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Ofgem
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By e-mail

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Dear Martin,

Re: Ofgem open letter on implementing the European Electricity Target Model in Great Britain

Thank you for the opportunity to respond to Ofgem's open letter on implementing the target model for electricity in GB. We believe that the implementation of the European Electricity Target Model could have some significant implications for GB market participants, particularly with regard to market splitting, and as such we welcome Ofgem's engagement in this area.

The key points of our response are as follows:

- The potential for splitting the current market into smaller zones represents the most important aspect of the Target Model for GB;
- Although we do not hold a position for or against market splitting at this stage, it would have significant ramifications for GB which will need to be fully examined in any review of GB price zones;
- Market splitting aside, we believe that GB's market arrangements are largely aligned to the EU target model and as such large-scale changes are unlikely to be required in this area;
- In particular, we believe that liquidity in the GB market is sufficient to support the target model, and that regulatory intervention is unnecessary in this respect;
- Centrica does not believe that a wholesale review of the impact of EU reforms would be appropriate at this stage;
- The best outcomes can be delivered by continued dialogue and consultation with GB stakeholders, providing increased clarity on the timescales and the end game of the Target Model, and Ofgem playing leading role within Acer, especially with regard to retaining optionality for GB.

1. What are the key aspects of the Target Model for GB?

The potential for market splitting represents the most important aspect for GB. Splitting the current single GB price zone would have significant ramifications on industry parties. Although we do not hold a position for or against market splitting at this stage, given its potential impact, it is essential that Ofgem thoroughly considers, with the input from industry, all of the ramifications on the market, rather than solely basing its assessment on the TSO's market efficiency analysis which has a limited remit. Although not exhaustive, below are some arguments that Ofgem should take into account in any assessment on changing price zones in GB.

- GB market arrangements already contain a number of locational signals and as such market splitting would be an additional layer through the energy price. A locational signal is provided through TEC availability, TNUoS, the Balancing Mechanism and there is also the potential for a locational capacity payment within EMR. Any assessment of market splitting will require consideration of these policy areas to ensure that the correct signal is still provided.

- The draft Capacity Allocation Congestion Management network code provides for bidding zones to be re-assessed by Ofgem every two years, based on analysis from National Grid. This potential adds to the current environment of regulatory instability and acts as a transfer of uncertainty from BSUoS costs to energy prices with the potential of undermining investment confidence. This transfer of risk would particularly impact power stations and holders of power purchase agreements given that they may contain a fixed price element such as a price floor.

- The high-level decision-making principles set out in the draft code appear to provide TSOs with a significant amount of responsibility with regard to defining bidding zones. Furthermore, the conditions under which NRAs should approve the formation of new zones are only loosely defined in Article 34 which creates a significant amount of uncertainty for market participants. In order to minimise this uncertainty it is essential that, as soon as possible, Ofgem lay out the conditions under which it would contemplate splitting the market in GB, the consultation process it would undertake with stakeholders and the implementation process that would ensue.

- Ofgem highlights the importance of liquidity to the EU target model and implies that liquidity may need to be further developed. To be clear, Centrica believes that liquidity in the GB market is sufficient to support the target model. Consequently, we believe that further regulatory intervention would be unnecessary in this respect and that liquidity does not need to be a key consideration in any assessment of bidding zones. The chart below demonstrates how day-ahead volumes on the N2EX day-ahead auction have grown exponentially since its launch in January 2010 and that any concerns over GB lacking liquidity are unfounded.
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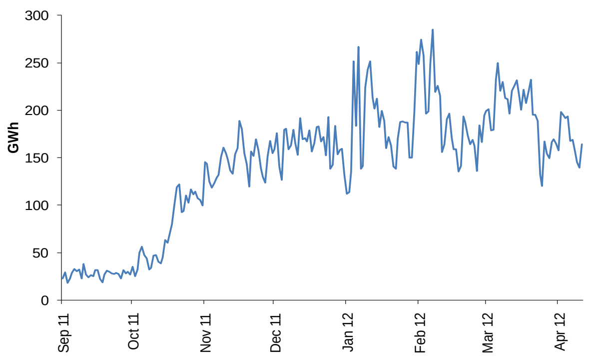
Figure 1: Volumes traded in the N2EX day-ahead auction



- A key consideration of separating the market into smaller zones is that it inevitably reduces the number of participants in each zone and can increase the potential of market power exercise. Currently, locational market power can only be exercised in the Balancing Mechanism and a ‘tailored’ monitoring regime, the TCLC, has been developed to address this issue. Market splitting may require a more systematic approach to market monitoring.

