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24th October 2012

Electricity Balancing Significant Code Review (SCR) – Initial Consultation

Dear Andreas,

We set out below RWE's response to the Ofgem Consultation on the Electricity Balancing Significant Code Review. This response is provided on behalf of the RWE group of companies, including RWE Npower plc, RWE Supply & Trading GmbH and RWE Npower Renewables Limited.

We welcome the opportunity to comment on this consultation.

The approach outlined in the consultation is comprehensive and ensures that all aspects of the electricity balancing arrangements are reviewed. We welcome the early workshops but note that between the closing date for this consultation and the issuing of the draft policy decisions in Q2 2013, there does not seem to be any further industry input into the process. We would suggest that if would be helpful to at least explain what will be happening during this phase and at best, involve industry in further development of the proposals.

We note your objectives to;

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

These are valid objectives to which we would make two points. There are many changes taking place within the energy industry that require coordination because they are parallel activities and checking to make sure that they do not just add cost for the consumer but deliver real efficiency gains.

Below we summarise our position on the Primary Considerations, attached is our response to the questions in your consultation.

- **More marginal main cash-out price –** We would support the move to more marginal cash-out prices as they provide the correct signals for balancing and peaking capacity, these signals will in turn feed into forward markets.

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Single or dual cash-out prices – We would argue that electricity is a single product and that there should only be one price for it in the balancing mechanism for each half hour. We do not believe that it would lessen the incentives to balance, indeed the additional transparency and simplicity from a single price should improve the signals and therefore the incentive to balance. A single price should also improve liquidity and create greater consistency with the Electricity Market Reform proposals.

Single or separate trading accounts - Separate trading accounts were introduced as part of the New Electricity Trading Arrangements as an administrative solution to the perceived benefits of vertical integration. As such they are a hindrance to developing an efficient market and should be removed.

Pay-as-bid or pay-as-clear for energy balancing services – There is a great deal of published economic theory on this debate which concludes that in a competitive market there is little difference between pay-as-bid and pay-as-clear and indeed a pay-as-clear methodology may be more efficient in terms of dispatch and investment where products are homogenous. There are particular issues around the balancing mechanism that mean a move to pay-as-clear needs careful consideration before a decision is made.

Attributing a cost to non-costed actions – We agree that non-costed actions should be priced into cash-out otherwise incentives to balance and invest in products are distorted/reduced. We would favour a simple approach but one that is consistent with EMR and changes being made to the gas cash-out arrangements in relation to cash out pricing such as the introduction of a Value of Lost Load. We note that it is important that supplier imbalances are adjusted during voltage reduction and demand interruption events so that the correct incentive on parties to balance are maintained.

Improved allocation of reserve costs – The present methodology for allocating reserve costs is one of the contributing factors to the missing money in the electricity market. Whilst this has proved a difficult problem to solve in the past, there must be a better method for allocating costs than the present method. We would favour some form of administrative uplift that reflect the value of contracted reserve into cash out prices at times when the system has the potential to be short of energy.

Balancing energy market (BEM) – From the description given it is difficult to understand how this market works in conjunction with existing arrangement and the advantages such an intervention would bring. At present it looks like bringing added complexity and cost when there may be simpler changes that achieve the same results.

Alternative arrangements for renewables – We do not support a central aggregation role on behalf of renewables. We believe that there should be appropriately incentives on individual parties to balance or to make arrangements for this to be done on their behalf. Aggregating centrally would remove these incentives leading to a less efficient and more costly market. Similarly we would not support the SO managing exposure to imbalance charges from fluctuations in wind, post gate closure.

Yours sincerely,

Alan McAdam
Wholesale Economic Regulation Manager

Electricity Balancing SCR – Initial consultation questions

Chapter 2: Approach

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

The high level approach outlined is comprehensive and ensures that all aspects of the electricity balancing arrangements are reviewed. The early workshops are welcome and give participants an insight into and chance to comment on the issues raised. Because of the nature of the workshops they lack the detailed debate on issues and clarity on a possible way forward. Looking at Ofgem's timetable following the closure of this consultation and a possible post consultation follow up workshop, there does not appear to be any further engagement with industry until the publication of draft policy decisions in spring 2013. It is not clear from the timetable how Ofgem intend to engage with industry in further development of proposals once the initial workshops have concluded. Further clarity on this would be appreciated.

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?

