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Dear Martin,

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

This document is the response from RWE Group to your open letter on implementation of the EU Target Model in Great Britain. It reflects the views of all Group companies including RWEnpower, RWE Supply and Trading and RWE Innogy.

Implementation of the EU target model is a positive step for the GB electricity market. Comprehensive market integration with neighbouring countries will deliver benefits from increased liquidity and competition, improved security of supply and lower prices to consumers. This is recognised at the highest level of government[1]. Both the UK government and Ofgem have played a central role over many years in explaining the benefits of decentralised competitive energy markets in delivering policy objectives efficiently.

As you note, the EU target model provides an opportunity to look at the GB market design in a holistic way to assess how best to proceed. Consequently Ofgem should consider setting out a blueprint for a "**GB target model**". As well as ensuring full alignment with the European initiatives, such a proposal would address other policy objectives including liquidity and security of supply. More detail regarding the possible components of such a model are set out in the attached Annex.

The EU target model is a key area of work where Ofgem, as the GB energy regulator, is required by EU law to take the lead. Ofgem should therefore give this area of work more prominence so that both companies and consumers understand the new arrangements and the benefits that will arise. We recommend that Ofgem should establish an overarching "GB Target Model Project" to deliver the required changes.

We encourage Ofgem to continue to work closely with DECC and other EU governments on wider market design issues associated with the EU target model and domestic policy initiatives. The benefits from integration will only be realised if the overall policy and regulatory framework is coherent. Although some steps have already been taken towards delivering the target model in GB, other policy initiatives do not appear compatible with the objective of better integration at the EU level. For example, there is the likelihood of significant conflict between nationally focused

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[1] "[Completing the internal energy market] can add several percentage points to EU GDP"
David Cameron 2 March 2012
http://www.guardian.co.uk/business/2012/mar/02/eu-summit-david-cameron-britain-voice-heard

capacity mechanisms and the EU target model. This is one of the reasons why RWE continues to question the implementation of such measures.

We note that Member States have to comply with the conditions set out in Article 8 of Directive 2009/72 and the requirements of Directive 2005/89. These allow for targeted interventions to deliver new or additional capacity if this is ***not provided by the market.*** They also emphasise the residual role of system operators in providing balancing services, rather than them becoming a centralised procurement agency for 'capacity' (a model that was removed in the second internal market Directive 2003/54).

Finally, the question of bidding zones delimitation requires careful consideration in the GB context. Regulators should avoid making changes that may damage the liquidity of wholesale markets which are the backbone of effective competition.

Our response to the individual questions raised on the Open Letter is enclosed.

Yours sincerely,

Alan McAdam

Wholesale Economic Regulation Manager

REPONSES TO INDIVIDUAL QUESTIONS

What changes will be needed to GB market arrangements, minimal change or holistic reform?

Implementation of the EU target model in GB in an effective way would be best achieved through a set of holistic changes that might be termed 'the GB target model'. Ofgem should consider setting out a blueprint in this respect with the following features.

- Removal of all charges and reserve prices on interconnectors.
- Continuous intraday trading on all GB interconnectors with both exchange\platform implicit allocation and OTC direct access.
- Establishment of a suitable reference price for the GB market.
- Adequate volume in the day-ahead reference market through meaningful participation by <u>all</u> companies.
- The use of financial derivatives for the majority of forward trades "along the curve".
- Harmonised EU balancing arrangements with a single imbalance price, based on the marginal accepted bid and gradual removal of load profiles in settlement as SMART is rolled out.
- Early implementation (on a reciprocal basis) of cross border balancing with a common merit order.
- Long term transmission rights.

These changes collectively imply an evolution of the current market design, rather than being a radical charge. Indeed the EU target model was heavily influenced by experience in successful markets such as GB and the Nordic countries so it would be surprising if far reaching changes were needed. At the same time, the changes proposed above set out a holistic approach and go beyond a simple minimal interpretation of the requirements of the target model.

The 'GB target model' would enhance trust in market processes and encourage liquidity by avoiding the regulatory uncertainty that is discouraging to new participants in wholesale markets.

How can the best outcomes be delivered?

