



3rd Floor North  
200 Aldersgate Street  
London EC1A 4HD  
Tel: 03000 231 231

[citizensadvice.org.uk](https://citizensadvice.org.uk)

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## **Review of Electricity Markets Arrangements (REMA): second consultation**

We welcome this consultation. It is important for consumers that this review progresses. We agree that the status quo is not an option and reform is necessary. Electricity market reform is important for consumers as:

- It can allow consumers to access cheaper renewable energy - a key part of the longer-term path to improving affordability
- It can protect consumers from volatile wholesale prices
- It can reduce energy system costs, and so energy bills, by tens of billions
- It can further improve affordability by allowing consumers to be properly rewarded for being flexible with electricity use

However, to achieve this we believe that analysis and decisions around REMA need to be undertaken within the wider context of other changes that will impact price signals and the overall affordability of bills. The introduction of Market-wide Half-Hourly Settlements (MHHS), and the subsequent impact of default tariffs in the energy retail market, will fundamentally change the baseline against which REMA needs to be assessed.

Also, as Ofgem has recognised<sup>1</sup>, the introduction of targeted bill support could ensure that all consumers are better off if considered as part of a package with locational pricing. Additionally, the ability of consumers to react to pricing signals should not be considered to be static. Improving the information and advice available to consumers, as part of wider engagement strategy to broaden

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<sup>1</sup> Ofgem, [Assessment of Wholesale Pricing for Great Britain](#), pg11

accessibility to the benefits of being able to use energy flexibly, has the potential to assist with affordability.

So, we remain<sup>2</sup> of the view that these reforms should be progressed and analysed in combination with other developments, including those outlined above. In practice this means, as a minimum:

- Distributional analysis should include a range of scenarios of how the energy retail market will develop, with potential affordability measures, alongside the REMA packages.
- The End User Challenge Panel should be made use of to further explore these interactions. This would build on the good work to date in setting up and making use of the Challenge Panel.

This should assist in ensuring public confidence is maintained in the energy transition. Consumer trust is vital to achieving net zero, not least because the vast majority of households will need to make significant changes to how they live their lives. To build this trust, REMA needs to deliver for consumers and be seen to deliver for consumers. There are a number of areas where particular care will be needed to avoid damaging public confidence:

- Contract for Difference (CfD) design - the perception of paying generators when not supplying power needs considering generally and reinforces the need to address: the gaming risk for deemed CfDs; the design of the consumer protection mechanism that would accompany a capacity-based CfD to ensure the lower cost of renewables can be passed onto consumers.
- Legacy arrangements - Financial effects need to both reflect, and be limited to, the legitimate and reasonable expectations of investors at the time arrangements were agreed.

Answers to selected consultation questions are below.

Yours sincerely,

Andy Manning

Head of Energy Systems Transformation

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<sup>2</sup> As presented in our [response](#) to our first REMA consultation

## Answers to selected consultation questions

4. Have we correctly identified the challenges for the future of the CfD? Please consider whether any challenges are particularly crucial to address.

We broadly agree with the assessment of the challenges for the future of the CfD as laid out in the consultation.

A challenge that is not addressed in this section is the potential public perception of CfD models that de-link payments from output, which would involve generation assets being paid at times when they may not be supplying any power. While this could be seen as similar to how the capacity market operates today, the context for this is different as assets in the capacity market are not expected to run sufficiently often to recover their costs. Negative public perception could impact political acceptability and so the long-term investment climate.

7. What specific gaming risks, if any, do you see in the deemed generation model, and do any of the deeming methodologies/variations alter those gaming risks? Please provide supporting reasoning.

A deemed generation CfD model will clearly come with gaming risks, the size of which will depend on how rigorous the deeming methodology is. Without site-specific data, the deeming methodology could also be inaccurate, which may end up under or over-compensating participants. A full cost assessment would enable a clearer picture of which deeming methodology would be most appropriate, and we hope this would accompany any further policy development on this topic.

As we noted in the response to Q4, there is a risk around the perception of the deemed model in general. This particularly needs to be taken into account when considering deeming methodologies. The potential for gaming itself is a risk to the acceptability of a deeming approach.

At this stage, options 2 and 3 seem less appropriate. Option 2 would clearly allow for manipulation of input data, and as a result the potential for gaming of deemed output regardless of whether this is being calculated by a third party. We would have concerns about whether this could be accurately monitored given the variability of wind speeds and number of assets. Option 3 risks being inaccurate, and as the consultation outlines could increase basis risk for individual assets. Depending on the size of this basis risk, this could distort siting decisions with participants closer to the reference generators better able to manage this potential basis risk.

On top of this, there are further gaming risks if payments are only based on deemed output under certain conditions. We would welcome a clearer assessment of how

these risks could manifest, particularly in a scenario where deemed CfDs were taken forward alongside a move to zonal pricing.

9. Does either the deemed CfD or capacity-based CfD match the risk distribution you detailed in your response to Q25 on which actors are best placed to manage the different risks?

