

RenewableUK response to Ofgem's consultation on: Electricity Balancing Significant Code Review: Draft Policy Decision Impact Assessment

Key points

- Variable renewable generation is going to contribute a significant portion of the future generation mix; reform is therefore required and desirable in order to create the necessary price signal to incentivise innovation and investment in balancing technologies/solutions.
- Ofgem must however balance what is feasible in the short term with what an appropriate price signal could bring forward in the long term and currently, the balance is not right; the proposed changes are too radical and too rapid.
- RenewableUK would therefore encourage a stepwise approach to a more marginal cash-out price, with a clear monitoring process in place to understand the impact of the marginal pricing and its effectiveness throughout the transition period.
- We also understand the need to reduce the scope of the reform in light of the EMR implementation however many of the reforms in the original scope still remain potentially highly desirable, such as shortening the time from gate closure to real time or the SO taking responsibility for variations in generation after gate closure.
- Additionally, Ofgem must anticipate the advent of smart grids/meters in its thinking and create a clear strategy on how these reforms will interact with these changes, namely with regards to the interaction with the VoLL.
- RenewableUK therefore believes that it is critical that Ofgem establish a clear roadmap for reform of the balancing mechanism to increase the resilience of these reforms and provide opportunities for assessing impact before taking further steps.
- Where these reforms integrated in the Future Trading Arrangement process, there should be a clear intent that it is with a mind to develop solutions for their implementation.

RenewableUK

RenewableUK is the trade association for the wind, wave and tidal stream industries in the UK, with over 600 corporate members. These technologies will be supplying the majority of new low-carbon generating capacity and energy, and also represent the best opportunities for the UK to benefit economically from development of low-carbon sources. The implementation of Ofgem's balancing mechanism reforms must reflect the needs of RenewableUK's members or the UK Government will fail to deliver on its aspirations for a secure and affordable low-carbon power sector which leads to a prosperous country. We look forward to the suggestions made in this consultation response being implemented in order to ensure the continued growth of these key industries.

Introduction

1. RenewableUK and its members welcome the Electricity Balancing Significant Code Review (EBSCR), as the UK's future generation mix will include a large amount of variable generation. There is a need to create a reliable long term price signal that will foster innovation and investment in demand side response, storage and interconnection.
2. It is important that the focus of the EBSCR should be to incentivise these new -technologies to provide more efficient security of supply and flexibility services. Such an approach would also support National Grid's current efforts to bring wind generators into the market for these services.
3. We also support the inclusion of initiatives to value disconnections and include demand control actions in the cash-out price. With increasing costs of electricity and the advent of smart grids/meters, Ofgem must make sure that appropriate mechanisms are in place to allow consumers to participate in balancing actions as well as to recoup the benefits of these actions, voluntary or not.
4. We are also conscious of the interaction of the EBSCR with the Electricity Market Reform (EMR) Capacity Market (CM) and must insist that any decision that comes out of this review must be clear well in advance of the first CM auction – the current target date for a final policy decision of spring 2014 cannot slip. We therefore understand the reasons for the reduced scope of the EBSCR, however we feel that it is important that a clear timetable is established for the necessary wider reforms which need to be in place well before 2020.
5. The analysis does however not seem to consider the interaction with the EMR CfD in an appropriate manner. There are significant concerns amongst our members that the current proposals will result in an increase in PPA discounts and increase in basis risk and thus the cost of capital available to renewable generation, which does not benefit the consumer.
6. Independent suppliers will face substantially higher balancing costs than vertically integrated players – with negative effects on competition. Similarly, independent wind generators will struggle to compete for CfDs with any vertically integrated developer. While this happens in both at the “Do Nothing” and the five “change” scenarios due to the expected increase in balancing costs, this disparity needs to be addressed or it will have negative effects on competition both in the supplier market and among developers.

