TEESSIDE POWER LIMITED

Response to Consultation Questions in "Zonal transmission losses – the Authority's 'minded-to' decisions": 26 June 2007

Chapter 2. Responses to the impact assessment

Question 1: Do respondents consider that we have appropriately summarised the key themes of the responses to Ofgem's impact assessment on zonal losses?

There are two "themes" on which we wish to comment.

I. Oxera analysis and modelling

Under this heading, you have included the "perceived inadequacy of Ofgem's assessment of the hedging proposals". We strongly believe that it is inappropriate to include the consequences of the hedging proposals under this heading.

The analysis undertaken by Oxera is intended to assess the impact of the introduction of locational charges for transmission losses. The impact as far as the analysis is concerned would be expected to be no different for, for example, P203 and P200 Alternate. When making decisions on generation or on consumption, participants in the market will be exposed to the same marginal losses charges under the two schemes.

The failure to recognise this important feature of P200 and P200 Alternate demonstrates a deficiency in the understanding of the schemes by Ofgem. We highlight below further examples of this deficiency which arise in the analysis which supports the "minded to" decision.

II. Impact on Risk

The "minded to" document states that "there was a range of views on the impact of zonal losses on risk". We consider that this statement is misleading. The "range of views" phrase suggests that this is a very open question. In fact, the views were more polarised than suggested.

We provide further comments on the subject of regulatory risk in the response below.

Question 2: Are there any other themes which respondents consider should have been highlighted?

We consider that you have failed to address two important points which we made in our response to the impact assessment:

I. Incentive for generation to locate closer to demand

In our response to the impact assessment, we highlighted the fact that there is an underlying assumption in the Ofgem impact assessment that the introduction of locational charging arrangements for losses would be expected to encourage new build generation to locate closer to areas of significant demand. We noted that this assumption is not supported by the evidence. We referred in our response to the NGC Seven Year Statement. Figures 7.3 and 7.4 in the 2007 Seven Year Statement serve to demonstrate the point. They show that currently and, according to the NGC forecast for 2013/2014, the Upper North zone of England and Wales has and will continue to have a net deficiency of generation compared with the level of demand. Despite this deficiency, each of the proposed schemes, being based on the same load flow modelling output, would discourage new build generation from siting in the Upper North zone.

The "minded to" consultation document makes no reference to this clear inconsistency as between the NGC analysis and the locational signals which are introduced by a zonal losses charging scheme. The failure to address this point is a clear deficiency in the reasoning undertaken by the Authority in reaching its decision.

II. Use of Selective Information

Again, in our response to the impact assessment we highlighted the deficiency in the report by Skyplex which did not recognise the decisions which had been taken by government prior to the introduction of the liberalised electricity market in England and Wales. We consider that the decision taken by the UK government in 1989 to remove effectively locational charges for losses was a far stronger signal to the market participants that such a charging arrangement was not a desired feature of the new electricity market.

The "minded to" consultation document continues to refer to the Skyplex report without any reference to the point. We can only conclude that Ofgem is unable to sustain any sound argument against the point and in favour of its position.

Chapter 3. Additional analysis

Question 1: Do respondents consider that the additional analysis we have provided addresses the concerns expressed by respondents to the impact assessment regarding analytical gaps in the impact assessment?

There are three matters on which we consider that the additional analysis has not addressed the concerns expressed by respondents.

I. The costs of re-despatch

We can find no evidence that the concern raised on the absence in the Oxera analysis of the additional cost of running generating units which were out of merit but which, as a result of the introduction of zonal charges for losses, become in merit has been addressed. This additional cost will serve to reduce the claimed net benefit for the scheme. As far as we can determine, whilst this point was raised in the responses to the impact assessment, there is no mention as to why further analysis has not been undertaken.

II. Risk and cost of capital

Additionally, we do not consider that the consideration of risk and cost of capital adequately addresses the concerns raised by us and by other parties. We draw your attention to the work undertaken by the UK Energy Research Centre on "the role of costs, incentives and risks in investment in electricity generation", undertaken in support of the development of government policy on current energy policy matters. This point is covered in more detail in the attached report by NERA.

