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FAO Ian Marlee
GB Markets
Ofgem
9 Millbank
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1st March 2012

Dear Ian,

Transmission Constraint Licence Condition Guidance

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax also owns an electricity supply business, Haven Power Limited ("Haven"), which supplies electricity to a range of business customers and provides an alternative route to market for some of Drax's power output. As the holder of a generation licence and an active participant in the Balancing Mechanism (BM), we believe we are well placed to provide comments on the proposed Transmission Constraint Licence Condition (TCLC) and the associated guidance.

The main points we would make in our response is as follows:

Aim of the TCLC

We agree that the uneconomic dispatch of generation should be prevented. Whilst we believe Ofgem currently holds significant enforcement powers relating to the manipulation of market rules, we are also aware of Ofgem's stated difficulties in applying meaningful enforcement action within a reasonable timeframe.

Ofgem process for defining scope of the TCLC

The application of the TCLC must be more strictly defined in both scope and effect in order to preserve effective competition and minimise unintended consequences. Market participants should have a clear understanding (in advance) of which constraints are targeted by the licence condition. The TCLC should only apply to activity behind enduring structural transmission constraints that Ofgem has pre-designated as problematic. In the first instance, the licence condition should only apply to the Cheviot boundary (B6). There should be a robust and transparent designation process to apply the licence condition to additional boundaries on the network. Ultimately, once the constraint has been resolved, the TCLC should no longer apply to that boundary on the network.

Ofgem guidance of excessive pricing

Ofgem's guidance must be significantly improved. Market participants must have greater certainty as to what behaviour will, and what behaviour will not, be considered acceptable by Ofgem. Without effective guidance the TCLC risks the development of a number of negative and perverse outcomes including, inefficient transmission investment signals, in addition to, inefficient generator entry and exit signals. This would be expected to increase the costs of System Operator actions ultimately to the detriment of end consumers.

Whilst the market price, cost etc. indicators outlined by Ofgem in the consultation provide some insight in to the range of factors Ofgem will consider in its determination of excessive pricing, there is little guidance on how Ofgem will evaluate these indicators in the context of excessive pricing.

To provide market participants with greater certainty on how it will determine whether prices are excessive or not, we believe that the guidance on excessive bids should be consistent with current Competition Act principles applied to excessive pricing. This is important as there is a strong possibility that a case brought against a firm accusing it of excessive pricing will be appealed to the Competition Appeals Tribunal (CAT). As such the Ofgem case must be made in manner consistent with how the CAT will judge the merits of the case.

Intertrip arming fees

It is not appropriate to impose restrictions on Intertrip arming fees under the TCLC.

Overall, we believe the introduction of a TCLC should involve minimal intervention and disruption to existing competitive market processes and should be accompanied by clear guidance.

Answers to the specific questions raised in the consultation document can be found in Annex 1. We have provided our response to the DECC consultation on the TCLC in Annex 2 for information.

If you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Stuart Cotten
Market Development Manager
Regulation and Policy

Annex 1: A response to the specific consultation questions

Chapter 2: The Licence Condition

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

Yes, the interpretation appears reasonable.

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

This seems reasonable for gas plant, where gas is likely to be purchased close to the point of delivery. For coal plant, whilst it is true that generators will use a “current” market price for their Short Run Marginal Cost (SRMC) calculations, the “product” used could depend upon the next purchase required by the individual generator (e.g. an annual, quarterly, monthly, etc. price). Availability (liquidity) of a given product will also be a factor.

There may be exceptions to the above, such as where a contract has been entered with provisions that require a generator to receive a volume of fuel regardless of price, e.g. “take or pay” arrangements. These will be individual to the generator.

It is also important to note that all generator costs must be covered over the year and some costs over several years (as such load factors of specific plant must be considered). Market participants endeavour to achieve the marginal price in any individual half hour in the expectation that the accumulated half hourly gross margins will cover the plant’s fixed costs and provide a reasonable rate of return. The main point to note is that the gross margin in any half hour period could vary enormously (perhaps as low as 1p and as high as £500/MWh). As such these gross margins should be treated cautiously as they in themselves do not provide a suitable benchmark when considering profitability in the context of the long term financial health of the power station.

