first:utility

October 24, 2012

Mr. Andreas Flamm
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

Electricity Balancing Significant Code Review – Initial Consultation

Dear Mr Flamm,

Please find First Utility's response to the Electricity Balancing Significant Code Review - Initial Consultation, below.

General Statement

First Utility is strongly supportive of a move to a single-priced cash-out regime, for many reasons:

- It will level the field for independents by removing a key economic benefit of vertical integration
- It will lead to more forward power being released in the wholesale market, stimulating wholesale liquidity
- It will reduce the barriers to independent retailer new entry and growth
- It will increase balancing market efficiency, lowering balancing costs for the industry
- It is a fundamental precursor to smart meter enabled Time of Use tariffs, which have the potential to unlock significant consumer-driven demand response.

First Utility believes that low liquidity and punitive dual priced cash-out are very strongly linked. We believe that volatile cash-out prices should be expected in a real-time balancing market, and this volatility is sufficient incentive for participants to balance, without the need for a punitive dual pricing regime. It is the punitive nature of dual priced cash-out that makes it more economically beneficial for integrated generators to retain plant flexibility as an imbalance mitigant at delivery for their retail book than to sell it forward in the traded wholesale market. This, we believe, is the fundamental economic signal that has driven the integration of generation and retail businesses in the UK electricity market. As a result, less wholesale energy is released into the forward market for independent retailers and other market participants to access. We strongly believe that a single-priced cash-out regime has the potential to increase wholesale liquidity to a far greater extent than the direct liquidity intervention (the Mandatory Auction) that has been proposed by Ofgem.

We are concerned that some of the measures being considered may, in the absence of single-priced cash-out, increase and not decrease barriers to independent entry and growth. We discuss these issues in our answers below. We believe that single priced cash-out, by lowering barriers to entry, could lead to a significant increase in retail choice and competition, which will be beneficial to all electricity consumers.

Chapter 2: Approach

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

These seem appropriate.

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?

We applaud Ofgem's consideration of a single-priced cash-out regime, which we believe will have a significant beneficial impact on balancing efficiency and on both liquidity and participation in the UK electricity wholesale market if implemented. This would be good for upstream and downstream competition and ultimately good for end consumers too. However, we are of the view that other changes proposed could, in the absence of single priced cash-out, lead to significant disadvantage for smaller players and achieve the opposite of Ofgem's aims. This would result if a sharpening of imbalance risk in the UK power market came without the offsetting increase in trading of forward products to mitigate these risks at delivery. In such a situation it could sharpen incentives to balance to the point that only large players will be able to bear the risk. This is likely to reduce liquidity and lead to decreasing levels of new market entry than seen in recent years.

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

The EU Target Model requires the SO to consider structural congestions on the network and to propose price zones to reflect the different value of energy at different locations, which would essentially equate to locational imbalance pricing. While we agree that this could reduce the necessity for SO actions within constrained areas it is also likely to have an economic impact on suppliers (particularly smaller suppliers) operating within these areas, which needs to be carefully considered.

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 proposed are comprehensive. However we are of the view that, apart from the proposal of a single-priced cash-out, the other changes to be considered by Ofgem are likely to result in reduced market participation, increased signals to independent exit and lower liquidity.

Question 5 - What other benefits or drawbacks can you identify for each of our primary considerations?

Although more marginal cash-out pricing will incentivise participants to balance, the greater perceived risk may act as a deterrent to market entry. A single cash-out price, by contrast, may remove much of the economic rationale for vertical integration and encourage greater access to generation output through the traded market.

On the subject of single trading accounts, we agree that this could reduce the complexity of balancing arrangements but would also suggest that formally allowing larger vertically integrated market participants to net generation imbalance against demand imbalance could even further reduce the already limited amount of generated power made available to the wider market. This could exacerbate even further the already serious liquidity issues which the UK power market is currently facing. Such a change would reward vertical integration and punish independent suppliers, increasing the signals to independent exit.

