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Dear Ms Brown

**BSC Modification P194 'Revised Derivation of the Main Energy Imbalance Price' – Impact Assessment**

Thank you for the opportunity to respond to your Impact Assessment consultation on Modification P194. Slough Heat and Power (SHP) is happy for this response to be published.

SHP is a small green generator connected into the Southern Distribution Network but also supplying to the Slough Estate private network. As a single BMU, we are vulnerable to price spikes arising in the balancing regime, which can only be effectively mitigated in large portfolios.

It is our view that Modification P194 will be damaging to competition and to the environment but will fail to improve security of supply or to improve efficiency of operation. Indeed its advertised intent to promote the carrying of reserve by market participants through their balance positions goes against the previous intent of the balancing regime, which was to incentivise balance. This is a distinct moving of the goalposts.

## Security of Supply

No market mechanism can be expected to efficiently carry sufficient security of supply to cover both supplier forecast error and generator failure. In a bilateral contract market, suppliers will reserve enough generating capacity through their contract positions to cover their expected peak demand. A strong price signal can give an incentive to contract up to a higher level of error.

But no price signal can be sufficient for suppliers to take on generation failure risk in their contract positions – the reverse is more likely. Generator incentives are to contract to balance and no more. A generator that under-contracts in case it trips will simply be spilling energy for much of the time and this small percentage of spill will never compensate for the occasion when it trips because that will always be a 100% failure. If a generator trips during the peak period then it is not able to replace the generation because the Grid Code does not permit this – only NGET can schedule replacement generation after gate closure.

Where a generator trips it faces imbalance cost. If the generator is of any size then the fact that it has tripped will almost certainly ensure that SBP is the main price. Therefore, even on an average imbalance price it will be painful – a strong incentive to properly maintain kit. The IA suggests that a marginal imbalance price will strengthen the incentive to maintain equipment but offers no evidence for this assertion, which is surely very doubtful in the first place.

This leaves incentives on specialist peaking plant. By their nature, such units have variable costs too high to be normally contracted. It is unlikely that they will earn sufficient revenue from normal peak contracting – their value is in availability for exceptional events after gate closure; only NGET can contract with them in such time-scales. What party is going to contract with sufficient peaking capacity to deliver energy to cover the risk of some other generator happening to trip and then spilling that energy because the trip failed to happen?

Unless NGET contracts with peaking capacity (through standing reserve) there is not sufficient money in the market to reward such capacity. Indeed, the trend since NETA started has been for a decline in the level of peaking capacity provided from OCGTs; there has been a greater tendency for the market to contract with mid-merit capacity and to spill excess energy at off-peak times. Encouraging a spill market will reduce NGET purchases of peaking capacity in the balancing mechanism and in standing reserve contracts, reducing revenues to peaking capacity – provision will reduce rather than increase.

There is little evidence that spark spreads in the market have been sufficient to encourage new build generally. Although encouraging a spill market will increase demand for base load and mid-merit capacity, there is little certainty that this will necessarily raise spark spreads.

**Efficient Operation of the System**

An efficient system is one that is balanced. A modification that seeks to encourage a generally spilling market will increase NGET balancing activity, which will raise costs to consumers as suppliers will be buying energy simply for spilling. The result will be an increase in part loading – more reserve will be carried but not on units efficiently selected by NGET but far more broadly than necessary. This reserve will be available at most times of the day except at the peak – suppliers, as already stated, will only contract up to their expected peak demand and will not cater for generation trip.

In the IA, you cite NGET analysis of the disparity between average prices accepted and marginal prices when the system is stressed (Figures 3 and 4 pages 37 and 38). You use this to suggest an inefficiency in pricing. However, this analysis is flawed. Prices are offered into the balancing mechanism before gate closure; system stress emerges after gate closure due to forecast error and generation failure. This analysis merely shows that BM offers are made against a range of expected conditions and can never be priced ex post. Parties will price BM offers in competition based on ex ante expectations of system stress; indeed the correct interpretation of Figure 4 is surely that period 23 introduced an unexpected market condition and the market quickly responded such that additional capacity was scheduled and by the system peak (period 35 or 36) there was no shortfall. Figure 4 shows that the price signal was already sharp enough.

