# Response to Ofgem's consultation on Electricity balancing Significant Code Review - Draft Policy Decision

## (I) About GDF Suez Energy International

GDF SUEZ Energy International (formerly known as International Power) is responsible for GDF SUEZ's energy activities in 30 countries across five regions worldwide (Latin America; North America; South Asia, Middle East & Africa; UK-Europe, Asia-Pacific). Together with power generation, we also active in closely linked businesses including downstream LNG, gas distribution, desalination and retail. GDF SUEZ Energy International has a strong presence in its markets with 77 GW gross capacity in operation and a significant programme of 8 GW gross capacity of projects under construction as at 31 December 2012.

As at 30 June 2013, the UK-Europe region (GDF SUEZ Energy UK-Europe) has 8.6 GW net ownership capacity in operation, which includes over 5.8 GW of plant in the UK market made up of a mixed portfolio of assets – coal, gas, CHP, wind, a large OCGT diesel plant, and the UK's foremost pumped storage facility. Several of these assets are owned and operated in partnership with Mitsui & Co.

The generation assets represent just under 9% of the UK's installed capacity, making GDF SUEZ Energy UK-Europe the country's largest independent power producer. The company also has a retail supply business and a significant gas supply business in the UK, both serving the Industrial and Commercial sector.

## (II) Summary of response

- **Imbalance cashout prices should provide sufficient incentives to balance without overly penalising market participants when they are unable to respond to an extreme pricing signal. GDF SUEZ believes that the current cashout arrangements achieve this balance.**

- **Whilst we see no pressing need for reform at this stage given all of the other market changes in play, GDF SUEZ agrees that the package of single, marginal cashout may deliver improvements to the current arrangements.**

- **Further work is needed to determine how the volumes of demand reduction and supplier imbalances will be determined. Pricing demand and voltage reduction into cashout should only be progressed to the BSC modification stage once these issues have been addressed.**

- **Similarly, with the Reserve Price Scarcity function, further work is needed on the high level proposals to set out the detail prior to a modification being raised.**

- **GDF SUEZ believes that the SCR should be split into two parts. If Ofgem does decide to go ahead with the changes, the single cashout and marginal pricing should be taken forward to the modification stage. A separate SCR should then be created to do further work on the detailed mechanics of pricing of demand disconnection and the RSP function.**

- **Should Ofgem authorise National Grid to tender for these new balancing services, consideration should also be given as to how SBR and DSBR can be incorporated into cashout so that the signals are in place for winter 2014/15.**

- **If Ofgem does decide to go ahead with changes to cashout, whatever they may be, they should be set out in final detail before the first auction for the capacity mechanism as the changes will impact on expectations of future wholesale prices and hence capacity mechanism bids.**

## (III) Responses to consultation questions

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

1. GDF SUEZ believes that the current cashout arrangements provide sufficient incentives to balance without overly penalising market participants when they are unable to respond to an extreme pricing signal. We do not see a pressing need to change the current methodology for determining cashout prices.

2. If Ofgem does decide to proceed with reform, we would support the proposal to make cashout prices more marginal but only if it is coupled with a single cashout price. Having dual marginal prices would encourage over-contracting by all parties which would not offer the most efficient outcome for consumers. GDF SUEZ believes that a single marginal price would create incentives for parties to balance their own positions.

3. One of the consequences of a marginal cashout price is that it could create an incentive for generators to withdraw plant from the Balancing Mechanism for fear of paying a very high marginal SBP if they fail to deliver on an offer (the generator would pay the greater of its offer price and the SBP for non-delivery). The logical action for the generator in this situation would be to increase its offer price to the marginal price which if demand control is likely will be slightly less than £6000/MWh. This would tend to increase Balancing Mechanism costs and therefore costs to consumers. We assume that Ofgem accepts this potential impact.

**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?**

4. Yes, we agree with the rational for going to PAR 1 but would support a phased approach provided it is coupled with a single cashout price. Given the increased impact on imbalance penalties, an ex-post process to address potential flagging errors should be introduced to give comfort that cashout prices have been correctly determined.

5. GDF SUEZ has reservations with this aspect of the SCR for two reasons:

    - Ofgem does not propose to adopt any kind of ex-ante warning before VOLL pricing is applied and without this parties may not be able to respond to the pricing signal and avoid the imbalance penalty; and

    - it will be difficult to determine the volume of demand reduction and supplier imbalances accurately - these issues have been considered in previous modification proposals and solutions have not been found.

<u>Responding to the price signal</u>

6. On February 11th 2012, demand control was instructed during the morning run up. The shortfall was not foreseen by the market or the System Operator – demand control instructions were issued prior to any system warning.

