significant code-based issues. This consultation lists Ofgem's key concerns with the current cash-out arrangements, as set out previously in Ofgem's Electricity cash-out issues paper. We continue to be of the view that these concerns and the materiality of these concerns have not yet been sufficiently defined. We are therefore not clear which significant code-based issues this SCR is trying to address. This in turn makes it difficult to assess the very broad range of solutions, i.e. the primary and secondary considerations, included in the consultation document.

Additionally, we are concerned that Ofgem appear to be placing too much reliance on qualitative analysis. We strongly suggest that Ofgem should place a greater emphasis on quantitative analysis rather than only qualitative analysis based on economic theory which may not be easily applied to the electricity sector with its technical imperatives.

SCR objectives

We also believe that further clarity is required with regards to the three SCR objectives, mentioned in the document (we assume these are the revised cash-out principles set out in Ofgem's earlier issues paper). As these objectives will be used to assess potential options for reform, it is important that these are understood and endorsed by stakeholders.

(1) Incentivise an efficient level of security of supply

Firstly, we are not clear what is meant by an "efficient level of security of supply" and an "optimal level of investment" (sub-bullet 1) and we believe this should be clarified.

Secondly, we continue to believe the key to achieving long-term security of supply is the introduction of a Capacity Mechanism as proposed by DECC. A number of respondents to Ofgem's issues paper have raised this point and questioned the role the cash-out prices can play in encouraging investment in new plant, i.e. whether cash-out prices feed through to the longer-term forward curve on which investment decisions are based. We believe these points should have been addressed in the consultation document.

Finally, we would like to understand the rationale for sub-bullet 2 (pay firm customers appropriately for the DSR service they provide if their demand is involuntarily interrupted).

(2) Increase the efficiency of electricity balancing

We believe it is essential that there is clarity regarding the purpose of electricity balancing, and cash-out arrangements in particular, before potential options for reform can be assessed. This would also help with identifying the interaction with other areas more clearly, including DECC's proposed Capacity Mechanism (see also Q2 below).

For example, it would be useful to better understand what Ofgem means by "efficient balancing", what the term "market distortions" refers to (sub-bullet 1), and how Ofgem defines "cost reflective" (sub-bullet 3). This also requires further insight into Ofgem's view on the SO's balancing role, in particular whether an increased role ultimately means higher costs for consumers and whether a structurally long system is an efficient outcome (with cost-reflective cash-out prices), as has been suggested in previous Ofgem decisions.

(3) Ensure our balancing arrangements are compliant with the TM and complement the EMR CM

We agree with Ofgem about the European interaction and the interaction with DECC's EMR process. We believe the interaction with the gas SCR and the SO incentive scheme (reserve procurement) are equally as important. They are currently included as part of the assessment criteria of potential reform options, but we believe they should be included in this SCR objective.

Q2 – Do you have any evidence that you would like to submit that may be relevant for any aspect set out in this document?

Not at this point in time.

We would like, however, to make some further comments on the significant interaction with DECC's proposed Capacity Mechanism and the gas SCR. We understand Ofgem and DECC are working closely to ensure their policies complement each other and we welcome this approach. We recommend that any work done in this area is shared with stakeholders at the earliest opportunity to enable them to contribute to the debate and we expect Ofgem to do the same with regards analysis carried out on the interaction with the gas SCR.

Interactions with DECC's proposed Capacity Mechanism

DECC's proposals for the Capacity Mechanism give rise to a number of potential interactions with the proposals for electricity balancing that we believe should be considered in more detail. For example, the current Capacity Mechanism proposals include a penalty regime for non-delivery which, combined with cash-out prices, could result in double exposure. In addition, there is a question around which mechanism should incentivise flexibility. Finally, if this SCR results in an increase in the cost of generation, then this should be reflected in the relevant support mechanism(s).

Interactions with gas SCR

We believe the combination of reforms proposed by Ofgem could lead to a situation where, if a crisis occurs simultaneously in the gas and electricity markets, the gas cash-out price would increase to £20/th (equivalent to roughly £680/MWh) while the electricity cash-out price would increase to £10,000/MWh (this could happen if Ofgem decides that National Grid must price consumer disconnection at VoLL and the cash-out price is made more marginal). If that is the case, then gas-fired power stations will be encouraged to run at maximum capacity during emergencies, leading to additional consumer disconnections in the gas market, while in practice from a system-wide perspective it might be better to switch off gas-fired power stations and disconnect electricity consumers.

Q3 – What is your view on the interaction between our considerations and aspects of the EU target model

There are some key interactions with the EU Target Model, and in particular, with the Electricity Balancing Framework Guidelines, the Capacity Allocation and Congestion Management Guideline and subsequent codes which are being developed simultaneously with the SCR. It is vital that the SCR process does not develop an electricity balancing regime which subsequently requires change due to EU developments.

The aim is for the European Target Model to be implemented by 2014 and hence the Framework Guidelines and subsequent network codes are progressing at a rapid pace. We very much support Ofgem's proposed pro-active approach in this area.

