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Dear Siobhan

Certification of transmission system operators under the Third Package – Consultation

We welcome the opportunity to respond to the Ofgem Consultation "Certification of transmission system operators under the Third Package". National Grid, through National Grid Electricity Transmission plc ("NGET") owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator (NETSO), operates the National Electricity Transmission System, which includes both of the Scottish transmission networks and which will, in due course, include offshore transmission systems.

National Grid also, through National Grid Gas plc ("NGG"), owns and operates the gas transmission system in Great Britain and four of eight gas distribution systems in England.

This response is made on behalf of the whole of the National Grid group of companies and comprises two parts – Part 1: general remarks concerning the issues raised by Ofgem's proposed approach, and Part 2: responses to the specific questions raised by Ofgem.
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Introduction and summary

The Third Package of European energy legislation is designed to drive forward the development of the internal markets in gas and electricity. One of the key mechanisms it uses to do this is through requiring the separation (unbundling) of companies engaged in gas and electricity transmission from those engaged in gas production and supply or electricity generation and supply. The certification of Transmission System Operators (TSO) by national regulatory authorities is an important step in confirming that the unbundling requirements have been adequately achieved. We fully support these objectives and look forward to working with Ofgem, DECC and other industry stakeholders in relation to the TSO certification process and the wider Third Package implementation.

We are however, unclear as to how some elements of the GB electricity market frameworks are compatible with the unbundling requirements of the Third Package because they appear to us to represent an industry model that is not provided for by the Third Package. The issue is particularly acute in relation to unbundled offshore transmission companies, but it could also affect Scottish Transmission companies under certain circumstances.

We set out our concerns and the reasoning behind them in detail below. The time remaining for the UK to implement the requirements of the Third Package is tight – particularly if there is the need for

significant changes to the GB market structure (i.e. Code changes, possibly requiring primary legislation) and so we call on Ofgem to clarify its analysis in relation to the areas we have identified as a matter of urgency so that the industry can consider the most appropriate way forward.

I hope that this response is helpful. If you need any clarification on the points made or have any questions please contact Andy Balkwill 01926 65 59 88 or andy.balkwill@uk.ngrid.com in the first instance.

Yours sincerely,

[by e-mail]

Andy Balkwill
Regulatory Policy Manager

Part 1: General remarks

While we welcome the thorough contribution to the debate made by Ofgem in the consultation, we believe that the implementation of the Third Package of European energy legislation:

- may raise significant challenges for the existing electricity regulatory and commercial regime - in Great Britain, especially its extension to offshore transmission networks; but
- presents no material issues in relation to the existing regime governing gas transmission.

Following detailed analysis, we have identified a number of concerns over the compatibility of the existing commercial and regulatory arrangements introduced for BETTA with the fundamental requirements of the Third Package, especially in the context of the separate TO and SO functions offshore. We are concerned Ofgem's analysis does not deal with these issues, being focussed solely on the unbundling/certification issues surrounding the implementation of Articles 9 and 10 of the Directive. As such, the consultation does not address the consequences that unbundling and certification of transmission system operators will have on unbundled TSOs and what they will be required to do in order to ensure compliance with that Directive (and the consequences this may have for BETTA).

We note that there are a number of interrelated and concurrent consultations currently underway, the outcome of which could potentially have a significant impact on the arrangements by which the Third Package will be implemented in Great Britain. Our responses to the issues raised in this consultation are therefore made in the context of the current uncertain background.

We echo Ofgem's concerns that the unbundling rules set out in the Third Package, if read literally, could render them unworkable and unenforceable. As such, we strongly support Ofgem's desire to seek a pragmatic interpretation of the rules, provided that this will genuinely lead to a proportionate and workable implementation, while maintaining the desire for a strict interpretation. For example, we agree that workable rules need to be developed to ensure that:

- the holding of minority shareholdings in a transmission business does not disqualify that business from certification as a TSO, especially where the TSO is publicly listed and, as such, not in control of who owns its shares (and, indeed, may not be aware of the identity of all of its shareholders where those shares are held through nominee accounts); and

- the *de minimis* activities undertaken by TSOs (including NGET) which cannot create any real or perceived conflict of interest in conducting their TSO functions are not prohibited by a too-literal implementation of the rules in the Third Package.

