

Government Response to the consultation on the Transmission Constraint Licence Condition (TCLC)

16 July 2012

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Annexes

Annex 1 - Finalised Licence Condition

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Related Documents

Final Impact Assessment of the TCLC

Available online at:

http://www.decc.gov.uk/en/content/cms/consultations/trans_const/trans_const.aspx

Executive Summary

Background

The Transmission Constraint Licence Condition (TCLC) seeks to prevent electricity generators from obtaining an excessive benefit at the expense of consumers during periods of electricity transmission constraint. During such periods, there is insufficient network capacity to transmit electricity from the location where it is generated to the location where the demand exists. The TCLC would be introduced through an enabling power given to the Secretary of State under the Energy Act 2010 to modify electricity generation licences in order to prevent generators from exploiting periods of transmission constraint.

DECC consulted from 8 December 2011 to 1 March 2012 on a proposed licence condition which would target three particular behaviours by generators:

- Circumstance 1 would prevent generators making uneconomic dispatch decisions that create or exacerbate a transmission constraint.
- Circumstance 2 would prevent generators obtaining an excessive benefit from bids they make to reduce their output during periods of export constraint¹.
- Circumstance 3 would prevent generators obtaining an excessive benefit by charging an excessive amount for the arming of commercial inter-trips².

Ofgem will be responsible for the interpretation and enforcement of the TCLC, and it consulted in parallel on draft guidance to accompany the licence condition.

This Response Document sets out the Government's conclusions and decisions following consideration of responses to our consultation.

Overview of consultation responses

Most respondents recognised the need for the TCLC, but considered that modifications were needed to ensure it functioned effectively and any unintended consequences were avoided.

Amongst other things, respondents felt that more detail should be provided on the operation of the TCLC in order to allow market participants to judge with greater certainty whether particular actions would be breaching the licence condition. There was also concern at the proposal to include commercial inter-trips within the scope of the TCLC, as it was argued that a competitive market for inter-trips had developed since the passing of the Energy Act 2010.

¹ An export constraint occurs when total generation in an area exceeds the total demand plus transmission capacity to export the excess electricity. An import constraint occurs when there is insufficient transmission capacity to import the required amount of electricity to meet net demand in an area.

² An inter-trip is a device installed on electricity generating plants that allows them to be automatically tripped (i.e. disconnected) from the transmission network under certain conditions, such as a transmission line becoming overloaded following a fault. This allows the relevant transmission lines to be run at a higher capacity loading than would otherwise be possible. Plants installed with inter-trips must be 'armed' in order for the inter-trip to be available for use. The charge for this is known as an 'arming fee'.

Overview of the Government's conclusions and decisions

The Government believes that the TCLC should be implemented in order to reduce unnecessary and significant constraint costs to consumers over the medium term until upgrades to the system can take effect³. The analysis within the Impact Assessment has been updated, and shows that the TCLC could save consumers between £115m and £300m over five years.

The TCLC will focus on two types of behaviour:

- preventing generators making uneconomic dispatch decisions that create or exacerbate a transmission constraint (circumstance 1);
- preventing generators obtaining an excessive benefit from bids they make to reduce their output during periods of export constraint (circumstance 2).

We have decided that it would not be appropriate to include commercial inter-trips (circumstance 3) within the scope of the TCLC at this time given that we believe a more competitive market for inter-trips has recently developed. However, we will keep this decision under review on the basis of observed behaviour following the introduction of the TCLC.

Ofgem will be updating its accompanying guidance in light of results from its parallel consultation process and will include more detail on the types of behaviour which would constitute a breach of the licence condition (behaviours noted under circumstances 1 and 2). This should provide greater certainty to generators.

Next steps

The updated version of the licence condition at Annex 1 has now been laid in draft before Parliament, and our expectation is that it will come into force on 29 October 2012.

Ofgem intends to publish an updated version of its accompanying guidance document on the date that the TCLC comes into force.

The licence condition is due to expire on 15 July 2017, with the option to extend it for two years (subject to consultation) following review.

³ Details of planned network upgrades are set out in the Business Plans prepared by the three Transmission Owners (National Grid, Scottish Power Transmission Ltd and Scottish Hydro Electric Transmission Ltd) as part of the next transmission price control (RIIO-T1). These are available from: <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/Pages/RIIO-T1.aspx>

Section 1 - Introduction

Background

The GB electricity transmission system has a finite capacity to transmit electricity between any two locations, and has not been designed in order to meet every possible supply and demand scenario. If flows on the system are too high, parts of the network can overload leading to system insecurity. Where the capacity of the network between two locations is insufficient to transmit electricity from where it is produced to where the demand for it is situated, that is termed a 'transmission constraint'.

Constraints can occur anywhere on the transmission system. While currently the major constraints are within Scotland and across the boundary between Scotland and England, we expect constraint issues could arise elsewhere as the electricity system develops over the coming years.

In its role as System Operator, National Grid has the responsibility for overseeing and managing the flow of electricity across the whole of the GB transmission network, including the elements owned and operated by the Scottish transmission network owners. Consequently, it is National Grid's responsibility to ensure that the network is balanced either side of any constraint, in order to maintain the stability of the system.

In order to do this, National Grid uses the Balancing Mechanism, which operates by generators submitting monetary 'offers' to increase or 'bids' to decrease the amount of electricity they produce from a particular plant. Other commercial tools to help balance the system are also available to National Grid and can include previously arranged bilateral deals, such as inter-trip contracts.

