

Peter Wesslau
Vice President, Sustainable Energy Projects
Country Manager UK & Ireland

Tel: +44 (0)203 301 9118
Email: Peter.Wesslau@vattenfall.com

Ref: UKCM-PW-023

22 October 2013

Andreas Flamm
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

Email to: EBSCR@ofgem.gov.uk

Consultation on the Electricity Balancing Significant Code Review – Draft Policy Decision

Vattenfall is one of Europe's largest generators of electricity and heat. The company conducts operations in the Nordic countries, Germany, the Netherlands, France and the UK. Renewable energy, and wind power in particular, is at the core of our business – 33% of Vattenfall's total investments in generation assets in the period 2012-2016 will be in wind power in the UK, Germany and Sweden.

Vattenfall is a major inward investor in the UK, investing over £2bn since 2008 and operating 3 onshore and 3 offshore wind farms with a further 16 in development. This includes our 7.2GW joint venture with Scottish Power in the Round 3 East Anglia Zone. More than 33% of our £2bn investment has gone to UK businesses supporting over 2000 jobs throughout the supply chain.

Vattenfall welcomes the opportunity to comment on Ofgem's Draft Policy Decision for Electricity Balancing and would welcome further engagement as the proposals are developed.

Yours faithfully



Peter Wesslau
Country Manager, UK & Ireland
Vattenfall Wind Power Ltd

Summary of Vattenfall's views

- Vattenfall shares Ofgem's view that the transition to a low carbon electricity system requires balancing arrangements that accurately reflect the true value of flexibility. There is room for improvement in the current balancing arrangements to ensure that all parties in the balancing regime face the real costs of their actions.
- Against this background, Vattenfall prefers a stable and predictable balancing arrangement with:
 - o A single cash-out price
 - o Marginal cash-out prices, implemented through a step wise move to PAR50MWh and after positive evaluation to PAR1MWh
- Whilst welcoming attempts to find a market based way to incorporate potential involuntary demand adjustments, and recognizing that there could be room for improvement on these issues, Vattenfall has nevertheless reservations about:
 - o The introduction of a price and compensation for disconnections and black-outs
 - o The introduction of a Reserve Scarcity Price function
- The package of proposals could have significant effects on the market and could substantially increase commercial risks, especially for smaller developers and generators. To avoid a disproportional increase in risk, closer examination of the effect of some proposals is needed. The current impact assessment offers valuable first insight into the effects of some proposals, but Vattenfall has reservations about some of the assumptions used. In particular, the assumptions on improved forecasting and other reductions of balancing risk seem optimistic. Vattenfall is also concerned that changes in bidding and hedging strategies are not appropriately reflected in the modeling.
- Vattenfall recommends Ofgem to exercise caution when introducing the new proposals. Many proposals can have unforeseen side effects, in particular in connection with other variables of the UK electricity market currently changing, such as the introduction of a capacity market.
- Vattenfall also recommends Ofgem and National Grid to pay closer attention to facilitating those parties that face large imbalance risks (intermittent generators) to manage their risk. These parties would benefit from more and improved system information from National Grid and from closer gate closure.
- Finally, Vattenfall strongly recommends close dialogue with neighboring countries and the EU Commission to ensure that new balancing arrangements support rather than obstruct next steps in integration and coupling of markets. To ensure that the balance mechanism is coherent with the evolving internal market Vattenfall recommends that the pay as clear principle as promoted in the draft Network Code for Balancing is used for settling trades in the real time market.

Vattenfall's answers to the consultation questions

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

Yes, Vattenfall supports the efforts to make the cash-out prices more marginal. Vattenfall believes the SCR should support the transition to a low carbon economy. That transition is best served if market participants face cost reflective, non-discriminatory and transparent incentives and prices for balancing. The balancing regime should provide such transparent price signals, which provide an incentive to market parties to balance their portfolio.

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?

Whilst Vattenfall agrees with the principle of more marginal pricing, we have concern about the effects if the regime is changed too drastically, too quickly. To ensure a soft landing and to enable the market to cautiously review the effects of the new proposed cash-out prices, Vattenfall proposes to start with the PAR 50 MWh and assess the impact after a pilot period, before considering moving to 1 MWh.

Vattenfall stresses that, for confidence in the system, it is essential that system pollution is prevented – energy actions should be separated from system actions as much as possible. A smaller subset of actions could increase the risk of system pollution. It is hard to assess whether this risk is significant, but this calls for a cautious initial move to PAR50 rather than PAR1. Additional checks and balances, as well as a process to mitigate flagging errors, are welcome, as long as not overly complex.

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

Vattenfall is sympathetic to Ofgem's wish to set a method for pricing voltage reductions and disconnections, ensuring these incidents provide an incentive for managing portfolio balance.

However, Vattenfall is concerned that including other components in the cash out price other than the marginal price established in the actual real time period may make the price less transparent and dependent on administrative decisions difficult to anticipate. In addition, it is questionable to what extent pricing these current actions without allocated cost will have the desired effect of providing better price signals for scarcity and balancing actions. As Ofgem notes itself, these actions do not occur frequently and when they do, they are likely to be removed in the NIV tagging process. Furthermore, there is the risk of unintended side-effects, sustained by the strong interaction of the balancing SCR with the intended introduction of the capacity market, which also aims to offer a solution to missing money problems.

Given the relatively low incentive for behaviour, Vattenfall is doubtful whether the benefits of more accurate pricing outweigh the cost of additional complexities and the risk of unintended side effects. This conclusion could change in the longer run, when there are more technical possibilities for Demand Side Response at which point demand side needs to be fully reflected in balancing options.

