

Department of Energy and Climate Change  
3 Whitehall Place  
London  
SW1A 2AW

29 January 2013

### **Synergies and Conflicts of Interest arising from the Great Britain System Operator delivering Electricity Market Reform**

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

EDF Energy is committed to delivering an affordable, secure, and diverse low carbon energy mix. We plan to invest in four new nuclear plants in the UK, starting with two at Hinkley Point in Somerset. With our co-investor Centrica, we are making continued progress on this project, including on site preparations, with a view to taking the Final Investment Decision (FID) as soon as possible. We are also developing renewables projects that we expect will be supported by the Electricity Market Reform (EMR) arrangements.

We believe that National Grid, as the current System Operator (SO), has the appropriate skills and resources to fulfil the role of the EMR delivery body. However, it is crucial that the Government remains fully responsible for setting the policy approach and objectives. This will require the Government to take the final decisions on the key rules and parameters of the delivery mechanisms. It is important that DECC ensures that the mechanisms deliver value for money in generation by allowing the effective comparison of costs between different projects. This will require greater transparency of the advice given by the SO, as well as the ability of stakeholders to assess and scrutinise this adequately.

EDF Energy believes that the main conflicts of interest or synergies arising from National Grid being the EMR delivery body have been broadly identified. We acknowledge that further steps will have to be taken to protect against any potential conflicts of interest but believe that the industry can work together to deliver acceptable solutions to resolve these issues. We recognise that the key area of concern relates to National Grid's competitive businesses. However, in the absence of further important detail on the proposed EMR framework and governance arrangements, it is difficult at this stage to determine the precise areas of delivery body discretion and information flows that present the greatest risk of conflicts of interest. This highlights the importance of developing the technical rules and requirements in conjunction with industry rather than in isolation.

EDF Energy believes that the ring fencing should occur around National Grid's SO, Transmission Owner, and EMR businesses (Option A). This level of business separation would ensure that the potential synergies identified between the EMR, TO and the SO role are realised, including operational efficiencies and therefore potential cost savings.

**EDF Energy**  
40 Grosvenor Place, Victoria  
London SW1X 7EN  
Tel +44 (0) 20 7752 2200

**edfenergy.com**  
EDF Energy plc.  
Registered in England and Wales.  
Registered No. 2366852  
Registered office: 40 Grosvenor Place,  
Victoria, London SW1X 7EN

We believe that in combination with the options highlighted in (2a) of the consultation document, which includes physical, employee and financial separation measures, this should provide sufficient safeguards against any potential conflicts of interest. We would also highlight that similar ring fencing arrangements have been used successfully in supply companies with distribution businesses.

It is our view that starting with the option of legal separation would be disproportionate to the scale of the problem, and would not represent the best value for money for consumers. We believe that starting with less onerous separation requirements, and tightening them as necessary, provides a better opportunity to realise the synergies that could arise from the SO assisting in delivering EMR. An alternative approach of starting from a high level of separation increases the risk that some synergies will be lost and unnecessary costs will be created. Nonetheless, it will be essential that the options for monitoring and reviewing the effectiveness of the business separation arrangements is retained by DECC and Ofgem. This does not preclude further action to strengthen the mitigation measures at a later stage if deemed appropriate.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Ravi Baga on 020 7752 2143, or myself.

I confirm that this letter and its attachment may be published on DECC's and Ofgem's website.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "D. Linford".

**Denis Linford**  
**Corporate Policy and Regulation Director**

## Attachment

### Synergies and Conflicts of Interest arising from the Great Britain System Operator delivering Electricity Market Reform

#### EDF Energy's response to your questions

#### Q1. Information – conflicts and synergies (monopoly conditions)

- a) Do you agree that there are unlikely to be material conflicts arising from the electricity System Operator having access to EMR related information? If not, please explain your reasoning.**

EDF Energy agrees that there are unlikely to be material conflicts arising from the System Operator (SO) having access to EMR related information. In particular, we would highlight the different timeframes involved in the two regimes. In balancing the electricity system, the SO is responsible for the short-term procurement of sufficient plant to ensure that demand is met on a minute to minute basis. In contrast, mechanisms such as the capacity market and contracts for difference (CfDs) are intended to operate over much longer durations, covering a period of many years.

In addition, we believe that any policy conflicts of interest have been further reduced by the confirmation that the CfD counterparty will be a Government-owned company rather than by National Grid as previously proposed. This helps reinforce the point that the key rules and parameters of the CfD contract will be designed and set out by the Government.