The costs that National Grid incurs from managing constraints on the network are charged to generators and suppliers in proportion to their share of the market across Great Britain (via Balancing Services Use of System, or 'BSUoS', charges) and are ultimately paid by all consumers. These charges are known as 'constraint costs', and were £324m in 2011/12.

Rationale for intervention

When a transmission constraint occurs the options available to National Grid to balance the system can be very limited if there are only a small number of generators on one side of the constraint who can be called upon to modify their output. This can provide the opportunity to generators to benefit more than they otherwise would have if the constraint had not been created or exacerbated, as National Grid will be forced to take action with a particular generator to balance the system. The costs of over-charging are ultimately paid by all consumers. In addition, a generator located in a constrained region may have the ability to exacerbate or create a constraint by notifying National Grid that it intends to dispatch its plant in ways that would not normally be economic. A generator is then able to gain an excessive benefit by having a bid or offer accepted in the Balancing Mechanism, when this would not have been the case had there not been a constraint.

Ofgem estimated that the costs of such actions to consumers could be as much as £125m in 2008/09⁴.

The specific characteristics and complexities of the energy market make it difficult, in many circumstances, to tackle such behaviour under existing competition law.

Section 18 of the Energy Act 2010 introduced an enabling power for the Secretary of State for Energy and Climate Change to modify the standard conditions of electricity generation licences in order to prevent generators from exploiting periods of transmission constraint. The licence condition provided for in the Energy Act 2010 would not displace the application of competition law where appropriate, but would be complementary to it and targeted at this particular harm. Accordingly, the Government does not intend the scope of the TCLC to be interpreted by reference to competition law and, in particular, the assessment of whether or not there has been a breach of the TCLC should be undertaken with reference to the framework of the TCLC and should not apply automatically the analytical framework for establishing excessive pricing under competition law. For the avoidance of doubt, it is the Government's view that whether the licensee is paid or seeks to be paid an excessive amount or whether the licensee pays or seeks to pay an excessively low amount (for the purposes of circumstances 1 and 2) shall be determined by reference to whether the licensee has obtained an excessive benefit which is the overarching test in paragraph 1 of the TCLC.

The new licence condition has been named the Transmission Constraint Licence Condition as its proposed application is limited to arrangements which relate to periods of transmission constraints.

Upgrades currently planned and being constructed for the transmission network will increase the capacity for electricity to flow between regions, reducing the frequency of transmission constraints and therefore the occasions when National Grid has limited options to balance the system. However, while these upgrades are taking place the frequency of periods when transmission is constrained is likely to increase as transmission routes are taken offline for these works to be carried out. This strengthens the case for implementing the licence condition to protect consumers while the transmission network is being upgraded from the unnecessarily high costs that can result from exploitative behaviour in providing system balancing services.

Consultation process

On 8 December 2011, DECC launched a three month consultation on the design of the proposed TCLC. Ofgem would be responsible for the interpretation and enforcement of TCLC, and it launched a parallel consultation on draft guidance setting out its intended approach to these aspects.

DECC's consultation proposed three circumstances that would be prohibited by TCLC:

- circumstance 1 would prevent generators from making uneconomic dispatch decisions that create or exacerbate a transmission constraint. Where such an uneconomic dispatch creates or exacerbates a constraint, the generator is then able to obtain an excessive benefit by having a bid or offer accepted in the Balancing Mechanism, when this would not have been the case had there not been a constraint;

⁴ Ofgem (2009) "Addressing Market Power Concerns in the Electricity Wholesale Sector - Initial Policy Proposals"

- circumstance 2 would prevent generators obtaining excessive benefits from bids they make to reduce their output during periods of export constraint. The objective of this circumstance would not be to discourage generators from submitting bids into the Balancing Mechanism or to prevent them making reasonable profits, but to ensure that generators would not derive unreasonable benefits when National Grid has limited constraint management options available to it;
- circumstance 3 would prevent generators from obtaining an excessive benefit by charging an excessive amount for the arming of commercial inter-trips. The suitability of generating plants for the installation of inter-trips can be limited by a range of technical, commercial and geographic considerations, resulting in areas where only a few generators are able to offer inter-trip services. This can allow generators to charge higher prices for inter-trip arming fees than they would be able to do when in competition with other generators to provide this service.

The consultation did not propose to address a circumstance in which excessive offers were accepted during an import constraint period, where a generator had not created or exacerbated a constraint. The rationale for this was that opportunities arising from the acceptance of large offers in the Balancing Mechanism could provide important investment signals for new generation in import-constrained areas, potentially leading to ongoing reductions in constraint costs associated with import constraints. Hence the removal of this signal might be problematic. In contrast, further generation investment in export-constrained areas would tend to exacerbate constraint costs.

In accordance with the provisions of the Energy Act 2010, the consultation noted that the proposed licence condition would expire after five years, with the potential to extend it by two years (subject to consultation) following review.

The framework for appeals to the TCLC was already set out in primary legislation. Details were therefore included in the consultation document for information only.

Responses to the DECC consultation

A list of the bodies responding to the DECC consultation is at Annex 2. In total, 17 responses were received, primarily from generating companies covering a range of fuel types. Three responses were received from representative bodies, with other respondents including National Grid and the Renewable Energy Foundation.

Respondents provided a range of detailed comments on the different circumstances proposed in the consultation document. These have helped inform the Government's decision on the way forward, as have discussions with Ofgem.

