

Andreas Flamm
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

22nd October 2013

Dear Andreas,

Ofgem Consultation: Electricity Balancing Significant Code Review – Draft Policy Decision

Please find attached the First Utility's response to Ofgem's consultation on the Electricity Balancing Significant Code Review – Draft Policy Decision.

First Utility is the UK's largest independent utilities supplier, offering electricity and gas services to a range of consumer and business customers. With now around 200,000 dual fuel domestic customers, we have gained substantial experience of the issues caused by a lack of competition in the energy sector and how these impact UK consumers.

We believe the only way to drive conditions for strong retail market competition is to remove the key barriers to entry: the vertical integration of the Big6 Utilities, and the current dual price cash-out. These barriers are strongly interrelated and drive the low liquidity currently observed in the wholesale market, which in turn are the root causes of retail market stagnation.

A single cash-out price makes rational economic sense in a world where many market participants have unavoidable forecasting errors in their generation or supply portfolios. This is especially the case in a market with ever increasing volumes of intermittent generation as will be the case under EMR.

Single priced cash-out is likely to provide substantial benefits in terms of reducing the economic incentive of vertically integrating, which may contribute to increases in liquidity. It may also aid management of network constraints and reduce barriers to market entry and growth. We continue however to support the introduction of Self-Supply Restrictions to drive up liquidity, as the single greatest measure that could be taken to reform the market.

Under these current reforms, we do however have concern around the impacts of future renewable deployment levels on the volatility of marginal prices. This, alongside a lack of visibility on the impacts of marginal prices on different types of independent suppliers, means more analysis could be done to confirm that independent suppliers will not be disadvantaged under the new scheme.

First Utility proposes that instead of a rapid move towards single priced cash-out, there is a phased transition towards more marginal prices. As confidence is developed, a step approach can be taken to phase in more marginal prices to ensure that there are no unintended consequences. These must be avoided to ensure that competition in the wholesale or retail electricity markets is not damaged.

Our full response is in the annex to this letter: if you would like to discuss any of our submission, I would be very happy to meet with you to discuss in person.

Yours sincerely,

Emma Piercy

Senior Regulatory & Policy Manager, First Utility

Annex: First Utility response to Ofgem consultation on 'Electricity Balancing Significant Code Review – Draft Policy Decision'

Annex: Consultation Question Responses:

Questions for the Draft Policy Decision:

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

Yes we agree with a move to single priced cash-out; however we have concerns around the potential for unintended consequences from a rapid move towards more marginal cash-out prices. In particular we have concerns around the risk of significant increases in volatility in the short term market prices and in cash-out marginal prices given the uncertainty around the projected levels of renewable deployment.

We would welcome a greater insight into the modelling on how volatility impacts marginal prices, and likewise on the impacts on the different types of electricity supplier (vertically integrated versus independent). To further competition in the market, smaller suppliers such as First Utility must not be disadvantaged. Given the classification of 'independent suppliers' in the analysis includes companies such as GDF and Total, we think it is important to investigate whether the impact on smaller independents is masked by the impact of the larger independents in the published results to date.

First Utility supports the move towards both single priced cashout and more marginal cash-out – both must take place, but a phased approach could be taken to implementing marginal pricing in staged approach. This would help the market adapt gradually to the increasing levels of renewable deployment, and thereby help minimise the risk of any unintended consequences that could be to the detriment of wholesale and retail competition.

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?

Yes we agree with Ofgem's rationale for making cashout prices more marginal, but we believe a phased approach may be best in order to ensure there are no unintended consequences to wholesale or retail competition as a result of a single step to the very marginal PAR1 approach.

No we are not unduly concerned with potential flagging errors given that, following implementation of BSC modification P217A, SO reports on the flagging procedure indicate a high level of accuracy in implementation.

However in the move to PAR 1 there may be a higher level of risk of flagging and tagging errors. A prompt ex-post system to address concerns and queries would help support and build industry confidence, in building a smoother transition process for cash-out reform.

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

First Utility agrees with the principal of including value associated with disconnections and voltage reduction in cash-out. This will help make the cash-out price much more cost reflective of balancing actions undertaken, and lead to more efficient investment outcomes.

However in estimating the value of lost load (VOLL) to set the cost of disconnections and voltage reduction, we are concerned there may be some unintended consequences on the development of demand side response products due to inconsistencies with National Grid's proposed Demand Side Balancing Reserve (DSBR). We have included some observations on this in the annex to this response.

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

Yes First Utility agrees with the principle assessment of the interactions between cash-out and the Capacity Market.

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, and for £10/hr for NNH business consumers?

Please see answer to Question 3 and Annex to this response.

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

Yes First Utility agrees with the introduction of the Reserve Scarcity Pricing function, but we do have some medium-to-longer term observations around the high-level design. These are noted in the Annex to this document.

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? Please explain your answer?

Yes.