Please see our response to question 10, where we outline concerns that a capacity-based CfD may not effectively protect consumers from volatile electricity prices.

10. Do you have a preference for either the deemed CfD or the capacity-based CfD model? Please consider any particular merits or risks of both models.

We do not have a definitive preference at this stage, but more work is needed to understand any potential complexities in designing the consumer protection mechanism that would accompany a capacity-based CfD. As highlighted in challenge one of the consultation, the CfD mechanism is a key route by which the lower cost of renewables can be passed onto consumers. Moving away from the mechanism that delivers this without a clear alternative option risks unnecessarily exposing consumers to future price rises.

Auction Round 5 showed first hand the challenges in setting the Administrative Strike Price (ASP), when it resulted in no offshore wind projects being awarded contracts. Similarly, if government were to decide the level at which projects begin to pay back to consumers (without competitive tension), it risks either overcompensating generators or jeopardising investment. If delivering a consumer protection mechanism relies on particularly complex methodologies or opens new gaming risks, then this would counteract some of the stated benefits of the capacity-based CfD as outlined in the consultation.

Separately, there is the potential for confusion if the capacity-based option continues to be referred to as a CfD, given that it does not actually calculate difference payments to generators.

22. Do you agree with the key design choices we have identified in the consultation and in Appendix 4 for zonal pricing? Please detail any missing design considerations.

We broadly agree with the design choices laid out. We acknowledge that more work will need to be done, but emerging views on the choices are outlined below. All considerations are important to consumers, but the approach to demand-side exposure is likely to have the most direct impact.

### *Demand-side exposure*

Analysis and decisions around demand-side exposure need to be undertaken within the wider context of other changes that will impact price signals and the overall affordability of bills. The introduction of MHHS, and the subsequent impact of default tariffs in the energy retail market, will fundamentally change the baseline against which REMA needs to be assessed.

Also, as Ofgem has recognised, the introduction of targeted bill support could ensure that all consumers are better off if considered as part of a package with locational pricing. Additionally, the ability of consumers to react to pricing signals should not be considered to be static. Improving the information and advice available to consumers, as part of wider engagement strategy to broaden the accessibility to the benefits of being able to use energy flexibly, has the potential to assist with affordability.

- Market-wide Half-Hourly Settlements (MHHS)

The introduction of MHHS will give suppliers more incentive to offer time-of-use tariffs to consumers. This represents a fundamental shift in the energy retail market and so REMA needs to be assessed primarily against this background. It should be assumed that more consumers will be exposed to temporal signals and so the impact of REMA is incremental to this. Of particular concern are areas where the local signal is in opposition to the national signal and so failing to provide a locational signal could increase system costs.

- Wider consumer issues

It needs to be ensured that all consumers benefit from the introduction of improved locational signals. As we outlined in our recent paper<sup>3</sup> around ensuring energy market reform stack up for people, these changes to the electricity system will make electricity bills more cost-reflective. While many people will benefit, there is also the risk of some households losing out, and a larger variation in costs between winners and losers. Introducing targeted bill support can minimise this risk, for example through a revised tiered Warm Home Discount that provides bill discounts to more people on low incomes, with support tailored to energy needs.

We should also be extending the benefits of energy flexibility to more people. In our research<sup>4</sup> on the barriers that many households are likely to face to participating in energy flexibility, we identified the key ways to address these barriers:

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<sup>3</sup> [Don't settle for second best: Ensuring energy market reforms stack up for people](#)

<sup>4</sup> [A flexible future: extending the benefits of energy flexibility to more people](#)

- Improved information and advice
- Appropriate regulation of the smart energy sector, including enhanced protections
- Industry innovation focused on inclusivity

It is important to separate the impact on a typical bill across different locations and the impact on temporal signals across different locations. Although typical bills could be lower across all locations, this should not be interpreted as all consumers being better off. We do not believe that differences in typical bills across locations provide a useful signal to domestic consumers, whereas differences in temporal signals could be important. We would expect an opt-in mechanism to have limited impact on preventing consumers from seeing differences in costs under zonal pricing. This is because customers in regions which would have cheaper prices under locational pricing could opt-in and receive cheaper prices without changes in their behaviour. Without this behaviour change, customers who haven't opted in could see cost increases. We believe a mechanism can be designed to address variations between the typical bills in different locations, whilst maintaining temporal signals.

Overall, we remain of the view that these reforms should be analysed in combination with other developments, including those outlined above. In practice this means, as a minimum:

- Distributional analysis should include a range of scenarios of how the energy retail market will develop, with potential affordability measures, alongside the REMA packages.
- The End User Challenge Panel should be made use of to further explore these interactions. This would build on the good work to date in setting up and making use of the Challenge Panel.