Chapter 4 – Primary considerations

Q4 – Do you feel there are any alternatives to the reform options presented under our primary considerations

As mentioned under Q1 we believe that first the issues and their materiality need to be more clearly defined. Until that analysis has been carried out, alternative reform options, including maintaining the status quo, should not be ruled out.

Q5 – What other benefits or drawbacks can you identify for each of our primary considerations? Please provide any evidence you may have to support your position.

1) More marginal main cash-out price

On the whole, we would be supportive of a more marginal cash-out price; we suggest that more marginal cash-out prices in combination with the Capacity Mechanism will provide stronger incentives for flexible plant to both be available and responsive to significant prices in times of scarcity.

If, however, the main cash-out price is made more marginal via a reduction in the price average reference (PAR) there is a danger that there will be a greater pollution from inaccurately tagged system actions, which could then become a significant factor in setting the cash-out price depending on the PAR selected. Ofgem should investigate the number of actions that make up each level of PAR they are considering, to determine how low, in practical terms, it is sensible to drop the PAR before there is a significant risk of wrongly tagged actions impacting the cash-out price.

Additionally, we suggest that Ofgem should consider the impact that potentially more marginal main cash-out price is likely to have on end consumers. As the risks to parties of increased cash-out costs in times of system stress rise, it is likely that these costs will be passed on to the end consumer. This should be factored into Ofgem's decision on how marginal cash-out prices should become. On a final note, it is important that sufficient information is available to enable parties to manage, as far as possible, this increased risk.

2) Single or Dual cash-out prices

We agree that the adoption of a single cash-out price could impact on a market participant's incentive to balance their position ahead of gate closure as it may be beneficial for generators to spill energy onto the system rather than manage their imbalance position. We are not convinced that a different system for when the system is short or long, or an alternative when the balancing volumes are greater than a set level, as suggested in the consultation would be an appropriate way forward. This could lead to greater risks and may be very difficult for participants to manage.

The combination of higher prices and a single cash-out price could create a strong incentive for generators to use the BM as a prompt market in times of system stress; this would result in these generators securing the highest price at these times, but could also impact forward trading and liquidity as generators would be de-incentivised to trade forward or within day. A decrease or lack of intra-day trading, could severely impact liquidity.

3) Single or separate trading accounts

We are not convinced that the benefits of moving to single trading accounts outweigh the expected costs and timescales required in implementing this change.

4) Pay-as-bid or pay-as-clear

Analysis has shown that pay-as-clear generally results in lower overall costs and removes the need for parties to bid based on their own expectations of the bid level of the marginal plant. However although we believe that pay-as-clear is theoretically the correct method for costing energy balancing actions within the balancing mechanism, we suggest that there are many practical obstacles to overcome, not least of which is the accurate tagging of purely energy balancing actions. Additionally, we suggest that a generator's bid into the balancing mechanism, if a pay-as-cleared mechanism was adopted, may be based on more than only the short run marginal cost of the plant, it may include additional messages to National Grid, for example an individual station's desire or inability to run.

We suggest that this area should be discussed with stakeholders in more detail. We believe that a pay-as-cleared concept could work if a homogenous product could be defined. However, interactions with other primary considerations within the SCR and other obstacles means that this option will need careful consideration and debate within the industry if it is to be taken forward.

5) Attributing a cost to non-costed actions

We are very critical of the process and derived value for lost load (VoLL) within the gas sector; as such we are extremely wary of supporting the determination of a VoLL for electricity as we strongly believe there are significant differences and a great potential for unintended consequences between the two sectors. We suggest that extreme caution should be used if Ofgem do decide to set a VoLL in electricity as there are many interactions between the gas and power markets and it is vital that the correct signals are used to incentivise the most appropriate market action and that any unintended consequences are minimised. It is vital that the most appropriate actions are encouraged and taken, if, for example, there was a simultaneous gas and electricity emergency.

We strongly suggest that consideration should be given to whether the current system actually requires amendment and what would be achieved by setting a VoLL within the electricity sector. Notwithstanding, if Ofgem decides to determine a VoLL, we suggest that further analysis should be undertaken on whether a VoLL should be calculated for each customer type or whether multiple or variable VoLLs are more appropriate e.g. by customer sector, by season etc.

On a final point, the interactions between VoLL and the penalty set under the EMR Capacity Mechanism should also be analysed and assessed prior to any VoLL being determined.

It is important to remember that cash-out prices are determined by the inputs into the balancing mechanism (BM). Unless the BM becomes more of a dynamic system, with industry parties reacting in the short term to changes within the electricity market, it is unlikely that participants behaviour will significantly change as a reaction to placing a cost on currently non-costed actions. These costing will have to flow into the BM for this to be achieved.

6) Improved allocation of reserve costs

Any changes to the way in which costs are allocated to a settlement period should be undertaken in an open, transparent and consistent manner. We suggest that care and consideration should be taken

to ensure that any changes do not alter the incentive of parties to balance. We strongly suggest that a perfectly allocated system should be strived towards, but that cost and simplicity should have an equal consideration. We do not consider that the benefits of improved allocation of reserve costs would be appropriate given the anticipated costs and implementation timescales.

