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Dear Martin

ENERGY UK RESPONSE TO OFGEM OPEN LETTER ON IMPLEMENTING THE EUROPEAN ELECTRICITY TARGET MODEL IN GREAT BRITAIN

Energy UK welcomes the opportunity to respond to Ofgem's open letter on implementing the target model for electricity in GB. Energy UK supports the development of integrated EU markets in electricity and gas, which should bring benefits for GB in terms of greater market efficiency, improved security of supply and more competitive customer prices.

Main Points

- The EU energy liberalisation agenda should focus on removing key barriers to trade rather than on full harmonisation of market design;
- In the short term the Target Model is unlikely to mean major changes for the GB market but this could change over time;
- The assessment of bidding zones (potential market splitting) is the major issue raised for GB at this stage;
- Some elements of the Target Model have not been set out in any detail and greater clarity would be beneficial for GB stakeholders;
- The Target Model is broadly compatible with EMR but issues could emerge in the detailed design phase of EMR;
- Ofgem should take an holistic approach to EU regulation but should ensure that the costs and benefits of implementation options are thoroughly assessed; ACER should also place greater emphasis on cost-benefit assessment;
- Ofgem should ensure that its domestic regulatory agenda is fully aligned with EU developments; initiatives which could cut across areas of future EU work should be avoided;
- Ofgem should continue to play an active role within ACER and should engage with GB stakeholders as early and as comprehensively as possible;
- Adequate timescales should be allowed for national implementation of Guidelines and Network Codes;
- It should be a priority to involve market players more directly in the Network Code process.

Energy markets across Europe are likely to change considerably over the next few years. It follows that a strategic vision such as the Target Model is necessary to promote convergence across the EU as markets adjust to the changing policy agenda, but this vision should be implemented in a pragmatic way, not as an objective to be pursued whatever the circumstances. Many of the details of the target model still need to be finalised, notably in respect of the intra-day market, and it is important that each set of proposals is subject to full regulatory impact assessment and that implementation is carefully monitored.

While much effort has gone into discussion of cross-border trade issues, it must be remembered that greater physical interconnection is needed if a true single market is to be achieved. This is particularly the case for regions such as France-UK-Ireland, where there is relatively weak interconnection and where the costs of market integration could outweigh the benefits unless more physical infrastructure is put in place.

Progress has been made towards integrating European power markets, but some aspects of current EU energy policy pose a potential threat to the development of a competitive market. Europe is rightly promoting more renewable energy production, but so far much of this has been done through non-market-based approaches, which are effectively removing increasing amounts of capacity from the competitive wholesale market. This is also causing problems on the European interconnected network and resulting in a reduction in the capacity available for cross-border trade. As the share of renewables rises to meet the 2020 targets, the issue of integrating these technologies in the market will need to be addressed.

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

Energy UK believes that the alignment of mechanisms for cross-border trade is the key element in terms of delivering benefits for the GB market. Issues without a major impact on trade should take on a lower level of priority.

The most important aspect of the current Target Model is the potential for splitting the existing market into zones. Energy UK does not have a position on market splitting at this stage but emphasises that the implications for the GB market should be very carefully considered before any decision is taken. The assumption that markets should follow national borders could be viewed as incompatible with the concept of a European market. On the other hand, the prospect of zones being changed on a two-yearly basis could result in uncertainty and damage investor confidence. The impact of market splitting on liquidity and the interaction with EMR, e.g. the implications for the CfD reference price, also need to be thoroughly examined. Ofgem should set out as early as possible the process it plans to follow and the factors to be considered in tackling this review.

As more intermittent generation comes onto the system, liquid intra-day markets will become increasingly important. Intra-day trading is already well developed in GB, but this is not the case in most of continental Europe and priority therefore needs to be given to this aspect of market design. Energy UK emphasises the need to maintain a choice between OTC and exchange-based trading across interconnectors in the intra-day market.

Energy UK supports the proposal to develop forward markets based on long-term rights to interconnector capacity. This should allow improved hedging opportunities for GB market players. Consideration will need to be given to incorporating such rights into the GB market regime.

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

The GB energy market is among the most competitive in Europe and already complies with most elements of the Target Model. In the short term, the amount of change required is likely to be relatively limited, though this could change as the European market evolves.

Day-ahead implicit auctions have already been introduced on the BritNed interconnector without any major problems and day-ahead liquidity in GB continues to improve. In this respect the Target Model fits well with current GB developments. Major changes at the day-ahead and intra-day timescales therefore should not be needed. Energy UK notes, however, that there are some suggestions that TSO would require additional economic data from market players, e.g. at the D-2 stage to allow them to manage the system more effectively. Energy UK does not believe that such measures are needed, given that TSOs already have all the historic data and that the situation at D-2 may in any case change significantly before real time.

