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Dear Robin

Call for input - Responding to high balancing costs in winter 2021: Update and proposal to introduce a new licence condition

We welcome the opportunity to respond to Ofgem's call for input regarding the proposed new licence condition. We understand and agree with the need to address the high balancing costs seen in winter 2021, with the context of the ongoing energy crisis rightly spurring efforts to lower customers' bills. We set out our detailed views on the six possible interventions Ofgem describes in the call for input in Annex 1.

Ofgem's call for input focuses on one particular behaviour which contributed to high balancing costs, where gas-fired generators increased their offer prices after posting a zero MW Physical Notification (PNs), leading to excessive benefits within the balancing mechanism. We assume that Ofgem's focus on this single cause is justified by the evidence seen in winter 2021, and we agree that Ofgem should take action to prevent generators making excessive benefits in these circumstances. We agree with Ofgem's position that Option 4 (a new licence condition) is the most appropriate intervention to tackle this – though Ofgem should keep open the option of using its Competition Act powers alongside the licence condition, eg where there is abuse of temporal dominance. We also consider there may be potential benefits from Options 2 and 3, which Ofgem may wish to revisit in future.

We also take this opportunity to highlight that there are other factors that we believe are contributing to exceptionally high balancing costs. We believe Ofgem should also consider other options that can also support the efficiency of the balancing mechanism alongside the proposed licence condition.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

**RESPONDING TO HIGH BALANCING COSTS IN WINTER 2021: UPDATE AND
PROPOSAL TO INTRODUCE A NEW LICENCE CONDITION
– SCOTTISHPOWER RESPONSE**

Question 1: Do you agree that our preferred option will effectively prevent the behaviour that caused last winter's high balancing costs? Please provide reasons for your answer.

Option 1 – Price cap on BM offer prices

We consider the introduction of a price cap on balancing mechanism (BM) offer prices as a heavy-handed approach to reducing balancing costs. Two options were proposed; either a cap on all BM offer prices, or a cap on a unit's BM offer prices only after submitting zero MW PNs, which would more specifically target the identified problem. With either of these two options, we believe there is a risk of negative unintended consequences including potentially adversely affecting security of supply. The balancing mechanism relies on responsive price signals to coordinate efficient transactions between NGESO and generators. The need to retain strong price signals had been reaffirmed by the increasing levels of intermittent generation on the grid. We believe any interference with these price signals would weaken NGESO's ability to coordinate with generators, possibly leading to generators choosing to reduce their participation in the BM. Pursuing Option 1 would dampen price signals with a complex, and difficult to determine, price cap - indeed, Ofgem noted the negative impact of Option 1 on price signals in its RAG assessment. Therefore, we do not believe this option merits further consideration.

Option 2 – Changes to BM bid/offer structures

Option 2 proposes changing the structure of BM bids and offers to better reflect competitive pricing. While the proposal is in its infant stage and has not been fully developed, it can be split between:

- introducing more complex bidding structures to account for varying cost drivers, or
- removing dynamic parameters, allowing generators to internalise different variables into their pricing strategies.

We agree with Ofgem that both the complexity and length of time to implement the proposal restricts its ability to address rising balancing costs quickly, potentially not for several years. However, we believe there is merit in exploring this option further, in particular the potential benefits of more granular pricing which could be achieved by changing bid/offer structures. For example, shorter dispatch times could make use of the dynamic information available from different BMUs, improving the efficiency of the wider balancing mechanism.

Further, we note that BEIS and Ofgem are exploring options for wider market reforms including the potential benefits of central dispatch in association with Locational Marginal Pricing (LMP). We believe the current self-dispatch market arrangements continue to be appropriate, though reforms to bid/offer pricing structures could be developed to provide some of the benefits of central dispatch whilst retaining the self-dispatch model. We suggest that separately to addressing the causes of high balancing costs, the ESO and Ofgem continue to evaluate the potential benefits of reforming BM bid/offer structures.

Option 3 – A new NGENSO balancing condition to procure firm reserve

A new ESO balancing service to procure firm reserve would provide an opportunity for NGENSO to 'lock in' reserve capacity in advance. Those who provide reserve capacity would be prevented from reducing their PNs to zero MW, since they would be contracted with NGENSO to provide a given volume. We believe that Option 3 - procuring a firm reserve - could reduce the number of instances where the ESO is compelled to accept costly offer prices. Therefore, this option could provide a cost-effective balancing service and a minimum level of reserve capacity. We would expect that if this option were to be considered further it could incentivise more widespread adoption of innovative storage and flexible demand solutions, for example Battery Energy Storage Systems (BESS) or hydrogen electrolyzers in standalone or hybrid operation, providing new opportunities for flexible services.

However, we note efforts to implement a firm reserve at present are negatively affected by cost and volume uncertainties, which may become clearer as new technologies are adopted. We do not believe the current market structure makes a new balancing service such as that proposed in Option 3 viable. Uncertainty regarding supplier participation could increase balancing costs overall and/or result in a limited reserve volume. We recommend Ofgem continues to monitor market development in BESS and similar innovative storage systems.

Option 4 – A new licence condition preventing excessive benefit after submitting a zero MW PN

We consider that the introduction of a new licence condition aimed at prohibiting generators from gaining excessive benefit after publishing zero MW PNs is the least challenging of the six options to implement. This licence condition would enable Ofgem to pursue wayward generators and demand justification that their offer prices reflected fair and effective pricing strategies, and impose penalties on those found to have broken the rules. The success of the licence condition relies on the clarity that the regulator can provide to industry and its ability to enforce the licence condition. Option 4 will give Ofgem the powers to identify and investigate examples of excessive benefit, but any preventative effect will only be attained if industry participants have confidence in Ofgem's ability to enforce the licence condition.

