

**TYNAGH ENERGY**  
**L I M I T E D**

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REF: TEL/DV/13/172

26<sup>th</sup> September 2013

**Re: Gas Transportation Capacity Costs Consultation on BCOP Modification Directions**

Dear Joe,

Tynagh Energy Limited (TEL) welcomes the opportunity to respond to the consultation paper on Gas Transportation Costs and BCOP Modification Directions (SEM/13/051) that was published on the 31<sup>st</sup> July 2013. TEL has also sought independent legal advice on the proposed amendments to the BCOP to formulate our position. TEL would like to make comments under the following headings:

1. Purpose and Status of the BCOP
2. Right to include principles of good market behaviour
3. Penalties Principle
4. Duties of the SEM Committee
5. Treatment of Gas Transportation Capacity Costs

**1. Purpose and Status of the BCOP**

The power of the SEMC to make and amend the BCOP is set out in paragraph 5 of Condition 15/17 of the Standard Generation Licence. The BCOP can be used to define Opportunity Cost, make provision in respect of the calculation of Opportunity Cost and set out certain principles of good market behaviour, but the BCOP is at all times subservient to the Licence and its scope is limited by the Licence. Also, the SEMC is not the arbiter of the correct interpretation of the BCOP or the licence. Interpreting the BCOP and the licence does not involve any exercise of discretionary power and is a question of law for the courts.

This position was upheld in the Supreme Court Decision of *Viridian Power Limited & Anor v The Commission for Energy Regulation & Anor*. In the majority judgment, Hardiman J makes it clear that it is not possible for the BCOP to be read as removing any "cost" from the total costs calculated pursuant to the Licence. The BCOP can define Opportunity Cost and make provision in respect of the calculation of Opportunity Cost in respect of a cost item, but it cannot remove a cost item from the definition of total costs in the Licence. It is therefore not lawful for the SEMC to use the BCOP to require generators to exclude a cost item from their commercial offer data that otherwise falls within the definition of "total costs" of the generator.

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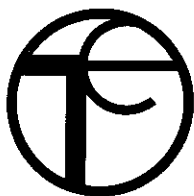
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Hardiman J concluded that the opportunity cost of a levy is the actual cash cost. This conclusion is equally applicable in relation to overrun charges. The cost of overrun charges are prescribed by a regulatory instrument (the Gas Code of Operations) and the opportunity cost of that charge is the actual cash cost. The Supreme Court Decision concluded that it was unlawful for any generator to engage in below cost selling. Any attempt to require generators not to bid in their actual variable costs of generation would breach this principle.

## **2. Right to include principles of good market behaviour**

The paragraph 5(c) of Condition 15/17 of the Standard Generation Licence gives the SEMC the right to include in the BCOP principles of good market behaviour that "should be observed by the Licensee and other generators in carrying out the activity to which paragraph 1 refers". Paragraph 1 requires that price components of all Commercial Offer Data submitted by Licensees are cost reflective. The SEMC may therefore set out principles of good market behaviour that should be observed by generators in ensuring that price components of all offer data submitted to the market operator are cost reflective. It does not have the power to impose principles of good market behaviour for any other purpose. The proposed amendments to the BCOP appear to go beyond this.

The proposed new paragraph 12D of the BCOP appears to be attempting to regulate generator behaviour in relation to booking gas capacity rather than simply regulate behaviour in relation to ensuring that commercial offer data is cost reflective. If this paragraph was only seeking to regulate generator bidding behaviour then it is in fact requiring generators to ignore their actual costs and would therefore not have the effect of ensuring that commercial offer data is cost reflective.

## **3. Penalties Principle**

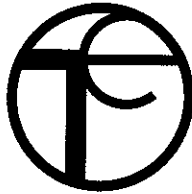
The second principle of good market behaviour proposed by the SEMC is referred to as the "penalties principle". The Consultation Paper states that "The SEM Committee does not accept that penalty charges are necessarily "costs" for the purposes of Condition 15/17 or would fall within a generator's SRMC".<sup>1</sup> The implication is that because such "penalty charges" are penalties as opposed to costs, they should not be reflected in Commercial Offer Data. TEL does not agree with the SEMC's assessment that these charges are penalties.

