

**OFGEM CONSULTATION ON GB
COST RECOVERY ARRANGEMENTS
FOR THE CACM REGULATION**

EPEX SPOT RESPONSE

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1. INTRODUCTION

1.1 EPEX SPOT SE

The European Power Exchange (EPEX SPOT) SE operates physical short-term electricity markets in Central Western Europe and the United Kingdom. The creation of a pan-European power market is what defines EPEX SPOT's mission. In 2016, our 278 members traded 529 TWh, the equivalent to a third of the domestic consumption in the eight countries in which we operate markets.

EPEX SPOT has 60 active participants in Great Britain, where our members have access to three liquid market segments, a day-ahead auction which is coupled to continental markets, a twenty-four-hour intraday market and a 15:30 day-ahead auction for 30-minute products.

In 2015 EPEX SPOT acquired APX Group, including APX Commodities Limited (which operated the GB day-ahead and intraday markets). On 31 December 2016 EPEX SPOT SE was designated by Ofgem as a Nominated Electricity Market Operator (NEMO) in Great Britain, and APX Commodities was de-designated (we may refer to EPEX SPOT and APX interchangeably in this response).

European Commodity Clearing (ECC) acts the clearing house for EPEX SPOT SE. ECC is the central clearing house for energy and related products in Europe. In its capacity as the central counterparty (CCP) ECC delivers clearing as well as physical and financial settlement of transactions concluded on the European Energy Exchange (EEX), EPEX SPOT, HUPX, NOREXECO, Powernext, Power Exchange Central Europe and SEEPEX.

Since the go-live of North West Europe (NWE) market coupling ECC also acts as shipping agent on the IFA interconnector. In addition, it was recently announced that EPEX SPOT and ECC have been chosen by the Irish transmission system operators EirGrid and SONI as service providers for the Integrated Single Electricity Market in Ireland (I-SEM) and the shipping agent on the Moyle and EWIC Interconnectors between the I-SEM and GB markets.

1.2 MARKET COUPLING INITIATIVES

EPEX SPOT is convinced that the development and integration of short-term markets is key to achieve a truly integrated Internal Energy Market. EPEX SPOT SE (together with APX) has successfully operated robust market coupling solutions, in cooperation with Transmission System operators (TSOs) since the launch of the first market coupling for the Dutch, Belgian and French spot markets in 2006 (the so called "*Tri-lateral Market Coupling*"). This project was conceived in 2003 and delivered well before the entry into force of the Third Package and the CACM Regulation.

EPEX SPOT has been an architect of Market Coupling in Europe for the past ten years, and involved in virtually all market integration projects. Today, 23 countries are part of Day-Ahead Market Cou-

pling, representing 90% of Europe's electricity consumption. Ultimately, millions of citizens across the continent benefit on a daily basis from these united electricity markets.

In 2011 we launched the first GB market coupling solution in cooperation with TSOs, when we developed and implemented an "embedded" price coupling solution which allocated capacity on the BritNed cable by connecting our GB day-ahead auction with CWE market coupling.

Furthermore, EPEX SPOT is committed to the voluntary cross-border intraday project (XBID project), a joint initiative by power exchanges and transmission system operators from 12 countries, which will presumably become the basis for the single intraday market coupling solution under CACM following approval of the MCO Plan.

As highlighted by the Commission, market coupling plays a beneficial role and consistently optimises EU-wide electricity flows, adds net social welfare, increases cross-border competition, lowers wholesale prices, facilitates the integration of renewables and contributes to security of supply.

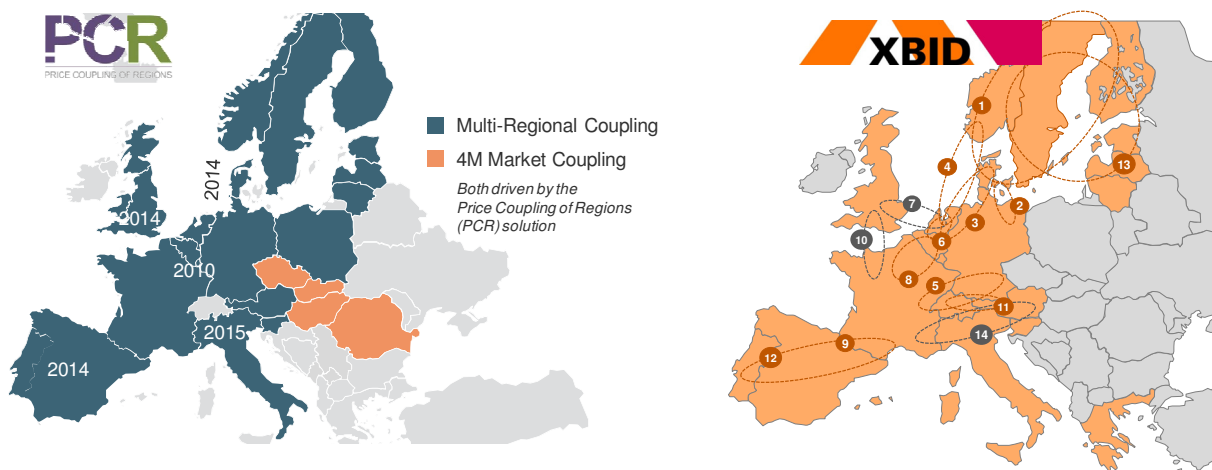


Figure 1 – Market Coupling: successful integration of Europe's Day-Ahead and Intraday markets
Source: EPEX SPOT

As explained later in our response we consider that these projects (with the exception of BritNed market coupling, which we understand was a commitment made by BritNed in its exemption application, and therefore mandatory) were developed, implemented and are operated on the basis of a voluntary and commercial cooperation by the parties involved.

While some of the more recent projects (MRC, PCR and XBID etc.) have been developed with early implementation of the CACM in mind, we do not accept that our activities as participant of these projects are pre-emptively subject to the requirements of the CACM Regulation, including the CACM provisions on costs.

1.3 BENEFIT OF MARKET COUPLING FOR GB CONSUMERS

There have been a number of studies that have sought to calculate the benefit of market coupling for GB Consumers. The benefit of market coupling is driven by optimised flows consistent with price differentials, resulting in better utilisation of the interconnectors as well as generation across the coupled countries.

