



FAO Andreas Flamm
Wholesale Markets
Ofgem
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24 October 2012

Dear Andreas,

Electricity Balancing Significant Code Review – Initial Consultation

Drax Power Limited (“Drax”) is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax also owns an electricity supply business, Haven Power Limited (“Haven”), which supplies electricity to a range of business customers and provides an alternative route to market for some of Drax’s power output.

A response to the questions raised in the consultation document can be found in the Annex 1 to this letter. However, we would like to highlight our main thoughts on the SCR to date. These are split in to considerations of (a) the SCR process and (b) the Primary and Secondary policy options (considerations) detailed in the consultation document.

SCR Process

- Ofgem needs to create a hierarchy of importance for the SCR Objectives and assessment criteria to ensure that options can be better assessed;
- Increasing electricity balancing efficiency should be the most important SCR Objective;
- Incentivising individual parties to balance their position and incentivising the system to balance efficiently are equally important;
- The primary vehicle for ensuring the efficient level of security of supply should be the Capacity Market. Cash-out prices alone are not sufficient to incentivise investment in generation build and/or maintenance;
- Internally coherent SCR policy packages should be tested against the wider electricity market arrangements (when known) to ensure compatibility;
- Additional stakeholder engagement is required in the period between the close of this consultation and the indicative publication date of Ofgem’s draft decision to ensure that Ofgem’s draft decision is robust. An industry expert group could be of value in facilitating stakeholder engagement;
- Ofgem needs to clarify what is defective with the current arrangements and what would constitute an improvement to them;
- Any consequential SCR Direction must be very clear to avoid delaying the reform process; and
- It should be borne in mind both the Electricity Balancing Framework Guideline (EBFG) and the Capacity Allocation and Congestion Management (CACM) Code seem to be compatible with the current GB electricity balancing arrangements.

Primary and Secondary policy options

Based on our interpretation of what the Objectives of the SCR should be and what defects currently exist within the current arrangements, we believe:

- A move towards more marginal main cash-out prices should improve the efficiency of the electricity balancing arrangements. However, the introduction of a fully marginal main cash-out price has not yet been justified;
- While we do not consider that a dual or single cash-out price produces radically different incentives for parties, we believe that the current dual cash-out arrangements should be retained. The current arrangements have worked well in practice, incentivising parties to efficiently balance their position. A move to a single cash-out price has not yet been justified;
- We believe that separate trading accounts should be retained due to minor concerns about how single trading accounts might distort balancing incentives and competition. However, if Ofgem is minded to introduce a single trading account style reform, we believe the best option would be to implement P282 as it would be the least intrusive and most cost effective option;
- Pay-as-clear for energy balancing services would provide a number of benefits in theory. This includes balancing service providers receiving efficient remuneration for their services. Unfortunately, it seems unlikely that pay-as-clear could be implemented in practice due to difficulties in separating energy and system balancing actions. However, endeavours should still be made to evaluate the feasibility of a pay-as-clear based mechanism to accommodate potential EBF requirements in the future;
- We do not believe that, at present, VOLL can be efficiently determined. An inefficiently determined VOLL would only result in an increase in costs and risk within the electricity balancing arrangements if it were introduced into the cash-out pricing methodology;
- We do not believe that a Balancing Energy Market (BEM) would be workable in practice and represents an unnecessarily intrusive change to the current arrangements;
- We do not believe that alternative arrangements for intermittent generation are warranted. Such measures risk being discriminatory and will misallocate resources;
- We believe that the current procurement of reserve is adequate and do not believe that a positive case for changing these arrangements has yet been articulated (this may be more pertinent after the conclusion of the EMR work-stream); and
- An information imbalance charge should be introduced to help improve the quality of signals for the SO. This should help incentivise efficient balancing actions by individuals, thereby minimising system balancing costs.

If you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Cem Suleyman

Regulation and Policy
Drax Power Limited

Annex 1

CHAPTER 2: Approach

Question 1: Do you agree with the approach and the proposed stakeholder engagement throughout the SCR?

We believe there are a number of ways that the process can be improved. Our suggestions are related to the SCR Objectives, the assessment criteria, consistency, stakeholder engagement and a potential Ofgem Direction. We consider each of these below.

