Regulatory Arrangements for the New Dutch-GB Electricity Interconnector

A Centrica response

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1 INTRODUCTION

In September 2006, Ofgem launched a consultation on the regulatory arrangements for the proposed Dutch-GB electricity interconnector. This relates primarily to the request for an exemption from certain licence conditions by the interconnector operator, as well as to balancing arrangements that should be in place for the interconnector.

Centrica is interested in this subject as a potential user of the interconnector, in that this will link two of the markets in which the company is currently active for both supply and electricity trading purposes.

Our response focuses on the questions outlined by Ofgem in its consultation – whether there is agreement for an exemption; what balancing arrangements are appropriate; views on the scope and duration for the exemption and the conditions for revocation.

2 OFGEM'S CONSULTATION QUESTIONS

2.1 QUESTION 1

> *"Do you agree with our overall assessment that the exemption should be granted based on the examination of whether the exemption criteria have been met?"*

Britned has requested an exemption in its licence from standard conditions 9, 10 and 11 relative to regulated third party access and use of revenues, and from Article 6(6) of Regulation 1228/2003 relative to the use of interconnector revenues. We agree with Ofgem's assessment that an exemption should be awarded to Britned. However, we wish to make some remarks on the level of risk to the investment, the primary capacity allocation mechanism and on the optimisation of capacity for the interconnector.

We consider it vital that other elements of the Regulation are adhered to in order to guarantee the correct operation of the interconnector. Greater detail on how Britned proposes to comply with other parts of the Regulation would be welcome, and may help alleviate users' concerns relating to whether the exemption request could lead to market distortions. Key areas to consider are information transparency (auction results, available capacity, actual flows etc. similar to that published by the UK-France interconnector), nomination rules, and use-it-or-lose-it (UIOLI) process. Experience with the Isle of Grain project for example has shown that it would be beneficial to get as much detail as possible resolved before an exemption is granted.

Although Britned has not formally requested longer term capacity allocation, we would consider that in principle some level of longer term contracts would not be detrimental to competition and may indeed help underpin the investment and further reduce risk, subject to certain conditions. These would include:

- A restriction to no more than a certain portion of the capacity (say one third),
- Possible limits on how much one individual company could obtain,
- Delivery via a competitive open process, and

- Strong UIOLI provisions

On this basis such longer term capacity allocation would not in itself be anti-competitive, unlike legacy long term contracts signed pre-liberalisation.

2.1.1 Investment Risk

Without regulated tariffs or long term capacity allocations, it is difficult to understand from where the investment protection arises. The exemption requested will not provide actual investment protection, only a reduction in regulatory risk. We have not been party to the financial data submitted by Britned to Ofgem in its application for an exemption. Hence we are unable to make a clear assessment of whether the level of investment risk is such that the investment would not take place without this exemption being awarded.

The example of Nor-Ned suggests that power interconnectors may be developed on the basis of regulated third party access, provided that the capital cost can be included in the regulated asset base. In the case of Britned, we presume that the national regulators were unwilling to see the cost “socialised” in this way and we are therefore sympathetic to the investment case for exemption.

In response to the exemption request made by Britned, we have further comments on the exemption’s scope and duration in response to question 3 below.

2.1.2 Primary Capacity Allocation Mechanism

Britned states that it will allocate capacity through a mix of implicit and explicit auctions, with no contract longer than one year. There is little further detail available. We would suggest that the following elements be considered:

- The ratio allocated for explicit and implicit auctions should not be a fixed percentage; instead a maximum of circa two-third should be allocated for longer termed explicit auctions, and a minimum of circa one-third reserved for implicit shorter termed auctions. This ratio should be reviewed over time and as the market structure develops the proportion of capacity reserved for implicit auctions could be increased.
- Explicit auctions should be available for annual, seasonal (half-yearly), quarterly and monthly timeframes
- Contracts should not be rolled over, or offered ‘grand-fathering’ rights, as this would otherwise create the opportunity for longer term contracts.
- We do not consider that limitations should be placed on individual participants’ short term interconnector capacity. This would be difficult to enforce when taking into consideration the potential use of trading by affiliated companies or bilateral trades.
- In the light of experience with the IFA (UK-France interconnector), there could, however, be a case for making reciprocal information transparency (on the part of the shipper’s generation arm or affiliate) a condition of acceptance as a Britned shipper.