- b) Do you agree that there is significant potential for synergies as a result of the electricity System Operator having access to EMR related information? If not, please explain your reasoning.**

EDF Energy believes that National Grid, as the current System Operator, has the appropriate skills and resources to fulfil the role of the EMR delivery body as envisaged by the Government. We broadly agree that there is scope for potential synergies, and acknowledge that National Grid has the technical and transactional expertise (for example in system forecasting and contracting for ancillary services) and the understanding of the operation of the electricity market required to administer both the proposed capacity market and CfD arrangements.

In particular, we agree that, subject to the right framework being in place, the new role could allow the System Operator to take a more holistic view of generation and transmission, potentially resulting in a better or timelier identification of potential future constraints that could be resolved through investment. This should lead to more efficient planning of system investment and would be to the ultimate benefit of the end customer.

- c) Do you agree that the potential for conflicts and synergies arising from the electricity Transmission Owner having access to EMR related information is limited? If not, please explain your reasoning.**

EDF Energy believes that there could be a potential conflict of interest arising from giving the Transmission Owner (TO) access to EMR-related information. There may be

a concern that National Grid could attempt to increase the value of its Regulatory Asset Base (RAB) and hence its profits, by favouring those generation projects that involved greater transmission investment, at the expense of more cost effective solutions. It is likely that the TO will find any additional information it receives useful, and to this extent this should, all things being equal, lead to lower costs for consumers. However, it is also likely that shareholders of National Grid will also benefit from this. We believe that this situation should be monitored by Ofgem, and if appropriate, any significant gains could be factored into the RII price control process.

**d) Do you agree there are limited conflicts with gas distribution, gas transmission and gas system operation arising from access to EMR information? If not, please explain your reasoning.**

EDF Energy believes that if the TO has access to more information then this could potentially lead to better co-ordination between the electricity and gas system. In particular, we note that there appears to be clear interactions between the future role of gas fired generation and the operation of the gas system.

In particular, the value of capacity at times of scarcity could provide the market signals to incentivise short term / fast-cycle gas storage capacity. The operation of combined-cycle gas turbines (CCGTs) is dependent on the clean spark spread and not on the absolute values of electricity and gas. As such a CCGT will continue to generate if the spark spread is sufficient. This link is significant especially when it is considered that CCGTs offer considerable potential for demand side response on the gas system. Equally, the striking of electricity capacity contracts in particular geographic regions, such as the South West of England, may help to avoid investment in the electricity transmission system but could trigger investment in the gas system to support this generation and this link should allow the market to optimise the investment needed.

**f) Are there any other conflicts of interest or synergies associated with access to EMR related information for businesses operating in mainly monopoly conditions that we have not identified?**

EDF Energy believes that the main conflicts of interest or synergies have been identified.

**Q2. Information – conflicts and synergies (competitive conditions)**

**a) Do you agree that the most material potential conflicts of interest with competitive businesses as a result of National Grid's increased access to information have been identified? If not, please identify which ones are missing, explaining your reasoning and providing evidence.**

EDF Energy agrees that the most material potential conflicts of interest with competitive businesses resulting from National Grid's increased access to information have been identified. However, one project in particular which may require focus is the potential transmission link from Ireland to the UK which would seem to have potential conflicts of interest. The concern is that National Grid may be incentivised towards allocating CfDs to relevant Irish wind farms to ensure its interconnector project goes ahead.

**b) Do you agree, that where competitive businesses are concerned, there is a need for additional mitigation?**

EDF Energy strongly agrees that there is need for additional mitigation with regard to National Grid's competitive businesses, and that going forward this represents the area where the most significant sources of conflicts of interest are likely to exist.

We would highlight that although the competitive businesses of National Grid currently only make up a relatively small proportion of its revenue, this will not necessarily remain the case going forward as the generation mix evolves. We recognise that National Grid already has regulatory requirements to guard against the conflicts of interest with respect to its competitive businesses. However, we believe that these should be reviewed, and maintained or reinforced as appropriate, to ensure that National Grid does not promote certain technologies over other low carbon solutions.

For example, we note National Grid Carbon's interest in carbon capture and storage (CCS) through its involvement in two of the projects (Captain Clean Energy Project and White Rose Project) shortlisted for funding of the UK Commercialisation Programme. It is clear that if National Grid Carbon was to have access to information from rival projects, then this could confer it with an unfair competitive advantage. The magnitude of this potential conflict is only likely to grow in size if the Government's timetable to deliver a cost-competitive CCS industry in the 2020s is to be met.

