

Addressing Market Power Concerns in the Electricity Wholesale Sector – Initial Policy Proposals – response of E.ON UK plc (E.ON)

Ofgem’s consultation on Initial Policy Proposals on Market Power Concerns in the Wholesale Sector (“the Consultation”) raises issues of great significance for many market participants, which require their considered attention. Given the materiality of the issue, we would request that Ofgem ensures that the consultation process allows sufficient time for effective engagement of all affected stakeholders going forward¹.

Executive Summary

In summary

- The Consultation sets out a problem that Ofgem has perceived in relation to structural transmission constraints – specifically in relation to the Scottish Interconnector and the unique situation within Great Britain that has arisen with the introduction of BETTA: if Ofgem has uncovered abusive behaviour arising from these constraints which cannot be remedied by competition law powers, then it is appropriate that other solutions should be investigated.
- However, E.ON does not believe that a case has been made, or any evidence presented, which would support the introduction of a broadly-applying Market Power Licence Condition (“MPLC”). In fact, given the structural changes that have occurred over the past 8 years, the case for a broad MPLC is even less well founded now than it was at the time of the MALC Competition Commission hearing in 2000. A broad condition would conflict with Better Regulation Principles and the Authority’s own duties and would be positively unhelpful and counter-productive in light of the sheer scale of investment in new, and in certain cases unproven, generation technologies that is required over the next decade.
- On balance, E.ON’s view is that, if Ofgem wishes to address the issue of structural transmission constraints, this problem is likely to be best addressed through a licence modification, which is targeted on the structural problem created by BETTA, and the changes to market arrangements currently being introduced. It is essential that any solution adopted does not deter normal commercial activity.
- In this response E.ON outlines a specific proposal which we believe will deal effectively with the issue of structural constraints whilst minimising the negative impacts on normal commercial behaviour.
- E.ON also addresses Ofgem’s specific questions.

¹ The present consultation allowed a bare 6 weeks.

Introduction

1. This document sets out;
 - The background to the present concerns and how in E.ON's opinion these issues might be best addressed (Section 1).
 - E.ON's views on the difficulty of distinguishing between acceptable and abusive conduct using the indicators proposed by Ofgem (Section 2).
 - E.ON's concerns over a broad based Market Power Licence Condition (Section 3).
 - E.ON's suggested approach for a narrow Licence Condition, which we believe addresses the concerns identified (Section 4).
 - Suggested complementary proposals for modifications to market arrangements / asset divestment (Section 5).
 - Other relevant policy developments (Section 6).
 - E.ON's answers to Ofgem's specific questions (Section 7).

Section 1: Current Market Power Concerns

2. Ofgem highlights its concern that the GB wholesale electricity sector is "vulnerable to undue exploitation of market power, both when there are constraints within the system... and more generally at times of system tightness." It seems to believe that this vulnerability has increased in recent years and is likely to increase further due to a variety of factors.
3. In light of these concerns and its view that Competition Act legislation is insufficient to deal with these issues, Ofgem highlights three options as being credible to deal with the concerns; a licence condition, price capping and some form of asset divestment. Ofgem goes on to state that its current preferred option would be a licence condition possibly combined with changes to market arrangements and that it is "currently minded to seek to address market power concerns through the introduction of a new licence with guidance.....which is broad and applicable to all generators."
4. The consultation paper sets out the context for the current market power concerns and the analysis is conducted purely in terms of Scottish transmission constraints. E.ON believes that the structural problem identified by Ofgem with bringing the former Scotland-England Interconnector (the Scottish Interconnector) within a single GB market was the inevitable result of the decisions taken on implementing BETTA. At that time, it was recognised that there were

risks and costs associated with the structural constraints, but it was felt, in light of NGET's forecasts, that these risks / costs were worth paying to secure the benefits of a single GB market.