Failure to allow these arrangements to continue would cause unnecessary cost and complexity to the detriment of consumers and the efficient operation of markets (including both energy and capital markets).

Gas Transmission

Ensuring that the requirements of Directive 2009/73 are met in relation to the unbundling of gas transmission from production and supply interests in Great Britain appears to be straightforward. We agree with Ofgem's assessment that the existing arrangements are fully compliant, given the existing industry structure, with the requirements of the Third Package inasmuch as no part of the National Grid group has any interests in gas production or supply.

Electricity Transmission

We consider that the position regarding the implementation of the unbundling rules in relation to electricity is not as straightforward as it is in relation to gas. It appears from the analysis that we have undertaken in the context of DECC and Ofgem's consultations on the unbundling and certification

aspects of the implementation of the Third Package that there appear to be a number of issues that remain unresolved as to how the legislation should be implemented in Great Britain in a manner that does not undermine the existing commercial and regulatory arrangements surrounding BETTA.

Our understanding of the regulatory scheme for transmission system operators created by the Directive is that any party meeting the unbundling requirements of Article 9 should be certified as a transmission system operator under Article 10 and, as a result, "*have responsibility for*" the activities set out in Article 12. The Commission has emphasised this point in its interpretative note on "The Unbundling Regime" at page 5, in stating that

> *"where a Member State has opted for ownership unbundling, … once a choice has been made for a specific TSO to apply one of the unbundling models … all the elements of that model have to be complied with; elements of different models cannot be mixed in order to create a new unbundling model for a TSO which has not been provided for by the Electricity and Gas Directives."*

On this basis, if the regulatory or commercial regime in a Member State were to require a particular TSO to use a third party to carry out the activities set out in Article 12 we would question whether this would have the effect of transferring the responsibilities of the TSO in question to that third party because it seems to be hard to argue that a party can truly be said to have responsibility for something for which it is required to use another party to undertake. As such, we are concerned that this type of arrangement creates a situation in which *"elements of different models"* are being mixed *"to create a new unbundling model for a TSO that has not been provided for"* in the Directive? If this were the case, it appears that any approach to implementation of the Third Package by Ofgem/DECC which will lead to any party which:

- meets the unbundling requirements of Article 9 and is therefore certified as a TSO for the purposes of Article 10 of the Directive; but
- does not extend to that TSO having responsibility for the activities set out in Article 12 of the Directive

appears to be flawed in the context of the Third Package.

Turning to the specifics of the regime in Great Britain, BETTA creates a TO/SO split for transmission licensees by:

1. placing the obligation on NGET to act as system operator ("NETSO") through the obligations in:
    - Condition C16 (Procurement and use of balancing services) of its licence "*to coordinate and direct the flow of electricity onto and over the national electricity transmission system in an efficient, economic and coordinated manner*" (this also makes NGET's licence the "coordination licence" for the purposes of section 91(1) of the Energy Act 2004); and
    - the industry codes; and
2. limiting the obligation on the Scottish licensees (in Condition D2 (Obligation to provide transmission services) to making available their systems available for the transmission of electricity, enabling the NETSO to configure its systems and complying with its directions and ensuring the NETSO has access to the required information). This approach is echoed in condition E15 (Obligation to provide transmission services) of the standard conditions of OFTO licences and further emphasised by the proposed Amended Standard Condition E12 - B2: Activities restrictions for OFTOs which prohibits them from co-ordinating or directing the flow of electricity onto or over the whole or any part of the national electricity transmission system except where permitted to do so under the STC, approved by the Authority, or where required another licence condition.

As such, under the present regulatory and commercial regime in the electricity industry (and the proposed offshore regime), only NGET can truly be said to have "…responsibility for *managing* electricity flows on the system, taking into account exchanges with other interconnected systems…" since it carries out this activity in respect of the whole of the national electricity transmission system pursuant to its licence and the industry codes. Indeed, it appears that only NGET can truly be said to be "responsible for" all the activities for which a transmission system operator is required to be responsible under Article 12 of Directive 2009/72/EC (the "Directive").

