18 October 2012

Statoil (U.K.) Limited

Ofgem
9 Millbank
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Re: Power Significant Code Review – Draft Policy Decision

Statoil (UK) Limited (STUK) welcomes the opportunity to respond to the proposals outlined in the consultation document and appreciate the level of stakeholder engagement with Ofgem in the process through the workshops held in advance of the consultation closing date. However, the workshops have shown that significant further work is needed to enable the industry to assess any potential changes and their likely impact.

STUK does not believe that now is the time to conduct a full review of the electricity balancing and cash out arrangements. The extent of regulatory change currently taking place in the UK energy market is significant, particularly under Electricity Market Reform, much of which is yet to be finalised. Further detail associated with the design of the Capacity market and the Contracts for Difference 'CfD' is not expected to be released until after the close out of this consultation. This makes it extremely difficult not only to respond comprehensively to this consultation, but also for market participants and investors to take a view on how the market will look and behave under the existing balancing and cash out arrangements. Further, due to UK energy policy, it is clear that the next few years will see significant shifts in the energy mix with increasing volumes of intermittent renewable energy generating. An additional suite of significant reforms at this time will, in STUK's view only increase the regulatory uncertainty associated with the generation sector and further decrease industry and investor confidence in the market.

To date STUK has been broadly supportive in principle of Ofgem's efforts to enhance liquidity in the power market, and we would urge Ofgem to prioritise this area of review and potential change to improve trading along the forward curve. Uncertainty surrounding the future of balancing and cash out arrangements could mitigate recent improvements and any future initiatives planned by Ofgem to improve the liquidity further along the curve.

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Cash out prices

STUK does not believe that a change in the derivation of cash out pricing is necessary at this time. We welcome Ofgem's analysis and review of the P217A rule, however as the assessment is retrospective and does not take a forward view on pricing, the analysis cannot give an informed view of how prices may be affected going forward. Historic prices can only be viewed in the context of an oversupply supply of capacity in the GB power market. Looking forward, this is expected to change and become significantly tighter, as detailed in Ofgem's Electricity Capacity Assessment published on 4 October 2012.

The significant tightening of de-rated capacity margins along with increasing volumes (possibly to a magnitude of two or three times those currently) of intermittent energy on the grid is likely to see significantly higher marginal prices. Even with the retention of the PAR 500 rule, cash out prices will still be at a level that incentivise market participants to balance. Ofgem also usefully provide some analysis of the impact on parties, which shows that smaller parties would be hit harder than larger companies, which can only be of concern to both market participants and Regulator. Further, policy decisions encouraging the development of renewable technologies such as offshore wind farms need to be supported by operational arrangements that recognise the challenges faced by intermittent energy sources. Offshore wind output is difficult to predict accurately and already faces significant balancing risk. An increased and more unpredictable risk through more marginal cash out prices could have a detrimental effect on investments and the ability to attract new investors to the industry. The offered strike prices would have to be adjusted to compensate for higher balancing costs. Similarly projects under the Renewables Obligation would face higher costs that would need to be compensated.

It is our view that dual cash out prices better incentivise parties to trade out their imbalances, whereas single cash out could have a detrimental impact on liquidity in the short term market, which seems particularly worrying given the industry's successful attempts to improve liquidity in the prompt market. Further, it is extremely difficult to give a view on possible cash out reforms until the publication of the further operational detail associated with the CfD's, part of Electricity Market Reform.

The heart of the issue, rather than a move to marginal or single cash out prices, seems to be the flagging of trades in the derivation of the cash out prices- Ofgem's paper details that 28% of the volume of all balancing actions taken by the SO were flagged, and thus removed from cash-out; and that in 40% of periods, the SO took one or more action outside the balancing mechanism to balance the system. STUK would urge Ofgem, in conjunction with the industry to examine both issues further in the first instance before making any significant decisions on cash out going forward. There is a need for improved transparency on the definition of and process associated with the flagging of excluded actions.

Single and trading accounts

STUK strongly supports maintaining dual trading accounts to encourage trading out of imbalances rather than 'netting off'. A single trading account would not only have a further dampening effect on market liquidity but also decrease imbalance charges for those who have both a production and consumption account, rather than smaller independent generators and aggregators in the marketplace.

Pay as bid or cleared auction pricing mechanism

We understand the rationale presented by Ofgem in support of a pay as cleared mechanism, however this would result in a fundamental redesign of the Balancing Mechanism and the System Operator's activities. We do not see that the potential positive effects would outweigh the potential negative effects, and that there is an urgent need to change the system. A pay as cleared auction would result in higher marginal prices, which as described earlier, can have negative effects in investments in renewables and would need to be compensated through higher strike prices under CfD. Further the suggestion in the workshop of different markets for different products, in our view significantly increases both complexity and costs but may also create perverse incentives for National Grid as the System Operator. It may also create cross boundary issues if different auction designs are used in different markets.

Balancing Energy Mechanism

STUK does not believe that a Balancing Energy Mechanism would add any value to the current arrangements but would increase complexity and costs with little benefit. However, as an alternative to an additional market mechanism, it seems prudent to re-examine the timing of gate closure to less than the current timescale to provide additional opportunities to trade out of imbalances.

Alternative arrangements for renewables

STUK welcomes Ofgem's recognition of the challenges faced by renewable generators in the accurate forecasting and balancing of their portfolio. However, it is clear from the document and from the discussions at the workshop on 3 October that the options of some form of central aggregation or the System Operator taking responsibility for imbalances after gate closure need significant further 'working up' so that the industry can have a meaningful discussion on the merit and impact of the proposals. The current regime favours companies that have a large and geographically diversified portfolio of intermittent assets. A model that reduces the exposure for independent generators would be beneficial and options need to be considered further.

We agree that a comprehensive level of stakeholder engagement is appropriate in this process, however given the complexity of the issues at stake and the significant impact the proposals will have on the UK power market, STUK would strongly urge that Ofgem carefully consider the timing of this Significant Code Review in the context of Electricity Market Reform and Third Package developments. It is essential that market participants have time to consider the next set of EMR documents due in November before being able to comment on further proposals to change balancing arrangements. We would suggest therefore a postponement of the next stage of the process until the end of this year, at which point it may be appropriate to consult with the industry again on these issues. Looking forward, it may be useful to provide a strawman for discussion so that interested parties can give a view not only on individual elements but also key interactions, risk and opportunities that can be created between the different elements of markets.

We trust that Ofgem will reflect the comments made in these meetings and in response to this consultation, in any future initiatives. STUK looks forward to a continued dialogue on these issues and would be happy to meet Ofgem to further discuss the issues raised.

Yours sincerely

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Due to electronic transfer this has not been signed