Estimates of the benefits of market coupling for GB range from:

1. £90 million per annum based on the interconnectors available today, or up to £160 million per annum based on the level of interconnection expected in GB in 2020 (***Vivid economics; November 2015***¹)
2. £65 million to £95 million annual welfare loss (presumably for both the UK and Ireland) due to the absence of market coupling on the borders between GB and Ireland (EWIC Interconnector) and GB and Northern Ireland (Moyle Interconnector) (**Agency for the Cooperation of European Regulators; September 2016**²)
3. Estimate that in the short run, the gains from integrating European electricity markets (for the whole of Europe) could be as high as EUR 3.3 billion per year. About one-third of this total comes from day-ahead coupling (EUR 1.1 billion) and another third from shared balancing (**January 2015, the benefits of integrating European electricity markets; D. Newberry; G. Strbac; I. Viehoff;**)

Newberry et al (2015) undertake the most careful review of the benefits of electricity market integration. They note that estimating the benefits of market coupling is not straight forward as an appropriate counterfactual is difficult to establish. However, the main benefits of market coupling derive from the most observable (easiest to measure) impacts of increased cross-border flows and price changes in the interconnected markets as the interconnectors are more efficiently used. They also note that there are harder to identify indirect benefits that may flow from increased cross-border competition (between electricity market participants), such as pressures to reduce cost, innovate, improve market functioning through increased liquidity, improve sustainability and potentially improve security of supply.

Finally, Newberry et al, explain that there are also longer run benefits to market coupling, as the economics of building interconnectors should improve, and by encouraging further investment and allowing more efficient location of generation across the EU to exploit the gains from improved trade.

In addition to the main economic benefits explained by Newberry et al, we would like to highlight that implementation of the CACM Regulation will also facilitate greater competition between NEMOs that

¹ <http://www.vivideconomics.com/publications/the-impact-of-brex-it-on-the-uk-energy-sector>

² http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/ACER%20Market%20Monitoring%20Report%202015%20-%20ELECTRICITY.pdf

are active in the coupled markets. We consider that such competition will benefit market participants by fostering greater innovation and product development as well as ensuring a cost-effective service.

We consider that the academic (and regulatory) literature on the benefits of market coupling provides an important and unbiased context. EPEX SPOT urges Ofgem to consider these benefits in setting its overall policy objectives and approach to regulating market coupling and the associated cost recovery arrangements. Based on the body of available evidence, we consider that the following points are particularly relevant:

1. **The benefits of market coupling of day-ahead and intraday market coupling for GB consumers are significant.** A reasonable benchmark for the benefit to GB consumers of the current day-ahead market coupling arrangements would be in the region of £50 million per annum. As the current market coupling has been in place between GB and the continent since 4 February 2014, this would imply a cumulative benefit to date for GB consumer of over £150 million; and, an expected cumulative benefit for GB consumers of at least £500 million over the next ten years.
2. **The main beneficiaries of market coupling in GB are GB consumers.** As explained by Newberry et al, the main benefits of market coupling derive from the increased cross border flows and price changes in the interconnected markets. It is easy to understand how more efficient use of interconnectors results in benefits for consumers, as sub-sea interconnectors represent significant capital investments.

It may be less easy to understand why “changes in prices in the interconnected markets” translates into a benefit for consumers. However, the change in prices represents the most significant benefit as it is fundamental to the functioning of the mechanism. Market coupling works by replacing more expensive generation in one market, with cheaper generation in an interconnected market, in the price formation process. As a result, the overall cost of meeting the demand in the interconnected countries decreases.

3. **The market coupling infrastructure that power exchanges and its clearing houses have established** on a mixture of commercial and regulatory terms (depending on the local market) deal with a significant volume of transactions and **are a critical part of the European electricity market arrangements.**

As explained in the rest of our response, we consider that the current approach proposed by Ofgem to GB cost recovery will not serve to deliver the best outcomes for either GB or European consumers.

1.4 DOES MARKET COUPLING BENEFIT POWER EXCHANGES?

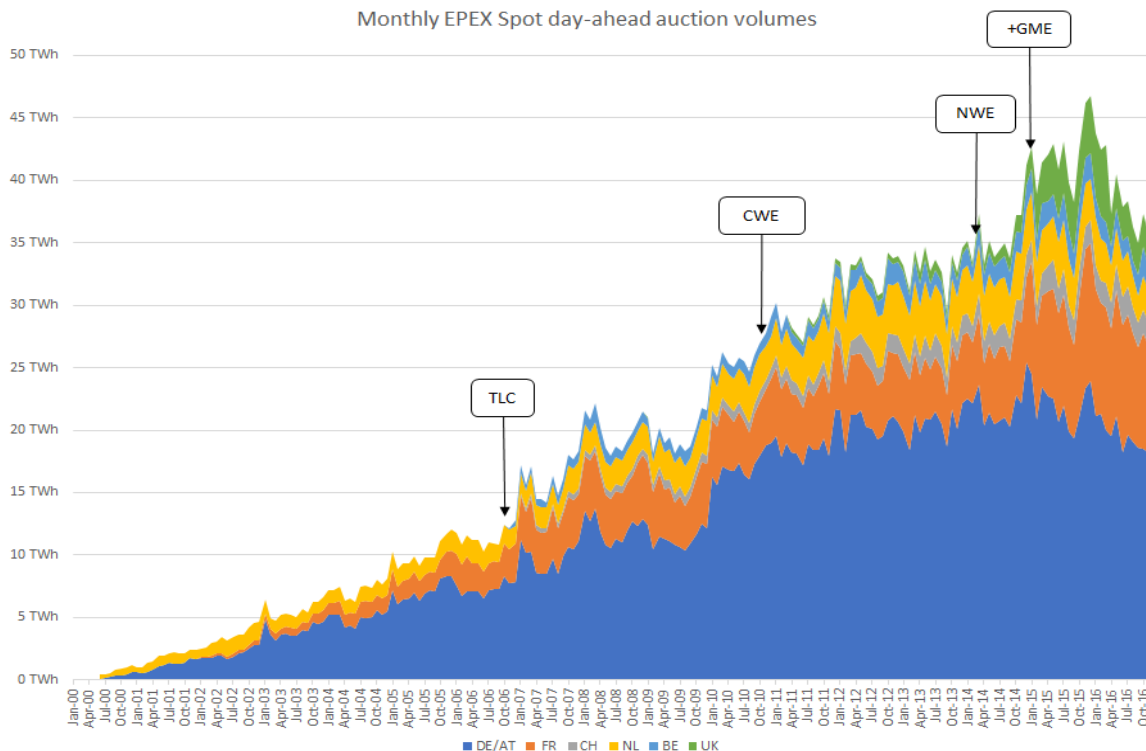
In the electricity markets, market participants may trade cross border to benefit from the arbitrage opportunities created by price differences. In the absence of market coupling, a market participant may (generally) purchase interconnector capacity explicitly and buy electricity in the country with the lower price and sell the electricity in the country with the higher price.