We agree with Ofgem's analysis that offshore networks appear to fall within the definition of "transmission systems" in the Directive and that as, for the most part, those offshore networks did not exist as at 3rd September 2009, they must be fully unbundled from generation and supply interests for the purposes of Article 9 of Directive (the ISO, ITO, and derogation models not being available). We also agree that there is no requirement for a TSO to be certified before it commences the activity of transmission (i.e. certification is not required during the construction phase[1]). We consider that the same argument underpins Ofgem's view that a transmission system that has not commenced the activity of transmission cannot be taken to be a transmission system for the purposes of the availability of options other than full ownership unbundling. As such, we agree with Ofgem's view that the only model available for Offshore Transmission Owners is for them to meet the full unbundling requirements of Directive.

If OFTOs are unbundled and certified as TSOs, it appears that the scheme of regulation set out in the Directive requires them to be "responsible for" operating their own transmission systems in accordance with Article 12 of the Directive (specifically "managing electricity flows on the system" and "ensuring the availability of all necessary ancillary services"). However, as set out above, our understanding of the respective roles of NGET as NETSO and OFTOs under their respective licences appears to conflict with this. In particular, it appears that OFTOs cannot, by their licences, be *required* directly or indirectly to subcontract part of the SO function back to NETSO as this would appear to create a model not provided for in the Directive. It would, of course, be open to OFTOs to *choose* to subcontract their SO functions (and the STC allows for subcontracting) but they must remain responsible for those functions in order to comply with the scheme of the Directive.

The comments set out above should not be taken to mean that we are of the view that the Directive prohibits any form of subcontracting: there are clearly many areas of the UK Electricity Transmission activities where sub-contracting currently takes place (e.g. construction of assets, maintenance etc.) but such behaviour does not relieve the licensee of any "responsibility". In this context, we would note that the Directive does not prohibit an OFTO from subcontracting its system operation activities to a generator or supplier, although under the principle of subsidiarity, Ofgem could prohibit this if it were to be of the view that this could lead to a conflict of interest of the kind intended to be addressed by the Directive. For example, licence obligations on TSOs could restrict them to subcontracting particular activities to third parties that met the same level of separation from generation /supply interests as is required by the Directive in relation to the TSOs themselves.

We also note the comments made in paragraph 2.42 of the consultation. We consider that, by the same token, this could be taken to mean that NGET, as a TSO, cannot be prohibited from seeking to develop offshore transmission networks without reference to the tender process, especially as this appears to be one interpretation of the requirements of Article 12(a) and we call on Ofgem and DECC to clarify their positions in the context of the development of the GB regime offshore generally. We therefore call on Ofgem and DECC to clarify their position in this area.

[1] We note that where generators undertake the development of offshore transmission networks (even though such generators may be yet to generate electricity and the networks they are developing may be yet to be made live) there remains the risk for them to behave in ways that the unbundling provisions of the third package were intended to prevent.

Alternative routes for compliance with the unbundling rules

We agree with the DECC analysis and that the ITO model appears to be incompatible with the GB market framework because the ITO model requires the ITO to undertake the full range of SO activities and does not permit the obligations to be discharged by a third party whereas the BETTA model involves SO functions for the Scottish transmission networks being undertaken by NGET as the NETSO. We also agree that unbundling is the preferred route (and the only one available) for offshore networks not in operation on 3 September 2009. In this light, we agree that ownership unbundling is the correct route to be undertaken for OFTOs to comply with the Directive, but seek clarification from Ofgem on the difficulties that this appears to present for the BETTA regime offshore as outlined above.

Derogations from the obligation to unbundled transmission systems for SPTL and SHETL

Ofgem states that the "derogation route" is preferred by SPTL and SHETL and that this is supported by DECC. We consider that, if a derogation is available for SPTL and SHETL, the BETTA arrangements can continue to operate as they are in relation to the transmission of electricity onshore in Great Britain. We also take the view that the availability of a derogation, while being required to be judged against the standard of protection against conflicts of interest set out in the ITO model in the Directive, should be assessed "in the round" rather than on too close a "point by point" analysis of the ITO model. This is because the existing BETTA arrangements do not "map" the ITO model, and too strict an interpretation of the requirements for a derogation might undermine the purpose of the Directive in making this option available.

