# Guidelines to Proposed Modifications to Licence Conditions

## *1. Introduction*

1.1 On 28 March 2001 the Department of Trade and Industry (DTI) issued a consultation document[1] which set out the Secretary of State's proposals to modify the licence conditions of electricity market participants, to bring about two new obligations. The first obligation would prohibit Licensees prejudicing the safe, economic and efficient operation or the economic and efficient balancing by the transmission company of its transmission system. The second would prohibit the (short run) limiting, without good cause, of generation or capacity availability if it would prejudice the interests of consumers. The DTI document invited views on these proposed licence modifications from Licensees and other interested parties.

1.2 In the DTI consultation document it was indicated that, if the Secretary of State were to modify licences to include the two new prohibitions, Ofgem would issue a guidance note to market participants on their application to assist understanding of how Ofgem would enforce the conditions. The guidance note is intended to reduce any uncertainty surrounding Ofgem's interpretation of the condition and to assist companies in framing compliance programmes.

1.3 This document sets out for consultation Ofgem's draft guidance note for the proposed licence conditions. It would be helpful to receive responses by 27 April 2001.

1.4 Replies should be sent to:

Dr Eileen Marshall CBE
Managing Director, Competition and Trading Arrangements
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE.

[1] 'Proposed modifications to licence conditions' - DTI consultation 28 March 2001.

Electronic responses may be sent to lorraine.ladbrook@ofgem.gov.uk

1.5 Respondents are free to mark their replies as confidential although we would prefer, as far as possible, to be able to place responses to this document in the Ofgem library. Unless clearly marked 'confidential', response will be published by placing them in the Ofgem library.

1.6 If you wish to discuss any aspect of this document, Sonia Brown (020 7901 7412) will be pleased to help.

## *2. Proposed 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.**

2.1 Whilst all relevant Licensees would have responsibilities to comply with the Condition, some companies are likely to be able to exert a greater influence than others on system operation and balancing costs.

2.2 Under NETA, an example of action which could cause concern under this Condition is the creation of a "virtual" constraint by submitting Physical Notification's (IPN's/FPN's) to the System Operator (SO) to try to force the SO to take an unnecessary balancing action. Although such Physical Notifications would not breach a generator's Grid Code obligations if its output matched its FPN as modified by accepted bids or offers, it could lead the SO to conclude falsely that the system is long or short or that there is a locational constraint. The SO would take balancing actions to correct the perceived imbalance or locational constraint. Since the Licensee would know that the SO could be about to take an action, it may adjust its bids/offers to benefit from the SO's need to use the Balancing Mechanism to balance the system. In these circumstances Balancing Mechanism prices could be kept artificially high or low, influencing wholesale prices more generally through arbitrage.

2.3 Any behaviour designed specifically to exploit shortcomings or loopholes in the trading rules under NETA that has a substantial impact on the costs of the SO could also fall within this category. However, changes in bid prices may be justified when a participant is aware that a plant is likely to be constrained down, provided that the adjustment reflects the opportunity costs to the generator of not generating.

## *3. Proposed Limiting capacity condition*

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

3.1 This condition encompasses behaviour such as artificially restricting the capacity made available to the market and the closure or mothballing of capacity that it would be economic to operate. The prohibition does not just apply to generation capacity that might be expected to participate in the Balancing Mechanism, and/or offer Balancing Services. Withdrawal of any generation capacity is potentially capable of having significant, foreseeable effects on cash-out prices and spot electricity prices, and is therefore capable of prejudicing the interests of consumers.

3.2 In determining whether a Licensee has good cause, Ofgem will apply the avoidable cost principle, outlined in more detail below.

3.3 In addition, Ofgem will generally not consider capacity withdrawal to be problematic if it occurs because of:

- maintenance requirements (whether planned or forced);
- limitations on the plant's output due to emissions constraints; or
- the exploitation of arbitrage opportunities between the gas and electricity spot markets.

### *Avoidable costs*

3.4 There is no single value of avoidable costs. What is counted in "avoidable costs" depends on the kind of business decision one has in mind. The avoidable costs of any decision are the expected cash outlays that would be incurred if the

decision were put into effect, and avoided if it were not. They will correspond to a set of revenues which (over an appropriate time horizon) would be expected to cover those outlays. The length of time contemplated in a particular decision can greatly affect the cash outlays relevant to that decision. A temporary withdrawal and mothballing of plant may allow a generator to save additional costs over and above variable fuel costs by, for example, de-manning the station and avoiding other fixed costs (such as NGC use of system charges and rates).

3.5 Therefore avoidable costs include variable costs (such as fuel and labour) and some element of fixed costs. Avoidable costs do not, however, include fixed costs which would be incurred whether or not the unit operated, such as finance charges and other capital costs, which are sunk or unrecoverable over the period of withdrawal being considered.

3.6 If a generating unit is withdrawn from service for a period of **less than twelve months** the avoidable costs of the unit will include the following costs:

- fuel costs;
- a proportion of labour costs;
- a proportion of operational and maintenance costs;
- a proportion of local authority rates; and
- start up costs.

3.7 The proportion of labour costs, operational and maintenance costs and local authority rates to include will depend on the period of the capacity withdrawal and the particular circumstances of the generator. For example, if the generator can show that he has reduced his workforce as a result of the withdrawal, then the full costs of these staff (possibly including an element for recruitment costs) would be included in the generator's avoidable costs. With regard to operational and maintenance costs, an appropriate consideration will be the proportion of budgeted costs that had been spent prior to the capacity withdrawal. Finally, the proportion of local authority rates included is likely to

be proportional to the percentage of the year for which it is intended to withdraw the plant.

3.8 If a generating unit is withdrawn from service for **over twelve months'** its avoidable costs will change to include further costs, in particular NGC use of system charges.[2] As a result the avoidable costs include:

- fuel costs;
- a proportion of labour costs;
- operational and maintenance costs;
- local authority rates;
- start up costs; and
- NGC connection and use of system charges.

3.9 In deciding whether or not to withdraw a plant, and in the absence of any market power and portfolio effects, a rational generator would forecast whether it could expect to cover its avoidable costs over the period of anticipated withdrawal. If it did not believe that it could cover its avoidable costs, it would withdraw the capacity to minimise its losses. If it believes it can cover its avoidable costs, it will minimise its losses by continuing to operate and making some contribution to its capital, financing and other costs. Ofgem will also consider the risks associated with the plant itself being the subject of an unplanned outage and being unable to operate.

3.10 In forecasting revenue that a unit or plant might recover, Ofgem will consider forward contract prices, spot prices and the balancing services revenue the plant

[2] Under NGC's current charging arrangements, generators pay network use of system charges for a whole charging year if they generate a single MW during the charging year. With the introduction of the Connection and Use of System Code and new transmission access arrangements this may change those NGC charges that can reasonably be included when determining a unit's avoidable costs.

could reasonably expect to receive. Ofgem may also consider the option value associated with having the plant available to run if market conditions change (for example if a significant unplanned plant outage led to higher than anticipated prices).