**Environmental Impacts**

There is no quantified analysis presented on potential environmental impacts and so it is difficult to be certain how Ofgem has determined that environmental impacts would be small. Certainly there is prima facie evidence that this is a false assessment. Firstly, although Ofgem dismisses the impact on renewable generators by noting that it is only wind technology it fails to note how much wind there is in the renewables mix, and how much more significant it could be in the near future.

Suggesting that the effect on part loading will be insignificant is surely mistaken. Given the reversal of the trend in reduced emissions from the power sector exhibited since the start of NETA when part-loading first became prevalent, this is surely an area that merits further consideration. We cannot agree with Ofgem's assertion that an increase in part loading – an admitted expectation from this modification – will be an insignificant detrimental environmental factor.

**Cost-reflective pricing**

One of the principles of the NETA market as expressed by Ofgem at the time was that parties that cause imbalance should bear the cost of managing them. In a marginal price regime where the BM remains a pay-as-bid mechanism, an imbalance price based on the marginal action will lead to over-recovery – the cost to those shorting the market will be greater than the overall cost of managing the imbalance. A long held view in the small generator community was that the pricing in the initial NETA regime was not cost-reflective. Modification P78 sought to address the lack of cost-reflectivity of the reverse price – the reverse price signal was setting a cost to parties that exceeded the cost of NGC buying the market out of the position caused by the imbalances in the reverse direction; by replacing the reverse price with a market price index, Ofgem accepted

the need to mitigate this lack of cost-reflectivity. This acceptance that the system operator should not over-recover costs of balancing in the reverse direction holds good in the main direction – cost-reflective signals in a balancing market should be based on average costs, not marginal ones.

**Price Distortions**

The evaluation of the analysis of the impact of constraints is misleading. In paragraph 4.33 it is noted that, based on a small sample, system trades affected cash-out prices in 7.6% of settlement periods. This is a significant number – the analysis in Figure 4 (already alluded to) saw significance in a single settlement period out of 48: 2.1% of periods. The analysis does not make clear what the impact of marginal pricing would be but it seems clear that the risk of failure of NIV-tagging to remove all system trades is significant. Marginal pricing is likely to increase price distortion; this is especially the case as the analysis pre-dates BETTA since when instances of constraint have increased significantly.

**Competition**

SHP cannot agree with Ofgem that the impact on competition will be negligible. The price spread has always been a significant barrier to entry for both supply businesses and for small generators and even large non-portfolio generators. The market has concentrated significantly since 2000. There is virtually no model in the market now other than vertical integration. This applies almost as much in generation (with only Drax and First Hydro being significant players not being part of a vertically integrated portfolio) as in supply.

An increase in the imbalance price spread when the spot market is so illiquid is a significant deterrent to new entrants in supply who cannot perceive a way of mitigating imbalance risk without relying on contracting with an existing vertically integrated participant. Lack of independent supply businesses is a deterrent to independent generators who also face a more hostile market through increased cost from trip risk.

There is also a deterrent to embedded generation because suppliers will pass on the perceived increased cost of volatility onto the generators who now have so few outlets for selling their output; small embedded generators cannot manage their own imbalance risk unless they sign onto the BSC, which is an unreasonable cost for them and is not efficient.

**Conclusion**

This modification will make the market more hostile and inefficient, and will significantly damage competition. The price signals will not be cost-reflective leading to over-recovery of NGET costs as well as to environmental damage form part-loading.

The evidence in the IA has been misinterpreted in some instances suggesting that the case that there is a problem to be addressed is not sufficiently made. There is no demonstrated evidence that security of supply will be enhanced because there seems no clearly argued causality leading to behavioural change. However, to the extent that the proposal will lead to an increase in spill, is it really efficient for the market to carry inefficient reserve (mainly at off-peak times) against random events rather than NGET contracting for that reserve competitively?

Yours sincerely

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