We note that Ofgem has not addressed in any detail the consequences of such a derogation not being available, either because the Authority or the Commission refuses its grant. The alternative models offered by the Third Package present a number of issues for the BETTA model if a derogation should not be available:

- in the case of the ISO model, there would appear to be the need for a significant transfer of responsibilities from SPTL and/or SHETL to NGET in order to comply with the ISO model as defined in the Third Package. This is what is commonly referred to as a "deep SO" model[2] – or
- if, on the other hand, SHETL and/or SPTL opted for full unbundling then this too raises questions in relation to their ability to fully comply with Article 12 under the existing BETTA framework.

As stated above, we consider that the current UK market arrangements appear to prevent fully unbundled Scottish TOs from taking responsibility for the matters set out in Article 12 of the Directive, and any attempt to prohibit them from seeking full ownership unbundling would appear to fall foul of Article 9(11) of the Directive.

[2] Article 13 (4) of the Electricity Directive: Each independent system operator shall be responsible for granting and managing third-party access, including the collection of access charges, congestion charges, and payments under the inter-transmission system operator compensation mechanism in compliance with Article 13 of Regulation (EC) No 714/2009,as well as for operating, maintaining and developing the transmission system, and for ensuring the long-term ability of the system to meet reasonable demand through investment planning. When developing the transmission system, the independent system operator shall be responsible for planning (including authorisation procedure), construction and commissioning of the new infrastructure. For this purpose, the independent system operator shall act as a transmission system operator in accordance with this Chapter. The transmission system owner shall not be responsible for granting and managing third-party access, nor for investment planning. [Emphasis added]

Part 2 – Responses to consultation questions

Question 1: Have we correctly identified the GB TSOs that require certification? Are there other TSOs that would require certification?

We are confident that Ofgem has correctly identified all of the GB TSOs that need to be considered for certification.

Question 2: Are there reasons why the subsidiaries of National Grid plc that act as TSOs should not be certified according to the OU model? What are these?

We agree with the general approach taken by Ofgem in considering the various ancillary generation and supply activities which it undertakes while seeking to ensure that the purpose behind ownership unbundling is achieved.

In particular, we agree with Ofgem's view that the provision of electricity to substations and stand-by generation activities do not give rise to any issues for certification as they form part of the means by which NGET will discharge its obligations to operate the transmission system under Article 12 of the Directive. As for the three issues that Ofgem considers in more detail in the consultation. We now discuss each of these in turn.

US Interests: it is clear that the holding of interests in generation or supply interests in the US by National Grid cannot have any effect within the EU since, for example, it is practically, economically and, most likely, technically impossible for National Grid's US electricity interests to be connected to any system in the EU. As such, we consider that National Grid's interests in the US cannot give rise to any actual or perceived conflict of interest in Great Britain or any part of the EU and, as such, are outside the jurisdiction of the EU law;

Generation Interests in the UK: Ofgem has granted a consent for up to 8 renewable power plants to be constructed on assets owned by National Grid Gas in the UK. We have been participating in a joint venture (called Blue NG) with 2OC to develop a new type of renewable power plant for use on these sites. We have always been aware that there was a possibility that we would need to divest our interests in Blue NG, and the Ofgem consultation makes clear that this will be required as part of unbundling to meet the requirements of Article 9. We have agreed with 20C that we will now exit Blue-NG during the course of 2011. Both parties are now working together to ensure a smooth exit for National Grid

Provision of electricity: we note and support Ofgem's analysis of the supplies of electricity that we make to Energis. We believe that similar considerations should also apply to Ofgem's analysis of our provision of electricity to tenants or sub-tenants at non-operational sites. We consider that the best means for Ofgem to address these activities is for Ofgem to retain the ability to give consent to transmission licensees to engage in activities such as these, on the grounds that this will enable Ofgem to ensure that the requirements of Directive are implemented in a proportionate manner. That said, we believe that such consents should only be available in limited circumstances, perhaps, where:

- the volumes of electricity (or gas) supplied are insignificant; and
- there is no scope (through the general means by which the gas and electricity markets operate or otherwise) for any conflict of interest to arise between transmission and supply interests as a result of any such supply.

We consider that this approach will allow for a proportionate implementation of the Directive, while adhering to a strong purposive interpretation of the rules.

Question 3: What do you think of our proposed approach to certifying the various interconnectors?