SCR Objectives

The SCR Objectives¹ are, in isolation, perfectly acceptable. However, we see the potential for these Objectives to conflict with one another when considering different policy options. Therefore, a hierarchy of importance should be created to provide clarity on which Objective takes primacy when considering the different options. We believe this would be helpful for Ofgem in determining what changes, if any, should be made to the electricity balancing arrangements.

We consider that the most important SCR Objective is the “increase [perhaps optimise would be a more appropriate word] electricity balancing efficiency”. We consider that the other SCR Objectives are of relatively less importance. We believe this for the following reasons.

We consider that the primary role of the electricity balancing arrangements is to optimise electricity balancing efficiency. In contrast to this, we believe that the primary vehicle for ensuring the efficient level of security of supply should be the Capacity Market. We are unconvinced of the argument that the electricity balancing arrangements (in particular cash-out pricing) have a significant role to play in ensuring that reliable electricity generation capacity is maintained and/or built.

The signals produced by the electricity balancing arrangements are simply not sufficient to incentivise investors to develop generation capacity. This is not due to the spikiness of prices, but due to the likelihood of the prices occurring and of the generator capturing them. The signals produced are too short term in nature; as such they cannot provide investors with the confidence they require. It is robust wholesale market prices, across the forward curve that provides confidence in the ability to hedge an investment. Unfortunately, the forward wholesale market is highly deficient at present; this is the focus of Ofgem’s wholesale market liquidity work-stream.

To mitigate this issue, the Government has proposed to implement a Capacity Market, i.e. to produce the signals required to incentivise efficient investment. Therefore we do not believe this Objective is as relevant to this SCR, although it is important that the proposed Capacity Market and the electricity balancing arrangements do not contradict one another. Similarly, the electricity balancing arrangements should only be designed so as to comply with the proposed European Target Model and relevant European Network Codes. As such, we also consider this to be a relatively less important objective compared to the electricity balancing efficiency objective.

What does “increase the efficiency of electricity balancing” mean in practice?

We believe that Ofgem needs to clarify what this Objective actually means in practice. We see a distinction between (a) individual parties balancing their position and (b) the balancing of the system as a whole, i.e. supply and demand equilibrium. We see both of these principles as important but applying to different market periods. The objective that individual parties should be efficiently incentivised to balance their position should apply up to gate closure, with cash-out pricing providing the mechanism to incentivise such behaviour. The objective that the system as a whole should efficiently balance applies to the period after gate closure. This is particularly relevant to the balancing mechanism in helping the SO carry out its role, as residual balancer, in an efficient manner. We believe (a) and (b) are related. They are related in the sense that as parties are incentivised to balance their position this should minimise the role of the SO as residual balancer and thus lead to the most efficient outcome for the market.

¹ These are Incentivise an efficient level of security of supply, Increase the efficiency of electricity balancing and Ensure our balancing arrangements are compliant with the TM and complement the EMR CM.

In principle, ensuring that the total system is balanced efficiently could be considered an optimal outcome for the market, i.e. the System Operator is incentivised to balance the market in isolation, with no incentive placed on individual users. However, in reality the most cost effective outcome will be achieved if market participants also face strong incentives to balance their individual positions. This is because there would be no incentive on individual parties to minimise the role of the residual balancer. As such, it is likely that the level of centrally procured balancing actions would increase, resulting in a material impact on end consumers.

The assessment criteria

We believe that a hierarchy is required for the numerous criteria Ofgem has suggested. This hierarchy will help Ofgem determine which options best deliver the desired electricity balancing arrangements. It will also assist in determining which policy options are most relevant to each criterion. For example, a proposal might have a positive impact on sustainability. However, if the proposal is detrimental to the achievement of efficient electricity balancing, then the proposal should be viewed as undesirable.

In our view the most important criterion in the hierarchy should be to ensure efficient balancing, for the reasons provided above.

Consistency

We agree that the method suggested² in the consultation document would allow policy options to be compared in the round. This approach should help Ofgem determine the compatibility of the individual options with one another when determining a final package of reform(s).

We also believe it would be useful to compare internally coherent SCR policy packages with other areas of wholesale market reform that are currently in development (such as the individual elements of the EMR package). This exercise must be conducted in a timeframe that complements these areas of reform.

Stakeholder engagement

We believe that Ofgem's policy formulation process could be further enhanced with additional stakeholder engagement. This is particularly relevant to the period between the deadline for responses to this consultation (24 October 2012) and the indicative date set for publishing the draft policy decision and impact assessment (Spring 2013). We believe that the impact assessment in particular would benefit from stakeholder oversight to allow market participants to scrutinise the proposals being developed.

