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Partner, Wholesale Markets
Ofgem

Minded to decision to extend the Supplemental Balancing Reserve (SBR) and Demand Side Balancing Reserve (DSBR) cost recovery arrangements for 2016/17 and 2017/18

12th November 2015

Dear Emma,

We welcome Ofgem's letter setting out your minded to position to extend the cost recovery arrangements for SBR and DSBR until 2017/18 (inclusive). There is continuing uncertainty around whether there will be sufficient capacity available for balancing purposes in 2016/17. We therefore believe that it is a prudent measure to extend the arrangements whereby we can recover the economic and efficient costs incurred in the procurement and use of SBR and DSBR for another two winter periods, prior to the delivery year of the Capacity Mechanism.

In our submission we referenced a piece of analysis that had been submitted to National Grid exploring the cost to generators of the SBR service, which manifests itself through two routes:

- Reduced profitability due to lower generation where non-SBR plant that operates near the margin is displaced by SBR plant when it is running outside of system stress events (through ramping up or down, or fulfilling its minimum run time).
- Reduced profitability through the dispatch of SBR plant depressing power prices, which otherwise could have risen as a result of scarcity signals.

We agree with Ofgem's assessment of the impact on both prices and generation levels and note that any analysis of this situation will be based on the counterfactual and so will contain an element of subjectivity. It does not take account of operational conditions that could occur on the day, such as the existence of constraints, and factors we have implemented to mitigate against this, such as requiring the control room engineers to consider plant dynamics when taking their dispatch decisions. However in order to assist Ofgem's assessment of the continuation of the services, we have commissioned a further piece of analysis to explore the impact of SBR and this is attached to this letter as a confidential annex.

In summary the analysis concludes that:

- Procuring a level of SBR capacity for 2016/17 up to the existing volume cap (2.7GW) could result in an impact on revenues across the generator fleet of £110m which, relative to the total generation fleet profitability, is a reduction of 1.9%.
- Procuring a ~50% increase¹ in SBR capacity for 2016/17 leads to an additional reduction in profitability of £33m which, relative to total profitability of the fleet, is a reduction of 0.3%.
- These impacts are largely due to the downward impact on wholesale prices in the settlement periods either side of the period for which SBR has been dispatched

¹ For the purposes of this analysis we assumed an increase of ~50% in order to explore whether there is a linear relationship between the volume of capacity procured and the impact on generator profitability.

whilst SBR plant is ramping up and down and, to some extent, reduced running hours for non SBR plant during the same periods. It should be noted that the plant most probably affected by reductions in wholesale prices (baseload generators) are likely to be active in longer term markets and so it is unclear whether the effects modelled in relation to the short term markets, where the impact of SBR is more likely to be apparent, would materialise to the extent shown.

On a long term basis, the Capacity Mechanism framework is designed to provide long term investment signals to encourage new, efficient generation to come forward and Ofgem's Energy Balancing Significant Code Review is designed to encourage a market response to scarcity signals. In the short term, we believe it is prudent to continue to assess the need for, and procure if required, SBR and DSBR for 2016/17 and 2017/18 in order to continue to provide an effective insurance policy for consumers. Our analysis demonstrates that the direct procurement cost to consumers and assessment of costs to generators outlined above is outweighed by the avoidance of energy unserved for consumers:

	Procurement of 2.7GW of SBR	Procurement of 4.1GW of SBR
Consumer benefit through effect on wholesale prices	£110m	£33m
Consumer benefit through avoidance of energy unserved*	£230m	£97m
Consumer cost of SBR procurement and utilisation	£40-60m	£15-30m
Net consumer benefit	£280-300m	£100-115m

* Assuming a VoLL of £17,000 / MWh

We therefore support Ofgem's proposal to extend the cost recovery arrangements for the economic and efficient costs incurred through the continuation of the services until 2017/18 (inclusive).

If you have any queries please contact myself or Claire Spedding

Yours sincerely

Cathy McClay
 Head of Commercial Operations
 National Grid

(by email so unsigned)