A summary of the main points raised by respondents is given in sections 2-6 of this document, together with the Government's response to points raised.

Section 2 – Circumstance 1

The first circumstance would seek to prevent the creation or exacerbation of transmission constraints by generators making uneconomic dispatch decisions.

Consultation Question 1

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| 1. | Does the prohibition set out under circumstance 1 of the licence condition adequately address the problem of generators profiting from actions in the Balancing Mechanism as a result of their exacerbation or creation of transmission constraints? |
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Summary of responses to consultation question

There was some support for the general aims of circumstance 1, but most respondents considered that it needed modification in order to function effectively and to avoid unintended consequences.

Most suggestions for amendments related to issues of transparency and clarity, on the basis that market participants would need more information to judge whether or not they would be considered to be acting in breach of the licence condition:

- there was a suggestion that the conditions and circumstances in which any generators would be acting in breach of circumstance 1 should be more explicitly outlined. Some felt that the licence condition should refer to some kind of predefined ‘trigger’ to signal when Ofgem would initiate an investigation, or include a ‘materiality threshold’ as guidance on what would be considered ‘excessive’;
- it was suggested that generators should receive adequate warning about the existence of specific transmission constraints, and that more information should be given in the accompanying guidance on what Ofgem would consider ‘more economic options’.

Several detailed drafting changes were also proposed for this aspect of the licence condition. Of particular note, two respondents proposed that the licence condition should be extended to cover an affiliate or associated company of the licensee. The purpose of this would be to avoid possible discrimination against those generation licensees which kept all activities within the licensed company, rather than holding some generation under a separate licence and therefore avoiding aspects of circumstance 1.

Finally, several respondents considered that there was no justification for the inclusion of circumstance 1 within the licence condition, at least at this time. It was noted that there were other routes to address the types of market abuse outlined under circumstance 1, including existing competition law and the Regulation on Energy Market Integrity and Transparency (REMIT)⁵. Others felt that it was reasonable that generators should be able to realise the benefits of having flexible portfolios by holding back generation to potentially benefit in the Balancing Mechanism.

⁵ Regulation (EU) No. 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency.

Government response

Transparency and clarity

The licence condition is intended to make the balancing market fairer for all its participants by preventing inappropriate market behaviour while continuing to allow legitimate actions by generators. We have sought to ensure that the licence condition's design does not introduce uncertainty into the electricity market that could undermine investment or impact negatively on market behaviour.

Importantly, the Energy Act 2010 provides for Ofgem to publish guidance on its intended approach to the interpretation and enforcement of the licence condition.

As noted earlier in this Government Response, Ofgem consulted in parallel to DECC on a draft of its guidance, and will be publishing a final version when the TCLC comes into force. Ofgem's guidance will provide further information on a number of aspects, including how it would determine whether generation has been dispatched or withheld when more economic options were available to the licensee. This will improve the transparency and clarity for generators on how the licence condition will be enforced.

We do not believe it would be appropriate to set a pre-defined trigger for formal investigations by Ofgem. Each case needs to be judged on its own merits, and there is a risk that such an approach may not be sufficiently flexible to deal with all instances of inappropriate market behaviour that could arise. It would also raise practical questions such as how the trigger would be set.

We do not believe that National Grid should be required to notify constraints in advance in order for generators to judge whether they would be acting in breach of the licence condition. It is our understanding that generators do receive information regarding factors that influence transmission constraints from a number of sources including:

- outage information via Grid Code Operating Code 2 – this provides for the exchange of outage information between generators and network operators. Under these provisions, generators receive information, across a variety of timescales, regarding those aspects of the transmission outage plan that affect them operationally. This includes where output may be (or need to be) restricted;
- information relating to transmission system zones – the Balancing Mechanism Reporting System (BMRS) presents information relating to five geographical zones on the network, including generation levels, demand levels and generation margins. A planned update to the BMRS will increase the number of zones to 17 to align with those in National Grid's Seven Year Statement;
- information on requirements for constraint management services – where National Grid identifies the need to procure constraint management services, it publishes invitations to tender on its website. These indicate the location and likely duration of the constraint.

More fundamentally, any ex ante system of alerts would, by its nature, only be able to provide details of expected constraint periods and could not provide a precise indicator of when unexpected constraint periods would occur. We would, however, encourage National Grid to continue working with market participants to ensure the most effective exchange of information relating to transmission constraints.

Detailed drafting change

We recognise that a potential loophole existed with the original drafting of the licence condition, whereby it would have been possible to avoid the full effect of circumstance 1 by structuring a company so that its generation units were held under separate licences. Hence one licensee would have been able to create or exacerbate a constraint, whilst another licensed entity within the group would have been able to receive payment to reduce/increase generation to help resolve that constraint. The drafting of circumstance 1 has been amended accordingly.

Use of existing competition measures

As noted above, the licence condition is targeted particularly at a specific harm. Circumstance 1 prevents a generator from creating or exacerbating a transmission constraint by taking uneconomic dispatch decisions. Once that has been determined, an excessive benefit will be established (subject to any objective justification) without there being a need to draw on the tools typically used for analysing excessive pricing under competition law. However, the TCLC is not intended to displace the application of competition law where appropriate. As such it should be viewed as complementary to existing competition law.

