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Our Reference:

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Dear Sonia,

Consultation on Impact assessment of P194 'Revised derivation of the Main Energy imbalance Price'

Thank you for the opportunity to respond to this consultation.

We continue to believe that the modification proposal will not facilitate the achievement of the applicable BSC objectives. In relation to this Impact Assessment, we have responded to Ofgem's subjective assessment criteria. Ofgem recognise that the case for implementing the proposal is finely balanced, but go on to conclude that the proposed change should be made. We would suggest that while it is indeed finely balanced, it is in fact an overall negative effect, suggesting the change should not be made, particularly in relation to Competition and Distributional Effects, the Impact on the Environment, and Security of Supply. We expand on these issues below. In addition, we believe that there should be a presumption of maintaining the status quo for the sake of market stability and to minimise unforeseen unintended consequences. In such a finely balanced situation, we would suggest that the status quo should remain, that there needs to be a significant benefit out of any change made.

Competition and Distributional Effects

Ofgem give this a single positive tick. We believe that overall this is negative. We do not believe that the increase in imbalance charges will enhance competition. As noted by Ofgem, even on a very simple level, the change in the cash-out arrangements could have a short-term adverse affect on all players. More substantially, we believe that the redistribution of a larger RCRC will have a disproportionate effect on small players, particularly suppliers and single site generators who will receive no RCRC re-distribution on failure. We have already seen the disproportionate impact a large cash-out price had on small players in the Damhead Creek incident. In addition, higher imbalance prices will have a negative impact through credit arrangements on small players, or indeed large players who have no credit rating. These effects can only put pressure on these players, perhaps to the extent of causing them to exit the market. The proposal will also make new entry more difficult.

In addition, we believe that rather than increasing liquidity in the market that liquidity will instead reduce as participants seek to avoid being out of balance through not offering plant that may well expose them to risk of failure, or seek to self supply.

On these counts, the changes cannot be said to enhance competition. Indeed, the recent conclusions of the EU Commission's Competition Inquiry made similar points – “High penalties imposed on suppliers that fail to maintain balance and tight general balancing regimes are particularly burdensome for new entrants.” and “heavy penalisation of deviations may reduce liquidity since vertical integration is encouraged when high balancing costs can be avoided by vertically integrating load (consumption) and generation.”

Overall, we do not believe that the Competition and Distributional Effects impact merits a positive tick. Instead we believe that it should be a minimum of a negative tick.

The Impact on the Environment

Ofgem have assessed this proposal as being neutral in its impact on the environment. We do not believe this to be the case. A more marginal imbalance regime only increases participants risks and will impact, albeit at the margin, on new entry. Ofgem have considered this in relation to renewable generation, and in particular wind. Whilst the impact of a chunky marginal cash-out will only affect marginal wind projects, this could be the majority of offshore wind, it will still have a negative effect. However, Ofgem fail to recognise the impact that this proposal will have on environmentally efficient CHP. Such a change will have a significant effect on an already ailing industry, with its consequent affect on the environment as well as the Government's 2010 target.

In addition, Ofgem believe that increased part loading of plant will be compensated by lesser requirements for reserve by NGET. However, this has to be compared with a centrally planned and dispatched generation schedule meeting a centrally estimated demand. Whilst not calling for a return to the CEGB or the Pool it is recognised that such a centrally planned schedule is more efficient than any disaggregated schedule. On a spectrum of efficient dispatch, the more marginal the imbalance price, the further away from a centrally dispatched schedule this will be and less efficiently the overall system will operate. This can only be detrimental to the environment.

Ofgem seem to conclude that P194 might result in a few players holding part loaded plant and using it more frequently by selling to others. On this basis, if P194 results in more efficient use of plant and fuel, Ofgem believe that total costs could reduce. We cannot agree with Ofgem's conclusion. This hypothetical situation will not happen, nor is it one in which NGET will readily give up their reserve responsibilities. We therefore conclude that further disaggregation of reserve holding will take place and that this can only be detrimental to the environment.

On these counts, we believe that the overall impact on the environment is negative by a minimum of one.

Security of Supply

As noted in our previous response, we believe that higher imbalance charges will disincentivise participants from making their plant available when it could be, because of the higher cost of the risk of failure. In particular, we believe that Ofgem have failed to take account of the real risk of fuel switching, as seen this winter, and how a more marginal imbalance charge will reduce operators' incentives to switch. A repeat of this winter's market

conditions alongside an approved P194 could have a significant detrimental impact on security of supply in the short term.

We are not clear on how Ofgem can view the short-term security as meriting two ticks. We can only assume that the extra length that participants will contract all the time has been interpreted to mean that security is improved all the time. However, increased security at times outside system stress is worthless, therefore only extra length at times of system stress provides a benefit. Taking account of the impact of fuel switching which will only happen when the system is in stress, we believe gives the short term impact on security an overall negative one tick.

We do not dispute that if higher cash-out prices feed into the forward price curves, then this should help participants' investment decisions, at the cost to the customer of higher prices. However, we do not believe that this will outweigh the disbenefit to short-term security and that overall, the impact on security of supply is neutral or negative.

Economy and Efficiency Impacts

As noted above, we believe that the impact of fuel switching has not been fully considered by Ofgem in relation to security of supply. This also impacts on the efficiency of operating the system. If higher cash-out prices disincentivise fuel switching, then this will reduce the efficiency of operation of the market.

Ofgem estimate a turn round in balancing costs from a £32m increase to a potential £87m decrease through participants changing their behaviour. We would question the extent to which participant's behaviour might change. In particular, we would question whether participants would increase their length by up to 10%. Across SSE's portfolio of generation, this would amount to SSE creating its own reserve of some 1,000MW. We do not believe that this is a reasonable assumption, nor that the 6GW implied to be held across GB could be done without significant cost. On this basis, we do not believe that the benefit of £87m is reasonable.

We also believe that the impact of tagging in price setting should mean a higher negative impact than Ofgem have given it. If the chunky marginal price set is susceptible to tagging, then it seems to go against the fundamental objective of the proposal, that is, to provide a clearer stronger signal to participants. If that signal is obscured then the merits of the proposal are severely affected.

Overall, we do not agree with Ofgem's assessment of the impact of economy and efficiency at two ticks (note this is different in the Executive Summary). Our view would be that at best the effect is neutral.

Conclusion

Taking account of our views on the above categories, our overall assessment of this proposal would be negative one, compared to Ofgem's positive one. Regardless of this, as noted above, we believe that due to the risk of unintended consequences, and for market stability, that the default on finely balanced proposals should be to remain with the status quo. We believe this to be the case in this instance. We do not believe the Impact Assessment provides a significantly positive assessment of the benefits of the change proposal and therefore that the change should not be made.

Please give me a call if you wish to discuss this further.

Yours sincerely

Rob McDonald
Director of Regulation