

5th December 2022

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Non-confidential

Dear Robin,

Response to Call for Input on options to address high balancing costs

Drax Group plc (Drax) owns and operates a portfolio of flexible, low carbon and renewable electricity generation assets – providing enough power for the equivalent of more than 8 million homes across the UK. The assets include Drax Power Station, based at Selby, North Yorkshire, which is the country's single largest source of renewable electricity. Drax also owns two retail businesses, Drax Energy Solutions (formerly trading as Haven Power) and Opus Energy, which together supply renewable electricity and gas to over 250,000 business premises.

We acknowledge the importance of reviewing the Balancing Mechanism (BM) to ascertain the underlying causes of higher balancing costs and ensure the BM delivers efficient outcomes. We broadly agree with the assessment of the six intervention options set out in Ofgem's Call for Input. In particular, we agree that Option 1 - *Price cap on BM offer prices*, and Option 5 - *Restrictions on amending PNs after day ahead*, are overly interventionist and may lead to a significant departure from existing self-dispatch market arrangements. With regards to Ofgem's preferred option - *A new licence condition preventing excessive benefit after submitting a zero MW PN* – we agree that this option could provide a meaningful enforcement measure to address the market behaviour in question. However, the proposed licence condition needs to be more strictly defined in order to target the behaviours and actions of the specific generators in question, and in so doing, preserve efficient market operation and avoid unintended consequences.

To that end, one approach would be to ensure that the new licence condition only applies to behaviours and actions that are manifestly or intentionally abusive and which lead to significant impacts on system margins. This means that market participants should only be investigated under the remit of this condition when their offer prices, in combination with specific technical parameters such as Minimum Zero Time (MZT) or Minimum Non-Zero Time (MNZT), exacerbate system tightness and lead to excessively high balancing costs. This could be achieved by setting a threshold MZT above which the licence obligation applies, and/or, a threshold MNZT, or a combination thereof. For example, a threshold MZT of 120 minutes would represent a balanced, proportionate and targeted approach to intervention.

Alternatively, the licence condition could explicitly exclude/exempt technologies that reduce their PN to Zero MW within-day as part of typical commercial and economically rational behaviour, while also having limited impact on system conditions due to their technical attributes. Specifically, storage technologies, as defined in the generation licence, should be exempted.

As currently drafted, the licence condition would apply to all licenced generators, which will lead to a significant and disproportionate administrative burden on generators and Ofgem. Whereas, having a more targeted application, as suggested above, will ensure the intervention addresses the actions and behaviours of concern without being unduly burdensome.

Notwithstanding our support for Ofgem's preferred option, we believe Ofgem's findings have not given due consideration to wider factors that may lead to higher balancing costs, such as the accuracy of system margin forecasts provided by the ESO, the interaction between the BM and the wholesale market, and the imbalance price calculations.

We would highlight a number of additional points that should be considered and reflected in Ofgem's assessment of the need and type of intervention, to ensure it is proportionate, targeted and effective:

- We're concerned that the case for change may be too narrow and may fail to address more fundamental concerns, such as the ESO's analytical and balancing capabilities, its transparency and timeliness of data provision and availability, and, its forecasting of demand, generation and interconnectors and sharing of associated data with the market.
- It is important to recognise that scarcity pricing has an economic justification and plays a key role in providing investment signals and driving economically efficient outcomes. Moreover, the BM operates interdependently with other parts of the market design, meaning changes to the BM should not be considered in isolation to the wider market framework.
- The assessment needs to consider implications on other types of technologies that are not widely discussed in the consultation document, such as flexible generation, ageing generation and assets with limited operating hours.
- The assessment should also consider broader repercussions for the GB market design and investor confidence. The risk to investors and market participants, caused by any dampening of scarcity signals (limiting the incentive to arbitrage between balancing and wholesale markets) or by suppressing the overall value in the market, should be avoided. There is also a risk that any reduction in revenue recovery through the BM as a result of the proposed obligation may manifest in other areas of the market, such as higher wholesale prices, potentially resulting in equal or higher overall costs to consumers and undermining the objectives of the intervention.
- Should Ofgem decide to take forward the preferred option, detailed guidance will be needed to provide clarity on the rules, definitions, exceptions, and application, as well as procedural aspects around monitoring and enforcing the new obligation.