III. **Hedging**

On the basis of the comments in paragraph 3.34, we consider that Ofgem has not fully understood the implications of the hedging scheme as proposed in P200 and P200 Alternate. There is no justification given, nor are we aware of one, for the statement that:

"***with the allocation of losses being determined based on historic volumes from a single historical year, over time the F-factor volumes are likely to become less reflective of parties positions, and thus lead to less accurate signals, and ultimately to less efficient decision making on the part of industry participants***"

We note that no evidence is provided for the statement that F-factor volumes are likely to become less reflective of parties positions. Furthermore, there is no justification for the subsequent statement that this will lead to less accurate signals and less-efficient decision making. The P200 and P200 Alternate proposals are designed such that the signals remain the same as those which are given by the equivalent schemes without hedging. Furthermore, because the hedging arrangements are designed to mitigate against the windfall gains and losses which will inevitable arise from all the other proposals under consideration, P200 and P200 Alternate will, in fact, result in more efficient decision making than would be case for the equivalent scheme without hedging. The Ofgem assessment on this fundamental point is incorrect and undermines the preference for P203 over P200 Alternate.

As a further more general comment, we consider that the document highlights the claimed benefits for the preferred scheme, without giving due consideration to the extent to which such benefits can be quantified and also, readily dismisses any costs and disbenefits associated with the scheme. As an example, we refer you to paragraph 3.16 where it states that "there is also planned to be significant offshore wind generation in the south and also CHP". The inclusion of CHP growth is clearly inconsistent with Tables 2 and 3 which show no new CHP build in the south in the period for which the claim is made.

Question 2: Do respondents consider that there are any remaining aspects of the modification proposals that require to be addressed analytically?

The costs and benefits attributable to the respective schemes are generally, in the context of the life of a power station, short term in nature. They are also small in the context of the annualised cost for a new build generating unit. In the light of this, we consider that there is potential for decisions on either closure or new build to be taken which are subsequently demonstrated to have been inefficient as a result of subsequent changes in the zonal loss charges as a result of further closure and new build.

Given the significance of new build costs, we consider that further analysis on the longer term implications of the introduction of the scheme should be undertaken, given the scope for the financial consequences of inefficient investments decisions swamping any benefits as claimed for the schemes.

Question 3: Do respondents have any additional analysis in relation to the impact of the modification proposals that they wish to bring to the attention of the Authority?

As Ofgem is aware, TPL and other respondents have consistently expressed concerns that the analysis by Ofgem particularly fails to recognise limitations in the cost benefit analysis undertaken by Oxera and equally importantly, the impact of the introduction of zonal losses and the consequent substantial financial transfers between market participants on the cost of capital. These concerns have been consistently dismissed by Ofgem. As a result, TPL has commissioned NERA to produce an independent economics report in relation to these aspects, and a copy of this is attached. You will note that the report also deals with other matters related to the zonal losses proposals.

Stage one–Assessment against applicable BSC objectives

Question 1: Do respondents consider that the modification proposals have been appropriately assessed against the applicable BSC objectives?

We do not agree with the assessment on applicable BSC objective (a) relating to discrimination and P200 and P200 Alternate. The references to discrimination and NGT's electricity transmission licence are not appropriate to the introduction of zonal charges for transmission losses as is clear from the text of paragraph 4.3. Furthermore, whilst there are general statements regarding discrimination in paragraphs 4.4, 4.5 and 4.6 we find no basis for the conclusion reached in paragraph 4.7. There is no substantive case for the view expressed that P200 and P200 Alternate would not better facilitate applicable BSC objective (a).

As regards applicable BSC objective (b) and the analysis presented on the "**Accuracy of locational signals and associated efficiency benefits**" we refer the Authority to section above headed "Hedging". We note that throughout the analysis presented on this objective, the same deficiencies are evident in the understanding of the way in which the hedging scheme is designed to operate. As an example, we note that in paragraph 4.12, it states that fixing the allocation of losses based on historic volumes is likely to lead to inaccuracies in signals and thus ultimately to inefficiency for the market as a whole. In fact, the inaccuracies in the signals are no different from those of the equivalent scheme without hedging, and furthermore, the efficiency of the market as a whole is expected to be increased as a result of the hedging scheme than it would be otherwise.

As regards applicable BSC objective (c) and "**stability and predictability and risk implications**" we refer the Authority to the section above headed "risk and cost of capital". The preferred scheme identified in the "minded to" statement, P203, if implemented, involves windfall gains and losses which are an order of magnitude greater than the benefits claimed. Such windfall gains and losses are not "in accordance with a sound regulatory process against clear objectives and duties". These objectives and duties can be met without the windfall gains and losses for existing market participants through the hedging arrangements, as proposed for P200 and P200 Alternate.

Finally, on this item, we note the comments in paragraph 4.46: "In the longer term, the introduction of location loss charging arrangements would be expected to inform decision making that may lead to the promotion of market entry at sites closer to centres of demand. As we have explained above, based on the evidence from NGC, the obverse is the case as far as the Upper North zone of England and Wales is concerned.

As regards applicable BSC objective (d) and "**complexity of design solutions**" whilst we accept that P200 and P200 Alternate are more complex than the other proposals, we dispute the claim made by the Authority that this additional complexity will create a barrier to effective competition. New entrants to the market will not be subject to the F-Factor scheme and hence will not be exposed to the additional complexity.