UK government has typically been at the forefront of efforts to encourage integrated and competitive energy markets. Ofgem is therefore in a good position to demonstrate to other regulators exactly what the target model implies. One of the major risks for the implementation of the Third Package and network codes is that national regulators and/or governments argue that they do not need to amend their national market design at all. This is already demonstrated in the draft CACM network code where many issues have been avoided with national regulators left to agree important changes outside the network code process. This will mean that process towards an integrated EU market could be based on the slowest mover which will mean that none of the deadlines agreed in European summits will be met, regardless of whether network codes have been agreed or not.

Ofgem and other like minded regulators should therefore take the lead in unilateral and voluntary implementation through pilot projects. The NWE project is a good example of this. However Ofgem could go further in working towards a market that is really open to all. This is particularly relevant for cross border balancing mechanisms as the current draft of the Framework Guideline envisages a 7 year delay before the common merit order will be established.

What process is needed to take this work forward?

This is an area of work where Ofgem, as energy regulator, is required by EU law to take the lead. Both Ofgem and the UK government need to reassert leadership with respect to the development and integration of the EU energy market. Therefore Ofgem needs to provide more prominence to this work and ensure that all companies and consumers understand the new arrangements and the associated benefits.

In terms of process, we recommend that Ofgem should kick off an overarching "project" to deliver the required changes.

ANNEX

GB TARGET MODEL – STRAW MAN

1 Background

The European Target Model is designed to ensure economic and efficient trading electricity across national borders. It is based on establishing common rules to facilitate efficient use of cross-border capacity and to encourage harmonisation of European wholesale market arrangements.

A high level summary of the EU Target Model is described in the Ofgem Open Letter published on 28th March 2012 entitled "Implementing the European Electricity Target Model in Great Britain". In this letter the main features of the Target Model in relation to cross border trades and expressed in the timeframes in which electricity is traded comprise the following.

- *"Day-ahead market coupling*: implementation of market coupling will mean that the GB day-ahead price will be calculated at the same time and through the same process as prices in neighbouring markets. Prices across borders will converge when sufficient cross border capacity is available. Across the market coupled area as a whole, consumers should benefit from lower prices as demand is automatically matched with the cheapest generation in Europe as long as there is sufficient cross-border transmission capacity.

- *Continuous intraday trading*: implementation will allow cross-border trading of electricity closer to real time. To the extent that cross-border capacity is available, market participants will be able to buy or sell energy to fine tune their positions to take into account changes in demand or outages. For intermittent generators, intraday trading provides an opportunity to manage their positions as the accuracy of their forecast generation improves closer to real time.

- *Electricity balancing*: following gate closure, the Target Model would require cross border balancing by Transmission System Operators (TSOs) using any remaining available capacity. This would be initially through a bilateral sharing of balancing bids and offers (TSO-TSO), evolving to a multilateral concept with a common merit order. Consumers should benefit from lower balancing costs and improved security of supply as this is expected to improve National Grid's access to cheaper balancing resources in neighbouring markets when available.

- *Long-term transmission rights*: in the forward time frame, the Target Model mandates the development of cross-border markets based on harmonised long term rights to access capacity on interconnectors. These changes will enhance long term hedging opportunities for new GB market participants.

2 Key Issues for the GB Target Model

In the GB context the EU Target Model certain elements can be recognised in the current trading arrangements which comprise forward trading (both OTC and day ahead cleared on the N2EX), within day trading through the "spot" markets and residual "trading" through the balancing mechanism. However, there are certain characteristics of the current GB arrangement that may impact negatively on implementation of the EU target Model.

- **The nature of forward trading:** The current GB market is based on forward trading utilising multiple GTMA arrangements. These are essentially physical contracts and market participants must have cash and collateral in place with each trading party in order to execute trades. This is a long and relatively expensive process which inhibits the development of efficient cross border trading and disadvantages new entrants. More recent developments have been put in place based on the N2EX price-based NASDAQ market financial contracts. These offer easier arrangements for forward market trading which is more attractive to new entrants with experience in continental or Nordic markets.

- **Balancing Mechanisms:** Alignment of the balancing arrangements across Member States will improve the functioning of day ahead market coupling and intraday markets (since participation in these markets is largely driven by the desire to avoid imbalance). Alignment of the balancing and settlement process across European markets will facilitate cross border trading. The potential risks associated with cash-out of physical contracts at asymmetric imbalance prices discourage both liquidity and new market participants.