On borders connected via market coupling, this arbitrage is performed by the market coupling algorithm itself, and not by the market participants: market coupling replaces the arbitrage actions that would be, in a non-coupled situation, performed by market participants. Since market participants do

not have access to the day-ahead capacity following the implementation of market coupling (since this capacity is implicitly allocated), the orders related to this arbitrage activity disappear from the order books of the power exchange. In other words, the efficiency generated by the market coupling mechanism will result a reduction in the volume of transactions. On the other hand, market coupling may improve the robustness and reliability of the reference price, and encourage greater participation in the coupled market.

Note as well, that in larger bidding zones (like GB), there is less incentive for traders to buy and sell power in coupled vs uncoupled market places, since cross-border flows do not account for a large share of the trading activity.

The absence of direct relationship between the implementation of market coupling projects and the overall trend of volume of transactions in EPEX SPOT Day-Ahead auction markets is shown in the chart below.



1.5 OFGEM'S APPROACH TO IMPLEMENTING EUROPEAN NETWORK CODES

In its open letter on implementing the Electricity EU Network Codes³ (ENCs) Ofgem stated that its *“guiding principles in determining how to ensure compliance with European Regulations is that:*

- 1. Ofgem would only make changes where needed; and*
- 2. Where changes are needed to implement part of a European Regulation, Ofgem would make only those changes necessary to the relevant industry document to ensure compliance with the European codes and guidelines.”*

Ofgem also noted that there would be an initial exercise to determine which parts of the GB framework will need to change to implement every ENC, and that this process would *“take place in an open and transparent way providing all parties with the opportunity to consider and comment on what changes will be required to the GB framework, by whom and by when”*.

In that respect, Ofgem noted that it intended to use the industry chaired Joint Electricity Standing Group (JESG) as its primary interface with stakeholders.

Ofgem also set out its position on the steps necessary to implement the CACM Regulation in GB. Ofgem explained that, *“the CACM Regulation establishes new entities such as NEMOs to operate single day ahead and intraday coupling, and [...] requires TSOs and NEMOs respectively to develop and propose common methodologies, terms and conditions for approval by National Regulatory Authorities (NRAs) within fixed legal timelines.”*

Ofgem also noted that *“[t]he CACM Regulation does not specify an operational ‘go-live’ date. Rather it requires the responsible parties to successfully complete all tasks outlined in the CACM Regulation. These requirements are set out on a National, Regional and Pan-European basis.”* Once roles and responsibilities have been allocated (NEMO designation, TSO responsibilities and definition of capacity calculation regions), the relevant parties would need to participate in pan European and regional processes to set out common methodologies, terms and conditions.

Ofgem note that, *“[t]hese processes and their approval by all regulators, or regional regulators, are important because the provisions of the CACM Regulation can only take effect following the conclusion of a series of steps, taking 31 months in total.”* Ofgem also explained that, *“[t]hese steps form a critical path and delay to any one element of the process will have a knock-on impact on the time at which the CACM Regulation can take effect.”*

In responding to this consultation⁴ EPEX SPOT confirmed our support for Ofgem's guiding principles, which we understood as: *“Ofgem would only make changes where needed, and where chang-*

³ **18 December 2014** – Ofgem open letter on “Implementing the Electricity EU Network Codes (as defined below); Implementing the EU Regulation on Capacity Allocation and Congestion Management (CACM Regulation) in GB, and; Consultation on Ofgem's proposed application process for NEMO designation and application of designation criteria.

⁴ **30 January 2015** “APX response to open letter on implementing EU Network Codes”

es are made, that these changes will be restricted to the minimum necessary to ensure compliance with the CACM Regulation.”

We also explained that we shared Ofgem’s understanding that the provisions of the CACM Regulation can only take effect following the conclusion of a series of steps; and that we expected to be able to continue with the existing day-ahead and intraday market coupling arrangements until the mandated EU-wide day-ahead and intraday coupling solutions have been implementing in-line with the CACM Regulation requirements.

In its decision following the consultation ⁵, which also set out Ofgem’s application process for NEMO designation and application of designation criteria, Ofgem re-confirmed its (and our shared) interpretation of the CACM Regulation. Which is that only once the detailed methodologies or terms and conditions have been approved, will all NEMOs be required (or able) to comply with the CACM Regulation and the approved methodologies, terms and conditions in delivering the NEMO tasks.

EPEX SPOT supports the guiding principles that Ofgem set out for its approach to ensuring compliance with ENCs; as well as Ofgem’s interpretation that the CACM Regulation can only take effect following the conclusion of a series of steps, taking (at least) 31 months in total.

We have elaborated this background here because **we consider that the proposals set out in the latest consultation, depart significantly from both Ofgem’s stated guiding principles and Ofgem’s previously stated interpretation of the requirements of the CACM Regulation.**

2. PROPOSED APPLICATION OF THE CACM REGULATION TO THE NWE PROJECT AND XBID PROJECT

In its consultation Ofgem proposes to apply the CACM Regulation requirements on cost recovery to costs incurred as part of existing projects [the NWE Price Coupling Project and the Cross Border Intraday (XBID) Project] from (and apparently even before) the entry into force of the CACM Regulation in August 2015.

Specifically, Ofgem states that operational and clearing and settlement costs for the NWE Project before August 2015 (i.e. before the entry into force of the CACM Regulation) and after August 2015 (i.e. after the entry into force of the CACM Regulation) should be borne by NEMOs, and not paid by interconnector TSOs.

