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Supporting energy and water
security and economic growth



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Dear Jonathan,

Ofgem's Response to DECC's consultation on Electricity Market Reform (EMR)

Thank you for the opportunity to respond to the EMR consultation. We welcome the review, and we are committed to working with the Government to deliver the EMR objectives at best possible value for consumers.

In February 2010 we highlighted in our Project Discovery Consultation document the unprecedented challenges facing the electricity and gas industries. We concluded that significant and prompt action would be called for, and that leaving the current arrangements unaltered would not be in the interests of existing and future consumers. We put forward a range of possible policy measures that could help to deliver both security of supply and environmental objectives at affordable prices in the long term. The EMR attempts to address the same issues as those identified in Discovery, and on this basis we welcome the Government's consultation on a package of options for reform as a positive step forward.

It will be important that the reforms are mutually consistent, working together efficiently to achieve the Government's objectives of decarbonised, secure and affordable energy supplies. Given our primary duty to protect existing and future consumers, we would ask the Government to pay particular attention to the potential significant impact of the proposed reforms on consumers, and also the potential wider implications for the effectiveness of the electricity market.

Below we highlight our high-level observations on the proposed policy package, and the interactions between the individual policy measures set out in the consultation. We have already provided a separate response to the HMT consultation on carbon price floor (appended to this letter).

Key observations

1) Impact on consumers and sustainability

Our principal duty is to protect the interests of both existing and future consumers. Therefore we consider it vital that particular attention is given to the potential impact of the proposed reforms on consumers both now and in the future.

We note from the consultation document and the impact assessment that bills are expected to increase significantly in the period to 2030, by around 60% for domestic customers. We recognise that these bill increases are primarily driven by the level of investment required

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in decarbonisation and security of supply, and we support the Government's aim of delivering a package of reforms that is more cost effective than the current arrangements. More work is required to understand the potential impacts of such a large increase in consumer bills, particularly for vulnerable customers. We note that the impact assessment assumes current and future energy efficiency schemes will ensure that these bill increases are less than they might have otherwise been. We are also conscious that the proposed reforms will take place in the context of wider energy policy initiatives, such as the Warm Homes Discount and the Energy Company Obligation. We are committed to working with Government with the aim of protecting vulnerable customers from being disproportionately affected by rising prices.

We welcome the Government's focus on providing greater long-term certainty to investors in low carbon generation, as this should reduce overall costs to consumers. However as we noted in our letter to the HMT carbon price support (CPS) consultation, we are concerned that a number of policy mechanisms in each of the proposed packages are essentially aimed at achieving the same policy outcomes. This may lead to unnecessarily high costs for consumers. For example, implementing CfDs together with CPS may result in consumers paying more than is necessary to decarbonise the GB electricity market. While this risk may be partially off-set if the removal of carbon price risk through CPS reduces the portion of overall revenue that generators receive through the CfD, this will ultimately depend on the design and allocation of the contracts. In addition, while an Emissions Performance Standard (EPS) may provide an additional backstop against new unabated coal plant, when considered in the context of the wider EMR package it is not clear how much additional benefit it will deliver.

We believe it is also important that the Government pays particular attention to wider sustainability issues. There is a significant potential future role for demand side response (DSR), both within the retail market and within any capacity mechanism. We believe that DSR can be compatible with the framework set out in the consultation, provided that market prices remain robust. We also consider it important to keep in mind the potential contribution that small-scale decentralised solutions can make to decarbonisation and security of supply.

Finally, in the interests of consumers we believe that more assessment of the extent to which the EMR package interacts with other policy measures such as the EU ETS, the Green Deal, the Green Investment Bank and the Carbon Capture and Storage (CCS) subsidies would be beneficial for inclusion in the White Paper.

2) Implications for the market

In line with our Project Discovery conclusions, we recognise that fundamental changes to the current arrangements may be required to meet decarbonisation, security of supply and affordability objectives. In this light, we welcome the Government's proposals as heading in the right direction, in particular the focus on providing greater long-term certainty to investors in low carbon generation. Provided that the reforms are properly designed (for example to avoid over-investment and gaming), this should lead to lower costs for consumers in the long-term.

We support the Government's objective of maintaining a market-based system. However, we would ask the Government to consider carefully the potential implications of the EMR 'lead package' for the survival of the market price as a signal for future investment. The scale of impact on the market arrangements will depend upon the extent to which the policy measures work together as a package, and also on some of the detailed institutional and market design issues. Further consideration is needed on some of the key assumptions driving the choice between the different low carbon policy options identified in the document, in particular the importance of the trade-off between providing investor certainty and retaining market-based efficiency incentives. In this respect, we would ask the Government to consider the extent to which risks other than long term price risk (such as construction risk) may be acting as a barrier to investment in low carbon generation.

