

Andreas Flamm
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

Tuesday 22nd October 2013

EBSCR@ofgem.gov.uk

Electricity Balancing Significant Code Review – Draft Policy Decision: RWE response

Dear Andreas,

We welcome the opportunity to respond to the Electricity Balancing Significant Code Review – Draft Policy Decision. This response is provided on behalf of RWE npower, RWE Generation SE, RWE Supply and Trading GmbH and the UK subsidiary of RWE Innogy GmbH, RWE npower renewables.

We support the draft policy decision to implement a move towards a single marginal cash out price. It is also sensible to introduce an administered cost that reflects the value of lost load combined with improvements to the way that reserve costs and demand reductions are included into the cash out pricing calculation. We believe that the proposals have the potential to improve security of supply. However, in the present climate where costs to consumers are a current focus of attention it is important the overall effects on customer costs should be taken into account prior to implementing any change.

We do not support the proposed arrangements to compensate domestic customers and small businesses for interruptions during demand control and demand reduction events since this has the potential to distort market incentives and penalise parties that are in balance or long during periods of system stress. We also have concerns over the funding arrangements for such payments. We note that the price cap in the form of the value of lost load reflects a notional reliability standard and that this also reflects an acceptance that interruptions can occur from time to time in accordance with this standard. Consequently we believe that customers benefit from electricity prices that are lower on average under the current arrangements and in the presence of the proposed cap reflecting the fact interruptions can occur under extreme conditions.

Cash out reform should be implemented as soon as practical and this should include a “true” value of lost load. The value should be reviewed once the details of the enduring capacity mechanism including its associated incentives are fully understood and its interaction with the energy market assessed. The value of lost load should then be adjusted to reflect the recovery of the “missing money” in the capacity mechanism (if any) with effect from October 2018.

RWE Supply & Trading GmbH
Swindon Branch

Windmill Hill Business Park
Whitehill Way
Swindon SN5 6PB
United Kingdom

T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.rwe.com

Registered No. BR 7373

VAT Registration No.
GB 524 921354

Supervisory Board:
Peter Terium
(Chairman)

Board of Directors:
Stefan Judisch (CEO)
Dr Markus Krebber
Alan Robinson

Head Office:
Essen, Germany
Registered at:
Local District Court, Essen
Registered No.
HR B 14327

Bank details:
Deutsche Bank Essen
Bank Code 360 700 50
Account No. 105 127 500
SWIFT: DEUTDEDE
IBAN: DE05 3607 0050 0105
1275 00

If you have any comments or wish to discuss the contents of this letter then please do not hesitate to contact me.

Yours sincerely

By email

Bill Reed
Market Development Manager

Annex 1: Responses to the specific questions in the consultation letter

Questions for the Draft Policy Decision:

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

We agree with the proposal to make cash out prices more marginal.

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?

We support the rationale for going to PAR1 rather than PAR50. We believe that National Grid have demonstrated that the tagging methodology is robust and reliable. However we think a case can be made for a “manifest error” process associated with the tagging methodology which would be applied ex post.

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

We agree with the proposals to introduce a Value of Lost Load for the pricing of voltage reduction and disconnections.

We assume that the “staggered” approach relates to the initial value of VOLL. We do not understand why the VOLL level should be set initially at a lower level than the enduring VOLL even in the presence of a capacity mechanism. Any discount to the enduring VOLL will result in an artificially low price cap and presumably an implied lower reliability standard. Indeed the prices of £3,000 and £6,000 and potentially lower than cash out prices in the current unrestricted energy only market.

If the “true VOLL” is £17,000 then this is the value that should be used in cash out. This will create the appropriate incentives on parties to contract forwards economically and efficiently.

We note the comments about the capacity mechanism and we believe that further work is required to understand its impact on the energy market and cash out. In the event that the capacity mechanism addresses the missing money problem, that VOLL could be lower after the introduction of the capacity mechanism (i.e. from October 2018). However this depends on the incentive properties associated with the capacity mechanism and the clearing price. By accepting a discount it would appear as though Ofgem are accepting that the capacity mechanism will clear at a non-zero price. This would appear to be an outcome of setting the VOLL at a level that is too low.

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

We do not have enough information on the enduring capacity mechanism arrangements and the demand side measures to comment fully on this analysis. We believe that the cash out arrangements should be robust, economic and efficient in the period prior to the introduction of the capacity mechanism (i.e. until October 2018). An assessment should take place in relation to cash out once the enduring capacity mechanism arrangements are fully understood.

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?

