

Modification P194 “Revised Derivation of the Main Energy Imbalance Price” Impact Assessment Consultation

Response from Barclays Capital

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Barclays Capital is pleased to submit these comments on Ofgem’s Impact Assessment for proposed BSC Modification P194 “Revised Derivation of the Main Energy Imbalance Price”. The Impact Assessment presents a thoughtful and thorough analysis of the benefits and costs associated with the modification. Our comments below address some of the specific assessment issues raised in the document. We conclude that the assessment is likely to have understated both the likely cost savings from the modification and the likely benefits attached to increased long-term security of supply. At the same time, the concerns about gaming remain largely unsubstantiated. We therefore conclude that the benefits of this modification significantly exceed the likely costs and risks and far from being a “finely balanced” assessment, there is a clear case for Ofgem to approve this modification.

Economy and Efficiency

The current weighted average methodology for calculating cash-out prices was explicitly predicated on the assumption that the weighted average of accepted offers (or bids) would reflect the marginal cost of balancing the system. The analysis presented by NGET demonstrates beyond any doubt that this assumption fails to obtain, that there is limited re-pricing of offers towards the marginal acceptance - particularly at times of system stress - and consequently, that cash-out prices significantly diverge from the marginal cost of balancing the system at these times. Modification P194 clearly overcomes this deficiency in the current baseline and ensures that cash-out prices will more accurately reflect the marginal cost of balancing the system.

As outlined in Ofgem’s assessment, the improved cash-out prices signals are likely to translate into significant reductions in the cost of balancing the system. However, the assessment arguably presents a relatively conservative estimate of this cost reduction since it assumes a percentage reduction in the volume across all offer acceptances, whereas in practice, the improved incentives to balance are likely to avoid the need to take the most expensive (ie, marginal) actions. The estimated costs savings could therefore be seen as a conservative floor on the likely cost savings.

Competition and Distributional Impact

We agree that P194 could lead to improvements in short-term liquidity as market participants seek to balance their positions more dynamically because of the enhanced cash-out signals.

With respect to the discussion of potential gaming of the rules, we are less clear that P194 presents even a “slightly higher” risk of manipulation than the current baseline. P194 does not change the basic “pay-as-bid” nature of the balancing mechanism and hence does not change participant’s incentives to maximise the direct benefit associated with having an offer or bid accepted in the balancing mechanism.

The only incremental question is whether market participants can benefit indirectly from having their bid or offer influence the cash-out price. Although the assessment highlights a small increase in the potential opportunity for a participant to influence the cash-out price, it is not clear how a market participant could actually benefit from doing so. Specifically, under dual-cash out pricing, market participants cannot access the benefit of having driven up SBP since they would receive SSP rather than SBP for any residual length. Moreover, as Ofgem note, participants are unlikely to be able to forecast the operation of the BM with

sufficient certainty to predictably benefit from any manipulation (which would require the ability to predict when one would be accepted to take a balancing action, the outcome of the tagging rules, whether the system is long or short, the outcome of the RCRC calculation etc.) Despite the apparent increase in the “opportunity” to do so, it therefore appears unlikely that P194 will result in any actual increase in offer price manipulation.

Finally, we would note that even in the (relatively few) periods that a single action may set the cash-out price there are likely to be *unaccepted* offers or bids in the vicinity of that acceptance which effectively limit the scope for manipulation (ie, even when a single action sets the price that does not necessarily increase the scope for manipulation).

In summary, even if manipulation was an incremental problem (and there is no evidence that it is), the scope for mitigation is even greater than that outlined in the assessment. Overall, therefore, we think that the summary of the impact of the “gaming issue” should be changed from negative to neutral.

Security of Supply

The single largest motivation behind P194 is to ensure that cash-out prices more accurately reflect the opportunity cost of balancing the system at times of system stress. As noted in the impact assessment, this will significantly improve short-term security of supply by ensuring that market participants have strong incentives not to be short when the system is at risk and/or to improve the reliability of their generating plant.

This impact on short-term security of supply will be, however, equally reflected in a significant increase in long-term security of supply. The assessment notes the likely increase in peak prices over the period 1 April 2004 to 30 June 2005 and questions whether this “would be sufficient to persuade participants to undertake investments that they would not have otherwise undertaken”. This represents a rather backward looking and static basis for assessment. Specifically, the improvement in balancing signals at times of shortage will ensure that *going forward*, if and when the system gets very short, prices will rise appropriately. To the extent that the supply-demand balance becomes increasingly tight over time, prices will rise to these higher levels more frequently and signal the need for new investment. However, not only are these signals crucial in sending an appropriate signal to invest in new plant, they also play a crucial role in delaying the closure of older more expensive plant and/or in increasing maintenance expenditure on existing plant to improve plant lives and reliability. With respect to the overall assessment we would therefore recommend that Ofgem upgrade the “slightly positive” rating for the long-term impact on security to “very positive”.

Environmental Impacts

As Ofgem note, the key purpose of this modification is to ensure that the costs “imposed by less predictable forms of generation are faced by those generators”. The assessment of this modification should therefore be neutral between technologies, renewable or otherwise (although, as noted, not all renewable generation is inherently unpredictable). We are also not clear that the modification necessarily results in increased part-loading of plant because of the effective substitution between reserve held by NGET and/or market participants and the fact that one effect of the modification may be to remove excessive length at times when the system is long (by reducing SSP).

Overall Assessment

Overall, we think that this modification will yield significant benefits in terms of market efficiency, competition and security of supply and that some of these benefits have been understated in the Impact Assessment. At the same time, it is difficult to substantiate the details about gaming concerns and against the magnitude of the likely benefits, the implementation costs are barely material. We therefore conclude

that, despite the residual concerns about tagging, it is clear that the benefits of Modification P194 significantly exceed the likely costs and risks and that Ofgem should therefore approve the modification.