



# Consultation Response

SENT BY EMAIL TO: DECC.capacity.mechanism@decc.gsi.gov.uk

3 October 2011

Matt Wieckowski  
Department of Energy & Climate Change  
4<sup>th</sup> Floor, Area D  
3 Whitehall Place  
London  
SW1A 2AW

Dear Mr Wieckowski,

## **ELEXON's response to "Consultation on possible models for a Capacity Mechanism"**

We welcome the opportunity to respond to the above consultation.

ELEXON delivers the centrally-mandated electricity settlement services that are critical to the successful operation of Great Britain's electricity trading arrangements. We manage processes and systems from electricity meter to bank, handling over £1.5 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.

### **How ELEXON can help develop and deliver DECC's Capacity Mechanism policy**

We recognise that the design and implementation of any Capacity Mechanism is a very complex task. We believe that the consultation correctly identifies that a diverse mix of functional capabilities will be required to give effect to this. It is unlikely that any single organisation will possess all of these. Therefore a number of organisations will need to work closely together to implement the most efficient operating model.

As part of this, we believe that building on our existing structures and capabilities would be the best way to achieve a swift, incremental policy implementation, and to avoid unnecessary duplication and cost to consumers.

Our team has extensive experience in major Government programmes, market operations and energy policy delivery - industry experts who can make DECC's outline plans work. We would be keen to discuss our response, and to assist DECC in developing the next level of detail.

We have over ten years' experience of implementing and managing highly complex, multi-party

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arrangements. Our highly successful record in procuring, managing the operations, delivering change, reducing costs and providing assurance across the electricity trading arrangements, means we have valuable experience and insight that can benefit DECC in both the development and delivery of its Capacity Mechanism proposals.

In particular, our operating model and core capabilities are closely aligned to the Delivery Organisation requirements detailed in the consultation (we expand on this in our responses to questions 10 and 23 below).

## **Our detailed response to the specific consultation questions**

We have not responded to every question: only to those questions where we can foresee either impacts on the BSC or opportunities to call upon ELEXON's expertise and capabilities to support DECC in the consideration and implementation of its policy options. Our detailed response to those questions is set out below.

Please note, the views expressed in this response are those of ELEXON Limited alone, and do not seek to represent those of the Parties to the Balancing and Settlement Code. In addition, our response does not favour any particular option where choices have been identified – we have limited our response to matters of practicality and advice rather than policy.

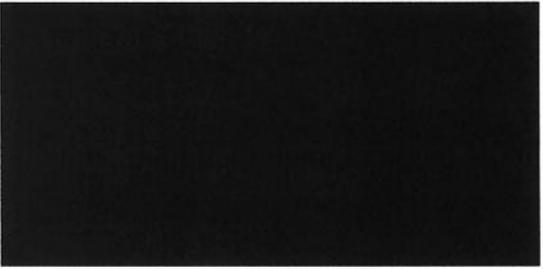
## **We are keen to help**

We look forward to discussing our response with you.

We would also very much welcome any further clarity that DECC can provide on the process and timing for the identification and/or appointment of the proposed Delivery Organisation(s).

In the meantime, if you or your colleagues need anything further from ELEXON, please contact my colleague [REDACTED] or by email: [REDACTED]

Yours sincerely



Director of Strategy and Development



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## Consultation on possible models for a Capacity Mechanism

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

### Targeted Capacity Mechanism: Strategic Reserve

#### Addressing Stakeholder Views

##### Question 1.

**Does this table capture all of your major concerns with a targeted Capacity Mechanism? Do you think the mitigation approach described will be effective?**

ELEXON Ltd is administrator of the Balancing and Settlement Code (BSC) arrangements and as such we can offer practical suggestions to help with the implementation of some of the proposed mitigation measures should the Government decide to adopt them.

In particular if, following this consultation, the Government concludes that:

- the despatch price would have a defined change process, then we have set out thoughts on this in our answer to Question 7; and
- the Strategic Reserve should be included in the cash out calculation, then we would refer you to our answer to Question 9.

### Setting the reserve despatch price

##### Question 7.

**How would the Strategic Reserve methodology and despatch price best be kept independent from short-term pressures?**

If the Government concludes that this is its preferred approach, ELEXON suggests that the requirements could best be codified within one of the existing industry Codes.

