To all wholesale market participants and other interested parties

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Dear Colleagues,

Responding to the high balancing costs in winter 2021

The ongoing gas crisis is putting consumer bills under extreme pressure. The costs that the Electricity System Operator (ESO) incurs to balance Britain's power system typically contribute around 2% to consumers' electricity bills. Between 2017 and 2020 total ESO balancing costs for the four months of winter (November to February) averaged just under £500m each winter. For the winter just gone this rose alarmingly to over £1.5bn, with record breaking daily costs being experienced during the period.

The large increase in balancing costs has primarily been driven by increased offer prices, rather than volumes. Last winter the energy markets and geo-political landscape was volatile and uncertain, with periods of tight margins and high fuel and emission costs contributing to the overall increase in total costs. Nevertheless, the frequency of instances of extremely high prices submitted by participants in the Balancing Mechanism (BM), combined with the inflexibilities in participants' offers raised questions as to whether market participants' behaviour was a reflective response to scarcity.

Following recording breaking daily balancing costs of over £60million on 24th November 2021, the ESO initiated an independent review of the BM. Ofgem also published an open letter[1] to market participants noting our close interest in the outcome of the ESO's review, and reminding parties of their obligations under existing regulations.

[1] Ofgem Open letter on trends in balancing costs in 2021: Open letter on trends in balancing costs in 2021 | Ofgem

The ESO's review is now complete and has been published today. It provides analysis of the different drivers of the high balancing costs observed over the winter, and describes a number of potential market reforms. It also concludes that, based on the information available to the ESO, there was no clear evidence of behaviour inconsistent with market rules.

In parallel with the ESO's review, we have carried out our own investigative work, including gathering a significant volume of information in relation to the period in question. To date, we have similarly found no conclusive evidence of market participants acting outside of their obligations under REMIT,[2] the Competition Act 1998, or the conditions in the generation licence. However, we remain concerned that evidence showed behaviours of some generators that appear to be immoderate.

Price signals have an important role to play in orchestrating supply and demand to ensure energy flows to where it is needed at the right time. 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. However, price signals must function alongside the need for effective consumer protections. Evidence such as generators submitting persistently high prices, inflexible and expensive offers, and intentionally exacerbating tight margins by scheduling to desynchronise their units with little notice just ahead of peak demand periods, shows that there is room within the existing market arrangements for changes that better ensure energy markets deliver in consumers' interests.

We plan to explore further a range of near-term interventions to improve existing market arrangements, in addition to supporting the Government to undertake its comprehensive Review of Electricity Market Arrangements. The options under consideration are designed to ensure that the existing market arrangements deliver in consumers' interests over the next few years, ahead of any longer-term market reforms. The range of potential options include (but may not be restricted to):

- Introducing direct measures to restrict BM offer prices. This could be achieved through the introduction of an explicit price cap or through an extension of the existing Transmission Constraint Licence Condition, which currently prohibits parties from submitting excessive bid prices when they hold market power behind a network constraint.

[2] REMIT is the Regulation (EU) No 1227/2011 on wholesale energy market integrity and transparency. It is the mechanism for reporting and preventing wholesale energy market abuse.

- Limiting generators' ability to amend their schedules with little notice. For example, generators could be required to submit and keep to their day ahead schedules, with amendments only allowed on the basis of open, transparent intraday trading.
- Restricting BM access or BM bidding flexibilities for generation capacity that is withdrawn with little notice.
- Changing the rules for how parties structure their BM bids. There is a spectrum of options that could minimise costs incurred by the ESO, such as: increasing the complexity of pricing structures to better reflect underlying costs; or removing dynamic parameters so that market participants internalise their own technical characteristics into their wholesale and BM trading strategies.
- Introducing new licence obligations that require generators to operate and behave in a manner that delivers in consumers' interests, for example in prohibiting actions that knowingly exacerbate tight system conditions.

We intend to continue to develop our proposals for intervention and will share these with stakeholders in due course. We will also continue to closely monitor activity in the balancing markets and will not hesitate to take any necessary enforcement action where we find conclusive evidence of market participants acting outside of their obligations. We look forward to working with all participants to ensure our market arrangements deliver in consumers' interests.

Kind regards,

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