

Proposed Transmission Constraint Licence Condition

Response by E.ON to DECC's and Ofgem's consultations

1. Introduction

- 1.1 E.ON supports the principle of trying to prevent abuse of situations where generators have effectively a dominant position. We recognise that this is the principle behind DECC's and Ofgem's consultations on the proposed Transmission Constraint Licence Condition (the Licence Condition).
- 1.2 We acknowledge that the intention is not to create wide powers, but to try and target the specific issues. Also, that this Licence Condition is being brought in under powers conferred by the Energy Act 2010 and consequently places restrictions on the Licence Condition's scope. However, we are concerned that implementing the current drafting of the Licence Condition and the Guidance would introduce a significantly greater risk of unintended consequences than is necessary.
- 1.3 The greatest risk of unintended consequences surrounds the future levels of competitive activity and general participation in the Balancing Mechanism, together with the associated knock-on effect that this would have for the wholesale market and investor confidence. To maintain the current levels of participation in the Balancing Mechanism, the Licence Condition and the Guidance need further development so that they can accommodate the practicalities of operating both in a competitive wholesale market that does not take account of transmission constraints and being connected physically to an electricity system that does have constraints. Failure to accommodate these practicalities increases the likelihood of licensed generators having to exit the Balancing Mechanism.
- 1.4 We recommend that the Licence Condition is modified so that generation licensees are only:
 1. judged to have obtained an excessive benefit from electricity generation in relation to a Transmission Constraint Period if they have been notified of all transmission constraints applicable to their generation units, (Applicable Transmission Constraints) together with the appropriate details of such transmission constraints;
 2. considered to have been notified if they are made aware of Applicable Transmission Constraints, and their sensitivities, by the system operator before 07:00 on the last working day prior to the delivery day on which the Applicable Transmission Constraint applies, so that the licensees are properly informed prior to the main trading activity for the respective day; and
 3. prohibited from obtaining an excessive benefit from actions relating to their generation units that are located within Applicable Transmission Constraints;

- 1.5 Our recommended changes to paragraph three of the proposed Licence Condition are set out in the Appendix 1 to this document.
- 1.6 The Guidance must provide a more transparent and non discriminatory way of implementing the Licence Condition's requirements than is achieved with the current drafting. This is particularly important in relation to how Ofgem will determine if licensees had "more economic options available", or had secured "excessive amounts" as set out in the Licence Condition. To achieve this, we recommend that:
1. the Guidance uses the appropriate wholesale market prices as the reference for determining if a licensee "had more economic options available to it";
 2. the methodology used for determining "excessive payments" is based on benchmarking against payments made to similar generation units that are not subject to constraints; and
 3. the Guidance sets out clearly what steps Ofgem will take to ensure that the system operator does not misuse the restrictions placed on generation licensees so as to help enhance the earnings that the system operator gains from its own incentive scheme.

2. E.ON's concerns with the drafting of the Licence Condition

2.1 The proposed Licence Condition should be modified so that generation licensees can only be judged to have obtained an excessive benefit from electricity generation in relation to a Transmission Constraint Period if they have been notified of all transmission constraints applicable to their generation units, (Applicable Transmission Constraints) together with the appropriate details of such transmission constraints.

2.1.1 The costs and risks involved in starting generation units mean that it is not rational to schedule such plant unless an appropriate level of profit is likely to be secured. Generally, the more marginal a generation unit the greater this profit has to be, in order that long run marginal cost, as well as short run marginal cost, is covered.

2.1.2 Also, the nature of the Great Britain wholesale electricity market means that those scheduling generation units have to consider their options and make a firm scheduling decision ahead of gate closure. These options are:

1. backing their positions through purchasing from the wholesale market;
2. backing their positions by using their own generation; and
3. entering gate closure not balanced.

2.1.3 When deciding if to use their own generation, the schedulers have to decide if the most profitable action will be by running the units to back commitments in the wholesale market, or not to commit and hold them available for use in the Balancing Mechanism.

2.1.4 The different factors which have to be taken into account mean that even without the influence of system constraints, when scheduling plant before gate closure, the level of predicted profit necessary for a generation unit to be scheduled to run is a variable. It also means that there will be circumstances when generation units will not be scheduled to run because the scheduler has chosen other options available, which in theory are less economic than running the generation units. For example, contracts available in the wholesale market can be such that the potential profit is insufficient to risk starting a generation unit, yet are sufficient that taking the contracts and running the generation unit to back them looks to be, theoretically, a more economic option. Equally, there will be circumstances where generation units are scheduled to run, before gate closure, when the predicted profit is lower than the normal level of profit at which the plant is usually not scheduled.