Dual priced cash-out significantly disadvantages independent suppliers relative to vertically integrated utilities. First Utility believes that current dual priced cash-out mechanism is the single largest market design feature that has driven vertical consolidation and the resulting lack of liquidity in the wholesale market. This has led to the lack of competition in the electricity retail markets to the detriment of consumers.

Currently, dual pricing in cash-out incentivises participants to hold a long electricity position into cash-out due to the asymmetric risks in the dual pricing structure: the System Buy Price can theoretically increase to infinity for short power positions (we have experienced SBP greater than £1000/MWh for certain settlement periods), but the System Sell Price rarely falls below zero for long participants. This incentivises market participants to hold a long position into imbalance, which is not efficient for system balancing and adds cost to consumers.

A vertically integrated utility holding flexible generation can internally contract extra sales or purchases of power to react to changing weather close to gate closure in order to minimise imbalance. This illustrates how the pairing of flexible generation with supply insulates such market participants from facing imbalance on excessive volumes.

For renewable generators and independent suppliers however, such participants have little or no flexibility in their business to easily adjust output/demand or increase contracted positions for sales/purchases in order to react to changing weather. The current arrangements therefore excessively penalise such participants for imbalances that they cannot avoid, and so act as a barrier to entry for those types of participant.

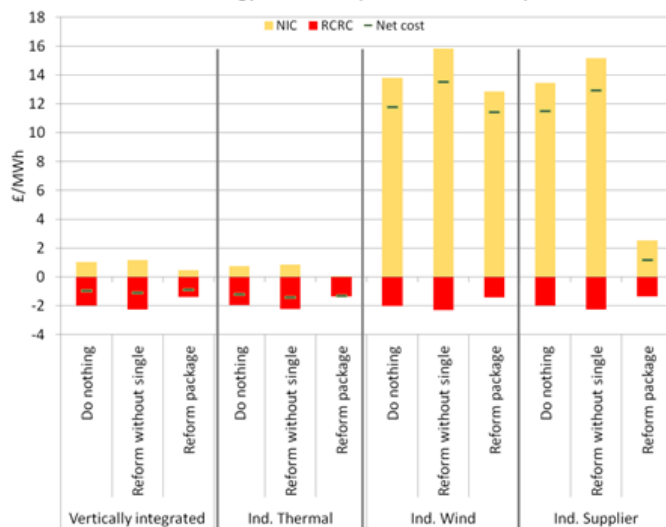
The analysis by Redpoint Energy on 2010 BETTA data, neatly illustrates this point, and clearly shows the benefit vertical integration provides to the Big 6 in this respect. As shown, the Big 6 all have significantly lower levels of imbalance on average than independent suppliers – in the case of EDF Energy as compared to First Utility, the level is almost five times lower.

	Energy volumes for 2010	Average imbalance across 2010
EDF Energy PLC (LONDELEC)	124,596,063	1.50%
SSE Energy Supply Limited (SSE)	103,452,268	1.55%
British Gas Trading Ltd (BRITGAS)	72,116,780	2.43%
SP Energy Management Ltd (SPOWER02)	51,211,661	3.53%
E.ON UK plc (POWERGEN)	49,722,143	2.04%
Npower Limited (NPOWER01)	49,427,273	1.84%
RWE NPOWER PLC (INNOGY01)	34,315,342	2.90%
E.ON Energy Trading SE (EONETRAD)	29,918,666	2.49%
Smartestenergy Limited (SMARTEST)	3,662,283	10.02%
Haven Power Ltd (HAVEN)	1,569,237	6.86%
POWER4ALL Limited (POWER4)	1,371,840	7.08%
First Utility Limited (FRST01)	354,358	7.18%
OVO Electricity Ltd (OVOE)	101,282	12.79%

Source: Analysis of 2010 BETTA Data by Redpoint Energy

In looking at Ofgem's analysis (overleaf) on the impacts of the reform package on key industry parties, it is clear that there will be a notable improvement to the financial barriers independent suppliers face in respect of imbalance. Imbalance costs will reduce in absolute terms by 6 fold, and the differential to vertically integrated companies will fall from around 15 times greater to around 5 times greater. While this still shows a clear benefit of being vertically integrated, this approach to cash-out reduces the size of the cash-out advantage.

RCRC and 'opportunity cost' as a proportion of total credited energy in 2030 – positive values represent costs



The rationale for a single priced cashout is to reduce the value a vertically integrated utility holds when retaining flexible generation in their own portfolios. By reducing the economic value of retaining so much flexible generation for imbalance mitigation and of holding long positions when going long into imbalance, this will result in the release of more flexible generation for sale into the wholesale market which would benefit liquidity, market access and competition in wholesale and retail markets. We note that because dual priced cashout has been in place for so long and driven such extensive vertical consolidation, it may be that single priced cashout is necessary but not sufficient to drive the step change in wholesale market liquidity that is required to drive vigorous competition in wholesale and retail markets. In this situation it will be important to also apply a Self-Supply Restriction on integrated utilities.

