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Dear Rachel,

Consultation on the potential requirement for new balancing services by National Grid Electricity Transmission plc (NGET) to support an uncertain mid-decade electricity security of supply outlook

Thank you for the opportunity to respond to the above consultation. We have provided answers to the three questions asked in the consultation in the attached annexe. We have also provided additional comments below on our view of the market and the need for these services as well as more general comments on the proposals for the Demand Side Balancing Reserve (DSBR) service and in particular the Supplemental Balancing Reserve (SBR) service.

We have consistently highlighted the emerging security of supply concern in GB, which is driven by an impending shortage of generation capacity. We concur with the conclusions in Ofgem's latest Electricity Capacity Assessment and welcome the recognition from DECC, Ofgem and National Grid that there could well be capacity shortages as early as 2014.

While the bilateral energy market has, in the past, been able to ensure security of supply, current conditions do not provide the necessary investment signals to maintain an economically efficient level of generation. The risks inherent in investing in generation in today's energy market mean that generators are likely to build less capacity than customers need. This is primarily due to the social nature of electricity reliability, which does not allow an individual consumer to contract for a differentiated level of reliability. The other principle market condition hindering investment in adequate generation capacity is the worsening "missing money" concern facing investors in firm capacity. With more zero/low short run marginal cost, inflexible and intermittent generation on the system, plant providing firm capacity will run fewer hours at lower average prices and more unpredictably, thus eroding their business case.

Even if capacity margins tighten, these market conditions are unlikely to improve without a shift in the way firm capacity is remunerated. As such, we have been supportive of the introduction of a capacity market as soon as practicable to enable investment into both existing and new forms of capacity. We welcomed the Government's decision to introduce the first auctions in the Capacity Market in 2014/15. Although starting payments in 2018/19 is appropriate for new investments it does nothing in the shorter term to prevent further closure or mothballing of existing plant, let alone to encourage mothballed plant back. We have therefore been calling for the first capacity payments to be available from 2014/15, and maintain that this is the optimal means of tackling the capacity challenge in an equitable and sustainable way.

The consultation document acknowledges that "security of supply is a function of the market which is underpinned by the energy policies under which the industry operates" and that it is not National Grid's role "to ensure there is sufficient generation capacity available to meet demand." However, the proposals aim to ask National Grid to do precisely this by procuring capacity through the Supplemental Balancing Reserve (SBR) and Demand Side Balancing Reserve (DSBR). This would be a fundamental change to National Grid's role as residual system balancer and of the energy market arrangements founded at NETA and raises new potential for conflicts of interest.

While the proposals under consultation for the procurement of additional services could, in theory, provide a form of additional balancing reserve for the 2014-2018 period, they will not improve the fundamental market conditions (if plant is no longer on the system, it can't be used to balance).

What the GB electricity market needs is not a temporary sticking plaster but rather an enduring mechanism that will enable not only investment decisions for new plant but also improve the economic viability of existing plant. These proposals do not encourage any investment in new plant, so only address part of the challenge and indeed, they could make things worse by crowding out commercial investment in the medium and long term. This problem can only be solved through a market-based (and market wide) capacity mechanism like the forward capacity market for which DECC is currently legislating. Early introduction of payments under this enduring capacity market would address both issues with the one mechanism. It would also allow resources to be focussed on the main objective and ensure costs for participants are minimised.

Notwithstanding our concerns in relation to these services being introduced, the following comments are provided should it be decided that either the DSBR or SBR are indeed introduced for a short period.

Demand Side Balancing Reserve (DSBR) – General Comments

We support efforts to improve the commercial opportunities for demand side response (DSR) measures. However, DSR is still a long way from being able to reliably contribute to addressing the projected capacity shortfall. DECC's research gives inconclusive evidence on the potential for and reliability of DSR in the domestic sector[1], while many non-domestic customers already participate in DSR through, for example, interruptible contracts. The DSBR product would need to be delivering in 2014/15, and it is unlikely that significant volumes will come forward before this time beyond what is already participating in the market through STOR. The pilots planned for DSR under the capacity market will provide a useful entry point for DSR into the market. Attempting to fast-track this process by introducing a new DSBR product would be premature and unlikely to deliver the desired results.