More long run calculations of profitability are likely to be more helpful in determining the actual profitability of individual power stations.

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

Many of the major costs are covered in the consultation document. Additional items that will be factored into running costs include revenue from Levy Exemption Certificates (LECs), plant start-up costs, maintenance costs (which will be specific to the plant’s running regime) and risk premia for plant failure (i.e. for exposure to imbalance costs). Moreover, we believe that opportunity costs should be included within the initial analysis where appropriate.

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

Ofgem should consider how commercial contracts other than pure power sales may affect the running regime of a plant. For example:

- Tolling contracts, where a third party provides the fuel and carbon allowances at their own cost and then nominates when the plant runs;
- Take or pay fuel contracts, where a generator must purchase a volume of fuel regardless of whether the fuel is delivered or the transaction is economic; and
- Heat contracts, where electricity could be considered a by-product that results from the production of steam for an industrial process.

There must be consideration of restrictions placed on Large Combustion Plant Directive (LCPD) opted-in plant, in terms of SO_x and NO_x emission levels. Future environmental legislation must also be captured, such as the Industrial Emissions Directive (IED) and its effect on plant running regimes. In addition, plant may need to adhere to local environmental constraints, for example only being able to start units between certain times in order to reduce noise pollution concerns in populated areas.

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

No, the justifications cited appear reasonable. However, we would question the following:

- Outages: It appears that a portfolio generator could dispatch plant uneconomically if “their hand was forced by unplanned equipment issues.” Should the generator be allowed to dispatch portfolio plant uneconomically if a more economic option would have been to buy replacement volume via the wholesale market?
- LCPD: It appears that an opted out capacity could be held back if it is felt that the generator could “make more profitable use of its remaining hours at some point in the future.” This may apply to all plant towards the end of its life, not just LCPD opted-out plant. For example, maintenance schedules may be planned that allow a finite number of plant starts between outage periods to reduce overall maintenance costs.

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? and

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

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

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

We agree that parties could exploit their position behind a constraint to make “excessive” returns. For example, where there has been an uneconomic dispatch of plant or a market participant places a Bid that is out of line with the market.

However, whilst the outlined indicators provide some insight into the range of factors that Ofgem will consider, there is still great uncertainty for generators surrounding how Ofgem intends to evaluate excessive pricing and/or benefit. This must be clarified or the TCLC will result in adverse consequences.

Consequences of distorting Bid and Offer prices

Export constrained regions of the network require a good selection of generation reduction (or demand increase) options to be available to the System Operator. It would, therefore, appear reasonable for the value of Bids to decrease to a lower level than what may otherwise be expected in a fully unconstrained BM market, i.e. the pricing of Bids could reflect the demand for balancing services in such circumstances. This should be regarded as making a “normal” return. If market participants are dispatching plant economically, then the constraint is caused by the connection arrangements / untimely building of transmission infrastructure, not by the market participant(s) per se.

Drax is concerned that the structure of the TCLC, as currently proposed, may diminish rational commercial, and hence competitive, behaviour. Careful consideration should be given to the consequences of dampening Bid and Offer prices in the BM. Dampening the cost of constraints may result in dulled transmission investment signals, which could further delay network infrastructure investment. Generation entry and exit signals are also likely to become distorted.

Moreover, the likely negative effect on BM participation might be expected to result in reduced competition for balancing services which will increase costs for the System Operator.

In addition, as both “system” and “energy” actions are taken from the same pool of Bid and Offer prices, manipulating what should be a competitive market in order to reduce constraint costs could lead to unintended consequences for imbalance prices. Dampening cash-out prices may reduce the signal for generators to meet contracted positions in the wholesale market (i.e. balance).

To help minimise the potential for negative consequences, similar to those highlighted above, Drax believes that Ofgem should treat the issue of excessive pricing and/or benefit in the following manner.

Excessive pricing and benefit

If Ofgem intends to use the powers granted under the TCLC to tackle instances of ‘excessive pricing or benefit’, it must clearly set out how it will provide market participants with the information required to make informed judgements on Bid and Offer pricing. The current guidance completely fails to do this.

We believe it is important that the guidance is firmly grounded in existing Competition Law principles. This is because it is likely that in the event of Ofgem finding against a party under the TCLC there will be an appeal against the decision to the Competition Appeals Tribunal (CAT). Therefore, it is important that Ofgem develops a case which is consistent with how the CAT is likely to pass judgement on the relevant case.