2.1.5 At present those scheduling generation units generally have to work without knowledge of transmission constraints. Consequently, under the Licence Condition, at times where "more economic options" were available, schedulers of generation units would face a choice of having to:

1. cease making the rational decision of not scheduling plant when potential profit is inappropriate; or
2. gamble that the scheduling of a generation unit on a rational trading commercial basis will not coincide with a Transmission Constraint Period where the generation unit's scheduled running contributes to a constraint.

- 2.1.6 This problem could be resolved easily if the schedulers were made aware of constraints and the generation units involved. With this knowledge schedulers of generation units would be able to:
1. continue to rationally not schedule a unit, when potential profit was inappropriate, where constraints were unlikely to involve that unit; and
 2. cease rationally scheduling those generation units likely to be involved with constraints and adopt a more theoretical economic approach to their scheduling.

This would reduce the risk of unintentionally breaching the Licence Condition.

- 2.1.7 To recognise that generators need to know if they are likely to be involved with a constraint, we recommend that paragraph 1 of the Licence Condition has "knowingly" added so that it reads,

*"The licensee must not **knowingly** obtain an excessive benefit from electricity generation in relation to a Transmission Constraint Period"*

2.2 The proposed Licence Condition should be modified so that generation licensees are only considered to have been notified if they are made aware of Applicable Transmission Constraints and their sensitivities by the system operator before 07:00 on the last working day prior to the delivery day on which the applicable constraint applies, so that the licensees are properly informed prior to the main trading activity for the respective day.

- 2.2.1 As the system operator is the only party who has the information on the likelihood of transmission constraints, schedulers of generation units can only gain knowledge of such constraints if the system operator informs them. The Licence Condition needs to make contravention of paragraph 1 of the Licence Condition (knowingly obtaining an excessive benefit from electricity generation in relation to a Transmission Constraint Period) dependent upon having being notified of a Transmission Constraint Period by system operator in sufficient time to respond.
- 2.2.2 The timing of a notification is important as schedulers will only be able to adopt a more theoretical economic approach, to the scheduling of generation units involved with Applicable Transmission Constraints, if they are given sufficient notice. Once informed, schedulers will often have to trade so as to move their positions to align with the new situation. The last practicable opportunity for potentially large amounts of trading will be the day-ahead auctions, which are currently held on the morning of the last working day prior to the delivery day on which the constraint applies.
- 2.2.3 We recommend that the Licence Condition is clear that the licensee will knowingly obtain an excessive benefit from electricity generation in relation to a Transmission Constraint Period only if it has been notified of Applicable Transmission Constraints by the transmission system operator before 07:00 on the last working day prior to the delivery day on which the constraint applies.
- 2.2.4 As constraints are often dependent on a number of factors, including the variables of demand and plant availability, schedulers need to know details of all the Applicable Transmission Constraints, their relevant sensitivities and which

generation units are likely to be involved. The Licence Condition needs to be clear that for a notification of an Applicable Transmission Constraint to be valid, the notification will include details of all the Applicable Transmission Constraints, together with each constraint's details, including which generation units could be involved and the relevant sensitivities.

- 2.2.5 It may be that the system operator believes that to provide such information by 07:00 on the last working day prior to the delivery day on which the constraint applies is not practicable. If so, then it is hard to see how a generation licensee could knowingly obtain an excessive benefit from electricity generation in relation to a Transmission Constraint Period.
- 2.2.6 If the system operator cannot provide details of all the applicable constraints, as described above, then the Licence Condition should not seek to address all transmission constraints. Instead, the Licence Condition should take a proportionate approach and address the main risks associated with constraints linked to parts of the transmission system that are not GBSQSS compliant, whilst avoiding most of the costs associated with damping competitive market signals/activity.
- 2.2.7 The actual licence proposal originates from a problem that Ofgem identified in relation to constraints linked to sections of the transmission system that are not GBSQSS compliant, which Ofgem believes cannot be remedied by competition law powers; specifically, the Cheviot Constraint, which for historical reasons, is not and has never been GBSQSS compliant. The risks associated with transient constraints and constrained on generation units are significantly lower than for constraints associated with parts of the transmission system that are not GBSQSS compliant. Therefore, the lack of GBSQSS compliance could be used for defining those transmission constraints which are applicable to the Licence Condition.
- 2.2.8 Regardless of which constraints are declared by the system operator, the Licence Condition needs to be clear that the only constraints to which the Licence Condition applies are those that the licensee has been notified of by the system operator.
- 2.2.9 We therefore recommend that:
- a) the Licence Condition refers to "*Applicable Transmission Constraints*", rather than the current "Transmission Constraints";
 - b) "*Applicable Transmission Constraints*" are defined as, "*Those Transmission Constraints, the details of which have been notified to the licensee by the system operator before 07:00 on the last working day prior to the delivery day on which the transmission constraint applies and where such details include the generation units that could be involved with the constraint and the relevant sensitivities of the constraint*"; and
 - c) "*Transmission Constraint Period*" is defined as, "*means any period of time, regardless of the duration when an Applicable Transmission Constraint occurs*"

2.3 The Licence Condition should be modified so that generation licensees are only prohibited from obtaining an excessive benefit from actions relating to their generation units that are located within the Applicable Transmission Constraints.