During the abovementioned period, we expect that Ofgem will be developing quantitative and qualitative evidence to support their preferred policy decision. External scrutiny from stakeholders would enhance this process ensuring that the evidence gathered is robust and allows policy options to be effectively evaluated. This work should reference how the different options perform against the SCR Objectives and assessment criteria, providing evidence to substantiate the conclusions Ofgem reaches. The creation of an industry expert group (or groups), similar to those used as part of the EMR process, could be helpful in allowing stakeholders to input in a constructive and targeted way.

One of the main difficulties stakeholders faced when attempting to constructively contribute to the four stakeholder workshops held between 7 September and 12 October was that Ofgem had not clearly identified what defect(s) exist within the current arrangements. Ofgem must clearly define what is defective in the current arrangements and what should be achieved by any identified improvements. This will enhance the ability of market participants to contribute towards the development of potential solutions to identified defects.

Potential Ofgem Direction

In light of the experience gained from the recent electricity transmission charging SCR (Project Transmit), we consider a key lesson to be that any SCR Direction that results from the process must be very clear on what the subsequent industry process (e.g. code modifications) must achieve. To clarify, the SCR

² Figure 1: Range of potential policy packages set out on page 11 of the consultation document.

Direction should not leave the Code Modification Working Group to 'figure out' what is required to achieve the Objectives of the SCR. A better defined Direction would provide more time for interested parties to develop alternative solutions, which might better address the identified defect.

Question 2: Do you have any evidence that you would like to submit that may be relevant for any aspect set out in this document?

No. Drax is not currently convinced that there is a weight of evidence to justify significant change to the energy balancing arrangements. We look forward to reviewing the evidence Ofgem will provide to substantiate its impact assessment.

Question 3: What is your view on the interactions between our considerations and aspects of the EU target model?

Drax's main involvement with the EU target model is via the European Network Codes which are currently being progressed by a variety of EU institutions and pan European trade associations. The two Network Codes which seem to have most relevance to the Electricity Balancing SCR are the EBF and the CACM Code.

The EBF has just been completed and can be characterised in the main as a high level principles document. As such the contents of the document will be open to a number of interpretations. Nevertheless, our view is that the EBF, as written, does not suggest that the current GB electricity balancing arrangements are incompatible with the guidelines.

However, it would be prudent for Ofgem to continue to monitor the development of the Code, particularly during the ENTSOe drafting stage (where public consultation on the draft Electricity Balancing Network Code is expected to be published in April/May 2013), to determine if certain policy options become incompatible or obligatory. This should help ensure that any recommendations Ofgem propose on the back of the SCR are consistent with the EU target model. Moreover, the EBF would seem to provide plenty of discretion to Member States to determine the parameters of their own electricity balancing arrangements within the overriding framework and principles set. This seems to indicate that Ofgem will have a relatively large amount of leeway to propose reforms to the current arrangements.

Our understanding is that the CACM Code also leaves a lot of detail to be determined at the Member State level. Therefore it seems that there will be sufficient scope for Ofgem to develop proposals without being constrained by the contents of this Code. However, we will only be certain of this when processes to determine Member State level decisions actually begin.

CHAPTER 4: Primary considerations

Question 4: Do you feel there are any further alternatives to the reform options presented under our primary considerations?

We believe that the options presented in the consultation document are comprehensive. Without clarity of what Ofgem's identified defect(s) is, it is very difficult to propose any alternative solutions. While alternatives might become more apparent as the SCR progresses, we believe it is wise to concentrate on evaluating the options that Ofgem has presented.

Question 5: 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.

And;

Question 6: Which of the reform options considered under each of our considerations do you believe would provide the most efficient balancing incentives and why?

Drax believes that the ability of stakeholders to evaluate the reform options is constrained due to a lack of clarity regarding what Ofgem's identified defect(s) is and what the primary objective of the SCR is. We have attempted to answer these questions ourselves (see answer to question 1 for discussion of SCR Objectives) and have come to the following conclusions on the reform options. However, if Ofgem is able to provide greater clarity on the defects and objectives that the SCR is attempting to consider, we will be in a position to re-evaluate our conclusions. We discuss our thoughts on the primary considerations below.

