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our reference 40.2014.18
by Mr P. Molenaar
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subject PVNED's response to Ofgem's consultation on the Electricity Balancing Significant Code Review Draft Policy Decision Impact Assessment

Goes, the Netherlands, 12 February 2014

Dear Mr Flamm,

First of all, apologies for our late response with regard to Ofgem's consultation on the Electricity Balancing Significant Code. PVNED UK Limited acceded to the BSC in October 2013 and we were not informed that this consultation was in the works. Since our position is neutral on all other points of the consultation, we will focus our feedback on the one point that we do have a strong opinion about. PVNED has a wide experience in dealing with imbalance in various countries and has very good understanding of 'unintended consequences' of various imbalance regime changes in different countries. We hope our response below can contribute to the decisions that are to be made over the coming period.

This response is provided on behalf of PVNED UK Limited (PVNED), is not confidential of nature and primarily focusses on the question whether the UK electricity market should have a dual imbalance pricing system or a single imbalance pricing system.

About PVNED

Founded in 2004, PVNED is a pan-European balancing service provider for electricity suppliers, producers and large industrial consumers and has studied the several balancing regimes across Europe. We execute the operational BSC tasks for our customers by leveling the playing field in the balancing market, by allowing our customers to reduce IT and operational costs and by aggregating their balancing positions, so the size of the aggregated portfolio allows our customers to better compete with the larger market parties. PVNED has a proven track record of reducing the gap in balancing costs between 'national champions', 'oligopolists' on one side and startups, new entrants and independent producers on the other side.

Need for a dual imbalance pricing system

PVNED is active in several balancing markets and has a good insight in the problems TSO's are facing to keep their grids balanced. With diminishing flexible power generation versus upcoming renewable power generation (such as wind) and regional transport congestions, we strongly believe that an electricity market like the United Kingdom should have a strong incentive for market parties to keep BSC portfolios balanced.

PVNED has seen that an increasing part of electricity production is delivered by 'green production', which is autonomous by nature and needs very high incentives before any balancing actions are executed on it. European markets tend towards diminishing the flexible production capacity as a result of high gas prices. As a result of 'mothballing' flexible production, we foresee a shortage in balancing capacity on several European electricity markets, among which also the United Kingdom.

The proposed changes supposedly have a stronger incentive for keeping the balance, as marginal prices would be used to calculate the single checkout price. In practice, the more extreme balancing prices do not occur if a simulation is executed on historic data. Since more extreme prices will not occur, the proposed change does not have a positive effect on keeping flexible production assets available. The changes do not improve the rewards for flexible production.

Advantages for bigger market parties

In a balancing mechanism with a single checkout price, there is always an incentive for 'gaming' imbalance positions. This can be partly mitigated by strictly enforcing FPN adherence, but especially larger (like the 'Big Six') portfolios can still use their size to marginally adjust their positions.

PVNED feels having a dual checkout price offers a stronger incentive towards 'self-balancing' at a zero position, which gives National Grid the best control over balancing actions. As an alternative, PVNED sees the Dutch balancing system as a good example of how a balancing mechanism contributes to system stability, security of supply and rewarding flexible production capacity. In this market 'self-balancing' is a prominent asset for market parties and parties are strongly incentivized to 'help the system'. We see this as an example of how market can balance themselves with minimal involvement from (and costs for) the TSO.

In its "*Position Paper Towards Market Integration of Reserves & Balancing Markets*" of July 2008, Eurelectric concluded in view of its European vision that the strongest incentive to balance the electricity grid should coincide with a dual imbalance pricing system. Eurelectric stated that adopting a single imbalance pricing system provides an economic incentive for gaming by BSC's on the imbalance markets. ENTSO-E endorsed the conclusion of Eurelectric in its position paper of January 2009.

In the European markets that PVNED services, utilities benchmark their 'make-or-buy' decisions continuously with imbalance prices and many market parties base their sourcing strategy on spot prices. If no strong incentive is in place to balance a BSC portfolio (at zero) in the imbalance market, market parties do decide not to buy (or sell) on the spot market and instead buy (or sell) on the imbalance market resulting in balancing issues for the TSO.

Recent lessons learnt by ELIA TSO in Belgium

In Belgium, ELIA TSO moved to a single imbalance pricing system in 2012. Prior to 2012, ELIA used a dual pricing system with an important flaw in determining the short and surplus imbalance price. This flaw provided a continuous and asymmetrical (on the surplus side) spread between imbalance prices of more than EUR 30.- per MWh. There was a need to resolve this flaw as it clearly incentivized the imbalance market not to be 'long'. This is more or less comparable to the current British situation where we notice an incentive not to be short.

However, since Elia TSO adopted a single imbalance pricing system without a strong incentive to balance at zero, imbalances volumes went up significantly (symmetrical). As there was not a clear incentive for market parties to balance to zero anymore, market parties saw the opportunity to game on the Belgian imbalance market. Since then, ELIA TSO joined the International Grid Control Cooperation (IGCC) in order for adjacent TSO's (such as TenneT TSO) to help ELIA TSO to balance its electricity grid. With upcoming offshore wind farms, ELIA TSO has serious concerns about balancing its grid in the near future.

Our belief is that as of 2016, ELIA will either adopt a dual pricing system again, or will implement a much stronger incentive in their single imbalance pricing system to force market parties away from gaming on the Belgian imbalance market. This methodology could be similar to the Dutch imbalance market. TenneT TSO uses a single imbalance pricing system with a built-in strong incentive. In about 15% of the time, there is a strong incentive (spread between short and surplus prices) based on the lowest decremental price and the highest incremental price. This incentive easily rises from EUR 200.- to EUR 800.- per MWh. This marginal pricing system incentivizes keeping flexible production available for reserve and emergency power, which is crucial for maintaining the balance on the grid as a whole, especially with the strong increase in (autonomous) green production capacity.

Follow up

We are interested in Ofgem's views on the need for strong incentives for the imbalance market and are very much willing to contribute in any way we can. I hope our response provides Ofgem some background on lessons learnt in other countries.

If you wish to discuss the content of this letter further or have any queries please contact my colleague Jean-Paul Harreman on +31 613.499.388 or via jharreman@pvned.eu.

Sincere regards,



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