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Open Letter on next steps from Ofgem's consultation on electricity interconnector policy

Dear Sir/Madam,

Ofgem's consultation on electricity interconnection policy described the proposed models for the allocation of cross border transmission capacity and efficient use of electricity interconnectors and set out alternative options for the regulation of new investment. The aim was to seek views on how Ofgem's policy should develop. The purpose of this letter is to set out our next steps, under two main areas: market coupling and regulating new interconnector investment.

Background

The consultation was published on 26 January 2010 and closed on 30 March 2010. Ofgem received 21 responses from interconnector owners, TSOs¹, energy companies and other organisations². A summary of responses to the consultation was published in July 2010³.

There are benefits of new interconnection between GB and other markets, given the current limited interconnection to only France and Northern Ireland. These include: price arbitrage opportunities; greater price transparency; improved security of supply; sharing of balancing facilities between interconnected systems; and improved liquidity and competition. The key question is not only whether benefits exist but whether they can outweigh costs of investment in new infrastructure.

An important and related issue is how efficiently interconnectors are used, i.e. that the maximum capacity is made available to market participants, while maintaining operational security and facilitating the flow of electricity in response to market price differentials. Whether the existing capacity is used efficiently will depend on the degree to which capacity products and national electricity markets create barriers, or facilitate economic trade between neighbouring electricity markets.

The consultation explored options for congestion management on interconnectors connecting to GB. These options were presented in the context of European policy

¹ Transmission System Operator

² List of respondents can be found on p.1 of our summary of responses paper:
<http://www.ofgem.gov.uk/Europe/Documents1/Summary%20of%20Responses%20from%20Electricity%20Interconnector%20policy.pdf>

³ Ofgem's summary of responses to the consultation on electricity interconnector policy:
<http://www.ofgem.gov.uk/Europe/Documents1/Summary%20of%20Responses%20from%20Electricity%20Interconnector%20policy.pdf>

discussions on the development of models for capacity allocation and congestion management and legal requirements promoting a single European electricity market. Our summary of responses paper provides a detailed explanation of the proposed models developed at European level. For the purposes of this letter it is worth noting that the central proposal is day-ahead market coupling developing into a single price coupling across Europe with single matching algorithm and common market rules. This means that, following longer term explicit auctions, remaining interconnector capacity would be allocated through optimisation between power exchanges at the day-ahead stage.

The consultation sought views on a) whether the proposed capacity allocation and congestion management models are appropriate for GB, b) how could the models be implemented in the GB and what role could the Regional Initiatives have in delivering them and c) the key issues that need to be addressed in parallel to ensure effective implementation of the capacity allocation models.

Regarding the framework for interconnector investment, recent GB interconnector projects have been developed as standalone activities outside the price controlled transmission business, where revenues are exclusively determined by auctions of capacity. For these projects, an exemption from aspects of EU legislation has been requested, to seek protection against regulatory intervention to cap profits or change the basis on which capacity is sold. By contrast, in other EU member states, it is more common for interconnectors to be developed by TSOs with revenues underwritten by consumers.

Recent experiences with the exemption process, implications of the Third Package (for example the development of cross border codes) and the fact that EU's default approach to interconnection is a regulated investment, led Ofgem to consider whether the current regulatory arrangements will continue to provide sufficient incentives to invest in efficient levels of new interconnection. The four options for regulating new interconnectors presented in our consultation include a merchant, a regulated cap, a cap and floor and a fully regulated model⁴. The consultation sought views on the key issues in regulating new interconnectors, on whether new interconnectors will be seeking for exemptions from aspects of EU legislation, on the preferred option for regulation as well as on the feasibility of having a mixture of different approaches for different interconnectors.

Having thoroughly considered the consultation responses, with this letter Ofgem presents the next steps on the issues of market coupling and the interconnector investment regulatory framework.

Next Steps

Market Coupling

We are committed to the implementation of an enduring market coupling solution between GB and the North West Region⁵ and subsequently including the whole FUI⁶ region, which will be a major step towards the implementation of a pan European market coupling solution. This was fully endorsed by the consultation respondents and is in line with the conclusions of the November 2009 FUI Stakeholder Group meeting. Our steps towards the enduring solution are as follows:

⁴ Background information on the four models can be found in the consultation paper: <http://www.ofgem.gov.uk/Europe/Documents1/Interconnector%20policy%20consultation.pdf> and the summary of responses: <http://www.ofgem.gov.uk/Europe/Documents1/Summary%20of%20Responses%20from%20Electricity%20Interconnector%20policy.pdf>