7) Balancing energy market (BEM)

We believe that it would be more beneficial to both market participants and therefore the market in general to have an understandable and timely model that will contain acceptable compromises than have a perfect system, that is hugely complex and that no user can understand or predict.

Additionally, creating a separate energy balancing market assumes that actions are only taken for either system of energy reasons; we do not support this premise and do not believe this would be an efficient change to the current arrangements. For the reasons above, we do not support the adoption of a BEM under this SCR.

8) Alternative arrangements for renewables

We have severe reservations on creating alternative arrangements for renewable generation. We hold that the PPA market is competitive with a number of offtakers in the market, including both large suppliers and independent aggregators. One of the key services offtakers provide to independent generators is the balancing of their generation and so having this area of change as a primary consideration under this SCR will impact the PPA market negatively and therefore impact future investment.

At present, renewable generators can purchase risk-management services in the market through PPAs. This is essentially a market-based approach to meeting the needs of renewable generators, and unless Ofgem has established the existence of a significant market failure we see no reason for moving to a regulated solution. At the moment we see evidence of intense competition in this market: over the past three years, we have seen a significant amount of new entry, a greater diversity of structures being offered, and a growing pressure on prices. The completion of EMR will further strengthen competition in this market: by transferring the price risk of new projects to consumers, CfDs will remove the need for floor prices in PPAs, a key risk for offtakers. Overall, this is a dynamic market that has the potential to innovate and meet the needs of independent developers.

Notwithstanding, care should be taken on the definition of renewable generation as opposed to intermittent generation and which types of generation plant Ofgem is considering under this section for example biomass and marine generation.

We strongly suggest that this consideration is removed from the SCR as quickly as possible.

Q6 – Which of the reform options considered under each of our considerations do you believe would provide the most efficient balancing incentives and why?

We believe this question should be answered when there is further clarity on issues and objectives, as mentioned under Q1.

Q7 – Alongside this initial consultation document we have published preliminary analysis of the last modification to the cash-out arrangements, P217A. Do stakeholders agree with the initial findings of this analysis?

We welcome the preliminary analysis published by Ofgem following the implementation of P217A in 2009. Although the analysis published shows that P217A has improved the tagging and flagging of actions and therefore reduced the contamination of system actions within the cash-out price, we suggest that there are still some actions being incorrectly tagged and flagged.

Issues with specific actions that we consider have been incorrectly tagged and flagged are raised directly with National Grid and we suggest that further work is required to further reduce or even eliminate the contamination of these actions.

If it is considered appropriate to move to a more marginal cash-out price, the contamination of the cash-out price with these incorrectly assigned actions could have a large impact on the level of the cash-out price calculated. We therefore suggest that this further analysis is undertaken and published prior to any further consideration being given to adopt a more marginal cash-out price.

Q8 – What additional analysis could be done as part of the SCR around Modification P217A and the flagging methodology it introduced?

As stated above, we suggest that further work should be carried out on the shortfall area of P217A, where the P217A tagging and SuperBaar tagging do not result in the correct classification of a particular action. This work could then be used to further improve the tagging and flagging process ensuring that the cash-out price is calculated to provide the most efficient signal for parties to balance as it reflects only the costs of energy balancing.

Q9 – Do you agree with our rationale for considering making cash-out prices more marginal?

As mentioned under Q1, we question the role cash-out prices can play in encouraging investment in new plant. In our view, DECC's proposed Capacity Mechanism is the key to achieving long-term security of supply.

See also Q5.

Chapter 5 – Secondary considerations

Q10 – Do you agree with the circumstances we have identified in which the secondary considerations are important?

We suggest that current modifications going through the modification process and developments in European legislation may also impact the need to investigate and develop some of the secondary considerations listed in Chapter 5. Additionally, as a result of the ongoing workshops, initial decisions and the impact assessment that Ofgem will be undertaking and publishing, there may be other areas that warrant further analysis and development.

Q11 – Do you have any other comments on the secondary considerations presented here? Please provide any evidence you may have to support your position.

Improved provision of information

We suggest that there should be some investigation on whether users could be incentivised to provide more accurate Physical Notifications; this could assist National Grid as system operator to improve the forecast of system imbalance. Additionally, the reasons behind current PNs and why and where the inaccuracies are occurring could be investigated.

Creating a reserve market

The nature and use of flexible plant in a system that is generally long, means that it will increasingly need some certainty or predictability over when it will be required and whether this usage will cover annual operating costs. We do not believe that a day-ahead auction will send the appropriate comfort and signalling to this type of plant, therefore this may impact on security of supply in the longer term as investment decisions for future plant and end of life decisions on current plant may be impacted.

Residual Cashflow Reallocation Cashflow (RCRC)

The methodology and process of RCRC may need to be changed depending on the primary considerations that are taken forward. Additionally, the efficiency of the RCRC process should be considered in light of decisions made to BSC modifications P285/P286 and linked CUSC modification CMP202/CMP201.