The Government supports the new rules adopted by the EU to help prevent manipulation of wholesale energy markets. However, we also believe that a specific and targeted licence condition would be beneficial as it would give greater clarity to generators as to what is acceptable behaviour in the particular situations covered by the licence condition compared to the more general definitions contained in the REMIT text.

Consultation Question 2

2.	Is this approach likely to have any unintended consequences on behaviour in the electricity market?
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Summary of responses to consultation question

Respondents suggested that circumstance 1, as drafted, risked several unintended consequences, predominantly relating to the potential for detrimental impacts on market behaviour and investment signals.

Concern was expressed that any lack of clarity in the licence condition and its associated guidance could introduce a risk for generators of numerous investigations being undertaken. It was felt that such an approach could deter generators from participating in the Balancing Mechanism, which in turn would reduce competition and increase constraint management costs. It could also potentially weaken investor confidence in new generation projects and distort transmission investment signals.

One respondent expressed concern that circumstance 1 could dampen locational price signals by preventing a generator located in an import-constrained area from withholding its capacity in order to offer it into the Balancing Mechanism. Whilst the respondent considered that transmission charging, rather than the Balancing Mechanism, was the appropriate mechanism to generate locational signals, it considered that the proposed outcome of Ofgem's transmission

charging review under Project TransmiT could suppress locational signals. It was suggested that the impacts of TCLC and Project TransmiT should therefore be considered in combination.

By drafting the licence condition to cover generation licensees, several respondents noted this would not cover licence exempt generators (those with a capacity at or below 100MW). A generator company would therefore potentially be able to avoid some or all TCLC requirements by keeping plant capacities below the licence exemption threshold of 100MW.

As regards the operation of TCLC, it was suggested that the Guidance should set out what steps Ofgem would take to ensure that National Grid did not misuse the restrictions placed on generation licensees in order to enhance earnings from the System Operator incentive scheme.

Government response

Possible deterrent to Balancing Mechanism participation and generator investment

The Balancing Mechanism plays a vital role in managing the system and we would not want the TCLC to deter generators from participating. As noted earlier, Ofgem will be expanding its guidance so that generators will have greater clarity on how the licence condition will be enforced and uncertainty is therefore minimised. Our expectation is therefore that the TCLC would not deter Balancing Mechanism participation or generator investment. Indeed, without measures to prevent undue exploitation of constraint periods, we are concerned that the potential for increases in balancing costs would impact adversely on market trading and new entry. Smaller players would be particularly affected given that they are less able to accurately forecast and hedge their positions.

Locational price signals

We believe that opportunities arising from the Balancing Mechanism can provide useful investment signals for new generation in import-constrained areas, which could potentially lead to constraint cost reductions on an ongoing basis. However, such signals will not be reliable where a generator is routinely creating or exacerbating transmission constraints through uneconomic dispatch decisions. We do not, therefore, consider it appropriate to revise circumstance 1 to take account of the respondent's concern about impact on locational price signals. In its conclusion to Project TransmiT, which was announced on 4 May 2012, Ofgem instructed National Grid and the Connection and Use of System Code (CUSC) industry group to develop specific changes to the transmission charging arrangements. We expect that appropriate aspects of the wider charging framework will be taken into account through the CUSC process.

Licence exempt generation

By definition, the TCLC was only intended to cover those generators holding a generation licence. Smaller generators are exempt from holding a licence and therefore fall outside the scope of TCLC. Such licence exempt generators are not capable of exporting more than 100MW to the total system in GB and, for the most part, do not participate in the Balancing Mechanism.

Nonetheless, Government would not wish to see any generator have the capability to derive excessive benefits from a period of transmission constraint. We are therefore considering whether, and if so how, this point should be addressed. As part of this, we invite National Grid and industry to work together to explore what changes might usefully be taken forward through the industry governance process.

Potential misuse of the TCLC

The System Operator (SO) incentive scheme incentivises National Grid to act in an efficient manner and to ensure value for money is provided for consumers. We will monitor any interactions between TCLC and National Grid's role as SO to ensure best outcomes from the two policies.

Section 3 – Circumstance 2

The second circumstance would seek to prevent the placing of excessively low bids in a period of an export transmission constraint.

Consultation Questions 3-4

3.	Does circumstance 2 adequately address the issue of excessively low or negative bids during periods of transmission constraints?
4.	Is this approach likely to have any unintended consequences on behaviour in the electricity market?

Summary of responses to consultation questions

As with circumstance 1, most responses to questions 3-4 focused on how circumstance 2 could be enforced in a clear and transparent way. Specific concerns and suggested solutions included the following:

- the Guidance document would have to be clear and detailed, particularly in explaining how Ofgem would consider the various costs and contractual obligations that generators factor into bid decisions and prices, in order to allow generators to avoid licence breaches. The Guidance also needed to recognise the complexity of generators' dispatch decisions;
- the meaning of the term 'excessive benefit' as used in the licence condition should be consistent with Competition Act principles on 'excessive pricing', and more detail should be provided on the terms 'more economic options' and 'excessive payments';
- a pre-defined trigger should be set for circumstance 2 to highlight when formal investigation by Ofgem could be expected;
- National Grid should notify constraints in advance to generators for circumstance 2.

A minority of respondents considered that the introduction of circumstance 2 was premature, at least in relation to wind generators, as National Grid and other industry parties were currently working to develop potential solutions to enable intermittent and inflexible generation to participate appropriately in the Balancing Mechanism. In contrast, National Grid and several other respondents argued that the TCLC would be complementary to this current work and would, in any case, act as a useful back stop.

