The voice of the energy industry

Ofgem Electricity Balancing Significant Code Review – Draft Policy Decision consultation response

22 October 2013

Energy UK is the trade association for the energy industry. Energy UK has over 80 companies as members that together cover the broad range of energy providers and suppliers and include companies of all sizes working in all forms of gas and electricity supply and energy networks. Energy UK members generate more than 90% of UK electricity, provide light and heat to some 26 million homes.

Energy UK welcomes the opportunity to respond to this consultation on Ofgem's Draft Policy Decision for the Electricity Balancing Significant Code Review. The outcome of this process will have a significant impact on the electricity market and therefore it is important that Ofgem consults with industry to understand the impact of the constituent proposals within the cashout reform package.

Executive summary

- Efficient balancing arrangements are a vital feature of a functioning electricity market and therefore Energy UK welcomes the Electricity Balancing Significant Code Review's focus on ensuring cashout prices are fit for purpose.

- Energy UK members consider it vital that before final decisions are made, clarity is provided on the interaction between proposed cashout arrangements and the Capacity Market, the policy design and auction parameters which are yet to be finalised.

- There is a consensus that clarity is needed as soon as possible on Ofgem's final decision in advance of the first Capacity Market auction in Winter 2014. This might require Ofgem to separate out the parts of the cashout package which are priorities for implementation from those that are less urgent and where more work is required.

- The majority of Energy UK members support implementation of a **single cashout price,** which should lead to more efficient balancing and improve liquidity. It should also be noted that there are some significant concerns i) that the beneficial impacts Ofgem cites would be unevenly spread among participants and would only be temporary for independent renewable generators; and ii) that a single cashout price should be linked to the introduction of marginal pricing.

- Ofgem needs to undertake some work to look at the impact of single cashout pricing on the liquidity of intra-day trading and take into consideration the trading strategy challenges that market participants will face.

- There is a diversity of views amongst Energy UK members with respect to **marginal pricing,** with some in favour of moving to PAR1 to ensure that cashout prices better

reflect scarcity. Others believe that moving to PAR1 would lead to disproportionate risks. Some believe that the case for a fully marginal price is not definitive, and moreover that a phased move towards more marginal pricing would be beneficial for independent renewables generators who are likely to be better able to improve forecasting and balancing incrementally, rather than via a "Big Bang" approach. All points are valid. With the proposed changes being so significant, we therefore urge that Ofgem undertakes more analysis to determine likely outcomes of moving to different PAR levels and share with the industry, prior to reaching final decisions.

- Energy UK members support the principle of **pricing VoLL** in cashout. Questions however remain on whether the high values could place a disproportionate risk on some participants. There are also a number of practical challenges that Ofgem must resolve as part of the SCR before implementation, such as the need for a warning ahead of demand disconnection events and ensuring that calculations of disconnection volumes are more robust than the 'top-down' approach proposed.

- Energy UK members have significant concerns with the proposed model for **payments to consumers for involuntary DSR services** due to the inconsistency with arrangements for demand control actions that are not related to energy imbalance reasons. As disconnections arising from energy imbalances are very rare events, the administrative process and cost of making the payments would likely outweigh the benefits to consumers.

- Energy UK members agree that the current arrangement for pricing reserve services is not optimal. However, the proposal for a **Reserve Scarcity Pricing function** requires a robust feasibility assessment including an assessment of the impact on the competitiveness of non-BM STOR units versus BM STOR units. As pricing reserve services is not an urgent issue to resolve, we propose that this aspect of the proposal becomes a long term goal and is considred separately from the rest of the cashout package.

- Ofgem must also be mindful of the changes to GB market arrangements arising from the European Network Code for Balancing. The Code is still under development, however, proposals for cashout reform must be consistent to prevent the need for revision of GB balancing arrangements once the European Codes have been implemented.

- Given recent political developments, Energy UK members are concerned about the bankability of cashout prices because of the political uncertainty around whether volatile and potentially very high cashout prices will be permitted or whether further intervention will ultimately be considered more acceptable, with the resultant distortion of the market.

