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Ofgem
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Thursday, 01 April 2010

Dear Emmanouela,

Re: Electricity Interconnector Policy Consultation

This response represents the views of companies within the Centrica group excluding Centrica Storage, it is non-confidential and may be placed on the Ofgem website and in the Ofgem library.

Centrica welcomes the increased focus on interconnection and market harmonisation in Europe, and we welcome the publication of this consultation. However, we also believe it is important that, whilst aiming for EU harmonisation, sufficient flexibility of approach remains to cater for national differences and characteristics. Moving from the current arrangements to a coupled market will impact Member States in different ways and to varying degrees. Each will require reasonable time to adapt / introduce the new arrangements and this will vary widely depending on the compatibility (or not) with existing market design.

We believe that there is a need in GB for additional interconnection, and that the regulatory environment should facilitate the involvement of a range of investors, both regulated and commercial. Limiting the opportunity to invest in new interconnectors to TSO closes the door to a range of parties who may be able to increase innovation, efficiency and customer choice in the market.

As these issues cut across a number of countries, jurisdictions and regulators, we hope that the national regulators will co-ordinate future consultations on overall regulation and specific issues (including exemptions and access rules) – joint consultation should be the norm wherever possible to aid the most efficient process outcome.

Q1.1 Have we accurately captured the benefits of and demand for new interconnection?

Are the projects under consideration all viable? Would they be sufficient? Are there other projects being developed?

Ofgem rightly notes the difficulties faced by GB in reaching the EU target of 10% of generation capacity in interconnection due to the geographical specificities particular to this country, notably the need for costly, long distance subsea cables to connect with other markets. However, Centrica believes that interconnection with other countries will be beneficial to the market in terms of security of supply, liquidity and improved price transparency. There may also be improvements in supply diversity and longer term benefits in that interconnectors may help to manage the expected increased intermittency caused by large volumes of wind generation on the GB market.

These latter points do depend, however, on a number of factors including whether the generation mix and weather patterns in adjoining markets are disparate enough to enable switching from one country to another for power reliance; and whether price signals in each country are flexible and responsive enough to provide true signals in the short term. Interconnectors should not be seen as a panacea for intermittency issues. Although we believe that there may well be benefits in this area, we would like to see the benefits quantified to ensure the advantages are properly understood.

It is not for Centrica to judge whether the existing projects in the pipeline contained in Ofgem's consultation document are viable, nor to speculate as to the number of other projects in various stages of development. However, we believe that in general, investor confidence would be increased by regulatory certainty from EU and GB agencies on allowable models for interconnector investment, and market coupling, as well as a simple and efficient planning system.

Q1.2 Are there other key aspects of the legal or regulatory framework that we should consider, or should some features be given a different emphasis?

Any action taken in relation to interconnector regulation should obviously take into account and be in accordance with developments in the ENTSO-E development plans, as well as ENSG work in GB. It is important to consider potential interactions with the OFTO regime and associated licensing issues. For example, if a wind farm were to be connected to more than one Member State, it is not entirely clear at present whether the current licensing arrangements would support or preclude a combined OFTO/Interconnector arrangement were this to be required. In addition, it is essential to ensure that any aspirations or progress in relation to a European Supergrid are considered fully. In addition, there are charging arrangements in GB, such as triads, which also need to be addressed.

Q1.3 How can the Regional Initiative best contribute to development or implementation of policy? Do you agree with the priorities and approach outlined?

The Regional Initiative provides a useful forum for discussion of the future direction of energy policy in Europe, including policy on Interconnectors, and we would hope that this will continue.

Q2.1: Are the target models explained in this chapter appropriate for GB? What are the issues that need to be considered Are there alternative approaches that would be better? Will the target models effectively accommodate increased intermittency?

Centrica would expect that a flexible approach is taken with respect to target models for interconnectors in GB. There are benefits and drawbacks to each of the models, and it may well be (as with the current plans for BritNed) that a proportion of capacity is retained at different timescales to be sold at different times in different ways (i.e. explicit auctions in the longer term and implicit at day-ahead and intraday). It could well be argued that the socio-economic benefits of interconnection in terms of equalised prices, efficiency of operation and maximisation of revenue to the interconnector owner (that may be reinvested) are likely to be maximised via an explicit market coupling arrangement. In fact research from CRE has quantified this benefit by comparing explicit auctioning to implicit auctioning and the theoretical €m available with perfect hindsight, and the annual value is in the order of tens of millions of Euros.

However, the needs of users must also be taken into account in any regime, and so reservation of explicit capacity for longer-term bookings (up to 1-2 years) should be made available in order to offer traders the requisite flexibility to trade.

It may be that market coupling is better in the day-ahead and intra-day markets for managing intermittency in terms of its flexibility and ability to capture the efficient direction and volume across the interconnector(s); however the issue of managing intermittency, as noted above, is more complex than simply assuming that an interconnector will automatically solve the problem.

It is clear that a large amount of cost-benefit analysis remains to be undertaken by Ofgem on the costs and benefits of the various approaches (perhaps building on the work performed by CRE in quantifying the efficiency benefits of market coupling vs. explicit auctions).

Q2.2: What should our approach be to firmness of interconnector capacity? Should this vary between new and existing interconnectors, or between regulated and exempt? What are the categories of costs and benefits from changing approach, where should they fall and can they be quantified?

In order to provide traders with the confidence to trade, we believe strongly that interconnector capacity should be sold on a physically firm basis, without variation or inconsistency between new, existing, regulated or exempt interconnectors. As it appears to be the case that there must be physical firmness in an implicit auction methodology, it would seem to be sensible to extend that across the board.

Q2.3: Should we seek regional solutions rather than individual project solutions for access rules, such as through a broader NW European solution for market coupling? What are the priority areas for greater regional co-ordination?

