

Gas SCR Technical Working Group 4

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| Industry working group to discuss design options for a demand side response auction. The meeting also set out the next steps for publication of Ofgem's decision on cash-out reform. | Date of Meeting Location | 15 May 2013 Ofgem, 9 Millbank, London |
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1. Introduction

1.1. Tom Corcut (Ofgem) welcomed everyone to the meeting and set out the reasons for holding the workshop. He noted that stakeholder responses have consistently expressed significant concerns with the DSR auction having any form of price cap. In the absence of a price cap, the cash-out price could theoretically be unlimited. One aim of the meeting was to discuss this possibility given that there was a significant proportion of large consumers that may have VoLL above £14/therm (including CCGTs, who could have a very high VoLL¹).

1.2. It was noted that Ofgem's original intention had been to publish a final decision on cash-out reform by early June. This has been delayed to stay aligned to the further interventions work carried out by DECC. The revised timeline anticipates is that a decision on the Gas SCR will be made in early July and this will be published shortly after.

2. Auction design proposals

2.1. Stephen Jarvis (Ofgem) presented straw men 1 and 2 as they were set out in the working paper circulated ahead of the working group.

2.2. It was noted that removing the price cap in straw man 2 could result in unlimited cash-out prices. Tom Corcut reiterated that the aim of the session was to understand stakeholders' views on the prospect of unlimited cash-out. It was observed that the potential for an unlimited cash-out price was not unique to Ofgem's proposals and a model following UNC modification 0435 proposals would also need to consider this issue.

NDM VoLL and target price concerns

2.3. A participant said that concerns were not as much about the cap being part of the DSR auction but the inevitability that the value of NDM VoLL would factor into cash-out, and that this value would be known in advance. They believed it was inevitable that cash-out would become £14 at stage 3 of a GDE (particularly in the case of straw man 1). If the market knows the price that will be reached in stage 3 of a GDE, it will drive prices up more rapidly than would otherwise be the case. They expressed a preference for NDM VoLL being separated from cash-out. Another participant thought stage 3 of a GDE was so unlikely, the inclusion of the £14 NDM VoLL was irrelevant.

2.4. Working group attendees were asked whether a trader immediately jumping to a particular price was rational and would they not seek to obtain the best position possible at the time. Participants felt that intervention or its unintended consequences were creating an artificial market and rational behaviour could not be guaranteed.

2.5. One participant said they did not believe the £14/therm level of NDM VoLL was accurate. They felt it was also wrong to use it as a cap in the DSR auction. Any NDM interruption would be some time after DSR bids had been called upon so participants considered it was incorrect to link the two.

¹ up to £10,000/MWh (£150/th) based on the Capacity Mechanism IA

2.6. It was noted that domestic electricity VoLL has been quoted at £10,000/MWh which equated to £150/therm. There were concerns from one participant that a higher VoLL was being deemed to be a better outcome. They believed this was not the case and that it would pollute trading. They were concerned about the risks to credit and liquidity that this would bring.

2.7. A participant suggested that NDM VoLL should not feed into SAP. They said that it needs to be retained in short shipper cash-out but could cause problems when also factored into cash-out for long shippers.

Use of a price or volume cap

2.8. A participant questioned the need for a cap as the price signal was currently unlimited. It was noted that the current arrangements return cash to shippers through neutrality. Ofgem's proposals sought to improve the price signal by redirecting this money to consumers in recognition of the involuntary DSR service they provide in balancing the system in an emergency.

2.9. Participants were asked how a volume cap could be established were one to be used. The aim of a volume cap was noted as being to create competition in the auction, but allow as much DSR as possible to be procured. This could be done by, for example, only selecting a certain percentage of bids.

2.10. One working group member had a preference for a fixed volume cap based on estimated need for DSR rather than an arbitrary percentage. It was noted though that this was very difficult to do as it is difficult to estimate participation and secondly CCGTs are potentially a huge proportion of the volume and could have highly unpredictable bidding strategies.

2.11. A participant questioned whether if there was no price cap, would NGG pre-empt the market and affect prices before giving the market time to resolve the situation. It was stated that NGG would seek to exercise bids alongside actions on the OCM and would do so in an efficient and economic manner.

2.12. Participants were asked for their views on the use a volume cap. There was no definite response as stakeholders said they were unsure of the consequences given that this is an untested proposal. They reiterated the desire to remove NDM VoLL from setting cash-out in stage 3 of a GDE, regardless of the chosen model for a DSR auction.

2.13. One person asked if the goal was cash-out reform to provide incentives or payments to consumers. It was argued that these are interlinked. The price signal generated by cash-out charges is key but the strength of the incentive is driven by making payments made to consumers in recognition of the balancing services they provide to the system when they are interrupted involuntarily during an emergency.