Single priced cash-out should encourage more capacity to be released onto the market and provide a driver for growth in the availability of flexible products. This will allow independents to compete with integrated utilities on more level terms (though still skewed), which may stimulate new entry. In turn this would increase consumer choice and drive down retail tariffs.

Whilst this is a substantial improvement, it is however only the first step in improving market liquidity. We continue to support the introduction of Self-Supply Restrictions to drive up liquidity, as the single greatest measure that could be taken to reform the market.

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

First Utility agrees with Ofgem’s view that the current arrangements fail to fully reflect scarcity at times of high system stress. This results in failure to always incentivise appropriate behaviour and is further compounded by the fact that those participants, who are not involved in the Balancing Mechanism, are not incentivised to provide accurate FPNs. Given that current System Buy - System Sell spreads can at times be very large, this disadvantages independents disproportionately and acts as a barrier to entry. It would also

seem appropriate to re-examine the relationship between RCRC and BSUoS and whether or not BSUoS should be split out into energy and system balancing costs.

First Utility also agrees that the effects of actions by the SO need to be carefully considered. It may be appropriate for a penalty to be applied for the submission of inaccurate FPNs although we accept that an exemption or lesser penalty may be required for types of generating plant whose output is inherently difficult to predict such as wind generation.

Question related to the accompanying Impact Assessment:

DSBR9 – Do you have any comments regarding any of the three approaches we have taken to assess the impacts of the cash-out reform packages?

No

In looking at the key assumptions and limitations of the modelling approach however, passage 3.18 states that for the core modelling, a baseline where there is no Capacity Market is in place, is assumed. The reason given was due to the uncertainty around the final detail of the Capacity Market design when the model was being developed. In this context we suggest that National Grid's proposed DSBR mechanism could be considered instead.

DSBR10 – Do you agree with the analysis of the impacts contained in this IA? Do you agree that the analysis supports our preferred package of cash-out reform? Please explain your answer.

Yes First Utility agrees with both the analysis and the conclusions thereof.

DSBR11 – 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? Please explain your answer.

Yes. However in regards to estimating the value of lost load (VOLL) to set the cost of disconnections and voltage reduction, there could be unintended consequences on the development of demand side response products. As noted in the annex, we observe that an assessment on the impacts of setting VoLL at £3,000 initially and then rising to £6,000/MWh on the development of DSR propositions under National Grid's proposed DSBR mechanism has been omitted.

DSBR12 – 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?

As discussed under question 1, we are concerned around the potential for unintended consequences from the impacts of volatility on marginal prices given the uncertainty around the projected levels of renewable deployment.

We would welcome a greater insight into the modelling on how volatility impacts marginal prices, and likewise on the impacts on the different types of independent supplier. To further competition in the market, smaller suppliers such as First Utility must not be disadvantaged.

Given the classification of ‘independent suppliers’ in the analysis includes companies such as GDF and Total, we think it is important to investigate whether the impact on smaller independents is masked by the impact of the larger independents in the published results to date.

Annex: Further observations

Interactions with National Grid's Demand Side Balancing Reserve

First Utility agrees with the principal of including value associated with disconnections and voltage reduction in cash-out. However in estimating the value of lost load (VoLL) to set the cost of disconnections and voltage reduction, there could be unintended consequences on the development of demand side response products, due to the discrepancy in values proposed to that of those under National Grid's proposed DSBR mechanism.

Under the EBSCR, VoLL will be set initially at £3,000 and then rising to £6,000/MWh. National Grid however is proposing utilisation fees of between £500/MWh to £15,000/MWh, but also noting that it 'would be subject to the Value of Lost Load determined by Ofgem and DECC as we did not foresee that it would be deemed economic to despatch resources at a cost greater than VoLL' ([Page 21, Section 4, 41](#)).

If DSR propositions are to be encouraged, consumers will need to receive payments that would be greater than those if they were disconnected. To avoid any perverse incentive on the development of DSR propositions, further analysis may be necessary in this area alongside communication with the Smart Grid Forum.

Imbalance & Cost reflectivity

In looking at the imbalance calculation and the issue of reflecting scarcity at times of high system stress, the consultation correctly raises the issue of STOR not currently being included, but which will be addressed under the reform package. Balancing actions undertaken by the DNOs however, are not mentioned.

Under current proposals, balancing actions taken by DNOs will remain excluded from the imbalance calculation. The impact of exclusion on cost reflectivity may however increase over the next few years should DSR be employed at much greater levels by the networks.

Currently, some DNO's already insist on connection agreements containing clauses around constraining off at times of system stress, such measures and DSR will only increase as DNOs face ever tighter constraints following demand growth as well as higher levels of embedded generation.

It may be prudent to undertake further analysis to ascertain when and provide an opportunity for Distribution Network participation in future cash-out arrangements. DNOs are currently not permitted to participate in the balancing mechanism, so a watching brief on this should also be maintained and provision made for potential future inclusion of this in the cash-out.