As a larger number of interconnectors connect around GB, it is likely that there will be *de facto* market coupling and we believe that a regional solution is likely to emerge without much

further regulatory intervention. Nonetheless it is imperative that for each interconnector, the two national regulatory authorities directly involved cooperate in their decisions and consultations on the implementation of relevant regulatory requirements from the outset. We recognise the ultimate EU vision of harmonised markets, and believe that there could be benefits to a NW Europe-wide market with price coupling where this is possible. However, care must be taken in introducing such a measure, particularly in respect of the timeliness of change. We believe that the proposal to use BritNed as an initial 'spur' towards coupling with the Dutch market is an appropriate first step.

Q3.1: Does this chapter capture the key issues in regulation of new electricity interconnectors? Should we assume that all new interconnectors will seek exemptions?

Ofgem has captured most of the key issues relating to interconnectors. We note the suggestion that the preferred route going forward is likely to be for exemptions to the interconnector licence to become less frequently allowed; and that TSOs are likely to be the preferred route for construction of interconnectors in the future.

We would note that while this would seem to be potentially appropriate, especially for those interconnectors that simply occur where meshed networks interact, this is one area in which GB may be different from many others. Not only are interconnectors linking the GB market direct current (DC) interconnectors, they also tend to opt for the 'merchant interconnector' model. Because of these peculiarities, it may be useful for Ofgem to formally assess the matters associated with DC interconnectors jointly with regulators and market participants in neighbouring Member States with which there are existing or planned interconnectors (France, the Netherlands, Eire and Belgium). Ofgem could also benefit from discussions with regulators in the Baltic region who studied the issue of optimising the use of the merchant interconnectors SwePol and Baltic Cable, as one of the projects within the Baltic regional initiative.

We do not believe that restricting interconnector development to Network Operators is necessarily beneficial – in a similar way to the developing tender process for OFTOs, it may well be the case that parties who do not operate electricity grids are able to innovate and invest in interconnector assets efficiently in a commercial manner, and to do so successfully for the benefit of all parties. It will, however, be essential to monitor closely the developments in the fledgling OFTO regime, ensuring that learnings are taken on board in the enduring arrangements as well as addressing those deficiencies already identified,

In an open electricity market where, for example, any licensed or exempt operator can construct a power station, it would seem a curious anomaly to remove the option of a market mechanism and enforce a regulated approach for one particular means of flowing power to or from GB.

Again, Centrica would not wish to speculate as to whether future interconnector investors will ask for exemptions from the interconnector licence conditions; however we would note that most recent investors have done so, which would seem to suggest that investors' preferences are in a particular direction which the licence itself does not entirely accommodate.

However, we do not subscribe to the belief that all future interconnectors would necessarily need to seek exemptions. We found the request from Imera particularly interesting in this regard¹. The main purpose of the application appeared to be securing regulatory stability for the period of the investment; rather than excusing the developer from compliance with particular requirements of the regime. This might indicate that if issues around the stability of the regulatory arrangements were addressed, then developers, whether regulated or merchant, might perceive the question of exemptions from aspects of the arrangements rather differently.

Q3.2: Of the options set out, which are preferable and why? What are the key considerations in taking forward any of the options?

Centrica believes that there may not be a generic solution for all interconnectors and all interconnector owners. In our view, it may be more appropriate to tailor the approach to the arrangements for the development of the relevant interconnector. For example, in the case of a regulated approach to development with an exemption a regulated capped approach to returns might be appropriate (with or without a floor). Where the interconnector is developed using a merchant approach and providing a full TPA regime, its hard to see why returns would need to be limited given the merchant developer bears the risk.

We believe however, that some types of investor may prefer the certainty of a regulated income with a cap & collar mechanism on the available return; whereas others may prefer the flexibility (with additional risk) of uncapped returns. We recommend that this is another area in which full flexibility of approach should be retained in order to encourage investment.

Q3.3: Is it feasible to have a mixture of different approaches for different interconnectors – such as some exempt and others regulated? If not, why and how should this be resolved?

This question is not entirely clear, i.e. does it relate to the approach to granting exemptions to more than one interconnector between the same pair of member states or interconnectors between different pairs of member states.

In the former situation for example, when the case for exemption is evaluated, it is quite likely that application of the criteria may result in different outcomes according to individual characteristics of the case in point. A large interconnector proposing exemption from the TPA provisions might be expected to have a different effect on competition to a small interconnector and hence a different outcome may result.

In our view, the key point is that the regulators on either side of the interconnector must agree on the rules for access, whether this is regulated or (for DC lines only) exempt. In the case of

¹ 3.28. In its application, EWC stated that its motivation for seeking an exemption is "related to the commercial and regulatory risk of the project". In relation to the regulatory risk EWC noted that even though the proposed access regime is in line with the current rTPA regime, an exemption from this rTPA regime is necessary to eliminate the risk that it changes during the period of the exemption.

disputes, the new regulatory agency can step in, and exemptions are effectively given final approval by the European Commission.

However, if the question relates to the building of the asset, then Centrica believes that a range of approaches to the development of interconnectors is possible. In particular it is important to distinguish the regulated vs. merchant approach to the building of interconnectors from the exempt vs. non-exempt debate on the access to the asset.

Whilst there may be arguments for a common approach it may be the case that different investors have different requirements and/or appetite for regulatory intervention in terms of revenue. We can see no reason why, by allowing optionality in the regime, these requirements could not be met whilst continuing to protect the interests of consumers.

We hope that these comments are useful, and would be happy to discuss any points in more detail. If you have any queries relating to the content of this response, I would be happy to help.

Yours sincerely,

By e-mail

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