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*Sent by email to EBSCR@ofgem.gov.uk*

Dear Andreas,

**Re: Electricity Balancing Significant Code Review – Draft Policy Decision**

Statoil (U.K.) Limited (STUK) appreciates the opportunity to respond to the proposals outlined in the above consultation. This is a non-confidential response, comprising a summary letter and an annex with more detailed answers to the questions set out in the consultation document.

In summary:

- While we support the focus in the EBSCR on ensuring that cash-out prices are fit for purpose, we believe current arrangements are working and there is insufficient cause for reform. Moreover the preferred set of measures would represent major changes to the market potentially within a short timeframe. We urge Ofgem to provide clarity as soon as possible and publish its final SCR decision before the first Capacity Market auction in late 2014.
- All the shortlisted policy packages comprise much sharper cash-out prices which will benefit existing flexible thermal generation. But it is unlikely that these higher and more volatile cash-out prices will in themselves be “bankable” enough for investments in new flexible generation. More volatile prices mean a higher risk to be managed, and typically more collateral being required for trading. We are therefore unconvinced that the proposed changes to the balancing market would ensure security of supply by providing an effective signal to invest. Rather, incentivising investment in flexible and non-intermittent generation is a matter for the Capacity Market.
- We are also concerned that the Draft Policy Decision does not consider more fully the effect of the Capacity Market on the proposals being put forward – there is only a short section on this in the Impact Assessment (IA). Given that DECC has confirmed that the Capacity Market will be going ahead and has recently published greater detail on the mechanism, we would urge Ofgem to do more analysis on the incremental benefit of the measures being proposed in the EBSCR. We also believe there is a risk this SCR could undo some of potential benefits of Ofgem’s measures to improve competition and liquidity in the electricity market through the proposed Secure and Promote package.
- We note there are interactions between the Capacity Market and the VoLL levels being proposed in both gas and power. As the proposals currently stand, in the event of a gas shortage, gas-fired power stations would be incentivised to continue running, potentially creating or exacerbating a gas shortage in the market. We urge DECC and Ofgem to reassess their respective proposals so as to incentivise the most appropriate result for the market and consumers.

- We also note that all the short-listed packages proposed are clustered around an “either, or” choice on each parameter, and some seem to have broadly similar effects quantitatively. This makes it difficult to pick out a clearly optimal package based on the evidence provided. In particular we see little gain in moving from PAR50 to PAR1 (in comparing Package 4 to Package 5 there appears to be little additional return) – therefore, given the risks we see with pricing fully at the margin, we view PAR50 as preferable to PAR1. But it is unclear from the IA whether PAR50 offers the optimal balance, and to this end we would like to see further analysis comparing packages with incrementally sharper cash-out prices against the current package. In any case, we would encourage a phased implementation of a more marginal cash-out price so that the impact on market functioning of these sharper and more volatile prices can be properly evaluated.
- We are concerned about the wider effects on competition in the market, which will in turn impact the consumer. The IA describes a situation where independent wind developers and independent suppliers will face significantly higher costs than vertically integrated players. We see this development as incompatible with ensuring competition in the electricity supply market and in that for Contracts for Difference (CfDs). Making cash-out significantly more marginal would increase the risk associated with wind projects for independent developers and undermine the benefits of the CfD regime in supporting low carbon generation. The higher risk through increased volatility would mean higher collateral being required which would impact smaller parties the most, inhibiting competition. For independent RES developers, a single cash-out price would offer little relief over the medium to long term.
- The proposals being put forward would mean all energy market participants will have increased balancing risk going forwards, but not necessarily the opportunity or tools to manage it. One area which we believe should be reconsidered is changes to Gate Closure which would allow participants this opportunity.

We would be happy to discuss any of the points in this response with Ofgem officials.

Yours sincerely,

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Statoil (U.K.) Limited

*Due to electronic transfer this has not been signed*

## Appendix: Consultation Questions

### A. Questions on the Draft Policy Decision

**Question 1: Do you agree with our 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?**

While STUK understands the rationale of making cash-out prices more marginal so as to provide a signal for more efficient balancing, we remain of the view that more marginal pricing carries a number of downside risks, which are most evident when moving to a fully marginal price.

We note that all the short-listed packages proposed are clustered around an “either, or” choice on each parameter, including on sharper prices (PAR50 or PAR1). It is not clear to us why only these two choices were considered as the results from the analysis strongly suggest there is little additional impact or benefit – for example the effect on SBP, or forecasted investment signals – in moving from PAR50 to PAR1 (e.g. in comparing Package 4 to Package 5), and hence the biggest effect is in moving from PAR500 to PAR50.

