

**22 May 2012**

## Electricity Market Reform (EMR): Potential synergies and conflicts of interest: Outcome of the 27 March 2012 workshop and responses to the 8 March 2012 open letter

### **Potential synergies and conflicts of interest arising from the designation of the Great Britain (GB) System Operator (National Grid Electricity Transmission plc) as delivery body for the proposed Capacity Market and Feed-in-Tariff Contracts for Difference (FIT CfDs)**

#### **1. Overview of the project**

The aim of Electricity Market Reform (EMR) is to meet the significant long-term challenge of decarbonisation and to deliver our renewable energy targets, while maintaining secure and affordable electricity supplies.

DECC's technical update on EMR published in December 2011 indicated that DECC intends to confer the EMR delivery function on the GB System Operator (SO). DECC and Ofgem are conducting this joint project to assess the extent to which the SO performing the EMR delivery role creates new conflicts of interest and/or new synergies for National Grid. It is intended that this project looks at synergies and potential conflicts from when National Grid would formally take on the delivery role, currently anticipated to be in 2014.

As part of this work we have engaged with stakeholders, including generators, consumer groups, large industrial energy users and investors. We published an open letter on 8 March 2012. The letter sought views on the synergies between the System Operator's (SO) existing role and its proposed role as EMR delivery body. The letter also asked respondents which, if any, conflicts they felt could arise and how best these could be mitigated.

As part of this dialogue DECC and Ofgem held a workshop on the 27 March, which was attended by over 50 representatives from industry, consumer groups and third parties. In addition we received 27 responses to the open letter, from a range of stakeholders including: Consumer Focus, the Campaign to Protect Rural England, five of the largest energy suppliers, trade associations, independent generators, interconnector companies, private individuals, the Scottish Government and National Grid. The 27 responses included two responses marked as confidential. The non-confidential responses are published on Ofgem's website.

## 2. Main conclusions

The responses to the open letter and feedback from the workshop were used to frame our ongoing analysis of where conflicts of interest and synergies may arise. They also provide an indication of the range of mitigating measures that may be required. This will inform DECC's legislative process, so that it can take the necessary powers in order to act if mitigation proves necessary. This report is being published at the same time as DECC publishes a draft Bill in which it will propose powers to address potential conflicts of interest.

This section sets out the main conclusions we have reached at this stage. Section 4 sets out the next steps that we will be taking in considering synergies, conflicts and mitigation measures.

**Conclusion 1: The current stage of the EMR programme, in which the detail of the role of the SO as EMR delivery body is not yet fully defined, means that it is not yet possible to identify fully the synergies and conflicts, and all appropriate mitigations.**

Responses indicated that there are likely to be conflicts of interest (or at least the perception of conflicts of interest), as well as, potentially, synergies, if the SO has the delivery function conferred upon it. However, the exact nature of these synergies and conflicts and, in the case of the latter, the full set of necessary mitigation measures, cannot be determined with confidence at this stage. This is because the relevant functions of the SO as delivery body are not at a stage of development where sufficient detail is available to understand how the SO will be asked to perform its role and functions and, crucially, how much discretion it will have in the performance of the role.

**Conclusion 2: It is, however, already clear that mitigation measures will need to include requirements for the SO to be transparent in its delivery role and to place restrictions on the information it obtains through EMR flowing to its other businesses.**

Despite the role of the SO as EMR delivery body being not yet fully defined, there was broad consensus that mitigation measures will need to include requirements for the SO to be transparent and to restrict the flow of information to National Grid's other businesses (particularly National Grid's businesses that operate in a competitive environment).

**Conclusion 3: It is recommended that all other options for mitigation as set out in the Open Letter remain available.**

In view of the need for further details to be provided on the functions that the SO will carry out in the EMR delivery role, it is necessary to leave all the other options set out in the 8 March Open Letter available. Therefore, DECC and Ofgem are of the view that it is appropriate to seek powers for implementing a broad range of mitigation measures, alongside other mitigating measures that can be implemented using Ofgem and DECC's existing powers.

The range of other possible mitigation measures will include:

- Clarity on the discretion of the SO in the delivery role and scrutiny of its use of discretion.
- Ring-fencing to separate different businesses or functions. This could include, financial, management, and operational separation.
- Monitoring and regulatory oversight of the SO's performance of the EMR roles.

While ownership unbundling remains an option for mitigation, DECC is of the view that there is not enough evidence at this stage to justify the granting of powers to impose such a measure, and so is not seeking such powers in the Second Session Energy Bill. However, DECC would be prepared to return to Parliament to seek the necessary powers if the need arises as a result of further analysis by DECC and Ofgem.

A key conclusion is that whatever the role of the SO and set of mitigating measures specified at this point, these need to be kept under review. It is probable that changes will be needed in the light of experience, through a suitable transparent process.

In designing the EMR delivery arrangements DECC will consider carefully the discretion that the SO is given to perform the role and ensure that any discretion is clearly monitored. It is also expected that Ofgem will play a significant role in the regulation of any EMR role that the SO performs.