⁵ This would involve the Northern (Denmark, Finland, Germany, Norway, Poland, Sweden) and the Central West (CWE) (Belgium, France, Netherlands, Luxembourg and Germany) electricity regions

⁶ French-UK-Ireland Electricity Region

1. BritNed⁷ is committed to implementing its “embedded solution” (BritNed’s order book being integrated into the Dutch order book which then feeds into the central CWE algorithm) facilitated by APX from the start of its operation in 2011 in order to meet its exemption requirement to provide day-ahead implicit auctions.
2. Support for and participation in the North West TSO and power exchange⁸ projects, with the common objective to put in place a single price coupling mechanism with a single algorithm. Both groups are developing a coordinated roadmap for the implementation of an enduring solution, including GB as a single “hub” (i.e. IFA and BritNed).
3. Based on the roadmap developed by TSOs and power exchanges, GB will implement the enduring solution, including both IFA and BritNed. Interconnector owners would need to coordinate to find a power exchange delivery solution that could potentially accommodate both GB power exchanges and also facilitate the enduring market coupling mechanism.
4. In the longer term, the enduring solution will be extended to include the whole FUI region. The timing for this to happen will depend on the changes needed to the market design of the recently developed All Island Single Electricity Market (“SEM”).

Consultation respondents as well as regional stakeholders have raised a number of issues that would need to be addressed for the implementation of market coupling and other capacity allocation and congestion management models, currently developed by European Regulators through the framework guideline process which will lead to legally binding European codes developed by TSOs. We have already achieved significant progress on some of these issues and are in the process of resolving others.

TNUOS Charging on Interconnectors

The majority of respondents highlighted GB use of system charges as creating a deadband, preventing price convergence and acting as a barrier to the full benefits of market integration. The recent adoption of a formal Inter TSO Compensation (“ITC”) mechanism designed to compensate TSOs for the costs they incur as a result of hosting cross-border flows of electricity on their networks, has led National Grid and Ofgem to review the British charging system against this background. National Grid published a consultation in July 2010⁹ proposing that interconnectors be treated as a separate class of transmission users as distinct from generation or demand and that they be exempt from both generation and demand use of system charges. The consultation closed on 26 August 2010. On 6 September, National Grid submitted its conclusions report on modification proposals to Ofgem for approval. Subject to Ofgem’s final decision, it is proposed that these changes in the charging methodology statements would take effect as of October 2010.

Firmness

Regarding the issue of firmness on interconnectors, we share our European colleagues view that implicit auctions require physical firmness and we recognise that physical and financial firmness should work towards delivering the same outcome. BritNed will be offering physically firm products for implicit auctions, a step in the right direction. We see merit in harmonising with the CWE’s region approach to firmness after nomination and we encourage all interconnectors in the FUI region to work towards adopting a similar approach. In parallel, we are committed and actively contributing to the European Regulators’ work to address the issue of firmness through the framework guideline/network code process which could lead to a common European approach.

⁷ BritNed: 1000MW Interconnector between GB and the Netherlands, operational in 2011.

⁸ “Price Coupling of Regions” project

⁹ National Grid Consultation Paper: <http://www.nationalgrid.com/NR/rdonlyres/2034BAE8-4F0A-485C-ADA9-D2E952256108/42273/GBECM26InterconnectorChargingReview1.pdf>

Power Exchanges

Market parties have identified the existence of two power exchanges in GB (APX and N2EX) as a potential issue for the implementation of the enduring solution of a single price coupling with a single algorithm across regions. As most European member states have one power exchange which will deliver price coupling, we've been considering how market coupling could be implemented in GB. This issue has been discussed at the FUI level and concluded that there is no barrier. For example, efficient solutions could be assured through the market coupling algorithm, assuming infinite capacity between the two exchanges. Alternatively, the power exchanges could combine order books or one could develop price coupling for both interconnectors. In any event, this can be addressed in implementation.

