Monkton Reach, Monkton Hill,
Chippenham, Wiltshire, SN15 1EE
www.goodenergy.co.uk
enquiries@goodenergy.co.uk
0845 6011410

Andreas Flamm,
Wholesale Markets
Ofgem
9 Millbank
London

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Dear Andreas,

Electricity Balancing SCR – Draft Policy Decision

Thank you for the opportunity to provide comment on the above consultation. As you are aware Good Energy is an independent licensed electricity supplier supplying over 35,000, mainly domestic, customers with electricity sourced primarily under bilateral agreements with decentralised renewable generators.

Executive Summary

Good Energy remains concerned about the rationale for this reform for two reasons. Firstly, we do not accept that decisions on investment in generation are determined by the way the Imbalance market operates. Decisions on investment in generation plant are based on forecast demand and market prices, and accentuating the volatility of imbalance prices will not impact those decisions. Secondly, in a market where imbalance prices are unknown until after the event, the prices have limited ability to influence behaviour. Accentuating unknown prices therefore have limited value, other than to penalise those less able to forecast them such as smaller independent market participants.

We would like Ofgem to do some additional analysis as to whether accentuating the volatility of imbalance prices, would change the behaviour of some market participants from balancing to making decisions to buck the market contrary to their own position in order to make a margin, effectively enhancing their returns from forcing the market into imbalance. This we believe increases the risk to smaller players who do not operate a 24/7 trading function, especially if faced with a single imbalance price that could be negative when a party is long.

Finally, as Ofgem is well aware, the market is heavily over collateralised and the impact on collateral requirements of a more accentuated imbalance price needs further consideration. Not just the amount that market participants need to post, but the amount they need to hold in reserve to cover increased requirements caused by volatility.

We have answered your specific questions below, expanding where necessary.

Q1. Do you agree with our proposal to make cash-out prices more marginal?

No. Market price signals are only relevant where the price is known before the event. A system which sets the prices after the event, sometimes reacting to unforeseen events happening after gate closure, serves no purpose in encouraging behavioural changes. Their unpredictability adds risk, the cost of which is ultimately reflected in prices to end customers. We are particularly concerned that making the system prices more marginal will favour large portfolio players who have the skills and resources to forecast system prices and react to unforeseen events. We are also very concerned that by making prices more marginal then there is a risk that certain players become less incentivised to balance and more incentivised to game the market to make a margin.

Q2. Do you agree with our rationale for going to PAR1 rather than PAR50? Are you concerned with the potential flagging errors, and would you welcome the introduction of a process to address them ex-post?

No. Whilst we accept that their may be scope for reducing PAR below 500MW, we are concerned about the unintended consequences, particularly with regard to unforeseen circumstances. In para. 4.8 you state that this would "produce a more accurate signal to the market", however, this is not possible as the system prices are not known until after the event. Larger parties running 24/7 trading desks and full time forecasting teams may be in a position to forecast imbalance prices to a degree, but smaller parties running 9 to 5 weekday operations are less able to do so.

There is a particular problem for independent generators if they fail to deliver due to a plant failure after gate closure because they will not only have to face steep imbalance costs, but also significant upload in credit collateral. This makes the market risk of plant failure more significant to independents and favours portfolio generators who may be able to bring on additional plant elsewhere.

In order to find the right level of PAR to recognise risk but increase incentive to balance in advance of gate closure we would prefer a gradual lowering of PAR over several seasons/years, until the optimum level is achieved (which may turn out to be 1, or not). Providing the market is clear of the intent to gradually reduce PAR, it should receive the desired signals.

Q3. Do you agree with our proposals for pricing of voltage reduction and disconnections, including the staggered approach?

We are broadly supportive of the proposals, but believe that the practicalities around providing compensation to customers needs to be better thought through. Firstly there are the practicalities of identifying customers affected and the duration of the loss of supply, secondly because the compensation payments differ from those made to customers who suffer disconnection due to a network fault, and finally, even if this could be worked out, the cost of managing this compensation payment would not be insignificant.

Q4. Do you agree with our assessment of the interactions with the CM and its impact on setting prices for Demand control actions?

We are concerned that the full interaction between the CM and the balancing mechanism is not fully understood, not least as the CM is not yet fully defined. One key question that we believe is not addressed is that both the BM and CM are aimed at flexible plant and if the market has a finite amount of flexible plant we could see the CM preventing flexible plant being available for balancing until a capacity shortfall is triggered, thus generation that could be available before prices reach VOLL, being out of reach until VOLL is achieved.

