

Deadline 24 October 2012

Jamie Black
GB Markets
Ofgem
9 Millbank
London
SW19 3GE

23rd October 2012

Dear Jamie

Electricity Balancing SCR

Eggborough Power Limited (EPL) is an independent generator which owns and operates Eggborough Power Station (EPS), a 2,000 MW coal fired power station situated in the Aire Valley in North Yorkshire. EPS was previously owned and operated by British Energy (and latterly EDF) to provide flexible and reliable mid merit support to the "baseload" nuclear portfolio. EPL is now owned by substantial private shareholders, and is operating as an essentially merchant power plant in the wholesale market.

Overview

EPL finds it difficult to respond to this consultation as the potential changes raised, while they could stand alone, realistically represent a variety of packages. We have therefore commented below on the different elements in the consultation, but believe Ofgem will need to put forward additional "packages" to allow parties to really judge the potential impacts. Notably the Secondary Consideration, is too high level at the current time to make detailed comments on.

There are some wider market issues that also need to be considered. Does Ofgem believe that the cash-out mechanism should encourage bi-lateral trading, or would a simple system of self-despatch against a single price work better? Do Ofgem want the incentives to change from doing what you said you would do to self balancing? EPL would like to see some better defined objectives and principles.

Objectives

Ofgem's objectives are too high level to give a meaningful set of goals against which to judge the likely success of any proposed policy changes. The statement of objectives is laudable, but how will Ofgem judge if the arrangements are more efficient or have delivered new capacity? EPL would suggest that Ofgem should refine their objectives to create some defined output that they are aiming for.

As EPL has said before, we remain of the view that the cash-out mechanism, while not perfect, is fit for purpose. We are also concerned that the discussions are occurring against a background of EMR developments, which remain too high level to allow reasonable consideration of potential interactions with cash-out. It could be very costly to make SCR changes only to find that changes then implemented under EMR require additional changes to cash-out. The same can be said for the EU target model, which is too undefined to allow a robust assessment to be undertaken.

On the Capacity Mechanism there are some specific interactions with the pricing of energy when capacity plant is used. For example under dual cash-out this plant will look to sell ahead, but under single it may chose to spill. These incentives may create additional issues for the SO. Ofgem says it wants to encourage new build with changes

to cash-out, which also seems to be the goal of EMR. When EMR policies are better defined then Ofgem can sense check that cash-out supports those mechanisms rather than working against them.

EPL believes that Ofgem needs to better define its concerns and goals before moving forward into an assessment phase. In the meantime, EPL would like to see Ofgem focus on the more pressing issues of market liquidity that create a bigger barrier to efficient development of the market than the cash-out rules do. Liquidity also seems vital in delivering EMR, notably the CfD FITs proposals.

Key issues

More marginal main cash-out price

The current arrangements encourage parties to buy/sell ahead of gate closure to cover what they believe their physical position will be and to then deliver/take power as notified at gate closure. The cash-out prices are currently expected to be "worse" than those parties should achieve in bi-lateral markets. Cash-out prices are also volatile and parties cannot forecast them ahead of time. The risk of being exposed to the main price in a period when prices are very high means that the incentive to "balance"¹ is already quite strong.

EPL does not believe that single site or smaller parties would feel any more incentivised to trade ahead of real time were the cash-out prices to become higher or more volatile. However, the parties may see the resulting prices as looking more penal, with the potential to increase barriers to entry and damage to competition. The integrated or portfolio players already have some advantage in the cash-out regime as they can perform a degree of "self-balancing"; increasing output from one plant to cover reduced output from another. There is therefore a risk with more marginal cash-out that the portfolio players, as well as benefiting from the law of large numbers, benefit more by self-balancing, but at the same time create additional costs for the SO.

The idea that a more marginal price will increase pre-gate closure trading is probably true, but would not in itself address the issues surrounding market liquidity. If EPL wanted to trade out all of its output, like other smaller parties, we would need a liquid forward market, with a wide variety of products, to trade in. While EPL has supported Ofgem's work on liquidity, it has not delivered any market changes that are having a notable effect on liquidity. We fully support Ofgem's goals of improving the forward market as we agree that it is vital to the health of the market and would urge Ofgem to progress this area of work as quickly as possible.

Looking at the P217 analysis that Ofgem has performed and the cash-out prices we see, EPL feels that the prices already carry enough risk. Any further increases in the costs, or the perceived potential costs, may increase the prices suppliers and generators have to charge to cover those costs. We are not convinced that such increases in costs will be accompanied by efficiency improvements, as the incentives are already strong, so overall customers would be worse off than under the current regime.