5. However, constraint costs arising from "Scottish Actions" show a significant increase (up from ~£65m pa since BETTA implementation to ~£210m in 2008/9 with similar predicted for 2009/10). Whilst these costs also include "intra-Scotland" constraint costs, they predominately reflect the impact of the structural transmission constraint on the Scottish Interconnector. Clearly, this situation will only be resolved with adequate investment in transmission. However given the timescales involved, if Ofgem perceives that this is a real problem now, then we would agree that it is necessary to develop appropriate 'interim' measures to address the problems associated with structural constraints. However, interim measures must not mask the true costs that such constraints impose on consumers.
6. E.ON considers that there are two distinct forms of transmission constraint, temporary and structural. Temporary transmission constraints cover normal transmission system operational events, such as outages on the system or action to maintain voltages. The issue of managing these costs has been largely addressed by established, or currently being developed, solutions. As a consequence, the effects of such constraints, and therefore any concerns, should now be less than in the past.
7. Structural transmission constraints arise where the role of the transmission system has fundamentally changed from that for which it was designed. In Great Britain this situation arises in relation to the interconnector and the supporting transmission lines that formed the boundary between the former England and Wales market and the former Scottish market, i.e. the Scottish Interconnector. Here, the interconnector between two independent trading markets became part of the integrated transmission system that supports a combined single market. As a result, the Scottish Interconnector's role has changed from conveying capped levels of power flows between independent markets to providing the infrastructure for unrestricted power flows within a single market. This creates a dislocation between the capabilities of the transmission system and the needs of the single market.
8. This issue was recognised, but not fully addressed, when BETTA was introduced. Similar problems would be expected at the French Interconnector, if the French and GB markets combined, or across the Moyle Interconnector, if the All Ireland and Great Britain markets combined.
9. In the case of the Scottish Interconnector, the problems associated with the dislocation between transmission capacity and market requirements are increasing. This is due in part to the investment in renewable wind technology, which is increasing the surplus of generation relative to local demand on the Scottish side of the

Scottish Interconnector. The surplus of power that generators wish to move from the former Scottish market to the former England and Wales market increasingly exceeds the capability of the Scottish Interconnector. This increases inefficiencies, which are materialised in higher constraint costs. As mentioned above, there are other constraint issues within Scotland, but these are not of the same order of magnitude as those relating to the Scottish Interconnector. It is for this reason that E.ON's proposal to deal with Ofgem's 'current market power concerns' (see Section 4) concentrates on structural transmission constraints.

10. However, before we outline our proposal, we wish to address our deep concerns with Ofgem's proposal for a broad licence condition (Section 3) and the difficulties of distinguishing acceptable from abusive behaviour (Section 2 below).

Section 2: Distinguishing between acceptable and abusive conduct

11. Ofgem considers that price spikes, which occur at times of shortage, can be a necessary and efficient market response that provides important signals for generation investment. We would agree. However Ofgem highlights concerns about price spikes that could arise as a result of undue exploitation of market power. It suggests that such situations may include when the price spikes;

- Differ unduly between times in which market demand and costs are similar, and/or
- Are due to non-economic despatch decisions (when considered over the long term and that cannot be explained by legitimate technical non-availability), which could only be profitable to the generator if they possess market power.

12. Examples given by Ofgem of non-economic despatch decisions are when plant is not dispatched despite significantly positive spreads (profit opportunities) in the market, or when plant is dispatched despite significantly negative spreads in the market, and in each case there is no short term or long term cost justification for such decisions. Ofgem requests consultees' views on the distinction drawn between legitimate and abusive price spikes.

13. It is worth dwelling on this issue as similar concerns were central to the Competition Commission's determination on the original 'MALC' Licence Condition. The Commission concluded that the 'uncertainty caused by the difficulty in distinguishing between abusive and acceptable conduct would deter normal commercial behaviour' and, primarily for this reason, rejected the MALC. The question therefore arises whether the description of 'abusive price spikes' set out in the consultation paper is sufficient to remove the concerns identified in relation to the original MALC and would enable a distinction to be drawn between legitimate and abusive commercial behaviour.