Question answers

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

7. Yes, we believe that the future of the UK electricity grid will include a high proportion of variable wind energy and that the long term sustainability of the electricity system therefore requires innovation and investment in flexible demand side response, storage and interconnectors. A more marginal cash-out price is one of the tools that can promote the roll-out of these technologies.
8. Appropriate innovation and investment will emerge providing that:
 - An appropriate, predictable and reliable price signal exists; and
 - Sufficient foresight exists over the introduction of this price signal.
9. Not only does the price signal need to be sufficiently high so that the opportunity cost of innovation and investment in innovative balancing solutions is higher than current balancing actions, it must also be balanced with affordability to avoid additional costs to the consumer as well as the availability of innovative solutions.
10. Because innovations in new technologies and systems are often long term decisions, market players need the certainty that the price signal will be strong in future but the capital to invest in R&D now. The shift towards a more marginal cash-out price must consider these market dynamics.
11. A gradual transition towards strong marginal cash-out price therefore appears to be the most desirable way forward.

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?

12. Although we agree with a shift towards more marginal cash-out prices, we do not agree with the proposed radical rapid shift to a PAR1 solution.
13. There is a lot of uncertainty surrounding the underlying assumptions, costs and benefits of the current proposals. The Baringa quantitative assessment cannot be relied upon as a sole basis for this decision process and this assessment does not provide sufficient certainty to justify this radical shift.
14. The feedback from our members suggests that the assumptions made with regards to the ability of wind generators to further reduce their imbalance charges are not justified in the short to medium term and are therefore overly optimistic.
15. This implies that the imbalance costs are undervalued, thus a rapid shift to PAR1 is likely to increase variable generators' exposure to imbalance charges and result in increased PPA

discounts for independent generators, which also makes them less competitive than vertically integrated generators.

16. Even if the Baringa quantitative assessment proves accurate, which is highly questionable, an immediate shift to a PAR1 marginal cash-out price would still result in a short term increase in PPA discounts; investor behaviour is precautionary and the PPA market is not sufficiently liquid. They will require evidence that the cost of balancing has not increased.
17. We also feel that the assessment does not fully account for potential behavioural changes and the impact on basis risk or from gaming behaviour.
18. There is a serious concern of increased basis risk. It is currently proposed in the EMR that the reference price for CfDs will be calculated using the day-ahead market price. Increased volatility in the intra-day market, which is where a wind generator will be incentivised to operate under these proposals, compared to the day-ahead market is likely to result in increased disparity between the reference price and the wholesale electricity price that variable generators are able to access. Currently this additional risk has not been considered in the design of the CfD or in these proposals.
19. Unlike the qualitative assessment that Ofgem has made, we do not feel that current regulation/codes are sufficient hedge to protect against gaming risk, which produces further risk of volatility in the short-term market.
20. Thus, the more marginal the cash-out price, the more volatile the cash-out price is likely to be. This is not desirable as this exposes generators to increased basis risk under the EMR CfD, impacting on generators' bottom lines and affecting the cost of capital for new generation plant.
21. RenewableUK and its members would therefore prefer to see a gradual, controlled stepwise transition towards a more marginal cash-out price. We would for instance encourage:
 - An immediate shift to a PAR100;
 - A shift to PAR50 towards the end of this decade;
 - A shift to PAR1 in the 2020s.
22. The transition towards more marginal price should be monitored and assessed against clear and agreed criteria to ensure the transition does not have unintended consequences and provides the required certainty the market needs.
23. This will provide sufficient long term clarity to foster the necessary investment and innovation in balancing solutions whilst helping avoid unnecessarily increasing the cost to operational renewable generation plant and/or investment in new plant.
24. Our members are also concerned about potential flagging errors and would encourage the development of a robust process to ensure that these are corrected ex-post.

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

25. We support the principle that pricing voltage reduction and disconnections will better reflect the SO's balancing costs. This reform should provide a more efficient balancing mechanism.
26. We understand that today we do not have a price discovery method for the VoLL which means that the current approach and proposed VoLL, although not robust, will suffice in the short/medium term.
27. We also support the stepwise approach to the introduction of the VoLL, however we do feel that in the long term, Ofgem needs to consider an 'exit strategy', i.e. a shift from the current static subjective methodology of setting the VoLL, to a dynamic market based solution that is more representative of the diversity (time, space and user) of the VoLL and will therefore deliver best value to customers.
28. We support the view that that a successful deployment of smart grids/meters should make this possible and even though the transition might not be clear now, the current proposal should not be considered as 'a possible interim' solution but be clearly labelled as an 'interim' solution.
29. Such an exit strategy would also eliminate the risk of creating a 'target price', the risk of which we believe increases with the higher VoLLs.
30. Finally, Ofgem must consider the impact of VoLL pricing on credit requirements. These could increase with the exposure to higher cash-out prices and adversely impact on independent generators and new market entrants.

