

Rachel Fletcher
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19 April 2013

Dear Rachel,

FUTURE TRADING ARRANGEMENTS DESIGN PROJECT

I am responding on behalf of ScottishPower to your open letter of 18 February 2013 in which you invite views on your proposed Future Trading Arrangements (FTA) Design project.

Should Ofgem launch a project?

We agree that there is a need to take stock of GB electricity trading arrangements and establish a holistic long term vision against which possible developments can be evaluated, and we therefore support the proposed FTA design project. We believe the project should be seen as a high level 'umbrella' process, complementing more detailed projects that address individual components of the trading arrangements. In planning the project it should be recognised that:

- individual components of the trading arrangements may be subject to their own timescales - which the umbrella project will need to work around;
- high level principles developed in the umbrella project may not always turn out to be optimal in the context of more detailed design studies – and should not be imposed too rigidly;
- Government policy objectives may not be delivered in full – and any future design will need to be resilient to a range of potential policy outcomes.

In other words, we believe the project should primarily have a coordination role, seeking to ensure that individual initiatives and activities complement each other and work to a common set of objectives. The design should be high level and should avoid being too prescriptive.

What key issues should be examined?

We broadly agree with the list of key issues set out in Annex 2 of your letter. While we believe that the core principles underpinning NETA remain valid, we agree that current trading arrangements are not delivering prices that fully reflect scarcity and risks to security of supply, and are thus not providing the right signals for investment in the range of generation GB requires to meet its environmental targets whilst ensuring

security of supply. This is being addressed by the Government's Electricity Market Reform (EMR) under which the Feed in Tariff with Contract for Difference (FiT CfD) will support investment in low carbon generation and the proposed Capacity Mechanism will provide the framework to ensure security of supply through investment in existing and new generation.

GB security of supply is a GB rather than a European issue and the principal method for ensuring this will be the proposed Capacity Mechanism. It is vital that other aspects of the GB trading arrangements, including those originating in Europe, work to support the Capacity Mechanism rather than against it. The detailed design for the Capacity Mechanism is expected in the next few months and the long term vision for GB trading arrangements should take this design as given, and assess the impact of alternative methods for implementing the European Target Model and European Network Codes.

What form should the process take?

Ofgem is proposing that the Electricity Balancing Significant Code Review (EBSCR) will now consider a narrower set of options, including more marginal cash-out prices, a single cash-out price, allocation of reserve costs, non-costed actions, a single trading account and gate closure. Whilst a final decision on these options can only be made when the detailed design of the Capacity Mechanism has been finalised, it is important that decisions are made on them by early 2014. These aspects of the trading arrangements must be known to potential bidders in the first Capacity Mechanism auction planned for later in 2014 – when potentially ten year contracts will be placed.

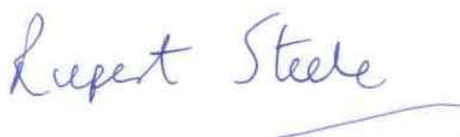
In order to avoid any detrimental impact on investor certainty, it must be understood from the start that the FTA design project will build on the Capacity Mechanism design and the outputs from the EBSCR and will not seek to re-open these elements.

We agree with the proposed structure of a Senior Advisory Panel to provide strategic input and direction; Focus Groups to provide expert input on the key issues identified; and regular workshops to discuss design principles, change proposals and the way forward.

We also agree that it is very important that DECC and Ofgem work closely to form a shared view on future trading arrangements to give industry stakeholders more confidence in the future environment in which they will operate.

We have provided more detailed responses to your questions in Annex 1. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

A handwritten signature in blue ink that reads "Rupert Steele". The signature is written in a cursive style and is positioned above a horizontal line.

Rupert Steele
Director of Regulation

**FUTURE TRADING ARRANGEMENTS DESIGN PROJECT: OPEN LETTER
SCOTTISHPOWER RESPONSE**

Question 1: Do you agree Ofgem should launch a project to create a high level design for the future electricity trading arrangements?

