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Dear Martin

Open Letter: Implementing the European Electricity Target Model in Great Britain

Thank you for the opportunity to respond to the Open Letter on implementing the European Electricity Target Model in GB.

This response is provided on behalf of National Grid which owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator (NETSO), operates the Scottish high voltage and offshore transmission system.

In the UK, our primary duty under the Electricity Act is to develop and maintain efficient coordinated and economical systems and also facilitate competition in the generation and supply of electricity. Our activities include the residual balancing in close to real time of the electricity market.

Through our subsidiaries, National Grid also owns the electricity Interconnectors between England and France, and between England and the Netherlands (jointly with RTE and TenneT respectively).

As National Grid Electricity Transmission plc, we are also an active member of ENTSO-E and as such have been a key contributor to the draft Capacity Allocation and Congestion Management (CACM) network code.

This response is written in two parts:

- General comments on the Target Model in the main body, and
- High level responses to the specific questions asked in the Open Letter included in Annex 1.

The general comments cover the open letter, the CACM Framework Guidelines¹ produced by ACER and the draft CACM network code² currently under consultation by ENTSO-E.

¹[http://www.acer.europa.eu/portal/page/portal/ACER_HOME/Activities/FG_code_development/Electricity/FG-2011-E-002%20\(Final\).pdf](http://www.acer.europa.eu/portal/page/portal/ACER_HOME/Activities/FG_code_development/Electricity/FG-2011-E-002%20(Final).pdf)

²<https://www.entsoe.eu/consultations/document/docdetails.do?uid=0004-4926-1a15-166f-fee8&%20>

Objectives of the internal electricity market

The creation of a genuine internal market for energy is one of the European Union's priority objectives. Amongst other things, this seeks to increase market accessibility (especially for small and renewable investors), keeping prices as low as possible for consumers and facilitating security of supply. A central tenet of this is that a truly integrated market will contribute to diversification and thus security of supply. Having identified that barriers to competition remain in the internal electricity market, the Third Package was adopted. The CACM Framework Guidelines and network code form part of the measures envisaged under the Third Package. CACM is intended to work alongside several other network codes, including Balancing and System Operation. These will combine to deliver the Target Model. The focus of the Third Package is on market integration and proportionality and we believe this must be borne in mind when considering the implementation of the European Target Model in Great Britain.

Assessing the impact of European developments

The Open Letter states that '*The impact on GB will be significant*'. We would broadly agree with this assessment but believe the impact may come in stages. For example, the initial introduction of Day Ahead market coupling (and co-ordination of all other capacity product offerings) is of lesser impact on the market than zone delineation. However, the impact of even these initial changes on existing and future interconnectors to/from GB (and the TSOs who own them) could be significant depending upon how GB regulates these investments. It will be important to ensure that implementing the target model does not act as a disincentive to those wishing to invest in future interconnectors; nor those operating existing capacity.

At this stage, given the status of developments, it is too early to ascertain the full impact and any approach to determine potential implications must be viewed in this light. Our approach to working within ENTSO-E on the drafting of the CACM code has been to pursue realisation of the relevant objectives while minimising impact on existing market structure and processes. Alongside this we have been actively involved in relevant regional initiatives that have been established to bring market participants together to test solutions for cross-border integration, carry out early implementation of European legislation and support the development of best practice. We consider this to be a proportionate approach to European developments and consistent with the aims of the Third Package.

At the end of the network code development stage undertaken by ENTSO-E, the network codes are required to go through comitology to determine the resultant legislation. As such clarity on the final requirements of the Target Model and GB impact cannot be attained definitively at this time. Moreover, the timeline stipulated for development of the different network codes makes delivery of all relevant network codes in a coordinated manner much harder. However, we acknowledge that it is useful to begin to form a view based on the Framework Guideline and draft network code.

It is vital that all relevant parties are involved in considering the impact and implementation – this includes Ofgem, DECC, the industry and any other interested parties. Throughout this process, consideration must be given to wider implications such as the potential to introduce an additional layer of uncertainty to investment decisions, implications of which would be contrary to the wider European objectives.

High level implications of the Target Model

Roles in bidding zone definition

The 3rd Package and the CACM Framework Guidelines lay out a requirement for '*delimitation of zones to be reviewed*'. The draft CACM network code proposes a two stage approach to consider bidding zone configuration. This sees preparation of a biennial report to identify if there is a requirement to launch a regional process to study bidding zone configuration; followed by a regional study as appropriate. As outlined in the Open Letter this will see TSOs (for GB we presume the NETSO) prepare an initial analysis of zones which will be evaluated and approved by NRAs.

