

Dear Graham

The Penalty Notice issued on 6 June 2023 in respect of SSE's compliance with the TCLC invited written representations. While I do not wish to comment on the individual merits of the SSE investigation, I do have some concerns about Ofgem's conclusion in the Penalty Notice that the bid pricing methodology which SSE used for Foyers, which priced bids at a similar level to competitor plants, "by its nature created an intrinsic risk of breaching the TCLC".

In particular, the statement made a paragraph 3.5 that "by linking its prices for Foyers to those of selected other generators...without regard to the costs and benefits it itself incurred when being bid down, SSE's policy failed to put any controls on the level of benefit it would obtain on bids in transmission constrain periods. This approach by its nature created an intrinsic risk of breaching the TCLC".

The Balancing Mechanism (BM) is a pay-as-bid market, which by its nature creates an incentive for plants to price their bids at the highest price they think will be accepted by reference to the prices of other BMUs, with the aim of being at the same level as the anticipated marginal bid. This is rational behaviour in a competitive pay-as-bid market, such as the BM.

A key problem with the TCLC is that a generator cannot know when it submits its bid whether that bid will, if accepted, be accepted for energy purposes, to manage a transmission constraint, or for other system management reasons. A genco therefore has no way of knowing whether its bid or that of a competitor will be subject to TCLC and, if it is, whether that bid would be considered by Ofgem to have resulted in an "excessive benefit".

Given the lack of foreseeability of application of the TCLC (something I have long argued needs to be addressed) and the design of the BM, it seems entirely reasonable (and rational) for a generator to price its bids competitively in most circumstances, i.e. to set its prices with reference to competitor bids which it expects will be accepted by the ESO rather than always pricing bids to reflect the costs and benefits of its own asset being bid down. I have no idea whether the benchmarks used by SSE were appropriate. However, an economist would expect any bid which has been accepted from another plant to logically be a reasonable comparator for a generator to set its own bid prices regardless of the presence of a transmission constraint as the accepted bid reveals an expected price that NGENSO should be willing to pay to reduce output. Were Ofgem to require the TOs to notify constraints to the market in real time, as requested since TCLC came in, then it would be reasonable to expect gencos to alter their behaviour in response. In the absence of constraint information the genco can only act based on what the information they do have, i.e. what prices are being accepted.

This competitor benchmarking is explicitly included within the TCLC guidance, which indicates that Ofgem will look at a range of factors to determine whether an excessive benefit has been obtained. This includes comparable generator benchmarks for pricing, specifically 'accepted bids behind an export constraint should be compared with those charged by comparable generators on the other side of a constraint'. However, the inference from Ofgem's penalty notice is that a generator can only ensure compliance with the TCLC if it prices its bids purely by reference to its own costs and benefits of being bid down, rather than with reference to its competitors. This would make the TCLC a blanket restriction on bid pricing in the BM rather than a control on market power in specific circumstances. As such it would interfere with the efficient operation of the market. The reason the Competition Commission rejected Ofgem's proposed "Good Behaviour" licence condition in 2000 was for this very reason, it would stop normal market behaviour and create inefficient market distortions.

Further, the penalty notice appears to be requiring the genco to place controls on the overall level of benefit it obtains during transmission constraint periods. I am not clear how any policy could control the overall benefit a generator may receive when it cannot know the volume of bids it will receive during a transmission constraint period. The only way a generator could be sure of not breaching the TCLC under such circumstances would be to set its bid prices such that it only ever covered its costs of being bid down with no margin.

This would be counter to the TCLC as it would place the generator behind a transmission constraint at a disadvantage to generators the other side of that constraint. Ofgem would seem to be seeking to place controls on the overall profit achieved, rather than the price charged, which is not in line with the TCLC or the TCLC Guidance and has not been subject to either proper consultation or an Impact Assessment.

Ofgem's approach to bid pricing and compliance with TCLC undermines competition in the BM and increases risk to gencos who can find themselves unwittingly subject to TCLC.

Competitive markets, like the BM, are designed to promote best outcomes for consumers.

An approach to regulatory enforcement which requires market participants to price by reference to their costs and benefits rather than competitively creates the risk of a worse outcome for consumers, as well as undermining investor confidence in markets.

I would therefore ask Ofgem to reconsider what it is asking of gencos and whether it needs a clearer definition of "excess benefit". Importantly, and with rising constraints, Ofgem should also consider whether the market needs far more transparency around constraints. Economic theory is very clear that the greater the market knowledge the more competitive a market is and the better the outcome for customers.

Happy to discuss.

Best wishes

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