Therefore, we see little benefit in moving to PAR1 given this, particularly also since it would not be reflective of overall cost of balancing. We also see a number of risks associated with pricing fully at the margin:

- It ignores the point that all balancing actions are not equivalent: moving to a fully marginal price would mean that cash-out would be based on the most expensive (and likely also a fast-response) action, which risks over-stating the marginal cost of an extended or steady-state imbalance;
- It provides parties with a risk that could be very difficult to manage, particularly if prices end up being set on a single, very small action – the IA says that for PAR1, a single action would set the price 22% of the time;
- While Modification P217A is considered to have reduced the likelihood of flagging and tagging errors, the analysis undertaken was retrospective and did not consider situations of system stress which are more likely in the future. Moving to PAR1 would exacerbate the impact of such errors. Ofgem’s offer to have an ex-post correction process will not solve this – it will only lead to added uncertainty for participants;
- The quantitative analysis highlighted there is also a risk that the System Sell Price may be set by ‘rogue’ bids from subsidised generators bidding below the opportunity cost of their subsidy;
- Regardless of any countervailing measures, PAR1 would preclude all players (including portfolio players with a number of thermal plants) from fully taking part in the Balancing Mechanism or even the intraday market – even portfolio players would need to hold back some capacity to self-balance and/or act as a fall-back for any unplanned trips. This will serve to reduce liquidity in the BM and the intraday market and increase costs for participants;
- This potential impact in the intraday market could lead to an increase in basis risk, as there could be an increased discrepancy between the day-ahead market, on which the reference price for CfDs will be calculated, and the intraday market. This additional risk is not considered in the current design of the CfD.

As we said in our last response, we believe PAR500 currently gives ample incentive to balance, particularly for wind generators such as ourselves. We would appreciate greater transparency here by showing the effects of incrementally sharper prices from the current PAR500 level (e.g. PAR250, PAR100) and which will in turn confirm the best balance in sharpening prices in terms of increased incentives, risks to parties and impact on market behaviour. If the decision is still taken to sharpen prices, this analysis should be used to plan a phased approach to a clear timetable, which would enable Ofgem to assess progress in the market against clear and agreed criteria.

We disagree with the assertion made in the Draft Policy Decision that independent wind parties can be insulated from imbalance risk, particularly at times of system stress, by making use of Power Purchase Agreements (PPAs). Such risks will be directly factored into the pricing of PPAs and come at a significant additional cost, meaning lower returns for independents which present a major impact on competition.

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

STUK understands the rationale behind pricing voltage reduction and disconnections is to prevent the need for voltage reduction or disconnection to take place. However we ask that Ofgem look at the impact of VoLL pricing on credit requirements, which are likely to increase with the exposure to higher cash-out prices, and may present a barrier to market entry and affect smaller players already in the market.

Furthermore, as the level of VoLL is an arbitrary estimate of VoLL for I&C consumers, there is a risk it may be subject to adjustment over time and lead to market uncertainty. We also see a risk that in the approach being proposed (where National Grid makes a “top-down” approach in estimating demand control volumes) that inaccuracies could be highly damaging to generators, and would ask Ofgem to consider measures to mitigate this risk.

In the longer term, we would want to see a shift from the current rather subjective methodology of setting VoLL to a more dynamic and market-based approach. We see the former, setting a VoLL level of £3,000 and £6,000 may act as a target price, as it will be more tangible than the current, much higher, limit in the BM.

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

There is a clear interaction between cash-out and the Capacity Market, and STUK would want to have seen the details of the final policy design and auction parameters before commenting further on the pricing of Demand Control actions. But we are concerned about the interactions between the Capacity Market and the VoLL levels in gas and power. The power VoLL is set at a higher level than that of gas, and there is no Force Majeure provision for gas-related incidents in the current Capacity Market proposal. Therefore, in the event of a gas shortage, gas-fired power stations would be incentivised to continue running to avoid incurring the penalties from the Capacity Market and the power VoLL. This could inadvertently create or exacerbate a gas shortage in the market. We urge DECC and Ofgem to reassess their respective proposals so as to incentivise the most appropriate result for the market and consumers.

**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?**

STUK is a generator and not active in the supply side of the power market. That said, while we understand the rationale for the proposed model for payments to consumers for involuntary DSR services, we are sympathetic to the view that it could lead to a significant reputational challenge for the industry if consumers are subject to different payment arrangements and levels for different causes of disconnection.

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

While STUK believes that the current arrangements for pricing reserve services are broadly effective, we accept there is room for improvement. Ofgem has said there are a number of questions to be addressed in the proposal for a Reserve Scarcity Pricing function, and we agree that significant further development is needed in consultation with industry. We see there being a strong case in making this a longer term measure to investigate so as to allow a comprehensive analysis to be done.

**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?**

STUK notes Ofgem's argument that moving to a single cash-out price would help "undo" some of the negative effects of the other proposals on smaller players (as per Figure 3 in the IA). We agree that single price should not lead to participants gaming the system to benefit from being out of balance in the wrong direction.

However there should be stronger acknowledgement that the relief offered to independent wind generators will be temporary as more intermittent renewable generation comes onto the system. We do not believe that it is acknowledged sufficiently in the analysis that as more wind generation comes onto the system, the imbalances of independent wind generators will increasingly be correlated with system imbalances, nullifying any relief offered by a single price from more marginal prices.

