

TO:
All Balancing Mechanism Participants

Email: Market.Conduct@ofgem.gov.uk

Date: 20 December 2021

Trends in balancing costs in 2021

Recent months have seen a very sharp rise in balancing costs. This follows what were already very high costs as a result of the challenges faced by the Electricity System Operator ('ESO') in 2020 due to the pandemic situation. Over £1bn has been spent on balancing the transmission system between September and November 2021, double the cost incurred in the same period in the previous year, and daily Balancing Mechanism ('BM') costs reached an all time record of more than £60m on 24 November 2021.

This trend has been driven by a large rise in how much coal- and gas-fired units have charged the ESO in order to generate in the BM in certain periods. In part, this increase can be attributed to rises in fuel and emission costs, as well as higher balancing services use of system ('BSUoS') charges, and greater volatility in imbalance prices. However, the increase in costs does not alone appear likely to fully explain the scale of the increases we have seen in offer prices submitted by some generators in the BM. With increasing frequency, we have observed instances of extremely high prices (accounting for around 40% of total spending by the ESO on offers for gas-fired units in recent months), implying extremely high margins over direct costs.

Despite these high prices, the ESO has on a number of occasions been required to bring units online at these prices during the period in order to operate the system in real time. Under existing market rules, generators can choose whether to self-dispatch or make themselves available in the BM, and at times, last minute changes have meant the ESO had to make the decision to instruct a unit to generate at short notice, further limiting its ability to explore alternatives. The impact of the high prices on overall balancing costs has been magnified because the ESO must pay for power in the periods immediately before and after

the peak, despite this not always being required, due to the dynamic parameters submitted by generators indicating the minimum length of time for which they are able to operate. We have on a number of occasions observed generators submit final physical notifications which indicate that – absent any action from the ESO – they will be de-synchronising at a time which appears designed to maximise the number of periods for which the ESO must pay them to run in the BM.

The existing market rules do not prohibit generators from submitting high offer prices in the BM, nor from charging high prices for the power they produce in other wholesale markets. This is because occasional high prices in wholesale markets in periods with tight margins can play an important role in allowing companies to recover their costs, as well as incentivising investors to bring forward additional generation when there is a scarcity of capacity. Nevertheless, we are concerned by the level and frequency of the high prices that we have observed in the BM – prices which are much higher than seen in previous years, and have on occasion been three or four times the prices clearing the day-ahead auctions – as well as by the limited flexibility that the ESO has had to consider alternative options. Given the implications of these prices for balancing costs, imbalance prices and ultimately consumer bills, we are actively considering whether the existing arrangements provide adequate protection against companies exercising market power, and remain in consumers’ interests. In this regard, we are closely monitoring the outcome of the ESO’s review of recent events in the balancing market, and stand ready to use our powers to change the market rules if necessary.¹

Alongside the very high prices, we have been closely monitoring the accuracy of the information submitted to the ESO both regarding generators’ intention to operate during peak periods, and regarding the operating characteristics of their units. Market participants will be aware of a number of actions that we have taken against companies that have been found to have breached their obligations under REMIT and the Grid Code in recent years.² We will not hesitate to take action if we find evidence of market manipulation.

We would like to take this opportunity to remind all BM participants of their obligations under existing regulations, and in particular:

- The requirements of the Grid Code, including the requirement that physical notifications reflect parties’ best estimate of their expected output; and for generators, the requirement that dynamic parameters “reasonably reflect the true current operating

¹ The ESO announces review of balancing market: <https://www.nationalgrideso.com/news/national-grid-eso-announces-review-balancing-market>

² See our [April 2020 finding](#) relating to InterGen, our [December 2020 finding](#) in relation to EDF Energy (Thermal Generation) Ltd, and our [August 2021 finding](#) relating to ESB Independent Generation Trading Limited and Carrington Power Limited.

characteristics of the BM Unit" (or, where submitted at the day ahead stage, the unit's "expected" true operating characteristics)³;

- The REMIT regulations⁴, which prohibit market manipulation, including disseminating information which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of wholesale energy products; as well as making it appear that the availability of electricity generation capacity is other than the capacity which is actually technically available, where this affects or is likely to affect prices;
- The Competition Act 1998, which prohibits agreements which prevent, restrict or distort competition, as well as requiring that one or more undertakings with a dominant position in a market should not abuse that position (including by imposing unfair selling prices or other unfair trading conditions);
- The Transmission Constraint Licence Condition,⁵ which requires that generation licensees must not submit bid prices in the BM which are excessively expensive during a period in which a transmission constraint occurs.

Kind regards

Charlotte Ramsay / Richard Smith

Directors - Energy Systems Management and Security

³ Grid Code BC2.5.1, Grid Code BC2.5.3.1, Grid Code BC1.4.2(e).

⁴ Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency

⁵ Ie condition 20A of the Electricity Generation Standard Licence Conditions