



Consultation Response

SENT BY EMAIL TO: EMR-condoc@decc.gsi.gov

8 March 2011

Electricity Market Reform Project
Department of Energy & Climate Change
4th Floor Area E
3 Whitehall Place
London
SW1A 2AW

Dear Electricity Market Reform Project,

ELEXON's response to the consultation on Electricity Market Reform

I am pleased to have the opportunity to respond to the Department of Energy and Climate Change consultation on "Electricity Market Reform". This is ELEXON Limited's response. The views expressed in this response are those of ELEXON Limited alone, and are not necessarily the same as those of Parties to the Balancing and Settlement Code.

What is ELEXON's interest in the electricity market?

ELEXON delivers the centrally-mandated electricity settlement services that are critical to the successful operation of Great Britain's electricity trading arrangements under the Balancing and Settlement Code (BSC). We manage processes and systems from electricity meter to bank, handling over £1 billion of transactions each year and interacting with over 200 companies in the electricity industry. As part of this we administer the settlement of the Balancing Mechanism and the determination of electricity imbalance prices for generators and suppliers in respect of each half hour of each day. We are independent of any specific interests within the electricity sector.

What we can offer

ELEXON is ready and willing to assist in whatever way we are able. For example, in this response you will see how we can build on existing BSC processes to produce a market price that can be used to settle the Feed In Tariffs with Contracts for Difference.

ELEXON can undertake the detailed design and implementation of settlement and monitoring aspects of the Feed In Tariffs and Capacity Mechanism and would welcome further discussion with you on this.

As you will see in our more detailed response below, we believe that using ELEXON to undertake the data collecting, administration, settlement and invoicing roles outlined for central agents in the new policy mechanisms will provide efficiencies given the synergy with our current operations, which include settlement, credit monitoring and data handling. We hold data that we believe will be required for the settlement of Feed In Tariffs and for monitoring generator/demand performance as part of any Capacity Mechanism.

Consultation Response

We also strongly believe that using ELEXON to deliver and administer the new policy mechanisms is the best option as we will drive out inefficiencies and deliver cost savings. This is much to be preferred over an even more fragmented system of administering the centralised parts of the electricity market. As noted in our response to the Smart Metering Implementation Programme consultation dated 28 October 2010, we would like to reiterate that we believe that consolidating codes and administrative functions should be the longer-term objective for the industry.

We also see a need for a Central Design Authority and given our expertise and experience in implementing change we offer ELEXON for this role. A Central Design Authority would provide for co-ordination across the existing Codes enabling a more efficient implementation, and because it will be able to identify where existing systems and processes can be utilised in operating the new policy mechanisms, it will give a better return on existing investment and a reduced risk in new investment.

The consultation refers several times to sharpening imbalance prices. The rules for calculating imbalance prices and settling the resulting payments, sit within the BSC and therefore we have a keen interest in this. We want to assist with analysis of imbalance prices, and with suggestions as to how imbalance prices might be practically improved. We have tools to undertake comparative analysis under different scenarios and formulations; and practical experience of operating with various imbalance price formulations. We also have experience of testing and implementing a number of changes to imbalance prices over the years, so we remain ready to assist in any further changes, and contribute to the future Significant Code Review of imbalance prices.

Our detailed response to the specific consultation questions

We have responded to those questions where we can assist with the detailed design, operation and implementation of new arrangements. Our detailed response to those questions is set out below.

We have answered those questions where we feel we can add most value for you. The Government and its advisors have clearly modelled the impact of various policy options and we cannot add to that, so we are not commenting on the policies themselves but rather considering how we can help you implement the various policy options. Our answers and comments have been drafted so far as is possible to stand on their own without cross referencing to other answers. However this has necessarily led to some degree of repetition.

We are keen to help

Please do not hesitate to contact me, or my colleague Steve Wilkin, if you wish to discuss any aspect of this letter or the current BSC electricity settlement arrangements. I can be contacted on **020 7380 4036** or peter.davies@elexon.co.uk and Steve can be contacted on **020 7380 4253** or steve.wilkin@elexon.co.uk.

Yours faithfully

Consultation Response

Electricity Market Reform

(As noted in our covering letter, we have not responded to every question.)

Chapter 3: Decarbonisation options for reform

Question 3.

Do you agree with the Government's assessment of the pros and cons of each of the models of feed-in tariff (FIT)?

ELEXON notes that the exposure to a short term price signal incentivises both generators and suppliers in ways that support efficient balancing of the system. So we agree that the FIT options that maintain this exposure have advantages over the fixed FIT option paid on output which removes this exposure completely.