We agree that there is a need to take stock of GB electricity trading arrangements in order to establish a holistic long term vision against which possible developments can be evaluated, and we therefore support the proposed FTA design project. We believe the project should be seen as a high level 'umbrella' process, complementing more detailed projects that address individual components of the trading arrangements. In planning the project it should be recognised that:

- individual components of the trading arrangements may be subject to their own timescales - which the umbrella project will need to work around;
- high level principles developed in the umbrella project may not always turn out to be optimal in the context of more detailed design studies – and should not be imposed too rigidly;
- Government policy objectives may not be delivered in full – and any future design will need to be resilient to a range of potential policy outcomes.

In other words, we believe the project should primarily have a coordination role, seeking to ensure that individual initiatives and activities complement each other and work to a common set of objectives. The design should be high level and should avoid being too prescriptive.

We believe the core principles underpinning the New Electricity Trading Arrangements (NETA) introduced into England & Wales in 2001, and also their extension GB-wide under the British Electricity Trading and Transmission Arrangements (BETTA) in 2005, remain valid. Market signals should continue to drive generators' self-despatch decisions ensuring that risks and incentives are faced by those best placed to manage them. Generators and suppliers should continue to have a strong incentive to self-balance, leaving a residual role for the System Operator with respect to balancing and congestion management. Generators, suppliers and traders should continue to be free to choose when and how to contract, with support for trading close to real time and information transparency.

It has however been recognised that the current trading arrangements are not delivering prices that fully reflect scarcity and risks to security of supply and are thus not providing the right signals for investment in the range of generation GB requires to meet its environmental targets whilst ensuring security of supply. This is being addressed by the Government's Electricity Market Reform (EMR) under which the Feed in Tariff with Contracts for Difference (FiT CfDs) will support investment in low carbon generation and the proposed Capacity Mechanism will provide the framework to ensure security of supply through investment in existing and new generation.

The Government is taking powers in the Energy Bill to introduce a Capacity Mechanism to incentivise sufficient reliable capacity on both the generation and supply side to provide the necessary security of supply. The detailed design for this Capacity Mechanism is

expected in the next few months and once this is known it would be an appropriate time to re-assess the long term vision taking into account this very significant change.

The Government are minded to implement a GB-wide Capacity Mechanism that enables the System Operator to contract for sufficient capacity (as required to meet a reliability standard set by the Secretary of State) through a competitive central auction held four years ahead, with the aim of holding the first auction in 2014. In addition to incentivising providers of capacity through steady capacity payments, the Government are proposing that parties successful in the auction will be subject to financial penalties should they fail to provide capacity when required. Thus parties bidding into an auction in 2014 must have a clear vision of GB trading arrangements over the period for which they are bidding into the auction. If such a vision is only available for a short period forward, this will increase the likelihood that existing plant will close earlier and investment in new plant will not be forthcoming – and may result in the Capacity Mechanism not delivering the required security of supply.

It is therefore necessary that sufficient high level vision of the GB trading arrangements is established before the first Capacity Mechanism auction. We think this can be achieved by a timely conclusion of EBSCR and a scope for the FTA project that either avoids creating basis risk for capacity agreements or falls within change of law protection clauses in those agreements.

The open letter has identified most of the principal initiatives currently facing GB electricity market participants – EMR, Retail Market Review, smart meter roll-out, Green Deal, European Target Model, European Network Codes, REMIT and EMIR. Other initiatives currently underway which could significantly impact trading arrangements for many market participants include Project TransmiT, Ofgem's proposals under Market Liquidity and Access and the issues currently being taken forward under the Electricity Balancing Significant Code Review. The outcome of many of these initiatives is likely to be significantly clearer by the end of 2013, particularly those originating within GB, and while there is likely to still be significant uncertainty around those issues which result from European developments, we believe that it should be possible to manage this project in a way which closes off most of the regulatory risks ahead of the first capacity auction in 2014.

