



**Legal, Regulation and Compliance**

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Friday, 08 May 2009

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By E-mail: [ian.marlee@ofgem.gov.uk](mailto:ian.marlee@ofgem.gov.uk)

Dear Ian,

**Re: Addressing Market Power Concerns in the Electricity Wholesale Sector – Initial Policy Proposals**

Thank you for the opportunity to comment on the above document. This non-confidential response is on behalf of Centrica plc excluding Centrica Storage Ltd. We are happy that Ofgem places this non confidential response on their website and in the Ofgem library.

We have set out our views in this letter and in the attached annex, where we address the specific questions raised in the consultation document.

It is important to ensure that the electricity wholesale market functions properly for all players - we believe strongly in competitive markets as supporting consumer interests. As Ofgem has noted, there have been major Scottish transmission constraints on the network which have resulted in significant costs. Given these costs, Ofgem will naturally wish to reassure itself as to the healthy functioning of the market in this regard.

As part of Ofgem's work in gaining this assurance, we would strongly support maximising the alignment of SO and TO incentives with the clear objective of minimising the constraints which lead to outages in the first place. We believe that better co-operation and alignment would be expected to reduce the number or duration of outages and that this should be encouraged.

We note the additional question in paragraph 1.8 on the distinction between price spikes which are a necessary and efficient market response providing important signals for generation investment and price spikes which might be the result of undue exploitation of market power. We welcome Ofgem's recognition that some price spikes are both normal and

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a necessary part of a healthy market; it would be regrettable if such useful signals for investment were dampened.

Looking forward, given the need to manage renewable intermittency, it will be necessary to ensure that the power market design supports a range of conventional backup. To this end, allowing the market to respond freely, while it may result in some significant price spikes, will signal the need for such investment rather than reflecting the undue exploitation of market power.

In our view, trying to design a solution which is wide enough to cover potential problems not yet identified will carry a high risk of adverse consequences and should only be considered as a last resort when other, more specific, approaches have proven ineffective.

Generally, actions are likely to be most useful when they are tailored. Thus, where issues have to be addressed such as those around the non compliant derogated boundary in Scotland, we believe it is essential to ensure that any proposed remedies are targeted and proportionate to the issue under consideration, measurable in their effects and that they do not have unintended consequences such that normal market activity is unduly constrained. Any changes implemented must also be transparently monitored to ensure that the desired result is being achieved.

The issue of constraints on the non compliant derogated boundary is not new and there are a number of proposals in development which we believe will, in time, resolve some of the impacts noted. For example, Transmission Access Reform, the new proposal on locational BSUoS and the Cashout modification P217. In particular, we believe that the additional transparency provided as part of the latter two will be very helpful, giving greater clarity on when constraints are active, when there is a risk of higher costs to the industry and how individual generators are responding, encouraging the industry to self regulate.

Nevertheless, if actions are taken as a consequence of this consultation, it is essential to ensure that they do not adversely impact normal market activity unduly. Whilst we do not favour a licence condition approach, if a new licence condition is to be sought, it is crucial to ensure that it is clearly defined - the clarity and quality of any associated guidelines would be also be key.

If Ofgem is minded to pursue this route, Centrica would be willing to work with Ofgem and the industry to develop a highly specific, targeted condition and associated guidelines, as we believe it would be important to create a condition which is effectively only “triggered” where there is a derogated, non compliant boundary and market power exists. It would also be an advantage to either end-date the condition or to schedule an automatic review after a defined period, perhaps [2] years. We believe that whilst a baseline would be needed for discussion, a constructive approach involving participants in the development could provide an effective way forward.

In conclusion, there are a number of actions underway (in particular investment in the physical network) which we believe will generate significant improvements and we are of the view these should be allowed time to take effect. We do not believe therefore that a broad Market Power Licence Condition is either necessary or appropriate. However, we would be willing to work with Ofgem and the industry to formulate a specific, targeted and above all proportionate, condition to be applied on a temporary basis whilst waiting for other measures mentioned to take effect.

We hope this response is helpful, and would be happy to meet with you to discuss any issues in more detail.

Yours sincerely,

*By email*

Alison Russell  
Senior Regulation Manager, Upstream Energy

## **Annex 1 – questions posed in the consultation document by chapter**

### **Chapter 1: Introduction**

#### ***Question 1: Do you agree with our analysis of market power concerns in the GB wholesale electricity sector?***

In general, we are of the view that the market is functioning as intended and we do not see major difficulties. However, we recognise that issues exist around derogated non-compliant boundaries, where during constraints National Grid has a very limited range of options available to it and hence there is the potential for the undue exploitation of market power. Such circumstances may well be alleviated when (planned) investment comes on line and hence the issue may not be enduring. The only current example of this situation is in Scotland and as such it is only reasonable to ensure that any actions are equally specific.

In terms of this narrow area for consideration, we agree that there may be transient market power and that one or more parties might be pivotal at such times.

Ofgem highlights (1.10) that this potential combined with a lack of enforcement powers can create issues for competition in the market and greater uncertainty which may impact costs, investment and new entry. However in our view, this risk is not high as Ofgem does have tools available to it in the form of its concurrent powers with the OFT and the existing licences.