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Appendix – Consultation Questions

Question for the Draft Policy Decision:

Question 1: Do you agree with our proposal to make cashout prices more marginal?

1.1 Energy UK in principle supports more marginal cashout prices, which should produce the signal for more efficient balancing. However, the key question is how marginal cashout prices should be. There are a diverse range of opinions amongst our members as to whether a move to a fully marginal price is appropriate (detailed in answer to question 2). Furthermore, the majority of our members would only support more marginal pricing if introduced in conjunction with a single cashout price.

1.2 Energy UK members require clarity on the introduction of more marginal pricing in advance of the first Capacity Market auction in 2014 as there could be significant impact on the investments being considered by our members at this time. According to current CM design proposals, DECC will require potential capacity providers to justify bids above a Price Taker threshold, which makes clarity on cashout prices all the more important. Our members therefore urge Ofgem to announce its final decision as soon as practicably possible, ideally before Spring 2014, mindful of the need for a full impact assessment.

Question 2: Do you agree with our rationale for going to PAR1 rather than PAR50? Are you concerned with potential flagging errors, and would you welcome introduction of a process to address them ex-post?

2.1 There is a diversity of views amongst Energy UK members on whether moving to PAR1 rather than PAR50 would be most appropriate. Some of our members are in favour of moving to PAR1 to ensure that cashout prices provide more accurate price signals. There are others who are opposed to moving to PAR1 because of concerns about the risk it would incur for parties, the impact on market behaviour and therefore whether there are diminishing returns. With all points having recognisable validity, we consider that Ofgem need to undertake further analysis and share the results with the industry, before final decisions are made.

2.2 Some members are concerned that Ofgem has not considered behavioural change as part of its impact assessment. For example, Ofgem has not looked closely at the impact on the market behaviour of low carbon generators in receipt of CfDs and the impact on imbalance pricing, particularly post-2020.

2.3 Some members would therefore prefer a phased approach to more marginal pricing, although not necessarily to PAR1 or even PAR50, so that the change is incremental. Independent wind generators would retain the incentive to improve forecasting and balancing without being too heavily penalised during that process.

2.4 It is unclear why there is a choice only between PAR50 and PAR1 and not a wider range - PAR250 or PAR100, for example.

2.5 Our members are concerned about potential flagging errors and a robust process would be required to ensure that these are corrected ex-post. We understand that National Grid is in the process of implementing new measures to meet future requirements if marginal pricing is implemented. However, it should be noted that this may have a negative impact on the accuracy of initial cashout prices published by Elexon.

Question 3: Do you agree with our proposals for pricing of voltage reduction and disconnections, including the staggered approach?

3.1 Energy UK members support the principle of pricing voltage reduction and disconnections but some members question the high values and the disproportionate risk it would place on parties. There are also a number of practical challenges that need to be resolved before taking this aspect of the SCR forward. Reasoned and evidenced direction is required from Ofgem before the modification process.

3.2 If implemented, a warning prior to gate closure by the SO will be required in order for market participants to be able to react and prevent the need for disconnection. Some members believe that in the absence of a warning, cashout should not go to VOLL in the event that there is demand control measures taken. Energy UK members encourage Ofgem to reconsider its decision that a warning is not required.

3.3 Energy UK supports the decision to adopt a phased approach to the introduction of VoLL pricing in the event that Ofgem decides to introduce it. However, we would question the robustness of the eventual VoLL level of £6,000/MWh, which according to Ofgem has been set somewhat arbitrarily at higher than the average estimated VoLL for I&C consumers. Our members seek clarity as to whether VoLL will change over time with discovery of more representative VoLLs.

3.4 Energy UK members have concerns about the proposal to use a 'top down' approach to estimating demand control volumes. We understand that Ofgem has decided on this option for simplicity reasons, rather than adopt the 'bottom up' approach. However, an estimation of demand control volumes could lead to inaccuracies with damaging consequences for generators in certain circumstances.