14. The original MALC proposals defined substantial market power as “the ability to bring about, independently of any changes in market demand or cost conditions, a substantial change in wholesale electricity prices”. The MALC Guidelines went on to illustrate in some detail what was meant by a substantial change in market prices². The first bullet above is very similar to the formulation used for MALC except that it is focused on price spikes (which are undefined³), rather than ‘substantial changes in market prices’. Concerns about distinguishing between legitimate and abusive price spikes similarly apply and it is worth noting that such concerns were not removed by the provision of guidance on MALC.
15. The second bullet above relating to non-economic dispatch decisions is, however, new and warrants further consideration. Ofgem highlights that abusive price spikes could arise as a result of non economic dispatch decisions (over the longer term), which cannot be explained by technical non availability, that could only be profitable if the generator possessed market power. The inference is that, where generation units have positive spreads and are not dispatched, this can only be a sign of abusive behaviour (the undue exploitation of market power). In E.ON’s view, this is not correct. There are numerous situations (as described below) where foregoing positive spreads would be legitimate and economically rational, so much so as to seriously undermine the usefulness of this as an ‘indicator’ for distinguishing between abusive and acceptable conduct.
16. In general, each generator will determine how and when it should sell its generation output across the various channels available to it, in order to optimize the value of its generation (or trading) portfolio. This assessment will be made in light of a wide range of constraints (e.g. environmental, operational, legal and regulatory, internal risk policies, market liquidity and so forth). If it foregoes positive spreads arising in the forward markets, this may be in the expectation of more profitable opportunities arising at a later date (e.g. in the prompt markets). Likewise, positive spreads in the spot markets may be foregone if the generator perceives more profitable opportunities arising in the Balancing Mechanism. The generator is taking a higher risk, which may result in no reward, or may result in a higher reward.
17. The generator is in effect ‘arbitraging’ between certain or known opportunities available today for uncertain but potentially more profitable opportunities tomorrow, i.e. the uncertain knowledge that it may or may not be called on to generate by NGET in the Balancing Mechanism. This is not abusive behaviour but a rational response to the commercial drivers embedded in the trading arrangements. Such ‘arbitraging’ activity has been apparent since NETA Go-Live,

² See The Prevention of Wholesale Market Abuse: Guidelines for Generators (January 2000 P5)

³ For example it is unclear whether Ofgem is referring to price spikes in wholesale prices or cash out prices. Constraint costs may not necessarily impact wholesale market prices.

and, moreover, is the mechanism by which the Balancing Mechanism is linked to the spot and forwards markets.

18. Generators also assess the risks of being exposed to cash out prices and seek to mitigate this risk through their trading strategies. This assessment will naturally vary by firm reflecting their individual circumstances, such as the structure/shape of its trading portfolio, the firm's perception of its inherent imbalance risk and its own risk appetite. Nevertheless, many generators will seek to manage these risks by carrying reserve capacity, and by doing so forego positive spreads in order to avoid potentially more punitive imbalance changes. Again this is a commercially rational response to the commercial drivers embedded in the trading arrangements and has been standard practice since the introduction of NETA.
19. Increasingly, environmental legislation has had an important impact on the operation of generation plant. It may be entirely rational for LCPD constrained plant to forego profitable generation opportunities today in the expectation of more profitable generation at some future date, given its constrained running hours. It is also worth highlighting the strong disincentive for dispatching single units within multiple unit stations given the station-based nature of the LCPD limits (which works to increase the opportunity costs of running single generation units in the Balancing Mechanism).
20. Similarly, Sulphur B Limits seek to constrain generation across a calendar year. Whilst firms are naturally incentivised to explore all opportunities to lessen this constraint including, as E.ON has done, through trading Sulphur B Limits, there may be times when Sulphur B Limits constrain generation. In such situations firms may consider it more profitable to forego less profitable opportunities early in the year, if this enables generation at more profitable times later in the year. These non-exhaustive examples serve to illustrate that, given constrained running hours, foregoing positive spreads cannot be assumed to be the exploitation of market power but merely an economically rational response to environmental drivers.
21. Hydro plant faces a similar optimization problem when determining when to generate given reservoir levels, forecast precipitation and current and forecast market conditions. Potentially profitable generation opportunities may be foregone today in light of forecast more profitable opportunities at a later date, given constrained water resources. Coal plant may face fuel logistical constraints or limitations on their number of starts, which can give rise to similar optimization problems. There are a range of technical, operational, environmental, legal or contractual factors which are individual to each plant in question and which are not necessarily reflected in external cost or technical availability parameters.
22. To summarise: the two 'indicators' of undue exploitation of market power (price discrimination and non-economic dispatch) do not sufficiently distinguish between acceptable and non acceptable

commercial behaviour. The first indicator is substantially unchanged from MALC and as a result suffers for the same concerns. The second indicator clearly includes legitimate actions, which undermines its usefulness as an indicator of abusive behaviour.

