

By email to EnergyMarket@cma.gsi.gov.uk

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ELEXON's comments on CMA Statement of Issues

We welcome the opportunity to comment on the CMA's Statement of Issues. ELEXON is responsible for managing the electricity balancing and settlement arrangements as set out in the Balancing and Settlement Code (BSC). We are independent of any part of the electricity industry and not for profit.

Observations on definition of Theory of harm 1

We are interested in the thinking behind Theory of harm 1 (hypotheses 1a and 1b and paragraph 29) as this is the area that touches upon some of the activities set out in the BSC, which ELEXON administers.

There is a close relationship between these two hypotheses. The current electricity trading rules were designed with strong incentives on generators and retailers to balance their own supply and demand portfolios, by making energy imbalances particularly expensive. Firms have responded to these incentives either through bilateral contracting or vertical integration (or both). These in turn may have led to low volumes of wholesale trading going through cleared, transparent markets, leading to poor-quality spot price signals, low liquidity in financial markets and limited availability of hedging products for vertically separated firms.

We agree that the intention of the trading rules, as designed by Ofgem's NETA Programme, was to allow for participants to self-balance through the sale and purchase of energy through bilateral contracts or on power exchanges. Participants can do this up to one hour before real time, after which National Grid finalises its view of the impact on the transmission system.

Your investigation should consider that some vertical integration was in place prior to the introduction of the NETA arrangements.

More substantively, we would question whether energy imbalance charges should be described as 'particularly expensive'. The rules for calculating energy imbalance charges were designed initially by the NETA Programme and set out in the BSC. Since 2001 those rules have been modified (through

industry debate but ultimately by agreement from the Authority (Ofgem)) on numerous occasions. The purpose of many of these changes was to refine the calculation to ensure it reflected the actual costs of 'energy balancing' by removing costs borne by National Grid that resulted from dealing with system issues. This has had the effect of making Imbalance prices generally lower than they otherwise would have been before the rules were refined.

We note that, after the start of NETA, reverse prices (for "helpful" imbalances that assist National Grid in its balancing efforts) were introduced. The reverse price is based on power exchange prices, so would generally be expected to be less volatile than those based on balancing actions in the shorter term.

The CMA will be considering future changes as part of its investigation. We would note that the conclusions of the Ofgem Electricity Balancing Significant Code Review (SCR) are currently going through the BSC Modification process and observe that the Ofgem proposals are likely to lead to more expensive imbalance prices. This is due to the fact that the proposed changes will use only the most expensive actions taken by National Grid, to balance the system, in setting prices.

As well as the SCR, you should consider the EU Electricity Balancing Network Code, currently in draft form, which is likely to constrain what imbalance prices can be. For example, the last public draft we have seen (December 2013) states that the imbalance price for shortage shall not be less than the weighted average price for certain defined balancing actions taken by the Transmission System Operator. So the current trend is take make imbalance prices more marginal rather than less.

All this suggests that "particularly expensive" could be an unjustified phrase as the intent so far has always been to be cost reflective (or neutral for reverse prices). In any event, the European Network Code will have the force of law in the UK as well (as other Member States of the EU), so if its final version still provides that imbalance prices shall "not be less than...", there would seem to be no option for lower prices than prescribed.

The questions would therefore seem to be "*are imbalance charges an appropriate reflection of the costs of energy balancing*" and "*is there a better way to incentivise market behaviour*".

Other ways to remove potential barriers to entry.- reducing the impact of the regulatory regime

You observe one of the key characteristics of the market to be the prevalence of regulation (para 16, bullet 5).

Regulatory interventions are prevalent in both gas and electricity markets. Gas and electricity networks, as natural monopolies, are generally subject to price regulation, for

example. Often the form of regulation in place differs considerably between jurisdictions, according, notably, to the degree of liberalisation – eg detailed market rules are required to underpin liberalised wholesale energy markets, while retail price controls are used in countries where the retail market is not liberalised. Operators in the energy sector can be exposed to a significant degree of regulatory risk, particularly those that undertake large, long-term investments, the costs of which need to be recouped through future revenues.

Your reference to long-term investments highlights the regulatory risk posed by changes in regulations over time. We have identified regulation which inhibits competition in energy markets through unnecessary complexity and duplication. ELEXON responded to Ofgem's consultation on whether to make a market reference¹ regarding the impacts of the wider regulatory framework. Our response highlighted three areas where competition could be improved in the energy markets, by:

- reducing the complexity of industry codes and agreements and thereby significantly reduce the cost of participation and compliance;
- improving the market entry experience for new licensees through a simpler market entry process, building upon the improvements and shared approach developed by ELEXON for BSC users;
- reviewing the reporting obligations across industry and avoiding unnecessary duplication of data thereby reducing the costs and burden of reporting and monitoring.

In summary, we believe that there may be merit in considering the effect on competition of the existing complex and fragmented regulatory design of industry codes.

If you would like to discuss any areas of our response, please contact me or David Jones, Senior Regulatory and Market Advisor, on 020 7380 4213, or by email at david.jones@elexon.co.uk.

Yours sincerely,

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¹ <https://www.ofgem.gov.uk/ofgem-publications/88403/elexonresponse.pdf>