



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to Ofgem: Transmission constraint licence condition guidance

March 2012

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Introduction

System balancing costs are smeared across all participants in the UK's electricity balancing regime. So while individual generators may benefit from gaming the balancing system to generate excessive profits, the consumer is always the loser. Consumer Focus welcomes this Ofgem consultation which recognises that the current arrangements do offer the potential – and most likely the actual – opportunity for gaming of transmission constraints by generators to the detriment of consumers.

Consumers not only bear the risk of direct detriment through balancing costs. Balancing costs that are elevated by market participants above the economically efficient level will reduce the quality of information available to the transmission operator (TO) when planning investment decisions. This could lead to sub optimal decision making when determining the appropriate level of investment in transmission upgrades. This could also lead to consumer detriment by increasing the overall cost of transmission, for example through the creation underutilised transmission cables, or high system balancing costs.

Generators do not always proactively price bids/offers to the System Operator (SO), sometimes preferring to submit 'sleeper bids'. It is not clear whether this is driven by abuse of market power or if these are simply default submissions intended to discourage the SO from calling on these assets. There is a risk that a generator might inadvertently fall foul of the transmission constraint licence condition (TCLC) by failing to update a long standing sleeper bid. We would hope that the SO and regulator would be proactive in ensuring that generators are fully informed of any changes and potential impacts from the TCLC. It might be prudent, therefore, to conduct an audit of bids/offers and contact those generators whose bids/offers are relatively high and longstanding before the TCLC goes live.

In general, we would prefer a regime that discourages generators from gaming the balancing and settlement market rather than applying ex-post penalties to those that do. Ex-post penalties represent, in effect, a 'double whammy' for consumers since the cost of fines is ultimately borne by consumers, in addition to the excessive system balancing costs which are smeared across all generators (and hence also passed onto consumers).

We would urge:

- a tighter definition of 'uneconomic dispatch' – it is currently in some generators' economic interest to seek to maximise revenue by gaming the balancing market
- greater clarity on the threshold for enforcement action to provide regulatory clarity to generators
- adoption of measures to disincentivise generators from submitting an excessively low bid, even if the bid is not accepted by the SO – excessively low bids will distort the market signals the TO uses to plan network development and might therefore lead to inefficient development
- the addressing of generators closing plant early in order to exacerbate constraints
- caution over the use contractual obligations between generators and suppliers as 'objective justification' given the vertical integration in the UK electricity sector

Response to consultation questions

Question 1: Do you agree with our interpretation of uneconomic dispatch?

No.

Companies who exploit the current absence of regulatory enforcement with regards to transmission constraints could be said to be dispatching in an economic – rather than an uneconomic – manner. It is in *their* economic self interest to seek to maximise their revenue by exploiting constraints where they perceive there is a low risk of regulatory or legal intervention to penalise this behaviour. It follows that companies will continue to exploit constraints until the penalty (both financial and reputational) exceeds their financial and strategic gain from doing so.

Thus it would seem prudent to ensure that the term ‘more economic options’ under (i) of circumstance 1 (paragraph 2.9) is defined more tightly so that it can be categorically said to apply to the behaviour that Ofgem is seeking to inhibit. We would suggest, for example, a reference to ‘more economic to the overall transmission system operation’ to avoid ambiguity.

Question 2: Is the use of within-day fuel and electricity prices to calculate generation profitability the most realistic approach?

In theory, although there are limitations to this methodology in the areas of fuel availability (for intermittent generation) and plant efficiency (for conventional thermal generation).

For intermittent generation, particularly wind, there is not a national market for fuel – or put more simply, wind speeds and water levels will vary with geography. For conventional thermal generation, plant efficiency will vary with age and running profile (for example, whether the comparator plant is actively involved in the balancing mechanism or part loaded). These factors will create noise in the model that may mean the price in unconstrained parts of the network may not be a particularly accurate proxy for what the price would have been had the whole network been unconstrained. Your model will need to find ways to filter out this noise.

It is also possible that market participants who are privileged to information over likely network constraints could use this position to optimise their generator position below any actual or perceived threshold of regulator intervention. This would again serve to obscure – and make enforcement more difficult – the behaviour that Ofgem is seeking to discourage.

You should also be aware that market participants are likely to set up their own monitoring algorithms to try and calculate what pricing activity may incur enforcement attention. This makes it extremely important that you apply the results of your model in a consistent fashion to all market participants.

Question 3: What other costs, if any, should be included in our initial analysis of dispatch decisions?

Ofgem's proposed model (2.7) does not appear to disincentivise generators from submitting an excessively low bid when this bid is not accepted by the SO. This contradicts paragraphs 2.13 ('...the TCLC also permits enforcement action where the generator has created or exacerbated a constraint and submits a bid or offer which would result in an excessive benefit being derived if it were accepted (but it is not)') and 2.23 ('...the license condition allows for the possibility of taking action if extremely low bids are submitted, but not accepted'). We are therefore concerned that, in practice, the application of any sanction by the regulator under the circumstance specified in paragraphs 2.13 and 2.23 will be deemed so unlikely as to be an irrelevance in generators' decision making. It seems that enforcement action will only be taken in the circumstances outlined in 2.7.

