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Project Transmit: Further consultation on proposals to change the electricity transmission charging methodology – RWE Response

Dear Catherine,

RWE welcomes the opportunity to respond to this consultation¹. We are responding on behalf of RWE companies operating in the UK.

Overview of our concerns

Having examined the new evidence commissioned by Ofgem² and Ofgem's statements in the Consultation Document, we remain concerned that, if the Authority were to approve Ofgem's "minded to" decision to implement CMP213 WACM2, it would fail to meet its statutory obligations and the obligations under the CUSC. Despite Ofgem having conducted additional modelling, serious and material issues with WACM2 are raised in the Ofgem Consultation Document. These must be considered before reaching a decision. In our view, an objective assessment of the issues would lead the Authority to conclude that it is not consistent with its statutory objectives and duties or the CUSC Objectives to implement WACM2 and that the Modification Proposal must therefore be rejected.

In light of comments made in the Consultation Document and the Redpoint/Baringa analysis commissioned by Ofgem, RWE commissioned NERA/ICL to conduct further analysis concerning the points raised. We enclose copies of their reports³ with this letter, which form part of this response.

¹ Project Transmit: Further consultation on proposals to change the electricity transmission charging methodology, Ofgem 25th April 2014 (the **Consultation Document**)

² CMP213: further analysis and review of consultation responses, Further analysis of CMP213 options and review of NERA/ICL and Poyry responses to CMP213 Consultation for Ofgem, Redpoint/Baringa, April 2014, (the **Redpoint/Baringa Report**)

³ Project TransmiT: Critical Review of Ofgem's April 2014 Further Consultation, NERA/ICL, 27th May 2014 and Project TransmiT: Updated Comparison of the WACM 2 and Status Quo Charging Models, 27 May 2014 (the **NERA/ICL Reports**)

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As you are aware, the Gas and Electricity Markets Authority's (the **Authority**) principal statutory objective when carrying out its functions is to protect the interests of existing and future consumers. Under Article 36 of Directive 2009/72/EC⁴ the Authority is required to take all reasonable measures in carrying out its regulatory tasks to meet a set of objectives that include "*helping to achieve in the most cost-effective way, the development of secure, reliable and efficient non discriminatory systems that are consumer oriented...*" (Article 36 (d) emphasis added) and "*ensuring that customers benefit through the efficient functioning of their national market, promoting effective competition and helping to ensure consumer protection*" (Article 36 (g), emphasis added). The Authority's regulatory tasks include the duty to fix or approve, in accordance with transparent criteria, transmission and distribution tariffs or their methodologies under Article 37 (1)(a).

Furthermore, CUSC Modification Proposals are required to "better facilitate" the achievement of the applicable CUSC Objectives under Condition C10, namely ensuring the efficient discharge of National Grid's duties imposed by licence or statute (which duties include, amongst other things, prohibiting discrimination between users, developing and maintaining an efficient, co-ordinated and economical system of electricity transmission and facilitating competition (CUSC Objective A), facilitating effective competition in the generation and supply of electricity (CUSC Objective B) and compliance with the Electricity Regulation (CUSC Objective C)).

We set out below our main concerns with respect to WACM2 and Ofgem's analysis of it. In our view, these issues will need to be considered and dealt with by the Authority in reaching its decision. Our answers to the specific questions raised in the consultation document are included in an annex to this letter.

Specific concerns

1. WACM2 is not in the interest of existing and future consumers

The Authority must ensure that any decision to approve and implement WACM2 is in line with its primary statutory duty i.e. to protect the interests of existing and future consumers. Ofgem has not demonstrated or justified that its "minded to" position is consistent with this objective. On the contrary, to the extent that Ofgem has commissioned and conducted any analysis of the efficacy of WACM2 and its effect on consumers, that analysis indicates that WACM2 would not be in the interests of consumers.

