Welsh Power

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Dear Mr Black

Electricity Balancing SCR

Welsh Power Group (WPG) is a privately owned energy company with a strong track-record in development, in both conventional and renewable energy.

In January 2009 the company received planning consent for the construction of a 49.9MW biomass plant at Newport Docks, Wales, through its wholly owned subsidiary Nevis Power Limited. Late last year WPG sold a 50% stake in the project to a subsidiary of Santander Bank to secure the financing of the plant.

As well as renewable energy, WPG submitted an application to develop Wyre Power, an 850MW CCGT (combined-cycle gas turbine) power plant near Fleetwood, Lancashire in August 2009. We also own and operate a 24MW OCGT, Leven Power, as well as a 10MW gas engine, Rhymney Power on STOR contracts to NGC.

Formerly, WPG owned and operated a 363MW coal fired plant, Uskmouth Power until its sale in 2009 to SSE. It developed and built Severn Power, a new 850MW CCGT plant in South Wales, which it subsequently sold to DONG Energy. WPG also started its own retail business, Haven Power, in 2007, but this has subsequently been bought by Drax.

Introduction

WPG does not currently own any assets that are active in the balancing mechanism (BM) and does not directly face the imbalance cash-out prices, though we have experience of the market and may do again in future. However, it is vital to our business that Ofgem creates a more liquid market for parties such us to allow for robust investment decisions. WPG would therefore like to see Ofgem move its resources from looking at cash-out to resolving liquidity concerns.

At the time of NETA the cash-out arrangements were specifically designed to incentivise forward trading and Ofgem should not undo that general design principle with a move towards a single price. Ofgem should also be mindful that the separation of the energy accounts was to try to limit the advantage of the integrated players. While we would like to see the issue of market dominance addressed head on with a break-up of the Big 6, at the very least Ofgem should not enhance the advantages of vertical integration by allowing single energy account cash-out.

It is difficult to comment in detail on Ofgem's document as there is no clear package of measures proposed. There are a number of areas of policy where we are also unclear as to exactly what the proposals would mean in practice, for example the balancing energy market. WPG has therefore commented at a high level on the key parts of Ofgem's document.

Objectives
WPG does not believe that Ofgem has set itself some objectives that could be measured. They are too high level, and while worthy, not truly related to cash-out. We would like to see Ofgem trying to ensure that the forward markets are liquid, that smaller players are not disadvantaged and that cash-out is not penal. WPG recognises the need to be consistent with the EU energy market, but the current design is too high level to impact this consultation. However, we do think there may be benefit in re-consulting on some better defined "packages" of change once the basic EMR design is known.

WPG believes that the EMR proposals represent a potentially significant change in the way that the market operates. Players, and Ofgem, need to fully understand the implications of those changes before tinkering with cash-out. The capacity mechanism (CM) in particular may alter the way that within day balancing occurs, increasing the incentives on some plant to "spill" power as the CM penalties make cash-out look attractive.

More marginal main cash-out price
Ofgem seems to want to incentivise balancing, which WPG believes that the dual cash-out system does. Looking at the analysis of P217A it would appear that a move to more marginal cash-out would make little difference to prices, except on some extreme days. However, WPG does not believe that making cash-out more marginal will encourage greater balancing efforts, as the prices are already significantly "out of the market" and therefore taking exposure to cash-out puts a player at a competitive disadvantage.

For smaller parties the fact that cash-out cannot be forecast, nor the risks hedged, makes managing imbalance exposure a significant business risk. Parties try hard to balance and there is little that they can do if say a power station unit trips out. To make prices more volatile and potentially higher, if not actually higher, will increase risks and thus barriers to entry.

WPG does not believe that making the main price more marginal will alter any behaviour in a "helpful" way, but will force smaller parties to go longer into each balancing period as it is the only way they have to manage their imbalance risk.

Single or dual cash-out price

WPG supports having a dual cash-out regime as it increases the incentive to balance by trading forward. The issues surrounding liquidity, or rather lack of it, in the market is the greatest barrier to entry and investment at the current time. Any changes that reduce the incentive to trade forward are to be discouraged. That said, we feel that the impact of cash-out on the forward curve is relatively minimal and Ofgem needs to make substantive progress on their liquidity work in a more timely manner.

The problem with single prices, as seen under the Pool, is that the market will move away from forward trading of power, instead signing contracts for difference around the energy imbalance reference price. This means that the market is likely to lose liquidity and investment signals may further weaken. Under the Pool there was also the concern that the marginal, price setting plant, was owned by a few, dominant players and thus was open to "gaming". Ofgem should undertake some market analysis to see whether that is still likely to be the case today before making any changes that revert to a Pool style design.

WPG wishes to make it clear that we do in principle object to Pool style energy markets. However, for them to work the SO takes on a far more active role. There must also be greater competition amongst the parties to ensure that the market operates effectively. Were Ofgem to believe that the market is competitive or that the SO will need to be more active anyway in a market more dominated by wind, then it would be better to make a wholesale move back to a pooling arrangement, rather than just introduce a single cash-out price.

Single or separate trading accounts

WPG does not support single energy accounts because: they enhance market power; they will reduce liquidity by allowing "internal" trading; and they incentivise portfolio players to internally balance their energy account. For all of these reasons such a move would be detrimental to competition.

Ofgem will be aware that WPG has long argued for the break-up of the Big 6. To allow this form of self balancing would simply further add to their dominance. It would make it virtually impossible to enter the market and compete with the big parties unless you could create an integrated portfolio yourself. Internal hedging will become a requirement of market entry and thus create a significant barrier to entry as few players will ever have the resources to create such a new business.

Again our key concern is that creating single energy accounts would reduce the requirements to trade at a time when market liquidity is such an issue. Ofgem must keep working towards creating liquid forward markets that deliver robust forward price curves against which companies can make longer term investment decisions.

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

WPG recognises the economic arguments that pay as clear creates a more efficient market outcome, especially when the product is as homogenous as electricity would appear to be. However, we do not believe that electricity is as homogeneous when considered in more detail. While the output is the same, MWh, the mode of delivery is very different and the range of technologies reflect the market's need to develop a "shape" of energy during the day that not only matches demand, but maintains quality as well.

The Government is clear that it favours a technology mix, the SO buys services from different types of plant because of their technical characteristics, so the prices of these power plants is different. Would Ofgem want to see a plant that can generate for £45/MWh being paid £250/MWh in a half hour where say reserve plant was needed because of a substantial TV pick-up? The "missing money" problem seems to only be an issue for the generator who did not have the perfect foresight to bid the same price as the reserve plant, but that works to the benefit of the customers. One of the key concerns that customers had about the operation of the pool was the pay as clear mechanism. While liquid commodity markets often use pay as clear auctions it is not the case that all bricks, or steel will trade at the same price, so to create a pay as clear market in electricity is not necessary or desirable.

Attributing a cost to non-costed actions
WPG agrees that there are some actions taken by the SO that could be priced and then reflected in the cash out calculation. WPG believes that Ofgem should urge the SO to work with other parties to identify these actions and find a way to price them such that their inclusion in the calculation would be feasible. For example, the DNOs could offer customers load shedding contracts that they could then "sell" as a portfolio for say voltage reduction, to the SO. Alternatively the SO could seek more direct contracts with customers.

As the owners of STOR plant we also believe that we could offer balancing energy to the SO outside the STOR windows if they wish to develop those types of contracts. We find that National Grid has an institutional bias towards not using smaller players for balancing services as the resource implications for them are higher than using the larger assets directly connected to their transmission network. Ofgem may want to consider how the SO can be encouraged to look for more innovative balancing solutions in the future.

WPG believes that Ofgem must be very careful about the use of VOLL to deal with demand disconnections as the prices could be penal and risk putting people out of business. A party may be exposed to VOLL prices as a result of actions taken by the SO on behalf of other parties who created the problem. For example if blackouts are caused by plant trips a supplier could face penal prices, even if their short position has no real impact on the system as a whole: a 200MW short would not have been the cause of a blackout in a situation where 800MW of generation fell over.

Improved allocation of reserve costs
Reserve, along with other ancillary services, are difficult to account for as they tend to be about delivering quality as well as energy. WPG would argue that reserve is like an insurance policy and is used to balance the system when the "normal" energy market cannot deliver energy fast enough to cope with system issues, such as fluctuating output from wind farms or TV pick-ups. The problem with placing reserve into cash-out is that it risks penalising parties who were not the cause of the need for reserve. For example a wind farm may gust, but still be in balance by the end of the balancing period.

WPG believes that putting reserve costs into cash-out risks simply increasing the cash-out risks and thus putting up costs and creating further barriers to entry. There is no way that a party can predict when a reserve product will be used. As noted above, there is no way that the parties can hedge imbalance risks. So again Ofgem risks simply creating a signal to go longer into each balancing period with no benefit for the system as a whole.

Balancing Energy Market (BEM)
WPG does not really understand how this concept would work. We understand that at the workshops parties had asked that Ofgem develop some sort of "day in the life" scenario to better explain this concept. WPG would welcome further explanation on this proposal.

Alternative arrangements for renewables
WPG does not support having different arrangements for different plant types and believes that such arrangements would be unduly discriminatory. There is nothing to stop renewable, or other, generators from pooling their output if they wish to under current market rules, though due to market structure they may not want to currently undertake such portfolio management activities. We know from our own experience that the Big 6 do not always offer the best terms for putting energy into their larger portfolios.

Secondary Issues
Improved provision of information
WPG always supports improving information in the market, but does not have any specific issues we wish to see addressed. There may be additional information that is needed by the market in the world of EMR changes, so this issue could be discussed again once the wider market design is known.

Creating a Reserve Market
The STOR market is already very competitive; we therefore assume that the "reserve" Ofgem is referring to is the warming and forward contracts that the SO buys under GTMAs. WPG believes that some form of screen based market where the generators could place offers for power in the next 24 hours may improve market transparency. We would assume that the products would need to be defined, unit specific and possibly limited by the technical parameters of the plant.

Amending gate closure
WPG believes that a shorter gate closure would help market participants to balance, but suspect that SO will have additional concerns about their ability to balance.

Residual cashflow reallocation cashflow (RCRC)
While this is not an ideal calculation, RCRC is fair given that the system must allow for the recycling of the money that will ultimately always exist given the nature of any central energy balancing system. We do believe that moving all of the costs onto one side of the market, as occurs in the majority of the EU would reduce barriers to cross border trading.

Reverse price
Ofgem cannot reasonably asses the reverse price until the main price calculation is known.

Setting an information imbalance charge
This charge would create potentially significant costs for generators. WPG understands why Ofgem thinks that such a charge may be necessary, especially under a single price cash-out, but for single site players they have no incentives to do anything other than what they said they would do. Smaller parties cannot benefit from any form of self balancing and thus an information charge would simply create a cost and not an incentive to which they can respond. We do not believe that it would be unduly discriminatory to put such a charge only on players who own or control more than a certain number of sites and can therefore benefit from portfolio balancing.

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A blanket introduction will simply add to customers' costs with no additional benefit in terms of reduced SO balancing costs.

WPG hopes that these comments are helpful. If you or your colleagues would like to discuss any of these issues further please do not hesitate to contact me.

Yours sincerely

Alex Lambie
Chairman