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Dear Lesley,

Response to Ofgem's letter of 26 January 2010 outlining current thinking and further consultation on competition issues regarding CAP170 Category 5 System to Generator Operational Intertripping Scheme

Thank you for the opportunity to respond to your letter of 26 January 2010 outlining your current thinking and further consultation on competition issues regarding CAP170 ("the second further consultation letter"). This response is submitted on behalf of ScottishPower Energy Management Ltd, ScottishPower Generation Ltd and ScottishPower Renewable Energy Ltd. This response should be read in conjunction with and supplements the previous submissions made by ScottishPower¹.

Our response is structured as follows:

- 1 Executive Summary
- 2 Response to Further Consultation
- 3 Legal Annex
- 4 Economic Annex
- 5 Confidential Annex

1. Executive Summary

ScottishPower considers that the proposed amendment will not better meet the Applicable CUSC Objectives and is not compliant with Ofgem's wider statutory duties (including those under European law) and therefore should not be implemented because (in addition to the points made in our previous submissions):

- **Ofgem's analysis and approach as revealed in the second further consultation letter is fundamentally flawed – not least because:**

¹ response to National Grid's consultation on CAP170 dated 13 March 2009;
response to Ofgem's impact assessment dated 2 July 2009;
procedural letter to Stuart Cook dated 17 August 2009;
response to Ofgem's further consultation on CAP170 dated 25 August 2009;
Engineering report on CAP170 dated 8 September 2009;
letter re CAP170 and Frontier Economics report for Ofgem on Connect & Manage dated 17 November 2009;
procedural letter to Stuart Cook dated 12 February 2010.

- **Ofgem has failed to adequately demonstrate a lack of competition in the provision of balancing services, including intertripping services: this applies both to the Cheviot boundary and to the likely further derogated boundaries.**
- **The 'competition analysis' set out in Appendix 1 to the further consultation letter omits any analysis or discussion of the history and evolution of the competitive market for balancing services behind the Cheviot boundary, e.g., as to the development and introduction of new products and services, or as to the nature and extent of new entry.**
- **Ofgem's 'competition analysis' entirely overlooks the wider history and development of the competitive market for balancing services within Great Britain, notwithstanding the fact that CAP170 is designed to apply to intertrip provision behind all derogated non-compliant boundaries and not merely the Cheviot boundary.**
- **It contains no evidence or analysis demonstrating the relative inefficiency of a market based solution to the provision of intertrip services behind the existing Cheviot boundary as compared with, e.g., that proposed under CAP170.**
- **The engineering issues raised in our response to the Impact Assessment and the major impact they have on the proper remuneration for the service have not been addressed.**
- **Given that each of the above areas are important matters on which consultees such as ScottishPower are likely to wish to express a view, Ofgem's failure to identify and analyse them seriously undermines the transparency of the second further consultation exercise.**
- **Approval of this amendment would be contrary to the Government's latest proposals in the Energy Bill for ex-post supervision of a competitive market for balancing services, including intertrip, through a Market Power Licence Condition.**
- **Ofgem has not adequately analysed, investigated or consulted on the issues which are relevant to assessing the efficiency of implementing CAP170 (including those raised by consultees) and there is no basis for concluding that implementation of CAP170 would better facilitate the CUSC efficiency objective.**
- **Approval of the amendment would not be proportionate and Ofgem has not adequately considered proportionality issues.**

We add that in the light of these points, and the points we have made previously, a decision to implement the proposed amendment would further be wrong in law because:

- there is no proper factual or evidential basis for a decision to implement CAP170;
- no adequate impact assessment has been carried out and published as required by section 5A of the Utilities Act;
- the consultation is and remains substantially defective – material issues have not been adequately identified or explained to consultees and consultees have not been provided with adequate information or adequate time to respond;
- the decision process, including the impact assessment and the consultation, has not been conducted with adequate transparency and accountability as required by section

3A(5A) of the Electricity Act and any decision to implement CAP170 would be contrary to the better regulation principles.

2. Consultation Response

We set out below our further representations on the second further consultation letter. These are expressed in high-level terms in this section and are expanded upon in the annexes.

Process

We refer to our letter of 12 February 2010 which highlights a number of significant procedural concerns with the second further consultation letter including:

- The selective nature of the current consultation
- The shortness of time for responses
- The fragmented approach to the consultation
- The insistence on the urgency process
- Gaps in the Ofgem analysis

and would once again call for Ofgem to abandon the present, flawed process, reject CAP170 and allow CUSC Parties to reconsider matters afresh.

Shifting Rationale for CAP170

CAP170 was raised by National Grid as an urgent proposal to deal with the short-term, time-limited issue of forecast constraint costs. Constraint costs have out-turned significantly below National Grid's forecast levels in large part due to the development of a competitive market for constraint management services and this rationale is no longer sufficient to justify the changes proposed.

The second further consultation letter, however, indicates that in the absence of this rationale a surrogate justification is now being sought on the issue of mitigation of apparent market power.

Lack of Rigour in Impact Analysis

Ofgem has failed to demonstrate the relevance of the inclusion of Figure 1 in the second further consultation letter which shows Accepted BM offers during periods of import constraint into Scotland in 2007. Ofgem acknowledges in the same letter at 1.10 that currently intertrip contracts can only be used to resolve export constraints and since this was also the situation in 2007 import constraint periods have no relevance in relation to CAP170.

