

Sonia Brown
Director, Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

Centrica Energy
Maidenhead Road
Windsor
Berkshire SL4 5GD
Tel. (01753) 431426
Fax (01753) 431150
www.centrica.com

Our Ref. P194
Your Ref.
24 February 2006

Dear Sonia,

P194 Revised Derivation of the Main Energy Imbalance Price

Centrica welcomes the opportunity to comment on the Ofgem Impact Assessment on BSC modification proposal P194 'Revised Derivation of the Main Energy Imbalance Price' (hereinafter: "**P194**").

As indicated in our response to the Elexon consultation, we have numerous concerns about this proposal submitted by NGET. We remain unconvinced that P194 will better facilitate achievement of the Applicable BSC Objectives. We believe that P194 will introduce significant risk and uncertainty for parties. As discussed below, this will have a negative impact on competition, the operation of the transmission system, security of supply and the environment. In addition, the likely impact of increased risk associated with P194 could result in increasing costs which may need to be passed onto consumers in the form of higher prices. Therefore we would urge Ofgem, in line with the majority recommendation of the BSC Panel, not to accept this proposal.

General comments

We believe that the current cash out arrangements provide appropriate incentives for parties to balance their portfolio commensurate with the market's ability to respond in a normally operating market. As far as we are aware, the System Operator (SO) has always been able to balance the system. In addition, plant margin is above the desired 20 per cent baseline and, considering existing and proposed investments in new generation plant, will be for the foreseeable future.

We acknowledge the role of the SO as the residual balancer and we believe parties endeavour to balance their position. However, in certain circumstances when parties are unable to balance, it may be more efficient for the SO to balance the system and to recover the cost through BSUoS charges and for parties to pay the imbalance price. This is not to say that improvements to the cash out arrangements cannot be made. We accept that in periods of system stress, the weighted average cash out price does not always tend towards marginal price, as economic theory suggests.

The current volume-weighted average methodology is, however, only one of the many (interrelated) factors that may be causing this dampening effect on cash out prices. We believe that the focus should be on remedying existing issues such as tagging, the methodology for introducing NGET's reserve contracting into imbalance prices, gate closure, and lack of

information, before introducing a new pricing methodology of which the benefits have yet to be proven.

As indicated by Ofgem, the potential benefits (and costs) identified in the Impact Assessment are the outcome of analysis based on a very limited amount of data. Moreover, the potential benefits are based on historical data. As parties' behaviour changes, especially in the dynamic energy markets, historical data alone may not provide an accurate reflection of future trends.

We are also concerned about the lack of justification for setting PAR at 100 MWh. We continue to believe that this figure is arbitrary and needs to be further substantiated. In addition, we have concerns about some of the assumption Ofgem have made in the Impact Assessment. For example, we believe it is a bit of a leap of faith to assume that more marginal imbalance charges will automatically result in re-pricing of bids and offers. This assumption, as well as others will be discussed in greater detail below.

Specific comments

Demand forecast error

In our view P194 will lead to imbalance prices that are both higher and more volatile. The average demand forecast across the market is approximately 2.5 per cent and this is currently felt to represent a good level of accuracy. It is questionable to what extent further increases in accuracy can be achieved even with significant investment. Parties will therefore have very limited ability to respond to higher imbalance charges. This means that P194 could result in a penal rather than a cost reflective scheme for parties to balance their portfolio.

Balancing costs

As mentioned above, we believe P194 will lead to higher and more volatile imbalance prices. We expect the impact on SBP to be greater than on the SSP, i.e. the increase of SBP will be higher than the decrease in SSP. In a generally risk averse market, this will encourage parties to carry extra length and accept lower SSP to avoid being exposed to these higher and unpredictable SBP prices.

With P194 the main focus of parties will be on reducing risk rather than balancing their portfolio. In a market that is already predominantly long, further balancing actions by the SO may be required. This could undermine the economic and efficient operation of the transmission system as well as increase, rather than decrease, the overall balancing costs.

