

Questions for the Draft Policy Decision

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

Cash-out prices should reflect the costs of balancing and at the same time create the right incentive for BSC Parties to reduce their imbalances as much as possible. In order to incentivise parties sufficiently, the difference between APX RPD intraday prices and the cash out price needs to be significant. Already the current price differences between APX RPD intraday prices and SSP and SBP are high enough to trigger active 24/7 management of physical positions in order to keep imbalances as low as possible. These current differences are based on the most expensive 500MWh.

Switching to the marginal costs of balancing creates some unfavourable issues without actually increasing the incentive to reduce imbalances. We foresee the following problems:

1. The volatility of imbalance prices will be high. Given that the distribution of imbalance prices is skewed to high prices, a risk-averse party will tend to stay long rather than short. This overly cautious behaviour creates inefficiency.
2. Participants in the balancing mechanism have an unjustified competitive advantage as they can anticipate being the marginal provider, i.e. can anticipate the cash-out price.
3. The providers of balancing services, which tend to have low balancing costs due to the flexibility of their portfolio, might have an incentive to increase balancing costs and have more influence on these costs if they only have to increase the price for the marginal unit. The argument that analysis of prices from the last three years "suggested a low likelihood that the marginal price will be set by one unrepresentative action" is not valid, because the revised arrangements as proposed by Ofgem will give rise to different behaviours by market participants.

The first two adverse impacts of switching to marginal costs can be alleviated if Elexon provides reliable online information about the actual status of the grid and committed generation through the Balancing Mechanism. Thus, we strongly recommend transparent online publishing of grid balance and activated reserves (and related costs), including proposed flagged actions which are currently not visible to the market until after delivery.

We understand the argument that marginal pricing can reduce the "missing money" problem related to flexible assets. However, in order to do so in a non-distortive manner this would require the System Operator (SO) to pay-out the marginal price to all activated reserves, but pay-as clear is not part of the Ofgem proposals.

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 are concerned about going to PAR1, although a move to more marginal prices may create a better signal to the market to balance (depending on the correct information provision by the SO). We believe marginal pricing should be reflective of the true cost to the SO to balance. We believe that PAR1 is not reflective of the true cost as it highlights only the most expensive action taken. A move to somewhere between PAR 500 and PAR50 as suggested in some of the scenarios would seem a fairer reflection of the true cost to the SO of balancing. We would prefer, though, to stick to PAR500 in order to make sure that a portfolio of different generators actually sets the price rather than a single unit and is therefore more representative.

We do not have major concerns about flagging errors; however we do have concerns about the general transparency of the flagging and tagging process. In order to incentivise the correct balancing behaviours Parties must understand what actions will feed into the Cash Out price. Currently it is very hard to know if a balancing action has been flagged until after delivery. Therefore we would suggest that early clarity on this is far more important than ex-post correction. In fact ex-post correction could lead to participants being penalised for taking the correct balancing action based on the information at the time of balancing, if the pricing is subsequently amended ex post. A correction ex-post implies that cash-out prices might frequently change later on. We actually see a value in publishing the cash-out price directly after delivery as it is an important feedback loop for appropriate balancing behaviour.

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

We agree that costs for voltage reductions and especially disconnections are substantial. But setting the cash-out price to a specific level (£3,000, then £6,000/MWh) under such circumstances is for several reasons problematic:

1. If BSC parties run the risk of facing costs of £6,000/MWh they are incentivised to stay at least slightly long on a permanent basis.
2. If Disconnections or voltage reductions are made but it is not possible for market participants to see if they are for a System action (flagged) then this could create unnecessary fear in the market leading to excessively high prices and would potentially incentivise the incorrect balancing behaviour (see question 2). In an extreme event such as this, small and independent parties would be at greater risk of a negative impact on their business and this may lead to an incentive to question the actions of the SO, and possibly even challenge their actions.
3. The IA shows that the introduction of a Capacity Mechanism (CM), which includes incentives to provide demand side responses (DSR), is likely to significantly decrease the need for Demand Control and may possibly remove it entirely (in combination with the other measures in this SCR).

We therefore question if Demand Control actions should in fact be priced into cash out at the present time. We believe it would be best to await the introduction of the CM and then re-evaluate whether it is necessary to then introduce Demand control actions into the cash out pricing.