In terms of prompting new investment, EPL does not consider more marginal prices necessarily help the investment case. A new plant will still want a PPA and will only be expecting to earn from the balancing mechanism his balancing bids and offers revenue. As a plant cannot guarantee it will get called the BM provides no reliable, bankable income stream. In a cleared, single priced market there may be an incentive to build more flexible, efficient plant in the hope that it will always be in merit order. However,

¹ Ofgem refers to balancing, but EPL believe that the incentive is to do what you said you would do, which we would see as different to balancing.

given wider market developments developers may feel that such a position in the merit order may not last long enough to justify investment. They may also have concerns that higher cash out creates additional length and reduced BM revenue. These "known unknowns" are making project finance extremely difficult.

Marginal prices may make parties more likely to go long into each balancing period, as the only effective means to manage the imbalance risk, which could push up prompt prices. It can be argued that increasing prompt price may influence the curve as a well, but the curve simply does not go out far enough to create a clear investment signal. This takes us back to the real issue being liquidity and not cash-out.

Single or dual cash-out price

EPL understands the argument that all energy in any given period is the same and to have two different cash-out prices can be seen as illogical. The reason that NETA originally put two prices in the design was to encourage trading. Again, the idea was that the two prices meant a party would see a worse outcome in the BM than in the market; selling forward earns £45/MWh, but going long risks getting paid only £35/MWh. So participants should prefer to trade than spill.

With a single cash-out price all parties may buy or sell power at one price. This may be better or worse than the pre-gate closure price, but would have the benefit of limited transaction costs. This may create an incentive not to trade forward, but simply spill or take from the BM depending on your view of what the outturn price may be. If going into a period, say a winter peak, a player expected prices to be quite high they may chose to spill power expecting the resulting price to be above their costs.

While Ofgem suggests that the "spill" could reduce the energy price, as the SO needs to buy less power, the nature of the market means the SO invariably only has relatively few, expensive plants at its disposal for balancing. The short term, marginal costs of generation tend to be high given the nature of the marginal plants. As Ofgem has also noted, there is also an element of "pollution" between energy prices and system costs (i.e. despatches that meet frequency requirements) so out of merit plant will be used. Heading into a market with more wind, there is also the potential for the market to move from long to short quickly, so the price volatility may increase. On balance EPL suspects that the incentives to spill and not trade could add to SO costs and further reduce liquidity.

EPL is also concerned that the weakened incentive to trade forward will result in a move away from trading power to hedging against the cash-out price, using contracts for differences. This is how the Pool system worked and could easily become the default position of most players. This may not be a bad outcome, but is a fundamental change from the incentives created by the current arrangements and may have wider consequences that need considering. Were Ofgem and importantly Government, to believe a single price, a cleared energy market is more efficient then a move to a Pool type market may be cleaner than a move to a single price with no SO organised merit order.

This issue could be very relevant in considering the EMR proposals. If the capacity mechanism (CM) plant is expected to run it should also be looking to sell its power. However, with a single price, at times of system stress the CM plant may simply spill. If suppliers also try to buy additional power the prices could become quite high, but at the same time send the system long. On the other hand, a single price may give a robust reference price for the CfD FITs, which is currently lacking in the power market.

EPL notes Ofgem's suggestion that it would be possible to have dual cash-out in some periods and single in others. We do not believe that this will be helpful as parties will

not know if they are heading for dual or single, potentially sending mixed signals about going long or short. The current dual system should capture the benefits of being long when the system is short, even though it still incentivises parties to follow their FPN. Likewise cash-out on consumption at a single price and generation on a dual price may lead to smaller suppliers going short. Ofgem may want to consider working with the industry on a couple of representative days to talk through the likely incentives and actions to see what the wider impact could be.

On balance EPL supports a dual cash-out regime. We believe in free markets as the best way to deliver cost reflective, secure supplies to customers. Energy should trade like other commodities and the dual cash-out will maintain the inactive to trade ahead and keep the SO role limited to balancing, not creating merit order stacks. Liquid forward markets also create the right environment for investment, with parties able to finance projects and hedge risks in an efficient manner. A move to a single price would be risky and we feel would disadvantage smaller parties such as ourselves by introducing new risks, such as informational imbalances and the potential for market power to be exerted in the BM.

Single or separate trading accounts

EPL has already responded to P282 on this issue stating out opposition to the proposal. EPL believes that single energy accounts will potentially damage the competitive position of single site and small players who will face greater financial risk from imbalance, and associated cash flows, than integrated competitors.

While we believe that smaller players will be worse off under this proposal and the work done by the P282 group seem to support that view. While the potential increases in RCRC exposure seem to have been examined, the change in imbalance (or no change) highlights that single account parties lost as the other parties often gain. EPL would expect to lose on both RCRC and relative imbalance costs, which are not specifically captured under the P282 analysis, but it clear that the bigger portfolios typically see reduced costs.