3.5 Ofgem must also consider the impact of VoLL pricing on credit requirements, which are likely to increase with the exposure to higher cashout prices. This could have an impact on the finances of smaller players and market entry.

Question 4: Do you agree with our assessment of the interactions with the CM and its impact on setting prices for Demand Control actions?

4.1 There is a clear interaction between cashout and the CM. Energy UK members need to review the details of the final CM policy design and auction parameters before being able to analyse the impact on setting prices for Demand Control actions.

4.2 Energy UK members are concerned about the interactions between the CM and the level of gas and power VoLL. Our members believe that due to there being no Force Majeure provision for gas-related incidents under the current CM design, coupled with the power VoLL being significantly higher than the gas VoLL, in the event of a gas shortage, gas-fired power stations would be incentivised to continue running to avoid incurring the high CM penalty and/or the power VoLL. This could inadvertently incur security of supply problems for gas. Our members are concerned that DECC and Ofgem have not developed a set of incentives and penalties that will lead to the most appropriate result for the market and consumers.

Question 5: Do you agree that payments of £5/hr of outage for the provision of involuntary DSR services to the SO should be made to non-half-hourly metered (NHH) consumers, and for £10/hr for NNH business consumers?

5.1 Energy UK members have significant concerns with the proposed model for payments to consumers for involuntary DSR services to the SO for the reasons outlined in the points below and therefore would suggest that this should not be included as part of the reform package.

5.2 The principle of paying out compensation is flawed when a Loss of Load Expectation is in place, as consumers will not be paying for 100% security of supply, which is already reflected in lower consumer bills.

5.3 Disconnection can occur for a variety of reasons which are not associated with a suppliers' own imbalance. Implementing this proposal would build expectation from consumers that compensation should be paid for every disconnection. Consumers are unlikely to be interested in *why* they have been disconnected and just that a standardised process is in place for compensation regardless of the reason. Government, suppliers and DNOs will be presented with a huge communication challenge if there are different arrangements for payment in different scenarios.

5.4 The administrative burden and cost of implementing processes for recompensing consumers is likely to outweigh the benefits, particularly as Ofgem's Electricity Capacity Assessment Report published in June esimates that the prospect of disconnection would be very rare (1-in-12 year chance in 2014/15).

Question 6: Do you agree with the introduction of the Reserve Scarcity Pricing function and its high-level design?

6.1 Energy UK members agree that the current arrangement for pricing reserve services in cashout is not optimal. However, the current lack of detail around the proposal for a Reserve Scarcity Pricing function is a cause for concern. As Ofgem states in the consultation, there are a number of questions to be resolved regarding the detail of implementation. Energy UK members believe that this proposal requires a robust feasibility process to be undertaken by Ofgem as part of the SCR before it can be implemented, which is likely to be lengthy.

6.2 Some members are concerned that this proposal may widen the competitive gap even further between BM STOR and non-BM STOR providers as the latter receive a payment from their supplier (typically SBP or SBP) for reducing their supplier's demand as the STOR output is netted off. This is in addition to the utilisation and availability fee received from National Grid. The introduction of this proposal would increase the level of the Supplier payment and make it more difficult for BM STOR providers to compete.

6.3 Energy UK proposes that the design and implementation of a Reserve Scarcity Pricing function should be separated out from the more urgent aspects of the cashout reform package.

Question 7: Do you agree with our rationale for a move to a single price, and in particular that it could make the system more efficient and help reduce balancing costs?

7.1 The majority of Energy UK members support moving to a single price and agree with the rationale that it could make the system more efficient and reduce balancing costs for independent wind generators and independent suppliers. Single pricing would also align GB with the direction of travel of the European Balancing Network Code. Those members believe it is particularly important that single pricing complements the implementation of marginal pricing.

7.2 However some members believe that Ofgem's arguments in favour of single pricing should acknowledge that the benefits to independent wind generators will be temporary as more intermittent renewable generation comes onto the system. These members

believe that the imbalances of independent wind generators will increasingly be correlated with system imbalances, nullifying any relief offered by a single price from more marginal prices.