We do not agree that payment 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 we do not agree that payment of £10/hr should be paid to NNH business consumers. In particular:

- **Prices caps in the form of administered VOLL based on a reliability standard limit electricity prices and reflect an acceptance that demand control will occur from time to time:** The Value of Lost Load is a “price cap” that prevents power prices rising above an agreed level to reflect a notional security standard. Consequently the price of electricity is discounted to reflect the existence of the price cap and there is an acceptance that the market will be subject to outages that reflect the reliability standard. This means that electricity prices are lower overall and that the system may be subject to outages from time to time. Customers should not therefore receive payments to reflect the outages since they have already received lower average power prices;
- **It is important that incentives are related to those parties that can respond:** If demand reduction occurs it is important that supplier imbalances are adjusted to reflect the notional imbalances that suppliers would have had if demand control had not occurred. This then enables cash out prices to be targeted on those parties that have caused the imbalance. Since the costs are based on the VOLL price this will ensure that the correct incentives are applied in the market and that the costs are targeted at those parties that cause the imbalance. Any short suppliers will therefore face significant costs in the event that demand reduction occurs and this penalty should be sufficient to ensure that suppliers are appropriately contracted and pay the resultant wholesale electricity prices (and reflect these in customer costs). To then pay customers would appear to impose an additional penalty on suppliers since these costs are already reflected in an efficient supplier’s wholesale costs;
- **The payments appear to penalise suppliers that are in balance or long:** We note that it is proposed that the payments will flow to customers subject to demand reduction. However, suppliers have no influence on the customers that are subject to interruption. Consequently there may be suppliers that are in balance or “long” that must fund payments to customers despite having procured electricity at high prices (or adopting prudent contracting strategies). These suppliers would appear to be funding costs that are being created by suppliers that are short and have created the problem. We note that energy imbalance cash flows may be insufficient to pay customers the required amount and that suppliers in balance will not benefit from any surplus residual cash flow if this is used to fund the payments;
- **It is unclear how the payments to customers will be funded:** The document suggests that customer interruptions are regarded as a form of balancing service (funding should therefore flow from the System Operator probably under BSUoS). However, since the System Operator does not have a relationship with customers some other third party (presumably suppliers) would have to pay the monies across to customers. This is administratively complex and as noted above would result in suppliers that adopt prudent contracting strategies incurring costs associated with suppliers that have created the problem;
- **Involuntary Demand interruption cannot be classed as a balancing service:** Suppliers and customers have the opportunity to respond to the market signals associated with reformed cash out and should develop appropriate measures to manage high prices. Consequently demand reduction should only occur in extreme circumstances to protect the total system and only when all other economic measures (reflecting price signals) have been exhausted This is

not, therefore, an “additional balancing service” and should not be regarded as a legitimate energy balancing tool. There should be an acceptance from customers that interruptions can occur and that the level of reliability is reflected in the VOLL cap and the wholesale electricity price.

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

We agree with introduction of the Reserve Scarcity Pricing function and its high-level design.

It is important that the costs associated with reserve activities for energy balancing are appropriately reflected into cash out. The current reserve pricing arrangements do not target the costs and reflect both energy balancing and system balancing. Consequently it is appropriate to consider the availability and dispatch costs in an administered arrangement and reflect these into cash out. However, the arrangements should also enable market to respond to the signal so that the intention to utilise uplifted reserve prices should be identified to the market in advance to facilitate an appropriate response. If there is no advance signal the reserve pricing function should not be applied in cash out.

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.

We agree with the rationale for a move to a single price, and we believe that it could make the system more efficient and help reduce balancing costs.

A single marginal cash out price reflects the fact that in any half hour the system is either short or long and appropriately targets the costs associated with party imbalances. It removes the concept that parties in the opposite direction to the market imbalance are “indifferent” to the direction of imbalance. Sharpening the market signals should ensure that total imbalance on the system is economically and efficiently managed by all trading parties.

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

We do not have any other comments on this consultation.

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?

We do not have any comments regarding any of the three approaches we have taken to assess the impacts of the cash-out reform packages.

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.

We agree with the analysis of the impacts contained in this IA and agree that the analysis supports our preferred package of cash-out 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? Please explain your answer.

We agree with the key risks identified and the analysis of these risks. We do not believe that are any further risks not considered which could impact on the achievement of the policy objectives.

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?

We do not believe that there is any further analysis that should have been undertaken or presented in this document. We do not have any additional analysis or evidence you would like to contribute to support the development of the EBSCR towards its Final Policy Decision.