On a TSO level the analysis required, as stipulated in the Framework Guideline, is far reaching covering all economic, technical and legal aspects of relevance. It is important to note that this will be resource and cost intensive to produce and review on a biennial basis.

The CACM Framework Guidelines are not entirely clear about where responsibilities lie between TSOs and NRAs. For instance, the code suggests that ..' *NRAs shall assess the delimitation of zones against the criteria of overall market efficiency.*' Whilst TSOs should be mindful of effects on the wider market operation, it is not clear to us that all TSOs are best placed to assess implications such as 'liquidity'. Within GB, possibly reflecting the disaggregated roles, market economics reviews have been conducted by Ofgem. Therefore this appears to suggest quite a fundamental role change in GB.

Interconnectors

We note that the Target Model has implications for the current 'non-regulated' (i.e. non-price controlled by revenue or RoR) approach to existing interconnector infrastructure³, and also for potential investment in future projects. The adoption of the Target Model, whilst seeking to deliver benefits to end consumers, leads to a significant change in the risk profile faced by existing investments with both operational and revenue implications for interconnector operators. . We note the importance of regulatory certainty for existing and new interconnector investments if they are intended to facilitate the aims of the Target Model.

Recent and ongoing developments

From a GB perspective it is relevant to consider recent and ongoing developments which may have a bearing on discussion of the Target Model.

- **Connect and Manage:** Within GB, Connect and Manage went live on 11 August 2010. The regime allows generation projects to connect to the transmission system in advance of the completion of the wider transmission reinforcement works (effectively over-allocating capacity). Connecting generators ahead of the completion of wider works may result in additional constraints on the transmission system. Under Connect and Manage any costs arising from the management of these constraints are socialised (our licence prohibits targeting the cost of this over-allocation). DECC took the decision to implement Connect and Manage in order to facilitate the timely connection of new generation (particularly renewables) to the transmission network.

A real time locational energy price differential (taking account of network capacities based on different zones) could be distorted by the over allocation of capacity under Connect and Manage. Given the extensive work involved in developing and delivering Connect and Manage, we would imagine that it is vital that the Target Model does not undermine these arrangements. Connect and Manage was designed to expedite the connection of new generation, it is therefore equally important that the Target Model seeks to minimise uncertainty for investors to ensure the necessary investment is still able to take place and the wider European targets remain realisable.

- **Interaction with TransmiT and TNUoS:** TNUoS provides a Long Run Marginal Cost signal based on Investment Cost Related Pricing (ICRP). This is a generic methodology that seeks to incentivise participants to locate and continue to be located efficiently i.e. take account of transmission costs when locating or deciding to close.

This is likely to change under the TransmiT Significant Code Review – with cost sharing being introduced (which seeks to apportion cost of investments whilst implicitly taking account that users are more likely to share the system in the future (i.e. transmission capacity will not be designed to

³ While Ofgem have always regarded the IFA as a “regulated” interconnector we note that given its revenues are entirely dependent on market conditions and it has never be underwritten by or received any support from consumers, it is to all intents and purposes an investment whose risks and rewards National Grid shareholders are entirely exposed to..

accommodate 100% of generation)) and charging solutions sought in respect of the incorporation of HVDC links and Islands.

The Target Model (based on our interpretation) potentially provides a Short Run Marginal Cost approach with the costs of major boundaries included in the energy price on either side of the boundary i.e. a varying locational energy price. Parties would hedge the volatility in Short Run Marginal Cost through hedging products. Hedging contracts and associated practicalities of transmission investment are difficult to establish. This would need to be approached at a European and/or regional level to ensure consistency and would need to be delivered in such a way as to not undermine investor confidence. We also note that the absolute recovery of transmission charges between generation and demand is different between member states, which potentially creates disjoint at member state boundaries, which could affect overall competition.

We note that in developing the CACM Framework Guidelines ACER indicated that *'that moving to FTRs is not the highest priority.'* Whilst we fully support this in the context of unchanged existing zones and coupling of zones, this is clearly not the case where existing zones are split. Should it be decided that the existing GB market could be split, Ofgem should carefully consider the need for hedging contracts to avoid any increase in investor uncertainty.