EPEX SPOT does not accept that Ofgem is entitled unilaterally to set cost recovery rules in the absence of any proposals from NEMOs and TSOs. Even if it can, though, it certainly cannot apply

⁵ **27 February 2015** Ofgem open letter on “Consultation decision on Ofgem’s proposed application process for NEMO designation and application of designation criteria; and, Formal invitation for applications to be designated a NEMO in GB for single day ahead and / or intraday coupling

those rules to costs that do not fall under the CACM Regulation and cannot apply the rules retroactively. We consider that such retroactive application is not in line with:

1. the treatment of costs under the CACM Regulation;
2. Ofgem's approach (and guiding principles) for implementation of European Network Codes and the CACM Regulation.

2.1 TREATMENT OF COSTS UNDER THE CACM REGULATION

EPEX SPOT considers that the CACM Regulation provisions on capacity allocation and congestion management costs, set out in Articles 75 to 79 of the CACM Regulation, can only apply from the entry into force of the CACM Regulation in August 2015.

We do not agree with Ofgem's proposal that the provisions on costs in the CACM Regulation can be applied to costs:

1. incurred by parties before the entry into force of the CACM Regulation; or,
2. associated with the performance of activities by EPEX SPOT SE and ECC as a CCP that are not required by the CACM Regulation; i.e. activities that are not subject to the CACM Regulation.

In relation to the first point, we consider that such retroactive application is not in line with the CACM Regulation Article 80 Paragraph 5, which states that "*costs incurred prior to the entry into force of this Regulation shall be shared among the NEMOs and TSOs based on the existing agreements governing such solutions*". Therefore, we consider that such retroactive application is prohibited by the CACM Regulation.

In relation to the second point, EPEX SPOT considers that the scope of application of the CACM provisions on costs (Articles 75 to 79) is restricted to costs incurred by NEMOs, CCPs and/or TSOs as a result of their fulfilment of tasks under the CACM Regulation for the implementation, operation and development of single day-ahead coupling and single intraday coupling.

As an example, ECC and Nord Pool currently provides shipping services on the IFA interconnector and operate a direct cross-CCP clearing link for these services, although CACM does not require CCPs to act as shipping agents. In case the IFA interconnector operator would act as a shipping agent on its own interconnector, it would become a standard member on the respective NEMOs/CCPs. Such an arrangement may result in a less operationally and cost efficient market coupling set up.

This point is highlighted by Ofgem in its consultation where it states that "*when CACM came into force on 14th August 2015 it provided a legal underpinning of what was previously a voluntary project and placed obligations on entities designated as NEMOs – for example, "Article 7: NEMO tasks [...] related to single day-ahead and intraday trading"*.

We agree with Ofgem that the costs associated with tasks performed by NEMOs to fulfil the requirements of Article 7 (and any other relevant requirements) of the CACM Regulation should be treated in accordance with the CACM provisions on costs. **However, we do not agree that our activities associated with operation of existing solutions for market coupling in GB today, fall under the CACM Regulation.** We explain the basis and implications of this below.

Following designation, NEMOs are required act in compliance with the designation criteria (set out in Article 6 of the CACM Regulation) in performing the tasks listed in Article 7 Paragraph 1 of the CACM Regulation (and any other requirements). With regard to single day ahead coupling and single intraday coupling, Article 7 of the CACM Regulation requires a NEMO to perform the following tasks:

- a) *implementing the MCO Functions set out in paragraph 2 in coordination with other NEMOs*
- b) *establishing collectively the requirements for the single day-ahead and intraday coupling, requirements for MCO functions and the price coupling algorithm with respect to all matters related to electricity market functioning in accordance with paragraph 2 of this Article, and Articles 36 and 37;*
- c) *determining maximum and minimum prices in accordance with Articles 41 and 54;*
- d) *making anonymous and sharing the received order information necessary to perform the MCO functions provided for in paragraph 2 of this Article and Articles 40 and 53;*
- e) *[etc...]*

In listing the tasks to be performed by NEMOs for single day-ahead coupling and single intraday coupling, Article 7 of the CACM Regulation states that the tasks should be performed in accordance with succeeding articles, which provide further detailed requirements on how a NEMO should perform that task.

For example, the boxes provide the requirements of Article 41 and Article 40 of the CACM Regulation, which set out in more detailed requirements for how a NEMO should make anonymous and share the received order information necessary to perform the MCO functions and to determine maximum and minimum prices:

| |
|--|
| <p><i>Article 40</i></p> <p>Products accommodated</p> |
| <p>1.No later than 18 months after the entry into force of this Regulation NEMOs shall submit a joint proposal concerning products that can be taken into account in the single day-ahead coupling. NEMOs shall ensure that orders resulting from these products submitted to the price coupling algorithm are expressed in euros and make reference to the market time.</p> <p>2.All NEMOs shall ensure that the price coupling algorithm is able to accommodate orders resulting from these products covering one market time unit and multiple market time units.</p> <p>[etc...]</p> |

Article 41

Maximum and minimum prices

1. By 18 months after the entry into force of this Regulation, all NEMOs shall, in cooperation with the relevant TSOs, develop a proposal on harmonised maximum and minimum clearing prices to be applied in all bidding zones which participate in single day-ahead coupling. The proposal shall take into account an estimation of the value of lost load.

The proposal shall be subject to consultation in accordance with Article 12.

2. All NEMOs shall submit the proposal to the regulatory authorities for approval.

[etc...]

In both these cases, the first task that NEMOs are required to perform as a result of the more detailed requirements is to develop a common proposal which sets out in more detail how NEMOs will perform this task. In addition, Article 9 of the CACM Regulation requires that any such proposal includes a proposed timeline for its implementation.

Similarly, for the MCO functions, Article 7 Paragraph 3 of the CACM Regulation states that the first task of NEMOs is to submit to all regulatory authorities and the Agency a plan that sets out how to jointly set up and perform the MCO functions. NEMOs are required to include a proposed timescale for the implementation of the MCO plan, which shall not be longer than 12 months.

In most cases, the requirements set out in CACM Regulation for NEMOs and TSOs to perform single day-ahead and single intraday coupling are for NEMOs and TSOs to:

1. Develop and consult on a proposed methodology or terms and conditions for how we will perform a specific common (or individual) task;
2. Submit the proposal to the relevant NRAs for approval; and
3. Once proposal has been approved, to implement the proposal (in accordance with the proposed timeline) and perform the task in accordance with the approved proposal and relevant CACM requirements.