As detailed in our Confidential Annex, the presentation of data in Table 2 of the second further consultation letter does not accurately reflect the full range of intertrip contracts struck in the period 2009/10 and this has resulted in inappropriate conclusions being drawn out in paragraphs 1.20 and 1.21.

The second further consultation letter does not address changing competitive conditions in the market for balancing services. Our experience shows increasing competitive pressures and strong downward pressure on prices, as well as incentives to develop products that better meet National Grid's needs for efficient services. (see Confidential Annex)

Urgency

We continue to believe that the consultation process which has been adopted for CAP170 has been inadequate to allow proper industry engagement and consideration of the significant issues contained in this proposal. In particular, the need for urgent treatment of this proposal can no longer be justified as it is acknowledged by Ofgem that "circumstances have changed since our urgency decision was made". Recognising this, the current process should be stopped

and re-started, if necessary, under a timescale which would allow proper consideration of the issue.

Longevity

CAP170 was originally proposed by National Grid in response to Ofgem's letter of 16 February 2009 which made reference to the Transmission Access reforms expected to be in place by April 2010 which "may help to mitigate the level of constraint costs". Industry participants therefore had a reasonable expectation that CAP170 would be a short-term, time-limited measure which would be allowed to expire on the introduction of the new Transmission Access arrangements (now anticipated in June 2010). This is reflected in Ofgem's statement that "CAP170 was originally intended to be a short-term measure".

However, the second further consultation letter indicates that Ofgem now sees CAP170 as a measure to address concerns about apparent market power and no longer a short-term measure. Thus the fundamental nature and purpose of the proposal has changed during the consultation/impact assessment process and industry participants are no longer considering the same proposal made by National Grid on 27 February 2009.

Remuneration

We wrote to Ofgem on 8 September 2009 highlighting serious engineering concerns with the implementation of mandatory intertripping services. The letter emphasised that CAP170 and its associated remuneration scheme did not adequately address the differing risks to plant of varying age and condition. While Ofgem acknowledges that "there may be a case for a different price to apply to CAP170" there is no detailed consideration of what that price should be.

It would not be acceptable to introduce a proposal containing a flawed remuneration mechanism in the expectation that CUSC Parties "could raise a new proposal to address this issue". The content and timing of introduction of such a "new proposal" would be extremely uncertain and leave parties exposed to the flawed remuneration mechanism.

Failure to adequately define the relevant market

Ofgem acknowledges that it has not carried out a detailed market definition exercise for the purposes of CAP170 nor has it conducted in depth analysis to conclude whether intertrip services constitute a distinct product market of their own. Without such analysis it is not possible to conclude that intertrip services constitute a separate market from the other options available to National Grid to manage transmission constraints.

The Economic and Confidential Annexes attached show why intertrip services cannot be considered to be a separate market and the degree of substitution we have experienced to date across the range of constraint management services available to National Grid.

Failure to adequately evaluate effective competition

Ofgem has failed to evaluate the level of competition that has developed to date in the provision by Scottish generators of services, including intertrip, to National Grid allowing them to manage transmission constraints. It has merely attributed to National Grid a view of the extent to which competition has influenced price (which was not stated in their documents) and has not provided any evidence to the market to justify a view that the reduction in intertrip prices in 2009/10 is primarily due to the regulatory attention that has been focused on the constraint costs issue.

The role of regulation and ex-ante vs. ex-post intervention

It is accepted regulatory best practice that any new regulation should be the minimum necessary to address adequately the market concern that has been identified. In relation to

conduct based instruments best practice requires ex-post measures such as a Market Power Licence Condition to be considered before ex-ante measures such as price regulation. The Government's latest proposals include a Market Power Licence Condition in the Energy Bill currently going through Parliament and thus it is against regulatory best practice to introduce CAP170 before the effectiveness of the Government's proposals can be assessed.

Previous points

We would reiterate the headline points we have made previously about CAP170:

- The case for replacement of a competitive market mechanism with an administered scheme has not been made.
- Unilateral replacement of existing commercial arrangements increases regulatory risk and will deter future investment.
- The proposed amendment discriminates against Scottish generators and in particular those which have an existing intertrip facility.
- The proposal will weaken market signals for greater infrastructure investment.
- The proposed payment mechanism does not reflect the economic value of the service provided by intertripping.
- The effects of the proposal would include inefficiency, undermining and distorting competition in the GB wholesale market and undue discrimination in that market.

Annexes

We enclose with this letter a number of further annexes to be considered along with our consultation response.

Annex 1 – Legal

ScottishPower would be entitled, with the permission of the Competition Commission, to appeal under s.173 of the Energy Act 2004 against a decision by the Authority to approve the modification of the CUSC proposed by CAP170. In that context, we have set out a number of submissions in Annex 1 addressing the legal points arising from the second further consultation letter which supplements our previous submissions listed above.

Annex 2 - Economic

We enclose an expert report which we have commissioned from Oxera in connection with the CAP170 proposal. The report addresses issues in relation to defining the relevant market, evaluating effective competition and best regulatory practice in relation to deciding between ex-post and ex-ante regulatory instruments.

Annex 3 (Confidential) – Market Development

This Annex sets out our experience of the level of competition in the provision of balancing services, including intertrip, during periods of constraints and the degree of substitution we have experienced across the range of services available to National Grid.

I hope you find these comments useful. Should you have any queries on the points raised, please feel free to contact us.

Yours faithfully,

James Anderson
Commercial and Regulation Manager