

Ian Marlee
Director, Trading Arrangements
Ofgem
9 Millbank
London
SW1P 3GE

Mark Ripley
Regulatory Frameworks Manager
mark.g.ripley@uk.ngrid.com
Direct tel +44 (0)1926 654928
Direct fax +44 (0)1926 65 3042

www.nationalgrid.com

8th May 2009

Dear Ian,

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

Thank you for the opportunity to respond to the consultation document regarding initial policy proposals on Addressing Market Power Concerns in the Electricity Wholesale Sector. This response is on behalf of National Grid Electricity Transmission plc (National Grid). National Grid owns the electricity transmission system in England and Wales and is the GB System Operator.

In summary, National Grid would suggest that, while changes to market arrangements may help to reduce the associated risk of undue exploitation of market power, such power is unlikely to be removed by such changes. The only means by which we feel the issue of market power can be fully addressed, at least within the fundamental principles of BETTA, is through the introduction of a licence condition on generators controlling their exercise of market power. We feel a narrowly drafted licence condition targeting the problems that Ofgem has already identified will effectively deal with those concerns and, by comparison with a licence condition drawn more broadly, is more likely to gain the necessary support from the generator community to allow the implementation to be effected via the collective licence modification route.

Chapter 1: Do you agree with our analysis of market power concerns in the GB wholesale electricity market?

National Grid shares Ofgem's concerns over the existence of market power in the GB electricity market, especially in relation to the provision of balancing services to National Grid as GBSO. A key question is whether or not undue exploitation of that power has taken place or is likely to take place in the future. However, regardless of this we would agree the potential for such exploitation exists specifically in relation to actions taken to resolve transmission constraints.

In respect of transmission constraints, there are often situations where only one generator can offer a service to the system operator (SO), and where more competition does exist, it is often the case that only a very limited number of generators have the necessary flexibility to offer a commercially competitive service (for example, nuclear is physically inflexible and wind is expensive to constrain off due to the loss of Renewable Obligation Certificate income).

In the medium term at least, we would consider that, regardless of the proposed Transmission Access Reforms (TAR), the energy capacity rights required by generators are likely to exceed available transmission capacity in certain geographical areas. While there are a number of benefits in maximising the amount of generation on the system, this should only be done if any resulting transmission constraints can be managed economically. Furthermore, we would consider that the generation mix of the future is likely to be less flexible, potentially giving more market power to those with flexible generation at times of constraint on the system. As a result, we consider that the issues surrounding the potential exploitation of market power are likely to continue well into the medium term and, as such, need to be addressed in order to protect the interests of consumers at least until the required transmission infrastructure can be put in place to remove the possibility of market power existing in relation to specific ancillary services.

We note the comments made that consumers could become more price sensitive and responsive in the future. In support of this National Grid has been working with a number of parties to develop our balancing services to facilitate new technologies that are currently being developed (for example, responsive refrigeration). Whilst such technologies will at some point in the future provide important balancing services (for example in relation to frequency response), the provision of services from consumers to manage constraints is difficult to envisage as this would, in most instances of export constraints, require demand to increase locationally over an extended period.

In respect of price spikes, we agree that, these can reflect genuine energy scarcity in the market and play an important role in delivering security of supply by providing important signals for generation investment. However, it is not so clear to us that the same arguments apply to the provision of balancing services to the system operator at times of constraint on the system where price spikes may be the result of undue exploitation of market power and may not incentivise third party investment to provide additional competition in the same way. Specifically there may be concern where the SO is required to accept a price behind a constraint which is considerably different to the price that it would have obtained from a similar generator in the unconstrained area.

Chapter 1: To what extent should further policy intervention be progressed or are there alternative approaches that can be adopted for dealing with the concerns?

As highlighted in the consultation, National Grid has raised a Connection and Use of System Code (CUSC) modification to set administered prices for inter-trips on non-compliant derogated boundaries. We have also recently received responses to a charging consultation to introduce a locational element to Balancing Services Use of System (BSUoS) charges and are now considering the responses. However, in respect of the latter proposal, we are concerned that if there was any undue exploitation of market power, this may negate the intention of the proposal to accurately reflect the costs of access onto the appropriate parties (i.e. generators with flexible plant to resolve constraints may be able to alter their pricing, as a result of market power, to recover the locational BSUoS cost, thereby removing their exposure to the signal). In addition, whilst the TAR proposals can help address the impact of constraints, the potential for undue exploitation of market power would not necessarily be removed.

In conclusion, National Grid believes that some form of policy intervention may be helpful and would also seem important given the difficulties you highlight in applying CA98 legislation in the wholesale electricity context.

Chapter 2: 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?