The following principles should help in determining whether a firm has priced excessively or not:

1. The European Court of Justice has held that “charging a price that is excessive because it has no reasonable relation to the economic value of the product supplied.... is an abuse”¹.
2. Moreover, in his decision in Napp² the Director General of Fair Trading stated that a price is excessive for the purposes of the Chapter II prohibition “if it is above that which would exist in a competitive market and where it is clear that high profits will not stimulate successful new entry within a reasonable period. Therefore to show that prices are excessive, it must be demonstrated that (i) prices are higher than would be expected in a competitive market, and (ii) there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be”.

To attempt to measure whether a price is above the level that would exist in a competitive market the following comparative analysis might be undertaken:

1. The accused firm’s prices compared with the accused firm’s costs;
2. The accused firm’s prices compared with the costs of its next most profitable competitor;
3. The accused firm’s prices compared with those of its competitors; and
4. The accused firm’s prices compared with the prices it charges in other markets.

Please note that even if the accused firm is demonstrated to be more profitable in comparison with its competitors this would not demonstrate abuse by excessive pricing. The relative advantage in terms of profitability might be objectively justified by a significant efficiency advantage. Sufficient consideration should also be given to whether this difference in relative profitability is likely to be long lasting or whether there is scope for any super normal profit to be competed away.

Finally, it is also important to ensure that the guidance produced by Ofgem can be unambiguously interpreted and acted on by shift traders who will be expected to make commercial decisions in relatively short time periods. If this is not the case the efficiency of the market will diminish and overall costs to end consumers will increase.

¹ Case 27/76 United Brands v Commission [1978] ECR 207, [1978] 1 CMLR 429

² Napp Pharmaceutical Holdings Ltd. v DGFT [2001] UKCLR 597, Paragraph 203

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

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? and

Question 12: Are there other factors or indicators that Ofgem should consider in interpreting this circumstance? Please include any reasoning and evidence in your answers.

We have significant concerns over the potential to impose restrictions on Intertrip arming fees. Intertrips are bilaterally negotiated contracts between the System Operator and individual market participants. Generators should be able to place what they believe to be a reasonable value on the Intertrip service that they are prepared to provide.

The System Operator has no obligation to enter an arrangement with a generator if it considers the terms are excessively priced. The System Operator also has a number of different tools open to it to enable it to carry out its role. As such, we believe the justification for imposing such measures on a bilaterally agreed contract remains unclear.

Annex 2: Drax response to the DECC TCLC Consultation

Consultation on the Transmission Constraint Licence Condition

Drax Power Limited (“Drax”) is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax also owns an electricity supply business, Haven Power Limited (“Haven”), which supplies electricity to a range of business customers and provides an alternative route to market for some of Drax’s power output. As the holder of a generation licence and an active participant in the Balancing Mechanism (BM), we believe we are well placed to provide comments on the proposed Transmission Constraint Licence Condition (TCLC).

The main points Drax would like to make in response to the consultation are as follows:

- The uneconomic dispatch of generation should be prevented
- The application of the TCLC must be more strictly defined in both scope and effect in order to preserve effective competition and minimise unintended consequences
- Market participants should have a clear understanding (in advance) of which constraints are targeted by the licence condition
- The TCLC must only apply to activity behind enduring structural transmission constraints that Ofgem has pre-designated as problematic. In the first instance, the licence condition should only apply to the Cheviot boundary (B6)
- There should be a robust and transparent designation process to apply the licence condition to additional boundaries on the network
- Ultimately, once the constraint has been resolved, the TCLC should no longer apply to that boundary
- Market participants must have greater certainty as to what behaviour will, and what behaviour will not, be considered acceptable by Ofgem. Its guidance on ‘excessive benefits’ should be consistent with current Competition Act principles applied to ‘excessive pricing’
- It is not appropriate to impose restrictions on Intertrip arming fees under the TCLC

Further consideration of licence condition, and the specific circumstances it aims to capture, can be found below. If you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Stuart Cotten
Market Development Manager
Regulation and Policy

Annex 1: Additional consideration of the consultation document

Specific circumstances covered by the TCLC

Circumstance 1: The creation or exacerbation of transmission constraints by generators making uneconomic dispatch decisions

Market participants with generation portfolios should not be dispatching plant uneconomically in a way that is designed to create or further exacerbate transmission constraints in order to make or enhance short-term gains in the balancing market (also known as the “INC and DEC Game”). This behaviour is unacceptable and is a blatant abuse of a dominant position which is likely to result in significant consumer harm.