7. Under Ofgem's proposals, the cashout price would have gone to £6000/MWh in two settlement periods. Market participants that were out of balance would have been hit by large penalties with no ability to respond to the signal – they could not trade out of the position or over generate on other plant and claw back some of the loss for an hour as under market rules they cannot change their FPN. Ofgem believes that more penal cashout prices will focus attention on plant reliability. There is however very limited additional reliability that can be put into the system without greatly increasing costs to consumers.

8. If Ofgem is to proceed with this change then GDF SUEZ believes it should only be applied with some prior warning to allow participants to respond and at least have the chance to trade out any imbalance. This would mean that prices could only rise to VOLL in cashout if the signal was given before gate closure.

<u>Accurate determination of volumes</u>

9. In its Draft Policy Decision, Ofgem describes the challenges of introducing pricing for voltage reductions and demand disconnections into cashout and recognises that there will be a trade off

between accuracy and simplicity. Given the potential imbalance penalties involved, GDF SUEZ believes that Ofgem should be seeking accuracy.

10. The challenges are:

- Accurately determining the volume of demand control

  Ofgem is proposing a top down approach based on Distribution System Operator estimates. There appears to be no incentive on DSOs to ensure that these estimates are accurate – they are not impacted by any inaccuracies. Parties that are out of balance could however be greatly affected if volumes are over estimated as this will increase Net Imbalance Volume and possibly the level of the marginal cashout price. Out of balance parties would therefore want to see volumes calculated against actual metering to ensure that they are not being overcharged for their imbalance. Without this, there is the possibility of legal challenge.

- Restoring customer imbalances to the correct pre demand control level

  There will be variations in conditions between the Demand Control period and the historic periods used to derive the baseline against which demand reduction is measured. Whilst Ofgem proposed to use a bottom up approach, it will not be accurate. Without accuracy, appeals on the estimated volume are likely given the potential imbalance penalties.

- Reimbursing suppliers for adjustments to their position

  Ofgem is proposing to reimburse customers for the electricity they procure that they cannot bill their customers for at a price that represents a proxy for the price that the supplier would have paid for the energy. There are two issues here, how much energy could not be billed and what should the proxy price be? Both of these would not accurately reflect reality.

11. These challenges should be explored further to assess whether they can be overcome before taking the option further or making a firm policy decision to proceed with this change. Since three previous modification have been raised in this area with no acceptable solutions found, we do not consider it appropriate to delegate this issue to the Modification group to resolve.

12. We note that Ofgem proposes to apply the same VOLL price if voltage reduction takes place. However, the proposals do not cover how the voltage reduction volumes would be accurately estimated.

13. We agree that if Voltage and Demand Reduction are to be priced into cashout then a staggered approach is appropriate.

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

14. GDF SUEZ believes that cashout reform will have an impact on the functioning of the market in the intra-day and to a lesser extent day ahead markets. We do not believe that it will much affect investment decisions in the medium to longer term as suggested by Ofgem – an investment in new plant would not for example be made of the basis of cashout prices.

15. The latest proposals for the capacity mechanism have only just been set out by DECC, and contain some important changes from the baseline published in June 2013. It would be premature to give a firm view on the extent of the interactions and whether the capacity mechanism rules and cashout changes are complimentary or contradictory.

**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?**

16. No we do not agree with this proposal for a number of reasons:

- Compensation for consumer outages does not sit well with a less than 100% security standard – with a proposed reliability standard of three hours, consumers are not paying for 100% security of supply. It would be inappropriate to levy a penalty on suppliers if the system has not been secured sufficiently through the capacity mechanism (when it comes in) to avoid disconnection.

- 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, rather they would want a standardised process 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.

- The complexity of determining which consumers are rebated may outweigh the benefit to the consumer given how infrequently demand disconnection is expected to occur.

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

17. The design of the RSP function is at present high level so it is difficult to comment without knowing what it will finally look like, what impact in isolation it will have on wholesale prices and whether it produces price spikes at the correct times.

18. GDF SUEZ considers that once the RSP function is worked up, Ofgem should undertake this further analysis before deciding to go ahead with this aspect of cashout reform. As part of this analysis, the SO should first establish how many STOR actions are tagged because they are of less than 15 minutes duration. If the majority of STOR actions are tagged then we question whether it will be worth adopting this complex proposal.

19. GDF SUEZ therefore considers that this aspect of cashout reform is worked up separately from the rest of the package of reforms.

**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.**

20. GDF SUEZ believes that the current cashout arrangements provide sufficient incentives to balance without overly penalising market participants when they are unable to respond to an extreme pricing signal.

