

Proposed modifications to licence conditions

DTI Consultation

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## **Introduction**

1.1 This document sets out proposals to modify the licence conditions of electricity market participants provided by Ofgem. The modifications would bring about two new obligations. The first obligation would prohibit prejudicing the economic and efficient balancing and operation of the transmission system. The second would prohibit short run limiting of generation capacity availability without good cause. This document invites views from licensees and other interested parties on Ofgem's proposed licence modifications.

1.2 The Secretary of State considers that it is necessary – indeed imperative - that the licence modifications are made so as to facilitate the operation of the New Electricity Trading Arrangements (NETA). It is important that confidence is quickly established in this new market. However there are particular characteristics of the wholesale electricity market which can create opportunities for market abuse, particularly close to real time and when the system is tight. During the early days of NETA, when all those involved are learning about and testing the market and its rules, there is a greater than normal opportunity for market abuse with adverse effects for other participants, consumers and the integrity of the new market. This is likely to be more of a problem for as long as the costs of electricity and of transmitting that electricity are bundled together ie until transmission access arrangements are in place.

1.3 The Secretary of State is therefore of the preliminary view that it would be appropriate to make changes along the lines proposed through the exercise of the power granted to him by s.15A of the Electricity Act 1989 which was inserted by s.68 of the Utilities Act 2000.

1.4 The Government recognises the need for regulatory stability and clarity in enabling companies to pursue normal, competitive behaviour and it is the DTI's intention to keep to the minimum necessary regulatory measures. In particular, DTI would include a sunset provision in the proposed licence modifications, causing them to expire one year after their introduction. In the longer term, DTI continues to expect that the NETA governance procedure coupled with the Competition Act 1998 will prove adequate in this area.

1.5 A key objective of NETA was to develop trading arrangements that would facilitate competition in electricity generation and supply. In evidence to the Competition Commission, DTI and Ofgem argued that the introduction of NETA would not remove the possibility of companies committing abuse under the new trading arrangements, although the opportunities for market abuse should be less than under the Pool.

1.6 Ofgem/DTI carried out an extensive consultation process throughout 2000 regarding the licence modifications required for the introduction of NETA and as a result of the Utilities Act 2000. It was made clear at the time that it was not appropriate to consider amendments in relation to issues that were then being considered by the Competition Commission in relation to the Market Abuse Licence Condition (MALC).

1.7 Following the Competition Commission's findings in relation to the MALC, Ofgem withdrew it from the licences of the remaining six generators. Ofgem has since advised DTI that more-focussed alternative conditions are necessary and the Secretary of State considers that it is now appropriate to consult on these licence issues.

1.8 The Secretary of State is proposing through the use of s.15A of the Electricity Act 1989 to amend conditions in the licences of generators and possibly also of suppliers. Ofgem has proposed draft conditions on which comments are invited.

1.9 The first proposed amendment would introduce a requirement into the licences of generators that a Licensee shall not knowingly or recklessly act in a manner that is likely to prejudice the safe, economic and efficient operation by a transmission company of its transmission system or the economic and efficient balancing by a transmission company of its transmission system. A similar condition already exists in gas shipper licences and Ofgem is seeking to align the two sets of licences. The proposed amendment to licences of generators to include the system balancing requirement is set out in Appendix 1.

1.10 The Secretary of State notes that there are arguments in favour of also inserting this amendment into the licences of suppliers as, under NETA, both the supply and demand sides of the market could be in the position to significantly prejudice the operation or balancing of the transmission system. Comments are invited on whether this amendment should also be applied to suppliers.

1.11 The second proposed amendment would introduce a prohibition relating to the short run limiting of generation or capacity availability without good cause. A copy of the drafting of the proposed amendment is set out in Appendix 2.

1.12 Ofgem has indicated that if the Secretary of State modifies licences to include these two provisions it would issue licensees and third parties with a guidance note on their application to assist their understanding of how Ofgem would enforce the new obligations. Ofgem will publish shortly after this document a draft guidance note.

1.13 Ofgem has now become the Gas and Electricity Markets Authority headed by a Board of eleven people. As part of the process for licence enforcement action or for the imposition of financial penalties, the licensee in question would now have the opportunity to be heard by the Authority. There is in any case a right of appeal to the Court from a decision to impose a financial penalty in certain circumstances.

1.14 Following this consultation, the Secretary of State will determine whether it is appropriate to use the power in s.15A of the Electricity Act 1989 to introduce the proposed amendments to the relevant companies' licence conditions.

1.15 The DTI would like to invite views from all interested parties as to the proposed licence modifications and the question as to whether to apply the system operation and balancing condition to suppliers as well as to generators.

1.16 Responses to the document should be received by 27 April 2001.

## **Background**

2.1 Following a consultation on the findings of the investigation into Pool prices in July 1999, Ofgem proposed the introduction of a MALC into the licences of initially six generators Ofgem believed were most likely to have substantial market power in determining wholesale electricity prices.

2.2 The MALC contained a non-exhaustive list of possible abuses which included:

?? Acting in such a way as materially to prejudice the efficient and economical balancing of the transmission system; and

?? Limiting, without good cause, generation or capacity availability in such ways as materially to increase wholesale prices for electricity.