The TCLC should provide the regulator with additional powers to investigate such behaviour and, where the evidence backs the case, take decisive action in a timely manner.

Circumstance 2: Prohibiting the placing of excessively low bids in a period of an export transmission constraint

We agree that parties could exploit their position behind a constraint to make “excessive” returns. For example, where there has been an uneconomic dispatch of plant or a market participant places a Bid that grossly overvalues the market. Whilst we understand the concerns of both DECC and Ofgem, we believe that it would be inappropriate for the regulator to place a strict collar on Bid prices in the BM.

Export constrained regions of the network require a good selection of generation reduction (or demand increase) options to be available to the System Operator. It would, therefore, appear reasonable for the value of Bids to decrease to a lower level than what may otherwise be expected in a fully unconstrained BM market, i.e. the pricing of Bids could reflect the demand for balancing services in such circumstances. This should be regarded as making a “normal” return. If market participants are dispatching plant economically, then the constraint is caused by the connection arrangements / untimely building of transmission infrastructure, not by the market participant(s) per se.

Moreover, the issue of ‘excessive bids’ has been the partially the focus of a National Grid consultation “Managing Intermittent and Inflexible Generation in the Balancing Mechanism”. Drax believes that some of the behaviour observed that resulted in the issuing of this consultation was due to a lack of understanding of the functioning of the Balancing Mechanism. We note that since this consultation was issued there have been a number of developments which we would expect to result in more competitive outcomes in future.

Consequences of distorting Bid and Offer prices

Drax is concerned that the structure of the TCLC, as currently proposed, may diminish rational commercial, and hence competitive, behaviour. Careful consideration should be given to the consequences of dampening Bid and Offer prices in the BM. Dampening the cost of constraints may result in dulled transmission investment signals, which could further delay network infrastructure investment. Generation entry and exit signals are also likely to become distorted.

Moreover, the likely negative effect on BM participation might be expected to result in reduced competition for balancing services which will increase costs for the System Operator.

In addition, as both “system” and “energy” actions are taken from the same pool of Bid and Offer prices, manipulating what should be a competitive market in order to reduce constraint costs could lead to unintended consequences for imbalance prices. Dampening cash-out prices may reduce the signal for generators to meet contracted positions in the wholesale market (i.e. balance).

To help minimise the potential for negative consequences, similar to those highlighted above, Drax believes that the TCLC should be applied in the following manner.

Application of the TCLC

Drax recognises that electricity network constraints will continue to exist for the foreseeable future. Newly connected generation capacity is expected to outstrip transmission system capability for many years to come, particularly north of the Cheviot boundary. This is a result of efforts to connect new low carbon generation in a timely manner, prior to the completion of wider transmission reinforcement (Connect & Manage).

It should be noted that the National Electricity Transmission System Security and Quality of Supply Standard (NETS SQSS) now requires a Cost Benefit Analysis (CBA) exercise to be completed in order to determine whether transmission network investment would prove more cost effective than continued constraint management. We believe that the TCLC should not apply to those constraints where it has been determined that constraint management (via the competitive BM market) is more cost effective than transmission investment.

The TCLC should only apply to activity behind enduring structural transmission constraints that Ofgem has pre-designated as problematic. We note that most congestion costs occur on critical boundaries between the 17 zones rather than within zones. These are constraints where there is a clear need, and plan, for investment in network infrastructure. At present, we believe the only enduring structural constraint to meet this criteria would be the B6 Cheviot boundary. As such, in the first instance, the licence condition should only apply to this boundary.

With regards to the future application of the TCLC, there should be a robust and transparent designation process to apply the licence condition to additional boundaries on the network. This process should involve an industry consultation that identifies the affected boundaries, the reasoning behind the designation and the actions and timescales required to resolve the constraint (for example boundary reinforcement, development of offshore bootstraps, expected plant closures, etc.).

