



29 January 2013

DECC/Ofgem Consultation on Synergies and Conflicts of Interest arising from the Great Britain System Operator delivering Electricity Market Reform

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax also owns an electricity supply business, Haven Power Limited ("Haven"), which supplies electricity to a range of business customers and provides an alternative route to market for some of Drax's power output.

Drax notes the additional work that Ofgem/DECC has undertaken to analyse the potential synergies and conflicts of interest associated with conferring this new role on the SO. We believe (as do DECC/Ofgem) that more detail is required of the final role of the EMR delivery body to fully understand and quantify (at least to some extent) the identified synergies and conflicts of interest. However, from the analysis completed to date we have come to the following high level opinions.

Synergies

The synergies identified in the consultation document seem plausible, although it is difficult at this stage to quantify the impact of these synergies (particularly on end consumers) and understand how likely it is that these synergies will materialise. However, we note that the primary synergies identified result as a direct consequence of National Grid's various business units receiving more accurate/new information from market participants. With this information they are then able to operate in a more efficient manner which should ultimately benefit consumers. This is a reasonable effect to identify.

However, it seems that this benefit is being provided in a very roundabout and ultimately inefficient manner. If elements of National Grid require more accurate information to improve the efficiency of their business it would seem far preferable for National Grid to propose information gathering processes, potentially as part of the industry code process. Such an approach would appear to avoid the potential for conflicts of interest and allow industry participants to more fully develop processes.

It must also be recognised that the synergies that have been identified represent a 'double edged sword'. If the resources National Grid receives are used in an appropriate manner this has the potential to produce benefits (utilising synergies). However, if these resources are used in an inappropriate manner (due to the creation of incentives which make conflicts of interest more likely to be exploited) then there is the potential for conflicts of interest to materialise to the detriment of consumers.

Conflicts of interest

The consultation document sets out the numerous potential conflicts of interest that various National Grid business units may be subject to. We believe the sheer quantity of potential conflicts of interest identified indicates that a problem exists with the proposed option to allow the SO to undertake the EMR delivery role. While accepting that it is difficult at this stage to evaluate the materiality and probability of these conflicts of interests being acted on, it is important that these conflicts of interest are recognised and taken seriously at this stage. In particular, we would have liked to have seen more emphasis and analysis on the conflicts of interest that could arise in the TO business. We believe these conflicts of interest are potentially more serious relative to those identified within the SO business.

We note the new piece of analysis undertaken to quantify the incentive for conflicts of interest to be acted on (information on the different profit centres within the National Grid group). While this is a useful piece of analysis it is limited in that it does not provide much indication of the future growth potential of the different National Grid businesses. Analysis to determine the likely growth areas for National Grid would be helpful in determining which areas of the business are likely to be subject to significant future conflicts of interest. As such we do not believe that the current analysis can be overly relied on to indicate which parts of National Grid's business are most likely to be subject to conflicts of interest.

We also question the assumption made that conflicts of interest are likely to be less problematic for monopoly firms relative to businesses operating in competitive markets. We do not consider this point is particularly well justified as it is self-evident that the decisions taken by monopoly businesses have the potential to create distortions in other related markets.

Evaluating the potential conflicts of interest and synergies

The most important evaluation to make is to determine whether the potential conflicts of interest outweigh the potential for synergies or vice versa. At this stage it is difficult to make a comprehensive evaluation due to the lack of quantification of the costs/benefits (which is a consequence of the stage we are at in the EMR process). However, based on the information which has been provided to date we have concluded the following.

The synergies identified seem plausible but could be achieved more efficiently via other means. In contrast the conflicts of interest are especially commonplace (as evidenced by the numerous examples produced in the consultation documents). Most importantly, the resources that will likely be become available to the delivery body can be used in either appropriate and/or inappropriate ways resulting in synergy creation and/or the development of a conflict of interest(s). It seems evident that the development of appropriate rules, oversight, business structure etc. is critical to determining how resources are employed. This leads us to consider that significant mitigation measures are required to ensure that conflicts of interest do not arise, or at least cannot be exploited effectively.