2.3.1 To help normal wholesale market activity to continue wherever possible, it is important that the Licence Condition only applies to the actions of the licensee in relation to generation units identified by the system operator as likely to be involved with the Applicable Transmission Constraints. Failure to achieve clarity on this issue risks forcing licensees with generation likely to be involved with transmission constraints to withdraw all plant from the Balancing Mechanism. To address this we recommend that paragraph 3 of the Licence Condition is modified, for this particular concern¹, to read,

3. The circumstances referred to in paragraph 2(b) are as follows:

a. Circumstance 1 is that:

*(i) the licensee creates or exacerbates **an Applicable** Transmission Constraint by dispatching or withholding one or more Generation Units **that have been identified by the system operator as part of the Applicable Transmission Constraint** in circumstances when **the licensee** had more economic options available to it; and*

(ii) under the Relevant Arrangements, either:

*a. the licensee is paid, or seeks to be paid, an excessive amount by the system operator in connection with an increase in electricity generation by the **licensee's generation units identified by the system operator as part of the Applicable Transmission Constraint** during the Transmission Constraint Period; or*

*b. the licensee is paid, or seeks to be paid, an excessive amount by the system operator, or the licensee pays, or seeks to pay, an excessively low amount to the system operator, in connection with a reduction in electricity generation **by the licensee's generation units identified by the system operator as part of the Applicable Transmission Constraint** during the Transmission Constraint Period;*

*b. Circumstance 2 is that, under the Relevant Arrangements and in connection with a reduction in electricity generation **by the licensee's generation units identified by the system operator as part of the Applicable Transmission Constraint** in the Transmission Constraint Period, either:*

i. the licensee pays, or seeks to pay, the system operator an excessively low amount, or

ii. the licensee is paid, or seeks to be paid, an excessive amount by the system operator;

c. Circumstance 3 is that, under the Relevant Arrangements, the licensee is to be paid an excessive amount by the system operator in connection with the licensee preparing for the possible cessation of generation of

¹ In relation to paragraph 3 we have a number of separate concerns. The consolidated set of recommended modifications to this paragraph is set out in **Appendix1**.

electricity by **the licensee's generation units identified by the system operator as part of the Applicable Transmission Constraint** in a Transmission Constraint Period.

2.3.2 For the same reasons, we also recommend that paragraph 4 of the Licence Condition is modified to read,

- 4 For the purposes of paragraph 3 any reference to an increase or reduction in generation by the licensee in a Transmission Constraint Period means:
 - a. an increase or reduction **by the licensee's generation units identified by the system operator as part of the Applicable Transmission Constraint** in comparison to the licensee's Notified Electricity Generation for that Transmission Constraint Period; and
 - b. includes an increase or reduction in generation of electricity by **the licensee's generation units identified by the system operator as part of the Applicable Transmission Constraint**, whether or not there is an overall increase or reduction in electricity generation in that Transmission Constraint Period.

2.4 The use of "withholding" in paragraph 3 of the Licence Condition is too vague.

2.4.1 In paragraph 3 of the Licence Condition there is reference to "withholding one or more generation units". It is not clear what "withholding" means in this context. For example, does "withholding" mean declaring generation units unavailable, or leaving them available, but not scheduling them to back trades? If it is the latter, it needs to be recognised that the production of the generation unit has often been offered to the wholesale market but it has not been bought. Consequently, there is no contract commitment to schedule against and so the generation units are not dispatched, but left available for use in the Balancing Mechanism. We therefore recommend that paragraph 3.a.(i), for this particular concern², is modified to:

"the licensee's scheduling and despatch actions creates or exacerbates a Transmission Constraint in circumstances when it had more economic options available to it"

2.5 The duration of the Licence Condition could be linked to those sections of the system that are not GBSQSS compliant becoming compliant.

2.5.1 Paragraph 8 of the Licence Condition sets out the parameters for when this Licence Condition ceases. This is somewhat redundant unless the Licence Condition is focused on constraints resulting from sections of the system that are not GBSQSS compliant. If the Applicable Transmission Constraints were tied to such constraints then there would be a clear reference for judging if the Licence Condition needed to continue.