As with question 2, respondents suggested that circumstance 2 risked several unintended consequences, predominantly relating to the potential for detrimental impacts on market behaviour and investment signals. The issue of licence exempt generators (i.e. those with a capacity at or below 100MW) not being covered by this measure was also raised in the context of circumstance 2.

Government Response

We recognise the importance of clarity for generators on what might constitute an excessively low bid. Ofgem will set out clearly in its guidance a non-exhaustive list of the typical benchmarks against which it would expect to compare bid prices. Unlike circumstance 1, circumstance 2 applies regardless of whether the generator has caused or exacerbated the

constraint by dispatching plant when it had more economic options available to it and it will be necessary for the Authority to assess the level of bid prices by reference to whether an excessive benefit has been obtained. However, the Government is of the view that this should be undertaken with reference to the framework of the TCLC and does not suggest that there should be an automatic alignment with a competition law analysis even though the analytical tools for assessing a breach of circumstance 2 may be similar to those sometimes used in excessive pricing cases.

We do not believe it would be appropriate to set a pre-defined trigger for circumstance 2 to signal when Ofgem is to begin a formal investigation. In addition to the reasons put forward for rejecting this proposal for circumstance 1, we consider that a generator's bid should be equally justifiable in a constraint period as during non-constraint periods when competition should ensure that generators cannot submit bids which lead to excessive benefits. No bid submitted by a generator to reduce generation should lead to an excessive benefit, regardless of whether a transmission constraint was active at that time. The introduction of a trigger also raises the practical question of why generators would not simply respond by bidding just within the level of the trigger, thereby reducing the potential cost reduction benefit to consumers.

For the reasons set out in the Government Response to Question 1, we do not believe that National Grid should be required to notify constraints in advance to generators for circumstance 2.

The licence condition should complement the work that National Grid is taking forward with industry to enable the appropriate participation of intermittent and inflexible generation in the Balancing Mechanism, and we note the expectation that the average related constraint payments will continue to reduce with increased experience of participation. The TCLC would not treat any particular form of generation differently from any other, and bids from all types of generation will be monitored by Ofgem.

Section 4 – Circumstance 3

The third circumstance proposed in the consultation sought to prevent charging excessive amounts for the arming of commercial inter-trips.

Consultation Questions 5-7

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| 5. | 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? |
| 6. | Does circumstance 3 adequately address the issue of excessively high arming fees for inter-trips? |
| 7. | Is this approach likely to have any unintended consequences on behaviour in the electricity market |

Summary of responses to consultation questions

Most respondents to the consultation opposed the inclusion of inter-trip arrangements within the scope of TCLC. Several considered that average inter-trip arming fees had reduced significantly over the last three years, and there were clear indications of a dynamic, strong and competitive market having developed. Hence it was argued that a market failure relating to inter-trips was not currently evident.

Another frequently cited reason for opposing the inclusion of commercial inter-trip arrangements was that they are bilaterally negotiated agreements between a generator and National Grid, with no obligation on either party to reach agreement. Should a generator offer an arming fee that National Grid considered to be excessive, then respondents argued that National Grid should simply decline to enter into an agreement and should instead rely on the acceptance of bids through the Balancing Mechanism. It was also suggested that the ‘regulation’ of bids through the TCLC would remove any compelling reason for ‘regulating’ inter-trips, since inter-trip agreements were only entered into as an alternative to the acceptance of bids.

Concern was expressed by some that inclusion of inter-trips in the TCLC – and the associated risks of investigation – could incentivise generators to remove this service from the market. This would leave no alternative for National Grid but to use the more costly Balancing Mechanism to resolve constraints. In its consultation response, National Grid noted that such a response would be detrimental to system security as it anticipated the increasing need for inter-trip services to manage expected increases in generation. From a practical perspective, two respondents considered that inter-trip contracts were typically complex arrangements involving a high degree of technical and operational risk for generators, and it would therefore be very difficult for Ofgem to determine a reasonable level of arming fees.

Two respondents supported the inclusion of inter-trips in the TCLC. If the TCLC was only to cover the Balancing Mechanism, it was suggested that there was a risk that ‘excessive’ prices could be transferred from bids to inter-trip services.

Whilst National Grid supported the inclusion of inter-trips, it considered that the focus on arming fees could encourage generators to reallocate high fees elsewhere, for example to a 'capability fee' (which remunerates the generator for the cost of installing and maintaining the inter-trip equipment), or through increasing use of bundled fees incorporating both arming and tripping. It noted that flexibility in the way that the TCLC covered inter-trips would allow a more holistic view to be taken on inter-trip contracts.

Government Response

We do not believe it would be appropriate to include inter-trips within the scope of the TCLC at the present time and have therefore removed circumstance 3 from the licence condition.

We agree with National Grid that inter-trips could become an increasingly important mechanism for managing constraints in the future:

- whilst inter-trips are armed before a fault occurs, the main cost is incurred post-fault following tripping. Therefore, based on the low probability of tripping they should represent a more economic and efficient means for managing constraints than the alternative of accepting bids and offers through the Balancing Mechanism to constrain generation pre-fault;
- the way in which inter-trips function means that the flow of electricity across a boundary is maximised, thereby facilitating maximum possible access to the transmission system.

It is therefore important that generators continue to offer commercial inter-trip services into the market at a competitive price.