### *Number of zones*

We would not see value in a model with only two zones, as it would likely be insufficient to represent the physical reality of the system. While it may seem less disruptive, choosing to go forward with a zonal model with a very small number of zones would likely lead to potentially further disruption from the need to review and alter zonal boundaries in the near future, or risk not addressing the issue of constraint costs. How zones interact with the way in which costs currently vary by location should be explored including whether it is possible to align, for demand, zones with GSP groups<sup>5</sup>.

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<sup>5</sup> Electricity network charges currently vary by Grid Supply Point groups

### *Approach to reviewing zonal boundaries*

We would see merit in this being predictable, as it would improve the investment case for developers within a given zone. Therefore, we would not expect reviews determined by a trigger condition to be in the interests of consumers as it may have undue impacts on investment in low cost renewables, unless the trigger was reasonably predictable. This emphasises the importance of ongoing updating of information and the need for transparency with the review.

### *Dispatch*

Overall we would expect to retain self-dispatch if zonal pricing was to be taken forward as we are concerned that centralised dispatch could impact cost of capital and as a result increase CfD strike prices, due to the volume risk that market participants would face. Alongside this, it would likely increase the implementation time for zonal pricing, meaning any potential benefits may be delayed and reduced. We also note that in terms of system operability, zonal pricing could help alleviate some of the operability concerns that currently form part of the case for more centralised dispatch.

### *Market power and gaming mitigations*

We would see value to consumers in any case in bolstering measures to address market power and gaming in the GB power system. This is important to maintain public confidence and consumer trust.

23. How far would our retained alternatives to locational pricing options go towards resolving the challenges we have identified, compared with locational pricing? Please provide supporting evidence and consider how these alternative options could work together, and/or alongside other options for improving temporal signals and balancing and ancillary services.

We offer views on some of the retained alternatives below but would note that a suite of alternative measures that can provide the same impact as zonal pricing in terms of constraint management is likely to carry a similar risk of impact on cost of capital. Also, we do not believe it is helpful for these options to be seen strictly as alternatives. Options can be progressed to deliver benefits ahead of any REMA implementation. Considering as alternatives risks stalling measures that could provide benefits to consumers. These options should be considered on their own merits and produce an 'enhanced status quo' for REMA to be assessed against.

*Using Ofgem's existing network charging reform programme:* potentially a limited impact as this affects investment signals but not operational. Past reforms to network charging have proved lengthy to deliver.

*Reviewing Ofgem's transmission network access arrangements:* Financially firm access rights, in and of itself, has not necessarily contributed to constraints. The problem is these rights interacting with insufficient network capacity. This could potentially have similar issues as we outlined regarding centralised dispatch.

*Expanding measures for local constraint management (LCM):* This is important to consider but unclear whether these would be able to deliver effective constraint management on a similar scale to zonal pricing. Improved constraint forecasting should be a no-regrets option. Potential of LCM is limited by it not being open to BM participants, turn up only, and difficulty in forecasting constraints ahead of time (as price is set day ahead).

*Optimising the use of cross-border interconnectors:* If zonal pricing is not taken forward then this should be seen as a high priority fix, in light of Ofgem analysis. Interconnectors will play a crucial role in balancing a net zero energy system and it's important to make the most of them.

24. Do you agree with our proposed steps for ensuring continued system operability as the electricity system decarbonises? Please detail any alternative measures we should consider and any evidence on likely impacts.

*Shorter settlement periods:* We understand the value this could provide in terms of harnessing the ability of battery storage and other DSR technologies to respond to more granular price signals, but are concerned about the implementation challenges that would go along with this. For example, it would need to be established whether current DCC network capacity is sufficient to handle this, especially in the context of MHHS. We believe it would need an extremely robust business case to take this forward.

*Centralised dispatch:* we recognise the challenges to operating the BM efficiently as things stand, but see a number of risks with a move to centralised dispatch that could result in higher costs for consumers. We would note that some of the system operability problems that are currently present in the BM could be alleviated with a move to zonal pricing - e.g. exacerbation of constraints.

27. Do you agree with our approach to assessing the impact of REMA reforms on Legacy Arrangements?



We agree with the 2 broad categories of functional effects and financial effects and believe this is a useful distinction. Managing functional effects should be a largely technocratic process where consumer interests relate simply to the correct design being delivered.

Financial effects may involve more discussion and judgement. It will be in consumers' interests for investment confidence to be upheld through sensible Legacy Arrangements. These need to be built around the legitimate and reasonable expectations of investors. The approach will therefore need to be significantly more sophisticated than simply arrangements agreed prior to a published government position on REMA reforms. Legitimate expectations will vary significantly depending on when arrangements were agreed.

28. What risks do we need to consider with regard to Legacy Arrangements, and how can they best be mitigated?

Legacy Arrangements, and especially financial effects, need to be based around the legitimate and reasonable expectations of investors at the time arrangements were agreed. For example, the current level of constraint costs was not forecast until relatively recently and so cannot form part of the legitimate expectations for many Legacy Assets. There is a risk Legacy Arrangements will reflect the current situation rather than reflecting when any arrangements were agreed.