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We would like to highlight the interaction between FITs and the capacity mechanism proposal, insofar as it may affect the long term viability of the BETTA framework.¹ A 'targeted' mechanism may, at least initially, only reward peaking plant (e.g. OCGTs and pumped storage), at the same time that potentially all low carbon plant will receive a FIT. This could potentially leave only flexible fossil fuel plant (e.g. CCGTs) purely reliant on the market price for revenues (which may become more volatile and unpredictable as the amount of wind generation increases). Over time, CCGTs might be expected to seek a contract under the targeted capacity mechanism, which could further squeeze the remaining flexible capacity operating in the market. We welcome the Government's recognition of this potential 'slippery slope' effect in the document, and we note it is an issue that has been increasingly and consistently recognised by stakeholders since publication.

We welcome the Government's focus on electricity security of supply as part of the EMR consultation. Further, we recognise the important role for an electricity cash-out Significant Code Review (SCR) in attempting to mitigate the potential impact of a targeted mechanism on price signals. However, in the context of the wider EMR package, and in the interests of creating a viable long term framework, we consider there may need to be more fundamental decisions made on whether energy-only prices or capacity markets are to provide investment signals for flexible capacity.

Although much detail is still to be worked through, we see that under the FIT proposal there may be a greater role for Government (than at present) in determining the generation mix. However we would ask the Government to consider maintaining competition between generation technologies as far as possible, so that efficient price discovery can emerge. We consider that the appropriate use of competitive mechanisms is likely to lead to the best outcome for consumers over the long-term, whether that be competition 'in the market' or competition 'for the market'.

Finally, the EMR document provides Ofgem with a key role in driving reforms which could improve market functioning more generally (e.g. Electricity Cashout SCR and Wholesale Market Liquidity). We believe that these reforms have an important role to play in retaining strong market-based incentives, which may have important knock-on benefits such as promoting DSR. Of course, the success of these measures will depend heavily on the role of the market in the final EMR package.

3) Broader implications for and interactions with Europe

The European vision for a single electricity market is gaining momentum, with Member States having recently agreed to deliver such a market by 2014. The vision of the single market is illustrated in the concept of market coupling, which aims to facilitate efficient use of cross border infrastructure and free power trade across the EU. It is essential to explore how the European single electricity market vision can be integrated into the EMR reforms. As a minimum, we should ensure consistency of the EMR policy measures with current EU legislation. The more we integrate the European vision into our current and future market arrangements, the greater the potential benefits for GB security of supply. Further, it is less likely we will end up with a market design that is out of step with Europe, requiring increasingly costly amendments to maintain legal compliance (and with GB consumers potentially bearing the cost of inefficient flows and cross border trade).

Market coupling with European markets is an approach to market integration that should bring benefits to GB in several areas. It maximises the efficient use of interconnectors and provides a platform for cross border trade. This can reduce barriers to entry for small players, decrease market power, and increase liquidity in national energy markets. We expect to see some of these benefits as GB will be coupled to the CWE area² via the BritNed

¹ In particular the proposal for an extended reserve mechanism operating with economic dispatch.

² Central West Europe includes: France, Belgium, Netherlands, Luxembourg and Germany

interconnector³ from April 2011. More specifically, under market coupling, prices determine the direction of cross border trade. The EMR measures aim to incentivise specific elements of GB generation mix, but any payments to make capacity available are likely to have an impact on GB prices, and therefore interconnector flows. The scale of the impact of EMR on cross border trade will depend on the detailed design of specific mechanisms.

Further, increased interconnection with Europe can increasingly contribute to the EMR objectives of security of supply, decarbonisation and affordability, as well as efficient market functioning. GB is likely to become more interconnected from the current 2.5GW interconnector capacity⁴, to 4GW⁵ by 2012 and there is an interest from developers of up to 7GW of additional capacity by 2020. We would ask the Government to highlight these potential benefits in the Impact Assessment.

Finally, as we highlighted in our response to the HMT CPS consultation, the EU Emissions Trading Scheme (EU ETS) sets an annual limit for carbon emissions across all Member States. A feature of a GB-only CPS scheme is that a greater and potentially cheaper number of EUAs are likely to be available for other Member States, and there is no net contribution to EU-wide emissions (as the amount of allowances is currently fixed by the existing ETS). However we recognise that it may be possible to take the effect of GB-specific carbon reductions into account in setting longer-term caps in the EU ETS.

4) Design and operational issues

The EMR proposals are currently at the first stage of consultation, and there is much more detail to emerge. We consider that the next stage of the EMR - the development of detailed policy and operational design - will be the key in ensuring policy measures achieve the Government's objectives at best possible value for consumers. More specifically, we think it is important to clearly address issues such as:

- how the generation mix will be determined and the extent of competition between technologies,
- the institutions responsible for implementation of the proposals, in particular the design and operation of FITs and the capacity mechanisms,
- the methodology used to determine the level of energy and/or capacity required,
- the need to determine whether a single FIT mechanism is appropriate for all technologies,
- the means of determining the reference price that will be used in a FIT with CfD mechanism, and ensuring that this price remains robust over time,
- whether auctions or contracts are the most effective way to allocate the correct level of support for different technologies⁶,
- the balance between providing certainty for participating bidders into the FIT mechanism, and the potential need for flexibility in the interests of consumers,
- the need to identify a mechanism for recovering costs from consumers (and back to consumers in case of the FIT w/ CfD),
- the need to ensure efficient dispatch of a growing share of low marginal cost generation,
- the need to be clear on the Emissions Performance Standards (EPS) level, taking into account the range of technologies potentially captured.