Applying this approach to the costs incurred by NEMOs to meet the requirements of the CACM Regulation for single day-ahead coupling and single intraday coupling:

1. the first type of costs that will be incurred by NEMOs, are the costs of developing and consulting on the proposed methodology or terms and conditions;
2. the second type of costs that will be incurred by NEMOs, are the costs of implementing the approved proposal (in accordance with the CACM Regulation and the timeline for implementation set out in each methodology); and,
3. the third type of cost that will be incurred by NEMOs, once all necessary proposals have been approved by NRAs and implemented, will be the costs of operating (developing and maintaining) single day coupling and single intraday coupling in accordance with the CACM Regulation and all relevant approved proposals.

Until the more detailed proposal has been approved by the NRAs, NEMOs are not able to perform the tasks listed in Article 7 in compliance with the CACM Regulation. However, once a proposal has been approved by NRAs, any costs for the NEMO activities necessary to implement and perform the relevant tasks should be treated in accordance with the CACM Regulation provisions on costs.

For example, on 10 February Ofgem approved the TSO proposals for arrangements concerning more than one NEMO in one bidding zone⁶. Now that these TSO proposals have been approved by Ofgem, any costs associated with TSO or NEMO activities to implement the proposal will be subject to the CACM Regulation cost provisions. Furthermore, once all proposals necessary for the single day-ahead coupling and single intraday coupling have been approved and implemented, the operational costs will also become subject to the CACM Regulation cost provisions.

In addition, once the MCO plan has been approved, NEMOs costs associated with the implementation of the MCO functions (in accordance with the MCO plan and the CACM Regulation) will be subject to the CACM provisions on costs. This is particularly relevant, as the MCO plan proposes the adoption of PCR and XBID as the basis (or starting point) for the development and implementation of the day-ahead and intraday MCO functions.

In the circumstances, we do not consider that the provisions and the requirements of the CACM Regulation, related to costs or otherwise, currently apply to the NWE Project or the XBID Project as the relevant activities have not been and are not conducted under the CACM Regulation.

As far as EPEX SPOT is aware, our interpretation of the timeline according to which the CACM Regulation enters into effect is shared by other NEMOs, TSOs as well as some NRAs. This view was clearly expressed at the tri-lateral meeting between NEMO, TSO and NRAs on the 18 January 2017, to discuss the treatment of common costs under the CACM Regulation.

2.2 OFGEM'S APPROACH TO IMPLEMENTING ENCS

EPEX SPOT considers that the proposal to apply the CACM Regulation cost provisions to the existing solutions would represent a significant deviation from Ofgem's guiding principles for the implementation of the European Network Codes. We see no grounds to propose changes to the existing solutions (contractual, commercial or otherwise) that have been established between power exchanges, CCPs and Interconnector TSOs for the implementation and operation of arrangements for day-ahead market coupling that first became operational in 2011.

The existing solutions were established following competitive tender processes organised by Interconnector TSOs for the provision of market coupling services by power exchanges. Based on the outcome of these tender processes, the treatment of costs for the development and operation of these activities was agreed between the relevant power exchanges, CCPs and Interconnector TSOs.

⁶ https://www.ofgem.gov.uk/system/files/docs/2017/02/cacm_45_57_decision_letter.pdf

The competitive nature of the tender processes has ensured the cost-effective implementation and operation of market coupling by GB parties.

Even if the CACM Regulation did apply to existing solutions, which EPEX SPOT does not accept for the reasons given above, the existing solutions are already compliant with the requirements of the CACM Regulation provisions on costs: to achieve compliance with the CACM Regulation provisions on costs, no change of the existing solutions is required.

Furthermore, in our correspondence with Ofgem we have on several occasions clearly stated that we expected to be able to continue with the existing solutions until the mandated EU-wide day-ahead and intraday coupling solutions have been implemented in-line with the CACM Regulation requirements. Ofgem did not express any views contradicting our understanding at that time.

EPEX SPOT does not consider that the proposals being consulted on are in line with Ofgem's previous statements (and its interpretation of the CACM Regulation), that the provisions of the CACM Regulation can only take effect following the conclusion of a series of steps, taking 31 months in total.

2.3 WAY FORWARD

In EPEX SPOT's view it is very important to establish a common understanding of the process and timelines according to which the existing solutions become the mandated single day-ahead coupling and single intraday coupling under the CACM Regulation. We have sought to explain in detail how our understanding of the provisions and requirements of the CACM Regulation is different to that of Ofgem.

To establish a common understanding, we would suggest the following steps (i) national regulatory authorities finalise their anticipated guidance paper on cost determination (categorisation) and sharing under the CACM Regulation (ii) Ofgem organises a process with the concerned NEMOs and TSOs to clarify the national rules for cost sharing and recovery under the CACM Regulation (iii) Ofgem and individual NEMOs establish a bilateral dialogue to establish the actual mechanism of cost identification, auditing and recovery, in compliance with the CACM Regulation.

3. EPEX SPOT PROPOSAL FOR THE GB APPROACH TO CACM COST RECOVERY

3.1 INTRODUCTION

Notwithstanding our comments on the proposed application of the CACM Regulation to existing solutions, we do agree that a clear, coherent, compliant and implementable process and approach for the determination, sharing and recovery of GB costs associated with the implementation of the CACM Regulation and the performance of NEMO and TSO tasks, needs to be established.

In this section, we explain EPEX SPOT's preferred approach for the determination, sharing and recovery of GB costs associated with the implementation and operation of single day-ahead coupling and single intraday coupling under the CACM Regulation. For the avoidance of doubt, this is not intended to represent a formal proposal under article 9 of the CACM Regulation.