GB security of supply is a GB rather than a European issue and the principal method for ensuring this will be the Government's Capacity Mechanism. It is vital that other aspects of the GB trading arrangements, including those originating in Europe, work to support the Capacity Mechanism rather than against it. It is thus important that a long term vision for the GB trading arrangements, incorporating the Government's Capacity Mechanism, is developed to assess the impact of alternative methods for implementing the European Target Model and European Network Codes.

In order to establish a high level design for future GB electricity trading arrangements, it will be necessary to address the short term issues currently being taken forward under the new reduced scope of the Electricity Balancing Significant Code Review – consideration of more marginal cash-out prices, a single cash-out price, allocation of reserve costs, non-costed actions, a single trading account and gate closure. These can only be addressed when the detailed design of the Capacity Mechanism has been finalised, but it is important that decisions are made on them by early 2014 to enable these aspects of the trading arrangements to be known to potential bidders in the first Capacity Mechanism auction.

We agree that work undertaken in 2013 to form a view and obtain consensus on the shape of future trading arrangements could lead to improved investor confidence with benefits for consumers.

Question 2: What key issues should be examined as part of a work stream on future GB trading arrangements?

It is widely recognised that NETA and BETTA have delivered more competitive GB trading arrangements than the previous arrangements under the Electricity Pool, and have to date delivered security of supply economically. They have been assisted by the free carbon allocations, which acted in a similar way to a capacity mechanism, and by the existence of inframarginal rents in periods where coal plant set the price and low priced gas could undercut it.

These conditions no longer exist and it has become clear that intervention in the market arrangements will be necessary to deliver the generation mix GB requires to meet its environmental targets and continue to deliver security of supply economically.

EMR is identifying the support required for low carbon generation and the incentives required to ensure sufficient reliable capacity is available on both the generation and demand side to provide the necessary security of supply. Once the EMR proposals have been finalised it will be important to ensure that the other aspects of the trading arrangements work effectively alongside the changes delivered through EMR, to deliver environmental benefits and security of supply in the best long term interests of domestic, commercial and industrial GB consumers.

Ofgem's initial view has identified the major issues requiring to be addressed:

- **Integration of renewables**

NETA and BETTA were designed to ensure that all generation, including renewables and nuclear, has a role in the wholesale market,. The penetration of renewables, particularly intermittent wind-powered generation, is however significantly greater than that envisaged under NETA and BETTA and is set to continue to rise sharply this decade. The high quantity of intermittent renewables is likely to reduce expected load factors for new gas fired plant, without significantly reducing the quantity of gas fired plant that is required.

With the significantly increased proportion of renewable generation in the mix it will be important to ensure that it continues to participate in the market under the FIT CfD support introduced by EMR, as it does under the ROC support mechanism, and that appropriate routes to market continue to be available to renewable generators. Under those conditions, and with an effective capacity market to protect security of supply, NETA and BETTA can develop energy products to integrate renewables successfully without further interventions.

- **Facilitating Demand Side Response**

Although NETA and BETTA have delivered more competitive electricity wholesale prices through ensuring that demand can have a price setting role, principally through bi-lateral forward contracting, we agree that Demand Side Response (DSR) should have the ability to perform a greater role in the market and developments are underway to enable this including provision in the EMR Capacity Mechanism, the roll-out of smart meters and other technological advances. It will be important to consider how the trading arrangements can fully reflect the full value of DSR flexibility following the implementation of the Capacity Mechanism and the wider commercial arrangements required to support the commercialisation of DSR services. The scale of

DSR opportunities that will emerge, and the extent to which the system will be able to rely upon them, is not clear at this stage.

- **Efficient balancing and system operation**

We agree that the growth of intermittent generation increases the need for flexibility to manage changes in renewable output over various timescales and that future electricity market design should signal clearly the requirement for flexibility and ensure there are sufficient incentives for the provision of balancing services.

