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Dear Andreas,

Consultation on Electricity Balancing Significant Code Review

Thank you for the opportunity to respond to the above consultation. E.ON's view is that it is important to ensure that existing electricity balancing arrangements support developments to the GB market being introduced by Electricity Market Reform (EMR), and the European Third Energy Package drive towards a single internal market for energy. With challenging timescales to implement a Capacity Mechanism for EMR to take effect in 2014, we believe it is desirable to complete a cash-out review in a timely manner. However, putting further aspects of balancing under review, and suggesting radical new arrangements, seems unnecessary and greatly increases uncertainty for existing and potential market participants.

With challenges faced by the industry not limited to EMR and the Retail Market Review (RMR) proposals, the electricity market is currently facing an unprecedented volume of change, while the roll-out of initiatives such as the Green Deal and smart metering must also be managed. We think it would be inauspicious to effect further market intervention in the next few years beyond any required to support TransmiT, EMR, or comply with European legislation. Market participants have recently faced a multitude of regulatory changes both British and European (e.g. the Transmission Constraint Licence Condition in GB; EU Markets in Financial Instruments Directive/Regulation (MiFID II) and Regulation for Energy Market Integrity and Transparency (REMIT), etc.). Resources are now being further stretched to handle forthcoming changes such as EMR and potentially additional measures in the Energy bill aiming to promote liquidity and competition. Clearly a long-term, stable policy framework is preferable to give some certainty to parties in all areas of the market; the SCR having such a wide scope does not improve things. An operating environment involving so many significant developments is challenging for many companies without the prospect of radical new balancing arrangements, or unwarranted adjustments to existing processes. E.ON supports the evolution of market arrangements to help facilitate security of supply while increasing volumes of renewable generation. Diverting resources from EMR, however, might jeopardise what is already a challenging timescale for this reform. We are also concerned that the more significant changes are made, the greater the risk of unintended consequences. Trying to develop some initiatives in parallel (such as development of a strike price simultaneously with cash-out reform) might appear efficient, but also risks multiple unintended consequences. This could potentially lead to parties going out of business and other regulatory changes being undermined, risking missing targets for reform and increasing costs to customers. It must also be noted that the uncertainty created by a wide-ranging review does not aid investor confidence and is unhelpful to potential as well as existing industry parties.

More fundamentally, we do not believe there is sufficient reason to make major changes to existing arrangements. Interfering with a design that works would not be a positive move especially when the industry faces so many pressures. In particular, we think that to change the reserve market is unnecessary at this present moment when it is unclear what role the Capacity Mechanism (CM) may play in this regard. Current cash-out prices, we believe, provide the right level of sharpness for the balance of the industry and have been developed through a number of Balancing and Settlement Code (BSC) modifications which have resulted in a cycle of sharpening and dampening imbalance prices. There is a suggestion that signals could now be made sharper through a more marginal imbalance price. In light of the impact that this could have on intermittent plant at a time that we are trying to increase the share of renewable generation on the system, we believe that it would not be productive to pursue this further, but that there may be merit in adopting a single cash-out price.

In addition to national developments, the European Electricity Target Model (TM) for market integration also has very challenging timescales. We believe that it is sensible to consider whether modifications might in due course be required to adjust GB balancing arrangements to further development of the Target Model (as has already happened, e.g. in CMP202 removing Balancing Services Use of System (BSUoS) charges/payments from Interconnector Balancing Mechanism Units, to facilitate cross-border trade). Beyond ensuring that balancing arrangements complement EMR, any further review should aim to highlight key issues and plan what actions should be taken in GB as European requirements evolve, but not rush to implement any ‘solutions’ before these are clear. We are wary of the risk of making pre-emptive changes at significant cost and disruption that might later have to be unwound or otherwise amended, increasing costs to consumers.

Further to these comments, our responses to the individual questions in the consultation are as follows:

<u>**1:** Do you agree with the approach and the proposed stakeholder engagement throughout the SCR?</u>

No. We strongly believe that extensive further engagement with stakeholders is required to develop the suggestions put forward in the initial consultation prior to any decisions being made. We appreciate the stakeholder events that Ofgem held in September and October and the chance for parties to contribute to discussions on those occasions. However, we were disappointed that little further information was forthcoming from Ofgem at these events, particularly when some of the more radical proposals are lacking in practical detail. It is difficult to comment on the suggestions made where some of these are only the 'bare bones' of an idea. We note that a potential follow-up seminar is scheduled for November; that would be welcome, and we would urge Ofgem to produce a detailed strawman particularly for the more radical proposals floated in the initial consultation. This would allow stakeholders to provide more informed feedback, which will arguably lead to a better outcome. We also believe there is merit in having more focused stakeholder engagement, with an industry working group to develop the more detailed design aspects of the options that will ultimately be taken forward for serious consideration.