Using the Balancing and Settlement Code, for example, would give the following advantages:

- Short-term pressures for change would be tempered: either by the requirement to go through the pre-existing defined change process with checks, balances and a process for regulatory approval and appeals or, if thought more appropriate, the requirements can be carved out of the pre-existing change



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process so that the requirements can only be changed with the prior permission of the Secretary of State or the Authority<sup>1</sup>;

- It aligns with the Government's "Red Tape Challenge" because it would remove any need to create another new process or document, with the associated cost, resources and time this would involve. And it gives the added benefit of not requiring yet another new document for new and existing entrants to assimilate and track in an already complex industry; and
- If it is decided that the pre-existing change process is appropriate:
  - it is familiar to the industry and proven by use (for example over 270 Modification proposals have been raised over the past ten years); it already includes open and transparent assessment, consultation and review stages, as is suggested for this process; and
  - it already includes provision for defining and managing a timetable for each of these stages.

Together these features should mitigate concerns that the despatch price could be changed as a result of short term pressures and bring the additional benefit that it uses existing proven and familiar processes.

## Into which market should Strategic Reserve be sold?

### Question 9.

#### Into which market should Strategic Reserve be sold and why?

ELEXON believes it would be straightforward to make Strategic Reserve available to the System Operator in the Balancing Mechanism. However, we suggest that the interaction with imbalance (cash out) prices needs to be considered whichever market/mechanism the Strategic Reserve is sold into.

If Strategic Reserve is sold into the Balancing Mechanism, we note the suggestion that the offers for Strategic Reserve would be lodged in the Balancing Mechanism at the despatch price. As currently structured, when National Grid accepts the offers it would pay for the acceptances at the despatch price, via the Balancing and Settlement Code (BSC) arrangements.

Payments would be made at the despatch price to the Lead Party responsible for the

<sup>1</sup> An existing example of this in the Balancing and Settlement Code is the section relating to Warm Homes (Section C1.2.1A).



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Strategic Reserve units. These offer acceptances would also feed into the main imbalance price calculations at the despatch price.

However, the despatch price is not necessarily linked to the utilisation costs of the Strategic Reserve plant, so an adjustment may be required to account for the offer payments to Strategic Reserve units, either within or outside the BSC.

And, if the Government decides that the BSC imbalance price (cash out) should reflect the total cost of (both procuring and utilising) Strategic Reserve, rather than the despatch price, then adjustments will need to be made to the calculation of the imbalance price to account for this.

If Strategic Reserve is purchased by National Grid outside the Balancing Mechanism, we envisage it would be included in imbalance prices via the existing Balancing Services Adjustment Data (BSAD). In this case, the question of which Strategic Reserve costs or despatch price it would be appropriate to include in imbalance prices would be defined within the BSAD methodology statement produced by National Grid and approved by Ofgem.

If Strategic Reserve is purchased by a party other than National Grid, the interaction with the calculation of imbalance prices will need to be considered as part of the detailed design of the policy mechanism. ELEXON is ready to help analyse and implement any changes to the imbalance price calculations should this be required.

Should the Government adopt the Strategic Reserve option, we are ready and able to assist with these aspects and would welcome discussions with you, Ofgem and the industry to ensure that existing processes are not replicated unnecessarily and costs to industry and consumers are minimised.

## Functional groupings

### Question 10.

#### **Do you have any comments on the functional arrangements proposed for managing a Strategic Reserve?**

The consultation correctly identifies that a diverse mix of functional capabilities will be required to give effect to a Strategic Reserve approach. It is unlikely that any single organisation will possess all of these. Therefore a number of organisations will need to work closely together to implement the most efficient Strategic Reserve operating model.

There may also be good reasons to maintain a degree of separation between the various functions identified, including to:

- minimise the scope for any conflict of interest; and
- ensure the most cost effective operating model.



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There are strong parallels here with existing industry arrangements, particularly those under the BSC. Here, for example, there is clear separation between various critical functions including:

- Regulatory oversight and approvals (Ofgem);
- Despatch (National Grid); and
- Change management, assurance, settlement and payments (ELEXON).