We have structured our proposal according to the main cost categories identified by Ofgem in its consultation (development costs, operational costs; and, clearing and settlement costs). In that respect, we understand Ofgem's proposed treatment of costs incurred under the CACM Regulation to be as follows:

1. **Development costs** for establishing the single day-ahead coupling and single intraday coupling, including providing continued access to the "trading platform" and necessary updates, to be recovered from Interconnector TSOs via congestion rents;
2. **Operational costs** for single day ahead coupling and single intraday coupling to be borne by NEMOs and recovered from transaction costs (not to be paid by Interconnector TSOs);
3. **Clearing and settlement costs** for single day-ahead coupling and single intraday coupling to be borne by NEMOs and to be recovered from transaction costs (not to be paid by Interconnector TSOs);

For the sake of clarity, we reiterate our view set out above, that we consider that the CACM Regulation cost provisions, and therefore any decision by Ofgem on the application of the CACM cost provisions in GB, can only extend to costs incurred by NEMOs and TSOs for their activities under the CACM Regulation.

Overall, we consider that the CACM Regulation entitles NEMOs (and TSOs) to recover costs that are efficiently incurred, reasonable and proportionate. Paragraph 23 of the recitals of the regulation clearly states that "**Any costs incurred efficiently to guarantee firmness of capacity and to set up processes to comply with this Regulation should be recovered via network tariffs or appropriate mechanisms in a timely manner. NEMOs, including in performing MCO functions should be entitled to recover their incurred costs if they are efficiently incurred, reasonable and proportionate.**"

We do not agree that requiring NEMOs to recover the costs of single day-ahead coupling and single intraday coupling through transaction costs, which would implicitly require for NEMO costs to be paid for through commercial fees, to constitute cost recovery within the meaning or intent of the CACM Regulation.

The CACM Regulation allows for NRAs to decide on different approaches to cost recovery, where one option is that the costs may be passed on through NEMO fees. We consider that this approach was only included in the CACM Regulation as an option to be applied in those Member States where the NEMO has a **monopoly position**, which means that passing such costs through via **regulated NEMO fees** would not have a significant negative impact on the NEMOs competitive position, liquidity or the effectiveness of the market coupling mechanism.

It is important to note that we are discussing recovery only of the costs associated with development and operation of the single day-ahead coupling and single intraday coupling, and not recovery of the costs associated with operating local markets. The activities that correspond to the MCO functions, and other tasks as defined in the CACM Regulation, are clearly distinguishable from those that EPEX SPOT carries out as a commercial power exchange, where its primary role is to generate reliable prices and provide a liquid trading environment for market actors. Similarly, ECC's activities according to CACM are separable from its commercial activities as a CCP for EPEX SPOT and other partner exchanges' local markets.

EPEX SPOT understands that the CACM Regulation creates a clear division between a power exchange's commercial competitive activities and its obligations as a NEMO under the CACM Regulation to develop and operate infrastructure for single day-ahead coupling and single intraday coupling, which will become (in effect) a fully regulated function. **We are not proposing that Ofgem should subsidise trading or clearing arrangements, we are proposing that Ofgem should allow for the recovery of costs associated with the development and operation of a critical European infrastructure, and that such recovery is in the interests of GB and European consumers.**

One of our main observations is that the systems, procedures, rules and contracts required for single day-ahead coupling and single intraday coupling represent a common European infrastructure which has delivered through a cooperation of power exchanges (now NEMOs), CCPs and TSOs, which has proven extremely cost effective in delivering significant benefits for consumers across Europe. Single day-ahead coupling and single intraday coupling will be implemented according to strict regulatory requirements, and should be seen as **a separate regulated activity** where costs are remunerated with a set rate of return to be defined ex-ante.

We see a real risk that there will be a proliferation of approaches to cost recovery developed by NRAs at the national level. Each approach will be intended to achieve an optimal outcome from the individual NRAs perspective, based on a specific set of regulatory principles – and with the aim of protecting consumers. However, the outcome of this process will represent a complex, ineffective and inefficient set of compromises and trade-offs, which will have a material and negative impact on operation and development of the single day-ahead coupling and single intraday coupling. This in turn will serve to limit the intended (or achievable) benefits of the mechanisms being established.

Therefore, we consider that all costs incurred efficiently to set up and operate the processes to comply with the CACM Regulation should be recoverable. In the GB context, we consider that the most appropriate route to provide for such recovery is to allow for the costs to be recovered via Transmission Network Use of System Charges (TNUoS), as proposed in Ofgem's consultation for costs incurred before entry into force of the CACM Regulation. We consider that this approach will, particularly in the long run, achieve the best outcome for both GB and European consumers.

In developing these proposals, we have sought to adhere as far as possible to Ofgem's guiding principles for European Network Code implementation.

3.2 TREATMENT OF DEVELOPMENT AND OPERATIONAL COSTS

The core part of Ofgem's consultation is on the proposed GB arrangements for the recovery of development and operational costs incurred by TSOs and NEMOs under the CACM Regulation. In this section of our response we elaborate our proposed approach to the recovery of GB costs associated with the development and operation of the single day-ahead coupling and single intraday coupling.

We understand that Ofgem is proposing that under the CACM Regulation, development costs should be borne by TSOs and recovered from congestion revenues, and that operational costs should be borne by NEMOs and recovered from transaction costs. EPEX SPOT interprets congestion revenue to mean any revenues resulting from the allocation of interconnector capacity by the Interconnector TSOs. However, for the recovery of operational costs, we do not understand what is meant by transaction costs, and would welcome clarification on this point. As explained above, we do not consider that passing on the cost of single day-ahead coupling and single intraday coupling through our commercial fees to constitute cost recovery within the meaning and intent of the CACM Regulation.

Justification for recovery of these costs

EPEX SPOT believes that it is in GB and European consumers' interests that any costs incurred to set up processes to comply with the CACM Regulation should be recoverable via transmission tariffs or any other equivalent mechanism. We do not consider that the proposed recovery of these costs through either Interconnector TSO congestion revenue or transaction costs, constitutes an equivalent or appropriate mechanisms for recovery of these costs.

Providing for the recovery of these costs does not mean that Ofgem would be subsidising trading arrangements. The systems, procedures, rules and contracts required for single day-ahead coupling and single intraday coupling are a common European infrastructure, which will deliver significant benefits for both GB and European consumers.

The activities that correspond to the MCO functions, and other NEMO tasks as defined in the CACM, are distinguishable from those that EPEX SPOT carries out as a commercial power exchange. Moreover, single day-ahead coupling and single intraday coupling will be implemented according to strict regulatory requirements.