More marginal main cash-out price

The main rationale provided by Ofgem for moving to a more marginal main cash-out price is that it will help solve the "missing money" problem. We believe that this rationale, while perfectly plausible in theory, is fairly academic and not applicable to the GB electricity market. Cash-out pricing is extremely unlikely to provide the incentives required to build reliable generation capacity. This view is implicitly supported by DECC explaining why it is currently designing a capacity market. In light of this, we believe that the only justified reason for moving to a more marginal main cash-out price is to magnify the incentives on parties to balance their position. Moving to a more marginal cash-out price methodology would almost certainly achieve this outcome.

Drax believes that a shift to more marginal main cash out prices³ would be beneficial in promoting optimal electricity balancing efficiency i.e. reducing the PAR value. It would place more efficient incentives on individual parties to balance their position. This would help better optimise overall industry balancing costs for the benefit of end consumers. We can also envisage further benefits. These include potentially incentivising incremental investment in more flexible generation, e.g. improvements to existing and planned power stations. Also, investment in intermittent generation forecasting technologies would be better incentivised which could result in further system balancing cost reductions.

One of the main arguments against a more marginal main cash-out price is the issue of system pollution, which could result in cash-out prices being incorrectly calculated. This could provide inefficient incentives to balance. The risk of system pollution is at its greatest when the cash-out price is calculated based on a single action. However, we note that National Grid's operation of tagging and flagging appears to be accurate (>98%). Moreover, we do not consider that competition concerns currently exist that would prevent a shift to more marginal main cash-out pricing. We also do not believe that the EBFM explicitly prevents or promotes marginal pricing. Therefore we do not believe there are any significant barriers to implementing a more marginal main cash-out price.

However, we do not necessarily believe that main cash-out prices should be set on the final MW trade. More analysis needs to be undertaken to quantify the effects of such a change to ensure that it sufficiently incentivises parties to efficiently balance their position, but at the same time does not lead to unnecessary 'gold plating' of the system to insure against disproportionate risk. Such risk could lead to increased costs to end consumers which are not necessarily efficient. Moreover, we believe that more analysis needs to be undertaken on the tagging and flagging methodology if it is decided that a fully marginal main cash-out price is desirable. As previously stated, the risk of system pollution is at its greatest when cash out prices are set on the marginal MW trade. Therefore greater confidence is required on the efficacy of the tagging and flagging methodology before such a change can be made.

³ For the avoidance of doubt, we consider more marginal pricing is synonymous with more expensive prices, i.e. more inferior actions.

Single or dual cash-out price

We believe that the hybrid models discussed in Ofgem's consultation document seem overly complicated, providing little additional benefit to the two better understood proposals, i.e. dual cash-out and single cash-out pricing. No firm case has been made for why any of the hybrid models would represent an improvement compared to single or dual cash-out prices. Moreover, some of the hybrid models would appear discriminatory, in part due to treating imbalances in opposite directions differently when both long and short imbalances are actually of equal importance. Unless these approaches are justified we see no need to consider these models further. Therefore we restrict our main opinions to the single and dual cash-out pricing approaches.

In theory, we are unconvinced that single and dual cash-out pricing methodologies produce substantially different incentives for individual market participants. Dual cash-out pricing provides clear incentives for participants to balance their position. This theory has been borne out in practice, although there is a body of opinion that believe it has incentivised parties to go long, due to the asymmetric risk of a potentially penal SBP versus a more benign SSP. While this asymmetric risk probably exists at present, we do not believe that this is caused by the dual cash-out price in itself. It is rather the differential costs of bids and offers, i.e. the same effect would occur under a single cash-out pricing methodology. In either case, the most prudent position is to be balanced regardless of whether parties tend to go long or short.

With regards to a single cash-out price⁴, a common view among the industry is that parties would be incentivised to go even longer and spill power to get paid a high value cash-out price (SSP). However, we believe that this would not occur in practice, as should the market (en-mass) spill power then this would lead to a collapse in the electricity price. This would result in spilling parties receiving very low or perhaps negative cash-out prices. In effect, there would be no benefit in spilling power.

A further consideration for the future is that with the expected connection of greater levels of intermittent generation, it is more likely that the SO will be forced to take bids from such plant to balance a long system. As this form of generation is likely to require a high bid price (due to the value of lost ROC opportunity), the SSP is likely to be more volatile and go negative more frequently. This could have the effect of reducing the asymmetric risk between SBP and SSP meaning parties will be more wary of going long.