Section 3: A Broad Market Power Licence Condition

23. Ofgem appears to favour a wider licence condition, principally, it appears, because a narrow licence condition would risk excluding potentially exploitative behaviour. Whilst acknowledging that a wider licence condition would create increased uncertainty for generators, Ofgem argues that this can be managed by issuing industry guidance, establishing an appeals mechanism and imposing a compulsory review date for the licence condition; all of which it should be noted were proposed during the discussions on MALC.
24. Whilst it is not appropriate or necessary to rehearse the MALC arguments again here, it is worth noting the following key points. The Competition Commission rejected MALC after a lengthy and thorough review. The Commission's principal concern was the inability for market participants to distinguish between abusive and acceptable commercial behaviour, which it felt would deter normal commercial behaviour. The OFT (in its evidence commenting on the proposed MALC) was concerned that MALC would lead to uncertainty for industry, risked inconsistency in enforcement and considered MALC should only be introduced if it was essential. Finally, the Commission felt that market manipulation concerns were best dealt with via rule changes, rather than a broad effects-based licence condition such as MALC.
25. The Competition Commission revisited its decision on MALC in early 2008 and it is worth setting out their conclusions in some detail as they were categorical in relation to the UK market experience:

*“the experience of the UK market in the years following the CC inquiry seems broadly to support the view that the MALC was unnecessary for the foreseeable future in 2001. Market concentration continued to fall, making strategic abuse of market power less likely. NETA resulted in significantly reduced scope for manipulation of market rules (and NETA's governance arrangements allowed for more flexible regulatory responses to any manipulation that did occur). Prices collapsed. The DTI decided not to pursue its licence modifications (which were more limited in scope and time than MALC). Academic commentators seemed to agree that an important threshold was crossed some time in the late 1990s, beyond which the likelihood of significant market power arising fell away considerably. The introduction of NETA reinforced this trend and Great Britain is generally believed to have had a reasonably competitive generation sector in recent years. **There does not seem to be a compelling case that MALC in operation during***

2001 to 2007, would have prevented any significant abuse of market power in electricity generation.”⁴ (emphasis added)

26. The Competition Commission went on to state: ***“On balance the market developments over the last seven years do not seem to provide support for the case in favour of MALC during that time, and provide some support against it.”*** (emphasis added)
27. In E.ON's view, a major weakness with a broad based market power licence condition is that it squarely contradicts BERR's Better Regulation Principles. Like MALC it would not be proportionate or targeted on the concerns that have been identified. BERR contends that Regulators should be proportionate in their actions and *“should only intervene when necessary. Remedies should be appropriate to the risk posed and costs identified and minimized”....Policy solutions must be proportionate to the perceived problem or risk and justify the compliance costs imposed – don't use a sledgehammer to crack a nut*. BERR goes on to state that Regulation should be *“focused on the problem and minimize side effects”* and that *“enforcers should focus primarily on those whose activities give rise to the most serious risks.”*
28. All of this is highly relevant to the discussion of a broader market power licence condition. It is particularly so in light of section 3A(5A) of the Electricity Act 1989, which incorporates the Better Regulation Principles into the Authority's statutory duties. The Authority must ensure that in carrying out its functions that any such action is, inter alia, both proportionate and targeted.
29. In E.ON's view, no case is made out by Ofgem for a broad Market Power Licence Condition. It would not be proportionate to the problems identified in the Consultation Paper and does not focus on the most serious risks. Ofgem has not demonstrated evidence of wider market power concerns that warrant such a broad based extension of regulatory powers. The consultation paper is striking for the lack of evidence on any issues other than in relation to structural transmission constraints. The analysis of 'current market power concerns in the GB market', for example, is conducted solely in relation to the Scottish constraints.
30. Similarly, the Competition Commission's review of market behaviour since the MALC case noted that few examples of abuse had occurred since 2001 and those that had occurred appeared to as a result of “deficient market rules” rather than the exercise of undue market power. This suggests that market rule changes, rather than a broad based market power prohibition, would be a more appropriate solution to these “isolated problems”. A broader licence condition would not be proportionate or targeted - moreover it creates uncertainty which would deter normal commercial activity. This is

⁴ Evaluation of the Competition Commission's past cases para 4.75 [Jan 2008]

particularly relevant at a time when the industry needs to invest tens of billions of pounds in new generation technologies.