### **3. Main themes from the workshop and response to the Open Letter**

#### **Synergies**

Most of the responses recognised there were some synergies between the SO's current role and the role envisaged under EMR. This was particularly the case with the capacity mechanism which was seen to build on its existing role with respect to balancing services including the Short-Term Operating Reserve (STOR). However, there were also concerns expressed around how the capacity mechanism would interact with other balancing services (discussed further under 'Conflicts'). Respondents were less clear on any synergies that exist between the SO's current role and the role of delivering CfDs.

Many felt that the role would give National Grid a more holistic view of the electricity market and aid system planning. However, there were also concerns expressed by several generators that this could lead to the SO becoming a "central planner" for the electricity system in the UK. Some commented that an advisory role was a logical extension of the SO's current seven year forecast while others argued that there was no reason the advisory role should be given to the same body as the administrative role.

While several responses oppose the idea of the SO having any role in optimising efficiencies across different roles, Ofgem and DECC remain of the view that this may provide benefits to consumers. This will be considered further once the EMR delivery role is more fully specified.

#### **Conflicts of interest**

As noted in the main conclusions, the responses and March workshop indicate that there is not enough information on the specific responsibilities of the SO under EMR at present to identify conflicts with any confidence. Nevertheless, there is general concern that conflicts, whether actual or perceived, could arise with potential impacts on

customers and investors. A number of those taking part in the workshop and responding to the open letter said that the greater the degree of discretion the SO was given in performing the EMR delivery role, the greater the potential for conflicts, though it was also noted that discretion and synergies were linked.

Most of the potential conflicts identified were consistent with those set out in the open letter. Potential conflicts included where the SO could use the EMR role (in terms of the information it has access to, the advice it gives to DECC, or the discretion it can exercise) to give a competitive advantage to, or increase the opportunities available to, those businesses within the National Grid plc group that face or could face competition (interconnectors, LNG import, offshore, CCS). It was also suggested that the EMR delivery role could be used to benefit National Grid plc's price regulated business by favouring generation solutions over demand side response, and favouring solutions that required network build in England and Wales.

It was also suggested that if incentives were not designed well, the EMR functions could be used to improve the delivery of TO and SO objectives (perhaps to the detriment of EMR objectives) and so increase the incentive payments that are made. A specific example of how this might happen is where the Capacity Market might be used to reduce the need for and costs of procuring ancillary reserve services such as STOR. Careful design and implementation of EMR, including distinct objectives and incentives for different roles, were suggested as mitigating measures.

Two other issues were raised about how the role of EMR will increase the importance of the SO to the energy sector and the economy overall and that the SO will have to have in place proportionate procedures for contracting with a larger number of small generators.

### **Mitigation measures**

In terms of mitigation measures, a broad spectrum from relatively limited intervention in addition to what is already in place, to full ownership unbundling (divestment) of the SO was raised in the March workshop and in the responses.

In both the workshop and the responses to the open letter there was a general consensus that a high level of transparency would be needed as a mitigating measure. Transparency on the advice that the SO provides to DECC and on the way the SO uses its discretion and makes decisions was seen as important. In terms of how transparency would be implemented, some suggested that the models, evidence and analysis underlying the decisions and advice should be made publicly available. Transparency was quite broadly defined and included obligations to consult (for example on the advice that the SO provides to DECC); subjecting the advice and decisions of the SO to rigorous scrutiny (by regulators and third parties); and publishing pre-qualification requirements and the criteria on which CfDs or capacity contracts are allocated.

Related to transparency, there was some consensus that clarity about the objectives of the Capacity Market and FIT CfDs could mitigate conflicts. Some respondents argued that potential conflicts could be reduced if these EMR functions did not influence, or take into account, the location of generation, but instead left transmission charges to act as the signal for location decisions.

Ring-fencing, unbundling and business separation were seen by many as potentially important methods of mitigating conflicts. The options ranged from preventing information from being passed between businesses (on which there was general agreement) to divestments. In terms of what should be separated, the EMR delivery role was seen as the main candidate for separation from the rest of National Grid plc to prevent the new role being used to benefit other businesses. The SO (including the EMR role) or National Grid plc's business that operate in competitive or potentially competitive markets were also proposed as the parts of the business that needed to be separated out in order to mitigate conflicts.

Current regulation such as SO incentives and the price control, tailored appropriately for the new EMR role, were also seen as important measures to mitigate conflicts. Appropriate incentives were suggested as potentially useful (for example, to avoid any inefficient overlap between the Capacity Market and ancillary reserve services). However, concerns were expressed that regulation in general, and SO incentives in particular, was already overly complicated and should not be extended further.

#### **4. Next steps**

As noted, one of the main conclusions is that there needs to be further detail on the SO's functions as delivery body before synergies and conflicts can be fully identified and appropriate mitigations designed. We will continue to develop this detail and carry out further analysis, before again seeking the views of stakeholders before the end of the year. In the meantime, DECC is taking the conclusions of this process into account in the proposed legislation and its ongoing policy development and design work.

Any questions on this report should, in the first instance, be directed to: [david.o'neill@ofgem.gov.uk](mailto:david.o'neill@ofgem.gov.uk) or [giles.hall@decc.gsi.gov.uk](mailto:giles.hall@decc.gsi.gov.uk).