Competition

Part loading & liquidity

Higher imbalance prices may also increase the risk that less reliable plants are made available, particularly at times of system stress. Plants being part loaded and thereby holding their own reserve will undermine the economic, efficient and co-ordinated operation of the transmission system.

Contrary to Ofgem's view, we believe that this could exacerbate the lack of liquidity that already exists in the short-term forward market (particularly within-day), diminishing further the ability of parties to balance their portfolio. Furthermore, parties holding back their own reserve could reduce the liquidity in the BM and the SO's ability to ensure generation meets demand.

Smaller parties and new entrants

Competition could also be negatively impacted because of the effect P194 may have on smaller parties and new entrants. Firstly, because they are less able to balance their position and therefore more likely to incur higher imbalance charges. Secondly, because of the requirement to lodge increased levels of credit cover which is already an area of concern for smaller parties. Recent upward pressure in the Credit Assessment Cap under the BSC and the requirements to lodge credit with numerous organisations are specific examples of this. This could result in parties being forced to exit the market.

Intermittent generation

Ofgem state in the Impact Assessment that parties should face up to the actual imbalance costs they impose on the SO. Whilst we understand this rationale, we are concerned about the potential impact of higher imbalance prices on intermittent generation, as also noted by Ofgem. When negotiating Power Purchase Agreements (PPA) with wind farms, suppliers will build this risk in the contract terms offered to intermittent generators. We believe the impact of P194 may result in (proposed) wind projects not being built as contract rates will no longer be economic.

Intermittent generation is unlikely to be able to access firm prices, and would most likely receive SSP instead. Electricity suppliers typically offer a power price discounted to baseload prices within PPAs to wind farms that reflects the difference between SSP and baseload prices. Were P194 to go ahead, wind farms would find that this discount would be increased. This would lead to less revenue for these wind farms, and may lead to those with marginal economics not going ahead. This appears to be inconsistent with the government policy of encouraging renewable generation.

Re-pricing of bids and offers

We do not believe that the frequency with which parties re-price is necessarily a good indication of the strength of the signals provided by the cash out arrangements. When balancing the system, the SO will consider a range of settlement periods, rather than one settlement period in isolation. In addition, the SO will take into account a range of factors, including technical parameters and the requirement to create margin. This could mean for example that the SO instructs a specific generator to commence generation for a period prior to the settlement period for which it is required due to the plant's dynamic parameters. The result is that in some settlements periods the cash out price may provide the wrong signal, i.e. indicate that the system is tight or tighter than it actually is.

Considering the issues with transparency, we fail to understand how P194 will enable parties to re-price their bids and offers as P194 will not change to provision of date to the market. Therefore we do not believe that more marginal imbalance charges will necessarily increase the frequency with which parties re-price. If it does, it could exacerbate the issue as re-pricing decisions could be based on the wrong signals which in addition could increase balancing costs because of the uplift on BOA price submissions.

Security of supply

Long-term

We disagree with Ofgem that higher imbalance prices alone will have a positive effect on long-term security of supply by providing stronger incentives to bring new plant to the market. Decisions to invest in new plant are generally based on much longer term views of the market (10-20 years). The key driver is generally the demand/supply balance. Imbalance prices do feed into forward prices, but forward prices will only provide limited signals because they go out for merely a few years (2-3 years).

Imbalance prices are considered when investment decisions on new plants are evaluated. In these cases imbalance cost are used to calculate the potential costs of outages and the risks associated with tripping. Higher imbalance prices will result in higher costs for unplanned outages. This takes value away from the potential investment which means that a higher rate of return may be required. This could ultimately lead to an increase in wholesale prices which may need to be passed onto consumers in the form of higher prices.

