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Dear Jeffrey

National Grid response to non-traditional business models: supporting transformative change in the energy market

This response is provided on behalf of National Grid Gas plc (NGG) and National Grid Electricity Transmission plc (NGET) and is not confidential.

Thank you for the opportunity to engage on the subject of Non-Traditional Business Models (NTBMs). New industry entrants, like those described in the paper, are of growing significance to the energy market. As such, we are pleased that Ofgem is actively considering how well suited the current regulatory landscape is for managing and supporting these emerging business models. As the rate of transformation increases, it is likely that industry rules and arrangements will require more flexibility to keep pace with change and maintain their relevance. With the potential scope for change, the suitability of code and licence obligations in relation to NTBMs is an issue that will require frequent monitoring and review as the industry evolves. These conditions might best be supported by a regulatory framework underpinned by clear and consistent principles but that allows the industry to function dynamically.

There are a number of external factors that may help inform thinking on this topic. Firstly, consideration of a particular issue should account for, and be consistent with, any provisions in the European Network Codes. Also, as noted in the paper, the CMA investigation has consulted widely on several issues that overlap with this topic in relation to potential barriers to entry (such as those associated with the market power of vertically integrated companies, market liquidity, wholesale market arrangements and the structure of the codes). The output of their investigation may prove informative in signalling how different parties see the industry changing. Thirdly, examining the development of energy markets in other countries may provide an indication of potential future paths that business models might take.

Turning to the issues raised in the paper, the definition given for NTBMs largely refers to organisations that may themselves be new or offer new products, services and/or modes of delivery. An additional perspective may be to consider how the nature of existing contractual agreements between 'traditional' counterparties may evolve to be more sophisticated and/or multifaceted than they have been historically. This applies to non-commercial contracts as well as commercial contracts. For example, when applying for planning permission for site developments we have had new conditions added to the terms. Whilst new contractual terms may be reasonable and innovative in themselves, they could in practice have the effect of

stretching our role beyond the traditional boundaries set out in our respective licences (possibly requiring Authority consent). Such terms, if feasible, may expand the scope for new efficiencies (environmental and/or economic) to be achieved across organisations but at the same time can present regulatory challenges.

Similarly, the activities that new entrants undertake may not readily fit into the 'traditional' roles that we recognise in the industry. Whether new roles are identified or existing roles are adapted to encompass these parties, there is a need to ensure that treatment of industry players is consistent and reasonable. As part of this if concessions are made to some parties on charges or the costs implied by market arrangements, we would expect greater costs to fall on others. That is, any socialisation of costs will result in 'winners' and 'losers' in the industry.

There are important reasons for the parameters and prohibitions on activities marked out in the conditions of the industry licences which act as valuable safeguards, ultimately to protect the consumer. Whether it is appropriate that an industry participant's activities extend outside the terms of their licence depends largely on the circumstances of the specific issue under consideration and it is likely that 'blanket' licence changes are not appropriate or desirable to accommodate these. Going forwards we might expect increases in the number of unique cases for which derogations are requested. Addressing these on a case-by-case basis may facilitate efficient solutions whilst preserving the intent of the existing regulatory framework.

The regulatory mechanisms in place for managing perceived risks of conflicts of interest are a valuable means of allowing NTBMs to grow within existing businesses whilst providing robust market safeguards. Current business separation requirements are appropriate, letting business develop into new areas in a prudent way. We would be cautious against introducing new measures that might unnecessarily restrict growth of businesses.

From an industry perspective, an advantage offered by the current regulatory arrangements for licenced networks is that they contain incentives to explore new ways of working through mechanisms such as innovation funding. As well as exploring new approaches internally within the business, this has facilitated opportunities to collaborate with new businesses and social partners that might not have been traditional counterparties.

NTBMs may emerge in response to a signal of need or individual problem. As multiple objectives and dynamics in the industry interact it will become increasingly important for arrangements to be co-ordinated strategically to deliver industry frameworks that drive the greatest value for the consumer. Continuously reviewing the extent to which the prevailing arrangements are fit-for-purpose will support this. Should any unintended adverse impacts be identified, then it is important that the governance frameworks are able to provide an objective mechanism for assessing changes holistically.

To ensure NTBMs are not discouraged from entering the market, it is vital that overarching code governance arrangements are not set up to be implicitly prejudiced against changes that divert away from the status quo. This might require scrutiny of the applicable objectives and the composition of panel representatives for each code to ensure there is sufficient opportunity for deep-seated changes to take place.

Finally, in order to provide the opportunity for participation in the energy market, to make full use of innovation and advancements, it should be allowed to continually evolve. This would favour an agile framework that has the flexibility to move in unspecified directions rather than an approach that formulates and then follows a prescribed framework for the industry. When considering the regulatory framework in relation to NTBMs, there is a balance to be met between the requirement for regulatory certainty (for investor confidence) and flexibility to be

open to new and diverse ways of operating if doing so is in the best interests of consumers. Placing increased emphasis on clear and stable guiding regulatory principles, whilst allowing the detailed rules to readily adapt may help achieve this. Such principles might include:

- Responsibilities and accountabilities of licenced entities must be outlined clearly without ambiguity.
- Any changes should not inhibit the ability of licenced parties to perform the activities required to fulfil those responsibilities defined in their licenses. In particular, as System Operator, it is fundamental to us that any developments should not constrain our ability to balance the system.
- Treatment of participants in the industry, whether new or incumbent, should be consistent and reasonable.
- Impacts of changes should be considered holistically and regularly monitored.

Guiding principles like these might provide a stable reference point for developments in the industry to be considered against which is key for both incumbent parties and potential entrants.

If you wish to discuss the content of this response further, or have any queries, please contact Sally Lewis on 01926 656984 or at sally.lewis@nationalgrid.com in the first instance.

Yours sincerely

[by email]

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