The ECC Committee recommendations

The analysis contained within the consultation document (and our own evaluation) seems to justify the recommendation of the ECC Committee, principally that the EMR delivery body should be a new, independent, not for profit company. This option would best reduce (or eliminate) the potential for conflicts of interest. While the potential synergies would not arise there would be scope to achieve at least some of these synergies via other routes (be it through code modifications, industry working groups/forums etc.). Moreover, there would be nothing to stop the new body sourcing the necessary expertise to undertake the role. We note that the SO has bought in consultancy to work on issues related to negative pricing under CfD FiTs. Therefore at this stage we believe the establishment of a new body represents the best option to undertake the EMR delivery role.

However, if the Government is determined to pursue the option of conferring the EMR delivery role on the SO, it is imperative that DECC/Ofgem do their utmost to design a framework which mitigates as best as possible the potential for conflicts of interest to be exploited to the detriment of end consumers.

We also would like to note our concern with the consultation process. Our specific concern is that it feels like the consultation process is taking place in parallel with DECC conferring responsibilities on the SO to undertake the EMR delivery role ahead of the conclusion of the consultation process. We fear that this approach could be subject to legal challenge which could further delay the EMR process. As such we ask that DECC/Ofgem properly consider the views of stakeholders before making any final decisions.

Mitigation measures

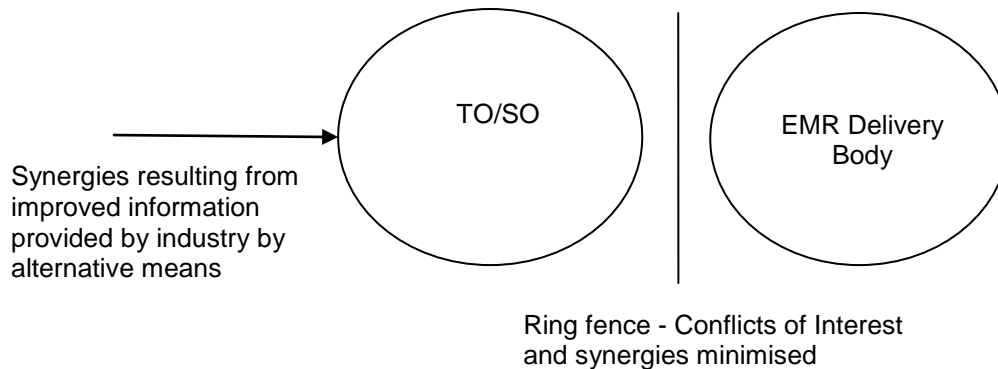
We consider the number of potential mitigation measures listed in the consultation is fairly comprehensive. It is also helpful that the consultation highlights present areas of legislation/regulation which could help mitigate potential conflicts of interest. With regards to the existing framework, we believe

it acts as a solid foundation to build the additional protections required to ensure against the potential for conflicts of interests. For example, the Memorandum of Understanding signed between DECC and National Grid represents a positive development.

However, we consider further mitigation measures are required as the existing framework (such as Special Conditions C1 and C2) is better suited to blunt the incentives to exploit the conflicts of interest (although we believe further measures can help create more desirable incentives). In contrast, the existing framework does not seem well equipped to limit the ability for National Grid to take advantage of potential conflicts of interests. This is because the existing framework seems primarily to require regulatory authorities to take action ex-post of an inappropriate behaviour developing.

Further desirable mitigation measures

For the reasons presented above we believe that there should be a strong focus on designing structural measures which limit the ability of the National Grid to exploit any conflicts of interest that materialise. Principally, a strong ring fence of the EMR delivery body is essential to ensure that the ability for National Grid to take advantage of conflicts of interest is limited. Our preference would be to have a ring fence of the EMR delivery body which incorporates information restriction as well as employee, physical, financial and legal separation. We have presented this in a simple graphical illustration below:



Such a model has the further advantage that it should be easier to transfer the delivery role body to an alternative organisation if required.

Additional 'ability' related mitigation measures that should be considered¹ as part of the ring fence include:

- To ensure that the potential for conflicts of interest is limited it seems sensible to limit the number of personnel with access to confidential information. Therefore a separate team to anonymise data should be further examined
- It is very important that measures are targeted not just on the separate corporate entities but also the composition of these corporate entities i.e. the employees. The development of such measures is more likely to encourage the correct behaviours.
- It is important that analysis undertaken on the Capacity Mechanism and CfD FiTs is initiated by the Government rather than National Grid. This should help ensure that its role is purely administrative
- The EMR delivery body should not be tasked with imposing penalties. This competence more naturally sits with Ofgem
- Limiting key input assumption discretion for modelling may be worth investigating
- The Rough acquisition case study briefly mentioned in the consultation seems worthy of further exploration

¹ The table presented in Annex C on page 67 of the consultation document provides a good overview of the measures that would be beneficial.