We note Ofgem's analysis that the networks of OFTOs and Interconnector operators are capable of being defined as transmission networks, not least because each of them clearly comprises transmission lines. However, we would also note that the wording of the Third Package as a whole is problematic in this area because the definition of an interconnector in the Directive ("*equipment used to link electricity systems*") does not clearly indicate whether it is intended that interconnectors under separate ownership receive TSO certification. Although Regulation 714/2009 goes further by defining interconnectors as "transmission lines", this does not fully clarify the position. This uncertainty is likely to be due to the regulated nature of interconnectors in Europe whereby most are owned and operated by the existing TSOs and are seen only as an extension of onshore networks. It is because in GB, where interconnectors take on a merchant status, that this issue arises.

That said, if interconnector operators are not certified as TSOs, Ofgem would need to seek a means of dealing with any TSO-type activities undertaken by those parties which otherwise might appear to fall within the definition of "supply activities" (such as balancing management by interconnector operators) in a manner that did not lead to any TSOs under common control with an interconnector operator carrying out these functions failing the test for certification.

We are also mindful that Interconnector policy is an area that is under active consideration by Ofgem, and more widely in Europe, in relation to facilitating market integration. However certification of interconnectors as TSOs could have a number of implications and unexpected consequences and therefore needs to be addressed in a manner that recognises these wider issues and deals with them in a proportionate way.

When considering whether interconnectors should be certified as TSOs, the decision should take into account the following:

a) the ability of an "Interconnector TSO" to retain an exemption under Article 16 of the Regulation. While we do not consider that this is necessarily a problem, as interconnectors in question are separate from the "main" transmission system, we would be very concerned if any approach to certification of TSOs meant that interconnectors ceased to be capable of benefiting from their existing exemptions granted under Regulation 1228/2003;

b) the ability of an "Interconnector TSO" to trade out imbalances resulting from a fault on their interconnector. This is linked to Ofgem's views on "firmness" of interconnector capacity and in this context it is important that all interconnectors/TSOs should be treated the same way. So if the GB adopts a "firm" approach to interconnector capacity (provided via implicit and/or explicit arrangements) in line with the CWE model then the treatment of the imbalances that arise due to interconnector faults should be consistent with this model – the CWE model socialises the ensuing imbalance cost through TSO revenues. As stated above, if carried out by a party which is certified as a TSO, this activity appears to fall within the interconnector operator's responsibilities for managing the flows on its system under Article 12 of the Directive. If the interconnector operator is not a TSO, there is a risk that these activities could be seen to fall within the scope of the definition of "supply" activities in the Directive, with consequences for the certification of TSOs under common control;

c) the need for revision to the industry frameworks to reflect the change of status of interconnectors and their responsibilities for supplying necessary balancing services. If interconnectors become TSOs, the CUSC and Grid Code may no longer seem to represent the appropriate framework and major changes to the STC (or an entirely new document) might be needed to manage the relationships between "network TSOs" and "interconnector TSOs". That said, this might be more of a "housekeeping issue" that could be addressed in time;

d) as TSOs, interconnector operators would be required to undertake the full range of activities set out in the Directive and Regulation. As such, there is a risk that, many of these will place a significant burden on these businesses without any practical additional benefit to consumers. It is important for Ofgem to adopt a proportionate and pragmatic approach to how it requires interconnector operators to deal with these matters if this issue is to not disadvantage consumers by imposing unnecessary costs;

e) regarding participation at ENTSO-E, it not clear what voting rights would apply given that there are no customers directly connected to the interconnector. Ofgem should consider whether it would be appropriate (and proportionate) for "interconnector TSOs" to be represented at ENTSO-E by their "parent" TSO (National Grid / Tennet in the case of BritNed and National Grid / RTE in the case of the IFA);

f) third-party access arrangements in relation to parties seeking physical connection to the HVDC interconnectors would need to be dealt with in a pragmatic manner (e.g. would an interconnector operator effectively be able to refuse access as a result of the physical nature of the HVDC network); and

g) complications will continue to arise over what elements of GB codes, regulations, security standards etc… will need to apply to an interconnector given that the facility must be designed as a whole yet operate in or interface with different jurisdictions with different rules. Proportionate and pragmatic solutions will need to be found to these issues.