Ofgem have provided a comprehensive overview of the issues raised in relation to electricity balancing and we have no supplementary evidence to submit.

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

It will be important that whatever decisions are made in the review of electricity balancing arrangements, that they are consistent with the direction of travel of the European Target Model. The Network Codes that are being developed will take precedence over national legislation and domestic industry codes and will be directly applicable in all member states. Ofgem is required to comply with and implement binding decisions of the Commission and ACER and will have the power to amend licence conditions to give effect to the Network Codes. The most relevant Network Codes are those to do with capacity allocation and congestion management and, the framework guideline on balancing.

Chapter 4: Primary considerations

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

The list of primary considerations is comprehensive and as well as covering the issues that have been raised during previous cash-out reviews, has extended the scope to cover more radical reform by consideration of the new balancing energy market and central balancing of renewables. We do not believe that there are any further issues that should be considered.

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.

More marginal main cash-out price – This is an important area for debate and clearly has interactions with the DECC proposals for a capacity mechanism where they seem to be indicating that successful reform of cash-out prices could reduce the need for a capacity market in the future, whilst linking the penalty regime to existing cash-out arrangements whilst making it robust to future reform.

We would recognise that it is almost impossible to completely identify system from energy actions in all cases, but the introduction of P217A gives sufficient confidence that the pollution of energy prices is minimised.

This would indicate to us that the time is now right to move to 'more marginal' cash out prices which has the following benefits;

- Incentives to balance would be stronger which should result in less consumer demand being shed
- Provide incentive to build peaking plant
- Provide the right incentives for DSR
- Potentially solves the missing money issue
- Simplicity, transparency and predictability
- Market solutions should reduce the need for non-market interventions
- Creates the right investment signals
- Compatible with the direction of travel for the European Target Model in using pricing zones as a signal for solving constraints

Single or dual cash-out prices – We would argue that electricity is a single product and that there should only be one price for it in the balancing mechanism for each half hour. We do not believe that it would lessen the incentives to balance, indeed the additional transparency and simplicity from a single price should improve the signals and therefore the incentive to balance. A single price should also improve liquidity and create greater consistency with the Electricity Market Reform proposals.

Single or separate trading accounts - Separate trading accounts were introduced as part of the New Electricity Trading Arrangements as an administrative solution to the perceived benefits of vertical integration. However, these arrangements add complexity and cost to the balancing arrangements with no demonstrable evidence that it has increased competition. In practice separate trading accounts have limited impact on overall market liquidity and the perceived benefits associated with vertical integration are difficult to detect. In practice trading with the market is based on the fundamentals of the products that are bought and sold together with the hedging strategies related to supplying customers and generating electricity (which are traded on different timescales). For certain parties more than 90% of requirements are market facing transactions which enhance liquidity. Consequently, an arbitrary rule which requires balancing on separate accounts appears unnecessary. The concentration indices for the generation market show that it is competitive. This evidence combined with the provisions in the Competition Act and the soon to be introduced Transmission Constraint Licence Condition should be adequate to address any market power concerns.

Pay-as-bid or pay-as-clear for energy balancing services – There is a great deal of published economic theory on this debate which concludes that in a competitive market there is little difference between pay-as-bid and pay-as-clear and indeed a pay-as-clear methodology may be more efficient in terms of dispatch and investment where products are homogenous.

The issues associated with pay as clear in the balancing mechanism are complex. In particular, dispatch decisions are not associated with a "cleared" auction given locational considerations which give rise to "out of merit" procurement, the products procured by the system operator are varied (energy balancing, frequency control, reserve, reactive power etc) and temporal factors are important (availability may be determined by actions taken in previous half-hours). Consequently, major change would be required to introduce pay as cleared to the relevant SO activities such as an auction in an "energy balancing market" separate from other balancing activities. However, such an approach would result in complex balancing arrangements and would increase costs for customers (for example by requiring energy balancing actions to be "unwound" as a result of the system balancing). Further thought is therefore required in relation to the introduction of a pay as cleared auction process in the balancing mechanism.

Attributing a cost to non-costed actions – We agree that non-costed actions should be priced into cash-out otherwise incentives to balance and invest in products are distorted/reduced. We would favour a simple approach but one that is consistent with EMR and changes being made to the gas cash-out arrangements in relation to cash out pricing such as the introduction of a Value of Lost Load. We note that it is important that supplier imbalances are adjusted during voltage reduction and demand interruption events so that the correct incentive on parties to balance are maintained.