It is therefore particularly concerning that Ofgem's current schedule suggests that a 'draft policy decision' could be made in spring 2013 on the back of only the initial consultation responses, without industry assistance to develop proposals that are presently only sketched out at a very high level. We would welcome the publication of a timetable for further industry engagement, with an 'action plan' anticipating when and why intervention might be prompted as other GB and EU policies progress, such as on EMR and the Target Model.

We appreciate Ofgem's acknowledgement that this SCR is anticipated to take 18 months, not 12 as SCRs were originally intended to last. However 18 months could still be challenging for such a wide review, more so if other changes in the regulatory environment require aspects of the SCR to be reconsidered. Elements of the SCR also have differing levels of materiality. We are mindful that any changes to support implementation of a Capacity Mechanism should not be delayed. But also, that decisions and potential implementation of some of the simpler proposals in scope (such as single or separate trading accounts), of less importance but that could be a standalone change of benefit to parties, will be delayed until the entire SCR has been completed. In consequence we urge Ofgem to work closely with industry to further explore the potential options; in particular to clarify as soon as possible which issues are deserving of further development and which might not be practical to take forward at this time, so that limited resources can focus on refining those options that could be useful.

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

We note that little if any evidence has been put forward in the consultation to suggest that electricity balancing is becoming either more difficult or more costly, and exactly how or why various proposals suggested might help. The lack of justification, and in some instances insufficient detail, makes it difficult to comment on some of the proposals, such as the Balancing Energy Market (BEM). There is also merit in allowing the market to develop in response to changes resulting from innovations as the N2EX trading platform. Likewise, for EMR measures such as a CfD strike price and the CM to be implemented before any significant reform of balancing arrangements is considered. This would allow a more informed review to take place if deemed necessary once their impact could be assessed.

3: What is your view on the interactions between our considerations and aspects of the EU Target Model?

The SCR must take account of the wider European market context to prepare for potential changes to ensure that the GB market arrangements do not conflict with the Target Model. Now that European Network Codes (NCs) are being developed to progress the TM, it is essential that Ofgem understand stakeholders' concerns on the various considerations and their interactions. We therefore welcome Ofgem's involvement in the cross-Code Joint European Standing Group (JESG), set up to facilitate two-way communication between stakeholders and National Grid (as TSO) where impact on the GB Codes is being considered.

While ACER's final Electricity Balancing Framework Guidelines (FWG) were only published in September, we hope for earlier stakeholder engagement from National Grid (as TSO), with Ofgem's input via the JESG while the Balancing NC is in development. In summary, reviewing current arrangements to assess how to achieve the best solution for GB in Europe is desirable, but this does not mean that there should be a rush to revise these arrangements. A holistic review of balancing in preparation for the impact of the related European NCs is welcome, but careful consideration is required before embarking on major change to the existing arrangements.

As far as specific considerations are concerned, as yet, we do not know whether the GB market will form one or more pricing zones under the European Target Model, or how this would affect the calculation and application of cash-out prices. We note that Ofgem have remarked that the SCR will not wait for market splitting, rather reassess when necessary; but it would be preferable to avoid repeating work.

We note that the Electricity Balancing FWG require imbalances to be settled in a non-discriminatory, transparent, fair and objective way. While a single or dual price for imbalances is being considered under the Target Model, it appears that the FWG can be interpreted to support either. However ACER have noted that many responses to their draft FWG did favour a single, marginal price, and the final FWG, in 3.3.1 does suggest that balancing energy products should be 'based on marginal pricing (pay-as-cleared)', unless a different methodology is demonstrated to be more efficient. We understand that a single account is the norm in Europe.

Any Value of Lost Load (VoLL) chosen would need harmonisation across the EU, i.e. co-ordination with the Balancing NC.