Regional Coordination

We welcome respondents' support for the positive role of the regional initiatives in developing and implementing regional and inter-regional solutions and stakeholders support for the FUI 2010-2012 priorities¹⁰. Apart from market coupling, coordination of auctions is a key priority for the region in order to meet the requirements of European legislation to have a coordinated approach to cross border capacity. We are currently working with regional regulators and TSOs on coordination and optimisation of capacity allocation on the existing links in the region (IFA, Moyle) and where appropriate, inter-regional links (East West¹¹ and BritNed). EirGrid, Moyle and Soni launched a public procurement process on 23 July 2010 for a new auction platform which will be common for Moyle and East West interconnectors and developed with a view to consistency with IFA and BritNed. This platform will introduce day-ahead explicit auctions for Moyle. It will be brought into operation as soon as practical, given the IT developments and testing needed, most likely over summer 2011. In parallel, regional regulators and TSOs are conducting an assessment of commonalities and differences in the auction rules in the region and further work will be undertaken to harmonise arrangements where practical and in consultation with stakeholders. Finally, regulators and TSOs will evaluate the possibility of moving to a common platform for auctions in the region, including consideration of other regional platforms, like the Capacity Allocation Service Company for CWE region (CASC CWE) with the intention to complete an initial evaluation in early 2011.

Intraday timeframe

As respondents highlighted, the increased amount of intermittent generation expected in GB and SEM markets places additional value to the intraday timeframe. We are committed to the development of a pan-European intraday model. Together with the Dutch and Danish Regulators representing CWE and Nordic regions, we are co-chairing, on behalf of FUI, the regulators' group of the North West Intraday Coupling Project. This project aims to deliver intraday market coupling between the three regions by 2012, which will then be extended to deliver a pan European intraday coupling solution. In addition, by January 2011 the SEM committee is expected to deliver a decision on the proposed model on intraday trading to be adopted by SEM, allowing East West and Moyle links to introduce intraday capacity products. This will allow FUI region to develop coordinated intraday capacity products and work towards the implementation of the intraday coupling model.

New Interconnector Investment Framework

We welcome respondents' views on the preferred options for regulating new interconnector investment; these are fully elaborated in our summary of responses published in July. We remain open to the merchant route but we share the view of most market parties that it has become increasingly difficult. Given that the preferred EU approach is a regulated model to interconnector investment, there is a need to develop a regulated investment regime for non-exempt interconnectors.

¹⁰ Link to FUI priorities papers: http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_INITIATIVES/ERI/France-UK-Ireland/Final%20docs

¹¹ East West Interconnector: 500MW Interconnector between GB and Republic of Ireland, operational in 2012

Whilst there are benefits from adopting a fully regulated approach, bringing GB in line with Europe, there are also disadvantages, such as reducing commercial incentives. On a practical level it would also signify a significant departure from our current approach, requiring several changes to our existing regime, which would take time to implement. As highlighted by many respondents, the cap and collar model could avoid some of the downsides of the fully regulated approach. It has the advantage of reducing the risks of the pure merchant approach and the need for exemption, while keeping incentives for project developers. It will bring us closer to the regulated approach preferred on the Continent and may be a good compromise between the advantages and disadvantages of the merchant and current regulated models. Importantly, we could still retain contestability, so that any interested party could propose to build an interconnector on an exempt or regulated approach.

Project NEMO (the proposed interconnector between Belgium and GB) will be our "pilot project" in exploring whether a cap and collar model could be implemented in GB. Together with our counterparts in CREG, and with assistance from National Grid and Elia, we aim to establish the high level principles for a new regulated regime (e.g. ensuring a basis for merchant investment, whilst safeguarding consumers from taking on undue levels of risk) and explore options for design of a cap and collar that could satisfy these principles. We are also evaluating the potential changes needed in the regimes on both sides of the border to administer a new approach. We intend to work up an initial proposal by the end of this year on which we would consult in early 2011.

Whilst we are using NEMO interconnector as our pilot project to develop our regulated investment regime, we do acknowledge there are other interconnector projects under discussion, such as additional links to France and Ireland and a new link to Norway. We envisage holding similar discussions with the relevant regulators to discuss if the cap and collar approach could be seen as a high level solution for other new non-exempt interconnectors.

We share market parties' views that a coordinated approach to interconnector investment between regional regulators and regulators on both sides of interconnectors is needed to mitigate risks associated with regulatory uncertainty and ensure compliance with the EU Congestion Management Guidelines. Under the FUI workstream on new interconnector investment we will present our progress on developing the new regime and consult regional stakeholders and other interested parties.

Whilst we will be developing our regulated regime for interconnector investment, we remain open to the exempt route for building new interconnectors. Much closer regional cooperation will be needed as regulators must agree on the terms of the exemption decision. Under the FUI workstream on interconnector investment, we intend to develop a coordinated approach towards exemptions with the other regulators.

If you have any comments or questions on the contents of this letter, please feel free to contact Emmanouela Angelidaki (Emmanouela.Angelidaki@ofgem.gov.uk).

Yours faithfully,
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