Giuseppina Squicciarini
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

gb.markets@ofgem.gov.uk

5th April 2013

Re: Update on the Electricity Balancing Significant Code Review (EBSCR) and request for comments on proposed new process to review future trading arrangements

Dear Giuseppina,

SmartestEnergy welcomes the opportunity to respond to Ofgem's Update on the Electricity Balancing Significant Code Review (EBSCR) and the request for comments on the proposed new process to review future trading arrangements.

In our response to the Electricity Cash-out Paper in January 2012 and the initial Consultation on Electricity Balancing Significant Code Review (SCR) in October 2012 we stated that we were unconvinced of the need for major change. We are still not opposed to further investigation of potential changes nor to consideration of the interactions with Electricity Market Reform (EMR), and, more importantly, market harmonisation with Europe.

However, we are still of the view that such further work should not presuppose that change is necessary and the case for change would need to be proved at some point.

We approve of Ofgem's decision to go for a reduced the scope of the EBSCR to prioritise changes to improve cost reflectivity and incentives to provide flexibility and security of supply, although we believe that the overall level of the incentives is much more important than refining cost reflectivity. Additionally, we agree with Ofgem's overall aim of considering potential changes to the GB trading arrangements by building on the successful

SmartestEnergy Ltd
Dashwood House,
69 Old Broad Street,
London, EC2M 1QS
T 020 7448 0900
www.smartestenergy.com
Registration No. 3994598

characteristics of NETA while reflecting Ofgem's new responsibilities with respect to European integration and incorporating the features of EMR and its impact on the market.

In order to minimise uncertainty it is essential that the first stage of this project re-establishes what the principles of the market should be. This should cover, amongst other things, a commitment to self-despatch, NGT as residual balancer, bi-lateral trading, incentives to balance and equal treatment of all generation (i.e. no separating out of renewables). It would also help reduce uncertainty if there were a principle that the market arrangements would not be changed unless this were absolutely necessary. It is not relevant that the current arrangements were not "designed for the low carbon era"; market principles should transcend that.

It is correct at this stage to park issues such as pay-as-bid or pay-as-clear for balancing services in the Balancing Mechanism, Balancing Energy Market, alternative arrangements for renewables and day-ahead reserve market. Our reasons are as follows:

- We are not entirely convinced of the reasons for rejecting pay-as-clear viz. that this change could only be implemented with a more radical change to the balancing mechanism. However, pay-as-clear may only slightly improve the efficiency of the mechanism, if at all, and therefore we agree that this should be out of scope but on the grounds that the change may not be justifiable on a cost vs benefit basis.
- A Balancing Energy Market is impractical as it does not take into account issues such as plant dynamics, nor locational constraints, but some kind of market which establishes the supplier relationship with the customer may be required in the longer term to facilitate the engagement of the demand-side.
- Any alternative arrangements for renewables would be discriminatory. We have always been of the view that subsidies for renewables are fine, but if these subsidies are mixed in with the market rules themselves, the level of the subsidy is unclear.
- The day ahead reserve market is simply unnecessary in our view but certainly needs to be reviewed in the light of the direction of European developments.

In terms of what remains in scope for immediate attention we remain sceptical of the need for a significantly more marginal cash out price (unless there is no capacity market – see below) and believe the desired effects could come about through the planned improvement of the allocation of reserve costs and attributing a cost to non-costed actions. The interactions therefore need to be understood. We are wholly supportive of further investigation into single or separate trading accounts, reducing gate closure and consequential considerations such as RCRC.

However, we are also sceptical of the need to move to single cash-out. We do not believe that this is in line with most of Europe, especially the countries Great Britain is geographically closest to. Even when viewed solely from a GB perspective single cash out is not desirable as it would reduce the incentives to balance: thermal plant would probably go less long and there would be consequences for NGT's reserve requirements; wind generators would probably be incentivised to spill even more since, instead of receiving SSP or MIDP, they would start to receive the equivalent of SBP when the system is short.