² In relation to paragraph 3 we have a number of separate concerns. The consolidated set of recommended modifications to this paragraph is set out in **Appendix1**.

2.6 The definition of "Generation Unit" should align with the Electricity Act.

2.6.1 The definition of "Generation Unit" in the Licence Condition seems to cover anything that makes electricity. This is far too wide; the definition should align with the Electricity Act. We suggest that the definition should be:

"means any apparatus which generates electricity for the purpose of giving a supply to any premises or enabling a supply to be given."

3. E.ON's concerns with the drafting of the Guidance

3.1 The Guidance should use the appropriate wholesale market prices as the reference for determining if a licensee "had more economic options available to it".

- 3.1.1 The use of generator licensees' changes in portfolio running order for determining if "more economic options were available", as suggested in paragraph 2.12 of the Guidance, would be discriminatory against generation licensees operating portfolios. Such an approach would increase the incentives on generation licensees with portfolios to place individual generation plants within individual companies. Once in separate companies then each licensee would no longer have the option of scheduling orders and so could not be accused of uneconomic scheduling, even though as a corporate group uneconomic scheduling of the whole portfolio could continue without breaching the licence.
- 3.1.2 For those generation licensees with portfolios that could not be split into separate generation unit companies, the perceived risks of unintentional breach of licence, due to portfolio running orders being used for determining "more economic options were available", may necessitate that they cease offering generation units to the Balancing Mechanism.
- 3.1.3 With the number of issues arising in determining if a generation licensee "had more economic options available to it" in Circumstance 1, a transparent and non discriminatory methodology is required. We recommend that the "more economic options" reference is always the day-head auction prices for the corresponding Transmission Constraint Period. Using this price as the reference means that generation licensees know what they are being measured against, that the measure is an option they can use in practice and that the value of the option is the product of the competitive market.

3.2 The methodology used for determining "excessive payments" should be based on benchmarking against payments made to similar generation units that are not subject to constraints.

- 3.2.1 Paragraphs 3a, 3b and 3c of the Licence Condition refer to the licensee being paid or seeking to be paid, an excessive amount by the system operator. An "excessive amount", as with "excessive benefit" can be subjective. By measuring "excessive amount" as relative to a reference, the degree of subjectivity could be reduced.
- 3.2.2 To achieve this and allow licensees to show why their actions were not securing "excessive benefit", the Guidance should set out a single three part generator benchmarking test for the three Circumstances, namely:
- 1, that an "excessive benefit" is provisionally concluded by Ofgem, only if the level of bid/offer for the generation unit was:
 - significantly greater than those posted for comparable generation units not involved with constraints; or
 - outside of historical norms (where comparison with generation units not involved with constraints was not practicable);
 - 2, where "excessive benefit" is provisionally concluded by Ofgem, Ofgem will inform the licensee and provide a copy of all the evidence it has acquired to

support this, together with its reasoning. The licensee is then given the opportunity to objectively justify its actions and challenge Ofgem's reasoning and evidence; and

- 3, only after having provisionally concluded that "excessive benefit" has been gained, presented its findings to the licensee and having considered any objective justification and challenges presented by the licensee, could Ofgem determine that the licensee had obtained excessive benefit from electricity generation in relation to a Transmission Constraint Period.

3.2.3 In support of this approach, the Guidance should also present examples of how Ofgem will operate this benchmarking test in practice.

3.2.4 The Guidance (paragraph 2.12) suggests that Ofgem's intention is not to carry out such benchmarking tests, for Circumstance 1, or even to evaluate if a bid or offer is actually excessive or not, but just use an arbitrary rule that if bids or offers are accepted, then that bid or offer is automatically excessive. To do this Ofgem would be removing a key test for establishing if a generation licensee has obtained excessive benefit from electricity generation in relation to a Transmission Constraint Period. That test must take place and be carried out in an appropriate way through a full analysis; not by a default ruling.

3.2.5 The example below illustrates the problem if such an arbitrary interpretation was used.

A licensee's power station has an operating cost of £50/MWh and is within an export constraint area. If the power station is scheduled to run it will "exacerbate" the export constraint in circumstances where the licensee could have more economically sourced power at, say, £40/MWh.

If the licensee sells a contract for £55/MWh and chooses to run the power station it will make a profit of £5/MWh.

If power station is scheduled to run it will have to be constrained off, because of the constraint. For this power station, the licensee would have to pay the system operator its bid price, which we assume will be the same as its operational cost (£50/MWh). It will be paid £55/MWh under its contract, will pay out £50/MWh through its bid, but not incur its operating costs of £50/MWh. Therefore, its profit will remain at £5/MWh and the licensee will make the same profit as if it had not been constrained off.