2.1.3 Optimising Capacity Allocation

As important as the initial capacity allocation mechanism is ensuring that capacity utilisation is optimised. It is thus imperative that there are possibilities for secondary trading as well as robust anti-hoarding mechanisms in place. Clear and objective rules on nominations, reallocation and UIOLI, or preferably use-it-or-sell-it (UIOSI), arrangements must be established and strictly applied to in order to ensure maximum capacity utilisation. These principles should be in place for all capacity, regardless of the duration of the contract. So far, there are no details available.

2.2 QUESTION 2

> *“Given the lack of clarity in the application surrounding the arrangements for dealing with the differences between the balancing periods in the markets in Great Britain and the Netherlands, do you have views on what the most appropriate form for such arrangements should be?”*

We strongly believe that the issue of the balancing regime must be resolved and agreed with the regulators prior to the exemption being awarded. As Ofgem states, there is lack of clarity in the application.

The current situation requires half hourly balancing in GB and quarter hourly balancing in the Netherlands. At present there is considerable value (high cost) in specific quarter hour balancing periods in the Netherlands, for example during weekdays in the early morning hours. There are also significant differences in the Dutch-GB imbalance prices. We would not advocate a Britned specific solution, which could create an artificial market distortion. Instead in view of the greater volatility in the Dutch balancing market, we would propose arrangements whereby those exporting from the GB can do so in quarter hour blocks, and not in a half hour block that is then split equally on the Dutch side. This avoids unduly penalising certain shippers.

Another important requirement in this respect is to ensure that Britned allows within-day nominations and re-nominations, with sufficient flexibility to allow Britned shippers to mange the half-hourly and quarter-hourly balancing requirements of the GB and Dutch markets respectively.

2.3 QUESTION 3

> *“Do you agree with the proposed scope and duration for the exemption, and the conditions for revocation?”*

Britned has requested an exemption for a duration of 25 years. We consider that this may be much too long and the exemption should therefore be reviewed after a shorter period. We have not been party to the financial model submitted by Britned to Ofgem on a confidential basis, and thus have little information on which to judge the justification of the exemption duration. The north west European electricity market is very dynamic, and we consider it unwise to award such long term exemptions at this stage.

We agree that a period of around 25 years is most likely correct for the lifetime of the assets. However we do not agree that this is necessarily suitable as the exemption/investment recovery period. In particular, Britned has requested an exemption from the rules governing revenue use. This revenue will be collected through short term capacity auctions. If, in fact, Britned turns out to be capacity constrained (and thus highly profitable) within (say) 10 years of commissioning, we are concerned that a guaranteed 25 year exemption may create an artificial incentive to delay/withhold investment in additional interconnector capacity - well beyond the point at which the sponsors have earned a return commensurate with the investment risk.

We would therefore suggest that the exemption be awarded for a shorter initial period of (say) 10 years, with a review taking place at the end of that period to assess whether (and on what conditions) the exemption should continue to apply for the remainder of the 25 year period. This would not expose the project to regulatory risk as the exemption would only be removed if sufficient return had already been made at the interim review date, thus not justifying a continued exemption.

Most importantly, if Ofgem became aware that any of the conditions - listed in §1.7(a) to §1.7(f) - on which it had based its assessment for the exemption were no longer valid, it should also carry out a review of the operator's licence. Key among the circumstances that we believe should lead to a review of the exemption would be non-enforcement of critical operating arrangements such as UIOLI/UIOSI conditions, or a change in the duration of capacity contracts being offered beyond the current proposal of 12 months.

3 CONCLUSION

Centrica supports greater market integration as this will give better signals to potential market investors, improve trading/market efficiencies and co-ordination between markets and aid future market development. This interconnector should increase resilience in each interconnected region and improve security of supply through better congestion management at the borders.

Whilst Britned's request does not contain proposals for long term capacity allocation, as stated above we would support a portion of longer-term allocation and a shorter exemption period. We believe that this may be preferable than only short term allocations with a longer exemption duration, and that if combined with certain conditions this should not in itself be anti-competitive.

To conclude, we support the provision of an exemption to the interconnector operator and look forward to receiving more details of the capacity allocation mechanisms and the operating arrangements.