Welsh Power

31 January 2013

Welsh Power Group Limited
Ground Floor, Tuscan House
5 Beck Court
Cardiff Gate Business Park
Cardiff CF23 8RP
Tel: +44 (0)2920 547200
Fax: +44 (0)2920 549896
info@welshpower.com

Mr Jonathan Brearley
Director, Energy Markets and Networks
Department of Energy and Climate Change
3 Whitehall Place
London
SW1A 2AW

europeanwholesale@ofgem.gov.uk
emr@decc.gsi.gov.uk

Dear Jonathan

EMR: Consultation on Synergies and Conflicts of Interest Arising From the Great Britain System Operator Delivering Electricity Market Reform

Welsh Power Group (WPG) is a privately owned energy company with a strong track-record in development, in both conventional and renewable energy.

In January 2009 the company received planning consent for the construction of a 49.9MW biomass plant at Newport Docks, Wales, through its wholly owned subsidiary Nevis Power Limited. Late last year WPG sold a 50% stake in the project to a subsidiary of Santander Bank to secure the financing of the plant.

As well as renewable energy, WPG submitted an application to develop Wyre Power, an 850MW CCGT (combined-cycle gas turbine) power plant near Fleetwood, Lancashire in August 2009. We also own and operate a 24MW OCGT, Leven Power, as well as a 10MW gas engine, Rhymney Power on STOR contracts to NGC.

Formerly, WPG owned and operated a 363MW coal fired plant, Uskmouth Power until its sale in 2009 to SSE. It developed and built Severn Power, a new 850MW CCGT plant in South Wales, which it subsequently sold to DONG Energy. WPG also started its own retail business, Haven Power, in 2007, but this has subsequently been bought by Drax.

WPG has therefore a real and direct interest in Electricity Market Reform (EMR), both from the point of view of supporting new generation investment, but also in managing its inevitable impact on our established activities. Although we support the appointment of National Grid (NG) as the EMR delivery body for the functions set out in the consultation document, we also believe it is essential to establish robust business separation arrangements between this role and NG's other roles as GB System Operator (SO) and Transmission Owner (TO).

At the very least this separation should involve the ring fencing the EMR delivery role through the regulation of information flows, employees, physical and financial separation (Option C, 2a in the consultation) and should ideally extend to full legal separation (Option C, 2b). Full legal separation would have the advantage of making it easier for the EMR delivery role to be awarded to another party should the Government consider this to be appropriate in future.

WPG agrees that there are organisational efficiencies to be had in placing the EMR role within the NG group of companies, but we believe a 'light touch' to business separation is extremely unwise. NG is a monopoly network business and as such is not subject to the normal competitive market disciplines faced by generators and suppliers; it is therefore right that they are subject to controls to limit potential abuse of monopoly power. NG already has scope to impact the market and steer the design of the market rules so as to shift costs and risks onto generators and suppliers. One example is the numerous onerous obligations sought by NG as it led the drafting of the recent ENTSOE Requirements for Generators Network Code for European TSOs. Providing further potential opportunities for National Grid to use their privileged position for commercial advantage seems foolhardy.

We are therefore surprised that DECC and Ofgem appear to be convinced that only a limited level of business separation is required. The strong reaction of industry participants and the wishes of the Select Committee on this matter, should suggest otherwise. In our view any additional costs from deeper business separation are small in comparison to the risks arising from conflicts of interest. Combining robust business separation with full transparency of the CfD and capacity mechanism contract allocation processes would in fact provide greater certainly for generators in assessing the financial impact of EMR on their activities. For example determining likely income streams from STOR and/or EMR capacity revenue, will impact offers made in a capacity auction. Any uncertainty arising from inadequate ring fencing will simply increase offer prices submitted by generators.

As the application of Option C, 2b approach is fairly standard practice for dealing with conflicts in regulated monopoly network businesses, we do not understand why this was not the starting point for consultation discussions. These types of business separation arrangements are to be found across the energy sector, e.g. between supply and distribution businesses owned by the same parent company, and they do not have to be too onerous or costly to manage. In this context the burden of proof should surely be on NG to demonstrate why these arrangements should not apply, rather than for the industry to demonstrate why they should. Turning now to some of the more detailed points raised in the consultation.

WPG agrees that the basic regulatory structure of using NG's Electricity Transmission Licence to capture its obligations and processes is appropriate. However, the Government will need to clearly define allowable information flows between the various business functions (EMR, TO and SO). Sitting under the licence will also need to be more detailed "rules" covering the processes for allocation of contracts, pre-qualification, etc. These may best be linked to the licence

as some form of principle documents that can only be altered, following consultation, with the agreement of Ofgem/DECC. The commercial delivery, involving the cash flows between the parties would be best placed into some form of industry codes to allow for timely change if required, with capacity best placed in the BSC and CfD may be subject to a new code or put in CUSC[1].