31. It is interesting to reflect upon Ofgem's comments when determining on Modification P194⁵ in early 2006, as Ofgem itself appears to be broadly in agreement with the above view. At that time Ofgem argued that peak prices were insufficient to reward investment in peaking plant and that the sharper cash out signals arising out of implementing Mod P194 would have a positive effect on security of supply. Ofgem explicitly considered the ability for gaming as a result to the move to more marginal cash out prices and concluded "we do not think that the risk and potential costs outweigh the benefits of the proposal". So, rather than there being concerns that generators were exploiting market power at times of system tightness and raising peak prices excessively, on the contrary, Ofgem's view was that peak prices were too low to reward new entry and, by implication, abuse of market power at times of system tightness was not of particular concern at that time. Similarly, if there was any increased risk of manipulation with the movement to more marginal cash out prices, this risk was small enough to be outweighed by the benefits of the sharper cash out signals⁶.
32. The main support for a broad based licence condition seems to come out of the extreme circumstances of the California Crisis in 2000/1. This resulted in severe blackouts and, in the Competition Commission's words, seemed to justify 'heavy handed intervention'. The Commission highlighted the lack of consensus on US regulatory developments following the Californian Crisis and noted: "In particular the provision of MALC-like powers for the FERC in the EAct of 2005 is controversial."⁷
33. In response to the Californian Crisis the former DGES highlighted that the Californian experience was not the inevitable result of liberalisation. He added: "There is not much therefore that is obviously wrong with the way in which the British energy market operates. Those who search for market failures to correct have some difficulty in identifying what they are. They have even more difficulty in demonstrating that there is an administrative solution which will improve matters."⁸ The same could equally be said to apply to a broad Market Power Licence Condition.
34. To summarise, Ofgem presents no evidence that a broader market power licence condition is necessary or appropriate for the circumstances for the GB market. On the contrary there is much evidence to suggest that the GB market is much more competitive than it was at the time of the proposed MALC and, aside from the

⁵ Note P194 was subsequently modified by the implementation of P205

⁶ Subsequent further modifications to the BSC have or are expected to dampen peak cash-out prices countering the sharper cash-out signals arising from P194. The latest change P217A will tag-out all 'suspect' system actions including all constraint actions.

⁷ Evaluation of the Competition Commission's past cases para 4.80 [Jan2008]

⁸ Ofgem Press R/76 (10th Oct 01)

current structural constraints issue, there is no history of abuse of market power since NETA. Most commentators consider the GB market to be one of the most competitive in Europe. A broad based market power licence condition would be in breach of Better Regulation Principles, which the Authority has an obligation to observe, and there are more appropriate targeted solutions available to tackle structural transmission constraints.

Section 4: Proposed Licence Condition

35. In light of Ofgem's concerns, here E.ON outlines a specific proposal for Ofgem's consideration, which we believe will mitigate the detriments identified with a broad based licence condition but will effectively tackle the concerns identified.
36. The structural problem with transmission constraints on the Scottish Interconnector is well known. We believe, however, that the problems that have arisen in relation to constraint costs are an inevitable consequence of the unique and exceptional circumstances surrounding the implementation of BETTA and the decisions taken in relation to the market arrangements. At that time it was recognised that there would be risks and costs associated with constraints across the interconnector but, in light of NGET's forecasts, it was felt that these risks / costs were worth incurring to secure the benefits of BETTA. Clearly there has been a step change in these constraint costs when compared to those experienced (and presumably envisaged) at the time of BETTA. It is therefore appropriate to consider whether the commercial arrangements continue to be appropriate. If, as Ofgem claims, these constraints have been 'unduly exploited' and Ofgem is unable to address this under its competition powers, then there could be a case for a narrow licence condition, designed specifically to address such "Structural Transmission Constraints" and it is logical that Ofgem would wish to consider it.
37. We believe, however, that care must be taken to ensure that the proposed licence condition does not hinder normal commercial behaviour or mask the fundamental costs of the constraint and so should be restricted only to plant affected by Structural Transmission Constraints. Our proposal, should Ofgem be convinced that action is necessary, would be to apply a "no better no worse" principle to plant constrained off/down by Structural Transmission Constraints, in order to make the generator financially indifferent to the Structural Transmission Constraint (i.e. make no additional profit by being constrained off/down than if it had run).⁹ Consideration could be given to the timeframe for applying the "no better no worse" principle to take into account practicalities (e.g. whether to apply it

⁹ NB conditions are sufficiently competitive for plant that are correspondingly constrained on (or up) not to warrant controls on BM Offer Prices. Any extension of regulation to BM Offer Prices would in E.ON's view be highly damaging and disproportionate.

on each occasion that a generation unit is constrained down/off or perhaps over longer a time period, for example a year).

