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Dear Ms Brown

Impact assessment: BSC modification proposal P194 'Revised Derivation of the Main Energy Imbalance Price'

Comments

energywatch welcomes the opportunity to consider the issues raised by this consultation on the impact assessment (IA).

Ofgem has highlighted a number of important aspects of the current cash-out arrangements against which P194 is to be assessed to determine whether it better meets Applicable BSC Objectives. We discuss these aspects below. We note that Ofgem needs to consider P194 not just against the Applicable BSC Objectives but also in terms of its wider statutory duties.

We would stress that energywatch is unconvinced, on the balance of argument, that P194 better meets the BSC Applicable Objectives, specifically Objective C (promoting effective competition in the generation and supply of electricity). No single aspect delivers a 'knock-out blow' in that respect; this is an overall assessment.

The aspects to which we refer above are:

- **security of supply** – National Grid (NGET) has focused on the increase in balancing costs associated with periods of system stress as a key reason why P194 may sharpen incentives on market participants to self-balance and thereby help reduce those costs overall. Ofgem has also detailed arguments on security of supply. However, unlike NGET, Ofgem appears to argue that P194 also has long-term security of supply benefits. NGET's focus on system stress indicates that its concerns are more to do with incentivisation of parties which leads to a more appropriate allocation of the costs of short-term balancing, not necessarily with security of supply. In other words, P194 may be seeking to provide more appropriate incentives to parties to self-balance and, by implication only, improve short-term security of supply. However, an improvement to long-term security of supply through a revised cash-out methodology based on P194 remains unproven. It is not clear that security of supply can be significantly influenced through imbalance cash-out arrangements alone. A number of factors, including parties' appetite for risk, ability and willingness to invest in the relevant infrastructure, and other economic and locational factors associated with investment, as well as incentives which influence investment decisions, will have at least as large a role to play overall in providing long-term security of supply.

- **imbalance cash-out methodology** – the current imbalance cash-out arrangements are acknowledged to be somewhat imperfect. The discussions of the Cash-out Review Working Group (CORWG) have highlighted a number of areas of imperfection, in particular the potential for some system balancing actions to be included in the energy balancing price calculation because the tagging process is not 'foolproof', the tendency for smearing of NGET's reserve contract costs rather than a pure 'cost reflective' calculation by settlement period, and the tendency, particularly during periods of system stress, for the weighted average cash-out price not to reflect a pure marginal cash-out price. It is also not clear that a pure marginal price is always truly 'reflective' in every half hour of the costs incurred by NGET to balance the system. Ofgem appears to suggest that there may be repricing (of bids and offers?) in the Balancing Mechanism and a reduced impact from reserve in imbalance prices. However, this assumes that the Balancing Mechanism is a market where prices can adapt to changes in NGET's requirements, when in fact it is a residual means for NGET to balance the system. Given the various imperfections, evidence has to be shown that parties would significantly change their current behaviour in terms of self-balancing and act more rationally in terms of market signals. The lack of transparency in the market and general illiquidity in trading means that there can be no real prospect that parties will adapt, even at times of system stress. If anything, the responses of those BSC parties who rejected P194 when it was undergoing assessment indicate that they would go longer in the market to prevent exposure to high imbalance prices.

This does not suggest that ‘rational’ behaviour will be forthcoming while market imperfections remain.