In the Consultation Document, Ofgem notes that "*the impact assessment modelling does not present clear evidence that the monetised benefits of WACM2 outweigh the costs*"⁵. Ofgem's own empirical modelling presented in the Consultation Document⁶ (which will presumably be relied on in arriving at any decision to implement WACM2) demonstrates that there will be negative financial effects on consumers in, at least, the short to medium term (to 2020). The further analysis presented by Ofgem as part of the Consultation Document provides evidence that these findings are consistent across a number of scenarios and across timescales up to 2030⁷. This outcome is supported by the conclusions reached in previous modelling WACM2 by NERA/ICL,⁸ and the latest NERA /ICL reports namely that consumers will face higher bills as a result of WACM2^{9 10}. It is therefore difficult to see how the Authority could conclude that it was protecting the interests of consumers, if it were to approve Ofgem's "minded to" decision.

⁴ Directive 2009/72/EC Of The European Parliament And Of The Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (the **Electricity Directive**)

⁵ Consultation Document, page 22, paragraph 2.49

⁶ Consultation Document, page 18

⁷ Redpoint/Baringa Report, table 19, page 67

⁸ Consultation Document, page 37

⁹ Project TransmiT: Updated Comparison of the WACM 2 and Status Quo Charging Models, 27 May 2014

¹⁰ Project TransmiT: Updated Comparison of the WACM 2 and Status Quo Charging Models, 27th May 2014, Table 4.1, page 49

To overcome this difficulty, Ofgem seeks to rely on a number of other “non-monetised” benefits that it asserts (without any evidence) will be enjoyed by consumers. In the absence of any evidence or empirical basis for these assertions, we consider Ofgem’s conclusions on these “non-monetised” benefits to be highly speculative and unsound. For example:

- There is no evidence that supports Ofgem’s assertion that WACM2 “*could support the long term government policy to deliver increasing amounts of energy from renewable sources and achieve carbon targets*”¹¹. In fact, the empirical analysis in the Redpoint/Baringa Report explicitly includes the monetised effects on greenhouse gasses and the delivery of low carbon generation and demonstrates that the Government’s policies can be met under both the status quo and WACM2, albeit with different policy costs¹².
- Ofgem’s assertion that “*the broader ranges of renewables technologies that might be developed under WACM2 contributes to benefits in terms of energy mix*”¹³ (our emphasis) is untested and unreliable. In fact Redpoint/Baringa provide monetised evidence on the plant mix¹⁴ that illustrate similar plant mixes in their analysis of both the status quo and WACM2 though the geographical disposition of plant varies (with “*the exception of*” substitution between CCGT and OCGT plant in south England and South Wales¹⁵).

The supposed non-monetised benefits relied on by Ofgem appear to stem from Ofgem’s view that WACM2 is more cost reflective than the status quo. However, as explained below and in NERA/ICL’s analyses (including the enclosed most recent analysis¹⁶), this view is simply wrong and is certainly not supported by the evidence that has been presented in relation to cost reflectivity to date.

Therefore, there is no evidence for Ofgem’s conclusion that the “*cumulative impacts of factors not included in the modelling*”¹⁷ would result in benefits that outweigh the negative financial impact on consumers. It would be irrational for the Authority to conclude that approving WACM2 would meet its statutory objective in the face of clear negative financial implications for consumers over a sustained period into the future, based on untested and highly speculative future benefits that may or may not materialise.

Ofgem asserts that “*there might be wider sustainability benefits for consumers which cannot be captured in a model. We therefore think that the cumulative impact of these effects mean that WACM2 would result in long term benefits to consumers*”¹⁸ (our emphasis). This conclusion is illogical since the statement is not supported by Ofgem’s own modelling (which does take into account at least some sustainability factors), nor does Ofgem attempt to determine or calculate the wider sustainability benefits. To the extent that Ofgem has produced any evidence on consumer impact, that evidence is unsupportive of this conclusion.