The focus should instead remain on the participation of DSR in the enduring capacity market through the planned DSR trial. The first auction for the DSR/storage trial under the capacity market should be run in 2014 with first delivery in 2015/16, not delayed until 2015 as has been proposed in the July capacity market update from DECC. It has been suggested that learnings from the DSBR will help inform the DSR trial. However, the two schemes will operate separately and do not appear to have many similarities in terms of qualification, participation and value of providing demand response. To realise its potential in the market, DSR needs a stable, supportive commercial framework to be developed as soon as possible. Creating two products will hinder this by introducing a time-limited product (DSBR) instead of giving the enduring product (DSR in the capacity market) a longer lead time to develop.

There is a lack of consistency in treatment of DSBR and SBR in terms of penalties for non-delivery. It is unacceptable for DSBR providers not to face a penalty for non-delivery. If DSBR providers are receiving a capability payment then there must be consequences for failure to deliver, it cannot simply be based only on using reasonable endeavours. Without a penalty, customers are paying for a false sense of security of supply that is not being guaranteed by DSBR providers.

It has been proposed that DSBR is despatched in order of economic precedence with other balancing services but that having done so, its cost would not be factored into the imbalance price. This would result in a depression of the market price, which is wholly unacceptable when DSBR is being despatched within the stack of all market actions. If despatch is to be done in this way then the cost must be included in calculating the imbalance price, and it should not need to wait the outcome of Ofgem's cash-out review.

Supplemental Balancing Reserve – General Comments

The SBR is being proposed as a time-limited, narrowly-focused contract for capacity that will exist in isolation from the energy and balancing services markets. Should the SBR be introduced as a short term measure, the following elements are critical to its acceptance:

The SBR must have a firm sunset date and must not interfere with the introduction of the capacity market;

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48552/5756-demand-side-response-in-the-domestic-sector-a-lit.pdf

- The SBR should only be used as a stop gap measure before the capacity market can practically be introduced. The SBR must cease before the first capacity market delivery year, which would therefore be in 2015/16.
- In approving changes to National Grid's Balancing Services Procurement Guidelines, Ofgem must stipulate that the powers to procure the proposed new balancing services expire before 2015/16. Only including a review clause would not provide sufficient confidence to the market that the SBR will be time limited in nature.

Strict conditions preventing SBR plant from interfering with the energy-only market must be imposed and adhered to.

- The presence of SBR plant must not be allowed to interfere with the potential profitability of plant that has remained online in the regular market. This can only be achieved by restricting despatch of SBR to after all other offers have been taken in the balancing mechanism.
- If used, the SBR must be priced into the imbalance price. This should not need to wait for the outcome of Ofgem's cash-out review.

National Grid and Ofgem must act quickly to finalise the detail of the SBR, as plant must make decisions today (e.g. on fuel contracts, staff, outage planning) if they are to participate in the SBR for 2014. The consultation document mentions earlier tenders could be run for an SBR trial in 2013/14, in which case there is already very little time to prepare stations before this winter. Realistically, it will be difficult to implement this solution quickly, especially if a decision from Ofgem is not forthcoming until the end of this year or into 2014.

Moreover, the introduction of the SBR creates another layer of uncertainty for operators and investors in a market already facing an investment hiatus due to the lack of clarity around the implementation of the Electricity Market Reform package, particularly when these measures may need to receive State Aid and other clearances from the European Commission.

I hope that you find our comments helpful. Should you have any questions on our response please do not hesitate to contact me.

Yours sincerely

Robert Hackland
Head of Market Development

Annex

Consultation Questions

1. **Do you agree with our assessment regarding the risk to mid-decade electricity security of supply?**

Ofgem's Electricity Capacity Assessment (2013) concludes that risks to security of supply are likely as early as 2014/15 driven by further reductions in electricity supplies from the withdrawal of installed generation capacity. It also highlights that future policy and price uncertainty are continuing to limit investment in thermal generation. This assessment is in line with our view and bolsters the case for bringing forward a mechanism to deal with the underlying issues contributing to generation inadequacy, namely the "missing money" and the uncertain economic viability of conventional generation going forward. In our view, the solution to this is to bring the first capacity market payments forward to be available from 2014/15.