The key problem with the use of the licensing regime is the time it takes Ofgem to act if it believes a licence breach has occurred. In order to maintain the confidence of all parties, some form of appeals process against NG's delivery decisions will be required. However, this will need to be accompanied by a commitment for Ofgem to investigate any issues arising in a timely manner.

NG is responsible for "ensuring the economic and efficient operation of the transmission system" and this has both a short-term operational efficiency focus as well as a long-term planning focus. On the face of it this may not appear to be in conflict with the EMR objective to ensure security of supply. However, how NG chooses to meet its responsibilities can have implications on the overall cost of generation and supply in the market. NG can in some instances favour investment in its system rather than procure additional balancing services from market participants. It is also subject to balancing incentives worth tens of £m, so the use of privileged information to gain advantage in negotiations on various balancing services contracts to driving down prices is to be expected. We do not consider it is appropriate for a monopoly counter-party to artificially distort this price formation process for such contracts just because they have 'insider information' on how future capacity is to be procured.

EMR support mechanisms for new generation will inevitably have an impact on the short term operation of the grid, including STOR, pre-gate closure agreements and actions in the balancing mechanism. The market will thus adjust offer prices in any capacity auction to reflect anticipated reductions in STOR income. However, artificially dampening STOR prices because the SO is able to use privileged information to aid negotiations will unfairly impact existing STOR service providers.

WPG is concerned that under the capacity mechanism the auctions must allow all plant to compete on a level playing field, as there is a risk that NG, as the SO, will favour certain types of plants in certain locations. STOR has become a locational product, though still not explicitly defined as such. However, the capacity plant should not have a locational or technological bias as capacity that is reliable can all provide the service as the Government has defined it to date.

---

[1] The difficulty for CfD FITs is that smaller players will need direct contracts with the CfD counter party, but may be of a size that they are not signatories to codes. If cash-flows are required to go via Suppliers this opens up the issues associated with PPAs that DECC has already identified. WPG therefore suspects a new code may be required, though the payments into the CfD pot could still be attached to the BSC cash flows.

In addition, NG will naturally wish to increase its profits by minimising their controllable costs and this can be achieved in part by seeking to shift costs and risk onto market participants. The apparent internal savings made can be more than outweighed by the higher external costs and risks faced by generators and suppliers. We do not criticise NG for seeking to deliver profits for its shareholders in this way, but it is important for regulators to understand the nature of these behaviours so that the right regulations can be established to ensure the NG actions are economic in the widest sense.

The extent to which NG will be permitted to influence the design of contract allocation processes, the terms of such contracts to be agreed, and any changes to rules and mechanism design (e.g. penalty regime rules) is also a major concern for market participants. The more mechanistic the rules are, the greater the confidence the market will have that NG's discretion is limited and undue discrimination between parties is unlikely. However, NG will need to build expertise in area such as assessing renewables projects for pre-qualification. Ofgem has taken years to build up expertise under the RO system and these skills may not be easily transferred to NG.

We welcome the statement in the consultation that the intention is to limit NG's discretion "by designing mechanistic processes which will be clearly and transparently set out". Applying this to allocation of CfDs, pre-qualification processes and auctions, monitoring delivery of plant capacity, and advising on rule changes to processes is a sensible approach. Nevertheless, implementation of such arrangements in practice will be difficult and unlikely to be completely 'watertight', hence the importance of also ensuring the fullest possible transparency for these processes within the bounds of preserving individual market participant commercial confidentiality.

Whilst NG is ideally placed to assist the Government in relation to understanding supply demand fundamentals for the purpose of planning the system; and they already do an excellent job in this regard; understanding energy markets or generator costs is not a key competence of theirs. Gathering data for Government with oversight from the Panel of Technical Experts is acceptable, but great care will be needed to avoid NG, whether intentionally or not, unduly influencing the strike price setting and capacity evaluation processes. One thing that will help is if the experts have industry, rather than pure academic, experience. As a small 'residual' player in the energy market, they should not be given a privileged position in advising the Government on market prices or support levels for particular technologies.

Whilst we support DECC in seeking to establish mechanistic processes, restricting NG discretion and full transparency, we consider robust ring fencing measures that seek to prevent detrimental behaviours are even more important. Indeed the highest standards of business separation should also be in NG's interests as it helps protect them from unfounded criticisms from the industry.

WPG urge DECC and Ofgem to adopt a prudent, precautionary approach (Option C, 2b) to business separation between the EMR delivery role and other National Grid functions and businesses.

We trust you find these comments helpful. Please feel free to contact Lisa Waters (020 8286 8677) or myself if you or your colleagues wish to discuss any of the issues raised here further.

Yours sincerely

Alex Lambie
Chairman