Further, Ofgem’s analysis indicates a significant risk of disproportionate negative impact (and hence discrimination) towards certain categories of consumers, which Ofgem appears not to have considered at all. On Ofgem’s own modelling, there is likely to be a negative financial impact on consumers in the short to medium term, with any benefits only potentially materialising in the long term. Implicit in this analysis is an acknowledgement that existing consumers will face greater negative financial impact than future consumers. This suggests that vulnerable consumers who are

¹¹ Consultation Document, page 22, paragraph 2.47

¹² Redpoint/Baringa Report, section 4.4.6, Page 60

¹³ Consultation Document, page 22, paragraph 2.48

¹⁴ Redpoint/Baringa Report, section 4.4.6, page 52 and page 53

¹⁵ Redpoint/Baringa Report, section 4.4.6, page 52 and page 50

¹⁶ Project TransmiT: Updated Comparison of the WACM 2 and Status Quo Charging Models, 27 May 2014

¹⁷ Consultation Document, page 22, paragraph 2.49

¹⁸ Consultation Document, page 5

of pensionable age may be disproportionately negatively impacted by the proposed changes and may never see the benefits (to the extent there are any) of implementing WACM2. The Authority has a specific obligation to have regard to the interests of certain categories of consumers, including consumers of pensionable age, when performing their duties.¹⁹ Ofgem has provided no evidence or indication that it has done so.

In any event, the longer-term consumer benefits relied on by Ofgem to support its approval of WACM2 requires Ofgem to ignore the prospect that the EU Target Model may require market splitting in the British market. If market splitting were to occur, this could erode any supposed benefits of WACM2. While Ofgem has chosen to ignore this risk as part of *this* consultation, it is currently separately examining the possibility of market splitting²⁰. The fact that market splitting is a real possibility and that this could affect costs and pricing in the medium to long term will impact on the locational signals that WACM2 will send if implemented at this time. It is illogical for Ofgem to ignore this issue in the context of TNUoS charging when at the same time it is separately consulting on the prospect of market splitting.

Taking the above into account, we consider that implementing WACM2 would not be in line with the Authority's principal duty to protect the interests of existing and future consumers and for the Authority to reach such a decision in spite of compelling evidence to the contrary (and without considering the full impact on all categories of consumers), would be irrational.

2. WACM2 is less cost reflective than the status quo

In making its decision whether to approve the implementation of WACM2, the Authority must consider whether WACM2 better facilitates the achievement of the applicable CUSC Objectives than the status quo. Based on the evidence presented during the consultation, the Authority is not able to conclude that WACM2 is more cost reflective than the current arrangements.

Much of the information presented by Ofgem demonstrates that WACM2 is in fact *less* cost reflective than the current arrangements. For example, Redpoint/Baringa state that: "*the analysis does suggest that charges under WACM2 for wind generation in Scotland are not as close to LRMC [Long Run Marginal Costs] as those under status quo once the need for HVDC bootstraps to reinforce the transmission system between Scotland and England is triggered*"²¹. Ofgem also states that "*in a significant majority of cases the current ICRP methodology will produce long run charges that are an appropriate approximation of the long run costs users impose on the transmission system*"²².

NERA/ICL have conducted further analysis in respect of cost reflectivity and their findings are that Ofgem's conclusion that WACM2 is more cost reflective than the status quo is "*not supported by evidence, and moreover, is not based on a logically coherent foundation*".²³ We agree with NERA/ICL's analysis and consider it is unreasonable and illogical to conclude that implementation of WACM2 would result in charges that are more cost reflective when compared to the status quo and the LRMC of investment in the transmission system, when the reports prepared by both Redpoint/Baringa and NERA/ICL suggest otherwise.

Ofgem asserts that "*on balance we think the benefits of greater cost reflectivity for the GB system as a whole outweigh the risks that WACM2 may result in less cost reflective charges in certain circumstances*"²⁴. However, Ofgem has failed to demonstrate and justify that WACM2 is more cost

¹⁹ Section 3A(3)(b) of the Electricity Act 1989

²⁰ See, for example, Ofgem's Open letter: Implementing the European Electricity Target Model in Great Britain, 28 March 2012 and Update on the Future Trading Arrangements Process, Ofgem 19th February 2014

²¹ Redpoint/Baringa Report, page 1

²² Consultation Document, page 15, paragraph 2.17

²³ Project TransmiT: Critical Review of Ofgem's April 2014 Further Consultation, NERA/ICL, 27th May 2014, paragraph 2.4, page 20

²⁴ Consultation Document, page 15, paragraph 2.20

reflective, on the apparent basis that to do so would be too difficult: “*we would be required to develop our own methodology and make our own simplifying assumptions. As this would be open to debate, we do not believe that carrying out our own modelling of LRMC would give any more weight to the existing evidence*”. This is an extraordinary conclusion to reach, given the importance of the issue in question and Ofgem’s duty to ensure that WACM2 will improve cost reflectivity. Furthermore, it is not too difficult to model the cost reflectivity of WACM2; NERA/ICL have done so. Given that NERA/ICL have succeeded in conducting this modelling, Ofgem should give due weight to their analysis, in the absence of any contrary analysis or modelling. It does not appear that Ofgem has done so.