It is important for Ofgem to be aware of these interests, to ensure that decarbonisation of the economy is achieved in the most affordable manner, to ease the burden on customers' bills. This can only be achieved by scrutiny of the advice given by National Grid to the Government.

**c) Are there any other conflicts of interest or synergies with businesses operating in mainly competitive conditions that we have not identified?**

We do not believe that any synergies exist for the wider industry (and customers) by allowing the EMR delivery body to share information with its competitive businesses. We believe that the areas with the main conflicts of interest have been broadly identified.

**Q3. Influence – conflicts and synergies**

**a) Do you think that all the major potential conflicts of interest and synergies arising from an ability to exert influence have been identified? If not, please identify which ones are missing, explaining your reasoning and providing evidence where possible.**

EDF Energy believes that the main areas of potential conflicts of interest and synergies arising from an ability to exert influence have been identified. However, in practice the ability of National Grid to exert their influence in respect of these conflicts can be adequately mitigated as highlighted in our response to Question 7a).

**b) Which aspects of the analysis that the SO will carry out for Government are most exposed to a potential conflict of interest? Please explain your reasoning.**

We believe that one of the main areas exposed to a potential conflict of interest concerns the procurement of capacity. The SO is responsible for managing the day to day operation of the electricity system and procures numerous ancillary balancing services, such as Short Term Operating Reserve (STOR), to help ensure that it is able to balance demand with supply at all times. The System Operator has an annual budget for this activity, with financial incentives to optimise performance and reduce the overall cost for customers. It will be necessary to ensure that, when National Grid procures STOR, this is kept separate from any capacity payments to secure the long-term availability of that plant. If a value to secure long-term capacity is included within STOR, then this will only serve to undermine the capacity mechanism. This may then result in a market equilibrium with a lower standard of security of supply than we currently have, and to which customers are accustomed. The structure of incentives available to the SO will need to be designed to ensure that both the operation of the capacity market and STOR are optimised, and so that there is not an over-procurement of capacity that may make it easier for the SO to fulfil its system balancing obligations.

With regard to the TO business, we share the concern highlighted about National Grid that its analysis on interconnection could drive more investment than is needed. This could potentially be at the expense of new build in the UK which would assure greater physical security of supply. We therefore believe that, as with the other areas identified where National Grid could give undue weight in its analysis it provides to the Government, that this information should be scrutinised by an independent panel of technical experts, as proposed in the consultation document.

**c) Do you agree with our conclusion that the main potential for synergies is between the SO and the EMR role? If not, please explain your reasoning.**

As stated in our response to Question 1b), we believe that the SO has the relevant technical and transactional expertise to realise the synergies highlighted in the consultation.

**Q4. Discretion – conflicts and synergies**

**a) Do you think that all the potential conflicts of interest and synergies arising from an ability to exercise discretion have been identified? If not, please explain your reasoning.**

We believe that the main areas have been identified, and agree on principle that the main conflicts of interests can be addressed by EMR process design, or are at least manageable. However, while we recognise that DECC and Ofgem will be limiting the scope for discretion in these functions by designing mechanistic processes, it is important not to “throw the baby out with the bathwater” and retain some flexibility in the exercise of discretion by the EMR delivery body (as long as it is clear and transparent to participants on the occasions this would occur) so as to benefit from its technical expertise.

**b) Which potential areas of discretion present the most risk of conflicts of interest?**

Without clear sight of the detailed governance arrangements and EMR framework, it is difficult at this stage to determine the precise areas of discretion that present the most risk of conflicts of interest. However, this highlights the importance of developing the technical rules and requirements in conjunction with industry rather than in isolation. It is important that input into this process is sought from a wide range of stakeholders to increase investor comfort and confidence. We believe that additional protections such as a robust audit framework/independent technical expert panel, as well as the ability for stakeholders to challenge decisions by the SO as a last resort (through a robust appeals process) will improve confidence in the system.

**c) Do you agree with our conclusion that the main potential for synergies is between the SO and the EMR role? If not, please explain your reasoning.**

As highlighted in our response to Question 1b), we believe that the SO has the relevant technical and transactional expertise to realise the synergies highlighted in the consultation.

**Q5. All conflicts and synergies**

**a) Do you agree with the assessment of the relative immateriality of the potential conflicts between the EMR role and the SO?**

EDF Energy agrees that the potential conflicts between the EMR role and the SO are relatively immaterial (especially when compared to the potential conflicts that could arise with respect to National Grid's competitive businesses). This is on the basis that the SO, in its current role, already has access to confidential and commercially sensitive information. The same principles used to manage the information currently available to the SO can be extended to the information provided under the EMR delivery function.