While not resulting in any direct balancing costs, the presence of excessively low/high bids/offers that are not accepted by the SO will distort the balancing and settlement market by introducing distorted price signals. Since they do not accurately reflect the market value of actual constraints, they are likely to reduce the quality of the information available to the TO when making decisions about transmission network investment. We therefore think there may be some merit in considering a mechanism to disincentivise the submission of opportunistic bids at an uneconomic (in terms of overall system costs) level, even if not accepted by the SO.

A transmission constraint is defined in paragraph 2.2 as occurring: '*where the transmission system is unable to transmit the power supplied onto the transmission system to the location where the demand for that power is situated...*' This condition is highly inclusive and covers all possible instances of a constraint; in practice the regulator will not take enforcement action in all instances of constraints that meet this broad definition. It will be incumbent on the regulator to have sufficient proof prior to taking enforcement action to reduce the risk of legal challenge by generators. Enforcement action will create a de facto enforcement threshold. This is undesirable as it may take several regulator interventions to establish 'case law' that provide sufficient certainty to generators and reduce risk premium. It would perhaps be helpful to discern the threshold for when enforcement action will be taken. For example, this could be when a transmission constraint exceeded a certain MW level, for a specified period of time, or when system balancing costs exceed a certain financial level.

Providing greater certainty on what constitutes an enforceable transmission constraint would serve to reduce risk for generators and should therefore lead to improved outcomes for consumers through reduced access to finance. It may also reduce a dispute avenue for generators, who might reasonably claim they were subject to sanction when, under previous similar constraint conditions, other generators had not been sanctioned. Such disputes are likely to be resource intensive for generators and the regulator, with costs for both parties ultimately borne by consumers. Clarity over what triggers enforcement action would serve to mitigate this risk.

It seems likely that some form of algorithm will be used to assess whether enforcement action will be taken by the regulator (3.1). There are merits to making this algorithm transparent and open so generators better understand the parameters for enforcement action and understand the risks they are exposed to more fully. Again this would be in consumers' interest as it should help to reduce financial risk (a cost ultimately borne by consumers). It would also provide a mechanism for industry to suggest improvements to the algorithm to ensure it operated effectively. It should be borne in mind that if the algorithm is provided openly, generators will likely use it to find the threshold for enforcement action and

submit bids/offers at a level so as to avoid enforcement, but maximise revenue. This may still result in a degree, albeit reduced, of gaming to consumers' detriment.

In general, we would prefer a regime that discourages generators from gaming the balancing and settlement market rather than applying ex-post penalties to those that do. Ex-post penalties represent, in effect, a 'double whammy' for consumers since the cost of fines is ultimately borne by consumers, in addition to the excessive system balancing costs which are smeared across all generators (and hence also passed onto consumers).

The proposals do nothing to discourage generators from retiring plant early in order to exacerbate constraints and derive excessive profits from doing so. For example, a generator may have plant on both sides of a network constraint. Closing down plant on the 'import' side of the constraint would afford opportunity to the plant on the 'export' side to exploit the increased likelihood of constraints that result. Clearly it would be uneconomic for generators to retire new plant early. However, it might be more economic to retire older plant early in the expectation of deriving greater revenue from exploiting network constraints than from running the plant until the end of its operational life. We do not have any data to assess the potential materiality or likelihood of such behaviour. Such manipulation of generator output is more longer-term in nature than the manipulation envisaged in the consultation document and appears out of its scope. It nonetheless poses a potential risk to UK consumers through increased balancing costs.

Question 4: Are there any further important arguments that provide objective justification for uneconomic dispatch?

No comment.

Question 5: Are there any objective justifications cited above which should not be considered in our assessment?

No comment.

Question 6: Do you agree that the indicators outlined above are useful for Ofgem to consider when determining whether the bids are excessive or not?

Yes.

Question 7: Are there other factors or indicators that Ofgem should consider in interpreting this circumstance?

The UK energy sector is a highly vertically integrated and dominated by the 'big 6'. We would therefore urge a note of caution over using contractual obligations as an objective justification for circumstance 2 (paragraph 2.27). Since much UK domestic electricity is supplied under bilateral agreements between the generator and supply arm of the same company, using contractual agreements as an objective justification will lack robustness. It is quite possible that contracts could be put in place (but never enforced) simply to provide 'objective justification' to the regulator. We think the current lack of transparency in bilateral contracts makes this a distinct possibility and further underlines the need for greater scrutiny of this aspect of market operation.

It might also be prudent to monitor plant reliability to reduce the risk that generators might claim plant needed to operate at lower capacity for technical reasons (in order to create or exacerbate a constraint) than was actually the case.

Question 8: Are there any further important arguments that provide objective justification for seemingly high bids?

No comment.

Question 9: Are there any objective justifications cited above which should not be considered in our assessment?

No comment.

Question 10: Do you agree with our definition of arming fees, and that this is the relevant price to capture under this circumstance?

No comment.

Question 11: Do you agree that the indicators outlined above are useful for Ofgem to consider when determining whether inter-trip arming fees are excessive or not?

Yes.

Question 12: Are there other factors or indicators that Ofgem should consider in interpreting this circumstance?

No comment.



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For more information contact Duncan Carter, Policy Manager (Duncan.carter@consumerfocus.org.uk)

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Consumer Focus

Fleetbank House
Salisbury Square
London EC4Y 8JX
t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk

Media Team: 020 7799 8004 / 8005 / 8006

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