In addition to the 'ability' related mitigation measures, 'incentive' related measures should be developed to complement the ring fence model. However, we stress that 'incentive' related measures will be inadequate if not introduced in conjunction with the 'ability' related measures highlighted above, 'Incentive' related measures which should be considered include:

- The use of independent external audits to ensure internal processes are robust should be explored
- Independent external review of National Grid's analysis is essential. As much granularity of the models and assumptions as possible should be disclosed
- An impact assessment of how decisions made by DECC may effect National Grid's business interests is worth exploring
- An Ofgem review of the SO incentives post EMR implementation would seem appropriate to ensure that the scheme(s) are fit for purpose
- There will need to be a prominent role for Ofgem in terms of overseeing National Grid's business activities and ensuring that potential enforcement action is effective
- There is potentially a role for Ofgem in determining what is or is not commercially sensitive information. This should ensure that National Grid is less able to frustrate efforts to increase transparency under the pretence of commercial confidentiality
- Appeals, at least in certain circumstances, should be considered
- We agree that an ex ante price control type incentive would be problematic and probably encourage perverse behaviour i.e. the trading off of the benefits of maximising financial incentives against the costs of regulatory fines

We provide answers to the questions set in the consultation document in the annex.

If you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Cem Suleyman
Regulatory Analyst
Regulation and Policy

Annex

1.

- a) **Do you agree that there are unlikely to be material conflicts arising from the electricity System Operator having access to EMR related information? If not, please explain your reasoning.**

No. The analysis on the operating profit of the SO does not provide adequate justification for this view. If the SO has access to EMR related information there are insufficient protections in place to stop it sharing this information with other parts of the National Grid group. While the benefits of this information may not accrue to the SO, the Group as a whole can benefit. The consultation analysis demonstrates the potential for significant conflicts of interest in other areas of National Grid's business. Therefore, even if material conflicts of interest do not arise within the SO business (although this has not been confirmed as yet) there will be the incentive to share information with other National Grid businesses.

- b) **Do you agree that there is significant potential for synergies as a result of the electricity System Operator having access to EMR related information? If not, please explain your reasoning.**

There are potential synergies which could be generated but it is too early to say how significant these may be. In any case the development of these synergies in the way intended is disproportionate relative to the difficulties involved in requiring the SO to undertake the EMR delivery role. Other means, such as the development of information sharing processes, should be explored.

- c) **Do you agree that the potential for conflicts and synergies arising from the electricity Transmission Owner having access to EMR related information is limited? If not, please explain your reasoning.**

It seems clear that there is potential for the creation of conflicts and synergies. It is unclear at this stage how material these are. However, it appears that the potential conflicts could be material (such as the TO boosting its RAB unnecessarily) whereas the potential synergies could be developed in a more proportionate manner.

- d) **Do you agree there are limited conflicts with gas distribution, gas transmission and gas system operation arising from access to EMR information? If not, please explain your reasoning.**

It seems clear that there is potential for the creation of conflicts and synergies. It is unclear at this stage how material these are. However, it appears that the potential conflicts could be material (such as the unnecessary boosting of the RAB) whereas the potential synergies could be developed in a more proportionate manner.

- e) **Are there any other conflicts of interest or synergies associated with access to EMR related information for businesses operating in mainly monopoly conditions that we have not identified?**

The areas identified in the consultation seem fairly comprehensive.

2.

- a) **Do you agree that the most material potential conflicts of interest with competitive businesses as a result of National Grid's increased access to information have been identified? If not, please identify which ones are missing, explaining your reasoning and providing evidence.**

We believe that the potential exists for conflicts of interest to materialise in competitive businesses. However, it is not clear at this stage, according to the analysis undertaken, that the risks are necessarily greater in this part of National Grid's business relative to its monopoly area businesses.

- b) **Do you agree, that where competitive businesses are concerned, there is a need for additional mitigation?**

Yes, although we think additional mitigation measures is also required for the monopoly businesses.