We believe that ELEXON can help the Government implement whichever FIT option is chosen in the most efficient way. We have looked at each of the FIT options and examined the interactions between these and the Balancing and Settlement Code (BSC), which we administer. And, for the FIT with Contract for Difference (CfD), we believe that wider developments in Europe provide opportunities for synergies on which the Government could build. We expand on this below.

When considering any of the FIT options, two design decisions need to be made:

- what volume is eligible for the FIT payment (for example, output or availability or fixed volume); and
- whether FITs replace the contracts that the eligible generators would otherwise sign with other BSC Parties or sit alongside them.

We note that under the current BSC arrangements, BSC Parties are charged or paid for the difference in volume between their notified contract position and their outturn metered generation or demand. We therefore collect and hold both metered generation/demand¹ and aggregated contract positions². In addition, generators provide details of their availability (Maximum Export Limit) for BSC settlements.

Considering the options in turn:

The FIT with Contract for Difference (CfD) option

The key benefits of this option are: that it maintains the exposure to short term imbalance prices with the benefits this brings in terms of efficient balancing; and that it

¹ Demand data is held at site level for some large demand sites connected to the transmission network. But more commonly for most demand we hold demand data by supplier for each GSP Group area (14 areas in Great Britain) and not at a lower level of granularity/geographical location.

² In respect of each Energy account of each Party.



Consultation Response

does not require a wholesale change of the existing contracting, imbalance and settlement arrangements. Current BSC imbalance arrangements could continue as now and the FIT with CfD is essentially independent of this process.

Below we have set out two options for deriving the market price that would be needed to settle the CfDs. These options build on our existing BSC arrangements and, in the case of the second option, a potential synergy with proposed European legislation. Progression of either of these options would of course require discussion with you, Ofgem and BSC Parties, and so we will be seeking views in the coming weeks. But we have elaborated on how it could work below.

We also note that the FIT with CfD may fall within the scope of the European legislation on derivatives and so our proposals below are made subject to the EU legislation making these possible.

How ELEXON can derive the market price building on the current BSC arrangements

The consultation draws attention to the fact that there needs to be a market price³ against which the CfD is settled. ELEXON can help with the implementation of this.

If we assume that the market price is derived from the open, pre Gate Closure⁴ markets, rather than the Balancing Mechanism (we consider this alternative below), ELEXON is already contracted with APX and N2Ex power exchanges to supply us with a 'market index price' that feeds into one of the two imbalance prices (the 'reverse' price) for each half hour.

It should be possible to build on this, for example by taking data from the wider over-the-counter (OTC) market (or from market reporters) to compile a market price either half hourly or averaged over longer periods that could in principle be used for settling the CfDs.

ELEXON, as a central, independent and neutral body, could collect data from several commercial sources and amalgamate so that it becomes anonymous and we can acknowledge all the commercial sources each time we publish. This is how we calculate

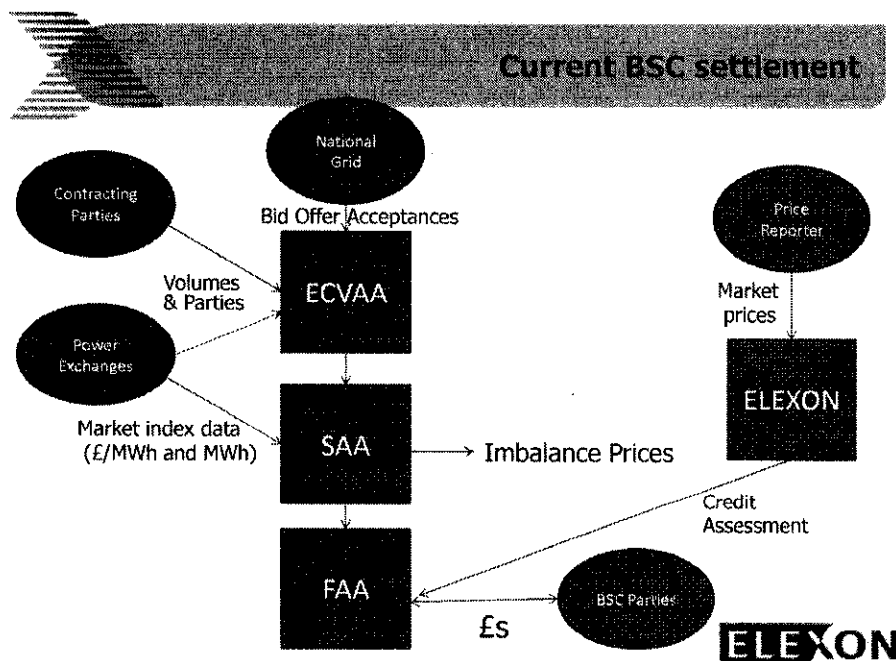
³ We have seen suggestions that there may be more than one market price, e.g. one set in advance for intermittent generation. We think that the proposed approaches, set out above, can work in this case as well as the single market price case; for clarity we have written this response as if there is to be a single price, but it could be extended to more than one.

⁴ Gate Closure is the point in time after which all energy contracts must be made via National Grid, and by which all contracts made in the open markets must be lodged with the Energy Contract Volume Aggregation Agent (ECVAA) to be recognised for imbalance settlement purposes under the BSC. Gate Closure is currently set to be 1 hour ahead of real time (the start of a half hour settlement period).

Consultation Response

a BSC parameter, the Credit Assessment Price. Our current method is to use data on wholesale market forward power prices. These are sourced from a commercial reporter⁵ of forward price data approved by the BSC Panel. As part of the agreement with the price reporter we acknowledge them as the source of the underlying data when we publish and review the Credit Assessment Price.

Our current BSC settlement arrangements are shown below. (ECVAA, SAA and FAA are the Energy Contract Volume Aggregation Agent, Settlement Administration Agent and Funds Administration Agent BSC Agent roles respectively under the BSC.)



At the beginning of this section we assumed that the market price would be from the open, pre Gate Closure markets, rather than the Balancing Mechanism. If, however, you intend that the market price is derived from the Balancing Mechanism, then ELEXON holds the data to do this. We observe that in this case, you may wish to strip out geographical effects, etc. and we already do this to compile the 'main' imbalance price.

We would welcome the opportunity to discuss any of these ideas further with you.

⁵ This is currently ICIS Heren.

Consultation Response

A second option: How ELEXON can derive the market price and support the implementation of the proposed European Regulation on energy market integrity and transparency (REMIT)

Alternatively, there is the option of collecting data on all the contracts made in the power market and using this to derive the market price.

ELEXON understands that the provision of contract data will be a requirement under the proposed European regulation on energy market integrity and transparency (REMIT)⁶. Because this is proposed to be an EU requirement and because the BSC already includes the requirement to collect contract data submitted by BSC Parties and keep it confidential – see below – we believe we can build on this to act as a data manager on behalf of BSC Parties and others to provide contract data under REMIT.

But more than this, combining this European requirement with the need to produce a market price for CfDs under the Electricity Market Reform proposals seems to us to be a logical way forward. Article 6 of the current draft of REMIT provides for the collection of wholesale energy market transactions by the new Agency for the Cooperation of Energy Regulators (ACER). Article 7 allows third parties to provide the data to ACER on behalf of market participants. We would propose ELEXON for this in relation to the electricity markets for Great Britain. It would seem efficient to not only collect the data for onward transmission to ACER but also, subject to this being possible and not unduly onerous for us under the EU legislation, to collect that data for the purposes of calculating a robust electricity market price as the data collection aspect is already a requirement. It also builds on an existing BSC agency role.

The Energy Contract Volume Aggregation Agent (ECVAA) collects confidential contract data from BSC Parties prior to Gate Closure for the purposes of calculating each Party's net contract position and hence imbalance. As ECVAA already collects volume and counter-party data this would be extended to include contract price data for the purposes of REMIT⁷ and calculating a market price for FIT CfDs.

ECVAA currently only needs net contract positions at Gate Closure so some parties may currently choose to net their positions in house before sending the data to ECVAA. Under REMIT the contract data would need to be provided gross, i.e. all contracts.

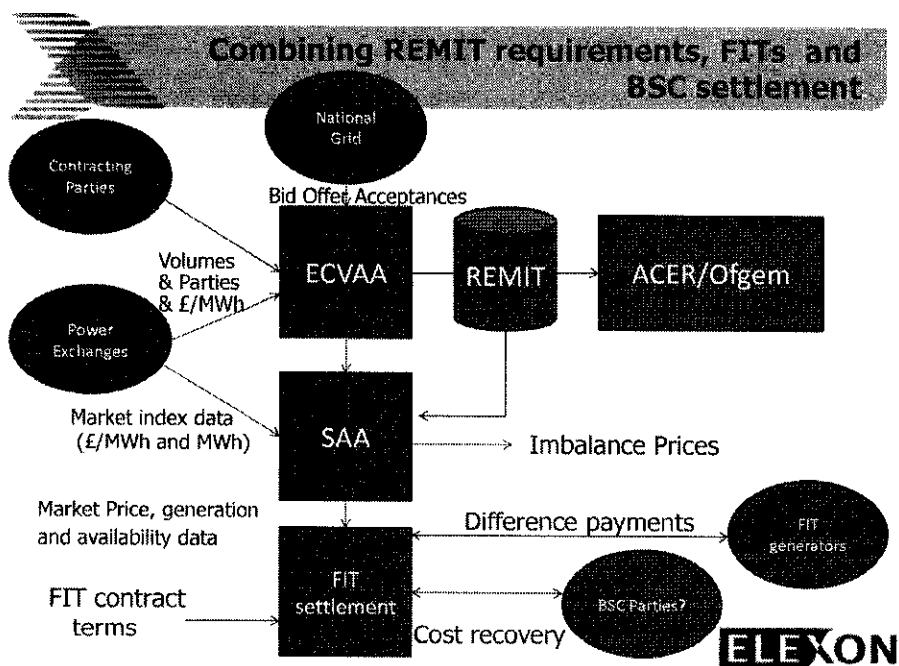
⁶ Proposed Article 7 requires that the Agency for the Cooperation of Energy Regulators (ACER) is provided with 'a record of wholesale energy market transactions including orders to trade'. 'Wholesale energy products' are defined in Article 2 to include contracts for the supply of natural gas or electricity; derivatives relating to natural gas or electricity; contracts relating to the transportation of natural gas or electricity; derivatives relating to the transportation of natural gas or electricity.

⁷ REMIT does not yet specify the timing, form and detailed content of data to be recorded. This will be set out by the European Commission in due course. We have assumed that it will include contract price data.

Consultation Response

ELEXON would be in a position to calculate a market price (or market prices) from this data.

A possible arrangement is shown below with the addition of a new REMIT storage and data flows to support REMIT and the settlement of FITs shown in red.



How ELEXON can settle Feed In Tariffs financially

ELEXON is well placed to settle FITs with CfDs⁸ given that we hold much of the data required; and could potentially compile the market price. We are keen to explore this with you.

ELEXON's core business is settlement of meter to bank processes with electricity generators, suppliers and traders, so we have experience of administering very similar processes⁹ and have relationships (including financial) in place with existing industry players that can easily be extended to new FITs generators as required. We already

⁸ Subject to EU legislation allowing us to do this and the acceptability to us of any requirements arising from EU legislation.

⁹ We administer settlement under the Balancing and Settlement Code and some of our staff also have experience of settlement under the previous Pooling and Settlement Agreement.

Consultation Response

operate such a system including a system of credit requirements to protect the industry from non-payments¹⁰.

ELEXON could recover the cost of FITs payments from the industry if this is what is intended to fund the FIT payments, rather than say out of general taxation, and we could then pass the payments on to the eligible generators. Our existing relationship is with a sub-set of all generating companies but our existing systems are capable of managing a relationship with all eligible parties.

The Premium FIT option

This option shares the same key benefits as the FIT with Contract for Difference option, namely: exposure to short term imbalance prices; and that it does not require a wholesale change of the existing contracting, imbalance and settlement arrangements.

However, ELEXON recognises that the Government sees relative disadvantages with this option as compared with the Contract for Difference option.

From the ELEXON perspective of operating and settling this option it would be slightly simpler to implement as it does not involve the need for a market price but the possible synergy with the REMIT requirement would also not be available.

Again ELEXON is very well placed to settle this option financially for all the same reasons as given above.

The Fixed FIT option

This option replaces existing market contracts with a fixed FIT payment.

If fixed FIT payments are made on actual metered generation this option would remove the imbalance exposure from FIT-eligible generation. This would clearly have a more radical impact, as noted in the consultation. And we believe that exposure to imbalance has helped to incentivise self-balancing over the years since NETA was first introduced, and that some exposure remains beneficial.

There may be some ways that this exposure could be retained even with the Fixed FIT option, but they do appear to require changes to the existing arrangements.

As an example, if the FIT contracts were paid on a fixed volume, say the de-rated capacity of the FIT plant, these contracts could lodged with ECVAA under the BSC in a similar way to other bilateral contracts.

So that they could be treated as bilateral contracts with suppliers under the BSC arrangements there would also need to be an allocation mechanism, putting this in the

¹⁰ The BSC requires that we settle payments in and out so that they net to zero each day. Any defaults on payments are currently drawn from credit or failing that from other BSC Parties. A FIT settlement system could operate in a similar way so that payments due to FITs generators on a certain date are matched by funding charges due from others on that date. If required this could be done daily, but it could also be done on a less frequent basis, e.g. monthly.

Consultation Response

BSC seems logical if the allocation is dynamic, so that these FIT contracts were allocated to individual suppliers.

Essentially the suppliers would then contract in the open market for their residual demand, not covered by the allocated FIT contracts so would need to know their FIT contract allocation sufficiently far in advance of Gate Closure to allow this. FIT supported generators could also adjust their contract positions to reflect their expected output by trading up or down in the open markets from the fixed volume in their FIT contracts.

The key element in this example is that the fixed FIT has to pay on a fixed volume, set in advance. There also needs to be an allocation of this volume to suppliers in advance. This then allows generators and suppliers to trade their remaining generation and demand or adjust their position on the open markets as usual and allows us to treat the FIT contracts as we would other bilateral contracts for ECVA so maintaining the imbalance exposure for any deviations from contract.

If the fixed FIT becomes your preferred option, we would be happy to help develop these or other ideas further. Regardless of the option chosen, ELEXON holds the data required to settle the FIT payments and we are keen to explore this further with you.

Question 4.

Do you agree with the Government's preferred policy of introducing a contract for difference based feed-in tariff (FIT with CfD)?

As noted in our answer to Question 3 above, ELEXON agrees that the exposure to a short term price signal incentivises both generators and suppliers in ways that support efficient balancing of the system. So we agree that the FIT options that maintain this exposure have advantages over the fixed FIT option paid on output which removes this exposure completely. Therefore we would support the introduction of a FIT with CfD or a premium FIT over a fixed FIT paid on metered generation. These two former options also have the advantage that they can operate alongside the existing BSC settlement arrangements.

ELEXON is keen to discuss how we can help implement and operate the financial settlement of any of the FIT options with you.

Question 5.

What do you see as the advantages and disadvantages of transferring different risks from the generator or the supplier to the Government? In particular, what are the implications for removing the (long-term) electricity price risk from generators under the CfD model?

As noted in our answer to Question 3 above, ELEXON continues to believe that exposure to short-term imbalance risk promotes self-balancing and therefore that some degree of exposure to short term efficiency incentives under any FIT option would be beneficial.

Consultation Response

Question 6.

What are the efficient operational decisions that the price signal incentivises? How important are these for the market to function properly? How would they be affected by the proposed policy?

How a short term price signal incentivises efficient operational decisions

ELEXON believes that exposure to a short term price signal incentivises both generators and suppliers in ways that support efficient balancing of the system.

For generators, it will incentivise them to be available to generate at times of high prices, and these high prices should be linked to higher demand or a shortage of other generation. In turn this encourages generators to invest in maintenance at periods of lower prices so that they are available at higher-priced times and the act of maintenance should reduce the risk of breakdown or trip at times of higher prices, so reducing the need for short-term, more expensive, balancing actions.

For suppliers, it encourages accurate demand forecasting to reduce the risk of imbalance and/or more accurate contracting particularly at times of higher prices.

ELEXON believes that the FIT with Contract for Difference; the premium FIT and some forms of fixed FIT (where the FIT payment is not based on actual metered generation) can all operate with continuing exposure to the short term imbalance price.

Changes to the imbalance price and incentives and how ELEXON can assist with analysis

When considering changes to the imbalance price formulation itself ELEXON has the following comments.

Over the ten years that ELEXON has administered the BSC arrangements, we have seen a number of different cash out price formulations proposed and some of these have been approved and implemented. We have observed the effect that changes in imbalance price can have on the market. For example, in the early period of the BSC we had a dual cash out mechanism where both imbalance prices were based on the costs incurred by the System Operator in balancing (buying or selling). This incentivised a tendency for BSC Parties to over-contract against the risk of being short against a volatile imbalance price, so requiring the System Operator to sell generation post Gate Closure to rebalance the system. With a change to the so-called Main and Reverse price formulation in February 2003, where one of the imbalance prices is based on an assessment of the pre Gate Closure market price, the incentive has moderated somewhat.

And we have the capability to model different imbalance price formulations on prices using historic input data. We have done this when analysing proposals for change in the past. This models the gross impact of any change of formulation but cannot model a change in participant behaviour as a result.

Consultation Response

Question 10.

**How important do you think greater liquidity in the wholesale market is to the effective operation of the FIT with CfD model?
What reference price or index should be used?**

ELEXON believes that sufficient liquidity is a key requirement to be able to define a robust and trusted market price on which to settle the CfDs.

Building on existing BSC arrangements to derive a robust market price (option 1)

In our answer to Question 3 above, we set out our view it should be possible to build on the Reverse price formulation to set a market price for settling the CfDs. When the N2Ex power exchange commences its spot market operation, scheduled for 5 April, we will be drawing data from both APX and N2Ex to derive a Reverse price from the market index prices supplied by both power exchanges and this could be extended so that we draw additional data from the power exchanges and data from other markets or market reporters, e.g. longer-dated forward contracts traded on the power exchanges and the over-the-counter (OTC) market.

The BSC, which ELEXON administers, has existing mechanisms for establishing and reviewing the Reverse price which can form a robust foundation for a new market price for CfDs.

The components that make up the Reverse price are set out in a document, the Market Index Definition Statement (MIDS). The BSC Panel is responsible for establishing and reviewing the MIDS in consultation with BSC Parties and other interested parties. The MIDS includes the full definition and methodology to be used by each power exchange to convert their trades into a single price for each half hour for each power exchange. And their adherence to these methodologies is subject to annual external audit, whilst maintaining the confidentiality of individual trades.

The MIDS sets out which types of trades are to be used and a minimum liquidity threshold. This threshold must be passed before we can use the price supplied by the power exchange. If there is insufficient liquidity we will use only that data that passes the threshold and if none of the power exchanges have sufficient liquidity for a given half hour we have defaulting rules that come into operation and set the Reverse price.

On behalf of the BSC Panel, ELEXON undertakes a review of the MIDS every year, for example to ensure that the liquidity thresholds and contract types included remain appropriate, and our conclusions are considered by the BSC Panel after consultation with the industry. The Authority must approve any change to the MIDS before it can come into force.

A similar approach could be developed to support the calculation of a robust market price using data from a wider range of trades and markets.

Consultation Response

Building on existing BSC arrangements and REMIT to derive a robust market price (option 2)

In our answer to Question 3 we also put forward a different approach to determining a robust market price for CfDs based on actual traded contracts. ELEXON understands that the provision of contract data to the Agency for the Cooperation of Energy Regulators (ACER) will be a requirement under the European regulation on energy market integrity and transparency (REMIT). Combining this European requirement with the need to produce a market price for CfDs seems to us to be an alternative logical way forward.

Using an existing BSC agency role to collect this data for onward transmission to ACER will also be efficient and exploit a synergy with what we currently do. The Energy Contract Volume Aggregation Agent (ECVAA) currently receives contract data from BSC Parties prior to Gate Closure for the purposes of calculating each Party's net contract position and hence imbalance. For the purposes of REMIT and FIT CfD this could be extended to include further contract data including prices from which a robust market price could be calculated.

Question 11.

Should the FIT be paid on availability or output?

ELEXON believes that a CfD or premium FIT paid on output or availability could co-exist with the current BSC arrangements. This is because all these particular options maintain an exposure to short term imbalance against market-based contracts; they do not replace the energy contracts that the FIT supported generator signs in the open markets and from which the energy imbalance volume is calculated¹¹.

A fixed FIT paid on output could not co-exist with the current BSC arrangements because it effectively replaces bilateral energy contracts and removes the exposure to imbalance.

All fixed FIT options would require other changes to the existing BSC arrangements, for example the question of how the energy expected to be generated by FIT contracted generators is allocated or sold to suppliers would need to be addressed. This may be a particular issue if the fixed FIT contract volume varies in short timescales as suppliers would not know how much of their demand was met by contracts with FIT supported generation and so how much residual generation needed to be procured in the open markets.

So a fixed FIT paid on fixed or known volumes could potentially be made to work while maintaining an exposure to imbalance because it would allow FIT generators and

¹¹ Imbalance volume is the difference between the contracted energy position notified by Gate Closure and the out-turn metered generation (or demand).

Consultation Response

suppliers to adjust their contract positions in advance of Gate Closure to reflect anticipated changes in output or demand that were not covered by FIT contracts.

However, because availability is variable it is less clear how a fixed FIT paid on availability would operate with the current BSC arrangements.

ELEXON notes that the exposure to a short term price signal incentivises both generators and suppliers in ways that support efficient balancing of the system. So we recognise the argument that the FIT options that maintain this exposure have advantages over the fixed FIT option paid on output which removes this exposure completely.

ELEXON holds both output data and declared availability (Maximum Export Limit) data so we could operate with either option.

Some of ELEXON's staff have experience (under the electricity Pool that operated in the 1990s) of monitoring availability. We are keen to share this experience with you. A FIT based on metered output would be simpler, but ELEXON would be able to monitor availability and settle either option.

Question 12.

Do you agree with the Government's assessment of the impact of an emissions performance standard on the decarbonisation of the electricity sector and on security of supply risk?

ELEXON does not have a strong view on the emissions performance standard but we collect half hourly metered generation data to support BSC settlements which could also be used to monitor and support the implementation of an emissions performance standard based on running hours or output.

ELEXON currently assists with the reporting of GB generators' emissions that are operating under the Large Combustion Plant Directive on our Balancing Mechanism Reporting website (see [Large Combustion Plant Directive downloads](#)). So we would be able to support reporting against an emissions performance standard in a similar way on the same site.

Chapter 4: Security of supply and market operation reforms

Question 19.

Do you agree with the assessment of the pros and cons of introducing a capacity mechanism?

ELEXON notes that any capacity mechanism that is introduced should be designed to minimise the impact/distortion on the operation of the open market. We note that some commentators have identified the potential 'slippery slope' effect on capacity build as an issue, but our comments here and below are limited to the potential operational impact on prices if such supported capacity has already been built.

How ELEXON can assist with the implementation of a Capacity Mechanism

If a capacity mechanism is introduced, then with any of the options ELEXON believes

Consultation Response

that there will need to be monitoring of the delivery of capacity/availability to ensure the financial support gives the desired result in terms of security of supply by ensuring that the supported plant, demand side, etc are available for use when most needed.

ELEXON staff, when employed by our predecessor organisation under the Pool, have had experience of the issues with the monitoring of availability in practice and would be happy to share this experience with the designers of any future capacity mechanism. Any capacity mechanism will need to be settled financially and would need to be funded, possibly by the industry, if not done under general taxation. As discussed above, administration of this sort of settlement arrangement is precisely our area of expertise and our existing systems and processes could be readily adapted.

Question 21.

What do you think the impacts of introducing a targeted capacity mechanism will be on prices in the wholesale electricity market?

As noted above, ELEXON notes that any capacity mechanism that is introduced should be designed to minimise the impact/distortion on the operation of the open market. So one of the tests of a well-designed capacity mechanism is that it would minimise the impact on prices in the wholesale market in the sense that it would only be utilised (or contracted) when its costs (including the costs imposed on society of supporting it in the capacity mechanism) justified its use.

Because the open markets, Balancing Services and Balancing Mechanism are generally settled 'pay as bid' or at the contract price there will be a need to recover or prevent double payments i.e. to ensure that payments made in the open markets, Balancing Services or Balancing Mechanism are not made on top of payments made through the capacity mechanism.

We are keen to discuss with you the impact of a capacity mechanism on imbalance prices and how distortion can be avoided. If changes to the imbalance price formulation prove to be necessary, ELEXON is experienced in analysing proposed changes and implementing approved changes to the imbalance price.

Consultation Response

Question 22.

Do you agree with the Government's preference for the design of a capacity mechanism:

- **A central body holding the responsibility;**
- **Volume based, not price based; and**
- **A targeted mechanism, rather than market-wide?**

ELEXON sees that there are up to four distinct central roles in administering a capacity mechanism. The exact number depends on the capacity mechanism option chosen. Because of this we do not believe that a single central body holding responsibility for all aspects of administering the capacity mechanism is necessarily the best one. We believe that a preferable approach would be to assign the roles to those existing bodies best placed to manage them, having the relevant experience and expertise. This would be better than establishing a new body or asking one existing body to take on additional roles with which it has no experience.

ELEXON sees the four roles as follows. Given the synergies with our existing role, ELEXON is well placed to undertake the third and fourth roles given that we already have systems that collect and process generation and availability data.

1. Determining a profile of capacity needs (setting the volume required if volume based; price or price formula if price based). This will be determined through Government/regulatory policy.
2. Running the tender process to decide who gets the 'capacity contracts' to build new generation; implement demand side measures, etc. This role clearly is not needed if the mechanism is market wide.
3. Administering and settling payments due under the contracts. Payments will be due to generators, demand response, etc. Since these payments must be funded and, if it is intended that this funding is coming from industry rather than out of general taxation, funding payments will need to be administered and collected from industry. This is a role for which ELEXON is well suited.
4. Monitoring the availability delivered as there will be penalties under the contract for not being available. This is a role for which ELEXON is well suited.

Although Annex 2 of the impact assessment, paragraph 7 of the capacity mechanisms section, states that the regulator would monitor suppliers and generators every half hour, this seems to be an inefficient use of the regulator's resources when there are already BSC systems that take and process data on a half hourly basis. The BSC also contains provisions which enable the regulator to have access to information.

Consultation Response

Question 24.

Which of the two models of targeted capacity mechanism would you prefer to see implemented:

- Last-resort dispatch; or
- Economic dispatch?

Without expressing a preference, ELEXON notes that whichever method of dispatch is chosen, the offer price submitted by entities that receive funds from the capacity mechanism into the markets including the Balancing Mechanism (for dispatch by the System Operator) should include the costs of the capacity mechanism support. This is so that market distortion is minimised and also so that the market price and imbalance price reflects the true cost of dispatching this generation. If such costs are included in the offer price, there will also be a need to recover or prevent double payments.

Chapter 5: Analysis of packages

Question 28.

Will the proposed package of options have wider impacts on the electricity system that have not been identified in this document, for example on electricity networks?

ELEXON notes that a number of new central agent roles are proposed as part of the package, for example to administer the settlement of Feed-In Tariffs and the Capacity Mechanism.

We suggest that where there is an existing body (ELEXON for administering settlement processes for example) who could easily perform the new roles as an additional service, this option should be seriously explored as the costs are likely to be lower from the existing synergies that could be exploited.