Furthermore, a key focus of Project TransmiT was to ensure greater cost reflectivity in respect of renewables. NERA/ICL’s analysis shows (which Ofgem appears to accept) that WACM2 is less cost reflective for wind generators in Scotland than the status quo. In the circumstances, this should be given particular attention.

While Ofgem says it is “not persuaded” by arguments which indicate WACM2 is less reflective of the impact different users have on the transmission system than the status quo, the only quantitative analysis and evidence of this impact is that produced by NERA/ICL, which shows WACM2 is less cost reflective. In the absence of any logical basis for Ofgem not being persuaded this conclusion is illogical and merely indicates that Ofgem has failed to take into account matters that it reasonably ought to when considering the efficacy of WACM2.

To the extent that Ofgem recognises the risk associated with the cost reflectivity of WACM2, it suggests that “*there is the potential to mitigate this risk if it does materialise through other modifications to the transmission charging arrangements*”²⁵. This is a wholly unsatisfactory approach to take. Ofgem’s duty is to ensure cost reflectivity now, as part of its review and decision-making on WACM2. It is not open to Ofgem to conclude that while WACM2 may not be more cost reflective than the status quo it may still decide to approve it on the basis that this failure could be overcome by future unexplained modifications. If that were a decision Ofgem could make, its duties and obligations could always be avoided on a similar basis. Accordingly, Ofgem must take steps now to mitigate the risk, either by conducting its own, meaningful analysis to demonstrate that WACM2 is more cost reflective or by acknowledging the analysis conducted by NERA/ICL and deciding that WACM2 is not more cost reflective and should not, therefore, be implemented.

3. WACM2 does not better meet the CUSC Objectives

We consider from the evidence presented by Ofgem, Redpoint/Baringa and NERA/ICL that WACM2 will result in charges that are less cost reflective when compared with the status quo and the LRMC of investment in the transmission system. In fact, the modelling shows that WACM2 would lead to higher transmission system costs, higher generation costs and higher consumer bills over the period to 2030 and does not support the introduction of the WACM2 model. Therefore, Ofgem has failed to justify that WACM2 better promotes competition and better reflects development of the licencees’ transmission business or better facilitates the CUSC objectives than the status quo.

4. WACM2 does not translate the SQSS arrangements into the charging methodology

Ofgem asserts in the Consultation Document that WACM2 is “*correcting a defect in the system by better aligning the TNUoS charging methodology with the updated SQSS*”²⁶. This is on the basis of reassurances from the transmission company, but Ofgem has neither conducted its own analysis to confirm that this is, in fact, correct, nor set out the basis on which National Grid has been able to provide such reassurance.

²⁵ Consultation Document, page 15, paragraph 2.20

²⁶ Consultation Document, page 15, paragraph 2.18

The factors used to represent the impact of users on the transmission system are fundamentally different between the updated SQSS and WACM 2. The updated SQSS uses generic “scaling factors”²⁷ for power station output while WACM 2 uses Applicable Load Factors for individual power stations derived from historic output. While there are apparent similarities between WACM2 and the updated SQSS, Ofgem have presented no evidence that leads to the conclusion that “WACM2 is consistent with the SQSS”²⁸. In fact there is a broad variation of plant annual load factors from year to year and a significant variation in annual load factors within the plant type CCGTs.