2.3 After a period of consultation, on 12 April 2000, Ofgem modified all of the generation licences of BNFL Magnox, Edison Mission Energy, National Power (now Innogy), PowerGen and TXU Europe to introduce MALC. Subsequently, London Electricity's licence for Sutton Bridge was also modified to include the condition. However, AES and British Energy did not consent to the modification of their licences and, on 3 May 2000, Ofgem referred these generators to the Competition Commission.

2.4 In December 2000, the Competition Commission concluded in respect of both AES and British Energy that the continuation of their licences without the MALC was not against the public interest. Following this decision, Ofgem withdrew the MALC from the licences of the remaining six generators. Subsequently, Ofgem advised DTI that more-focused alternative conditions were necessary in place of the MALC.

2.5 Ofgem and the Secretary of State have a duty to take a wider view of the need for consumers to be protected from the manipulation of the electricity market. The new principal objective of the Authority is to protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity.

2.6 The Competition Commission, in reaching its conclusions, noted a number of concerns about the MALC, in particular its broad, effects-based nature. In considering Ofgem's proposed modifications, the DTI notes that they are more focussed on the specific matters of concern to Ofgem and the DTI.

## **Proposed Modifications**

## Introduction

3.1 The Secretary of State is proposing that two modifications are made following this period of consultation using the powers in s.15A of the Electricity Act 1989 . The first change is the introduction of a system balancing condition and the second is the introduction of a prohibition on the limiting of capacity without good cause.

## System balancing

3.2 It is proposed that generators' licences are amended to include a system balancing provision (as set out at Appendix I).

3.3 A system balancing condition is already a standard licence condition for all gas shippers. Ofgem's experience of this condition in the gas market has underlined the continuing need for and value of such a condition in the electricity market. The government has made clear that the regulatory framework in gas and electricity, including the licencing regimes, should be aligned as far as possible as well as being updated. A system balancing condition is also thought to be necessary by the Secretary of State to facilitate the operation of NETA.

3.4 Ofgem has identified circumstances where a company may submit information to the system operator which results in unnecessary balancing action being taken from which the company then profits. The Competition Commission's report additionally identified circumstances where companies could manipulate complex rules. The Competition Commission identified rule changes as a remedy for this form of behaviour. Whilst DTI agrees that the ability to change NETA rules will greatly improve the ability to adapt to developments in the market, DTI also agrees with Ofgem that during the early days of NETA it is necessary to also provide protection to consumers through a change to licences, modelled closely on arrangements for gas shippers.

3.5 The Secretary of State notes that there are arguments in favour of also inserting this amendment into the licences of suppliers as, under NETA, both the supply and demand sides of the market could be in the position to significantly prejudice the operation or balancing of the transmission system. Comments are invited on whether this amendment should also be applied to suppliers.

## Limiting capacity

3.6 Some generators' licences already have conditions that deal with the provision of information to the Authority concerning plant availability and with the withdrawal of plant from the market. It is proposed that the Secretary of State will modify this condition (as set out in Appendix II) where it exists to include a prohibition on short run limiting of capacity availability without good cause in order to facilitate the operation of NETA. It is also proposed that the condition (as set out in Appendix II) will be inserted into those generation licences that do not already have conditions that deal with the provision of information to the Authority concerning plant availability and with the withdrawal of plant from the market.

3.7 The introduction of this condition follows concerns that were raised in the Competition Commission's report. The Competition Commission found that there are particular characteristics of the wholesale electricity market which can create opportunities for market abuse, particularly close to real time and when the system is tight. Ofgem and the DTI continue to share concerns about the risk of adverse effects as the result of these characteristics in the context of the new market.

### **Views Invited**

4.1 The DTI would like to invite views from all interested parties as to the proposed licence amendments and the question as to whether to apply the system operation and balancing condition to suppliers as well as to generators. Responses to the document should be received by 27 April 2001. Responses should be sent to:

Jeffrey Barretto  
Energy Policy Directorate  
Department of Trade & Industry  
Room 2119  
1 Victoria Street  
London SW1H 0ET

Or sent by e-mail to [jeffrey.barretto@dti.gov.uk](mailto:jeffrey.barretto@dti.gov.uk)

Or sent by fax to 020 7215 2867

## **Appendix I**

### **System balancing condition**

*The Licensee shall not knowingly or recklessly act in a manner (either alone or with some other person) which is likely to prejudice*

- (a) the safe, economic and efficient operation by a transmission company of its transmission system; or*
- (b) the economic and efficient balancing by a transmission company of its transmission system.*

*This condition shall expire on [12 months after date of insertion]. Such expiry shall be without prejudice to any enforcement action the Authority may take in relation to a breach of this condition by the Licensee prior to [as above].*

## **Appendix II**

### Limiting capacity

*The Licensee shall not limit, without good cause, generation or capacity availability in such a manner as to prejudice the interests of consumers.*

*This condition shall expire on [12 months after date of insertion]. Such expiry shall be without prejudice to any enforcement action the Authority may take in relation to a breach of this condition by the Licensee prior to [as above].*