The appendix to this letter provides more detailed commentary against the four questions posed in the Call for Input. We would welcome the opportunity to discuss our response with you directly.

Yours sincerely,

Matt Young

Group Head of Regulation

Drax Group plc

Appendix - Detailed response to questions in Call for Input

1) Do you agree that our preferred option will effectively prevent the behaviour that caused last winter's high balancing costs?

Ofgem's preferred approach may address some of the commercially driven practices observed last year. However, the proposed licence condition is too broad and doesn't target the behavioural patterns of particular generators identified by Ofgem as causes of high balancing costs last winter. As discussed in the cover letter, the application of the condition should be more tightly linked to the specific technical and commercial attributes of BM Units that exacerbate tight system conditions.

More broadly, we believe that the optimal solution should lead to more efficient behaviour of BM participants resulting in system benefits and lower costs to consumers. It is hard to conclude with certainty for the impact assessment whether the proposed intervention will lead to this outcome. Our specific concerns with the broad impact assessment are:

- Scarcity pricing has a well-established economic rationale with higher prices reflecting scarcity being a key driver of investment cases and ultimately return on investment. With the BM being a key revenue stream, impacts on investor confidence and security of supply need to be considered carefully. This is particularly important for plants with limited or restricted running hours who consequently have reduced opportunity to recover their investment and ongoing costs and which in turn is reflected in their commercial operating and pricing decisions.
- The assessment does not discuss what the impact of the intervention will be on other types of generators, specifically on technologies that consider reducing PNs to zero MW throughout the day as normal operational and commercial behavior. For example, storage technologies do not typically have perfect foresight of their running profile in advance, and often respond to peakier periods in the day in order to recover their costs in the most efficient manner given their limited number of cycles and operating hours. As such, changing their PNs throughout the day is an appropriate practice for assets with these attributes. The proposed intervention will increase trading risks for these assets, undermine their ability to operate flexibly and hinder efficient commercial practices. It is also likely to increase administrative burden on smaller operators and may undermine the investment case for much needed flexibility.
- The proposed condition may address a very specific aspect of generator behaviour in a relevant settlement period. However, it is difficult to assess the full impact on prices across the day. The limitations introduced on one side of the decision-making may lead to increases in offer prices in the periods running up to the zero MW PN submission. This could be done in order to reduce risks of falling into the remit of the condition after increasing a PN from zero MW, since the comparison will be based on the prices before and after the submission. This may lead to an overall higher system average price and will erode any potential benefits from the proposed change.
- We also encourage Ofgem to consider cost and resource requirements of the proposed approach. For example, the wording of the proposed condition needs to be clear whether a generator's pricing will only come under scrutiny if an excessive offer is accepted by the ESO, or, if it impacts system tightness, or, if an 'excessive' offer is made but isn't accepted by the ESO. The latter will lead to significant volumes of cases and data to be interrogated, resulting in a significant administrative burden to monitor and assess compliance.

Overall, while the proposed option may address the specific behaviours in question, we are keen to see a wider assessment of the steps and decision-making points in the BM, including the accuracy of forecasts provided by the ESO, the timing of data and forecast updates that may in of themselves materially impact system tightness, and the overall transparency of information available to all market participants.

Q.2) Is the proposed licence condition drafting in Annex 1 sufficiently clear? Are there any drafting edits or additions that you would encourage us to consider?

In our view, the drafting of the proposed licence condition isn't sufficiently clear. Market participants must have greater certainty as to what behaviour and pricing will and won't be considered acceptable by Ofgem. In particular, we would make the following recommendations:

- The definition of excessive benefit fails to provide clear criteria for establishing what is considered 'excessive'. We would urge Ofgem to provide a transparent methodology and benchmarks for determining whether a particular price submission is excessive or not.
- The wording of paragraph 2 should specify that all three conditions have to be met in order for an offer to be considered 'excessive benefit'.
- As per the consultation document, the submission of a PN of zero MW in of itself should not fall into the remit of this condition and is considered to be a normal operating practice. This needs to be clear and consistent throughout the text.
- Paragraph 2a refers to submitting a PN of zero MW within the same Operational Day as that Settlement Period, but does not explain how prior submissions will be treated, i.e. where a generator starts an operational day with a zero MW PN. It may be clearer instead to explicitly reference a change from non-zero to zero MW PN within the operational day.