3.2.6 In this example, while the licensee is in the same financial position as if it had been able to run, with the arbitrary ruling described in the Guidance, this would be sufficient to establish that the licensee had paid an excessively low amount. In practice the power station would only benefit from being constrained off if its bid price was below its operational cost. Clearly, to assume such bids will always be an excessively low amount is wrong.

3.2.7 Ofgem gives its own example, again in paragraph 2.12 of the Guidance, which further suggests that Ofgem will assume that the generator has automatically gained greater profits as a result of having a bid or offer accepted in the Balancing Mechanism, regardless of the level of that bid or offer. As our example above showed, this is does not have to be the case.

3.2.8 The real issue is when a generator seeks to make additional profit by planning to run its generation units in the manner described above and then posting a low or negative bid. For instance, in the above example, if the generator had posted a bid of £30/MWh for the power station and the bid had been accepted, then this would net the licensee an additional profit of £20/MWh, if compared to the power station running, and £10/MWh if compared with the more economic option of £40/MWh. Whether this means that the licensee has paid an excessively low amount relative to comparable generation units outside of the constraint has not been established at this point. That should be determined, as described above, through benchmarking the bid against the bids of comparable generation units not involved with constraints.

3.3 The Guidance should set out clearly what steps Ofgem will take to ensure that the system operator does not misuse the restrictions placed on generation licensees so as to help enhance the earnings that the system operator gains from its own incentive scheme.

3.3.1 The Licence Condition will limit the way licensed generators price and schedule generation that could be involved with transmission constraints. Consequently, the Guidance should set out clearly what steps Ofgem will take to ensure that the system operator does not misuse the situation so as to benefit from its own incentive scheme.

3.3.2 To protect the wholesale market, the number of generation units restricted from fully competing in it, because of transmission constraints, needs to be kept to a minimum. Therefore, the Guidance must also set out how Ofgem will secure that the system operator will ensure that the number of generation units listed as involved with an Applicable Transmission Constraint is kept to the minimum.

4 E.ON's responses to DECC's specific questions

Q#. *Does the prohibition set out under circumstance 1 of the licence condition adequately address the problem of generators profiting from actions in the BM as a result of their exacerbation or creation of transmission constraints?*

Generators have to be able to make a profit. If generators are prohibited from securing a profit from actions in the Balancing Mechanism, including as a result of unintentionally creating transmission constraints, they are likely to stop offering generation units to the Balancing Mechanism. We trust that the intention of the question was about a generator licensee obtaining an excessive benefit from actions in the Balancing Mechanism when exacerbating or creating a transmission constraint by dispatching or withholding one or more generation units in circumstances when the licensee had more economic options available to it.

Any licence modification is likely not to adequately address the problem of generators securing excessive benefit from actions in the Balancing Mechanism as a result of their exacerbation or creation of transmission constraints. The main reason for this is that generation which is not by a generation licensee will not be covered. Therefore, this approach can only partially address the issue.

The Licence Condition refers to the licensee obtaining excessive benefit, entering into relevant arrangements, dispatching and withholding generation units and being paid. Many licensees, such as E.ON UK plc, have presold their generation capacity to a third party. In these situations it is the third party who could be obtaining excessive benefit, entering into relevant arrangements, dispatching and withholding generation units and being paid. As the third party is often not a generation licensee, the requirements of the Licence Condition, as written, will not apply. Equally, as the generation licensee is not carrying out these activities, the Licence Condition will not affect it. This situation would seem to be discriminatory against those generation licensees that keep all such activities within the licensed company. We recommend that, for the Licence Condition, the reference to "the licensee" in paragraphs 2a, 3.a.(i), 3.a.(ii)a, 3.a.(ii)b, 3.b.i and 3.c, is extended to "*the licensee, or an affiliate or associated company of the licensee*"³.

The degree to which Circumstance 1 adequately addresses the issue of excessively low or negative bids from generation licensees during periods of transmission constraints will be dependent on how well the Guidance ensures that bids are objectively evaluated as to if they are excessive, or not, relative to generation units not involved with transmission constraints.

To reduce the risk of discrimination against certain types of generation licensees, the determining of "more economic options" must be a transparent process. Within the transparent process the value of "more economic options" should be referenced against wholesale market trades for the time of the Transmission Constraint Period.

³ In relation to paragraph 3 we have a number of separate concerns. The consolidated set of recommended modifications to this paragraph is set out in **Appendix 1**.