Removing the price cap

2.14. It was noted that arrangements in several energy markets incorporate consumer VoLL.

2.15. Tom Corcut explained that one alternative might be to remove the price cap and let the DSR auction determine cash-out in stage 3. DSR providers would be remunerated at the price set by the auction. The marginal price would also be used to make payments to NDM consumers who were involuntarily interrupted (effectively including NDM consumers in the pay-as-clear arrangements). It was noted that this could likely lead to payments to NDM consumers in excess of £14 per therm. It was reiterated that pricing consumer interruptions into cash-out is important in order to create appropriate incentives.

2.16. One participant thought the principle was sound but could be complicated by interactions with the electricity capacity mechanism that would drive up bids.

2.17. Another noted that this could cause problems with cost recovery. Not all funds would necessarily be recovered from short shippers so the remainder could need to be charged to neutrality.

Straw man 3

2.18. Stephen Jarvis (Ofgem) presented an alternative third straw man auction design. This included a fixed option fee for successful DSR bids.

2.19. A consumer representative said they supported option fees and asked how the fee would be set. It was confirmed that National Grid would have a budget and the option fee would be a fixed figure for all consumers. They did not understand a fixed option fee regardless of consumer and preferred a refund on the capacity charge as an alternative. Ofgem explained that this model, which previously applied for interruptible capacity, was not considered sustainable.

2.20. Straw man 3 was explained in more detail to the working group. To start with, to ensure participation in the first auction, the option fee may be set at a higher level and therefore in the first year a lower volume would be procured. Over time, competition may drive down the option fee allowing National Grid to procure more DSR for the allowed budget. It was suggested that the Operating Margins model could provide an initial level for the option fee.

2.21. One participant asked what would happen if the consumer was willing to forego the option fee. They felt that an option fee may dilute costs signals and not be the best option for consumers.

2.22. Some participants thought the option fee offered very poor value for money as it was unrelated to investment. One noted that an option fee would be paid regardless of whether a GDE occurred and therefore created a subsidy. They did not believe it would encourage investment by those consumers who have no wish to take part in the auction.

2.23. One participant commented that the ability to provide DSR came at a cost and the option fee was an appropriate way of reimbursing this. Another supported the idea of an option fee in addition to the possibility of not receiving anything should they not take part in the auction (a "carrot and stick" approach).

2.24. In concluding this section of the workshop it was summarised that:

- Stakeholders had significant concerns with £14 NDM VoLL feeding into cash-out at any stage of a GDE.
- A volume cap was preferred to a price cap on the assumption that the £14 NDM VoLL did not feed into cash-out.
- There were mixed feelings about option fees but a variable option fee would be preferential to a fixed one.

3. Gas fired generation

3.1. Anjali Mehta (Ofgem) and Julie Cox (Energy UK) presented on the issue of gas-fired generation eligibility within the DSR auction.

3.2. One participant felt that if participating in the electricity capacity mechanism, there was no incentive for gas-fired generators to take part in the DSR auction. This was due to the level of penalties in the electricity capacity mechanism. They also believed some

degree of complexity such as indexation to electricity prices, was required to attract gas-fired generation.

3.3. Another participant said it was difficult to compare the costs of electricity and gas as there was no linear correlation between the lengths of interruption in each fuel.

3.4. The possibility of penalties was raised. Participants felt that a failure to interrupt when called on to do so should result in some form of penalty but agreement that self interruption should not be penalised.

3.5. When asked, no one within the group indicated that they considered that gas-fired generation should be excluded. A participant noted though that they were unsure what their participation would provide beyond what they are currently able to offer through locational bids on the OCM. If their bid was indexed to electricity then it may be too costly to call upon.

3.6. One participant said that a large industrial consumer may submit a high bid, while CCGTs may bid at electricity VoLL. They did not believe there was an easy way to predict this. They believed a simple auction is more likely to deliver high-priced bids. They said that introducing complexity through some form of indexation to electricity may encourage more realistic bids. Another participant felt an index to electricity may encourage greater participation in the DSR auction.

3.7. It was noted that the electricity capacity mechanism will be transparent. There was a concern that large consumers may look at CCGT bids in that mechanism and adjust their DSR bids accordingly. There was therefore a risk of the electricity capacity mechanism creating a target price.

3.8. Further comments were invited on CCGT eligibility. These should be sent to GB.markets@ofgem.gov.uk.

4. Next steps

4.1. Tom Corcut thanked the working group for their comments and set out the next steps.

4.2. Depending on the decision by the Authority, the intention is to publish a decision letter on cash-out, a consultation on high level principles of a DSR auction and a summary of the responses to the July 2012 proposed final decision in July 2013.