We considered it important to consult on the possible inclusion of inter-trips in the licence condition given the possibility that National Grid could be forced to pay unduly high arming fees because of limited competition for providing this service. The number of plants suitable for the installation of inter-trips will inevitably be restricted by technical, commercial and geographic factors.

We received only limited evidence through the consultation process on the development of the inter-trip market since the Energy Act 2010 was passed, but this did point to an improvement in the level of competition and a reduction in pricing. On balance, we therefore decided that it would not be appropriate to include inter-trips within the scope of the TCLC at the present time. However, given the importance of a competitive inter-trip market, Government will keep this decision under review in consultation with Ofgem, and we would be open to receipt of any new evidence from market participants.

Section 5 – Other circumstances

Consultation Question 8

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| 8. | 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. |
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Summary of responses to consultation question

Of those who responded to question 8, most felt that there were no other circumstances which should be addressed by the licence condition. It was also suggested that the TCLC was already too broad, that it would encompass all circumstances related to constraints, and should therefore be tightened.

Only two respondents outlined other areas of concern. National Grid suggested that there was potential for generators to set the dynamic parameters of generating units to require National Grid to commit to actions for periods longer than usually required to resolve transmission constraints. National Grid also suggested that other transmission constraints be taken into account, notably to cover any excessive bids and offers related to the frequency response services that keep electricity demand and supply balanced.

The other respondent believed that consideration should be given to the accuracy of wind farm generators in matching their Final Physical Notifications (FPNs)⁶. Where a generator could not demonstrate it was reliable at delivering the notified power, it was suggested that the appropriate level of constraint payment was unlikely to be fairly established.

Government Response

The Energy Act 2010 allows for the licence condition to address a relatively wide range of circumstances. However, we recognise that a general condition could significantly increase the regulatory risks and burden faced by companies, with resulting negative effects on investment. Our preferred approach therefore remains to target specific areas of potential exploitative behaviour where concerns have been identified and are supported by evidence, and hence the licence condition does not encompass all circumstances related to constraints.

Possible coverage of dynamic parameters and frequency response

Government is not aware of any instances of generators altering their dynamic parameters in order to exacerbate constraints. The Grid Code requires National Grid to observe a generator's dynamic parameters, and it will monitor developments to ensure that any concerns can be addressed through appropriate measures if necessary.

⁶ Generators provide National Grid with a Final Physical Notification (FPN) of their estimated output at 'gate closure' (i.e. one hour before the relevant 30 minute trading period). This provides National Grid with a view of projected generation, and it is the FPN that bids and offers are instructed against.

Extension of the licence condition to cover frequency response services would contradict the targeted approach of our intervention. We encourage National Grid to monitor the level of bids and offers relating to frequency response, and to raise any concerns with Ofgem.

Wind Farm Notifications

As noted below, work is being taken forward on the accuracy of FPNs from wind generators, but this is not a matter for the TCLC.

The nature of wind generation means that it will not always be possible for actual output to match FPNs. National Grid is currently taking forward work with industry to mitigate the impacts of inaccurate notifications from wind generators. A proposal is being developed by National Grid to look at the utilisation of an alternative signal to determine bid/offer volumes for settlement purposes. This concept has been termed a 'power available signal'. It would calculate the possible output of a wind farm during real time so that, if the output was curtailed and there was a sudden drop in wind, the settlement would be based on the power available rather than their notification on which it is normally calculated. In this situation, a wind generator would not be paid if the wind had stopped as the power available would have been zero.

In addition to this work, National Grid is discussing with the industry how best to manage wind generation during times of high wind which may lead to a risk of wind generators ceasing to generate. The operational nature of this work will be complementary to the commercial focus of the work on a 'power available signal'.

Consultation Question 9

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| 9. | Should the licence condition also cover excessive benefits from offers in the Balancing Mechanism beyond the prohibition in circumstance 1? Please provide evidence to back up your response. |
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Summary of responses to consultation question

The majority of respondents agreed that the licence condition should not cover excessive offers where a generator had not exacerbated or created a transmission constraint. There was support for the rationale put forward in the consultation document that opportunities arising from the Balancing Mechanism could provide useful generation investment signals in import-constrained areas, which might lead to ongoing reductions in constraint costs associated with import constraints.

Two respondents felt that the licence condition should protect against excessive offers. It was considered that excessive benefits from bids and offers should be treated in the same way, as both behaviours sought to exploit the same market constraint and could ultimately lead to significant increased costs to the consumer.

Government Response

We note the reasoning put forward by two respondents for the licence condition to also protect against excessively high offers. However, we did not receive evidence to contradict our view that such an extension of the licence condition would reduce the incentive to build new plant in

import constrained areas. This would, in turn, tend to exacerbate the problem of import constraint costs in the longer-term by reducing the competitive pressure on generators in those areas, ultimately leading to increased consumer costs. In the absence of output manipulation, price spikes in import constrained areas may be a true reflection of scarcity of generation in a particular location, and hence a reasonable investment incentive.

Section 6 – Evidence used for the consultation

Consultation Question 10

10. What are your views on the evidence presented in the 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?

Summary of responses to consultation question

There was a range of views on how the Impact Assessment⁷ had assessed the costs and benefits of the TCLC.