If the decision is nevertheless to actually set the cash-out price based on VoLL at £6,000/MWh, we strongly recommend the following two related actions:

1. Elexon has to provide reliable online information about the actual status of the grid (see answer to question #1 & #2).
2. Elexon should provide information about a risk of curtailment being applied *after* gate closure. This would ensure that providers of flexible generation will do their best effort to activate all potential production in order to avoid being short. This might actually help avoiding a VoLL measure. Information *before* gate closure would have the adverse impact that no producer would be willing to sell below £6,000/MWh, i.e. the market would be disrupted and a fair market price could not be established anymore. A VoLL measure might then become a self-fulfilling prophecy

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

As stated in our answer to question 3 we do agree that the introduction of a CM is likely to significantly reduce the frequency and therefore the cost of Demand Control. However given that this is the case we question the need to factor Demand Control actions into the cash out price prior to the introduction of the CM. We believe it would be better to introduce the CM (if a CM is deemed necessary) and then re-evaluate if the inclusion of DC into the cash out price is still necessary to incentivise the correct balancing behaviours, Rather than forcing involuntary demand control, the SO will be able to contract voluntary DSR even at very high prices for activation. In doing so, a market price for disconnections can be achieved, so that cash-out prices remain a proxy for the actual costs of balancing.

In this context we note that Germany introduced a "deferrable load act" guaranteeing voluntary providers of DSR specific payments. Although this is also not a fully market based approach, it at least shows the possibility that industry can be incentivised to participate in balancing activities.

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?

No comment

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

We agree with using pricing in the availability element of BM dispatched STOR and all non BM STOR actions to cash out. However we do not believe that this should be used for VoLL or that the cost should be linked to a VoLL value. Rather we consider that the actual cost of the actions taken should be passed into the calculation. Marginal pricing should reflect the true cost to the SO of balancing in that half hour and not an assumed avoided cost. Therefore we do not believe that the proposed RSPF is the best way to cost these actions and feed them into the cash out price.

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 are convinced that a single price is the most efficient way of reducing balancing costs, because it not only incentivises balancing but goes one step further as it rewards participant actions that support the grid.

It is noteworthy that Germany has a single cash-out price system. Over the last years balancing costs remained stable or even decreased while at the same time the share of intermittent renewable production has grown significantly.

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

We would like to highlight that any change to the cash-out system should also trigger a reassessment of the necessary information that should be available to all market participants.

There is no information provided on the basis for the judgments that the timing of Gate Closure should not be shortened. As a minimum we would have expected to see some quantification of the costs and benefits.

Questions for the Impact Assessment

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?

The 3 approaches taken to the analysis (Historical, Quantitative and Qualitative) seem to be a good starting point. However we believe that a 4th key approach should also have been taken, that of looking at behavioural change in the market. The purpose of the changes is to incentivise better balancing behaviours in the market. However what that behavioural change may look like and how that would in turn impact on cash out and the market price has not been adequately considered. All 3 approaches taken have assumed no behavioural change, or made some broad brush assumptions. Therefore the results do not adequately reflect the true impact of the changes, especially when taking the historical approach.

Also, although the interaction with the CM has been factored into the analysis, other key changes such as the move to CfD FIT has not. We believe this could lead to some significant cost implications for the market especially for intermittent generation. This is as under the CfD FIT intermittent generation will be marked to a day ahead price. However actual wind production deviates from the production forecast of the day before delivery potentially exposing the generator to a greater basis risk between the day ahead and intraday price. This impact is likely to be significantly increased with the increase in volatility of intraday prices.

Also future changes under the Future Electricity Trading Arrangements work stream could have a significant impact when combined with the proposed EBSCR changes.

Finally the IA has not taken into account the interaction between market prices and cash out price. The increase in volatility (and therefore risk) in the cash out price is likely to impact directly into the market price increasing volatility and the risk premiums especially with respect to PAR1/VoLL based pricing applied by the market. This change in market price is likely to be reflected in customer bills, and as a consequence we do not believe that the effect on the end consumer will be neutral to slightly positive as implied by the impact assessment. We believe that implementation of these measures is likely to increase cost and risk for the industry and therefore overall increase the cost to the consumer.

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.

The Impact analysis seems to draw some odd conclusions, which do not seem fully backed up by the analysis. We are concerned in particular that the impacts on smaller parties and Intermittent generation will be very different from the assessment in the IA. Also that some of the factors which IA implies will mitigate negative factors will in fact not do so or at least not to such a great extent. Taking each impact in turn:

Investment in new flexible capacity – We do not believe that more volatile short term prices will incentivise more flexible capacity to be built. In order to build new flexible generation (such as CCGT or OCGT) developers will need to see long term security over revenues to secure finance. This incentive should be provided through the CM or long term STOR contracts. The short term volatility will not incentivise this build and in our opinion flexible generation is unlikely to be built on a merchant basis.

Negligible impact on Consumer bills – As discussed in the response to Question 9, we do not believe the impact of cash out reform will be negligible on Consumer bills. The increased cash out volatility

will feed back into market pricing and risk premiums. This is very likely to push Consumer bills up considerably as even larger players cannot absorb this kind of increased risk.