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

31. We are conscious of the interaction of the EBSCR with the Electricity Market Reform (EMR) Capacity Market (CM) and we understand that these reforms must be clear prior to the first CM auction.
32. We also feel that there is a direct link between these reforms and the EMR Contract for Difference reforms and that these are currently not given sufficient consideration in the Impact Assessment, namely in terms of the impact on the cost of PPAs for independent generators, and basis risk.

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 NHH business consumers?

33. We agree with the principle that involuntary DSR services should be priced, however we are not in a position to comment on how this is done and at what level this should be set as we represent the generation side of the industry, not the supply side.

34. Again, we believe that Ofgem needs to identify how the market will transition from this regulatory price setting approach towards a market based approach with the advent of smart grids/meters.

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

35. We agree that the current arrangements for pricing STOR distort the cash-out prices and that reform is required. We also agree with the philosophy of trying to use scarcity as a variable in the function, however extreme caution is required moving forward.

36. Our understanding is that reserve will be called in merit order of utilisation price, taking into consideration the service dynamic characteristics. The RSP would be based on a measure of system margin, the details and point of calculation of which still need to be determined.

37. The consultation does not provide access to the necessary historical data on STOR actions and the overall costs. This proposal therefore requires significant further development and extensive engagement with industry before it can be implemented.

38. It is therefore questionable whether or not it is feasible to do this before the CM deadline and we would like to see a detailed programme for this work stream. This is particularly pertinent because the ability of market participants to forecast the value of STOR contracts brought forward in a particular trading period is a key concern that must be addressed before implementation.

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?

39. We agree with the rationale behind this decision and believe that this could provide some benefits to generators.

40. We do however feel that these benefits are very difficult to quantify, not least because this will lead to behaviour change and the risk of gaming, such as pre-gate closure spilling. These are not appropriately assessed in the published documents.

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

41. We understand and support the need to reduce the scope of the reform in order to make sure that decisions are reached before the CM auction process starts.

42. This does not stop us from being disappointed that many of the proposals that could have benefited variable generators have been abandoned or pushed back to an unspecified future date.

43. Many of these reforms do, however, remain desirable. We would therefore request a roadmap for the implementation of these wider reforms in order to provide the necessary clarity to market participants. This should include confirmation that the FTA maintains its focus on the integration of renewables.
44. It is also important that this reform is accompanied by soft measures that will help facilitate forecasting and the management of imbalance. For instance, there is a need for more transparency on the status of the grid and more detail of balance expectations before gate closure than is currently available. For instance, increasingly more accurate forecasts should be provided as real time approaches.

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?

45. We agree that the quantitative assessment cannot be relied upon for the decision process and therefore agree that qualitative assessment must form part of the approach. We emphasise, however, that in light of the high level of uncertainty of all these approaches, that a precautionary, smooth and clear transition to implement the reforms appears preferable and justified.

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?

46. No: as highlighted above, we believe the IA does not fully address our concerns and does not appropriately cover the interaction between the reform package and the CfD. We have therefore put forth a clear plan for a transition towards this reform package that would give industry long term clarity and the foresight needed to deliver the benefits that Ofgem seeks to see emerge as a consequence of reform.

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?

47. As previously mentioned we feel that gaming risk has not been sufficiently addressed, however we do feel that it is partly not possible to do so at this stage, gaming behaviour is an emergent property of a system, not a planned outcome.
48. This highlights that Ofgem needs to consider a more precautionary approach, namely the stepwise approach to a more marginal cash-out price.

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?

49. There is a clear statement that reducing the time to gate closure does provide a level of benefit but that this is currently outweighed by the cost and complexity.



50. We feel that this analysis should consider what level of variable generation penetration at which the benefits from reducing the time to gate closure become sufficient to justify this move.

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