- **economic and efficient operation of the transmission system** – we note the arguments made by NGET during the progress of P194 through the BSC modifications process regarding the potential benefits of having sharper incentives on parties to self-balance during periods of system stress. We appreciate the evidence that NGET has presented to back up this view. However, there are two points to note. Firstly, NGET’s evidence, particularly in relation to periods in the recent past where system stress has occurred and NGET has had occasion to take significant balancing actions, is very much historic and not reflective necessarily of whether parties would be able, or willing, to significantly rationalise their behaviour in future should similar circumstances of system stress re-occur. Secondly, a significant number of respondents to the P194 consultations indicated that NGET, even in some extreme market circumstances, has always been able to balance. There may be question marks against whether this balancing occurred in the most economic and efficient manner and at an acceptable cost. However, given that there are imperfections in the cash-out arrangements in any case, it is arguable that NGET is still in the best position to residually balance at an appropriate (not necessarily cost reflective) cost rather than passing this responsibility to participants with varying ability to manage the risks involved. The historic analysis of system prices presented in the IA, and the extrapolation of this data to provide a view of the possible effect on participants’ behaviour of the introduction of P194, is not entirely convincing. Much of the analysis indicates that, under certain market conditions of system stress there may be a beneficial impact in terms of reducing the costs of NGET’s balancing actions. <u>(Incidentally, but very importantly from a consumer viewpoint, it is not made clear whether the reduced costs of balancing would be shared by NGET with consumers, who should be part beneficiaries of NGET’s ability to more efficiently operate the system, preferably through the setting of appropriate targets under the System Operator (SO) incentive scheme.)</u> It assumes that there will be a rational and adapted response if historic patterns of actions re-occur in the future, and that there will be a larger degree of self-balancing as a result. It would be surprising if participants did not seek to adjust their behaviour in terms of contracting for energy if they perceive a significant change in their incentives and the behaviours of others towards self-balancing. However, we would stress that this probably allows those better able to manage risk to undertake those actions and not those who are unable to trade out their positions, perhaps due to lack of access to liquid markets. We are also not sure that the risk of single bids and offers determining the cash-out price, if P194 is implemented, is entirely eliminated by the setting of a PAR100 value. This may provide some market players with a much more significant role in setting imbalance prices than currently.

- **competition** – we have particular concerns that sharpening incentives to self-balance, as proposed by P194, will have a real adverse impact on small players who will be unable to manage the risk of exposure to spiky marginal imbalance prices. If, as indicated by the historic pricing evidence presented in chapter 4 of the IA, and assuming that it is a helpful predictive guide to participant behaviour, marginal system prices rise, it is likely that participants best able to respond to market signals would do so, namely, large players who, through a significant presence in both generation and demand, are better able to manage these risks. Smaller players have a limited ability to trade out of imbalance, subjecting them to a real risk of exposure to penal prices, adversely impacting their cashflow and ability to operate. Ofgem only expresses the hope that liquidity will improve in future to allow players to trade out imbalances but provides no firm evidence that forward markets will be stimulated sufficiently to provide products to do so. Further, if there is also a requirement on small players to post higher credit cover to limit the impact of potential default on the market in general, as is implied in the IA, the cumulative effect would be to drive these players out of the market which would clearly be inimical to promoting competition. P194 therefore fails to meet Applicable Objective C. While we recognise that the impact on consumers is not a test against which a BSC modification would be judged under the BSC alone, if our concerns are borne out and further small players exit the market as a result, we would regard that as a failure to protect the interests of consumers through the promotion of effective competition, which is stated as Ofgem's primary statutory duty.

- **costs and benefits** – we agree that both quantitative and qualitative aspects of implementing P194 are clearly relevant in deciding whether to proceed with the proposal. The quantitative analysis provided about implementation is inconclusive. We are not convinced that the implementation costs can be justified in terms of the potential benefit, particularly given the broad range of participant costs (£300k - £6m) which are additional to Elexon implementation costs of £350k. It is unlikely that participants will provide a more clearly defined set of costs in response to the IA because their views may be coloured by whether they support P194 or not and further costs of self-balancing would be a subjective judgement.

We note the tighter than normal timescales in which this consultation has been undertaken. Given that the BSC Panel's recommendation was available on 8 December 2005 and that Ofgem had indicated at the December Panel meeting that an IA would be published, we are somewhat surprised that the IA was not issued earlier and the full six weeks for consultation allowed. Clearly, however, Ofgem should be given adequate time before 23 March to make its decision.

Going forward, we will keep these issues under review as and when they are raised, always considering the possible impact on consumers.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs