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Dear Mark

Informal consultation on Demand Side Reserve and Supplemental Balancing Reserve

Wärtsilä Corporation welcomes the opportunity to respond to National Grid's consultation on the potential requirement for new balancing services to support security of supply in the middle of this decade. As we have previously discussed with National Grid, we are providers of innovative flexible power generation technologies, and therefore we have a strong interest in well-functioning markets that efficiently value flexible resources.

We understand that Ofgem, DECC and National Grid are considering actions that could be taken to mitigate a potential generating capacity shortage in 2014/15 and 2015/16. However, we have some serious concerns with both the rationale for, and the design of the current set of proposals, and the impact that this could have on the market. In our response to Ofgem's parallel consultation, we have urged it to consider these concerns alongside the feedback received from other stakeholders at the workshop on 17 July, before it considers making changes to National Grid's Balancing Services Procurement Guidelines:

- First, we consider that the introduction of new balancing services to solve a capacity adequacy problem is misguided, and likely to confuse market participants on the real purpose of a further intervention in the market. A far more suitable solution would be for the Government's Capacity Market to start allocating annual contracts for delivery year-ahead from the first auction;
- Secondly, the proposed designs of the products themselves risks both the creation of gaming incentives, and blocking out investment signals to the market, especially where the services are not priced into cash-out, and where there is the potential to extend the schemes and further lock-out new plant. The introduction of the products will also create unprecedented issues for the System Operator (SO) Incentives scheme to manage.

We expand on these points overleaf.

Using balancing services to solve a capacity adequacy problem

We believe that the new balancing services confuse ensuring capacity adequacy with the provision of flexibility that National Grid requires in its role as residual balancer. The proposed Supplemental Balancing Reserve (SBR) in particular has characteristics that are similar to a strategic reserve to ensure capacity adequacy, instead of a balancing service to manage deviations in market participants' outturns from forecasts.

However, we understand that the proposed balance of roles and responsibilities in the market involves the Government's capacity market addressing the issue of capacity adequacy, (ie having sufficient spare capacity to ensure that a given security of supply standard is met) while National Grid continues to procure balancing services for the purpose of managing unforeseen short term variations in supply and demand (ie having sufficient flexibility resources). The new SBR product changes this balance and extends National Grid's responsibility for security of supply. Further, if the product is extended beyond the initial two year period as suggested at the workshop on 17 July, it could potentially risk muting investment signals for new plant, as National Grid could react to forecast shortages by tendering for more existing capacity rather than letting the market supply it of its own accord (often referred to as the "slippery slope" effect of a strategic reserve).

Instead, we consider that the capacity market should be the prime facilitator of capacity adequacy, and that the role of balancing services should be left in its current form (subject to any changes under the Future Trading Arrangements (FTA) work). While the draft design for the capacity market is for agreements to be allocated with a four year lead time (to enable to construction of new capacity), we think that the auction should be brought forward to allocate annual agreements for delivery of capacity at the year-ahead stage. In this way, adequate levels of existing supply and demand side resources could be annually procured on a competitive basis from winter 2014/15 onwards to mitigate a capacity shortage, and new plant could participate in auctions when they are at a stage of development to do so (potentially with delayed delivery if this is deemed required). This system would bring the added benefit of increased accuracy of forecast capacity requirements in the auction, removing the need for supplementary auctions and separate arrangements for DSR during the lead-in period. Further, it reduces the number of interventions in the market and the complexity of their interactions, and concentrates competition between providers into a single market which should deliver a better outcome for consumers.

For these reasons, we have suggested to Ofgem that it considers with DECC whether it is more appropriate to refine the capacity mechanism to deliver its objectives earlier than expected. We are aware of issues surrounding State Aid clearance. However, implementing potential expensive and complex interventions to get around these barriers does not seem consistent with an efficient, well-functioning market in the longer run, and therefore we consider that National Grid's role, and the purpose of its balancing services should remain unchanged until FTA has reached a conclusion.