Increased Balancing efficiency – As discussed in our answers to earlier questions, sharper cash out price will only lead to better balancing behaviour if it is also accompanied by adequate information which allows parties to respond to the signals in advance. If this information is provided, this impact should materialise to a certain extent (although intermittent generation will still struggle with forecasting to balance). However without extra information provision the impact is likely to be increased costs for parties and increased barriers to entry in the energy market.

Single Price mitigates negative impacts for intermittent Generation and Small Suppliers – We believe that this is not the case at all. Although we strongly support a move to single cash out price, we do not believe that it will fully mitigate the other negative impacts especially with regard to impacts on intermittent generation. As we will discuss in the impacts on sustainable development the ability to forecast wind generation is constrained by the quality of the weather forecast and will never be 100% accurate. Intermittent generators will always be at a disadvantage to conventional generation in the market, and the EBSCR will increase this risk.

It is also worth noting here that no distinction is made between transmission and distribution connected intermittent generation. Therefore the effects of the RCRC in Figure 7 of the IA will vary dramatically as, while transmission connected generation will receive RCRC (as depicted in figure 7), this will actually be a charge to distributed generation and increase their imbalance costs accordingly.

Sustainable Development – As stated above Statkraft does not believe that the move to a single price will cancel out the negative effects of the rest of the proposals on intermittent generation. Intermittent generators are much more exposed to cash out pricing than traditional thermal generation due to an inability to control load. Wind operators (such as Statkraft) already spend a large amount of time and money on forecasting the production from their intermittent portfolio. The IA assumes that the proposals would incentivise better forecasting (although it also notes in various places limitations on their ability to do anything about this). However we would argue that those incentives are already there. In order to further improve our forecasting ability the available weather forecasts would also need to improve substantially. Whilst intermittent generators may use a number of different models to forecast generation the underlying data on weather comes from a very small subset of providers. Therefore forecast errors based on weather are likely to have a strong correlation. If the weather forecast is wrong even by a few hours, this could have a significant effect on the exposure to imbalance pricing.

The IA also assumes that as many intermittent generators have a PPA that they will be shielded from the effects of sharper cash out prices. This is unlikely to be the case as PPA providers will not be able to bear this increased risk and will have to pass it back to the generator at least in part. Also the IA assumes that these PPAs are with vertically integrated suppliers who can use their supply portfolio to mitigate the imbalance effect. This makes the assumption that only the Big 6 provide PPAs to the Market, this is not the case. Statkraft is a leading PPA provider in the UK market however at present we have no supply base and would face the full impact of the increased cost of imbalance on our intermittent portfolio (both for our own assets and 3rd party PPAs). We believe that this increased cost would reduce competition in the PPA market further as only the large vertically integrated players would have the advantage of a large and diversified supply portfolio to mitigate some of the cost (as shown in the IA). DECC have recently held a call for evidence due to concerns on competition within the PPA market. In their current form the proposals of the EBSCR would reduce the ability for independent PPA providers to compete in the PPA market, hindering competition further.

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.

The risks identified in the IA are valid and correct However as noted above we doubt some of the conclusions which have been drawn.

With a PAR1 the ability for BM participants to influence the cash out price (driving it up towards VoLL) is significant. In this context we would note the current requirements that have been applied as part of the reverse price calculation to ensure a minimum threshold has to be achieved before the price can be set. Use of any small PAR value may lead to a market reaction which leads to higher prices based on the fear of a high cash out price. This is especially true if better information on system length and flagging is not provided to the market in a timely fashion. We agree that the measures may in fact increase liquidity in the intraday market as parties seek to mitigate imbalance costs. However just because there is a liquid market does not mean that the price in the market will be unaffected. It is quite possible that very high prices will be seen in the market on days of system stress even if liquidity remains good. This does not seem to have been taking into account in the IA.

The single price will benefit parties by not having a penalty both ways for imbalance. However again information will need to be provided in a timely fashion on the anticipated NIV to allow parties to react to balancing signals. One of the main functions of a 24/7 trading desk is to minimise the cost of imbalance and they will therefore always reference the price achievable in the market to the cost (or benefit) of imbalance when making their balancing decisions. As discussed earlier the EBSCR proposals could incentivise trading parties to stay long against forecast on tight days to avoid high imbalance charges.

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?

As discussed in the response to question 9 we believe that further analysis is needed of the potential behavioural changes which the proposed measures could lead to. This also needs to explicitly consider the impact that better types of information will have on these behaviours Above all there is an urgent need to consider how information dissemination can be improved after Gate Closure .

Also that further consideration should be given to how these changes interact with other market initiatives such as CfD FIT, the single target market for electricity, FTA and the liquidity work stream. We also believe that the general impact on market price should be considered. We believe that, if these elements are not considered further, there could be a number of unintended consequences that will cause participant and consumer detriment resulting from the implementation of the EBSCR proposals.