Discussions on balancing arrangements at European level are not yet well advanced. However, Energy UK notes that the draft Framework Guideline recently produced by ACER calls for balancing actions to be priced as pay-as-cleared rather than the current pay-as-bid arrangements in the UK. This would clearly represent a major change if it were decided, though harmonisation of national balancing arrangements will probably take some time to agree.

As the open letter mentions, some changes to the GB charging regime for interconnectors are already underway. Energy UK believes that all specific charges and reserve prices on interconnectors need to be removed if the full benefits of cross-border trade are to be obtained. At the same time, Ofgem's review of transmission charging needs to take into account the broader European picture and notably the fact that GB generators are disadvantaged by having to pay TNUoS and BSUoS charges, when in much of Europe the average G charge is 0. Finally, to ensure optimum use of cross-border capacity, an alignment of trading timetables and some harmonisation of products would be sensible.

Energy UK agrees with Ofgem's statement that EMR is broadly compatible with the Target Model. However, issues may arise in the detailed design of EMR or indeed market reform in other countries. For instance, a series of different capacity mechanisms across Europe could potentially distort trade and there may be a case for harmonising them at least at the level of principles.

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

A single market in energy should be beneficial to GB and will come to have a greater impact as more physical interconnection is built. Over time an increasing number of regulatory changes will probably be needed anyway to implement EU legislation. In this light it makes sense to take a holistic approach rather than to attempt systematically to reduce the impact of the European market. In particular, Ofgem's GB market work should take full account of likely developments in the EU and new initiatives should be avoided if they overlap or conflict with European ones. There are clear interactions between a number of ongoing Ofgem projects, e.g. Project TransmiT and the cash-out review, and upcoming European initiatives on transmission charging and balancing. Care has to be taken to avoid overloading market players with regulatory initiatives and in particular introducing changes which are incompatible with the EU market and later have to be unwound. The 2007 Davidson Review[1] proposed that the UK Government "should not generally pre-empt European

[1] Transposition Guide: how to implement European Directives effectively

legislation by legislating in the same area". Energy UK believes that Ofgem should also apply this principle to GB regulatory changes.

While Energy UK supports a "joined-up" approach to policy, we believe that Europe should aim at a convergence of national markets and removing the key barriers to trade, rather than harmonisation of every market detail. Changes in market design can be expensive and full impact assessment and cost-benefit analysis is needed to ensure that the right implementation options are chosen.

4. How can we deliver the best outcomes?

Both DECC and Ofgem should continue to press for a more open European market in energy. Ofgem should be fully involved in ACER, particularly in the process of producing Guidelines and Network Codes, and should consult with GB stakeholders as early and as comprehensively as possible. Ofgem should also start to consider GB implementation issues as soon as the "direction of travel" of EU policy is clear – this is often a long time before the final legislation is actually published.

It is essential that reasonable implementation timescales are built into the Guidelines and Network Codes. A recent example of poor regulatory practice has been the adoption of the EU Regulation on Energy Market Integrity & Transparency (REMIT), which was rushed through for political reasons, without sufficient consideration to the clarity of the text. In particular, REMIT introduced two prohibitions before setting out compliance requirements and enforcement mechanisms. The result has been considerable regulatory uncertainty for market players. Implementation timescales for Network Codes will often need to take into account the time needed to procure and commission IT systems, if unnecessary costs are to be avoided.

The Target Model has not been set out in any detail and Energy UK would like to see ACER provide clarification on the substance and the planned timescales, which will allow GB market players to prepare more effectively. As mentioned above, Ofgem should ensure that its domestic regulatory agenda is fully aligned with likely European developments.

In parallel with the EU-wide process, continuing efforts should be made to integrate markets on a regional basis. This can allow practical experience to be obtained before EU-wide solutions are attempted and can facilitate more rapid progress among those countries which already have similar market designs. While much attention will inevitably be devoted to the continental market, it is important that integration with the All-Island Market, which is further removed from the Target Model, is not forgotten.

5. What process is needed to take this work forward?

The major problem in the current EU process is that ENTSO-E is responsible for drafting the Network Codes, but is not impartial and has its own commercial interests. This has been particularly evident in the Connection Requirements for Generators Code, which has sought to shift major costs and risks from TSOs onto generators. The Third Package envisages that market players should be able to propose amendments to Network Codes and Energy UK believes it important that ACER should establish an effective process for this as a matter of priority. In the medium term, the Guideline/Code process needs to move towards a more balanced system of industry governance, on the lines of that existing in GB. For the immediate future, ACER needs to scrutinise ENTSO-E drafts with considerable care, in particular in areas where national TSOs have a commercial interest.

In the process of producing Network Codes it is not entirely clear who is responsible for analysing the costs and benefits of the proposals. The European Commission is required to undertake an impact assessment at the end of the process, but this is likely to come at a stage when the major policy options have been decided (since ACER will have approved the ENTSO-E draft). Consequently, Energy UK believes that ACER should take on this responsibility, which could if necessary be delegated to specialist consultants.

Yours sincerely,

David Porter
Chief Executive