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

See answer to question 3.

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?

Vattenfall believes that a one-off payment to households and especially to business consumers should not be implemented in the proposed fashion. Firstly, the benefit of financial compensation for affected consumers would not outweigh the administrative burden imposed on parties involved. Secondly, the proposed mechanism does not include any relation to real cost and financial impact experienced and is therefore likely to be received badly by interrupted customers, particularly by business consumers.

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

Vattenfall is supportive of the general principle that reserve capacity should be priced in such a way that it provides an adequate incentive to those active on the balancing market and thereby improves balancing efficiency. Vattenfall is not convinced, however, whether a shift to Reserve Scarcity Pricing (RSP) is currently unwarranted.

Whilst an RSP function could theoretically work, a more thorough analysis of the current STOR costs and actions is needed to assess its qualities. For one thing, Vattenfall has trouble reconciling the typical costs of STOR actions at present, with those in the RSP function, which seem much higher. In addition, National Grid can take a number of actions which are not transparent to the market, such as STOR, BM Unit buy out, exchange trading and other “cost-effective” commercial agreements. The market might not be able to see where the marginal balancing action takes place but needs to piece it together once the monthly report has been published ex post.

Vattenfall encourages National Grid to be more transparent about the actions undertaken in under STOR. Ofgem is encouraged to carry out additional analysis on the issue of reserve pricing and be cautious not to move ahead too fast.

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.

Yes, Vattenfall supports a move to a single price and believes it can help make balancing more efficient. A single price mechanism is a simple system that gives a clear incentive to all parties. On the downside, the introduction of a single price could increase gaming opportunities for larger players, which would increase, rather than reduce, overall balancing costs. This risk seems insufficiently addressed in the modeling and we ask Ofgem to provide us with additional information on how gaming can/should be prevented in the proposed mechanism.

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

Vattenfall is supportive of the underlying principles of the proposals. However, we observe a lack of focus on enabling balancing parties to react to the more expensive and extreme balancing incentives, which will result from the proposed measures. The modeling assumes that intermittent generators will find ways to improve their forecasting and reduce their exposure, but at present these possibilities are limited. We strongly encourage Ofgem and National Grid to study the possibilities for shorter gate closure and publish more accurate and near term balancing information and forecasts.

Secondly, given the rapid regulatory changes in the UK market and the potentially far reaching effect of some of the proposed measures, we urge Ofgem to take a cautious approach to implementing any of the proposals stemming from the SCR. In particular, a step by step approach, in which the measures would be introduced over the course of several years, rather than immediately, would ensure a soft landing and could prevent regulatory uncertainty becoming a market risk in itself.

Finally, Vattenfall strongly recommends paying even closer attention to alignment with neighboring markets. In particular, the EU target model will achieve more alignment on market coupling and integration. Vattenfall opposes any steps in the UK that are at odds with the intended market arrangements in the EU target model.

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?

In general the chosen approach looks like a balanced one. When it comes to the quantitative modelling, it is a good first step. However, we have reservations about some of the assumptions used. Our reservations include the following:

- Some of the behavioural changes seem unrealistic. Although in principle higher balancing costs should improve balancing behaviour, we believe there are clear limits to this ability of market parties. For instance in the case of wind production, weather forecasting still remains just that – forecasting. It already is in our best interest to improve our forecasting as much as possible under the current regime. Increasing balancing costs are not likely to enable us to improve this even further. Our alternative is to find buffering/storage opportunities. Even if these were available for realisation, they would be costly and require innovation and therefore time. In the current technically developed market and, to a lesser extent, financial climate, increased imbalance costs will have limited effects on the ability to balance. Vattenfall believes that some of the assumptions of behavioural changes of Ofgem are rather optimistic and should be adjusted.
- In addition to the above, we believe it is crucial to study the effects of all individual proposed measures. All measures are designed to affect prices of capacity in extreme (or at least tight) situations. Introducing more than one of such measures could lead to unexpected and even undesirable effects, when one method influences the other. In this respect, it is desirable to introduce measures one by one, to study the individual effect.

- There seem to be no changes assumed in bidding behaviour and hedging strategies under different packages which would be questionable.

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 understand from Ofgem that the improvement of pricing of capacity in times of system imbalance is the key goal for this reform package. Although some of the assessments do show an increased balancing price, we would appreciate a clearer assessment on how each proposed measure aids this specific goal. It would be very helpful if Ofgem can indicate how each proposed mechanism improves the pricing during times of scarcity and how they are likely to affect the balancing market.

As mentioned before, Vattenfall believes that the assessment of groups or clusters of mechanisms is less clear in this respect than if the assessments would separate each proposed measure and indicate their effect on the market.

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.

Yes, we largely agree on the risks identified and look forward to see any proposals on how to mitigate these risks. In particular we are concerned about:

- Increased risks for smaller parties without flexibility and/or ability to steer their demand and/or supply
- Risk of pollution of system prices
- Risk of manipulation of cash-out prices

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?

As mentioned throughout our response to this consultation, we believe additional assessment or explanation of the original assessment is required in the following areas:

- The use of STOR in scarcity pricing
- The assessment of the ability of market parties to improve their balancing and other actions – behavioural change assumptions
- Tagging and flagging of balancing actions, especially when using PAR 1.
- The interaction between CM and BM measures
- The possibility of gaming under the single cash out price. We understand that in previous considerations of a single cash-out price, gaming was a great concern. In this respect, assessments of the ability for gaming would be very beneficial to the success of the proposal.