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SmartestEnergy

energy trading solutions for the independent power and gas sectors

20th March 2006

Sonia Brown
Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Dear Sonia,

Re: IMPACT ASSESSMENT MODIFICATION P194

SmartestEnergy Limited ("SEL") welcomes the opportunity to contribute to OFGEM's decision making with regard to Modification Proposal P194.

Founded in October 2001 and wholly owned by Marubeni Corporation of Japan, SEL holds a unique position in the GB mainland electricity market as the only independent consolidator of embedded generation. Providing a service tailored to the needs of small and embedded generators, SEL today manages the output from 181 generation sites representing 1,039 MW of generation capacity as owned by 63 independent generators. SEL also provides trading services to independent supply companies and today assists 4 independent supply companies manage the sourcing of their power in the traded forward markets.

Although supportive of the principle that individual generators should bear the financial cost of their imbalance, SEL has considered its view of the proposed modification P194 and does not support the implementation of this proposal, and agrees with the recommendation of the BSC Panel, and the majority of respondents to the original consultation, that this modification should be rejected.

SEL does not believe that a quasi-marginal pricing methodology will improve the operation of the balancing mechanism nor will it improve the pricing signals necessary to encourage market participants to balance their position. Instead SEL believes that the proposed change will merely exacerbate the penalties on those participants who happen to be short at the same time as the system as a whole.

It is important to note that prices calculated under P194 will not be cost reflective, as they are neither average prices nor true marginal prices and the value proposed for the Price Averaging Reference (PAR) would appear to be arbitrary and based on a value that gives a desired result based on historic data and in doing so, risks setting a parameter based purely on the justification of historic data that subsequently proves to be inappropriate.

It is likely that the proposed modification will result in much higher and more volatile SBP during the peak periods and, overnight SSP will be more volatile with the possibility of regular negative SSP values. These effects will undoubtedly encourage Suppliers to go longer during the peaks and perhaps less long or even short overnight. Such an arrangement will put additional pressure on smaller portfolio and single site market participants with such pressure being disproportionate relative to that felt by larger portfolio market participants.

Any attempt to introduce a proxy for marginal pricing will also result in an over recovery of charges in relation to the actual cost of balancing the system. This will result in an increase in the size of RCRC payments, and as embedded generators are exposed to the opposite of the rest of the market, the RCRC 'credit' will mean a cost to embedded generators. The behaviour of participants bidding into the balancing mechanism is unlikely to change and so there will be little effect on the level of BSUoS. For embedded generators this will mean overall an increase in costs or a reduction in total benefit.

With current market conditions not supportive to small Suppliers, the increased pricing levels and volatility together with the modification proposed will bring further disadvantages to small market participants and is likely to discourage new entrants from entering and providing much needed competition to the established large portfolio market participants.

In the outcome envisaged by SEL, balancing cost and the responsibility for providing reserve would effectively be split with Suppliers encouraged to carry reserve to cover for a large forecast error in their own demand position and NGT carrying generation reserve as now. The difficulties associated in an individual Supplier accurately forecasting their demand are head and shoulders above attempts to forecast the position of the system as a whole and this new system will encourage Suppliers to hold reserve considerably in excess of what would be optimal, from a whole system perspective, with such reserve provided by synchronous plant available at call and only stepped down at short notice being a sub optimal environmental outcome.

In the Impact Assessment OFGEM makes a number of statements in relation to how participants may respond to the changes implemented by P194 to manage their exposure, namely: -

- *engaging in more active management of their generation/customer portfolio or improved trading and contracting ahead with other parties.* With the current levels of declining liquidity it is difficult to see how participants can be expected to 'engage in more active management' of their portfolios and indeed in relation to the investments to improve reliability it is unlikely that the current level of penal reserves is not sufficient to encourage expenditure to address this problem;

- *reducing the likelihood of imbalance (e.g. by investments to improve the reliability of their plants, improved demand-forecasting and/or contracting for more flexibility and demand-side response).* For the single site generator or small portfolio market participant to 'generate more than their contracted position' will be of limited benefit as a risk mitigation strategy as when and if the site trips, all volume will be lost and no cover will be available for when it is needed; and

- *using risk mitigation such as financial hedging instruments or by managing its overall physical portfolio so that they are long overall (i.e. generating more than their contracted position).* Financial hedging instruments are not readily available in the GB market and it is unrealistic to expect that they will develop to the required level in the face of a two-price penalty against which physical imbalances are cashed out.

In conclusion SEL cannot support a modification that would appear to provide little benefit to the market as whole, and places smaller market participants at a disproportionate disadvantage in comparison to large portfolio market participants.

We are happy to discuss this further or provide more information if required, please do not hesitate to get in touch with us.

Yours faithfully,

Robert Groves
Vice President