There is also a view that certain parties might be better able to anticipate system length and thus better 'play' a single cash-out price to maximise returns. While we believe that further analysis on this would be beneficial, we are unconvinced that individual parties are better able to anticipate system length as all parties in practice view the same data. It would seem that if parties attempted to anticipate system length and react accordingly, a herd like effect would occur and negate the benefits associated with anticipating system length (similar to the scenario illustrated above, prices collapse, etc.).

With regards to which approach is more cost reflective, as explored by Ofgem's slides during an SCR Workshop, we are unsure what Ofgem is attempting to evaluate here. We do not believe that the cost reflectiveness of cash-out prices is ultimately determined by whether a single or dual cash-out price is employed. The most important aspect to consider is whether the correct incentives are provided to market participants to efficiently balance their position. We consider this is likely to be the case as long as the main price is set by relatively marginal SO actions. Overall, the discussion seems to be a bit philosophical in our opinion.

In terms of simplicity, we do not believe that a single cash-out price is particularly simpler than a dual cash-out price. We are less convinced that it would improve market entry opportunities as a result of being considered simpler.

Taking account of the above points, we believe in theory that either a dual or single cash-out price is likely to incentivise parties to balance their position. However, we believe that of the two options the current dual cash-out price arrangements are most appropriate. This is for the following reasons:

⁴ For the avoidance of doubt, we envisage that the single cash-out price would be set based on SO actions (main price) not a market index price (reverse price). In our view, a single cash-out price based on a market index will be more prone to manipulation by market participants which could lead to perverse incentives and consequences.

1. The dual cash-out arrangements can be demonstrated to incentivise parties to balance their position. In practice too, we believe that parties react to the signals provided and try to balance their position. In summary, it has worked in our market, and benefitted from refinement, since its introduction. Moreover, we do not believe that the EBFGB intends to prohibit dual pricing.
2. A compelling positive case for shifting to a single cash-out pricing system has not been provided. Why go through the upheaval (to pricing methodologies, IT systems, market participants contracts, etc.) if there is unlikely to be much difference in the incentives provided and the outcome?
3. Whilst in theory a single cash-out price is likely to incentivise parties to balance their position, there might be subtle differences in the incentives produced for different market participants. For example, highly vertically integrated parties might be better able to offset opposing imbalances held by their generation and supply assets by spilling and/or going short on their generation output. This might have detrimental impacts on competition and/or the SO's role (particularly as such actions are being taken post-gate closure).

If Ofgem considers that a single cash-out pricing methodology would provide benefits over the current arrangements, it will need to produce further analysis/modelling to test how incentives on different parties might develop under a single cash-out price method. It will also need to consider the effect on competition, the SO, and most importantly, whether it would optimise the electricity balancing arrangements. It should also be noted that implementing a single trading account style reform would negate one of the main purposes of implementing a single cash-out price, i.e. to eliminate the SBP-SSP (main and reverse price) spread.

Single or separate trading accounts

We believe that the issues being discussed by the P282 Modification Workgroup are very relevant to the debate on whether to implement a single trading account rather than retain separate production and consumption trading accounts. As such, the analysis undertaken by the P282 Working Group has provided a valuable source of information for the industry on this issue. It is our view that allowing parties to net off their opposing energy imbalances (which a single trading account would provide for) is likely to slightly dilute incentives to balance and could involve the SO incurring additional costs to the detriment of achieving optimal electricity balancing. In addition, further thought might need to be given on the possibility that non-Grid Code parties, i.e. licence exempt generators, might be incentivised to spill after gate closure to achieve 'netting' benefits.

However, if Ofgem is minded to implement reform to introduce a single trading accounts style option, then we believe the best solution would be to approve the P282 MVRN solution. We recommend this approach for two main reasons. Firstly, P282 is not a mandatory change. Those parties that do not wish to adopt the solution do not have to, i.e. they can continue to operate separate production and consumption accounts. Secondly, it is also the least intrusive change, which indicates that the costs associated with the solution are likely to be lower than introducing single trading accounts. Conversely, we consider implementing compulsory single trading accounts to be more intrusive and entail higher implementation/system costs.

