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Electricity Balancing Significant Code Review - Draft Policy Decision

Dear Andreas,

Introduction

SmartestEnergy welcomes the opportunity to respond to Ofgem's Electricity Balancing Significant Code Review - Draft Policy Decision. As an active trader in the wholesale market and a commercial aggregator, we are aware that this SCR could lead to significant impacts if certain proposals are implemented.

Overview

We are of the view that the current arrangements are still appropriate for the fuel mix we have now. We do not believe we are yet at the point where significant change is justified.

The current arrangements reward flexibility much in the way Ofgem claim single cash out will. The difference is that the proposals for single cash out reduce the incentive to balance and therefore over-reward inflexibility. The reason for this is that the threat of prices going negative is still not there to disincentivise participants going long, although in the longer term we agree with Ofgem's logic.

Ofgem state that there are various features which dampen cash-out prices, leading to insufficient signals to the market to invest in flexible generation, demand participation and other technologies that can react quickly to changes in market conditions. However, signals to invest in the market are being created through a capacity mechanism. We believe it is unnecessary to introduce both a capacity mechanism and sharper price signals and the impact of each will not be fully understood if they are implemented together.

Ofgem have argued that sharper price signals and the capacity mechanism complement each other: one is short term and the other long term. However, we are of the view that short term signals are the incentive for long term investment and having both is simply double rewarding.

There is a real danger that going to a highly marginal arrangement will have unintended consequences, especially as it is being introduced at the same time as single cash out and participant behaviour has not been modelled/experienced. The "tinkering" of the NETA arrangements has often been criticised, but the ability to make smaller changes and observe the effects has been advantageous. We believe that Ofgem should take a softly softly/incremental approach to any radical changes, especially since the modelling work has been done on historic prices without taking into account any changes in behaviour.

In essence, we agree that it is important to signal the value of flexible and peaking generation and some increased marginality may be acceptable. However, we believe that single cash-out will overcompensate non-flexible but intermittent generation in the short term. We believe a move to single cash out in 2015 is too early and the point at which wind generation is no longer overcompensated needs to be identified.

More preferable changes, which would improve things now and could still be part of an enduring solution, would be adjustments to gate closure and single accounts.

Ofgem's specific questions

For your convenience we answer Ofgem's specific questions below in the order in which they are presented in the consultation document.

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

> No. Ofgem argue that as a result of the shortcomings with the current arrangements, the market does not currently sufficiently value flexibility which, they argue, means that flexible generation capacity, demand response and storage have insufficient incentives to provide (or invest in) the flexibility they could offer. Ofgem are right that greater use of flexibility could be made but it does not follow that the shortcoming is in the cash out aspect of the arrangements. It could equally be difficulties co-ordinating demand response and this, it is anticipated, will be solved with smart metering. Larger chunks of demand should become more active in the market through NGT's proposed balancing services.

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?

> It has always been known that balancing actions can be used for system and energy and it is sometimes difficult to say for certain that a certain action was 100% for one reason or the other.

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We are concerned about enhanced risks of system pollution, greater susceptibility to flagging and tagging errors and susceptibility to manipulation through exercise of market power; such extremes could lead to unintended consequences. It would not be satisfactory if certain parties found themselves in financial difficulties because of being on the wrong side of some very high prices. For this reason, if a policy of reducing PAR is pursued, we would advise a process of reducing PAR in stages and reviewing the effects, especially since the modelling work has been done on historic prices without taking into account any changes in behaviour. The interaction with the CM also means that continual monitoring would be sensible.

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

We are not convinced that voltage reduction should have a value close to that of a black-out. This is not well justified in the document.

We agree with including Demand Control actions in the stack of balancing actions, with a top-down volume and price attached and subject to flagging and tagging procedures as opposed to automatically setting the cash-out price at VoLL when Demand Control is used to balance the system.

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

It is not clear which section of the document this question is referring to.

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?

It is not clear to us how the supplier will receive this money to pass on or how the compensation level relates back to the cash out mechanism. It also needs to be made clear whether this relates to NHH customers or small business customers, customer or MPAN. We think it would make more sense to do it on MPANs so that each affected site is compensated.

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

We agree that it is appropriate to adjust cash-out prices where they are dampened by the SO's forward provision of balancing services. It is important that the RSP differentiates between genuine reserve and balancing services. It is not entirely clear to us how this will be achieved.

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.

Ofgem argue that moving to single cash out will help smaller parties balance. It is correct to help smaller participants where there are barriers to entry. However, our view is that the main immediate advantage will be to wind generators but in the longer term, with swings in marginal imbalance prices, smaller suppliers could suffer large losses.

It seems strange for Ofgem to argue that they are concerned that the SBP/SSP spread does not reflect the true costs or cost savings which out of balance parties place on the system without considering options to reduce that spread.

Also, if it is thought that the spread under current arrangements over-incentivises balancing particularly at times when the system is not tight, one solution could be to reduce the marginality at off-peak, not to go for single cash out in all periods. This appears not to have been considered.

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

More preferable changes would be adjustments to gate closure (which would help the balancing of wind but without showing preferential treatment) and single accounts. Dual accounts are less of an inconvenience to large vertically integrated players than was envisaged at the inception of NETA, but their existence makes it difficult for smaller participants to move from being a one-sided player to a two-sided player. These two things would have been simpler ways of improving imbalance whilst at the same time levelling the playing field between larger and smaller players.

In spite of the risks of greater spilling it is not necessary to include an information imbalance in the arrangements at this stage, although this could be considered at a later date once changes in participants' behaviour has been evaluated.

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?

Our main comment on the three approaches (the impact on cashout and volatility, distributional impacts and cost benefit analysis) is that there has been no consideration of the optimal timing to implement the changes nor to the potential impacts immediate and simultaneous implementation would have on participant's behaviour.

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.

Please see our comments above.

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.

No comment

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?

Please see answer to Q9

Should you wish to discuss any aspect of this matter, please do not hesitate to contact me.

Yours sincerely,

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