- c) **Are there any other conflicts of interest or synergies with businesses operating in mainly competitive conditions that we have not identified?**

The areas identified in the consultation seem fairly comprehensive.

3.

- a) **Do you think that all the major potential conflicts of interest and synergies arising from an ability to exert influence have been identified? If not, please identify which ones are missing, explaining your reasoning and providing evidence where possible.**

The areas identified in the consultation seem fairly comprehensive.

- b) **Which aspects of the analysis that the SO will carry out for Government are most exposed to a potential conflict of interest? Please explain your reasoning.**

Not enough detail on the analysis that will be undertaken has been provided to give a considered opinion at this stage. However, we would note that it is important that analysis that the SO undertakes must be initiated by Government to ensure that the SO's role is solely administrative.

- c) **Do you agree with our conclusion that the main potential for synergies is between the SO and the EMR role? If not, please explain your reasoning.**

Maybe, but the analysis presented to date does not substantiate this view. More in depth analysis is required to demonstrate that this is the case.

4.

- a) **Do you think that all the potential conflicts of interest and synergies arising from an ability to exercise discretion have been identified? If not, please explain your reasoning.**

The areas identified in the consultation seem fairly comprehensive.

- b) **Which potential areas of discretion present the most risk of conflicts of interest?**

Not enough detail has been provided at this stage to provide an informed opinion.

- c) **Do you agree with our conclusion that the main potential for synergies is between the SO and the EMR role? If not, please explain your reasoning.**

Maybe, but the analysis presented to date does not substantiate this view. More in depth analysis is required to demonstrate that this is the case.

5.

- a) **Do you agree with the assessment of the relative immateriality of the potential conflicts between the EMR role and the SO?**

No. The analysis on the operating profit of the SO does not provide adequate justification for this view. If the SO has access to EMR related information there are insufficient protections in place to stop it sharing this information with other parts of the National Grid group. While the benefits of this information may not accrue to the SO, the Group as a whole can benefit. The consultation analysis demonstrates the potential for significant conflicts of interest in other areas of National Grid's business. Therefore, even if material conflicts of interest do not arise within the SO business (although this has not been confirmed as yet) there will be the incentive to share information with other National Grid businesses.

- b) **Do you agree that any potential conflicts with other activities including the electricity TO and businesses operating under mainly competitive conditions have the potential to be material?**

Yes.

- c) **What further analysis could be carried out to determine the materiality of the conflicts we have identified?**

The analysis will become more authoritative as details on EMR are developed. However, the identification of numerous potential conflicts of interest within the consultation document in our opinion is enough to indicate the requirement for robust mitigation measures.

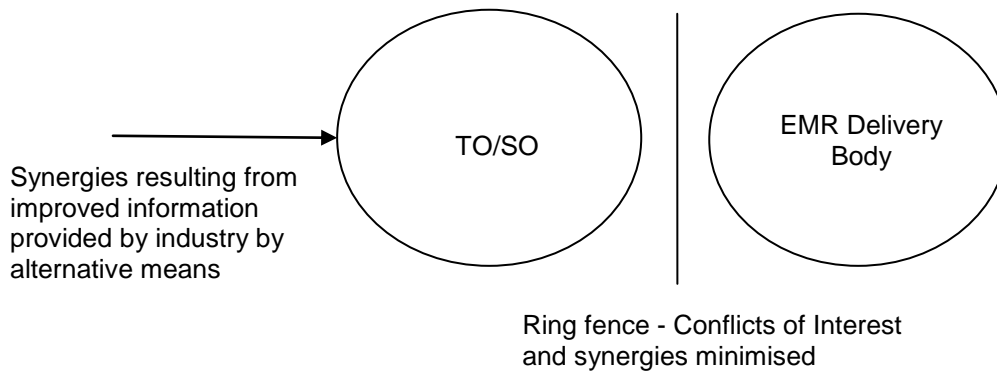
6.

- a) **Do you think that conflicts of interest relating to access to information can be addressed through the design of EMR and EMR governance measures set out above? Please explain your reasoning**

No. Governance measures alone do not seem sufficient to ensure that information is not shared within National Grid inappropriately. Structural remedies are needed alongside governance measures to ensure against the *ability* as well as the *incentive* for National Grid to take advantage of conflicts of interest.