The ability to simply "internally" trade is likely to impact wider market liquidity. The BSC applicable objective to promote effective competition, and Ofgem's statutory duty to secure effective competition, cannot be better met with this proposal. The Competition effect will also feed into the wider market, at a time when Ofgem is trying to improve liquidity. It would be detrimental to make a change that further facilitates passive sales and purchases rather than market based trading. Like many players on one side of the market, along with developers, it is vital to us that the traded market improves and not worsens.

EPL also suspects that having only one energy account could lead to less active monitoring of output, as the production units can allocate all energy imbalances into one account. This may reduce the incentives to control BMUs as accurately, especially if "self balancing" is used. Again with the work Grid is doing with intermittent generators to get additional information and control, this modification would be a move in the wrong direction.

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

This proposal interacts with the single vs. dual energy price decision and is probably best considered after those issues have been bottomed out. The choice of pay as bid was again a design criteria at NETA, that generators should not be able to earn additional profits by being paid a marginal price when their costs of generation could be very different. However, with a single price, the generator will consider his costs when selling a CfD forward around the single price.

In a dual cash-out regime the single price for bids and offers could be introduced but it is not clear if this would be beneficial. It could be argued that generators will bid down to make sure they run, but EPL suspects that the dynamics of the system, compared with the central despatch of the Pool, could see odd prices being created as bid and offer pairs, along with dynamic data, are used in different ways.

EPL recognises that economic theory would suggest that the outcome should be the same in a cleared market as a pay as bid market. However, for the theory to work in practice requires participants to be perfectly competitive, with perfect foresight, etc. This is simply not the case in the short term electricity markets. We do not believe that parties submissions to the BM, price and dynamics, are trying to capture short term costs as well as operational requirements. It is not straight forward for many plants to price actions and they would not simply start or offer cheaper power.

Ofgem suggests that new entrants may expect to earn additional revenue from BM actions under pay as clear. While again this may be true in theory, plant is not built as BM plant as it would not be possible to finance a plant based on actions in the BM that may or may not occur. Instead new build wants longer term PPAs, setting a market for their power before plant is built. It is lack of liquidity in the forward market that is stopping new build, not revenue from the BM. Looking across the BM, for the vast majority of the time the SO is using plant that is already running for BM actions. The plant is running because it has sold energy forward. Only plant warmed by NG is earning only BM related revenue, which is not "bankable" as the implied contracts are short and income is not reliable.

EPL believes that Ofgem should keep the pay as bid model as being the best way to ensure that plants are pricing themselves as close to the short run marginal costs as possible. While a MWh may be the same the costs of generation differ dramatically between technologies. Ofgem also need to consider the political ramifications of customers paying a plant £200/MWh if they were prepared to be paid £40/MWh.

Attributing a cost to non-costed actions

There are actions that should be priced and could then feed into cash out. For example when the SO asks for voltage reductions they do so as they have no requirement to buy DSR either directly or via the DNOs. This issue may be partly resolved in a world of smart metering, but before trying to create shadow prices, Ofgem should consider whether the "services" taken for free from customers could be redesigned as commercial services. The SO can take the services for free so it does, when DSR contracts could be more prevalent. We note that DNOs under their charging methodologies are trying to develop DSR via the use of super red periods and this work could usefully build on in this area.

The use of VOLL to deal with demand disconnections could be penal. For example, when a number of simultaneous power plant trips have lead to a black-out the generators would face extreme prices, but so could some suppliers through no fault of their own (Supplier A's customers were not cut off, but he was short), as the trips created the problem not one supplier being short.

Improved allocation of reserve costs

EPL does not believe that targeting these costs into single periods or at out of balance players is necessarily cost reflective. Reserve is like an insurance policy for the whole market, with the system needing the service even if the system is in balance. Were the costs to be targeted to a specific period Ofgem risks adding to costs to companies who were not the cause and not targeting to those that were:

- Supplier A has "peaky" customers who create within half hour reserve requirement (i.e. domestic TV pick-up), but by the end of the period is in balance

(i.e. his customers' metered offtake equals his power purchases). Supplier A faces no cost from reserve even though his customers were a key cause of reserve requirements.

- Supplier B has baseload demand, but due to a change in the weather post gate closure he is out of balance (the customers started to turn on lights). The slow change in demand did not require reserve just BM actions, but Supplier B is heavily penalised in one period.

The same could be true of a portfolio player whose plant trips, but they increase output from other plants, so while causing a reserve requirement are in balance by the end of the half hour.

Reserve has no specific time of day use, as power plants can trip any time, so the inclusion of the costs into cash-out could create further incentives for the suppliers to go long to manage their imbalance risk. If there is a perceived increase in imbalance risks then these costs will ultimately be borne by customers.

The need to create reserve by warming plant is partly due to the plant dynamics. The capacity mechanism may reduce the need for this type of reserve creation, so the issue may best be considered when the more detailed design of the capacity mechanism are known.