The SEMC argues the penalty charges are generally designed to incentivise behaviour and it would therefore be "perverse" if these charges were costs. Many costs are designed to incentivise behaviours – this does not mean that they are not costs. Short term capacity products are priced higher than longer term products for particular reasons. This does not mean that the cost of a short term product cannot be bid. The fact that an overrun charge is priced differently again does not mean it cannot be bid in. O&M Charges are often structured to incentivise generator behaviours, but this does not mean that variable O&M costs cannot be included in commercial offer data.

It is a long established principle of the common law that penalty clauses in contracts are unenforceable<sup>2</sup>. The Code of Operations is both a regulatory and a contractual document and to the extent that it is contractual, penalties are unenforceable. A clause may be deemed a penalty if the sum stated "is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed [the breach of contract]." As a matter of public policy, a clause whose dominant purpose is to deter or intimidate a party against breaching a contract may be unenforceable. If the SEMC was correct in its

<sup>1</sup> Paragraph 4.10.

<sup>2</sup> *Dunlop Pneumatic Tyre Company Limited v. New Garage and Motor Company* [1915] AC 79



assessment that overrun charges and unauthorised flow charges were in fact penalties then they would be unenforceable.

If these charges are not in fact penal, then paragraph 5 of Condition 15/17 of the Licence provides that principles of good market behaviour can only be included in the BCOP for the purposes of ensuring that offer data is cost reflective. It is not open to the SEMC to include principles of good market behaviour for any other purpose. The majority judgement in *Viridian Power Limited & Anor v The Commission for Energy Regulation & Anor* concluded that the BCOP cannot be used to exclude any costs from the "total costs" of a generator. If overrun charges or unauthorised flow charges are part of the "total costs" of a generator they cannot be excluded from offer data by the BCOP. It is not possible to include a principle of good market behaviour for the purpose of requiring generators to include a cost item in a manner which is not "cost reflective". The Supreme Court found that there was no distinction between a levy and the cash used to pay the levy. Similarly there should be no distinction between an overrun or unauthorised flow charge and the cash used to pay the charge.

#### **4. Duties of the SEM Committee**

The SEMC has a range of duties that are reflected in both the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 and the 1999 Act. Particularly relevant in this context is the duty of the SEMC to have regard to the need to ensure that undertakings are capable of financing their activities. There does not appear to be any evidence on the face of the Consultation Paper of the SEMC having regard to the financial implications of this decision for generators and, in particular, whether it could have the effect of causing generators to have to offer to generate at a price that is lower than their long run average cost.<sup>3</sup> It is arguable that the SEMC has failed to have regard to this duty in proposing these changes to the BCOP.

#### **5. Treatment of Gas Transportation Capacity Costs**

The provisional good cause determination made in SEM-13-039 means that gas capacity transportation costs are being treated differently to other costs which have the same characteristics. Specifically, Condition 8(ii) of the BCOP has been drafted for the express purpose of valuing cost items in circumstances where a recognised and generally accessible trading market ("RAGATM") does not exist. Disapplying Condition 8 for the sole reason that a RAGATM does not exist is therefore inconsistent with the treatment of every other cost item which is valued pursuant to Condition 8(ii), and doing so risks inconsistent valuation principles being applied in the BCOP.

In making an assessment of the costs associated with GTC a generator is required to calculate the costs on the basis of the Short Run Marginal Cost. This is defined as the difference between generating and not generating and should not take account of an assessment of the expected market schedule quantity as suggested by the SEMC. Neither would the generator be able to make an assessment of the anticipated availability of GTC on any particular trading day prior at 9:00am D-1. The current provisional good cause determination is inappropriate and should not be made enduring.

Yours sincerely,

**David Vaughan**  
**Business Analyst**

<sup>3</sup> In the Supreme Court Decision of *Viridian Power Limited & Anor v The Commission for Energy Regulation & Anor*, Hardiman J stated at p 49: "That is, it is not lawful for any operator in this market to engage in below costs (sic) selling, or to exclude any actual costs from the category of "total costs".