- **Other ongoing GB developments:** The impact of the Electricity Market Reform work and the Cash-Out Significant Code Review will need to be carefully considered.
- **Other European network codes:** It will be important to understand the interactions with other network codes including Forwards, Balancing and System Operation as they emerge. Timing stipulated for the development of the different network codes makes understanding and addressing the interactions in a co-ordinated manner challenging.
- **Locational losses:** BSC modification proposal P229 was raised by RWE Npower on 28 November 2008 and sought to introduce a seasonal zonal transmission losses scheme – allocating costs of variable losses in a more cost reflective manner. The proposal was rejected, amongst other things, due to the context of the changing external environment including the European drive for integration. We note that consideration of predictable and accurate losses by participants is an important factor in delivering an efficient real-time despatch solution. However, this must be a pan-European solution to avoid distortions between market participants who may be exposed to different signals and disjoints in signals at market borders.
- **Locational BSUoS:** This issue was considered in 2010 as a response to increasing actual and forecast constraint costs associated with managing transmission capacity shortages. The proposal sought to target constraint costs on generators whose actions gave rise to the costs. This proposal was rejected, amongst other reasons, based on doubt over the ability of parties to respond to locational charge signals made available on a two day ex-post basis. Such considerations should be borne in mind for any review of the Target Model.

Summary

We welcome the opportunity to respond to the Open Letter as a first step to considering the potential impact of the Target Model, recognising that on a European level there remains significant work to be completed to finalise arrangements. All relevant European developments must be taken into account which will be challenging given the network code development timeline. It is also vital that the approach adopted in GB is commensurate with the aim of promoting efficient cross-border trade and is consistent with the regulatory treatment of our European counterparts so as not to introduce additional risk or complexity.

If you have any questions regarding this response then in the first instance please contact Ian Pashley (ian.pashley@nationalgrid.com).

Yours sincerely

[By e-mail]

Paul Whittaker
UK Director of Regulation

Annex 1: Responses to questions raised in the Open Letter

*What are the key aspects of the Target Model for GB?
What changes will be needed to GB market arrangements?*

The Target Model has the potential to have a significant impact on the GB interconnector model – through the introduction of implicit mechanisms for cross border capacity allocation and the consequent impact of ensuring physical firmness. There are also impacts associated with intraday gate closure timings close to real time and in relation to cross-border balancing arrangements, which will need to be resolved. Appropriate mechanisms for valuation and pricing of Intraday capacity are as yet unclear.

The Target Model introduces a governance framework to assess, review and amend market zoning. Were market splitting pursued as a result of this, there could be significant implications for GB. Interaction with the existing GB Connect and Manage regime would need to be evaluated and it is likely to require changes to TNUoS charging – more information is provided on this in the main body of this response. It would also be essential to develop longer term hedging contracts to avoid increased investor uncertainty.

All GB codes will also need to be reviewed and updated in line with the final Target Model. There are also likely to be some significant changes to TSO licence arrangements.

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

In our participation within ENTSO-E, NGET's approach has been to pursue realisation of the relevant objectives while minimising the impact on existing market structures and processes. This is important as volatility in market arrangement has the potential to undermine investment certainty and bring unnecessary cost.

We believe that this is an important starting premise which should be considered when reviewing the Target Model. We note, however, that such an approach does not preclude adopting a holistic approach to delivering the changes necessary to implement the principles of the Target Model in GB, although there should be demonstrable benefit to the end consumer. It must also be considered against the backdrop of the approach adopted by our European counterparts, to ensure that the GB approach does not present additional risk in comparison.

How can we deliver the best outcomes?

The Target Model is being driven on a European level – and we must await the outcome of the European process (completion of comitology) before we can firmly identify implementation requirements on a GB level.

The full range of developments cannot be considered in isolation (including CACM, Balancing and System Operation). Any assessment undertaken must be wide and robust.

It is vital that all interested parties have the opportunity to feed into the process for evaluating and delivering the Target Model – DECC, Ofgem, the industry etc. We welcome this Open Letter as an initial step to achieving this.

What process is needed to take this work forward?

Work on a European level, processes for which are applied under the Third Package, will drive the initial stages of determining the principles of the Target Model.

We believe that following completion of the developments at a European level existing governance processes in GB should be used to implement arrangements. This approach will give GB

stakeholders the maximum opportunity, within the confines of the European obligations, to influence modifications to the GB framework that are required to implement those obligations, facilitating robust and thorough development.