We think that all of the points above need to be considered in detail so as to limit any potential unintended consequences that may undermine the overall policy intent. A

³ 1 GW interconnector between GB and the Netherlands, operational in April 2011

⁴ 2GW to France via IFA (Interconnexion France-Angletterre) and 500MW to Northern Ireland via Moyle Interconnector

⁵ 1GW in April 2011 via BritNed and 500 MW in September 2012 via East West Interconnector, connecting GB to the Republic of Ireland.

⁶ We note that auctions have had mixed success in GB. It may be important to include obligations to deliver projects as part of the auctions process.

thorough analysis of international experience with some of the different mechanisms under consideration may be helpful in this regard. We would also ask the Government to avoid putting in place unduly complex arrangements that may create an investment hiatus, and may favour larger players over small and independent players.

5) Interactions with ongoing Ofgem projects

There are clear interdependencies between Ofgem's *liquidity project* and the EMR. Firstly, we note Government's view that liquidity may be required for the successful functioning of its EMR proposals. The liquidity project is concerned with making sure that participants in the GB power market have the products and signals they need to operate effectively – and this should take into account any new mechanisms introduced as part of the reform package. In our December Open Letter⁷ we highlighted the importance of ensuring that any action we take is aligned with the Governments' proposals. We are working closely with DECC to ensure that this objective is met. However, we would like to highlight that no decision to intervene has yet been made.

Secondly, the reform package may itself have impacts on liquidity. To the extent that the EMR policy measures change incentives, they may change participants' behaviour and therefore affect liquidity. For example, measures which enhance revenue certainty or provide alternative revenue streams may affect incentives to interact with the wholesale market. The direction and scale of any impact will depend on design, and we look forward to working closely with DECC to consider these issues.

There are clear links between the targeted capacity mechanism proposal and Ofgem's pending *Electricity Cashout Significant Code Review (SCR)*.⁸ We welcome the emphasis placed on electricity cash-out reform in the EMR document, and we are committed to working with the industry to reform cash-out in a timely manner. However we believe that cashout reform alone may not be sufficient to mitigate some of the potential unintended consequences associated with elements of the EMR proposals (for example those related to the 'slippery slope effect' that is discussed in the EMR document and in section 2 above). On implementation, given the close interactions we would ask DECC to consider whether it would be best to implement the detail of the capacity mechanism proposals alongside cash-out reform as a single project, working to DECC's high level policy objectives.

The EMR is also likely to have implications for the GB gas market and thus there are clear interactions with Ofgem's *Gas security of supply Significant Code Review ('Gas SCR')* project.⁹ Depending on the final design, the EMR package may put additional pressure on gas demand, with potential implications for security of supply. Conversely, we need to ensure that any changes brought about in the interest of long term gas security of supply do not have an undue negative impact on electricity security of supply.

There are also clear links with *competition in the electricity retail market*, particularly with respect to the ability of small and independent players to enter the market and access the products required to manage their risk. Ofgem will release its Retail Market Review (RMR) findings and initial proposals in March 2011.

Finally, *Project TransMIT* is reviewing GB transmission charging arrangements and the associating connection agreements, taking into account initiatives on market coupling and the need to manage constraint costs. EMR is likely to impact on the wholesale market design and the price formation process, which could interact at various degrees with

⁷ See our December 2010 Open Letter:

<http://www.ofgem.gov.uk/Markets/WhlMkts/ComandEff/Documents1/Open%20letter%20Liquidity%20in%20the%20GB%20power%20market%20update%20and%20next%20steps.pdf>

⁸ We expect the Electricity Cashout SCR (including a review of P217) to commence later in 2011, following publication of the White Paper.

⁹ The objective of the Gas SCR is to minimise the likelihood, severity and duration of a gas supply emergency in GB. The project was launched in January 2011 with an initial consultation document, and we expect to release a draft decision mid-year.

options to be considered under the charging review. For example, a connection agreement (potentially in response to a locational signal) could be part of the design mechanism for a FIT with CfD or a capacity contract (alternatively a firm contract may become a pre-requisite of a connection offer). However, this must be considered alongside any locational signals contained in the charging arrangement to ensure the appropriate level of overall locational signals are allocated to users.

Further engagement

We are committed to working with the Government to deliver the EMR objectives at the best possible value for consumers. In order to achieve this we consider it essential that the design of the reforms is considered as a complete package, noting the important interactions between the individual EMR elements (for example between the FIT mechanism and any capacity mechanism). We intend to engage with the Government at all levels to provide constructive and expert input across the whole spectrum, to ensure the interests of existing and future consumers are protected. On an enduring basis, we anticipate having a significant role in the implementation of the Government's reform proposals, and we look forward to engaging with the Government to understand our role as the consultation progresses.

If you have any further questions regarding our response please feel free to contact either [redacted]@ofgem.gov.uk or [redacted]@ofgem.gov.uk.

Yours sincerely,

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