Ofgem should also ensure that the implementation of the TCLC is properly targeted to ensure that its use is proportionate as envisaged by the Primary Legislation. Any 'mission creep' will put the efficient operation of the power market at risk.

Lifespan of the licence condition

Moves to provide greater regulatory certainty on the lifespan of the TCLC are welcome. However, we question the logic behind setting an arbitrary time limit for the new licence condition.

There is recognition from both Government and industry participants that enduring structural constraints will only be resolved by increasing the level of investment in network infrastructure. It would appear sensible to implement a licence condition that (a) specifically targets enduring structural constraints, (b) sets out the investment required to resolve the constraint, and (c) lapses only when the constraint has been resolved. This approach would ensure the root cause of a constraint is targeted, rather than setting an arbitrary sunset date that has no relevance to investment timescales.

The time period identified to resolve specific enduring transmission constraints should be adopted to set the date when re-consultation of the continued application of the TCLC will occur e.g. if an enduring transmission constraint is expected to be resolved by 2017, the application of the TCLC to this transmission constraint should be re-consulted on in 2017 to determine whether the continued application of the TCLC to the affected transmission constraint is still justified. If the planned investment has been insufficient, for whatever reason, in remedying the transmission constraint a new action plan can be identified and a new time period can be determined for how long the application of the TCLC would apply for and when the next re-consultation exercise would commence.

Only once the constraint has been resolved, should the TCLC no longer apply to that boundary on the network.

It should also be noted that future regulatory developments have the potential to make the requirement for a TCLC obsolete (for example locational energy pricing). In the event of any such regulatory developments, there must be the ability to repeal the TCLC in an adequate time period.

Excessive pricing and benefit

If Ofgem intends to use the powers granted under the TCLC to tackle instances of 'excessive pricing or benefit', it must clearly set out how it will provide market participants with the information required to make informed judgements on Bid and Offer pricing. The current guidance completely fails to do this.

We believe it is important that the guidance is firmly grounded in existing Competition Law principles. This is because it is likely that in the event of Ofgem finding against a party under the TCLC there will be an appeal against the decision to the Competition Appeals Tribunal (CAT). Therefore, it is important that Ofgem develops a case which is consistent with how the CAT is likely to pass judgement on the relevant case.

The following principles should help in determining whether a firm has priced excessively or not:

3. The European Court of Justice has held that "charging a price that is excessive because it has no reasonable relation to the economic value of the product supplied.... is an abuse"³.
4. Moreover, in his decision in Napp⁴ the Director General of Fair Trading stated that a price is excessive for the purposes of the Chapter II prohibition "if it is above that which would exist in a competitive market and where it is clear that high profits will not stimulate successful new entry within a reasonable period. Therefore to show that prices are excessive, it must be demonstrated that (i) prices are higher than would be expected in a competitive market, and (ii) there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be".

Furthermore, it is also important to ensure that the guidance produced by Ofgem can be interpreted and acted on by shift traders who will be expected to make commercial decisions in relatively short time periods. If this is not the case the efficiency of the market will diminish and overall costs to end consumers will increase.

Circumstance 3: The charging of excessive amounts for the arming of inter-trips

We have significant concerns over the potential to impose restrictions on Intertrip arming fees. Intertrips are bilaterally negotiated contracts between the System Operator and individual market participants. Generators should be able to place what they believe to be a reasonable value on the Intertrip service that they are prepared to provide.

The System Operator has no obligation to enter an arrangement with a generator if it considers the terms are excessively priced. The System Operator also has a number of different tools open to it to enable it to carry out its role. As such, we believe the justification for imposing such measures on a bilaterally agreed contract remains unclear.

Investigating generator behaviour

When investigating the behaviour of market participants, Ofgem must be mindful of the potential for adverse reputational impacts for those being examined. The investigation should reach a final conclusion prior to a "naming and shaming" process. If the process is not robust, there could be substantial reputational risk for both the regulator and those parties that have been investigated.

³ Case 27/76 United Brands v Commission [1978] ECR 207, [1978] 1 CMLR 429

⁴ Napp Pharmaceutical Holdings Ltd. v DGFT [2001] UKCLR 597, Paragraph 203