One respondent agreed with the evidence presented in the Impact Assessment. Another suggested that the benefits had been underestimated, arguing that:

- the portfolio effect of a generator profiting from both sides of the constraint (i.e. having both a bid and offer accepted) would increase the benefit brought about by constraint gaming;
- if the licence condition was not enforced, it would potentially reduce the deterrent for further exploitation of constraints;
- the Balancing Mechanism naturally had a redistributive impact for generators who were either in or out of balance. Constraint gaming would distort this process allowing an unfair competitive advantage to exist at times of constraint.

In contrast, several respondents believed that the Impact Assessment had overestimated the net benefit of the TCLC:

- one respondent suggested that the Impact Assessment appeared to attribute a benefit to addressing excessive offers, even though these were not within the scope of TCLC, and that an assumption had been made that 100% of future constraint costs were resolved through the Balancing Mechanism. The respondent also suggested that the TCLC risked reducing the availability of inter-trips by including these within the scope of the licence condition;
- another respondent suggested that the Impact Assessment had underestimated the costs by not including the costs to Ofgem of appropriate market monitoring activities or the costs to generators of objectively justifying their pricing strategy to Ofgem in the event of an investigation;
- two respondents considered that TCLC presented a regulatory risk to generators which could send a negative signal to investors. They considered that it was not clear how this potentially negative impact had been factored into the analysis;

⁷ Impact Assessment of the Transmission Constraint Licence Condition (Consultation Stage)
<http://www.decc.gov.uk/assets/decc/11/consultation/transmission-constraint/3737-transmission-constraint-cons-ia.pdf>

- it was also suggested that the Impact Assessment assumed an untested level of exploitation and did not take account of the possibility that any current exploitation could be reduced under the threat of action under current competition law.

Finally, several respondents noted the potential for reputational damage of those being investigated, suggesting that generators should be warned about behaviour that could lead to a breach, and have input into proceedings prior to information about investigations becoming public. It was also emphasised that investigations should not be instigated lightly, over-aggressively or for political expediency. One respondent put forward an opposing view, considering that a good effect on the behaviour of market participants would be achieved by putting details of any investigation in the public domain.

Government response

Presentation of evidence in the Impact Assessment

We note the comments relating to the costs and benefits of implementing the licence condition. The Impact Assessment that was published alongside our consultation document noted that there was much uncertainty on the exact constraint reductions that the licence condition could deliver, given that this would depend in part on how generators decided to change their behaviour in response to it. The Impact Assessment therefore presented a relatively conservative assessment of benefits than implied by some other modelling approaches, and this has been retained in the final Impact Assessment. We agree with the respondent who said that a benefit should not be attributed to addressing excessive offers under circumstance 1 and that 100% of future constraints should not be assumed to be resolved through Balancing Mechanism actions; the impact assessment does neither of these.

The final Impact Assessment reflects the decision to exclude inter-trips, at least for the time being, from the licence condition.

As regards costs, the analysis presented in the Impact Assessment takes the view that Ofgem's monitoring costs are likely to be negligible. Ofgem already monitors generator behaviour in the wholesale market, and shares our view that it would be unlikely to incur significant additional day-to-day costs in administering the licence condition. The analysis already covers possible investigation costs incurred by generators. Again, these are expected to be negligible impacts as objective justification of pricing strategy is assumed to be a normal function of a generator's operation.

The Impact Assessment also notes our expectation that any impacts on generation investment will be insignificant. There will be no restrictions on dispatch or pricing behaviour in the wholesale market during non-constraint periods. In addition, the licence condition is expected to result in some offsetting positive impacts for generators including an overall reduction in the level and volatility of Balancing Services Use of System charges.

The level of assumed exploitation took into account a robust assessment undertaken by Ofgem. It also notes the limitations of existing competition powers in relation to transmission constraints. As noted above, the licence condition is not intended to displace application of competition law where appropriate, but it is intended to address a specific harm. Given that Competition Act 1998 powers preceded Ofgem's assessment by some years, their impact on generator behaviour (to the extent that they have an impact) would already have been taken into account.

Approach to investigation of potential breaches

Enforcement of the licence condition is a matter for Ofgem, and this will be done in accordance with its existing procedures. Ofgem's published guidelines set out its proportionate approach to investigating matters and enhance the transparency of the investigation processes. Further details will be set out in the guidance which Ofgem will be publishing on the date that the TCLC comes into force. As noted earlier in the Government Response, Ofgem will be expanding the final version of its guidance to provide more detail on what constitutes a potential breach of the licence condition, and hence provide greater certainty to generators.

Section 7 – Next steps

The Licence Condition and accompanying guidance

At the same time as publishing this Government Response, the Secretary of State has commenced his enabling power under Section 18 of the Energy Act 2010 and the licence condition has been laid in draft before Parliament. This will permit the licence condition to come into force on 29 October 2012.

Following completion of the Parliamentary process Ofgem will publish an updated version of the accompanying guidance document on the date that the TCLC comes into force.

Monitoring and enforcement

Ofgem already monitors generator behaviour in wholesale markets, and will draw from these activities to assess whether a potential breach of the TCLC has occurred. It will also regularly discuss balancing actions with markets participants.

Ofgem will enforce the TCLC in accordance with its most recent enforcement guidelines at that time. Its current guidelines are: 'Enforcement guidelines on complaints and investigation'⁸.

Duration of the TCLC

The Energy Act 2010 placed a five year sunset clause on the TCLC, with the possibility of a two year extension following an order of the Secretary of State.

The five year period for duration of the TCLC starts from the date on which Section 18 of the Energy Act 2010 comes into force. Section 18 came into force by Order on 16 July 2012. Hence the licence condition is due to expire on 15 July 2017.