38. Structural Transmission Constraints would be defined in relation to boundaries that were associated with a former interconnector and are not *and have never been* GBSQSS Compliant. To be deemed a Structural Transmission Constraint, Transmission Owners (and GBSO if appropriate) must have been granted a derogation from the GBSQSS by Ofgem. The derogation must be time-limited, with a remedial plan in place to make the boundary compliant. Also, the derogation would define and describe the affected boundary in terms of the affected circuits. In effect, Structural Transmission Constraints would be explicitly recognised as a technical distortion on the market through the derogation from GBSQSS standards and its former role as an interconnector between previously separate markets.
39. This targeted Licence Condition would be a Standard Licence Condition but only have implications for all Large Generators (as defined by the Grid Code), which are not Exemptable (as defined by CUSC). The Licence Condition would be tied to the GBSQSS Derogation and hence be time-limited and fall away as the work is completed to remove the GBSQSS Derogation.
40. The Licence Condition would provide a mechanism for ex-post enforcement should there be concerns that constraints are being exploited beyond the “no better no worse principle”. It also avoids a prescriptive ex ante-solution which, as Ofgem has highlighted, which is likely to be too costly and take too long to implement. Careful consideration should be given to developing an independent appeals mechanism which can assess the substance of differing views on relevant costs and revenues. Determinations by the Appeals Body on such matters should be binding.
41. There must not be incentives on the GBSO in relation to derogations from Security Standards. Ofgem must ensure that NGET does not seek derogations from Security Standards in order to avoid responsibility for managing constraint costs. It is important that the GBSO is exposed to constraints costs, even when there is a derogation, in order that it is incentivised to manage and control these costs on behalf of customers. Derogations from GBSQSS Standards should be seen as exceptional and our proposal seeks to address this by tying the definition of Structural Transmissions Constraints to *former market interconnections* boundaries *that have never been GBSQSS compliant*.
42. Such a Licence Condition does not eliminate the costs of the structural transmission constraint; it is only to stop abuse. It does, however, provide a solution that keeps the cost of the structural constraint transparent and in so doing promotes economic long term solutions.

43. To summarise, in response to the specific problems identified with the Scottish Interconnector, E.ON proposes that Ofgem considers a narrow targeted Licence Condition that would:

- apply a mechanism to defined Structural Transmission Constraints only – defined in relation to derogation from GBSQSS Security Standards and be related to former market Interconnectors;
- apply a “no better no worse principle” for constrained off plant sitting behind a Structural Transmission Constraints ;
- be a Standard Licence Condition, which should apply to all Licensed Large Generators;
- would be linked to the derogation from SQSS security standards for that former interconnector and would expire along with the derogation;
- provide an independent appeals mechanism that binds both parties; and
- limit defined Structural Transmission Constraints to constraints associated with former interconnectors between former separate markets that are subject to the derogation from SQSS security standards.

44. We believe that this is a proportionate targeted approach that, when coupled with the changes to market arrangements proposed by NGET, provides a comprehensive and coherent policy response to the issues identified. In particular, this approach would be unencumbered with the disadvantages associated with a broader licence condition, as outlined in detail in the previous section.

45. E.ON's proposal also has many advantages over a prescriptive ex-ante approach, which would require significant costs and time to implement what is in effect an interim solution until transmission investment removes the GBSQSS derogation. Furthermore an ex-ante approach suffers from moving commercial activity in to a largely regulated sphere. On occasions, ex-ante pricing decisions would be taken out of the hands of the firms and replaced with some form of administered price cap based upon costs or average bids and offers in the BM. The firm effectively becomes a passive participant in BM, restricted in its ability to vary prices in response to its individual circumstances, changing costs or market dynamics. Under E.ON's proposal, however, the firm would retain control over its pricing decisions, but be required to price plant constrained off/down due to structural constraints, according to clear principles.

46. Finally, it is worth reflecting on concerns that a narrow licence condition would potentially risk excluding exploitative behaviour. Clearly E.ON's proposal does not seek to address all transmission

constraints as it, deliberately, does not apply to transient constraints or constrained on plant. The risks associated with transient constraints and constrained on plant are significantly lower than for structural constraints and, in our view, the costs associated with 'regulating' such constraints would be so high as to effectively transform the nature of the BM into a centrally regulated mechanism, which in turn would feed through to the wholesale traded markets. Instead, our proposal takes a proportionate approach and addresses the main risks associated with structural constraints whilst avoiding most of the costs associated with damping competitive market signals/activity.

