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Dear Martin

Implementing the European Target Model in Great Britain

E.ON supports the broad vision of a single European market set out in the Target Model. We therefore believe it is important that Ofgem, the Government and GB stakeholders continue to positively engage in the process to help deliver this vision.

It is fair to say however, that that some aspects of the current GB market arrangements (BETTA) make adoption of the Target Model more difficult than in some other member states. This means that compromises will have to be made to ensure we retain important features of the GB regime whilst not compromising the essential features of the Target Model. In addition there are certain pro-competitive features inherent in current GB arrangements that could be applied elsewhere in Europe and contribute to improving the likely effectiveness of the Target Model. A number of these design features could be reasonably be included into the eventual enduring single market arrangements and are set out below.

As part of the process of agreement between member states and the plan for greater harmonisation of market arrangements we would like to see the eventual wider adoption of competitive market principles going beyond the mainly short-term optimisation of use of cross border capacity; this might include matters such as, greater cost targeting (e.g. network charges related to the costs users 'cause' or drive in terms of the development and operation of transmission systems), greater cost reflectivity though wider adoption of locational transmission charges and consideration of the adoption of a 'shallowish' connection policy model with the majority of cost recovery coming from on-going use of system, rather than up-front connection charges.

Consistent treatment of these underlying user costs would help avoid distortions in the price formation process of the implicit auctions, improving the efficient allocation of cross border capacity and in turn trade between member states. Adoption of particular measures should also improve long term investment signals and help reduce inefficient congestion at cross border

points as well as the money transfers required as part of the inter-TSO compensation scheme. The policy stance of Ofgem and its predecessor Offer on each of the above broad economic principles is a sound and long standing one. We therefore think it is important for Britain to 'bring these matters the table' as part of the agreement on the detailed design of a single European electricity market.

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

It is the shift to European wide market-coupling with implicit auctions rather than separate allocation of energy and capacity at cross-border points that is at the heart of these proposals. The simultaneous allocation of energy and capacity at the day-ahead stage is different in approach to the continuous uncoordinated trading of energy (both over the counter and exchanged based) and separate allocation of capacity rights currently facilitated by BETTA.

Other than transactions in the balancing mechanism BETTA doesn't prescribe how and when market participants should trade energy, indeed this was seen at the time as a key benefit of the arrangements compared to the previous centralised price setting mechanism of the Pool. This lack of prescription does however mean that the 'top down' rule based approach of the Target Model can be overlaid on the GB regime.

If market areas are delineated appropriately so as not to include 'structural' congestion (i.e. significant network bottlenecks that persist for long periods¹) within those market areas, the Target Model is likely to lead to more efficient utilisation of EU transmission systems. In this context the concept of price zones and market splitting both spanning member states or within member states is helpful (for example Scotland in theory could become a separate price zone from England and Wales). However, it should be noted that Third Package is framed in such a way as to apply to cross border matters between member states rather than arrangements within a member state.

One essential feature of the Target Model is the need to develop long-term financially firm cross-border transmission rights. This will provide an important tool for players to hedge their risks across the interconnectors to continental Europe.

What changes will be needed to GB market arrangements?

There is always a risk that integration of market arrangements may result in adoption of the standards of the lowest. In contrast we view much of the Target Model as a 'levelling-up' exercise in which GB arrangements are improved by adoption of practices that have been successful in other member states; for example greater market coupling through implicit auctions and driving more exchanged based trading are to be welcomed. However, there are other changes that may appear to be detrimental from a GB perspective or could become so if other consequential changes are not made to arrangements in other member states. We need to make the right choices on the former and advocate further appropriate changes for the latter.

Relevant changes;

¹ Relief of such congestion will require investment. If grid investment is unlikely to relieve such constraints in the near future it would seem appropriate to split market areas.

1. Removal of TNUoS charges to interconnector power flows to/from GB (implemented).
2. 100% recovery of TNUoS from demand (including retention of locational charges so that positive and negative charges for generators recover in aggregate 0% ($G_{ave}=0$)). A logical means of aligning GB arrangements closer to those of many other member states, but without losing the benefits of locational charges within GB (not currently under consideration).
3. Removal of BSUoS charges to interconnector power flows to/from GB (currently under consideration).
4. Point 3 plus 100% recovery of all BSUoS from demand (currently under consideration)
5. Point 3, plus point 4 plus removal of generation from the residual cash flow residual cash flow (RCRC) calculation, i.e. the excluded party will not receive or pay any excess or shortfall of cash arising from balancing costs less cash-out payments/receipts (not currently under formal consideration).

GB generators would be disadvantaged if they have to pay for transmission, BSUoS charges or have to make residual cash-flow payments, where importers of power generated in other member states are able to avoid such charges/payments. In our view the greatest parity between GB generators and those in adjacent member states linked by the interconnectors would be best achieved through implementation of points 1, 2, and 5, including the adoption of GB style locational charging arrangements with $G_{ave}=0$.

Clearly some of these changes would result in significant redistribution affects between interconnector users and other users as well as amongst generators and between generators and suppliers. Hence consideration would need to be given to when best to implement changes. In the case of changes to transmission charges set out in point 2 and BSUoS under point 4 and 5 a minimum 2 year lead time would be required. This is because the purchasing and hedging strategies of suppliers typically extend up to 2 years forward, and it would take this time for the lower costs faced by generators to be passed through to them.