While changes to SO and TO incentives and other market arrangements may help to reduce the risk of undue exploitation of market power, they are unlikely to remove it. The only area where we feel the issue of market power can be fully addressed within the short-to-medium term and within the fundamental principles of BETTA, is through a licence condition for generators.

As highlighted in the consultation document, National Grid is considering options for greater alignment of SO and TO incentives and will continue to develop its ideas with Ofgem and the TOs. Whilst some amendments can be made to the SO-TO Code (“STC”) to facilitate such alignment, we feel it is more likely that amendments will be necessary to the TO licences. Whilst National Grid can make suggestions in this area, it is clearly not within our gift to make licence amendments.

Within the consultation document initial thoughts are provided on mechanisms that could potentially improve alignment between the incentives of the SO and TOs with respect to minimising the frequency and severity of constraints. We agree that these are broadly the three areas in which such alignment could be improved and would offer the following comments on each:

- ***Changes to the way in which the timing and duration of outages is determined.***
Whilst this would make the SO’s role in managing TO outages easier, it may not necessarily lead to the most efficient outcome. The SO takes account of Generator outage plans in line with OC2 of the Grid Code (OC2 allows the Generator to amend its best estimates of outages required up to current day). Such changes in generator outages can lead to significant increases in costs as careful alignment of TO and generator outages are lost. However, we believe that the locational BSUoS proposals, if implemented, may help to incentivise generators to take their outages in line with Transmission outages.
- ***Cost-sharing arrangements for constraint costs across TOs***
National Grid agrees that there is scope for cost-sharing arrangements for constraint costs between the SO and TO and are developing proposals in this area. These proposals are being developed around incentives on the availability and capability of critical boundaries and circuits.
- ***Considering ways in which SO could facilitate more investment in TO regions***
The STC currently allows for the SO to be active in the planning of the whole of the GB Transmission System. Under the STC the TO or SO can request the other party to change its investment plans. The STC planning request process works well for changes requested by the SO for works beyond current year but the involvement by the SO in planning the Scottish part of the GB Transmission System could be further improved and we are considering proposals in this area.

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

In respect of other changes to existing market arrangements that Ofgem should consider, National Grid feels that the availability of market information should be carefully considered. In our opinion it is important (in some circumstances) to provide detailed historic information to allow potential providers to make decisions on whether to provide a service (for example, in relation to commercial intertrips in specific locations). However, National Grid is restricted from publishing this level of detail under Section 105 of the Utilities Act without consent from the parties to whom the information relates, and such consent is not always forthcoming. We recognise that amendments could be made to the CUSC, for example, to require us to publish detailed information on constraint actions. We are considering raising proposals in this area and intend to seek industry views on this at the Constraints Management Workshop we are proposing to hold on 3rd June as we recognise parties feel that certain information is commercially sensitive and by publishing it, may prohibit them from offering a service. Despite this, National Grid presently publishes the most detailed information it can in respect of constraints costs in the Monthly Balancing Services Summary.

As previously highlighted, National Grid, as SO, takes account of Generator outage plans in line with OC2 of the Grid Code when planning Transmission outages in order to minimise constraint costs. Changes to generator outage plans, especially at short notice, can have major impacts on costs. There is clearly a balance to be struck between restricting OC2 changes and allowing generators to amend outages due to market signals or for technical reasons, but we feel this area needs further development and is an area where there is scope for the undue exploitation of market power. As stated earlier, we believe that the locational BSUoS proposals, if implemented, may help to incentivise generators to take their outages in line with Transmission outages.

Chapter 3: To what extent do you think increased transmission investment is a feasible option and likely to be effective in addressing the problem?

It is widely accepted that significant investment in the transmission system is required to enable us to meet future energy challenges. Most recently, the Electricity Networks Strategy Group (ENSG) developed a vision for the transmission network required to meet 2020 renewable targets. This identified the requirement for £4.7bn of transmission investment against a generation scenario containing a significant volume of renewable (predominantly wind) electricity generation. Funding has been agreed with Ofgem to enable National Grid and the Scottish

Transmission Companies to continue developing this work through 2009/10, and we expect that more enduring regulatory arrangements for strategic investment will also be introduced.

The aim of the network produced by the ENSG is to provide transmission access to those generators who will contribute to our future energy production mix.

Whilst such investment is unlikely to address all potential market power issues it will help to reduce the associated risk of undue exploitation of market power, but only in the long term after any such assets have been constructed. The reduction of such risk is in two parts. First, the level of constraints will be lower, and secondly, the transmission outages that are required are more likely to be able to be co-ordinated to occur with generator outages. In the short term such risk will increase as in order to construct new assets, we have to take transmission outages which, temporarily, increases constraints.