Section 5: Market Arrangement Changes / Asset Divestment

Market Arrangement Changes

- 47.E.ON believes that the incentives on the TOs and SOs need to be aligned to ensure that the TOs give appropriate consideration to the effect of their actions on constraints. We believe that the TOs should be made to make outage plans available to the SO and be penalised for late changes to these when they cause additional constraint costs on the system. Consideration should be given to including more prescriptive timelines for information exchange in the STC. We believe that a meaningful proportion of identified costs associated with the constraints should be charged to the TOs to incentivise them to reduce volume of constraints, with the pass through of full constraint costs caused by outage movements after initial notification of outage plans to the SO. This, we believe, will provide appropriate drivers to manage constraints and goes some way to mitigating concerns over integrated transmission and generation business models.
- 48.E.ON is broadly supportive of the locational BSUoS proposals recently put forward by National Grid. These proposals will ensure that locational costs (i.e. balancing costs arising from structural constraints) that are likely to persist to a significant degree even after the implementation of a targeted licence condition, will be paid by those generators that collectively contribute¹⁰ to the structural constraint.
49. Cost reflective targeting of these locational balancing costs will help ensure that generators sitting behind a structural constraint make more efficient pricing decisions from the point of view of the GB system as a whole. This is because such constrained-off plant will face a greater, and fairer, share of the balancing costs that arise from their pricing decisions rather than socialising these costs across all GB users.

¹⁰ This arises from the granting of unimpeded access rights to the GB wholesale market despite the continued existence of the Structural Transmission Constraint.

Asset Divestment

50. In E.ON's view, this is a dis-proportionate response to the identified problems, is likely to be costly and time-consuming to pursue. For these reasons we do not favour this approach and believe it should only be considered once all other alternative approaches have been exhausted.

Section 6: Other relevant policy developments

51. Ofgem cites other policy developments such as the EU Market Abuse framework for wholesale gas and power markets, in support of its proposals. In E.ON's view, these developments weaken, not strengthen, the case for a broad licence condition. The regulatory space for wholesale energy firms is becoming increasingly crowded with firms subject to competition legislation, financial services legislation (FSMA and in certain cases Markets in Financial Instruments Directive – MiFID), increased transparency requirements arising out of the EU Sector Enquiry and proposals for a specific Market Abuse framework for wholesale power and gas. Increasing regulatory burdens will inevitably present more of a challenge (or a barrier to entry) for smaller firms. In this context the case for a broad based Market Power Licence Condition is particularly unwelcome. It increases the potential for regulatory overlap and confusion of responsibilities between regulators and regulatees.

Section 7 : Ofgem's Questions

CHAPTER: One

Question 1: Do you agree with our analysis of market power concerns in the GB wholesale electricity sector?

E.ON agrees with Ofgem's suggestions that there is likely to be a problem in relation to the former Scotland England Interconnector. As a structural transmission system constraint, this former interconnector's role has changed from conveying capped levels of power flows between independent markets to providing the infrastructure for unrestricted power flows within a single market. This has created a dislocation between the capabilities of the transmission system and the needs of the combined market.

This problem is likely to be best addressed through a combination of licence modification and the current changes being made to market arrangements. Any new changes need to be targeted on the problem created by structural transmission system constraints. Care, however, must be given to ensuring that any proposed solution does not deter normal commercial activity.

E.ON does not believe that a case has been made, or any evidence presented, which would support the introduction of a wider MALC-type licence condition. Given the structural changes that have occurred over the past 8 years, the case for a wider Market Power Licence Condition is even less well founded now than at the

time of the Competition Commission hearing. Such a licence condition conflicts with Better Regulation Principles and is positively unhelpful given the sheer scale of investment in new, and in certain cases unproven, generation technologies required over the next decade.

Question 2: To what extent should further policy intervention be progressed or are there alternative approaches that can be adopted for dealing with the concerns?

Temporary transmission constraints (events such as outages on the system or action to maintain voltages) are largely being addressed by established solutions, or solutions currently being developed. As a consequence, the effects of such constraints, and therefore any concerns, should now be less going forward than in the past. Further policy intervention, in relation to temporary transmission constraints, is unlikely to deliver a proportional benefit to consumers.

The nature of the structural transmission system constraint relating to the former Scotland England Interconnector and its associated structural transmission constraints, suggests further policy intervention may be warranted. Any policy intervention needs to be proportional and focused, which in this case means focusing on hastening removal of this structural transmission system constraint and, while the structural transmission system constraint remains, focusing on keeping the resultant costs transparent and to a minimum.

CHAPTER: Two

Question 1: To what extent do you think that changes to SO and TO incentives and/or changes to other market arrangements are likely to be effective in addressing the concerns discussed in Chapter 1?

The combination of the changes to SO and TO incentives and other planned changes to other market arrangements will help to address the concerns raised in relation to temporary transmission constraints. They will also, while not removing the fundamental problem, help address the effect of structural transmission constraints.

Question 2: Are there any other changes to existing market arrangements that Ofgem should consider?