Pay-as-bid or pay-as-clear for energy balancing services

In theory, the benefits of pay-as-clear, as outlined in Ofgem's consultation document, would be beneficial in optimising the electricity balancing arrangements. Pay-as-clear would ensure that the prices of energy balancing actions are efficiently calculated. At present, market participants attempt to maximise value captured in the BM. Under pay-as-clear we believe this process would be further optimised and reduce over and under valuations, as parties do not currently know what the marginal bid/offer is in each half hour

It would also lead to a change in behaviour by generators that result in bids/offers reflecting their underlying efficient short run marginal cost. Furthermore, there is sufficient competition in the generation market to ensure that a move to pay-as-clear pricing is unlikely to lead to gaming concerns. Ultimately, however, the real question is whether pay-as-clear for energy balancing services can be implemented efficiently in practice.

The BM is currently used for executing both energy and system actions. There is a great deal of uncertainty surrounding the reasons why individual bids and offers are accepted by the SO. In some circumstances bids and offers will be taken for both system and energy reasons. Therefore, it seems unlikely that a pay-as-clear approach could be developed for energy balancing services. Moreover, there is a real risk that in attempting to amend the Balancing Mechanism, the SO's role might be impaired such that the SO will no longer be able to exercise synergies associated with being able to take system and energy actions in the most cost effective manner. Therefore, while in theory pay-as-clear has a number of attractions, in practice these benefits are unlikely to be realised.

However, we note the EBF states a preference for pay-as-clear⁵. Therefore, it would seem prudent to investigate the practicalities of implementing such a change, should it become a requirement for the GB market. Ofgem and National Grid should investigate how, in practice, pay-as-clear could be made to work; this process should involve input from interested stakeholders. This might be achieved by implementing a further form of flagging in the BM. There might also need to be separate procurement processes for system and energy BOAs (with parties perhaps submitting two sets of bids and offers, one set to be used under pay-as-clear and one to be used under pay-as-bid).

Attributing costs to non-costed actions & improved allocation of reserve costs

We recognise the benefits of trying to ensure that the costs of various actions are allocated in a cost reflective manner. However, of the limited number of proposals submitted by Ofgem at the Workshops held to improve STOR option fee targeting, none of these seem to represent an improvement on the methods the market currently employs⁶. Of the STOR option fee targeting proposals suggested we consider:

- (ii) Buy price adjusted with forward-looking element: We are unconvinced that the SO would have the required expertise to accurately forecast the forward-looking element.
- (iii) Uplift based on ex-ante expected usage: Similarly, we do not believe that the SO has the required expertise to predict ex-ante the expected usage.
- (iv) Replacement price: We consider that such a methodology risks being inherently arbitrary. There is no guarantee that the replacement price is like-for-like in terms of the output characteristics it produces.
- (v) Ex-post adjustment: This could materially distort ex-ante balancing signals to the detriment of optimising electricity balancing arrangement costs.

If more efficient STOR option fee targeting methods can be developed then we believe there may be some benefit in implementing them. However, until these new approaches can be demonstrated to be an improvement on the methods the market currently employs, we believe that it might be best to retain the current arrangements. This approach is further justified given that the materiality of the problem (that inaccurate cost allocation is perceived to cause) has yet to be ascertained. This is further work that needs to be undertaken by Ofgem. Further thought should also be given to the fact that STOR is often used within a given settlement period, whilst market participants are incentivised to balance prior to the start of the settlement period. Thought should be given to how this might distort balancing incentives.

The process for allocating non-BM STOR costs appears to be the best candidate for reform. A methodology similar to that used by BM STOR might be appropriate. However, Ofgem will need to undertake analysis to determine whether the costs of non-BM STOR would have a material impact on cash-out prices, otherwise there could be a disjoint between the cost and benefit of such a reform.

Better targeting of reserve creation costs could provide theoretical benefits. However, the ability of the SO, or any other organisation, to do this in an effective way would seem very difficult. More analysis is required on the materiality of the problem and how viable the potential solutions could be before a more meaningful view can be provided by market participants.

⁵ Framework Guidelines on Electricity Balancing, 3.3.1 Activation of balancing energy p.16

⁶ Where option fees are currently targeted into the seasons and settlement periods that STOR was used in the previous year using the Buy Price Adjuster. We accept this method is far from perfect.