- b) **Which of the additional mitigation measures set out under 'further mitigation measures' should be considered to address these conflicts of interest? Would anything else be necessary? Please explain your reasoning.**

For the reasons given earlier we believe that there should be a strong focus on designing structural measures which limit the ability of the National Grid to exploit any conflicts of interest that materialise. Principally, a strong ring fence of the EMR delivery body is essential to ensure that the ability for National Grid to take advantage of conflicts of interest is limited. Our preference would be to have a ring fence of the EMR delivery body which incorporates information restriction as well as employee, physical, financial and legal separation. We have presented this in a simple graphical illustration below:



Such a model has the further advantage that it should be easier to transfer the delivery role body to an alternative organisation if required.

Additional, 'ability' related mitigation measures that should be considered² as part of the ring fence include:

- To ensure that the potential for conflicts of interest is limited it seems sensible to limit the number of personnel with access to confidential information. Therefore a separate team to anonymise data should be further examined
- It is very important that measures are targeted not just on the separate corporate entities but also the composition of these corporate entities i.e. the employees. The development of such measures is more likely to encourage the correct behaviours.
- It is important that analysis undertaken on the Capacity Mechanism and CfD FiTs is initiated by the Government rather than National Grid. This should help ensure that its role is purely administrative
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- The use of independent external audits to ensure internal processes are robust should be explored
- Independent external review of National Grid's analysis is essential. As much granularity of the models and assumptions as possible should be disclosed
- An impact assessment of how decisions made by DECC may effect National Grid's business interests is worth exploring
- An Ofgem review of the SO incentives post EMR implementation would seem appropriate to ensure that the scheme(s) are fit for purpose
- There will need to be a prominent role for Ofgem in terms of overseeing National Grid's business activities and ensuring that potential enforcement action is effective
- There is potentially a role for Ofgem in determining what is or is not commercially sensitive information. This should ensure that National Grid is less able to frustrate efforts to increase transparency under the pretence of commercial confidentiality
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² The table presented in Annex C on page 67 of the consultation document provides a good overview of the measures that would be beneficial

- We agree that an ex ante price control type incentive would be problematic and probably encourage perverse behaviour i.e. the trading off of the benefits of maximising financial incentives against the costs of regulatory fines

7.

- a) **Do you think that conflicts of interest relating to influence can be addressed through the design of EMR and EMR governance measures set out above? Please explain your reasoning.**

Please see answer to 6 a).

- b) **Which of the additional mitigation measures set out under ‘further mitigation measures’ should be considered to address these conflicts of interest? Would anything else be necessary? Please explain your reasoning.**

Please see answer to 6 b).

8.

- a) **Do you think that conflicts of interest relating to discretion can be addressed through the design of EMR and EMR governance measures set out above? Please explain your reasoning.**

Please see answer to 6 a).

- b) **Which of the additional mitigation measures set out under ‘further mitigation measures’ should be considered to address these conflicts of interest? Would anything else be necessary? Please explain your reasoning.**

Please see answer to 6 b).

9.

- a) **Overall, will the design of EMR, the proposed governance arrangements and the existing regulatory framework be sufficient to mitigate the conflicts that we have identified? Please explain your reasoning.**

Please see answer to 6 a).

- b) **Are other mitigations also likely to be necessary? If so, please specify what and why.**

Please see answer to 6 b).

- c) **Are business separation requirements (beyond restrictions on information flows) necessary?**

Please see answer to 6 b).

- d) **If business separation is necessary what entity should be subject to the ring fence?**

Please see answer to 6 b).

- e) **What degree of business separation do you think would be necessary to mitigate conflicts of interest?**

Please see answer to 6 b).

f) How can we best protect the synergies between the EMR and SO roles when considering additional mitigation measures?

We note that the primary synergies identified result as a direct consequence of National Grid's various business units receiving more accurate/new information from market participants. With this information they are then able to operate in a more efficient manner which should ultimately benefit consumers. This is a reasonable effect to identify.

However, it seems that this benefit is being provided in a very roundabout and ultimately inefficient manner. If elements of National Grid require more accurate information to improve the efficiency of their business it would seem far preferable for National Grid to propose information gathering processes, potentially as part of the industry code process. Such an approach would appear to avoid the potential for conflicts of interest and allow industry participants to more fully develop processes.