Rather than looking to address the issue through a broad brush approach of changes to existing market arrangements, Ofgem should focus on tackling the problem, namely the costs associated with structural transmission constraints, i.e. the constraints associated with the former Scotland England Interconnector. By focusing on the structural transmission constraint, Ofgem will be better placed to ensure any solution minimises side-effects and that no unintended consequences result from the measures.

CHAPTER: Three

Question 1: To what extent do you think increased transmission investment is a feasible option and likely to be effective in addressing the problem?

The consequences of a structural transmission constraint can only be resolved effectively by investment that delivers a combined transmission system capable of meeting its users' requirements. It is essential that the right investment

incentives are set to achieve an economic grid enhancement around the former Scotland England Interconnector.

For the former Scotland England Interconnector it is recognised that, given the increases in generation capacity in Scotland, it may be in the longer-term before the combined transmission system does not have constraints on power flows north to south. Nevertheless, there must be a clear focus on removing this dislocation between the wholesale market and transmission system limits.

Question 2: To what extent do you think that the other asset related options discussed are likely to be effective in addressing the problem?

Asset related options are a disproportionate response to the identified problems. They are also likely to be costly and time-consuming to pursue. For these reasons we do not favour this approach and believe it should only be considered once all other alternative approaches have been exhausted.

Question 3: Are there other asset-related remedies that Ofgem should consider?

As stated above, asset related remedies are a disproportionate response to the identified problems. They are also likely to be costly and time-consuming to pursue. For these reasons we do not favour this approach and believe it should only be considered once all other alternative approaches have been exhausted.

CHAPTER: Four

Question 1: Is a licence condition on generators appropriate? If so, do you have views on what form of condition is the most appropriate?

It is important that any change to licences is appropriate for the perceived problem or risk. To minimise any side-effects and ensure that no unintended consequences will result from any licence modification it is important that the modification is focused purely on the actual problem.

In response to the specific problems identified with the former Scotland England Interconnector, EON proposes that Ofgem considers a narrow targeted Standard Licence Condition that, in summary, would;

- o apply a mechanism to defined Structural Transmission Constraints only – defined in relation to derogation from GBSQSS Security Standards and be related to former market Interconnectors;
- o apply a “no better no worse principle” for constrained off plant sitting behind a Structural Transmission Constraints ;
- o be a Standard Licence Condition, which should apply to all Licensed Large Generators;
- o would be linked to the derogation from SQSS security standards for that former interconnector and would expire along with the derogation;
- o provide an independent appeals mechanism that binds both parties; and

- o limit defined Structural Transmission Constraints to constraints associated with former interconnectors between former separate markets that are subject to the derogation from SQSS security standards.

This would provide a proportionate targeted approach to the fundamental issue identified. The approach would also be unencumbered with the disadvantages associated with a broader licence condition.

A licence modification that gave “Ofgem sufficient powers to address market power concerns which may arise on a forward looking basis” would clearly fail to focus on issues where there is already a view that they operate, or may be expected to operate, against the public interest and thus would not be acceptable.

Question 2: How important would a formal appeals mechanism be?

Careful consideration should be given to developing an independent appeals mechanism, which could assess the substance of differing views on relevant costs and revenues. Determinations by the Appeals Body on such matters should be binding. The enforcement regime should also seek to distinguish between genuinely held differing views on methodology from blatant exploitation of constraints, which could be covered in guidelines.

Question 3: Is an ex-ante price framework an effective tool? If so, do you have any views on what would be the most appropriate form?

We agree with Ofgem that a prescriptive ex ante-solution is likely to be too costly and take too long to implement.

Question 4: Are there other specific mechanisms that will effectively address the issues identified?

Ofgem should consider a narrow targeted Standard Licence Condition as proposed in our answer to Chapter Four’s Question 1.

CHAPTER: Five

Question 1: Do you have any views on the preferred mechanism for implementation?

Where possible the implementation of changes considered should be by using established industry procedures.

E.ON agrees with Ofgem that any licence modification should be through the collective licence modification route. To ensure that less than 20% of generators elect to veto any proposed change, Ofgem needs to work with the generators to ensure that any proposed licence modification will receive generators’ agreement. Key for E.ON’s agreement would be a licence modification proposal that was proportionate to the scale of Ofgem’s concern, was clearly focused on the issue of structural transmission constraints and was unlikely to have significant side-effects or unintended consequences. Ofgem’s current proposals for a broader condition do not meet these criteria.

CHAPTER: Six

No question