We are wary of introducing the concept of VOLL in to the electricity balancing arrangements as it is an entirely subjective concept that cannot be efficiently determined. VOLL would likely be attributed a very high value which would increase the risk, and thus costs, that parties and ultimately consumers would have to bear. These additional costs could not be justified as VOLL cannot be calculated efficiently.

With regards to voltage control, as this is applied to all parties when activated by the SO, we are unsure how the costs of this activity could be targeted in a meaningful way.

Balancing Energy Market (BEM)

We understand that one of the main objectives of this proposal is to better ensure that system actions do not pollute the energy imbalance price. In any case we have found it very difficult to adequately evaluate this proposal without a more clearly defined working model of how the BEM would work in practice. We would encourage Ofgem to undertake the task of explaining how a BEM would work in practice. However, our initial view is that such a change is likely to be very intrusive to the market and unlikely to be required to address any perceived defect. The changes that a BEM would try to introduce can probably be more easily implemented by incrementally amending the current arrangements. In effect, the scale of the intervention is highly unlikely to be commensurate with the defect Ofgem is trying to solve.

Moreover, there is a great risk that a BEM will reduce the synergies that the SO is, at present, able to exploit in managing energy and system issues in the most efficient manner. Also, it would be very difficult for National Grid to accurately forecast the NIV.

Alternative arrangements for renewables (intermittent generation)

We do not believe that providing special arrangements for particular forms of generation technology is likely to promote efficiency (and innovation) in the electricity balancing arrangements. The proposals discussed to date seem to involve particular generation technologies externalising the costs they create and then socialising these costs across the whole market. This does not seem to be a recipe for promoting optimal electricity balancing arrangements. Moreover, it appears that the EBFG envisages that intermittent technologies should not receive preferential treatment with regards to the balancing arrangements⁷. Therefore, we do not believe there is a strong case for regulatory intervention to target special treatment on specific generation technologies.

With regards to two of the three options proposed by Ofgem at their recent workshop⁸, we believe there are further disadvantages associated with the models it is considering:

1. It is plausible that a number of smaller aggregators are more likely to provide a reliable combined forecast than a single central aggregator because forecasting errors are likely to net off to an extent. There is also a danger that efficient market solutions will be crowded out by centralised regulatory interventions;
2. In particular for Option 3, this suggests that the imbalance risk after gate closure for intermittent generation would be passed to the SO. The SO would then smear the costs of this risk across the whole market. This is completely unacceptable. If this option was pursued we would expect similar treatment for non-intermittent (flexible) generation, e.g. if freight carrying fuel was unexpectedly delayed or there was a gas interruption;
3. The options could reduce incentives to invest in improving weather related forecasting;
4. We note the experience of the German market where intermittent generators have been incentivised to balance their own positions, having previously not had this responsibility;
5. Ofgem needs to consider carefully how these approaches might interact with the PPA market and NGET's work-stream on intermittent generation (power available concept, etc.);
6. Could intermittent generators not take advantage of the existing MVRN process instead?

⁷ "generation units from intermittent renewable energy sources [should] not receive special treatment for imbalances" 5.2 p24 of the EBFG

⁸ Option 2: Central Aggregator and Option 3: SO taking responsibility for fluctuations after gate closure. In particular, more work is required to explain how Option 3 would work in practice.

Overall, we do not believe that a compulsory mechanism for insulating particular generation technologies from market fundamentals is warranted. Option 1, of those presented to the Workshop (Monitor independent aggregation), would seem the most appropriate course to take.

Demand Side Response (DSR)

Ofgem throughout its consultation document mentions the need to facilitate greater DSR participation. We agree that it is appropriate that DSR should compete with generation technologies. However, this competition has to take place on a level playing field otherwise the efficiency of the market is likely to become skewed with any resulting cost borne by end consumers. It is important that the electricity balancing arrangements are designed with the principle of non-discrimination in mind so that the arrangements incentivise optimal technologies and solutions.

Question 7: Alongside this initial consultation 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?

Overall, we believe that the findings are reasonable and intuitive.

However, we are unsure that the efficacy of the flagging and tagging process is quite as comprehensive as indicated by the analysis. The analysis claims that P217A has improved the extent to which cash-out prices reflect the cost to the SO of energy balancing. We do not believe this can be fully confirmed unless analysis is undertaken to determine the efficacy of the tagging and flagging methodology (something Ofgem has yet to attempt). Unless this analysis is undertaken it is likely to make moves to a fully marginal main cash-out price more controversial.