To address the points above and those in response to question 1, we would suggest the following changes to the proposed legal text:

1. *The licensee must not obtain an excessive benefit from electricity generation in respect of a Settlement Period in relation to which the generator has submitted a Physical Notification of zero MW for the relevant BM Unit if:*
 - the Minimum Zero Time of the BM Unit is equal to or greater than 120 minutes, or
 - the Minimum Non Zero Time of the BM Unit is equal to or greater than 120 minutes.
2. *For the purposes of paragraph 1, the licensee shall be considered to have obtained an excessive benefit from electricity generation in respect of a Settlement Period if all of the following conditions apply:*
 - a. *the licensee has ~~submitted a~~ changed its Physical Notification ~~of from non-zero to zero MW to the system operator~~ in respect of that Settlement Period within the same Operational Day as that Settlement Period;*
 - b. *the licensee and the system operator enter into, or have entered into, Relevant Arrangements in respect of that Settlement Period; and*

- c. *under the Relevant Arrangements in respect of that Settlement Period and in connection with an increase in electricity generation the licensee is paid or seeks to be paid, an excessive amount by the system operator, as demonstrated by the licensee having submitted an offer that is manifestly excessive.*
3. *For the purposes of paragraph 2 the reference to an increase in electricity generation by the licensee in respect of a particular Settlement Period means:*
 - a. *an increase in comparison to the licensee's Physical Notification of zero MW; and*
 - b. *an increase in generation of electricity by a particular generating plant, whether or not there is an overall increase in electricity generation.*

Q.3) Do you agree with the initial list of factors to consider when assessing excessive behaviour? Are there any other factors that you would encourage us to consider?

We agree with the proposed list of factors. However, the guidance needs to include much greater detail for each item. We are concerned there will be a lack of granularity, clarity and consistency of interpretations and definitions in the guidance, as well as a lack of reference points or suggested reference sources that may be used in any assessment. Moreover, it is critical that there is absolute consistency in interpretations and meanings across the suite of related documents, i.e. the final decision document, the proposed draft legal text and the draft guidance. We suggest that Ofgem incorporates the following factors in the assessment and the associated guidance.

a) Overall system tightness: An assessment of the publicly forecasted system margin for the settlement period for which offers are submitted, as well as any published system warnings.

- The guidance needs to provide clarity and transparency around the reference materials and reference points that will be used in the assessment.
- With regards to relying on publicly available system forecasts, it is important to recognise that the quality and accuracy of ESO forecasts in the past has been questioned by the industry. Therefore, many market participants rely on their own internal forecasting tools. If an assessment was based solely on the forecasts provided by the ESO, there is a risk that it may result in an incomplete view of the participant's decision-making framework.
- Another factor that may provide an incorrect signal is the view of interconnector flows. As part of the Balancing Capability Strategic Review and other relevant projects in this space, the ESO has highlighted that interconnector flow forecasts can change materially closer to real-time and often lead to an increase in the number of actions the ESO needs to take in the BM. If the PN data for interconnectors is not updated and reflected in system forecasts in an accurate and timely manner, this can lead to a false or incorrect view of system conditions. There have also been a number of instances where interconnector flow position was incorrectly reflected in system reports, i.e. even though low prices were available to the ESO to reverse exporting flows, the report would demonstrate very high scarcity risk and price.
- The guidance document needs to provide clarification around the level of margin that would count as overall 'tightness', as well as the timing reference point for when the 'tightness' will be assessed. For instance, in a scenario where the market is not considered 'tight' at gate closure, but then reverts to being 'tight' after gate closure, how will this change be reflected in the assessment considering that offer prices cannot be changed after gate closure.