21. Whilst we see no pressing need for reform at this stage given all of the other market changes going on, we do agree that the package of single, marginal cashout may deliver improvements to the current arrangements. A single marginal cashout price should encourage parties to self balance as this will be the logical position to take to minimise imbalance exposure.

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

22. Two of the policy proposals are very simple to implement (a lower level of PAR and a single cashout price). Pricing in demand disconnection and treatment of reserve in cashout are far more challenging. GDF SUEZ believes that they require more work to assess how the practical issues can be overcome prior to Ofgem making any decision to instruct the SO to raise modifications.

23. If Ofgem does decide to proceed, GDF SUEZ suggests that the SCR is quickly called to a close and single cashout and PAR 1 taken forward through the BSC modification process. A second SCR should then opened to look in greater detail as to how demand control and reserve pricing can be incorporated into cashout.

24. Under the latest proposals for the capacity mechanism, existing plant that wants to act as a price maker must provide a justification as to why they need to bid at a price higher than the price taker threshold. To determine this price, capacity providers will need to have certainty of what the cashout arrangements will look like in the first delivery year as this will influence wholesale prices and hence the degree of profitability. The details of these proposals and the implementation date should therefore be finalised before the first auction for the capacity mechanism although we do not see the necessity of implementing them before the first auction.

25. National Grid is consulting on the design for the new SBR and DSBR balancing services. If a tender for these services does go ahead, usage of these products will also need to be included in cashout prices for Winter 2014/15. It is not clear whether the RSP function will have been implemented in cashout by that point. Until it is, an alternative method should be used in order that cashout prices capture this scarcity signal. To simplify the price calculation, SBR could be priced at the highest accepted offer price plus £1/MWh.

26. In terms of the considerations where Ofgem has decided not to propose changes, we have the following comments:

- Information imbalance charge – we agree that this is not necessary.

- Shorten gate closure – we agree that gate closure should be left at one hour due to the risks and costs of the SO of balancing the system over a shorter timeframe.

- Singe trading accounts – GDF SUEZ agrees that this is not needed alongside a single cashout price.

**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 cash-out reform packages?**

27. No.

**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 cash-out reform? Please explain your answer.**

28. The work undertaken by Baringa was supposed to allow an assessment of the relative impact of the different reforms. It has also been used by Ofgem to determine a net benefit to consumers out to 2030. Baringa have rightly made a number of approximations in their analysis. To give a few examples:

    - an assumption has been about the slope of the RSP function curve and the margin at which it starts to have an impact. The SCR lacks detail on how the RSP function will be applied and may not be as per the Baringa proposal

    - Baringa has assumed that current relationship between cashout prices and the market index price holds in the future (would this be appropriate with increasing and uncertain wind intermittency?)

    - Baringa has assumed that the introduction of the capacity mechanism will not change bidding behaviour. Whilst we appreciate that the near final design was not set out at the time of the

CBA, now that it has been published, this assumption would warrant a second look. To give one example, the latest design for the CM penalises capacity providers for not operating at their FPN notified at the start of the warning period. If all the generation is not needed for the whole of the warning period (because of a demand trough) it will need to be bid off/down potentially affecting imbalance costs and BM and wholesale prices.

29. Whilst we recognise that an Impact Assessment is necessary before making such changes, we do not believe too much weight should be given to its conclusions in deciding what proposals are to be adopted.

30. **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? Please explain your answer.**

31. We do not agree that the proposals as a package will improve the transparency and simplicity of the cashout arrangements. Pricing in demand reduction and the proposals to rebate consumers is likely to create confusion with consumers as to the circumstances in which they will get compensation and how much the compensation might be. The RSP function can only add complexity.

32. Ofgem has considered whether or not parties would see VOLL as a target price. Whilst we agree that the current high limit on the pricing of bids and offers could be seen as a target now, if VOLL pricing is enacted, parties will want to try and price close to this level in the BM to minimise non delivery penalties. This is very much different to now as such high cashout prices are not seen. In approving the proposed combination of options, we assume that this impact is recognised and is acceptable.

**Question 12: What if any further analysis should we have undertaken or presented in this document. Do you have any additional analysis or evidence that you would like to contribute to support the development of the EBSCR towards its final policy decision.**

33. No comment.

For further information please contact:

Libby Glazebrook
Policy Advisor, Electricity Markets
GDF SUEZ UK-Europe
Senator House
85 Queen Victoria Street
London, EC4V 4DP
Telephone: 01244 504658
Email address: libby.glazebrook@gdfsuez.com