The proposed Strategic Reserve payment function (which will calculate and settle the monies due to the procured Strategic Reserve providers) bears obvious similarities to the core function of ELEXON under the balancing and settlement arrangements. ELEXON administers the calculation of imbalance payments under these arrangements, which includes: the issuing of invoices; the establishment and maintenance of payment mechanisms between ourselves, National Grid, generators, suppliers and other trading parties; and the payment and credit monitoring processes.

In addition, you propose that the costs of the mechanism should be met by market participants, based on market share, through industry charging and settlement arrangements. Comprehensive and proven industry cost recovery arrangements of this nature also already exist under the BSC (including funding share calculation, billing and payment processes).

A range of other activities, resources, systems and processes will be required to ensure that these key functions operate in a robust and transparent manner, including (but not limited to):

- Data reconciliation;
- Audit and assurance;
- Reporting;
- Credit/collateral management;
- Disputes management; and
- Data and financial transaction security.

ELEXON already operates established approaches for all of these, and we would welcome the opportunity to explore the opportunities to use this existing expertise and capabilities, so avoiding duplication and unnecessary costs, to support the implementation of this mechanism, if it is DECC's favoured option.

It will also be important to ensure that the organisation responsible for these governance and settlement functions is independent, transparent, trusted and accountable. We believe that ELEXON is uniquely placed in these respects.



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## Financial Flows

### Question 11.

**Given the design proposed here and your answers to the above questions, do you think a Strategic Reserve is a workable model of Capacity Mechanism for the GB market?**

As with any of the Electricity Market Reform proposals, if the Government opts for the Strategic Reserve option, ELEXON would welcome the opportunity to discuss how we can add value and reduce the overall costs to customers by building on, and using the synergies with, our existing settlement and payments processes to deliver it. And we envisage that we would need to work with you, Ofgem and the industry to define how imbalance prices should be affected by the despatch of Strategic Reserve (see our answer to Question 9).

## Market-wide mechanism: Capacity Market

### How and by whom capacity is bought

### Question 12.

**How and by whom should capacity in a GB Capacity Market be bought and why?**

ELEXON Ltd is administrator of the Balancing and Settlement Code (BSC) arrangements and as such we can offer practical suggestions to help with the implementation of whichever policy option (central institution purchase or supplier obligation) is chosen. We are independent of any specific interests within the electricity sector.

We can also add value and reduce costs for consumers where the implementation builds on the synergies with on our existing settlement and payment processes, which is particularly the case with the Capacity Market options. We give further detail on this in our answer to Question 23 but in essence:

- if a central institution buys capacity in an auction, we have comprehensive and proven industry cost recovery arrangements that already exist under the BSC (including funding share calculation, billing and payment processes) that could be extended to the payment, billing and cost recovery for the subsequent calculation and settlement of payments due under the contracts, particularly since Capacity Markets are likely to require payments to be made to and from multiple parties, as does the BSC;
- if an obligation is placed upon suppliers to buy capacity that results in a need to monitor the extent to which individual supplier capacity holdings and their customers' demand match then this would look the same as the energy imbalance settlement arrangements that ELEXON administers under the BSC.



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In summary, it would not be appropriate for ELEXON to comment on the policy decision as to who should buy and sell capacity in a GB Capacity Market, but ELEXON can administer and help implement whichever option is chosen at reduced cost given the synergies with our existing processes and expertise.

## Primary and secondary markets

### Question 15.

**Should there be a secondary market for capacity? Should there be any restrictions on participants or products traded?**

ELEXON believes that any requirement for suppliers to trade capacity will be driven by policy decisions on, for example, whether there are incentives or obligations on suppliers to match capacity with their customers' demands or regulatory limits. It would not be appropriate for ELEXON to comment on the policy decision of whether there should be such incentives or obligations.

However, if the result of your decision is that there is a need to monitor the extent to which individual supplier capacity holdings and their customers' demand match, then this could look the same as the energy imbalance settlement arrangements that ELEXON administers under the BSC.

If such is the case, we would welcome discussions with you, Ofgem and industry on how we could build on the synergies with our existing BSC arrangements and deliver a cost effective system to deliver the policy requirement. See our answer to Question 23.