Regarding reserve, future reforms may be needed to fit into a single European market where the Target Model has a different view of reserve and balancing. However, if this does transpire to be required it would be part of much bigger change potentially moving away from a Balancing Mechanism.

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

No.

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.

The current balancing arrangements already provide a strong incentive for parties to balance. It does not appear that making cash-out prices more marginal would bring any further benefits to the market. Economic theory might suggest that changes to a marginal cash-out should be made as this is the result which would occur under a perfectly competitive market. However, in models of perfect competition this outcome arises when all parties price at the marginal level as a result of perfect information. In reality, perfect information does not exist in the market and parties are unable to achieve this outcome. Forcing the imbalance price to be set on a marginal basis is not a substitute for a theoretically perfect market outcome and instead provides parties with a risk which is very difficult to manage.

Parties cannot predict when prices might spike, so it would seem futile and unfair to expose them to a marginal price. In particular, small companies might have already changed their behaviour as much as possible, or be unable to find other parties such as aggregators willing to take on their risk.

Intermittent renewable generators such as wind farms will be vulnerable to more marginal pricing, and it is not clear that sharpening the signal will change behaviour. They may find it difficult to change their behaviour due to the intermittent nature of their fuel source, and have already invested significant sums to improve forecasting capabilities in order to minimise imbalance exposure. At a time when we are trying to encourage more renewable and low carbon generation through subsidy payments, increasing the potential balancing costs will simply result in a higher level of subsidy being required to attract this investment.

A Price Average Reference (PAR) of 1MWh may also not be appropriate because the SO takes balancing actions for different reasons over different periods. Some actions are for system and energy so accurate flagging would be crucial to determine the marginal action for energy. The size of the marginal action also then comes into question – how many trades might make up a PAR of 500/250/100MWh? PAR 1MWh might be more consistent with the concept of a marginal price, but should one be set on what might be a very small action?

Though various BSC modification proposals to change the current dual cash-out pricing system have been put forth and rejected by GEMA since NETA, Littlechild and Cornwall concluded that the drivers for the dual price as set up in 2001 were less of a concern by 2007. We agree that a single price is now preferable, and may help to increase liquidity in the market, which will be a key ingredient for encouraging new market participants.

Dual accounts serve no purpose and simply waste time and money to administer. We do not believe that trading and hedging activity would reduce with a move to a single trading account. We are mindful too that vertically integrated companies supply the bulk of domestic demand; ultimately the consumer is paying for this artificial arrangement to be administered. In recognition that systems have been set up for managing dual accounts, maintaining both, but pooling the imbalance post-event might be a simpler solution to realising the objective of a single trading account, whilst minimising IT changes and costs for parties and ultimately customers.

While pay-as-clear has merits in theory, we are not convinced and think it more practical to continue with a pay-as-bid mechanism. Bidding depends on more than just the short-run marginal cost (SRMC) but also on physical issues such as plant dynamics and running plans. Under a pay-as-clear system, flagging of system actions also becomes more critical, raising the difficultly of tackling actions that impact system and energy. A flagging error could have serious consequences and it would have to be considered how such situations could be challenged.

Attributing a cost to non-costed actions, while desirable in theory, would be difficult. Establishing a robust value for voltage control and VoLL would be essential but difficult to achieve in practice. It is also unclear whether VoLL would actually incentivise demand-side response, or feed through to prices. Prices may rise towards VoLL but if this did not feed into the far end of the curve it would not help to incentivise generation investment. There is also an interaction with the Gas SCR (where Ofgem's estimate of VoLL is punitively high at £20/therm for domestic customers in a Gas Deficit Emergency), in the context of generators consuming gas to produce electricity.

To develop better allocation of reserve costs, clarification of the interaction between the Capacity Mechanism and reserve is necessary. However, improving targeting of reserve costs is challenging. The ex-ante options being considered by the SCR all rely on an assumed attribution of costs which on an out-turn basis may not reflect reality. We are not convinced that any of the alternatives put forward represents any significant improvement on the current approach.

The proposal around a Balancing Energy Market represents a more radical approach to the current regime. We are extremely disappointed that this concept has not been firmed up to explain to stakeholders how such a regime would operate, what it is seeking to achieve, and an assessment of the pros and cons of the proposal. Further clarity is required before parties can provide more detailed comments. An initial observation with an ex-ante cash-out regime is that the assumed forecast imbalance is wrong, requiring more SO actions than initially thought, which would have the effect of increasing costs for customers.