If a capacity market goes ahead then we believe that it goes a long way to address the issue of 'missing money' and incentivises people to invest in new capacity. To have both a capacity market and more marginal pricing would be double rewarding the capacity. In the absence of a capacity market then the dual cash-out system with a more marginal main price (using PAR) would be simplest and most appropriate. Potential benefits of a more marginal cash-out price could be to increase the incentive for people to trade more before gate closure, and to increase the incentive to improve forecasting. However, a consideration to be aware of is that the price should avoid being excessively marginal as this could have an unintended consequence- namely of creating a barrier to new entrants who perceive imbalance costs as too high a risk.

The remainder of this letter responds to the questions laid out in the order in your letter

1. Do you agree Ofgem should launch a project to create a high level design for the future electricity trading arrangements?
If not, why not and how would you see the changes to the industry noted above being managed?

> A high level picture of future trading arrangements will be useful to see how things may develop as Europe develops. However, certain things (such as any proposals to centralise renewables or combine the balancing costs of intermittent plant) should be ruled out now on the basis that they are discriminatory and their overshadowing merely creates uncertainty. Thus far, the government has reaffirmed its commitment to market solutions and aims in the longer term to remove all subsidies from the electricity market, allowing it to compete on a level playing field. It would therefore be inconsistent with this view to indicate to the market that there is a possibility of building mechanisms into the market structure arrangements which effectively subsidise the balancing costs of renewable/intermittent plant in an opaque manner, as this would deter new aggregators from entering the market.

2. What key issues should be examined as part of a work stream on future GB trading arrangements? (We welcome specific comments on our initial thoughts set out in Annex 2.)

SmartestEnergy Ltd
Dashwood House,
69 Old Broad Street,
London, EC2M 1QS
T 020 7448 0900
www.smartestenergy.com
Registration No. 3994598

Integration of renewables: The document states that “the existing trading arrangements, dating back to the NETA implementation in 2001, were not designed primarily with the integration of renewables in mind.” Nor should they have been. The market rules/arrangements should be technology neutral. Ed Davey has stated that the aim of government is to return eventually to arrangements which are subsidy free. It is imperative, therefore, that subsidies are placed around the rules and not as a fundamental part of them. We are totally against anything which, for instance, removes imbalance obligations from generators. Services to take on these risks are available commercially now through aggregators and there should be no compulsion on suppliers to take them on involuntarily.

We support initiatives which improve liquidity and the ability to trade closer to real time, but these initiatives need to be market-wide and not discriminatory i.e. initiatives to improve liquidity should concentrate on liquidity in the wholesale market and not just access to market issues for minority players, and initiatives to trade closer to real time should apply equally to wind as well as other types of plant so that they are all on a level playing field.

Facilitating Demand Side Response: We support further investigation into the incorporation of the demand side, but this should be on an equal basis as generation and any mechanism needs to be watertight in assuring that demand reduction is genuine and that it is not rewarded where it would have happened anyway.

Congestion management is mentioned under section 3 “Efficient balancing and system operation.” We believe congestion management is best dealt with through market splitting so Ofgem should link this in the EU developments.

Effective integration with the wider European market : We are not so convinced of the argument that market splitting and price zones under the European TM could support the integration of renewables. Market splitting can be justified on the grounds of market efficiency alone.

We agree that incentives to maintain and invest in new capability, interactions with gas arrangements and institutional arrangements should be examined as part of a work stream on future GB trading arrangements but they need to be borne in mind during the focus on the issues targeted for the reduced scope of the SCR.

3. What form should the process take?
How can the process help increasing certainty about the impact of the EU TM and its interactions with EMR while limiting any unintended detrimental effect on investors’ certainty?

What structures should we use to maximise the opportunities for stakeholder involvement?

We agree with the proposal to set out a timetable with clear deliverables at each stage of the project, but as stated above, the most important phase is to establish the market principles. The remaining phases should merely tie in with EMR and European developments. We also approve of setting up a range of working groups and holding regular workshops to gain stakeholder input during the “design phase” and to ensure that all interested parties are informed of progress and early thinking. This process has worked relatively well on liquidity issues; it important that industry is involved and that no hasty decisions are made.

Should you wish to discuss any aspect of these issues further, please do not hesitate to contact me.

Yours sincerely,

Colin Prestwich
Head of Regulation
SmartestEnergy Limited.

T: 01473 234107
M: 07764 949374