Any benefit for wind parties from single prices is sensitive to the correlation of forecast errors – the analysis presented by Ofgem and undertaken by Baringa assumed in its central case there was no correlation of forecast-to-production errors. The Baringa report makes clear that if there is some correlation – which there certainly will be due to the limited number of forecasting services that exist, and the geographic grouping of wind parties – then there is a greater likelihood of wind imbalances driving system imbalances, making wind parties worse off and also affecting system level prices. Moreover, while the IA shows independent suppliers would on average be better off under a single price rather than a dual price, the other measures in the preferred package (P5) would amplify the absolute costs to them when they fall the wrong side of a system imbalance, which raises competition issues. This issue should therefore be looked at in greater detail.

We do not agree that a single price is effective in reducing market complexity. We are also concerned about the impact a single price will have on the liquidity of intra-day trading in that it could remove the incentive for market participants to trade in the intra-day market, as they might instead look to "net off" between their generation and supply businesses and/or benefit from spilling in the Balancing Mechanism. This would be detrimental for generators needing to trade for small chunks of power in the event of short term trips. We ask that Ofgem undertake an assessment of this and consider remedies.

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

STUK maintains our view that changes to gate closure should be considered as part of the EBSCR. As the rationale behind the EBSCR is to incentivise trading parties to mitigate their imbalances, there should also be greater opportunity,

in the provision of tools and information, to do so. A change of gate closure (for some or all parties, reducing it to 30 minutes for physical and contract notifications, or allowing contract notifications after gate closure) would be of particular benefit to smaller and independent parties who are more likely to be out-of-balance as it would allow them more time to balance and benefit from increasingly accurate information, in particular forecasting of renewable generation. This measure would therefore have a sizeable and beneficial impact on competition and more effectively act as a counterweight to the measures being proposed in the EBSCR.

## **B. Questions 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?**

**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?**

STUK does not believe the analysis of the impacts in the IA currently presents a convincing case for the preferred package of measures. The implementation of Electricity Market Reform will have major effects on system balancing and pricing which have not been taken into account and so make the move to a fully marginal cash-out price (under P5) very risky. The forecasted long-term benefits are therefore highly uncertain while the more certain effects are those on smaller independent parties. In particular, we are unconvinced by the analysis of the investment signal provided by cash-out reform due to future revenue streams being highly volatile and therefore unbankable, and also the uncertain impact of the implementation of EMR.

On the sharpening of cash-out prices, there appears to be a relatively small quantitative difference in moving between PAR50 and PAR1 (e.g. by choosing P5 over P4), which seems to indicate diminishing returns. Thus the rationale for choosing PAR1 over PAR50 seems to be based on a belief, touched on in the qualitative analysis, that pricing at the margin is the best way to ensure security of supply. We do not agree, due to the risks we have set out above in moving to PAR1.

We believe it would be more transparent to show the effect of a wider range of PAR values (e.g. PAR250 and PAR100) by comparing additional packages with these PARs and the other measures being considered against the five Ofgem has so far presented.

**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?**

As an independent wind developer, we believe Ofgem's assessment in the draft decision that intermittent generators would be sheltered from sharper prices by a single price and PPAs greatly overestimates the ability of either measure to do so. Going forward, this risks reducing competition in, and the total amount of, future renewables development and thus also the government's objectives for the sector.

More generally, we are concerned that the draft decision, if implemented, would harm liquidity and competition in the power market. As Ofgem says in the IA, the packages will increase the value of flexible generation in near-term markets – but the increased imbalance risk may also lead to parties withholding capacity to self-balance or act as a fall-back for

any unplanned trips. This risks undoing the potential beneficial effects on competition from the Secure and Promote package that was consulted on by Ofgem over the summer.

**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?**

In particular, we believe it is very important that Ofgem undertake further investigation of the impacts of a Capacity Market, on which the government has now published further detail, on the value of the EBSCR proposals. The baseline used for comparison between packages is a “do nothing” scenario which, as it does not include a Capacity Market, is far from ideal. However many of the qualitative arguments and much of the quantitative analysis has been presented in contrast to this baseline, which undermines the case for the packages.

As one example, the IA shows that even with some simple assumptions of the Capacity Market the benefits decline significantly: the Cost-Benefit Analysis for the preferred package (P5) falls by two-thirds, from £152m per year in 2030 to £53m per year. We believe further analysis is warranted which could well lead to a different, or indeed an entirely new, package of measures being identified as offering the best overall benefit.

As mentioned above, we are concerned about the effects that both much sharper cash-out prices and a single price will have on liquidity in both the Balancing Mechanism and in the intraday market. We believe more work is needed to assess the behavioural effects, beyond the assumed changes in trading strategy in the forward modelling, and to also quantify the effect of changes in cash-out on the intraday market.

Also mentioned above, we believe it would be more transparent to show the effect of a wider range of PAR values (e.g. the current PAR500 plus PAR 250 and PAR100) by comparing additional packages with these PARs and the other measures being considered against the five Ofgem has selected.