2. **If so, do you agree with our view that it is prudent to consider the development by NGET of additional balancing services, which NGET would procure and use if there is a need for them?**

The consultation document acknowledges that "security of supply is a function of the market which is underpinned by the energy policies under which the industry operates" and that it is not National Grid's role "to ensure there is sufficient generation capacity available to meet demand." However, the proposals aim to ask National Grid to do precisely this by procuring capacity through the Supplemental Balancing Reserve (SBR) and Demand Side Balancing Reserve (DSBR). This would be a fundamental change to National Grid's role as residual system balancer and of the energy market arrangements founded at NETA and raises new potential for conflicts of interest.

While the proposals under consultation for the procurement of additional services could, in theory, provide a form of additional balancing reserve for the 2014-2018 period, they will not improve the fundamental market conditions (if plant is no longer on the system, it can't be used to balance).

What the GB electricity market needs is not a temporary sticking plaster but rather an enduring mechanism that will enable not only investment decisions for new plant but also improve the economic viability of existing plant. These proposals do not encourage any investment in new plant, so only address part of the challenge and indeed, they could make things worse by crowding out commercial investment in the medium and long term. This problem can only be solved through a market-based (and market wide) capacity mechanism like the forward capacity market for which DECC is currently legislating. Early introduction of payments under this enduring capacity market would address both issues with the one mechanism. It would also allow resources to be focussed on the main objective and ensure costs for participants are minimised.

3. **Do you agree with our assessment of the key factors we should have regard to when considering whether to approve any changes to NGET's Balancing Services Procurement Guidelines and associated documents?**

The factors identified are important in assessing whether or not NGET's balancing Services Procurement Guidelines and associated documents are changed. We would go further than the three factors proposed and include that NGET's dispatch processes also need to be objective and transparent. From the information available across the two consultations, we do not believe that the proposed additional services will meet these conditions and we have highlighted our concerns below.

a) NGET's procurement must be economic and efficient and the products must represent value for money to electricity consumers.

In terms of providing value for money to electricity consumers, we note DECC's view that using existing powers to create the SBR is "a much more cost-effective solution, much more reliable, [and] much more certain." DECC sees the SBR as an extension of current payments for balancing services and thus the quickest and cheapest way of managing short term capacity shortfalls. As noted above, DECC also expect there to be savings to the consumer as the extra capacity procured through the SBR will prevent prices from peaking as high as they otherwise would have (giving rise to our reservations with regard to interference in the market expressed above).

However, we are concerned that no impact assessments quantifying the costs and benefits of the SBR and DSBR have been carried out to support the above statements about cost reductions and that there is no intention to bring forward impact assessments until after the consultation is complete. It must be demonstrated that the impact from the National Grid proposals on the magnitude and volatility of prices represent better value for money to customers than bringing forward the enduring capacity market.

b) NGET's product design and proposed use of the new products must minimise unintended consequences to market participants and the operation of the market.

Our most significant concern is that there will be unintended consequences through the products interfering with the proper functioning of the market.

It is clear that the SBR is essentially a form of strategic reserve with last resort dispatch. Strategic reserve was rejected by DECC, acknowledging that such a mechanism does not address the "missing money" in the energy market and could even exacerbate problems should investors fear the strategic reserve would be deployed before intended, i.e. when other capacity is available albeit at very high prices. This would dampen the investment signal for players outside of the strategic reserve, leading to the "slippery slope" effect whereby no new investment is viable without a SBR contract and more and more capacity must be procured within the strategic reserve.