We do not believe the Scottish issue to be enduring at this level, as in time, investment should mitigate much of the impact (it is probable that a (lower) level of constraints would persist as it is unlikely to be economic and efficient to build a network that is never constrained). However, if additional enforcement powers are contemplated, steps must be taken to ensure that all reasonable and necessary safeguards are in place and that the proposals cover only those powers that can be shown to be necessary.

#### ***Question 2: To what extent should further policy intervention be progressed or are there alternative approaches that can be adopted for dealing with the concerns?***

As noted elsewhere in this response, we believe that policy intervention in the form of additional powers should be proportionate and specifically targeted to the issue under consideration. Appropriate safeguards need to be in place and proper reviews and reporting built in.

It is important to note that there are a number of activities under consideration or in the process of implementation at present which have the potential to be effective in the areas in which Ofgem raises concerns. In particular, the additional transparency around constraints resulting from Cashout Modification 217 implementation will improve visibility of constraints and make it more difficult for generators behind constrained non-compliant derogated boundaries to take undue advantage of location related market power.

These actions must be given time to bed in before further significant change is contemplated. If Ofgem is minded nonetheless to pursue a licence condition at this stage, it should be strictly defined and limited to the issue in question. We believe such a carefully targeted approach would be more consistent with “light touch regulation” and would reduce actual and perceived regulatory risk.

## **Chapter 2: Changes to existing market arrangements**

***Question 1: To what extent do you think that changes to SO and TO incentives and/or changes to other market arrangements are likely to be effective in addressing the concerns discussed in Chapter 1?***

We agree in principle that SO/TO incentives should be aligned and that this should provide an efficient outcome for customers, but it will be important to consider the incentive regime holistically to minimise the risk of unintended consequences.

We would be concerned about the risks associated with piecemeal but major changes to market design - such as changing to a cleared auction - especially if implemented hastily, as the risk of adverse consequences is high. Ofgem does note some of these risks, but we believe that such changes are unlikely to be proportionate to the issue and hence such wholesale changes should not be considered further until more proportionate measures have been shown to fail.

***Question 2: Are there any other changes to existing market arrangements that Ofgem should consider?***

As noted, we support greater transparency around constraints; this should naturally arise as a result of some of the other actions being undertaken. We believe it is important to keep the area under review before considering whether any further changes would be beneficial.

## **Chapter 3: Changes to existing assets and/or ownership of assets**

***Question 1: To what extent do you think increased transmission investment is a feasible option and likely to be effective in addressing the problem?***

Investment is clearly part of the longer term approach to managing constraints and their associated issues such as those noted above. In addition to the existing “business as usual” planned investment, supported by user commitment, significantly more investment for 2020 has already been identified by the ENSG. This work has received almost universal support and National Grid is endeavouring where practical to advance plans. The Transmission Access Review is seeking to address connection issues and manage the outcome effectively.

Whilst the investment identified by ENSG is clearly needed and should commence without delay, it should be noted that transmission investment is neither quick nor a panacea and gold-plating the system will not be an efficient outcome for consumers. An economic and efficient transmission system will always have economic levels of constraints and periodic limitations of capacity. On this basis it is important to have a range of tools available to manage the resulting impacts. We believe the kind of balanced approach advocated in this response, combining information transparency and an element of locational BSUoS, should provide an adequate solution in the first instance, leaving the possibility of a carefully targeted, measurable licence condition if found then to be warranted.

***Question 2: To what extent do you think that the other asset related options discussed are likely to be effective in addressing the problem?***

As noted by Ofgem, these could only be much longer term proposals, and potentially only available as remedies after a referral and investigation by the Competition Commission, this

may render such an approach impractical as a solution to the relatively narrow issue of constraints.

In addition, as noted above, proposals in this area such as those relating to asset ownership appear disproportionate. We believe such remedies would be more appropriately considered as a part of a Competition Commission Inquiry rather than in advance of such an investigation. We continue to believe that if a change is required at this juncture, a more targeted approach should be used.

***Question 3: Are there other asset-related remedies that Ofgem should consider?***

No response

**Chapter 4: Specific Mechanisms for addressing market power concerns**

***Question 1: Is a licence condition on generators appropriate? If so, do you have views on what form of condition is the most appropriate?***

There are a number of actions underway which we believe in combination will improve the position including Cashout Modification P217, Locational BSUoS and activities under the Transmission Access Review. As these activities have not yet been embedded, it is not clear that additional actions are required. However, if Ofgem believes an additional safeguard is needed after these other changes have bedded in, then the approach proposed should be strictly targeted and specific. We do not believe that a broad licence condition is necessary or appropriate given the relatively narrow issue of constraints which we believe needs to be addressed.

If this option is to be pursued, Centrica could only support a narrowly defined licence condition, targeted to derogated non-compliant boundaries and triggered only during constraints where market power may exist (for example, when National Grid has little or no choice in the actions it can take to resolve the constraint). The condition would need to include provisions for monitoring and reporting on its effect, as well as an automatic review of its effectiveness (and potentially renewal) after a defined period of time.