7.3 Some Energy UK members have expressed concern about the impact of a single price on the liquidity of intra-day trading and request that Ofgem undertake an impact assessment. There is concern that a single price could remove the incentive for market participants to trade in the intra-day market, who might instead look to benefit from spilling in the Balancing Mechanism particularly at times of system stress. This would be detrimental for generators needing to trade for small chunks of power in the event of short term trips. Ofgem should consider the implementation of extra measures that would ensure that the incentive to trade remains.

Question 8: Do you have any other comments on this consultation, including on the considerations where we did not propose any changes?

8.1 Some members believe changes to gate closure should be reconsidered as part of the EBSCR. As the rationale behind the EBSCR is to incentivise trading parties to mitigate imbalances, there should also be greater opportunity, in the provision of tools and information, to do so. These members believe that a change of gate closure (for some or all parties, reducing it to 30 minutes for physical and contract notifications, or allowing contract notifications after gate closure) would allow for improved forecasting of renewable generation. Some other members believe gate closure should be kept at one hour.

8.2 Some members believe that Ofgem should also consider whether curtailment of interconnectors by the SO for energy reasons should be priced into cashout i.e. at the price the cross-border action was taken and at VoLL. Such changes will be required to ensure that cross-border exchanges are treated the same as GB exchanges, as required by the EU Energy Third Package.

Question related to the accompanying Impact Assessment:

Question 9: Do you have any comments regarding any of the three approaches we have taken to assess the impacts of the cashout reform packages?

9.1 Some members believe that there should be further investigation by Ofgem of the impacts of a CM on the value of the EBSCR proposals. The baseline used for comparison between packages is a “do nothing” scenario which does not include a Capacity Market but many of the arguments in favour of the EBSCR proposals have been made with this baseline in mind, e.g. on investment signals, impact on consumer bills. But the Cost Benefit Analysis for Ofgem’s preferred package (P5) falls by two-thirds, from £152m/yr to £53m/yr in 2030, when the effects of a CM are considered, and moreover other options (P2 and P4) provide a better result.

9.2 On the sharpening of cash-out prices, there appears to be relatively little difference from a quantitative point of view in moving between PAR50 and PAR1, which seems to indicate diminishing returns. It would be more transparent to show the effect of a wider range of PAR values (e.g. including PAR 250 and PAR500) by comparing packages with these PARs and the other measures being considered against the five Ofgem has selected.

Question 10: Do you agree with the analysis of the impacts contained in this IA? Do you agree that the analysis supports our preferred package of cashout reform?

10.1 Some members believe the analysis of the impacts does not present a convincing case for all the measures being proposed, particularly in light of other energy market reforms, particularly the CM and CfDs as part of EMR. The effect of these market interventions will have major effects on system balancing and pricing, which makes the move to a fully marginal cashout price (as part of P5) risky, with the forecasted benefits in the longer term less certain and also potentially harming competition in the energy market by negatively impacting smaller independent parties.

Question 11: Do you agree with the key risks identified and the analysis of these risks? Are there any further risks not considered which could impact on the achievement of the policy objectives?

11.1 Some Energy UK members believe that there may be a risk to the liquidity of intraday trading arising from implementation of a single cashout price if pay as cleared is not also implemented.

11.2 The Impact Assessment also needs to look at how the proposals will affect independent generators across different technologies and suppliers, particularly if they face a sustained short term period of imbalance.

Question 12: What if any further analysis should we have undertaken or presented in this document? Do you have any additional analysis or evidence you would like to contribute to support the development of the EBSCR towards its Final Policy Decision?

12.1 Some Energy UK members would like to see analysis undertaken by Ofgem on the impact of marginal pricing on behavioural change at different PAR levels. They would also like to see analysis undertaken of the impact of a single price on the liquidity of intraday trading.

12.2 Ofgem should undertake more analysis to show the effect of incrementally sharper prices, including PAR250 and PAR100, and make clearer the impact of all packages with a CM in place – on SBP & SSP, costs of balancing to parties, investment incentive, etc.