However, we do not believe that it is appropriate to "pay" interrupted customers the value of lost load since this would reduce incentives on customers to provide demand reduction services. In addition, there are significant practical difficulties in estimating the volumes interrupted and identifying the customer subject to payments.

Improved allocation of reserve costs – The present methodology for allocating reserve costs is one of the contributing factors to the missing money in the electricity market. Whilst this has proved a difficult problem to solve in the past, there must be a better method for allocating costs than the present method. We would favour some form of administrative uplift that reflect the value of contracted reserve into cash out prices at times when the system has the potential to be short of energy.

Balancing energy market (BEM) – From the description given it is difficult to understand how this market works in conjunction with existing arrangement and the advantages such an intervention would bring. At present it looks like bringing added complexity and cost when there may be simpler changes that achieve the same results.

Alternative arrangements for renewables – We do not support a central aggregation role on behalf of renewables. We believe that there should be appropriately incentives on individual parties to balance or to make arrangements for this to be done on their behalf. Aggregating centrally would remove these incentives leading to a less efficient and more costly market. Similarly we would not support the SO managing exposure to imbalance charges from fluctuations in wind, post gate closure.

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?

Of the primary considerations identified we believe that the following should be considered further for the reasons set out in our answer to Question 5.

- More marginal main cash-out price
- Single cash-out price
- Single trading account
- Pay-as-clear for energy balancing services (if practical)
- Attributing a cost to non-costed actions (without payments to customers)
- Improved allocation of reserve costs

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 finding of this analysis?

From your analysis we would agree that the implementation of P217A has resulted in cash-out prices providing a more efficient signal for parties to balance. This is because cash-out prices now better reflect the actions taken by the SO for energy balancing.

P217A has reduced the incidence of actions taken by the SO to resolve constraints, polluting cash-out prices, and has reduced the incidence of price spikes from these polluting incidents.

Overall this has resulted in more cost reflective cash-out prices based upon fundamental energy balancing requirement and improved efficiency of the balancing arrangements.

Question 8: What additional analysis could be done as part of the SCR around Modification 217A and the flagging methodology it introduced?

Ofgem have provided a comprehensive analysis of P217A and we have no supplementary evidence to submit.

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

This is an important area for debate and clearly has interactions with the DECC proposals for a capacity mechanism where they seem to be indicating that successful reform of cash-out prices could reduce the need for a capacity market in the future, whilst linking the penalty regime to existing cash-out arrangements whilst making it robust to future reform.

We would recognise that it is almost impossible to completely identify system from energy actions in all cases, but the introduction of P217A gives sufficient confidence that the pollution of energy prices is minimised.

This would indicate to us that the time is now right to move to 'more marginal' cash out prices which has the following benefits;

- Incentives to balance would be stronger which should result in less consumer demand being shed
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Chapter 5: Secondary considerations

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

We agree that a number of the secondary considerations identified are linked to the outcome of discussions on the primary considerations and as such cannot be considered until decisions on these are made.

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.

Improved provision of information – There is quite a range of information already published that is of value to the industry. Before a decision is made to publish further information there must be a balance between the value of further information and the cost and added complexity of making it available. Before a decision could be made on whether to introduce an information imbalance charge we would need to understand the error in current forecasts and the perceived costs of this error.

Creating a reserve market – The creation of a reserve market has merit in that it could bring more transparency to the way reserve is presently procured. It could also give a value to reserve which is presently a free option for the SO. If the idea is to have a market that clears at a point in time, this may reduce the flexibility of products being offered and flexibility the SO requires to changing circumstances. This may mean that any reserve market would need to be flexible so as to accommodate the changes in production and demand.

Amending gate closure – Moving gate closure on its own would not bring any benefits and one hour before the balancing period is realistically as close as it could be. As you point out in your document, consideration of other issues such as the creation of an energy balancing market, ex-post trading or multiple final physical notifications could make the case for moving gate closure.

Residual Cashflow Reallocation Cashflow (RCRC) – As you say in your document, it may be worth looking at this in the light of other changes.

Reverse price – Again, as you point out, this is dependent on the single cash-out price discussion. If dual cash-out prices are retained we have a preference for prices based on SO actions as they are likely to be more representive of the actions taken.

Setting an information imbalance charge – See our response to "Improved provision of information".