For intermittent generation, the current arrangements already provide strong incentives to actively manage imbalance risk. We note that central aggregation could benefit from a pooling of fluctuations across GB. However, the market is also providing this type of service. We believe that if there is to be a focus, it is to consider how the current balancing arrangements could be improved in specific areas that have the effect of encouraging new commercial aggregators into the market place, rather than proposing effectively a single buyer approach that would stifle innovation and efficiency.

6: 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 that much of the existing balancing arrangements have worked, but that there are some areas where improvements could be made. In particular we would strongly urge the removal of dual cash-out prices and separate production and consumption accounts. More radical change should not be considered at this moment in time until the Capacity Mechanism proposals have been fully developed and the full implications of the Target Model are known.

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?

Yes.

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

Detailed issues such as whether system and energy actions are identified accurately have been extensively examined in the past ten years, as part of Ofgem reviews and through the assessment of modification proposals regarding cash-out arrangements in the Balancing and Settlement Code. We doubt that further effort in this area would be particularly beneficial, and have to trust National Grids' analysis, which for 2010-12 suggests that where prices would have spiked under a Price Averaging Reference (PAR) volume of 1MWh, this would have been owing to energy actions. However it would be useful to repeat this analysis for 2008, when the system was under greater stress. Also, as a smaller PAR value, particularly PAR 1MWh, would indeed make accurate flagging more important, it might be interesting if National Grid could consider if/how they might split out actions for both System and Energy purposes. It would also be informative to understand how many trades might make up a PAR of 500/250/100MWh? PAR 1MWh might be more consistent with the concept of a marginal price, but should one be set on what might be a very small action?

9: Do you agree with our rationale for considering making cash-out prices „more marginal"?

No. It is not possible for parties to predict spiking prices, thus 'peakier' prices would just raise risks to all. To operate under greater risk of financial penalty, parties would require greater reward, while the likelihood of increased costs might cause banks to request more collateral, potentially a challenge for smaller companies in particular who could be hit hardest by marginal prices. If any were to go out of business as a result, this would result in less competition and increasing costs, to the detriment of the consumer.

Secondary considerations

10: Do you agree with the circumstances we have identified in which the secondary considerations are important?
11: Do you have any other comment on the secondary considerations presented here?

Information provision could be improved, for instance more information provided to parties on embedded generation with an import/export meter. Sources of demand-side response should also be made more transparent, both the type of DSM, availability and utilisation thereof (ideally broken down by provider, without necessarily naming the provider). For non-BM STOR, this would be useful to level the playing field for ancillary services to give BM STOR providers the same degree of information that non-BM are currently privileged to have.

We do not believe that the case for a separate reserve market has been made. Furthermore we believe that if there was a need for one, it could emerge naturally, provided there were no regulatory counter-measures.

In respect of shortening gate closure; key to this is whether National Grid could manage it, as it would reduce the SO's operational timeframe to balance. It would be less transparent than the current set-up, and shortening timescales might also be impractical for some plant. On balance we do not believe any changes should be made now, in light of the potential for harmonisation across Europe at some stage in the future. Ex-post contract notifications of pre-gate closure trades, however, could be relatively straightforward to implement and helpful to parties in giving another ~15 minutes to self-balance rather than having to spend time ensuring that notifications are accurate.

We see no reason for an information imbalance charge. Not only would this be difficult to set, but unnecessary when parties already have obligations under the Grid Code and do not want to risk breaching licence conditions.

In conclusion

The SCR should focus on ensuring that cash-out arrangements are fit for purpose to deal with a changing market and a significantly different generation mix. It is sensible to plan for the potential impacts of European policy developments as well as EMR, but not to pre-empt them unnecessarily.

We believe that the timescales suggested for the SCR are too challenging and risk detracting resources from other key concerns in the industry at present, such as the Capacity Mechanism. Some ideas require much more commitment to develop; we hope that following this initial consultation Ofgem will engage in further work with industry. It would be most helpful to all concerned to clarify promptly which potential options will not be taken forward, to reduce uncertainty and enable resources to be focused on developing workable solutions on those measures which might be progressed.

If you have any queries, please do not hesitate to contact me.

Yours Sincerely

Esther Sutton
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