Short-term

We also disagree with Ofgem that P194 will have a positive impact on short-term security of supply by providing signals to improve reliability of plants. As noted by Ofgem, the introduction of NETA, which first targeted balancing costs on to out-of-balance participants, has resulted in an appreciable improvement in the reliability of plant. We do not believe plant reliability can be increased much further. Unfortunately plants trip and will always trip unexpectedly. In the event of plant trip during gate closure the registrant cannot take mitigating actions, but has to face the impending imbalance cash out prices. As with demand forecast error, why should parties be

penalised for something that is outside their control? It will increase risk and therefore costs which may need to be passed onto consumers in the form of higher prices.

Environment

Contrary to Ofgem's view, we believe that P194 could have a detrimental impact on the environment. As mentioned above, we believe that P194 will result in part loading as parties will want to reduce the risk of being exposed to higher imbalance charges. This means that fuel usage and emissions will increase. We expect the EU ETS prices to be only a small fraction of the higher and more volatile imbalance prices. Therefore the EU ETS will not minimise parties' incentive to part load.

A further argument is that we expect the system to be long because parties will want to avoid higher imbalance prices. When parties carry extra length this means that electricity is "spilled" onto the system. This additional electricity and the actions required to reduce the energy imbalance will increase emissions and the usage of fuel and therefore have a negative impact on the environment. Finally, as mentioned above, we believe that P194 may act as barrier to entry for wind generation and this goes against the government's policy to encourage renewable generation.

Impact of system actions

Finally, we share Ofgem's concern that P194 may exaggerate the impact of system balancing actions on imbalance prices, something that is already an area of concern. Unlike Ofgem, we believe that the risk of polluted energy prices and its financial impact could be significant.

Under the current arrangements the Net Imbalance Volume (NIV) tagging mechanism results in system actions polluting energy imbalance prices. This will provide incorrect signals to parties and will undermine the original intention of the balancing mechanism, namely reflecting the cost of energy balancing actions taken by the SO.

Rather than resolving this problem, P194 will increase the likelihood of system actions significantly polluting the energy imbalance prices further, because these prices will be based on PAR 100 MWh and no longer on all remaining eligible energy balancing actions. A clear example of the significant impact constraints action can have, as also mentioned by Ofgem in its Impact Assessment, is settlement period 19 on 26 September. In this case the SSP under the current base line was suppressed to £2.51 because of constraints actions taken by the SO in Scotland. Under P194 the SSP would have been -£52.76 MWh, a difference of more than £55 MWh.

The analysis in the Impact Assessment (p.48) shows that in a representative sample some form of constraint management action was present in 28% of settlement periods. This is nearly one third of all cases. At the Operational Forum (8 February 2006) National Grid disclosed that by December 2005 the £30m constraints costs allowance for 2005/2006 had almost been exceeded and that ongoing constraints of a similar level are expected to continue throughout Q1 2006. Similar assumptions are being made for the 2006/2007 incentive scheme. This shows that the risk of polluted energy imbalance prices remains significant.

Conclusion

The Impact Assessment does not give us sufficient confidence that P194 will be an improvement on the current baseline. We believe that the current cash out arrangements provide the appropriate incentives for parties to balance their portfolio and to invest in new generation plant. P194 will introduce higher and more volatile imbalance prices which will create risk and uncertainty in the market. The higher imbalance costs and the costs of risk management may need to be passed on to customers in the form of higher prices.

We disagree with Ofgem that the P194 will improve balancing and reduce SO costs as parties will carry extra length to reduce risk. In terms of competition we believe P194 will decrease liquidity in the market and will have a detrimental impact on small parties and new entrants as well as intermittent generation. This negative impact on intermittent generation seems to be contrary to

government's environmental policy. P194 will also exacerbate the distortions caused by the tagging mechanism and this will in turn increase risk and costs to parties and potentially prices to customers.

Considering these risks and (unintended) consequences, we believe the focus should be on remedying the current issues regarding the current cash out arrangements as identified by the CORWG.

If you have any questions regarding this response, please give me a call on 01753 431426.

Yours sincerely,

Merel van der Neut Kolfshoten
Commercial Manager