Question 2: Do respondents consider that there are any aspects of the modification proposals that have not been adequately assessed in relation to the applicable BSC objectives?

We consider that the Authority has not demonstrated that it has adequately considered the longer term implications for overall market efficiency under applicable BSC objective 9b).

Chapter 5. Stage two−Assessment against applicable BSC objectives when those are considered collectively

Question 1: Do respondents consider that the Authority has appropriately assessed the modification proposals against the applicable BSC objectives when considered collectively?

We do not agree with the Authority's views that P198, P198 Alternative, P203 and P204 better facilitate the achievement of the applicable BSC objectives overall, compared with the existing provisions of the BSC.

Whilst we agree with the Authority's views that P200 and P200 Alternative do not better facilitate the achievement of the applicable BSC objectives overall, compared with the existing provisions of the BSC, we nevertheless consider that P200 and P200 Alternate better meet the applicable BSC objectives compared with all the other proposals.

Question 2: Do respondents consider that there are any aspects of the modification proposals that have not been adequately assessed in relation to the applicable BSC objectives when considered collectively?

As stated above we do not consider that the effects a zonal losses scheme will have on the longer term market efficiency have been adequately assessed.

Chapter 6. Stage three–Assessment against Authority's legal duties

Question 1: Do respondents consider that the Authority has appropriately assessed the modification proposals against its duties?

We do not consider that the Authority has appropriately assessed the modification proposals against its duties. The Authority has reached conclusions based on speculation and analysis which is inconsistent with the current electricity market in England and Wales.

We note that the Authority has:

a) adopted a central estimate for the cost of carbon which is significantly greater than current market value for carbon of circa £47/tC;
b) persisted in assuming that there will be fuel switching between coal and gas and used this to derive the environmental benefit for the P203 proposal. Currently, the losses differential would not be sufficient to trigger any fuel switching: it may simply result in generation switching from one gas fired generating unit to another, less efficient, gas fired unit at the margin. In these circumstances, a reduction in CO_2 emissions will depend upon the relative efficiencies of the two plants: a reduction is not guaranteed and an increase may well result. We conclude that there is no sound basis for Ofgem to claim any environmental benefits from hypothetical fuel switching as a result of the introduction of zonal loss charges;
c) erroneously assumed that the proposed hedging scheme will reduce the strength of the signals to some parties: this is not correct for the reasons given above;
d) speculated that there is significant potential for CHP in southern GB: in fact, as shown in tables 2 and 3 on page 17 of the document, despite the benefits for CHP available currently, there are no further CHP schemes currently envisaged in the NGET Seven Year Statement; and
e) Re-iterated its view that P200 and P200 Alternate in relation to discrimination: we reject this view for the reasons set out above.

We do not agree that modification proposals P203 and P198 are more likely to secure a diverse and viable long-term energy supply than the other proposals or the status quo.

Question 2: Do respondents consider that there are any aspects on the modification proposals that have not been adequately assessed in relation to the Authority's duties?

We do not consider that the impact of the substantial windfall gains and losses for generators from each of the proposals has been adequately assessed in relation to the Authority's duties. We note that subject to the retail market being sufficiently competitive, there are no windfall gains or losses for suppliers as all suppliers would be expected to eventually pass through the appropriate increase or decrease to customers in each respective GSP group.

Chapter 7. Stage four–Assessment against the principal objective

Question 1: Do respondents have any comments on any of the issues set out in this chapter?

For market participants, the most significant impact of the introduction of the proposals, other than those which include a hedging scheme, is either a windfall gain or a windfall loss. We do not consider that such substantial gains and losses are in the best interest of consumers. We consider that the lower financial impact achieved by P200 and P200

Alternate, whilst preserving the full benefit from any changes to marginal despatch decisions better protects consumer interests.

Conclusions and way forward

Question 1: Do respondents wish to raise any specific issues regarding the Authority's minded to position?

We note that in the document which sets out the minded to position, in a number of areas, the Authority appear to have neglected to give due consideration to P200 and to P200 Alternate in its analysis. Specifically, we note that in paragraph 3.23 where the Authority highlights the benefits from changes in despatch, there is no reference to P200 and P200 Alternate, whilst the other proposals are all identified. This is one example: we note that reference to consideration of P200 and P200 Alternate is absent in a number of sections of the report.

Question 2: Do respondents have any views on both the process and timetable that are proposed for the Authority making its final decisions on the modification proposals and for publishing those decisions?

We refer the Authority to our comments under Question 1. above.

Keith Miller
31 July 2007