The option of pay as cleared, if implemented, would incentivise market participants to balance but it is also likely that the more marginal imbalance prices that this would likely result in could disproportionately impact smaller players, with a negative impact on competition.

Steps have already been taken in the gas market for suppliers to face Value of Lost Load (VoLL) payments to firm customers whose supply is interrupted and it seems likely that Ofgem will replicate this in the electricity market. While we agree that this would focus participants' attention on balancing themselves, it could be the case that they find themselves facing potentially large payments as the result of situations which they did not create and are beyond their ability to control. We believe that smaller participants will be disproportionately disadvantaged by changes to the arrangements of this nature as they will be less able to bear the potentially heavy costs that could result from situations of this type.

Improved allocation of reserve costs is likely to result in a similar situation, particularly as smaller retail businesses, unlike larger retail businesses, will almost never be on the receiving end of the payments for providing this reserve as they tend not to own generating capacity.

We do not believe that the introduction of a balancing energy market alone would necessarily improve liquidity and market participation. We believe this would increase costs for suppliers and would not lead to increased trading of forward power the far end of the forward curve, which is where the real liquidity problems occur.

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?

We believe that a single cash-out price is likely to provide the most efficient balancing incentives without creating extra barriers to market entry and competition. It is also likely to remove the majority of the incentives which have historically driven vertical integration within the UK power market and should result in more generator output being made available in the traded market. This should increase the level of market participation and increase liquidity to the benefit of all market participants.

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?

We agree that removing pollution from system, rather than energy, balancing actions by the SO as introduced by P217A provides a purer price signal than was previously the case. However, we also feel that an imbalance price based on the marginal 500 MWh of generation offered through the Balancing Mechanism during times of significant system stress places a strong incentive on market participants to balance themselves. Our previous comments apply equally here: independent players are less able to bear the increased cash-out prices that are likely to result during such periods and are less likely to have access to generator output to offset this risk. We also recall that, although the 500 MWh PAR was introduced by P194, P217A was an alternative proposal to P217 which, although rejected by Ofgem, suggested that the marginal 100 MWh of generation should be used to calculate the imbalance price in these situations. If implemented, this would have led to even higher cash-out prices than have been realised on tight days since the introduction of P194 and we are concerned that Ofgem may be minded to revisit its earlier decision in line with its concerns around security of supply in the electricity market. If such a decision were to be made, in the absence of a single priced cash-out regime, the detrimental effect upon liquidity and new market entry could be significant as very few independent companies would be likely to have appetite for the levels of imbalance risk that would result.

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

It would be interesting to see how imbalance prices would have varied under a scenario where P217A had not been implemented and whether there would have been cases where SO system actions not being tagged out resulted in more anomalous imbalance prices.

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

Not in the absence of a single priced cash-out regime. As already stated, sharpening cash-out prices will provide a greater incentive to balance, but will discourage new entry and reduce liquidity as generating capacity is held back from the market to cover this increased risk.

<u>Chapter 5: Secondary considerations</u>

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

Yes, however, it is difficult to fully consider the result of these without knowledge of the decisions Ofgem is likely to make in relation to the primary considerations discussed above.

In particular, we would agree that increased provision and transparency of information is likely to be of real benefit. We believe the efficient functioning of an energy wholesale market and imbalance regime requires generators to provide accurate and timely information on plant availability – as this information drives the supply and demand fundamentals that drive price discovery in the traded market. Information provision requirements should be similar to information disclosure rules placed on participants in equity markets and other traded markets.

The other secondary considerations (with the exception of the possible creation of a reserve market which we have already discussed in another response) are likely to be of lesser overall impact in relation to the primary considerations and will largely be determined in relation to those.

Question 11 – Do you have any other comment on the secondary considerations presented here?

Please see our answer to Question 10 above.

Please do not hesitate to contact us if you have any questions or would like any further information.

Yours sincerely,

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