Just because a new possible methodology superficially emulates the broad structure of SQSS does not mean that it better reflects, or is more consistent with, SQSS in practice. As NERA/ICL sets out in its most recent report, the mere fact that WACM2 adopts the use of ALF and the observation that plant load factor is a driver of optimal transmission reinforcements in CBA, is not enough to translate SQSS into WACM2.²⁹ It is entirely illogical to reach this conclusion without testing the actual impact of WACM2 and merely relying on the assumption that common factors will greater align the TNUoS methodology with the SQSS.

4. General Observations on the WACM2 Decision

We have a number of general observations about the latest Ofgem consultation. These are summarised below:

- **Ofgem has still failed to conduct a full impact assessment.** Redpoint/Baringa (on behalf of Ofgem) and NERA/ICL have been able to model the future development of the transmission system, as has Ofgem in determining the price controls for the transmission system³⁰ and producing the annual capacity adequacy reports³¹. The conclusion that modelling WACM2 cannot be carried out is unsupported and demonstrates that Ofgem has failed to conduct the required full impact assessment.
- **Ofgem has been selective and partial in considering evidence on the impact of WACM2:** We can find no reference to the extensive and well-reasoned scenarios presented in the Redpoint/Baringa report in the Ofgem document. These indicate negative consumer welfare in almost all cases, as well as increased power sector costs in all cases to 2020 and half the cases to 2030. We have serious concerns that the information relied on by Ofgem and the conclusions reached are selective and do not represent the facts as presented both by Ofgem’s consultants, Redpoint/Baringa, and by work previously undertaken on behalf of RWE by NERA/ICL. This raises real concerns as to whether Ofgem has taken account of all relevant matters in reaching its current view.
- **Ofgem has failed to address our concerns about negative distributional effects:** While Ofgem acknowledged in the Consultation Document the concerns we raised in our initial response that its assessment failed to account for distributional effects, this has not been addressed in any meaningful way. Nor has Ofgem conducted any modelling or assessment of

²⁷ National Electricity Transmission System Security and Quality of Supply Standard, Version 2.2, March 5th, 2012, Page 85, Appendix E

²⁸ Consultation Document, Page 28, Paragraph 1.7

²⁹ Project TransmiT: Critical Review of Ofgem’s April 2014 Further Consultation, NERA/ICL, 27th May 2014, Paragraph 2.2.7.3, page 18

³⁰ See for example “RIIO-T1: Initial Proposals for National Grid Electricity Transmission and National Grid Gas – Impact Assessment”, Ofgem, 27th July 2012

³¹ See for example “Electricity Capacity Assessment Report 2013”, Ofgem, 27th June 2013

the impact of such effect on consumers. This issue has been consistently ignored throughout the consultation process.