Q5. 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) customers, and for £10/hr for NHH business customers?

Whilst we acknowledge the policy intent, we believe there are several practical reasons why this proposal should be considered in more depth. There are practical difficulties for the SO or any other industry party in identifying affected customers, and the duration of their outage. It also needs to be considered in the wider arena of customer compensation for loss of supply due to local network failures, as customers are unlikely to see any logical difference in the level of compensation offered. On balance, we feel that whilst the sentiment is right, the practical realities mean that the proposal is unworkable.

Q6. Do you agree with the introduction of a Reserve Scarcity Pricing function and its high level design?

The high level design seems to be sensible, but it will need to include checks and balances to prevent manipulation, and this element needs to be better considered in tandem with the CM.

Q7. 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?

Whilst we understand the rationale for moving to a single price, we are concerned that by combining it with more accentuated prices it will actually change the behaviour of larger players from balancing, to attempting to play the market to make a margin by being opposite to the market, or indeed bring in speculative market participants whose aim is to beat the market. This means that far from improving the balancing market and making the anticipated pricing signal stronger, it will become unpredictable to the detriment of those market players who are actually attempting to balance their position.

We strongly urge Ofgem to commission research on the risks of such a market developing and whether additional measures can mitigate this risk.

Q8. Do you have any other comments on this consultation, including on the considerations where we did not propose any changes?

We still take the view that unless imbalance prices are reasonably foreseeable by all market participants equally then they do not fulfil their purpose of sending correct signals to the market. We believe that Ofgem should consider if there are ways to improve the transparency of imbalance prices in reasonable time for all parties to take action.

We are sceptical of Ofgem's analysis that the reform will reduce the cost of smaller suppliers as we do not believe that the proposed reforms have been tested against how market players will adjust their balancing strategy in response to the proposals being implemented. In particular, whether key players would favour "beating the market" to balancing.

Q9. Do you have any comments regarding any of the three approaches we have taken to assess the impacts of the cash out reform packages?

We believe that historical analysis needs to be treated with caution for two reasons. Firstly, if prices were different then parties may have changed imbalance trading strategy, thus resulting in a different outcome. Secondly, the period selected does not reflect the increasing amount of intermittent generation coming online, which would also affect imbalance.

On the forward modelling, we are concerned about the assumption that parties will change their imbalance strategies reflecting the changing position of the market. Whilst this may well be true of larger players with a portfolio of solutions including I&C DSR contracts along side controllable generation , this will not be true of independent suppliers and generators, especially renewables who are weather dependant. We are also concerned about the assumptions about access to flexible plant, again an advantage that portfolio players have over independents.

We are particularly concerned that the modelling shows a significant increase in negative SSP prices. Independent suppliers tend to protect themselves from imbalance prices and excessive credit collateral by typically erring on the side of being long on supply. If negative SSP prices occur then this will impact not just the cost of imbalance, but the amount of credit collateral independent parties will need to post.

Q10. 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?

Whilst we have some concerns with the analysis we are more concerned about the impact on independent suppliers and generators of negative prices for being long in the market. This, combined with the potential for some larger players to speculate on the market thus creating a long or short market against expectation, will impact independent players ability to manage their trading in a cost effective manner. For this reason we do not agree with the proposed reforms as we do not share Ofgem's view that the package of reforms will benefit Independent market participants, especially those involved in renewable technology such as wind because the predictability of market position (i.e. long or short) will be more difficult to predict, something the Baringa report does not consider.

Q11. 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?

One of our biggest concerns is that Ofgem does not appear to have considered the potential for greater volatility to be exploited by some more complex market participants to make a margin rather than achieving a balanced position. Ofgem acknowledges that a single price would see a better reward for independent parties if they are against the market, but there is an assumption here that these parties can predict the market. If speculators enter the market, then trades undertaken close to gate closure to shift the market could impact independent players who are unable to respond.

Q12. 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 finally policy decision?

We would welcome further analysis of the potential impact on the market should some parties take to playing the market to make a margin, rather than balance. We would also welcome further quantitative analysis of the impact on credit collateral that independent players would need to post with Elexon under the proposed package.

I hope you find this response useful. If you wish to discuss any of the above further, please do not hesitate to contact me.

Kind regards,

Chris Welby
Policy & Regulatory Affairs Director.