- Clarification is also required to explain the treatment of the Loss of Load Probability (LoLP) calculation at D-1 which sets potential BM pricing levels (and expected system tightness) at the day ahead stage on tight days.

b) Has the offer price changed significantly after revising the PN to zero? Comparing the price of offers made by the generator before and after the reduction of its PN to 0, whilst considering any change of market conditions during this time.

- It should be acknowledged that offer prices after a reduction to a zero MW PN are always likely to increase to reflect the required economic and commercial factors associated with an increase in generation. We do not consider an increase in the offer price itself to be a sufficient criteria for querying the behaviour of a BM Unit.
- There is a risk that the proposed assessment approach may lead to units increasing offer prices in the lead up to the zero MW PN submissions in order to mitigate the risk of falling foul of the rules. This could blunt the usefulness of comparing changes in offer prices.
- When considering changes in market conditions around the period under assessment, the assessment must include both fundamental and risk drivers, such as changes in generation and demand margins, wind forecasts and interconnector flows.

c) Has the revised PN materially affected the system margin? Without this generator being synchronised what remaining options does the ESO have to balance the system.

- As discussed above, the fundamental criteria for establishing the applicability of the proposed rule should be the impact of a BM Unit's actions on system margins. This condition should only be considered as breached when a submission of an excessive offer price, in combination with the MZT and MNZT of the particular BM Unit, exacerbates system conditions and leads to the ESO having limited options for balancing the system.
- 'Materiality' and its measurement should be clearly defined. The guidance documents needs to provide a clear list of conditions and steps that will be applied when assessing material impacts on the system margin.
- The assessment also needs to consider that taking a unit off the system will likely result in the next available unit having higher costs and higher offer prices.

d) To what extent is the offer price in line with prices in similar periods of scarcity? Benchmarking against offers in settlement periods with similar market and system conditions.

- Definition of excessive benefit in periods of scarcity needs to be specified.
- There is little guidance on what criteria will be used in establishing 'similar' periods. Will this reflect similar system margin or will it take into account wider factors, such as similar seasonal attributes or specific market conditions.

- This part of the assessment needs to take into account market/portfolio risks. While the spread in pricing for an individual unit may be high, the pricing could be justified when considering a large portfolio risk and trading approach.
- Managing exposure to imbalance prices needs to be considered carefully as it can be one of the determining drivers for changing PNs and prices across periods both intraday and beforehand. Where prices are lower than the ESO's forecasts (i.e. around the LOLP equivalent price), units may be under-priced relative to cashout exposure from an unplanned outage. This could cause a false consideration of an excessive benefit.

e) To what extent is the offer price in line with the market's valuation of scarcity? Comparing the price of the offers to the prices paid for energy in day ahead and intraday trading for delivery in the relevant settlement periods.

- There will need to be a clear methodology and explanation of how Ofgem would consider the market's valuation of scarcity against the ESO's value of scarcity. For example, when a unit fails, the cost of running on a PN instead of being available in the BM results in the system being shorter. This will translate into a different view between the ESO and Generator, i.e. the Generator will factor in a higher offer price to account for costs than would be reflected in the ESO's value of scarcity.
- The treatment of cashout and imbalance risks are key considerations. Generators will not take excessive risks to achieve marginal gains where the value of prices paid for energy in day ahead and intraday trading do not reflect the value of cashout. In that scenario, Generators will buy units off as a justifiable cost and risk based commercial decision.

f) What and how have other costs been factored into the offer price? Any other relevant economic factors that influence pricing, such as fixed and variable costs of power generation, sunk costs, opportunity costs and expected costs (e.g., imbalance or network charges).

- A clear definition of opportunity cost, and what facets will/won't be considered appropriate, will be important, specifically clarifying that a valid opportunity cost includes the cost of running to a PN, i.e. not being able to run in the BM.
- We would welcome clarification of expected costs and how they should be considered against cashout and unplanned outages in reference to LOLP.

4) Is there any specific information you would like to see in the accompanying guidance related to interpretation and enforcement of the new licence condition?

In addition to clear and transparent assessment and evaluation methodologies, and unambiguous interpretations and definitions, it would be useful to set out how Ofgem will monitor generator behaviour under the licence prohibition.