New UK balancing costs to increase short-term trading

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Major reforms to the UK's balancing market entering force later this year will trigger a shift-change in trading strategies in and outside of the wholesale market, increasing trade in short-term products, experts have told ICIS.

Earlier this month, energy regulator Ofgem approved changes to the balancing and settlement code that will mean imbalanced power generators and suppliers are likely to be penalised more for failing to settle positions (see EDEM 8 April 2015).

The code modifcation, which will usher in the introduction of a single and more marginal cash-out value, has been approved to take efect from this November.

And experts believe the complexity of the reforms and uncertainty over their potential efects on the balancing market means that physical trading parties need to urgently reassess possible risks to their trading strategies.

Retrospective analysis by Elexon on the code modifcation – called P305 – and its hypothetical impact on 2013 cash out prices showed that balancing prices would have been less than £50/MWh 60% of the time and greater than £100/MWh around 5% of the time, says Aily Armour-Biggs, director of wholesale trading at energy technology innovator Utilidex.

To put this in context, the cash-out price – the amount paid by generators whose production is short of what they are contracted – has not climbed above £100/MWh yet in April.

Formerly an energy trader and head of European power and utilities at the Royal Bank of Scotland, Armour-Biggs said the risk attached to the 5% scenario combined with this winter's shakier market landscape, with peak capacity margins set to fall, will force companies to re-evaluate their hedging strategies and adopt smarter trading tactics. "Trading could become shorter-term with traders keeping a close eye on the balancing market, taking advantage of lower or negative prices and covering up when prices are higher," Armour-Biggs said.

She added that a strategy of taking cover from higher balancing costs could involve increased trading on shorter-term products, or in the case of suppliers, invoking demand side response and calling on embedded generators.

Harsher regime

And Alastair Martin, founder and chief strategy ofcer of power reserve company Flexitricity, believes the evolution of trading strategies that will develop out of a harsher balancing regime can only favour smaller suppliers.

“For any licensed supplier wanting to gain market share, it’s the innovation you’re waiting for,” Martin said. “In terms of efect, there’s a need to transform the behaviour of all suppliers. While you can argue sharper balancing costs increases their risks, smaller suppliers are better able to innovate. You can bring in the portfolio of trading demand side response,” he added, arguing that larger market participants will have less fexibility to incorporate new trading strategies.

An increase in the UK’s deployment of zero-marginal cost wind and solar generation, which enters near the bottom of the generation stack, has helped to push wholesale and balancing prices lower on more frequent occasions in recent years.

The result this summer has been the more frequent appearance of negative cash out prices at times of low system demand and high wind and solar generation.

Predicting electricity demand is also becoming harder for the grid operator and the market.

This was highlighted by the National Grid in its recent Summer Outlook, in which it forecasts peak weather corrected demand for this summer to be 900MW lower than last based on increased quantities of embedded solar generation (see EDEM 9 April 2015).

Warnings that trading behaviour is likely to alter as a result of the new balancing costs are not new.

Last year, Intergen’s head of energy markets Chris Elder warned that companies would likely be forced to enter the wholesale market more to counter the efects of sharper and harsher balancing prices (see EDEM 22 October 2014).
Henry Evans