Q#. *Is this approach likely to have any unintended consequences on behaviour in the electricity market?*

The proposals, as drafted, carry a high risk of unintended consequences for behaviour within the electricity market in four particular areas:

1. The lack of transparency within the Licence Condition, together with the interpretation being presented in the Guidance will introduce very high risks for generators who try to continue to participate in the Balancing Mechanism. There is a risk of forcing some generation licensees with portfolios of generation stations to withdraw from the Balancing Mechanism;
2. The current drafting presents those generators considering building new plant with greater incentives to keep each company's generation limit below 100MW and therefore avoid the need to become a licensee and be exposed to licence requirements;
3. The Guidance, as currently drafted, will introduce incentives to alter company structures so that there is only one generation plant per licensee, which would remove some of the requirements set by paragraph 3 of the Licence Condition; and
4. The risk of the system operator misusing the restrictions placed on generation licensees in ways that helps it enhance the earnings it secures from its own incentive scheme.

To address these points:

1. The Licence Condition should be modified so that generation licensees can only be judged to have obtained an excessive benefit from electricity generation in relation to a Transmission Constraint Period if they have been notified of the Applicable Transmission Constraints that their generation units could be involved with, together with the appropriate details of such Applicable Transmission Constraints;
2. The Licence Condition should be modified so that generation licensees are only considered to have been notified if they are made aware of Applicable Transmission Constraints, and their sensitivities, by the system operator before 07:00 on the last working day prior to the delivery day on which the Applicable Transmission Constraint applies, so that the licensees are properly informed prior to the main trading activity for the respective day;
3. The Licence Condition should be modified so that generation licensees are only prohibited from obtaining an excessive benefit from actions relating to their generation units that are located within the Applicable Transmission Constraints; and
4. The Guidance should set out clearly what steps Ofgem will take to ensure that the system operator does not misuse the restrictions placed on generation licensees so as to help enhance the earnings that the system operator gains from its own incentive scheme.

Q#. *Does circumstance 2 adequately address the issue of excessively low or negative bids during periods of transmission constraints?*

Circumstance 2 will only be applicable to generation licensees. The issue of excessively low or negative bids during periods of transmission constraints has recently been associated with wind generation. However, large amounts of wind generation has been by companies that have capacities sufficiently small that they are not licensees and therefore the Licence Condition will not be applicable to them.

The degree to which Circumstance 2 adequately address the issue of excessively low or negative bids from generation licensees during periods of transmission constraints will, again, be dependent on how well the Guidance ensures that bids are objectively evaluated as to if they are excessive or not relative to generation units not involved with a transmission constraint.

Q#. *Is this approach likely to have any unintended consequences on behaviour in the electricity market?*

Generators considering building new plant, such as wind, will have greater incentives to keep each company's generation limits below 100MW and therefore avoid the need to become a licensee and be exposed to these requirements.

Q#. *Do respondents consider that since the passing of the Energy Act 2010 the market has developed in a way that may mean the proposed prohibition is no longer appropriate?*

As explained above, excessively low or negative bids during periods of transmission constraints have recently been associated with wind generation, a large amount of which is not operated by generation licensees. The industry, once aware of this problem, has taken steps to address it. Given the large number of generators that are not covered by this Licence Condition and the fact that the industry has addressed the issue relating to wind generation, the need for Circumstance 2 is redundant.

Q#. *Does circumstance 3 adequately address the issue of excessively high arming fees for inter-trips?*

The degree to which Circumstance 3 adequately address the issue of excessively high arming fees for inter-trips in relation to transmission constraints will, as with the other two Circumstances, be dependent on how well the Guidance ensures that bids are objectively evaluated as to if they are excessive, or not, relative to bids for other generation units.

Also, greater clarity is needed as to which inter-trips are being covered by Circumstance 3.

Q#. *Is this approach likely to have any unintended consequences on behaviour in the electricity market?*

Generators considering building new plant, such as wind, will have greater incentives to keep each company's generation at below 100MW and therefore avoid the need to become a licensee and be exposed to these requirements.

If the Guidance takes an unreasonable view of excessive benefit in relation to inter-trips, then there is the risk that generation licensees will refuse to offer this

service, resulting in higher costs through more generation units being constrained off within constraints.

Q#. *Are there any other circumstances in which generators can derive excessive profits during a period of transmission constraint that should be addressed in the licence condition? Please provide evidence to back up your response.*

We are concerned that the focus of this question is on "excessive profits". Considering excessive profits suggests that the aim is actually to regulate generators profits. The Guidance needs to be explicit that this is not the intention.

Q#. *Should the licence condition also cover excessive benefits from offers in the BM beyond the prohibition in circumstance 1? Please provide evidence to back up your response.*

Broadening prohibitions on generators' pricing further increases the risk of creating an unofficial price control for generators. Clear of transmission constraints, the GB generation market, for which the Balancing Mechanism has a key role, is a highly competitive market. Placing greater restrictions on trading activities increases the risk of suppressing competitive behaviour.