- **Ofgem has failed to assess the non-monetised benefits (if they exist) against the CUSC Objectives or wider statutory duties:** Ofgem states that “*modelling does not give a full picture of the impact on consumers*” and rely on “*wider sustainability benefits*” to maintain their minded to decision. We have seen no evidence that Ofgem has assessed these benefits against the CUSC Objectives and its wider statutory duties. Therefore a decision to implement WACM2 on the basis of these wider benefits and notwithstanding the evidence of clear dis-benefits where empirical evidence exists is unjustified.
- **Ofgem has failed to take into account the distorting effect of trade with neighbouring markets:** As noted above, under Article 36 of the Electricity Directive Ofgem has certain objectives, including: the promotion of a competitive Community electricity market with effective market opening for all customers and suppliers (Art 36(a)); “*eliminating restrictions on trade in electricity between Member States, including developing appropriate cross-border transmission capacities to meet demand and enhancing the integration of national markets which may facilitate electricity flows across the Community*” (Art 36(c)); and “*facilitating access to the network for new generation capacity, in particular removing barriers that could prevent access for new market entrants and of electricity from renewable energy sources*” (Art 36(e)). However, despite NERA/ICL’s initial analysis highlighting that the implementation of WACM2 could distort trade with neighbouring markets, as non-British generators tended not to face the same energy-linked charges, and despite NERA/ICL repeatedly identifying this issue in their reports to date, Ofgem has repeatedly failed to consider this issue. While Ofgem commissioned Redpoint/Baringa to model the impact on plant dispatch and concluded that “*impact on generator dispatch decisions would be minimal...We therefore disagree with the suggestion that the impact could be significant and potentially distort trade with other EU member states*”, Ofgem’s summary of the modelling in the Consultation Document only considered the impact of WACM2 on dispatch within the British market and not the impact on neighbouring markets. In fact, Redpoint/Baringa’s report supports NERA/ICL’s assertion that WACM2 will distort trade with non-British markets. This warrants further consideration, given the Authority’s obligations under the Electricity Directive.
- **Ofgem has failed to consider wider issues:** Notwithstanding the specific issues raised in this response, it appears Ofgem has not considered the potential impact of several significant developments in the political and economic climate over the course of the next 12 months. In particular, while both NERA/ICL and Poyry indicate that changing the TNUoS methodology may not be justified if wider changes occur, such as market splitting and electricity market reform, and Redpoint/Baringa specifically notes that Ofgem needs to consider the validity and importance of these arguments (para. 2.5), Ofgem has failed to do so in the Consultation Document. Due consideration needs also to be given to the potential impact of the outcome of the referendum on Scottish devolution, the effect of which could mean the entire TNUoS charging methodology would need to be revisited again. Against this backdrop of political and market uncertainty, it is difficult to see how the Authority could justify making a decision to implement WACM2 at this time. To do so would cause significant disruption to transmission users; this may be entirely disproportionate if the methodology has to be revisited almost immediately. This would not be in anyone’s interests. Such uncertainties will also impact on the effectiveness of any locational signals provided by WACM2 (which has not been considered by Ofgem to date).
- **Ofgem has failed to take into account further development of the SQSS:** The SQSS review Panel are currently considering a modification proposal to address issues associated

with embedded generation and in particular the potential for “significant under estimation in the determination of the required transmission capability”³² under the current MITS studies. Ofgem have failed to consider this issue and its potential impact on WACM2.

Conclusions

We consider that Ofgem’s continuing “minded to” decision to implement WACM2 is unsustainable in the light of the information presented in the Consultation Document itself, together with the analyses and conclusions of Redpoint/Baringa and NERA/ICL. It would be entirely contrary to the Authority’s principle statutory objective to approve the implementation of a proposal that has negative consumer welfare effects. Furthermore, Ofgem’s arguments that consumers will receive other, “non-monetised” benefits that outweigh the negative financial impacts are entirely without evidence or merit.

For the avoidance of doubt, we continue to support the elements of WACM2 that relate to the treatment of HVDC transmission assets and transmission links to the islands. This response relates exclusively to the proposed introduction of a dual background and an Applicable Load Factor (ALF) into the charging methodology.

If you have any comments or wish to discuss the contents of this letter then please do not hesitate to contact me.

Yours sincerely

By email

Bill Reed
Market Development Manager

³² SQSS Review Panel – Modification Proposal “review of Generation Scaling Factors and Modelling of Embedded Generation in MITS studies, Ref GSR016, 22 Jul 2013

Annex 1: Response to the specific questions raised in the consultation document

Question 1: Do you agree with our interpretation of benefits to consumers of implementing WACM 2, including revised impact assessment modelling?

As set out in our covering letter, we do not agree with the Ofgem interpretation of benefits to consumers of implementing WACM 2, including revised impact assessment modelling. As noted in our covering letter WACM2 is not in the interest of existing and future customers. The revised impact assessment modelling demonstrates that there will be a material costs to existing and future customers.

Question 2: Do you agree that the revised impact assessment modelling captures concerns raised during August 2013 consultation about the NGET modelling?

We agree that the revised impact assessment captures concerns raised during the August 2013 consultation with regard to the impact on consumers. However, as set out in our covering letter, Ofgem have failed to undertake work on the cost reflectivity of the proposals and on this basis there is no evidence that enable the Authority to implement the proposed modification proposal.

Question 3: Do you agree with our minded-to position in light of new evidence discussed below and the responses to the consultation set out in Appendix 2?

As set out in our covering letter, we do not agree with the minded to position in the light of the new evidence.

Question 4: Do you agree with our minded-to position to implement in April 2016?

No evidence has been provided that implementation in April 2016 would be in the interest of existing and future consumers.