Balancing Energy Market (BEM)

EPL does not really understand how this proposal would work in practice so it is hard to comment on it. We are unsure of the mechanics of the "clearing" and it is unclear how the SO would clear the energy and then start to balance the system. However, we believe that parties could balance better if markets were more liquid and gate closure was shorter.

An alternative may be to allow contract notifications after gate closure, which would facilitate trading up to gate closure. Gate closure could remain at the same time, with FPNs submitted by gate closure, but trades done closer to real time could stand. We understand that BSC systems can already accept time dated trades for notifications from the exchanges. EPL thinks this may be different from the ex-post trading that Ofgem's document mentions. Such a move may help all parties better manage their potential imbalance exposure.

Alternative arrangements for renewables

EPL does not believe that it would be helpful to have different arrangements for different plant types and could be unduly discriminatory. Renewable generators can pool their output if they wish to now, using the BSC rules to reallocate all volumes into one account. The fact they chose not to do so may be in part related to the market structure; so the problem is only an issue for small, intermittent generation players, not portfolio players. In this sense EPL has the same risk as the renewable generator, though their risk is from intermittent output where our risk is from single unit failure.

Secondary Issues

Improved provision of information

In principle we support Ofgem's proposal to require the SO to undertake and publish information of the forecast system imbalance. However, Ofgem would need to feel comfortable that the SO's forecasts are reasonably accurate and that the publication would not create market panic at times of system stress sending the system into a longer position and pushing up costs, or vice versa.

Again this could fit in with the design of the CM and the triggers for system stress periods that we assume Grid will have to give.

Creating a Reserve Market

EPL supports creating some form of reserve market. We do not believe that this could reasonably include STO plant, but should replace the trades that the SO does under Schedule 7 of the GTMAs. Under these contracts Grid buys power forward, we believe making a number of calls to generators for prices before executing a trade. These offers to sell power forward could be placed on a transparent platform. It may require the SO to flag a need to parties who are registered (via BMRS?). The SO may also have to state the product it is looking for and possibly any locational issues.

For EPL having such a market would ensure that we can compete against others offering this service. The transparency may also help add to liquidity in the market, as it creates another market for power that is visible to all parties.

While Ofgem has concerns that the costs of reserve creation do not get correctly targeted, that seems to be the nature of insurance. Ofgem would need to be careful about the perception of the "reserve market". Grid does not know when it will need the reserve and flagging to the market it has warmed plants for reserve creation would not inform parties about likely usage so may simply add to perceived risk. This may be an area to consider additional information flows to accompany the new market.

For the provision of the longer term reserve (STOR) that Grid uses, the need for longer term contracts to secure capacity has altered the nature of the market to more bi-lateral based negotiation. The current tendering appears to offer a good degree of competition given the structure of the market itself.

Amending gate closure

EPL would favour a shorter gate closure, as it allows parties to better manage their balancing risk, notably intermittent generators. However, we suspect that other markets offering shorter gate closures may either have a different generation mix, allow the SO to trade before gate closure or more have reliance on balancing services.

As noted above, there may be a compromise in setting a physical gate closure that differs from the traded (contract notification) gate closure. We believe that it may be worth exploring that option further. It is not clear, where Ofgem refers to ex-post trading, if this is the sort of arrangement they have in mind.

From what we recall from NETA, Quiescent FPNs were considered to allow demand side participation in the BM. They were meant to recognise that a customer may be willing to load manage, but only to certain elbow points. If their process only allowed 25MW to come off, then 50MW to take them to zero, a BOA of 75MW would cause them problems. The Grid Code dynamic parameters do not work when applied to many offtake points. We would suggest that Ofgem talks to the energy intensive companies about their view on this issue.

Residual cashflow reallocation cashflow (RCRC)

EPL agrees that RCRC is not an ideal mechanism and can create swings in costs that parties cannot hedge. However, the principles behind the current proposals to remove BSUoS and RCRC from generators should be considered before any alteration to the calculation is considered.

Reverse price

While again not perfect, EPL feels that the Market Indexation Definition Statement does provide a reasonable proxy for short term energy costs. Ofgem would have to consider what else it wants the reverse price to capture and why before considering any changes.

Setting an information imbalance charge

EPL does not support the introduction of such a charge as it would add to our costs with no change in our behaviour. We believe the incentives to balance against your notified position and any BM actions are already sufficient to influence operations. We suspect that the portfolio players can benefit from some form of self-balancing; increasing output marginally at a number of plants to cover a problem at one plant. While we believe this behaviour, if it is occurring, needs to be discouraged, that would require a more focused change that only charged those capable of profiting from such actions.

If you would like to discuss any of these issues further please do not hesitate to contact me.

Yours sincerely



Michelle Dixon
Commercial Director