## Reliability Market

### Question 17.

**How should the reference market for reliability contracts be determined and what would be an appropriate reference market if it is set by the regulator? How could any adverse effects of choosing a particular option be mitigated?**

It would not be appropriate for ELEXON to comment on this but we can assist with deriving a reference price and advise on the practicalities of implementation. See our answer to Question 23.

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## Functional groupings

### Question 23.

#### **Do you have any comments on the functional arrangements proposed for managing a Capacity Market?**

Our answer here is very similar to our response under Question 10 above, as again we have identified significant similarities between ELEXON's current role and key elements of the proposed delivery arrangements for any Capacity Market, synergies that avoid replicating existing processes and systems and so minimise costs to industry and consumers.

ELEXON agrees that a diverse mix of functional capabilities will be required to give effect to a Capacity Market approach. We also agree with DECC's view that an effective Capacity Market operating model might entail these functions being split between one or more organisations, to avoid conflicts of interest and realise operating efficiencies.

Again, there are strong parallels between the activities and capabilities required to implement any of the potential variants of a Capacity Market, and those found under existing industry arrangements – particularly those under the BSC.

In particular, any payment function (which will, for example and depending on the Capacity Market option chosen, calculate and settle the moneys due to the procured capacity providers and/or the monies due as a result of capacity imbalances under a capacity obligation) bears obvious similarities to the core function of ELEXON under the balancing and settlement arrangements.

As noted earlier, comprehensive and proven industry cost recovery arrangements already exist under the BSC (including funding share calculation, credit, billing and payment processes).

In our view, the delivery organisation activities and capabilities for a Capacity Market will be considerably more complex than those under the Strategic Reserve option. This is due to the larger number of potential market participants and the more dynamic and frequent nature of Capacity Market transactions (resulting in significant increases in data and communications). In our role as delivery organisation for the BSC, we have significant experience of the types of systems and processes required to handle this type of operation.

When reviewing the Feed-in Tariff (FIT) proposals set out in the White Paper we identified strong synergies between what ELEXON currently does for reviewing the Credit Assessment Price (CAP) and the proposed process for setting the FIT Reference Price for baseload generation; and between the proposed process for reviewing and calculating the reverse imbalance price and the FIT Reference Price for both intermittent and baseload generation. In a similar manner, we envisage that there could be strong synergies with the tasks ELEXON already undertakes with the derivation of a reference price for a Capacity Market, depending on the policy option chosen.



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As stated in our answer to Question 15, ELEXON notes that one of the policy options could result in a need to monitor the extent to which individual supplier capacity holdings and their customers' demand match. This would look the same as the energy imbalance settlement arrangements that ELEXON administers under the BSC. A check of the imbalance between purchased capacity and the metered supplier out-turn demand with appropriate payments made for any capacity difference, for example, would have extremely strong similarities with the BSC process of monitoring generation and out-turn supplier demand and comparing that with the BSC Party's energy contract position and applying energy imbalance charges where there is a difference.

ELEXON has over ten years' experience of operating a daily settlement process; the BSC, which ELEXON administers, operates on a daily settlement basis where financial settlement occurs each working day approximately 28 days in arrears. In the context of a Capacity Market, daily or frequent settlement of capacity difference and/or imbalance payments could have advantages over a longer (monthly or annual) settlement because it will make cash flows more regular and could reduce the credit requirements.

Some of the other activities, resources, systems and processes that will be required to ensure that any Capacity Market operates in a robust and transparent manner, include (but will not be limited to):

- Contract oversight and enforcement of financial penalties;
- Data processing and collection systems and processes;
- Registration;
- Data reconciliation (meter to contract);
- Calculation of financial liabilities;
- Banking and funds transfer;
- Reporting;
- Credit/collateral management;
- Assurance;
- Helpdesk;
- Disputes management;
- Governance support and change management;
- Procurement and service management of service providers;
- Stakeholder management;
- Design authority; and
- Systems integration.

ELEXON already operates established approaches for all of these in accordance with the BSC, and we would welcome the opportunity to explore the opportunities to apply these capabilities to support the implementation of this mechanism, if it is DECC's favoured option.

It will also be important to ensure that the organisation responsible for these governance and settlement functions is independent, transparent, trusted and accountable. We believe that ELEXON is uniquely placed in these respects.



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For more information, please contact

**Market Advisor**