Finally, we would agree that even in the long term with an efficient level of transmission investment, with optimum trade-off against constraint and other operational costs, would still not be constraint-free. Therefore, transmission investment would not by itself eradicate all constraint-related market power issues.

Chapter 3: To what extent do you think that the other asset related options discussed are likely to be effective in addressing the problem?

In respect of physical or virtual divestment we would agree with the view that it may not fully address constraint-related concerns in Scotland and the scale and level of divestment that would potentially be required to deal with these concerns could be impractical. Furthermore, given the necessary interference with property rights that such divestment would entail, we feel that such an approach would send the wrong signals to actual and potential investors in generation plant in Great Britain and act as a disincentive to the investment required to ensure that future energy needs are met.

National Grid agrees that the split between the SO and TO roles in Scotland means that the SO has only limited scope to optimise and manage constraints on those networks. In addition, since the TOs do not face the associated costs it may they may not be fully incentivised to act to reduce constraints. However, National Grid as SO does work closely with the TOs to manage constraints in the most effective manner, for example by sharing best practice from our own TO activities.

The SO/TO interface for the England and Wales system being internalised has encouraged innovation, aligned incentives and reduced balancing costs. It has allowed the identification and implementation of the most efficient solutions, with the benefits being shared with consumers via lower BSUoS charges. Unbundling of ownership of transmission networks in Scotland, a deeper SO role or TO incentives are all likely to have merit, and help to reduce the associated risk of undue exploitation of market power. Clearly these are issues that Ofgem will also be considering in the context of the implementation of the third package of EU energy legislation.

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

We do not consider there are any other asset-related remedies that Ofgem should consider.

Chapter 4: Is a licence condition on generators appropriate? If so, do you have views on what form of condition is the most appropriate?

National Grid agrees that a Market Power Licence Condition (MPLC) is warranted. We recognise the merits of a licence condition specifically tailored to the characteristics of the electricity sector where market power can be intermittent or transient in nature. However, it is also important that such a licence condition is able to distinguish between legitimate commercial behaviour in a competitive market (that may be necessary to incentivise investment) and 'abuse'.

Whilst we recognise some of the benefits of a broadly drafted licence condition, on balance we feel a narrowly drafted licence condition will both effectively deal with the concerns raised now and more importantly have a greater chance of acceptance by generators. We feel that should any further market power issues come to light that were not envisaged in such a narrow licence condition, then further amendments could be considered at that time. We feel such a narrow licence condition should cover potential market power issues in relation to:

- pricing of constraint management tools (e.g. bids and offers in the balancing mechanism, constraint contracts, constraint management service and intertrips);
- generator output during periods of constraint; and
- submission of generator outage information.

Chapter 4: How important would a formal appeals mechanism be?

The Utilities Act 2000, introduced financial penalties for breach of licence of up to 10% of the licensee's turnover and also introduced a right to appeal a finding of breach to the High Court in

England and Wales or the Court of Sessions in Scotland. Even before the decision is made Ofgem has a duty to consider any objections that the licensee has to the proposed finding. As a result, National Grid considers that there is therefore already a formal statutory route for appeal which is already considered to be adequate to deal with complex economic questions arising under various licensees' licences, such as issues involving discriminatory conduct or the grant of cross-subsidies. While National Grid considers that the existing appeals mechanism could be improved, we do not consider that an appeal mechanism should be set up to deal solely with breaches of any licence condition introduced to deal with market conduct.

Chapter 4: Is an ex-ante price framework an effective tool? If so, do you have any views on what would be the most appropriate form?

Whilst we agree a US-style ex-ante regulation framework may be less complex to administer and provide greater certainty to market participants regarding what is "acceptable" behaviour, it is likely to be too narrow to address all the potential means by which market power may be exploited within the current market structure. In respect of constraint management, National Grid utilise a number of tools in addition to the balancing mechanism, such as contracts to cap the output of generation and intertrip agreements. The ex-ante price framework is therefore unlikely to be effective in dealing with all market power issues that may occur in relation to constraint management.

Chapter 5: Are there other specific mechanisms that will effectively address the issues identified?

We do not consider there are any other mechanisms that will effectively address the issues identified.

Chapter 5: Do you have any views on the preferred mechanism for implementation?

We agree with Ofgem's view that the quickest and simplest method of implementing a change would be by licence modification utilising the collective licence modification route. In taking this approach it is important to find the correct balance between a narrowly and broadly drafted licence condition to ensure the requisite level of support from the licensees in question.

If you wish to discuss this further or have any queries please contact me, or David Smith on 01926 655534.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Mark Ripley', with a stylized, cursive style.

Mark Ripley
Regulatory Frameworks Manager