**b) Do you agree that any potential conflicts with other activities including the electricity TO and businesses operating under mainly competitive conditions have the potential to be material?**

We agree that any potential conflicts with other activities including the electricity TO and businesses operating under mainly competitive conditions could have the potential to be material. Appropriate ring fencing as detailed in our responses under Question 9) should act to ensure effective management of any potential conflicts of interest.

**c) What further analysis could be carried out to determine the materiality of the conflicts we have identified?**

It is difficult to ascertain at this stage what further analysis can be carried out in the absence of further detail of the proposed governance arrangements and the final EMR framework design.



## **Q6. Information mitigations**

- a) Do you think that conflicts of interest relating to access to information can be addressed through the design of EMR and EMR governance measures set out above? Please explain your reasoning**

EDF Energy believes that conflicts of interest relating to access to information can only be partly addressed by the design of EMR and EMR governance measures highlighted. We note that the legally binding information agreement between DECC and National Grid provides the option of sanctions should National Grid fail in its obligation to keep information pertaining to EMR confidential. Transparency of both commercially non-sensitive information and the processes for the EMR delivery function should allow for sufficient scrutiny by all stakeholders. However, the effectiveness of these proposed measures is difficult to assess with the level of detail currently provided. Further information and clarity is required with regard to the envisaged governance framework, including definitions of what is considered to be 'confidential' and 'non confidential' information.

- b) Which of the additional mitigation measures set out under 'further mitigation measures' should be considered to address these conflicts of interest? Would anything else be necessary? Please explain your reasoning.**

We believe that incorporating a more rigorous application of data protection requirements and regulation or restrictions on information flows would further address these conflicts of interests. This should be extended to also include financial and employee physical separation arrangements on the ring fenced entity (e.g. EMR + SO + TO) from other National Grid competitive businesses. These arrangements should be sufficient to target both concerns in respect of the ability and incentive to share information. Further or deeper business separation arrangements, which also include legal separation arrangements such as those relating to the Rough gas storage facility for example, would appear at the extreme end of the proposed mitigation measures. We expand this point in our response to Question 9 with regard to options for business separation.

We believe that the effectiveness of the arrangements above requires incorporating specific clauses into the relevant licence conditions to ensure enforcement, such as making an improper use of confidential information flows, a breach of licence rather than inadequate corporate governance.

## **Q7. Influence mitigations**

- a) Do you think that conflicts of interest relating to influence can be addressed through the design of EMR and EMR governance measures set out above? Please explain your reasoning.**

We broadly agree that the conflicts of interests relating to influence can be addressed by the design of EMR and EMR governance measures highlighted, and believe that the industry can work together to deliver acceptable solutions to resolve these issues. However, this is on the proviso that the precise roles and accountabilities of the Government, System Operator and Ofgem work under the basis proposed. It is crucial that the Government remains fully responsible for setting the policy approach and



objectives, and makes it clear what societal outcomes it is looking to achieve. This will require the Government to take the final decisions on the key rules and parameters of the delivery mechanisms. These include any impacts that policy decisions will have on public expenditure accounting protocols. The Government will be responsible for specific EMR policy objectives and for agreeing the key terms of CfDs. This will help ensure that the CfDs can be trusted by investors to provide a fair risk/return profile that ensures projects can be financed.

The Government will need to assure all electricity market participants that appropriate structures are in place to protect their respective commercial interests. With our respect to our response to Question 3b), we believe that any conflict between ancillary balancing services such as STOR and the Capacity Market can be avoided by clearly stipulating the different roles that the two mechanisms have to play in achieving security of supply. This can be achieved by having total transparency in the respective capacity procurement processes.

In addition, EDF Energy believes that the concern over National Grid favouring projects that lead to larger transmission investment, over potentially more cost effective solutions, can be mitigated through the price control process and through having the appropriate incentives in place to prevent this. It will also be necessary to ensure that National Grid's Licences are amended to prevent any potential abuse of its position.

**b) Which of the additional mitigation measures set out under 'further mitigation measures' should be considered to address these conflicts of interest? Would anything else be necessary? Please explain your reasoning.**

EDF Energy believes that Ofgem will need to provide greater scrutiny of the outcomes delivered through the EMR delivery body, by conducting regular and rigorous assessments to ensure that perverse outcomes such as superfluous investment in transmission is minimised. Although the System Operator will be tasked with providing expert independent advice to the Government, it will be important that DECC and Ofgem scrutinise this information and assure themselves that the advice is rational and consistent with providing the best value for customers. It will also be necessary for the Government to consider alternative sources of independent advice, including conducting its own studies, utilising academic expertise, as well as drawing on work done by external developers/consultancies, just as it did for the recent Renewables Obligation banding review.