DECC's concerns about the premature deployment of a strategic reserve go to the heart of the problem with the SBR. Although on paper the SBR will come with conditions that prevent reserve plant interfering with the energy-only market, in practice it will be difficult for National Grid to strictly adhere to these conditions, due to factors related to plant dynamics and cost as well as regulatory and Government pressure. Indeed, in his response[2] to a question from Dan Byles MP, Ed Davey stated "**whether it is in the short term, as Ofgem and National Grid are doing, or in the medium term, as we are doing with the capacity market, is that by the fact that you have that capacity, prices will not peak as high as they otherwise would have done**". The clear implication of this is that the reserve plant in the SBR is expected to interfere with the energy market.

Indeed, the consultation document recognises this interference and points out that there are instances where National Grid will have to "begin ramping up SBR plant before other balancing services had been fully exhausted." The draft Balancing Principles Statement also proposes that the SBR will be used before reserve is used (paragraph 5 page 17/18).

We also have concerns with the way that it is proposed SBR and DSBR will be dispatched and how their costs will feed into the imbalance price. It has been proposed that DSBR is despatched in order of economic precedence with other balancing services but that having done so, its cost would not be factored into the imbalance price. This would clearly result in a depression of the market price, which is wholly unacceptable when DSBR is being despatched within the stack of all market actions. If despatch is to be done in this way then the cost must be included in calculating the imbalance price. It should not have to wait for the outcome of Ofgem's cash-out review. For SBR, if used, it must also be priced into the imbalance price. To ensure all other priced generation is despatched before SBR, we believe SBR plant should be valued at VoLL and factored into the imbalance price at this level. Again, this should not need to wait for the outcome of Ofgem's cash-out review. If dispatched, SBR plant would not receive VoLL but rather its agreed utilisation price (as well of course as its capacity fee).

c) NGET's procurement process must be objective and transparent.

We have already expressed our concerns over the latitude that it is proposed National Grid will have in the dispatch of SBR plant e.g. the warming of SBR plant ahead of market priced plant, and the contradictory statements over exactly when SBR plant will be dispatched.

In addition to this major concern, we have concerns with regard to the eligibility criteria for participation in the tender process. We recognise that National Grid might wish to put in place eligibility criteria to prevent all forms of generation coming forward to tender for an SBR contract. However, there appears to be a fundamental conflict between the Government's desire to use this mechanism to keep existing plant open and for there to be additionality. Any criteria imposed (e.g. date mothballed) would have to be carefully chosen so as not to create a perverse incentive for plant to mothball early nor to disadvantage those plants that have stayed open in

[2] Oral evidence from Energy and Climate Change Committee "Review of DECC Policy", 2 July 2013: http://www.publications.parliament.uk/pa/cm201314/cmselect/cmenergy/uc554-i/uc554.pdf

anticipation of a capacity market being introduced for 2014/15. Injudicious imposition of eligibility criteria could result in National Grid turning down plant that will in fact be forced to close or mothball without a contract based on administrative eligibility criteria instead of on its relative cost effectiveness.

There is a lack of clarity in what has been proposed with regard to the Transmission Entry Capacity (TEC) that SBR plant must hold to be eligible to take part in the tender. In our view, plant must not be required to hold their own TEC. Plant that is closed or mothballed may have already released their TEC. It would be unreasonable to require SBR plant to incur the cost of retaining TEC or procuring short-term TEC since it is likely to run rarely and all despatch will be at National Grid's instructions. National Grid should facilitate the process by guaranteeing TEC with a successful SBR tender where such TEC can only be used when the plant is called under the SBR contract by National Grid. This could be provided to SBR contracted parties through a TEC transfer from National Grid or by National Grid refunding the cost of TNUoS to SBR plant that already hold sufficient TEC.

In terms of NGET having discretion over the location of plant, we disagree that SBR tenders should be evaluated on the basis of location in transmission constrained zones. If National Grid wish to attempt to assess tenders based on location and potential for plant to be behind constraints, then the Ofgem capacity margin numbers on which the rationale for the SBR is based must similarly recognise the potential for these constraints. As it stands Ofgem's Electricity Capacity Assessment (2013) does not take into account transmission constraints when estimating future capacity margins. If it did, this would highlight the current situation as being even worse than anticipated.

Finally, there should be no discretion over plant that has exhausted their permitted running hours under the LCPD and remain mothballed. These must not be awarded SBR contracts in the tender process.