It will be necessary to recognise recent and likely forthcoming changes in Balancing Services Use of System (BSUoS) charges and locational Transmission Network Use of System (TNUoS) charges. Interconnector users now no longer pay BSUoS or TNUoS charges; it is proposed that GB generators should no longer pay BSUoS charges; and proposed new TNUoS charges from Project TransmiT will reflect the sharing of transmission assets between fossil fuelled and low carbon generation.

It will be important to ensure that, following these significant changes to the trading arrangements, market participants continue to be incentivised to facilitate efficient balancing and system operation.

- **Effective integration with the wider European market**

We agree that it will be important to maximise the benefits of wider EU integration for GB consumers. In particular, implementation of the European Target Model and European Network Codes should recognise and work to support the EMR Capacity Mechanism and low carbon support schemes rather than work against them.

Market coupling has the potential to reduce balancing costs and improve liquidity, and the creation of a GB Hub is likely to deliver a more robust reference price for GB that could be a positive impact on developing CfD under EMR. However, it is important that, when considering any possible market splitting and price zones under the European Target Model, the potential impact on renewables investment and GB security of supply is to the forefront.

- **Incentives to maintain and invest in new capability**

It is of paramount importance that the long term vision of GB electricity trading arrangements provides appropriate incentives to invest in new and existing capability, including generation, interconnection, demand-side response and storage, and also to maintain existing assets.

We agree that many reserve providers will be incentivised to participate in the EMR Capacity Mechanism and that it will be appropriate to review the trading arrangements in relation to the provision of reserve services to ensure appropriate incentives still remain.

Future GB trading arrangements should facilitate and recognise the added value that investment in generation technologies such as pumped hydro storage gives to the system.

- **Interactions with gas arrangements**

We agree that it will be important to consider the implications for the electricity market of any changes to the gas trading arrangements. Of particular relevance are those

driven by the Government's Gas Generation Strategy, Ofgem's Gas Emergency Arrangements Significant Code Review, and the movement towards a single European market (with the ongoing work to develop the relevant Framework Guidelines and Network Codes in furtherance of the Gas Target Model).

It is now recognised that gas-fired generation will play a key role in GB electricity security of supply for the foreseeable future and it is thus essential that the long term vision for the GB electricity trading arrangements recognises the interactions between gas security of supply and electricity security of supply.

Question 3: What form should the process take?

Potential investors in the electricity market are facing particularly high uncertainty at this time and a number of initiatives are under way aimed at addressing this. While the aim of the FTA design project is to reduce this uncertainty through establishing a long term vision of trading arrangements, there is a risk that launching another new workstream could itself increase uncertainty.

In order to avoid increased uncertainty it is essential that the process builds on established elements of the new trading arrangements and does not seek to re-open these elements. It is likely that the first element of the arrangements to be defined in detail will be the EMR Capacity Mechanism and the process should not commence until this has been finalised. Additional elements will be defined by the EBSCR initiative¹, where decisions will need to be made by early 2014 in order to give certainty to potential bidders in the first Capacity Mechanism auctions planned for 2014.

Once these elements and the detailed design of the EMR FiT CfD support for low carbon generation have been finalised, it would then be appropriate to consider how the European Target Model and European Network Codes could best be implemented and what other changes if any would be in the long term interests of GB consumers.

Although this may result in extended timescales, this is in our view the preferred approach as it reduces investor uncertainty throughout the process at a time when investment decisions are essential if GB is to meet its environmental targets whilst ensuring security of supply.

We agree with the proposed structure of a Senior Advisory Panel to provide strategic input and direction, Focus Groups to provide expert input on the key issues identified and regular workshops to discuss design principles, change proposals and the way forward.

We also agree that it is very important that DECC and Ofgem work closely to form a shared view on future trading arrangements to give industry stakeholders more confidence on the future environment in which they will operate.

ScottishPower
April 2013

¹ The reduced scope will now cover consideration of: more marginal cash-out prices, a single cash-out price, allocation of reserve costs, non-costed actions, a single trading account and gate closure.