Q#. *What are your views on the evidence presented in the attached impact assessment? Do you have any additional evidence or arguments that could inform our view of the costs and benefits of different options for implementing this licence condition?*

The impact assessment states that; "*Historically, Scottish constraints (particularly along the Cheviot boundary between Scotland and England) have accounted for the majority of these costs.*" However, the current proposal goes much wider than addressing the constraints that have accounted for the majority of these costs. If a balance is to be achieved, between preventing high costs to customers and avoiding unintended consequences, the Licence Condition should be focused on the constraints that are of the type associated with the Cheviot boundary.

DECC has considered three options and suggests that Option One is its preferred option. Option One is the most focused prohibition with Options Two and Three becoming increasingly broader. However, as drafted the Licence Condition would be best described as implementing the requirements of Option Three and thus, as DECC has explained for Options Two and Three, carries greater risk for investment than if it had been limited to delivering the objectives of Option One.

5 E.ON's responses to Ofgem's specific questions

Circumstance 1

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

The Licence Condition is concerned with dispatch of a generating unit when the licensee had more economic options available, it is not requiring Ofgem to judge if the dispatch decision was uneconomic.

The approach to determining if "more economic options were available" needs to be within a framework using the appropriate wholesale market prices as the reference.

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

We are concerned that Ofgem is considering calculating generation profitability. The Licence Condition is not intended as a generator price control. Ofgem needs to focus its work on determining if the actions of a generation licensee have breached the licence requirement (that the licensee must not obtain an excessive benefit from electricity generation in relation to a Transmission Constraint Period).

The Guidance should use the appropriate wholesale market prices as the reference for determining if a licensee "had more economic options available to it". Also, the methodology used for determining "excessive payments" should be based on benchmarking against payments made to similar generation units that are not subject to constraints.

Consequently, the use of "within-day" fuel and electricity prices for determining if "more economic options were available", or if "an excessive amount" has been secured, is not appropriate.

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

We assume that Ofgem's initial analysis relates to if a licensee "had more economic options available to it". This analysis should always be referenced against the day-head auction prices for the corresponding Transmission Constraint Period. Using this price as the reference means that generation licensees know what they are being measured against, that the measure is an option they can use in practice and that the value of the option is the product of the competitive market.

If the "initial analysis" is in relation to starting the later stage of the process of considering if "excessive payments" have been secured, then this should be based on benchmarking against payments made to similar generation units that are not subject to constraints. However, when comparing the despatch decisions for a generation unit involved with an Applicable Transmission Constraint with the despatch decisions made for similar generation units that were not involved with

constraints, differences in actual costs have to be taken into account. Very similar generation units can have different costs because of changes in efficiency due to a number of factors, including predicted operating conditions, non fuel variable costs, start-up costs and BSUoS assumptions. These factors do need to be taken into account when questioning why two similar machines have seen different despatch instructions.

Experience has shown that unexpected factors can come together resulting in unusual running orders of generation units that could not be fully anticipated. Therefore, the Guidance must be clear that it does have sufficient flexibility to take into account all of the factors (including costs) that the licensee, or its trader, has taken into account when making dispatch decisions.

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

The Licence Condition is concerned with dispatch of a generating unit when the licensee had more economic options available, it is not requiring Ofgem to judge if the dispatch decision was uneconomic. The determining if more economic options were available should be limited to comparisons with the day-ahead wholesale market prices.

Why a less economic option was taken should not be questioned. Instead, having established that a more economic option was available than the scheduling, or otherwise, of a generation unit located within an Applicable Transmission Constraint, Ofgem should move onto the second test of benchmarking to determine if excessive benefits relative to similar generation units not involved with constraints have been secured.

The Licence Condition and the Guidance must be explicitly limited to generation units involved with the Applicable Transmission Constraints. This would limit the number of generating units to which the question of uneconomic dispatch could be applied and so minimise the scale of any adverse affects on the competitive market.

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

Ofgem should not be considering if actual levels of benefit are excessive or not, or if what the licensee had been seeking to pay, or be paid, was excessive or not. Ofgem should be restricting itself to considering if the levels of benefit and payments are excessive relative to similar generation units that were not involved with constraints.

Circumstance 2

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?*

When considering any of the three Circumstances as to whether the bids are excessive or not, it must be as relative to bids of similar generation units that are not subject to known transmission constraints. We therefore agree with the use

of comparable generator benchmarks. However, the use of avoidable costs and other indicators should only be used for adjustments to recognise the inevitable differences that will exist between similar generation units.