One key factor that needs to be considered is how National Grid as the GB SO forms a view of what generation plant is likely to be scheduled to meet forecast demand at the day-ahead stage, so that this can in turn be used in the market coupling algorithms to optimise anticipated use of cross-border capacity at that point in time. It would not necessarily be a problem if the GB SO uses its own market view and models to assess the likely merit order of generation plant in GB, but it could become more complicated if market participants were required to give a view of their planned dispatch at the day-ahead stage.

Clearly one of the benefits of the self-dispatch model under BETTA is that it allows GB generators to notify their final physical notifications just before gate closure (1 ½ hours ahead) and this allows the market participants to dynamically respond to changing market conditions. Under the Target Model a 'snap shot' view of anticipated power flows within each coupled market is required and it is this information that is used together with the prices from implicit auctions to seek to make best economic use of cross-border capacity. From that point onwards the cross border power flows may need to alter in response to changes in the positions of market participants operating in the respective markets.

In GB any SO re-dispatch will typically take place after gate closure (<1 ½ hours ahead) in the balancing mechanism with generators continuing to self-dispatching before then, whereas on the continent it is more typical for changes in scheduling plant to be managed within-day through re-dispatch by the SO. It will be important to ensure that the implications of these key differences between the GB regime and adjacent national regimes are considered, and solutions found, before applying the Target Model. In general we think the different dispatch approaches can be managed perhaps at the cost of some loss of efficiency in scheduling both cross border power flows and generation plant within particular markets. However, it is clear that in future the increased level of intermittent generation on the GB system will require more active and complex within-day balancing by the GB SO. The implementation of the Target Model thus perhaps provides an opportunity to adapt some of the GB SO balancing arrangements to make them more relevant to a world where the generation mix will be significantly different than that of today.

The market-coupling arrangements that exist in parts of Europe can suffer from a lack of transparency in relation to how the market-coupling calculations are applied. In this regard there is a sense that the SOs and exchange operators know best and information is provide on a 'need to know basis,' whereas it is our view that the best interests of market efficiency are best served if there is full transparency. Publication of the detailed processes, methodologies, procedures and the algorithms to be applied by the exchange operator and SOs in the process of optimising cross border power is required to give confidence in these new arrangements.

Another relatively straight forward change that will be required is the change to the calculation of the Market Reference Price by Elexon if, in due course, day ahead prices are to be determined by the GB price from the implicit auctions.

Should we try to minimise change or consider holistically the best combination of GB and EU requirements?

In our view, seeking to minimise change is not a stance that is likely to achieve the best outcome for GB. It now seems inevitable that in the electricity market at least, GB will be integrated with other European markets through market-coupling. On balance the Target Model s positive for trade (e.g. the export of excess power produced from GB wind-farm) and it helps underpin security of supply in a more integrated world in which more interconnection will help us manage intermittency.

It is helpful that the day ahead implicit auctions for cross-border capacity fit well the Government's EMR proposals and Ofgem and the industry's joint aspirations to encourage more liquidity. Concentrating liquidity through one platform and coupling markets to provide a wider liquidity pool, should help facilitate the establishment of more reliable day-ahead reference price against which forward financial contracts can be struck.

A more holistic approach that not only combines the best of GB and EU arrangements, but also involves Ofgem, the Government and GB stakeholders advocating the appropriate adoption of the best of GB arrangements by other member states offers the best chance of delivering the best for GB in the long run.

How can we deliver the best outcomes?

The best outcome for GB is likely to be served by embracing the core principles and design features of the Target Model whilst advocating a step by step approach to its implementation. As the Target Model is an ambitious and radical 'top-down' vision its implementation across all member states is unlikely to be straight-forward. Doing too much too soon risks failure of the whole project and we think it would be best to follow a route that quickly establishes the key elements of the target model and then through refinements and incremental change build a robust enduring solution. This would also allow GB to argue for wider adoption of important and related competitive market principles such as cost targeting, cost-reflectivity and promoting efficient market entry/exit described above.

Also continuing the co-operative stance with our fellow Europeans may make EU institutions more amenable to home grown GB developments, which inevitably have knock on implications for EU energy policy and policy within other member states. The need for a capacity mechanism to help ensure future security of supply, and CfDs to support investment in low carbon generation (particularly nuclear) are the most obvious examples.

What process is needed to take this forward?

It is difficult for GB stakeholders to influence these developments as much as we would wish or to the same degree as we are used to when dealing with home grown changes but the challenge is to work within the processes established.

Clearly we will continue to use the formal consultation processes established by the Commission, ACER, and ENTSOE to make comments on the development of the relevant EU Network Codes, such as Capacity Allocation and Congestion Management (CACM). Nevertheless we think that the most helpful processes at a national level are those that allow proposed European changes to be discussed with relevant GB stakeholders as early as is practicable, and ideally at the formative stage. Thus the work of the National Grid Joint European Standing Group and the DECC – Ofgem stakeholder groups are most worthwhile. We think Ofgem's and DECC's negotiating positions will be enhanced if Ofgem, from time to time, hold subject specific Ofgem workshops so that views, ideas and positions of stakeholders active in the GB market can be better understood.

We trust you find this information helpful. Please feel free to me a call if you wish to discuss our submission.

Yours sincerely

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