EPEX SPOT considers that ensuring the participation of market participants in the coupled markets is fundamental to achieving the potential efficiency gains associated with market coupling mechanisms, and we see a real risk that Ofgem's proposals will have a significant negative impact on those potential gains. This is particularly the case when we consider that the costs associated with the development and operation of the market coupling mechanisms are immaterial when compared to the potential benefits. Because it would negatively impact the efficiency of coupled organized market places, Ofgem's approach would not:

- *"promot[e] effective competition in the... trading... of electricity"* (CACM Regulation Art. 3(a))
- *"ensur[e] optimal use of the transmission infrastructure"* (CACM Regulation Art. 3(b)) or

- “*optimis[e] the... allocation of cross-zonal capacity*” (CACM Regulation Art. 3(d))⁷

Furthermore, consumers’ interests will be better served by the fact that the CACM Regulation facilitates greater competition between power exchanges for the provision of trading services – and suggest that regulators should focus on achieving the potential efficiency fostered by competition – rather than putting policies in place which risk discouraging participation in, and the development of, the coupling mechanisms themselves.

This is underlined by the fact that, if NEMOs are required to recover development or operational costs through transactions costs, there will be little incentive (beyond compliance) to participate in the continued development and enhancement of the single day-ahead coupling and single intraday coupling. This is similar to the thinking behind Ofgem’s approach to Network Innovation Funding, which recognises the challenge faced by regulators to incentivising the efficient development of regulated functions.

Therefore, EPEX SPOT consider it in the best interests of GB consumers that the single day-ahead coupling and single intraday coupling is treated as a regulated activity, which is entirely separate from, but will serve to promote competition in, the competitive activity of organising trading in spot markets. In accordance with the provisions of the CACM Regulation, single day-ahead coupling and single intraday coupling should be treated as a separate regulated activity where costs are remunerated with a set rate of return to be defined ex-ante.

Ensuring that costs are efficient, proportionate and reasonable

In providing for cost recovery Ofgem may consider that there is little incentive for NEMOs and TSOs (beyond compliance) to ensure that the costs associated with single day-ahead coupling and single intraday coupling are efficient, proportionate and reasonable. It is important for regulators to ensure that the development and operation of the coupling mechanisms represents a cost-effective use of public money.

As confirmed in its NEMO application, EPEX SPOT is committed to fully complying with the CACM Regulation requirements with regards to cost-efficiency of NEMOs under article 6(1)c of the CACM Regulation, as well as with all conditions for cost-recovery stated under articles 75 and 76.2 of the CACM Regulation.

EPEX SPOT has experience of regularly reporting its costs to its authorized stakeholders (regulators or TSOs providing cost-recovery in market coupling projects, shareholders...) and main contractors with detailed information on costs.

⁷ Ofgem’s interpretation would also be inconsistent with its UK statutory duties. It does not protect the interests of existing and future consumers in relation to electricity (Section 3A(1), Electricity Act 1989) to discourage the use of trading on coupled markets and thereby likely increase the cost of wholesale electricity.

As explained above, the activities that correspond to the MCO functions, and other NEMOs tasks as defined in CACM, are distinguishable from those that EPEX SPOT carries out as a commercial exchange.

EPEX SPOT considers that we have a strong incentive to ensure that any costs incurred to set up processes to comply with the CACM Regulation are efficiently incurred, reasonable, proportionate; as these are the conditions for such costs to be subject to recovery.

3.3 TREATMENT OF CLEARING AND SETTLEMENT COSTS

EPEX SPOT, and ECC at its clearing house, would like to highlight that clearing and settlement costs have to be treated differently from the other NEMO costs for the development and operation of the common European infrastructure necessary to achieve compliance with the CACM Regulation (see article 77 below).

Article 77

Clearing and settlement costs

1. All costs incurred by central counter parties and shipping agents shall be recoverable by means of fees or other appropriate mechanisms if they are reasonable and proportionate.
2. The central counter parties and shipping agents shall seek efficient clearing and settlement arrangements avoiding unnecessary costs and reflecting the risk incurred. The cross-border clearing and settlement arrangements shall be subject to approval by the relevant national regulatory authorities.

This is because clearing and settlement is a fundamental but discrete service provided by power exchanges, and in some cases via their clearing house, towards parties on non-discriminatory terms. For the GB market, the costs associated with the provision of clearing and settlement services are charged to market participants and Interconnector TSOs through fees.

For the implementation of single day-ahead coupling and single intraday coupling NEMOs, or their respective clearing houses, provide services to Interconnector TSOs for the clearing and settlement of the cross-zonal transactions.

According to the proposal being consulted on by Ofgem, NEMOs should be required to bear clearing and settlement costs and these costs should not be paid by Interconnector TSOs. EPEX SPOT and ECC are fundamentally opposed to this proposal.

EPEX SPOT and ECC see no reason why Interconnector TSOs as the sole economic beneficiary of congestion revenues should avail to the clearing and settlement services that we provide, without paying for those costs on a non-discriminatory basis. Moreover, this would also trigger concerns of compatibility with the principle of non-discrimination enshrined in financial regulation to which ECC is

subject and reflected in its clearing conditions. The proposal would in effect provide the Interconnector TSOs with free access to clearing and settlement services, which would then have to be paid for by our other market participants.

We consider that the current GB approach to dealing with clearing and settlement costs, if fully implemented by Interconnector TSOs, to be reasonable, efficient and proportionate. EPEX SPOT and ECC propose that the current arrangements, for the treatment of clearing and settlement costs, should form the basis for the approach to treating these costs are subject to the CACM provisions on costs.

EPEX SPOT's proposed approach is as follows: Interconnector TSOs continue to select (through a competitive tender process or otherwise) the NEMO (CCP or shipping agent) that provides the most efficient solution to facilitate the clearing and settlement of cross-zonal flows; and, once these activities are subject to the CACM Regulation provisions on costs, the Interconnector TSOs should pay for the services received and should be entitled to recover these costs.

4. ADDITIONAL AREAS FOR CONSIDERATION

We understand that in consulting on its proposals Ofgem is seeking to develop a coherent framework for the recovery of GB costs associated with the development and operation of single day-ahead coupling and single intraday coupling by NEMOs and TSOs that is compliant with the CACM Regulation.