Towards the end of the initial five year period we will review this policy to assess whether the licence condition should be extended by two years. Any decision will be based on an assessment of its effectiveness and its future requirement, and will be informed by the monitoring activities undertaken by Ofgem. In addition, the Secretary of State must first consult before making an order to extend the duration of the licence condition.

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<http://www.ofgem.gov.uk/About%20us/enforcement/Documents1/Enforcement%20Guidelines%20post%20consultation.pdf>

Annex 1 – Finalised Licence Condition

1. The licensee must not obtain an excessive benefit from electricity generation in relation to a Transmission Constraint Period.
2. For the purposes of paragraph 1, the licensee shall be considered to have obtained an excessive benefit from electricity generation in relation to a Transmission Constraint Period if:
 - (a) the licensee and the system operator enter into, or have entered into, Relevant Arrangements which relate to a Transmission Constraint Period; and
 - (b) either or both of the circumstances set out in paragraph 3 occurs.
3. The circumstances referred to in paragraph 2(b) are as follows:
 - (a) Circumstance 1 is that:
 - (i) the licensee, or any affiliate of the licensee, creates or exacerbates a Transmission Constraint by dispatching or withholding one or more Generating Units in circumstances when the licensee and its affiliates together had more economic options available to them; 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 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 during the Transmission Constraint Period;
 - (b) Circumstance 2 is that, under the Relevant Arrangements and in connection with a reduction in electricity generation 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.
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 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 particular generating plant, whether or not there is an overall increase or reduction in electricity generation in that Transmission Constraint Period.

5. This licence condition shall be interpreted and enforced in accordance with guidance issued by the Authority in accordance with section 19 of the Energy Act 2010.
6. The Authority may from time to time revise the guidance referred to in paragraph 5 and before issuing any such revised guidance the Authority shall consult:
- (a) the holder of any licence under section 6(1)(a) of the Act;
 - (b) the Secretary of State; and
 - (c) such other persons as the Authority thinks it appropriate to consult'
- setting out the text of, and the reasons for, the proposed revisions.
7. The licensee shall provide to the Authority, in such manner and at such times as the Authority may reasonably require, such information as the Authority may require or deem necessary or appropriate to enable the Authority to monitor the licensee's compliance with this condition.
8. This condition will cease to have effect on the Expiry Date unless the Secretary of State makes an order extending the Expiry Date pursuant to section 23(2) of the Energy Act 2010.
9. In this condition:

"Balancing Mechanism"	means the mechanism for the making and acceptance of offers and bids to increase or decrease the quantities of electricity to be delivered to, or taken off, the total system at any time or during any period so as to assist the system operator in coordinating and directing the flow of electricity onto and over the national electricity system and balancing the national electricity system pursuant to the arrangements contained in the BSC ;
"Expiry Date"	means 15 July 2017;
"Generating Unit"	means any apparatus which produces electricity;
"National Electricity Transmission System"	means the system consisting (wholly or mainly) of high voltage electric lines owned or operated by transmission licensees within Great Britain, in the territorial sea adjacent to Great Britain and in any Renewable Energy Zone and used for the transmission of electricity from one generating station to a sub-station or to another generation station or between sub-stations or to or from any interconnector and includes any electrical plant or meters owned or operated by

	any transmission licensee within Great Britain, in the territorial sea adjacent to Great Britain and in any Renewable Energy Zone in connection with the transmission of electricity;
“Notified Electricity Generation”	means the intended level of generation notified by the licensee to the system operator for a period pursuant to the notification arrangements established by BETTA and the BSC;
“Relevant Arrangements”	means arrangements entered into by the licensee and the system operator within the Balancing Mechanism, and the entering of such arrangements shall include the making of a bid or offer by the licensee whether or not that bid or offer is accepted by the system operator;
“Renewable Energy Zone”	means any area designated by Order in Council under section 84(4) of the Energy Act 2004;
“Transmission Constraint”	<p>means any limit on the ability of the National Electricity Transmission System, or any part of it, to transmit the power supplied onto the National Electricity Transmission System to the location where the demand for that power is situated, such limit arising as a result of any one or more of:</p> <p>(a) the need not to exceed the thermal rating of any asset forming part of the National Electricity Transmission System;</p> <p>(b) the need to maintain voltage on the National Electricity Transmission System; and</p> <p>(c) the need to maintain the transient and dynamic stability of electricity plant, equipment and systems directly or indirectly connected to the National Electricity Transmission System;</p> <p>and such limit being used by the system operator to operate the National Electricity Transmission System in accordance with the National Electricity Transmission System Security and Quality of Supply Standard referred to in standard condition C17 (Transmission systems security standard and quality of</p>

	service) of the standard conditions for electricity transmission licences or any other provision of the transmission licence, the Act or any other requirement of law;
“Transmission Constraint Period”	means any period of time, regardless of the duration, when a Transmission Constraint occurs.

Annex 2 – List of Respondents

Responses from the following bodies were received:

1. The Association of Energy Producers
2. Centrica
3. Drax
4. EDF Energy
5. E.On
6. International Power / GDF Suez
7. National Grid
8. The Renewable Energy Association
9. The Renewable Energy Foundation
10. Renewable Energy Systems
11. Renewable UK and Scottish Renewables
12. RWE
13. Scottish Power

We also received three confidential responses from market participants and one response from an interested member of the public.

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