Question 8: What additional analysis could be done as part of the SCR around Modification P217A and the flagging methodology it introduced?

Ofgem needs to test the efficacy of tagging and flagging methodology. Work should also be done to ascertain the effect on cash-out prices by moving to more marginal cash-out pricing methodologies particularly in 2008, where wholesale prices were particularly volatile. National Grid should also look into how many actions would typically make up the PAR level to establish how many prices are being averaged and therefore the extent to which system pollution could cause a problem.

Question 9: Do you agree with our rationale for considering making cash-out prices “more marginal”?

Please see answer to question 6.

CHAPTER 5: Secondary considerations

Question 10: Do you agree with the circumstances we have identified in which the secondary considerations are important?

Similar to our response to question 6, we have attempted to answer these questions in accordance with our view of what defects exist within the current arrangements and what the primary objective of the SCR should be. These views will be re-evaluated if Ofgem provides a clearer indication of the defect(s) and Objectives. Our views on each of the considerations are provided below.

Improved provision of information

It might be worth Ofgem providing a questionnaire to market participants to gather their views on what additional information might be useful to help balance the system. We would be interested to see the views provided from market participants. However from our perspective, we are not of the view that any

additional information is required to ensure that parties are able to balance their positions. It seems to us that the information required to balance is already freely available to market participants.

A Reserve Market

It is unclear as to what is currently wrong with the current procurement of reserve. If Ofgem could clarify what it believes is defective with the current arrangements we would be able to provide further comments. However, of the options considered by Ofgem⁹, Straw man 3 seems particularly unworkable. Ofgem needs to consider the effects on competition, liquidity and the capacity market before it can develop a fully workable proposal.

In any case, as the current arrangements seem to work well we are content to leave them untouched. Moreover, it is far from clear that the EBFGB would require the UK to make amendments to the current procurement of reserve in GB. However, a review of the procurement of reserve might be warranted after the conclusion of the EMR work-stream (in particular the Capacity Market reform).

Amending Gate Closure

We cannot see a great benefit of changing this. The EBFGB suggests that GB will probably be compliant with the suggested gate closure time¹⁰. There would have to be adequate liquidity to allow market participants to take advantage of a small reduction in the current gate closure. There is also the problem of notification risk which is likely to deter parties from trading closer to real time even if gate closure is incrementally reduced.

RCRC

We do not consider that the current existence of RCRC is of much concern for market participants or the industry. It is just a mechanism to ensure that the correct revenue is recovered. The impact of proposals on RCRC should be considered, although no great weight should be attributed to the effects on RCRC in determining the merits of the other options.

Reverse Price

We do not believe there is currently a problem with the methodology for setting the reverse price. However, the requirement of a reverse price will ultimately depend on whether a single or dual cash-out pricing methodology is adopted. Our view is that the dual cash-out pricing should be retained and as such the reverse price should also be kept.

Setting an information imbalance charge

The SO takes actions to balance the system because it either knows that the system will be long or short or because it has reason to suspect that the system will be long or short. If parties are not providing accurate FPNs this is likely to mislead the SO resulting in it taking actions it otherwise would not be required to. It might even result in the SO incurring further costs related to having to unwind these actions previously undertaken based on misleading information.

Therefore we believe there is value in amending the BSC to set an information imbalance charge. In our opinion, the incentive would help reduce electricity balancing costs for the benefit of end consumers. It would also help incentivise more efficient forecasting techniques for intermittent generation, which is likely to further reduce system balancing costs. We do not believe that current Grid Code provisions are sufficient in incentivising parties to behave in an efficient manner.

Ofgem should investigate users' operating deviation from submitted PNs over the last decade to gather an understanding of the potential materiality of this issue. We accept that further work needs to be

⁹ Straw man 1: One sided market, Straw man 2: Two sided market and Straw man 3: two-sided market – offsetting imbalance risk

¹⁰ "The Network Code on Electricity Balancing shall allow BSPs [market participants providing balancing services] to place and/or update their bids as close to real time as possible and at least up to one hour before real time". Para. 3.3.1 Activation of balancing energy p16.

undertaken to determine how the value of an information imbalance charge will be set. However, we believe this work can be undertaken as part of the next stage of the SCR.

Question 11: Do you have any other comment on the secondary considerations presented here? Please provide any evidence you may have to support your position.

We have no further comments.