In such an eventuality, it would be helpful for Ofgem to issue guidance on the application of the condition, but we would prefer that the condition itself contains the salient points to aid clarity. We would be happy to participate in a working group with Ofgem and the industry to develop such a condition and guidance.

We continue to believe that a broad licence condition would carry a high risk of adversely impacting normal market behaviour. This might particularly be the case if such a condition was drafted widely enough to capture a range of market power issues on an ongoing basis (4.5), including issues not yet anticipated or defined. Ofgem's recognition of the need to ensure that normal responses to market scarcity would not be caught is welcome and we strongly support this objective.

In the Competition Commission's comments on the Market Abuse Licence Condition (MALC) proposed a few years ago, the difficulties inherent in distinguishing between abusive and acceptable conduct were highlighted with the risk that such uncertainty would deter normal market behaviour and inhibit the normal operation of the market which could reduce the effectiveness of price signals and have other deleterious effects.

We note Ofgem's view that a licence condition could be easier to enforce (4.2). This could clearly be the case, but as a result appropriate checks and balances on any new powers need

to be in place. Given that the condition would be used to address competition/market power concerns, we believe it would be important to ensure that potential ease of use does not result in a lower quality test being applied to potential infringements. In the previous MALC inquiry, the Competition Commission also noted the risk of such a MALC setting a lower threshold for regulatory intervention than the Chapter II prohibition.

In respect of the second licence condition that Ofgem is suggesting, on Information Retention and Disclosure, subject to the usual caveats around possible confidentiality concerns, the provisions would seem reasonable. However, it may be simpler and therefore preferable to amend existing condition 13 (Provision of information to the Authority) to clarify that certain types of information should be retained. Also it is worthy of note that these proposals in terms of information do go further than the requirements currently expected under the 3<sup>rd</sup> Legislative Package.

***Question 2: How important would a formal appeals mechanism be?***

In general, we believe that appropriate checks and balances need to be in place on all regulatory powers. As a new licence condition would add to these powers, we believe it would be essential that it be accompanied by a robust appeals mechanism, for example, to the Competition Appeals Tribunal. Again, this approach would be consistent with the observations made by the Competition Commission in the MALC inquiry.

***Question 3: Is an ex-ante price framework an effective tool? If so, do you have any views on what would be the most appropriate form?***

As noted above, in the first instance we believe that this approach would be disproportionate in relation to the narrow issue under discussion, namely constraints on non compliant derogated boundaries.

In America, we do not believe that ex-ante regulation has provided a resolution to potential issues of market power abuse, and indeed we believe it has created a different set of problems. In our view, ex ante regulation has caused unreliable price signals potentially inhibiting investment and demand response. For example, where short run marginal costs are the bid limit, prices are artificially low during times of scarcity. In turn, this could lead to a requirement for further intervention as the resulting “dampened” prices may not attract necessary investment and may also act to reduce the motivation for consumers to participate in appropriate demand side response activities.

In addition, the American experience has been that even with ex ante regulation, regulators are not freed from the requirement for detailed regulation. The regulatory authorities must still verify marginal costs (or whatever baseline is used), which requires full engagement in order to undertake significant analytical activity. Moreover, even with ex ante regulation, the regulator is not relieved of the obligation to monitor and prosecute unacceptable behaviour, which can be costly and involves lengthy regulatory proceedings.

Finally, a new phenomenon appears to be surfacing in America, where, due to lack of clarity in the rules, generators are afraid to submit offers that reflect true scarcity pricing. For example, in Texas, there is an offer cap of \$2,500 but bids are rarely near the cap. This is because the rules also say that a generator may not submit offers that are “substantially above marginal costs.” However, the rules neither define “substantial” nor “marginal costs.” This leaves generators with a lack of certainty, wondering, for example, if a bid \$5 over short run marginal costs is “substantial” or if “marginal costs” is short run or long run costs. Recently, regulators alleged that a market participant violated these rules when it bid \$50 above its

short-run marginal costs. The regulators sought \$171 Million in penalties. The market participant argued its bids were proper under the rules because its bids were long run costs and/or not substantially above its costs. The regulators did not address the inherent uncertainties, instead settling the case for \$15 million.

Since this case, many believe that prices are artificially low during times of scarcity. As a result, regulators are seeking permission to impose a regulatory or administrative hockey stick curve so as to allow for adequate price signals in times of scarcity.

In conclusion, ex ante regulation, if not carefully planned and implemented, may be expected to lead to a series of layered regulations that introduce even greater complexity into market design. If an ex-ante approach were to be pursued, considerable development would be needed, which is likely to be time consuming, making this approach more of a longer term option for consideration if more proportionate changes are not effective.

***Question 4: Are there other specific mechanisms that will effectively address the issues identified?***

#### **Chapter 5: Potential Mechanisms for Implementation**

***Question 1: Do you have any views on the preferred mechanism for implementation?***

We have some reservations as to the scope of proposals. We believe that if a licence condition is to be implemented it would be preferable to manage this through the Collective Licence Modifications process if possible. To this end, we are inclined to believe that a exploring a workgroup approach to the development of the licence condition and associated guidance may be beneficial.