We believe that the three measures highlighted under "Further mitigation measures", namely the publication of details on the SO model input and outputs, an impact assessment analysing the effect of SO's advice on National Grid's businesses, and requiring the SO to use certain key assumptions provided by the Government are reasonable and welcome steps that could be taken to increase the transparency of the analysis undertaken by the SO.

#### **Q8. Discretion mitigations**

- a) Do you think that conflicts of interest relating to discretion can be addressed through the design of EMR and EMR governance measures set out above? Please explain your reasoning.**

Please see our response to Question 4a)

- b) Which of the additional mitigation measures set out under ‘further mitigation measures’ should be considered to address these conflicts of interest? Would anything else be necessary? Please explain your reasoning.**

Please see our response to Question 4a)

#### **Q9. Mitigations – business separation**

- a) Overall, will the design of EMR, the proposed governance arrangements and the existing regulatory framework be sufficient to mitigate the conflicts that we have identified? Please explain your reasoning.**

EDF Energy believes that the various business separation options proposed are sufficient to mitigate the conflicts identified in a range of circumstances (please see our response to Question 6b and the transmission link project referenced in our response to Question 2a). In particular, we believe that the mitigation requirements can be met by ring fencing of National Grid’s SO, TO, and EMR businesses (Option A) combined with deeper business separation arrangements proposed under option 2a.

- b) Are other mitigations also likely to be necessary? If so, please specify what and why.**

An additional mitigation could include a right to appeal against National Grid’s exercise of discretion in a given direction. However, we would suggest this is treated very much as a measure of last resort to be used under clearly defined circumstances so as to avoid unnecessary delay into the process.

- c) Are business separation requirements (beyond restrictions on information flows) necessary?**

We believe that business separation requirements (beyond restrictions on information flows) are necessary, and should act to ensure potential conflicts of interests resulting from the SO’s current role and its new role as delivery body for EMR are sufficiently mitigated.

- d) If business separation is necessary what entity should be subject to the ring fence?**

EDF Energy believes that the ring fencing should occur around National Grid’s SO, TO, and EMR businesses (Option A). This level of business separation would ensure that the potential synergies identified between the EMR and the SO role are realised, including operational efficiencies and therefore potential cost savings.

We believe that the benefits resulting from these synergies (and synergies in relation to the TO role, such as system investment and outage planning and coordination activities) will outweigh any perceived conflicts between the EMR role and the TO functions (which in turn can be handled via the price control review process). However, a broader point in this respect concerns the Integrated Transmission Planning Review (ITPR) project. This is also considering expansion of the National Electricity Transmission System Operator (NETSO) role to undertake a wider system planning function (or central design authority function) to facilitate offshore network coordination. In a similar context to the above, we believe that the entity subject to ring fencing, being the SO and TO, would require some level of appropriate separation arrangements. The entity could therefore, for example, appear as SO + EMR + Central Design Authority.

Overall, we believe that the key aspect is to ensure that there are effective business separation arrangements in place between the monopoly and competitive businesses. The same is true in the context of ITPR and offshore coordination, where the monopoly businesses are subjected to certain business separation arrangements. For example, in the case of National Grid's interconnector businesses (a separately licensed activity), separation with NGET extends to the separation of regulatory accounts (financial separation) to enforce the prohibitions on cross-subsidies and discrimination.

The efficacy of these business separation measures in the face of expanded SO roles under EMR, and/or ITPR, will require ongoing monitoring and review. In any event, we believe that there is likely to be further expansion of the SO role in the future, given the changing nature of the transmission system and generation mix which has the potential to require ongoing revision of National Grid's business model. We believe that Ofgem would be the most appropriate body to undertake this necessary function.

**e) What degree of business separation do you think would be necessary to mitigate conflicts of interest?**

We believe that the degree of business separation should consist of EMR + SO + TO ring fencing (option A). If this is considered in combination with the options highlighted in option (2a) of the consultation document, which includes physical, employee and financial separation measures, then this should provide sufficient safeguards against any potential conflicts of interest.

**f) How can we best protect the synergies between the EMR and SO roles when considering additional mitigation measures?**

We believe that the synergies between the EMR and SO roles can be best protected by allowing the ring fencing of EMR, SO and TO roles and suggested in option A as described in our response to Question 9d).

**EDF Energy**  
**January 2013**