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

There will inevitably be other factors and indicators that Ofgem will need to consider in interpreting particular circumstance. While operating within a defined framework for determining whether the bids are excessive, or not, relative to bids of similar generation units that are not subject to known transmission constraints, the Guidance needs to clearly allow sufficient flexibility so that both Ofgem and the licensee can best present their understanding of the particular situation.

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

Again, there will inevitably be arguments that arise, which provide objective justification for seemingly high bids relative to similar generation units that are not involved with transmission constraints. The Guidance needs to be very clear that there is sufficient flexibility to ensure that the merits of such arguments will be considered.

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

The Guidance states that in relation to comparable generator benchmarks; "We would look at a range of factors such as profits obtained by comparable generators and historical profits from bids in the BM when determining a reasonable profit". Circumstance 2 is not referring to profit but securing excessive amount or an excessively low amount. The Guidance needs to be sufficiently rigorous that "excessive" relates to bids and offers relative to similar generation units that are not involved with transmission constraints.

The assessments must not be determining what a reasonable profit is. If Ofgem were to start determining this, the figure would quickly become a regulatory cap on bids and offers to the Balancing Mechanism, which in turn would form a cap on the wholesale market.

Circumstance 3

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

There are currently two types of commercial inter-trip;

1. "Commercial" contracts for manual tripping by the system operator; and
2. Contracts for automatic tripping at times of high frequency.

While the Guidance refers to “commercial inter-trips”, the descriptions suggest contracts for automatic tripping at times of high frequency. The definitions need to be much clearer.

As an operator of generation units we try to avoid having our plant trip. The tripping of plant, as opposed to controlled shutdowns, carries significantly greater risk of plant failure. We would much prefer to have our plant taken off in a controlled manner than being tripped off. Unless we are allowed to strike contracts that reflect our desire that the plant is not tripped off, then it is unlikely that we would be prepared to offer such services.

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?*

As with the other two Circumstances, when considering whether the fees are excessive or not, it must be as relative to fees paid to similar generation units, even though for inter-trip they are, probably, also subject to known transmission constraints. We, therefore, agree with the use of comparable generator benchmarks. However, the use of avoidable costs and other indicators should only be used for adjustments to recognise the inevitable differences that will exist between similar generation units.

Currently there is little or no data is available of the historical level of pricing of arming fees, or the number of contracts that are annually committed by the system operator. To aid transparency for inter-trip fees and align with the Balancing Mechanism, the system operator should be required to publish, on a generation unit basis, details of the inter-trip fees it has paid.

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

There will inevitably be other factors and indicators that Ofgem will need to consider in interpreting particular circumstance. While operating within a defined framework for determining whether the fees are excessive or not relative to bids of similar generation units, the Guidance needs to clearly allow sufficient flexibility, so that both Ofgem and the licensee can best present their understanding of the particular situation.

Appendix 1

Recommended modifications to Paragraph 3 of the Licence Condition

3. The circumstances referred to in paragraph 2(b) are as follows:

a. Circumstance 1 is that:

(i) the licensee, **or an affiliate or associated company of the licensee**, creates or exacerbates **an Applicable Transmission Constraint through its scheduling and despatch actions** in circumstances when it had more economic options available to it; and

(ii) under the Relevant Arrangements, either:

a. the licensee, **or an affiliate or associated company of the licensee**, is paid, or seeks to be paid, an excessive amount by the system operator in connection with an increase in electricity generation by the **licensee's Generation Units that have been identified by the system operator as part of the Applicable Transmission Constraint** during the Transmission Constraint Period; or

b. the licensee, **or an affiliate or associated company of the licensee**, is paid, or seeks to be paid, an excessive amount by the system operator, or the licensee, **or an affiliate or associated company of the licensee**, pays, or seeks to pay, an excessively low amount to the system operator, in connection with a reduction in electricity generation **by the licensee's generation units that have been identified by the system operator as part of the Applicable Transmission Constraint** during the Transmission Constraint Period;

b. Circumstance 2 is that, under the Relevant Arrangements and in connection with a reduction in electricity generation **by the licensee's Generation Units identified by the system operator as part of the Applicable Transmission Constraint** in the Transmission Constraint Period, either:

i. the licensee, **or an affiliate or associated company of the licensee**, pays, or seeks to pay, the system operator an excessively low amount, or

ii. the licensee, **or an affiliate or associated company of the licensee**, is paid, or seeks to be paid, an excessive amount by the system operator;

c. Circumstance 3 is that, under the Relevant Arrangements, the licensee, **or an affiliate or associated company of the licensee**, is to be paid an excessive amount by the system operator in connection with the licensee preparing for the possible cessation of generation of electricity by **the licensee's Generation Units identified by the system operator as part of the Applicable Transmission Constraint** in a Transmission Constraint Period.