In our responses to questions 2, 3 and 4 below, we explain our position regarding the best way to define and target "excessive benefit." We also recommend Ofgem review data of past winters to get an idea of how balancing costs would have been affected had the proposed licence condition been in effect – the results may positively steer future development of the option.

Option 5 – Restrictions on amending PNs after day ahead

We do not believe Option 5 is the most appropriate method of responding to increasing balancing costs. This proposal would be a significant step away from the existing self-dispatch model, as generators would have to publish final PNs much earlier with limited availability to adjust closer to real time. The increasingly dynamic nature of the grid is a further argument for retaining the self-dispatch model and publishing final PNs close to real time. We do not recommend moving forward with Option 5 on account of its unnecessary interventionism and the shift away from self-dispatch.

Option 6 – Clarifying 'good industry practice' in the Grid Code

Option 6, as a complementary reform to work alongside the proposed licence condition, could clarify the good industry practice that is expected of generators when participating in the market. We note the greater difficulty of clarifying good industry practice, rather than targeting examples of clear, concerning behaviour that Ofgem has identified through a licence condition.

We believe Ofgem should prioritise Option 4 ahead of Option 6, with the possibility of revisiting Grid Code changes in future.

Competition Act powers

Ofgem notes that the above options are not necessarily mutually exclusive and that it may also take other enforcement action, such as through its competition law powers. We agree that Ofgem should keep open the option of using Competition Act powers alongside any new licence condition, and should continue to monitor the market for evidence of abuse of dominance. Given the high degree of ownership concentration of flexible CCGT assets (and tight system margins aggravated by a poorly designed CM), it may be that some companies find themselves with temporal dominance at times of system stress.

Options to address other causes of rising balancing costs

The options above target one specific cause of rising balancing costs, the ability of generators to gain excessive benefit after posting zero MW PNs. We believe Ofgem should also be giving consideration to other factors that contribute to rising balancing costs, and how they could be mitigated, for example:

1. The lack of flexibility markets – We believe Ofgem also needs to take steps to respond to the long-term increase in intermittent generation and its impact on balancing costs. We note the longer-term strategy that is being explored with the REMA programme, and urge Ofgem to develop new, flexible market instruments to help mitigate the impact on balancing costs. Without these market instruments, NGESO may continue to struggle with providing a cost-effective balancing mechanism.
2. Outdated dispatch model – As discussed in our review of Option 2, we believe there is room for Ofgem to explore the inclusion of dynamic parameters within bid/offer structures. We believe such measures may be necessary as the system becomes more dynamic and intermittent generation is more common. The introduction of dynamic parameters could accommodate dynamic information that is available from different BMUs.

Question 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?

To be successful, the proposed licence condition must be sufficiently clear such that all interested parties are aware of how the proposal will operate and can determine in advance whether a particular course of action will be compliant with the licence condition. We note the following instances where more clarity is required:

- a) Condition 2c – As Ofgem has noted, it must give guidance as to what is meant by an “excessive amount”.
- b) Condition 3b – it would be helpful if Ofgem could provide a concrete example of where the test in 3b would be relevant.

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

Ofgem has published a non-exhaustive list of factors that will be considered to assess if an offer is excessive.

- Overall system tightness

Ofgem would assess offer prices against the publicly forecasted system margins for that settlement period, along with any system warnings. Ofgem may wish to consider how much weight this factor is given in the overall assessment – if the system is forecasted as tight, it would be reasonable for generators to submit higher prices.

- Has the offer price changed significantly after revising the PN?

We agree that market conditions at the time should be considered, not simply the difference between offer prices before and after a zero MW PN is published. However, it may be sensible to compile an industry benchmark, which considers market conditions themselves, and judge revised PN offer prices against this benchmark – this way, Ofgem can isolate the excess difference the PN revision has on that gas generator's prices. It may be easier to seek justification of excess offer prices with this information.

- Has the revised PN materially affected the system margin?

The effect that gas generators revising their PNs has on balancing costs is made worse when ESO has fewer alternative options to balance the system. We agree with Ofgem that PN revisions which materially affect the system margin are of concern, since the generator may exploit their own effect to make an excessive benefit on offer prices. In future, Ofgem may consider publishing pre-emptive system alerts when a revised PN does materially affect system margin. This would inform both the gas generator that they should be ready to supply offer justification, and the wider market of an important pricing signal.

- Is the offer price in line with other prices at similar scarcities?

We agree that Ofgem should compare offer prices with benchmarks of similar market conditions. We ask if Ofgem has the data and IT systems to reliably compare offer prices to these baselines in real time to trigger an alert of excessive prices, or if this tool will only be used retrospectively.

- Is the offer price in line with the market's valuation of scarcity?

Ofgem proposes to compare the generator's offer price with the market prices in the day ahead and intraday markets. We are unsure of how much weight should be given to this factor, since the real-time balancing mechanism faces different cost profiles than these markets.

- What and how have other costs been factored into the offer price?

We believe this factor is the most important and may require elaboration – it is these other costs that will be used by generators to justify their offer prices if they are asked to do so. Ofgem may wish to clarify the extent of evidence that will be asked for to provide justification of increased offer prices, so that generators may know in advance of what is required of them.

Question 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?

We have noted that Option 4 is the simplest of the six proposed interventions to implement. We expect the licence condition to have a positive impact on reducing balancing costs, but it may be difficult to quantify the proposal's preventative impact on immoderate behaviour. We

would welcome further discussion of how to assess the effectiveness of the licence condition, both on preventing generators from manipulating the balancing mechanism and on lowering balancing costs - such assessment may be useful if Ofgem decide to review the condition.

ScottishPower
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