- **Cross border intraday and balancing:** Currently, access to interconnectors on an intraday basis is either not possible (Moyle) or is restricted to certain intraday slots (IFA and Britned). These arrangements are not compatible with the target model. Likewise, although much has been achieved in this respect, there remain specific charges which relate either to losses or in the form of reserve prices imposed by the owners of the interconnectors.

- **Long term Transmission Rights**: The issue of long term transmission rights has not been addressed for GB transmission system users and is clearly an issue for alignment of EU markets.

- **"Liquidity":** At the same time as the target model discussion have been taking place, Ofgem have also been considering potential interventions into the GB wholesale electricity market to improve "liquidity". The stated objectives are to ensure "provision of products which support hedging" (Objective 1); "the development of robust reference prices along the curve" (Objective 2); and the "development of an effective near term market" (Objective 3). The initial conclusions are that, despite positive development in relation to their third objective, objective one and two "are not being met at present". Consequently Ofgem have proposed an intervention in the form of an obligation on a subset of generators to sell a specified level of output (25%) in a "Mandatory Auction" based on physical products. The proposed liquidity intervention clearly has implications for the European Target Model. In particular a mandatory auction may undermine price signals in day-ahead and forward markets and potentially act as a barrier to cross border trade. The physical nature of the obligation is likely to be an obstacle to the transition of the GB market towards the successful models in other Member States based on financial forward products. Likewise the discriminatory nature of the proposed obligation will discourage the non obligated parties from changing their trading practices towards that envisaged by the EU target model (i.e. day ahead auction and financial forward trading).

In the light of these issues this note describes a transition process to deliver the EU Target Model by the implementation of a GB Target Model that is fully compatible with European initiatives and will deliver other policy objectives such as liquidity and security of supply.

3 Description of 'GB Target Model'

Interconnectors

- Removal of all charges and reserve prices on interconnectors with socialisation of losses.
- Continuous intraday trading on all GB interconnectors with both exchange platform and OTC direct access.

  Interconnector charges are not compatible with efficient continuous intraday trading or balancing and need to be removed. Interconnector owners already have an advantageous regulatory framework which allows them to retain a proportion of any congestion rents. There should not be permitted to also collect revenue when there is no congestion. Trading of residual imbalances in the market should be facilitated through intraday trading of electricity closer to real time. As a consequence markets participants should be able to buy or sell energy to fine tune their positions to take into account changes in demand or outages and efficiently utilise cross border capacity. In the GB context the existing intraday platforms (both cleared and OTC) form the basis for efficient intraday trading.

Day ahead trading

- Establishment of a suitable reference price for the GB market.
- Adequate volume in the day-ahead reference market through meaningful participation by all companies.

  The day-ahead market should become the key platform for electricity trading. Trading should be aligned with other markets in terms of timing. This means that prices should be calculated at the same time and through the same process as prices in neighbouring markets. It is essential that there is sufficient depth and liquidity in this market to ensure that price signals are robust with all market participants offering adequate volumes. GB prices should converge with other markets when sufficient cross border capacity is available.

Forward markets

- The use of financial derivatives for the majority of forward trades "along the curve".

  Forward trading should evolve towards financial rather than physical products. This will remove barriers to entry, enable efficient market signals, lower costs for customers through price convergences and result in economic use of cross-border transmission capacity. The GB Target Model must also addresses the issue of long term transmission rights, particularly in relation to cross border trading in forward markets. The GB Target Model must enable harmonisation long term rights to access capacity on interconnectors in order to enhance long term hedging opportunities for new GB market participants.

Balancing

- Harmonised EU balancing arrangements with a single imbalance price, based on the marginal accepted bid with gradual removal of load profiles in settlement as SMART is rolled out.
- Early implementation (on a reciprocal basis) of cross border balancing with a common merit order.

Following gate closure, the residual balancing market should continue to operate on the basis of current arrangements (half-hourly, using bids and offers). This will facilitate balancing between Transmission System Operators (TSOs) using any remaining available capacity across borders. The GB cash-out review should look towards closely aligned EU arrangements based on a single marginal cash out price. NGC should be encouraged to develop a common merit order model with neighbouring TSOs in advance of the proposed timetable in the draft Framework Guideline. Similarly, in view of both UK and EU commitments, balancing arrangements need to anticipate the roll out of SMART meters and the use of this data in the settlement process.