- Market splitting shifts the responsibility for managing constraints on key borders from the system operator to market participants. The case for doing this states that it is ultimately more efficient for market participants, through a locational energy price, to solve constraints rather than the TSO. However, in order for market participants to respond efficiently they need to have the confidence of a stable price zone boundary. If capacity is calculated using the flow-based methodology, the capacity rating and the physical location of the optimal zonal boundary will be dynamic and market participants will not be able to take a forward view. In this case it could be argued the TSOs have the best knowledge of the capacity on the boundary and as such are best placed to manage the constraints efficiently. An additional consideration on moving the responsibility from TSOs to solve constraints is that it could lower the incentive for required network investment and have implications for TSOs’ long term investment plans.

2. What changes will be needed to GB market arrangements?

GB’s self-dispatch arrangements, coupled with a liquid day-ahead and intra-day market, mean that market arrangements start from a position that are largely aligned to the EU target model relative to central dispatch markets such as the SEM in Ireland or MIBEL in Spain and Portugal. In addition, the introduction of market coupling on a proportion of Britned’s capacity has been undertaken without any notable issues. As mentioned above, by far the most significant impact on market participants is the potential for market splitting.

As the network codes are not yet complete it is impossible to list all of the changes that will be required. Market splitting aside, it is likely that the majority of changes will not be require significant amendments to the current arrangements. Changes of this type are already taking place with the reclassification of interconnectors as transmission and the subsequent removal of TNUoS, BSUoS and transmission losses. A future change that is currently visible will be the obligation on market participants to provide commercial data (availability, PNs, bid offer and dynamic data) two days before real time to input into the Common Grid model. This and other similar changes could have IS implications and as such a sufficiently long lead time for implementation will be required.

We should not, nevertheless, preclude the possibility of more significant changes. For example, the draft Framework Guidelines on Balancing state that balancing actions should be priced at pay-as-cleared price rather than the current pay-as-bid price. This would represent a significant change.

3. Should we try and minimise change or consider holistically GB and EU requirements?

Whilst Centrica does not believe that change should necessarily be minimised, we do not think that a holisitic review of market arrangements would be appropriate for a number of reasons. First, given that GB arrangements are largely aligned with European Target Model, any holistic review is unlikely to result in any recommendations that are substantially different to the status quo. Second, a review would create a significant amount of uncertainty and may paralyse investment in some areas. As well as acting as an additional element of uncertainty to current ongoing policy developments such as EMR, liquidity, cash-out and project TransmiT, any measures taken on the back of a holistic review are likely to have significant interactions with these developments and could end up burdening industry with unnecessary legislation. Third, given the 2014 deadline for implementing the EU target model, the timescales are unlikely to allow for a large-scale review and the implementation of its findings. Such a review could distract from the Framework Guideline and Network code process which is proceeding at a fast pace and is already demanding significant resource from industry. A more beneficial solution is likely to be continued engagement between Ofgem and all stakeholders in order to influence and assess ongoing developments.

Nevertheless, whilst we do not believe that such a wholesale review is necessary, it is vital that Ofgem holistically considers the compatibility of the EU target model when developing GB policy in areas such as liquidity, cash-out and project TransmiT in order to avoid, where possible, any obvious contradictions.

4. How can we deliver the best outcomes / what process is needed to take this work forward?

There are a number of areas where Ofgem can contribute to delivering a positive outturn for GB. First, it is essential that Ofgem remains a leading member of Acer, representing the interests of GB when drafting of Framework Guidelines, especially with regard to retaining optionality, and assessing the alignment of the Network Codes to the Framework Guidelines. The experience to date of the Requirements for Generators code highlights the importance of the latter. Continued dialogue with industry is also essential through formal consultation, open letters and stakeholder events such as that held on 30th April. Second, as discussed above, the European Target Model represents a significant amount of uncertainty for industry players and as such any clarification and insight that Ofgem can provide will be highly useful. More specifically, the European Target model currently appears somewhat abstract and to this end we would welcome from Ofgem and Acer clearer timescales of what will happen and an explanation of the expected end game for GB. Finally, as noted above, it is of the utmost importance that Ofgem considers the interactions between the Target Model and its other prevailing policy developments such as liquidity, EMR, and cash-out. It is not clear that this is currently happening. The failure to do this is likely to lead to the requirement for changes to be made in these areas a short time after implementation. A key area where consideration is required is the interaction of the Framework Guidelines on Balancing, which prescribe some detailed arrangements for pricing imbalance, and Ofgem's upcoming SCR on cash-out.

I hope these comments have been useful. In the meantime, if you have any questions, please do not hesitate to contact me on 07789 579169 or at Ricky.Hill@centrica.com.

Kind regards,

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