Question 4: Do you agree that OFTOs should require certification with respect to the unbundling provisions and be obliged to comply with the ownership unbundling model (with possible exceptions noted below)?

We agree with Ofgem that offshore networks are captured by the requirements of the Third Package and that, as a result, it is necessary for any offshore transmission owner (OFTO) to be certified as a TSO. This means that, when the provisions of Articles 9(1)(a) and 12 of the Directive are considered together, it appears TSO certification carries with it the obligation to fulfil all of the responsibilities of the TSO role under the Directive.

In the light of the comments made in Part 1 of this consultation, we seek clarification of Ofgem's view as to how these obligations can be implemented offshore without significant disruption to the existing BETTA regime.

The key element that remains unclear to us from Ofgem's consultation (and the DECC consultation on implementation of the Third Package) is how the phrase "*each transmission system operator shall be responsible for …*" in Article 12 of the Directive will be interpreted when it is transposed into UK legislation. If a mechanism could be developed whereby the SO element of an OFTO's TSO obligations could be discharged by the NETSO without contravening the Third Package legislation then it is possible that the BETTA regime could survive broadly intact. This would require the OFTO to accept a situation whereby it holds the liability corresponding to the SO element of the TSO duties despite the fact that it would be NGET as NETSO which would execute them. At the very least, legally binding contracts (as well as licence conditions on both the OFTO and NGET) would be required for this arrangement to be enforceable on a working level.

If such a solution is not considered viable and each OFTO, once certified as a TSO, is obliged to carry out all of the responsibilities set out in Article 12 of the Electricity Directive, the notion under BETTA of a NETSO appears to be undermined. In addition, a number of the issues highlighted for interconnectors apply (e.g. revisions to industry frameworks, participation at ENTSO-E, overly bureaucratic requirements etc…). The flip side of this is that OFTOs would also need to carry out a

number of the 'control' functions currently performed by NGET as NETSO at the Electricity National Control Centre (ENCC).

Question 5: Do you consider that the arrangements relating to the Scottish electricity transmission companies guarantee more effective independence of such licensees from the vertically integrated undertakings of which they are part of than the provisions of the ITO model? Why?

Our view on this subject depends on whether the existing arrangements are required to "*guarantee more effective independence… from the vertically integrated undertakings of which they are part of than the provisions of the ITO model*" in the round or whether it is necessary to meet each of the individual provision of the ITO model. From the way that Ofgem describes the issue in paragraph 3.6 of the consultation it would appear that a degree of proportionality will be adopted in assessing whether the test for derogation has been met. As stated above, we agree with this approach being one that looks at the position "in the round" rather than on an "item by item" basis.

With this in mind, we consider that arrangements in Scotland (as at 3rd September 2009) have the potential to guarantee more effective independence from the VIU than the provisions of the ITO model as a result of the fact that NGET (a fully ownership unbundled TSO) performs a number of the TSO tasks outlined in Article 12 in its role as GBSO. However, many of the ITO provisions which form the test are related to issues such as the independence of staff, management etc as set out in Articles 18 and 19 and we are not in a position to comment in any detail on which of these arrangements, if any, are in place.

Question 6: Are there further areas of investigation or clarification we could consider?

The areas of investigation or clarification that we believe may warrant further consideration relate to the situation where a derogation under Article 9(9) is not approved. In this case, the remaining available options would both require significant changes to the current commercial and regulatory framework. Under the ISO model, assuming that NGET were to be proposed by the Scottish TOs, the SO role would have to be much 'deeper' than is currently the case. For example, NGET would be responsible for planning, constructing and commissioning of new infrastructure with the residual TO role consisting only of financing these investments. If full ownership unbundling was to be implemented, the same issues arise as for OFTOs (i.e. the Article 12 duties). This could lead to wholesale unravelling of the BETTA regime in order to comply with the EU legislation.

Question 7: Do you consider our overall approach to the assessment of the Scottish electricity transmission companies against the Article 9(9) derogation appropriate?

We consider that Ofgem's overall approach to the assessment of the Scottish companies appears appropriate. As mentioned above, the question of whether the companies pass the ITO test required for derogation under Article 9(9) must be considered in the round rather than based on meeting the individual provisions of the ITO model. However, as indicated above, we are not able to comment in detail on all the specific matters relevant to the assessment.