Design issues with proposed products

Aside from the principle of whether the SBR product should be introduced at all, we are concerned that if the new products were introduced, the design of the products as proposed by National Grid in its consultation could create gaming incentives, and potentially block investment signals for new plant to the market.

Gaming concerns

The SBR has the potential to create gaming incentives because other existing market participants can use its eligibility criteria to force its expansion and prevent market exit signals from emerging. For example, existing capacity providers could signal their intention to close in the near future (genuine or otherwise), which would tighten forecasts of capacity margins. National Grid would then feel pressure to expand the SBR to maintain sufficient capacity. The result of such a situation would be increased volumes of capacity held out of the market by National Grid under contract, and the blocking of exit signals from the market and associated investment for replacement. This effect would be embedded if the products are extended past their two year applicability period as suggested as a possibility at the workshop.

If the SBR goes ahead, National Grid could mitigate this risk by not constraining itself to only contracting with existing capacity under the SBR, but instead opening the product up to full competition between new and existing capacity providers, which would substantially reduce the influence that plant nearing the end of their operational lifetime could have on National Grid's procurement volume decisions.

Pricing into cash-out

Wärtsilä notes that National Grid initially proposed for no adjustment to be made in the calculation of imbalance prices for the procurement or use of SBR or Demand Side Balancing Reserve (DSBR), pending the outcome of Ofgem's EBSCR. However, we understand from the workshop that pending the outcome of the EBSCR, utilisation of SBR would likely be treated in the same way as costed demand control actions.

We strongly support pricing the cost of the new products into cash-out, and believe that these products should be treated in the same way as that being proposed for pricing non-costed demand actions in the EBSCR proposals. We believe that the original proposals would create unintended consequences on the operation of the market, and would therefore conflict with the second of Ofgem's assessment factors in its consultation letter.

As rationale, we argue that it is critical for market participants to make efforts to balance efficiently their trading positions during the period 2014/15 and 2015/16 given Ofgem's analysis on the potential shortage of capacity in the market at this time. Cash-out prices will continue to be the main balancing incentives on market participants during this period, so it is imperative that these prices reflect the costs of balancing the system as accurately as they can under the prevailing market framework, which includes reflecting the costs of balancing services held and utilised over the period – including any new balancing services.

Further, we consider that an added benefit of incorporating the utilisation costs of DSBR in particular into the calculation of cash-out prices is the discovery of certain consumers' willingness to pay for electricity supply at certain times, which is an important marker for helping to value flexibility resources (such as DSR, storage and fast response generators) which DECC and Ofgem are focused on encouraging in their current workstreams (such as the Electricity Systems Policy, and the recent FTA work).

Lastly on this point, we note that National Grid is concerned that including the costs of DSBR into cash-out could potentially influence cash-out prices significantly over a small number of periods. This may be the case, but we see little difference between this and Ofgem's proposals for costing demand control actions under the EBSCR.

Incentives on the system operator and cost recovery

The new balancing services will require extra allowances to be made under the SO Incentives scheme, but determining this will be difficult for both Ofgem and National Grid, as putting a price on maintaining sufficient capacity levels to maintain security of supply is a politically sensitive issue (hence the ministerial decision around the reliability standard for the capacity market). Further, the introduction of the new mechanisms may put unintended incentives on National Grid to use the new services over other balancing services to increase its performance under the regime, especially if the cost of their usage is ring-fenced from existing balancing services.

Further, we consider that the cost of maintaining capacity adequacy is not something that existing generators are imposing on the system, and therefore the proposed allocation of the costs of the new balancing services into BSUoS (which is currently part paid by generators) seems inappropriate. We note that this proposal is misaligned with the precedent set out in the capacity market (where the costs of capacity adequacy are to be paid for by consumers).

We would welcome the opportunity to discuss these points in more detail at National Grid's request, and we look forward to reviewing the outcome of both Ofgem and National Grid's consultations in this area.

Yours sincerely,

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