This also means that there should not be a presumption that a single central body would be more efficient and effective either across all policy mechanisms or even under a single policy mechanism. For example, we believe the capacity mechanism agent role actually splits into up to four distinct roles (see our answer to Question 22) that, separated, sit well with existing bodies' areas of expertise and experience. We are keen to discuss this further with you.

Under any proposed change that could potentially impact the BSC settlement arrangements, ELEXON will follow our normal processes of developing detailed requirements and undertaking impact assessments to make sure that any change is clearly described, costed, planned and implemented. The impact assessments we undertake include asking BSC Parties (including generators, suppliers and traders) for the impact on them. We can also offer analysis to the Government and Ofgem on the impact of proposed changes within the BSC arrangements, e.g. changes to imbalance price and we have analytical tools to support this.

Consultation Response

Chapter 6: Implementation Issues

Question 30.

What do you think are the main implementation risks for the Government's preferred package?

Are these risks different for the other packages being considered?

ELEXON has successfully planned and implemented many changes to the BSC arrangements over the past ten years of its operation, including their introduction and transition from the Pool and the extension to Scotland which had to be done seamlessly while not disturbing the existing settlement arrangements. Some of our staff also had experience of implementing the changes necessary to support the opening of the electricity market to retail supply competition under the Pool. We are experienced in managing change while mitigating the risks and we would be most keen to assist with the implementation of this or any other package that impacts the energy markets.

We strongly believe that ELEXON has a role to play in the implementation and operation of this package because:

- we have existing commercial relationships with existing service providers and developers which would minimise risk and delay in implementation;
- there are synergies with what we currently do, particularly administering the settlement of Feed In Tariffs and capacity mechanisms;
- we have information relating to the market that we believe can be extended to develop a potential market price for Contracts for Difference;
- we have data on generation output and availability that could be used to support settlement of the capacity mechanism; and because
- we have systems and financial arrangements already in place with the industry that would support settlement of these new policies.

As noted in our response to the Smart Prospectus, ELEXON also strongly believes that we need to move to rationalise the number of electricity Codes rather than create additional new ones. We believe our role could be extended to encompass the settlement of the Feed-In Tariffs and Capacity Mechanism.

Question 32.

What changes do you think would be necessary to the institutional arrangements in the electricity sector to support these market reforms?

In chapter 6, paragraph 20 of the Government's consultation ELEXON notes that "the Government's approach will be to define the set of activities and capabilities required in the reformed electricity market and determine the arrangement of institutions best placed to undertake these activities. In particular, care would be taken to define the required nature and future role of the System Operator. The Government will seek to create an institutional framework that is cost-efficient, effective and once implemented,

Consultation Response

creates stability for market participants and opportunity for new entrants."

ELEXON supports this and we note that that ELEXON can undertake the new central agent roles and that it is unnecessary and potentially less efficient to set up new organisations to do so.

A few detailed observations

ELEXON would like to add thoughts to a couple of statements made in the impact assessment, as follows. We hope this is helpful.

1) Paragraph 42 of Part C on page 62 states that balancing charges are payable if a generator generates more or less than it said it would at Gate Closure.

We would just like to clarify this a bit further. There is a charge, the Information Imbalance, that works in this way but the rate of charging is currently set to zero and has been since the BSC was implemented in 2001. The main imbalance charge is a payment to or from generators (and suppliers) if their actual output (or demand) is more or less than the volume that they have in their notified contracts. The imbalance charge therefore incentivises accurate ex-ante contracting rather than generating to their stated physical position at Gate Closure.

It may also be worth noting that cash out prices do not recover the costs of balancing. Although cash out prices are intended to reflect those costs, there is a "money go round" whereby the total net receipts from all imbalance payments are paid out to, or recovered from, generators and suppliers via a smeared charge based on their generation or demand.

Recovery of the costs incurred by the System Operator in balancing the system is done through the System Operator's Balancing Services Use of System (BSUoS) charges (both for funding the costs of balancing services and the paid-as-bid accepted Balancing Mechanism actions) which are paid by generators and suppliers.

2) Footnote 130 on page 119 states that cash out is cost-reflective for those whose imbalance helps the system and only penal where it exacerbates the system imbalance.

Our understanding of the intent of imbalance prices is that when the imbalance is exacerbated, the imbalance price is intended to reflect the costs that the System Operator incurs. When the individual Party's imbalance helps the overall system to rebalance the price is unrelated to the costs that the System Operator incurs but is intended to reflect the open market price (drawn from power exchanges) within a short period (currently 20 hours) in advance of Gate Closure. The cash out prices in our understanding were not intended to be penal.

For more information, please contact

Steve Wilkin, Market Advisor

T: 020 7380 4253 or email steve.wilkin@elexon.co.uk