In this section of our response we highlight some areas in Ofgem's consultation where we consider that there is considerable scope for uncertainty, which could have a significant impact on EPEX SPOT or any other GB NEMO seeking to participate in single day-ahead coupling and single intraday coupling.

4.1 SHARING OF COSTS BETWEEN UK NEMOS

The CACM Regulation provisions on costs deal with the allocation of costs to NEMOs and TSOs operating in a Member State. However, it does not deal with how those costs should be shared between the NEMOs and TSOs operating in that Member State.

We note that Ofgem's consultation is silent on the issue of how costs should be shared between NEMOs in the UK. This is a significant omission, as the GB share of the costs for single day-ahead coupling and single intraday coupling could be significant.

To ensure the principles of fairness and efficiency of costs, we consider that only common costs should be shared between NEMOs, while each NEMO should remain accountable for its individual costs associated with single day-ahead coupling and single intraday coupling.

4.2 CREATING A LEVEL PLAYING FIELD FOR NEMOS

Article 3 of the CACM Regulation sets out the objectives against which NEMOs, TSOs and NRAs proposals are to be assessed. EPEX SPOT understands that any NRA proposal for cost recovery should be in line with the CACM objectives. In particular, objective (e) requires parties to ensure fair and non-discriminatory treatment of TSOs, NEMOs, the Agency regulatory authorities and market participants; and, objective (i) requires parties to create a level playing field for NEMOs.

The approach and process for cost determination, sharing and recovery should be in line with these objectives both within a Member State and on a European wide basis. In that respect, we understand that the costs for the development and operation of single day-ahead coupling and single intraday coupling will be allocated to the United Kingdom in the first instance, as the relevant Member State. The costs will then be allocated to (or shared between) the active NEMOs and TSOs.

Both the process to allocate and share these costs between NEMOs, as well as the process and approach for the recovery of these costs, needs to ensure both non-discriminatory treatment of NEMOs active in the United Kingdom and the creation of a level playing field. EPEX SPOT suggests that the cost recovery arrangements for other NEMOs in the United Kingdom will be relevant to consider whether a level playing field has been created. **We suggest that the only way to achieve this is to allow for cost recovery.**

We also believe that the approach and process for costs recovery should ensure non-discriminatory treatment of NEMOs and the creation of a level playing on a European-wide basis. This is because the costs are being incurred for the development and operation of a European asset, and we know that there are NEMOs active in multiple Member States and Member States with multiple NEMOs active. As a result, we believe that the level playing field criteria applies not only within a Member State but across Member States: we do not agree that having substantially different cost recovery arrangements in each Member State would be in line with achieving this objective.

4.3 POTENTIAL IMPACT OF BREXIT

EPEX SPOT notes that the UK Government launched the Article 50 process for the UK to exit the European Union on Wednesday 29 March and that the process to negotiate the UK's terms for BREXIT is due to conclude at the latest by 29 March 2019, unless all parties agree to an extension. Our current expectation is that the Article 50 process will conclude with the UK exiting from the European Union and that the relevant provisions of European law will cease to apply in the UK.

It is not possible to forecast, at this stage, the actual impact of the Article 50 process on electricity market trading arrangements in the UK, and cross-border trading arrangements – including single day-ahead market coupling and single intraday market coupling. In relation to the potential impact of the Article 50 process, EPEX SPOT considers that two points are particularly salient to the proposals being consulted on by Ofgem:

1. The current arrangements for market coupling, and for the treatment of the associated costs, were established and are being operated (or implemented, in the case of XBID) without being mandated by European law. Therefore, we consider that the current arrangements could form the basis of enduring arrangements both under the CACM Regulation and in a post-March 2019 regulatory environment. EPEX SPOT considers that the adoption of the current arrangements would minimise the regulatory uncertainty faced by NEMOs and TSOs.
2. The process creates significant regulatory uncertainty over the future of market coupling arrangements and whether the CACM provisions on costs will continue to apply. EPEX SPOT sees the regulatory uncertainty as material, and would like to work together with the relevant regulatory authorities and the Governments to manage and minimise that uncertainty. We believe that Ofgem should at least acknowledge the significant regulatory uncertainty, as well as consider options to mitigate it, in developing its proposals.

4.4 INTERPRETATION AND EXPLANATION OF THE CACM REGULATION

It has been noted in various fora, that the CACM Regulation established a complex and detailed (and in some cases ambiguous) regulatory regime for single day-ahead coupling and single intraday coupling. This creates a significant regulatory risk (even without the BREXIT process) for the parties that are currently involved and committed to delivering these arrangements – a regulatory risk which parties (power exchanges, TSOs and NRAs) had to be able to manage prior to entry into force of the Regulation.

As explained in our response we consider that Ofgem's interpretation of the requirements of the CACM Regulation has not been entirely consistent. This inconsistency may potentially have a significant impact on EPEX SPOT and ECC as its clearing house, and the level of our potential participation in the arrangements for single day-ahead coupling and single intraday coupling in GB. Given the specific example of shipping agent services currently conducted by CCPs (not a mandatory task given to CCPs under CACM), this may also result in less efficient market coupling arrangements in the future.

To elaborate one example, we consider that the CACM Regulation provisions on costs have been established with the intent that any costs incurred efficiently to set up processes to comply with the CACM Regulation shall be recoverable for both the relevant NEMO and TSOs. We also consider that NEMOs, its CCP and TSOs are only able to perform (many) of the tasks involved with single day-ahead coupling and single intraday coupling once the more detailed methodologies, term and conditions have been approved by NRAs.

EPEX SPOT was surprised to note that Ofgem is proposing to provide for cost recovery – against TNUoS – of some Interconnector TSO costs incurred before the entry into force of the CACM Regulation (for which, in our view, cost recovery is not mandated by the CACM Regulation); but is not proposing to provide for recovery of costs incurred since the entry into force of the CACM Regulation (for which, in our view, cost recovery is mandated by the CACM Regulation).

As explained in our response, EPEX SPOT consider that the interests of GB consumers will be best served by providing for the recovery of all costs associated with the implementation of the CACM Regulation against TNUoS.

We would like to discuss with Ofgem the best way of establishing a common baseline interpretation of the CACM Regulation, which would be sufficiently clear and robust, to mitigate the significant regulatory risk that we now observe.