

## **Response to Ofgem Call for Input on Responding to high balancing costs in winter 2021: Update and proposal to introduce a new licence condition**

5 December 2022

### **About EPUKI**

EP UK Investments (EPUKI) is a UK energy company, primarily focusing on power generation from conventional and renewable sources.

EPUKI is the UK division of Energetický a průmyslový holding (EPH), a leading energy group of over 70 companies that owns and operates assets across Europe. EPH group employs circa 25,000 people internationally, owns €16.7bn of assets, generating €8.6bn of revenue and an EBITDA of €2.1bn.

Since it was established in 2015, EPUKI has expanded to be one of the largest independent generators in the UK and Ireland and owns and operates multiple renewable and flexible power generating assets in those markets. These include Lynemouth Power, a market leading 400MW renewable biomass plant and 3.3 GW of gas-fired plants which provide flexible generation and services: South Humber Bank, Langage, Ballylumford and Tynagh Energy.

### **General comments**

While we recognise Ofgem's concerns regarding costs to consumers, it is not immediately apparent that the generator behaviours that Ofgem has outlined in its Call for Input are abusive or manipulative rather simply rational responses to scarcity and volatility in the market. Frontier Economic's report for NGESO showed that the highest BM cost days in winter 2021 were among the tightest margin days in the period. On such days, generators will seek to maximise revenues by optimising their trading between products and markets. Buying back positions which may have been sold days, months or even years ahead of time and then seeking revenues that reflect the prevailing level of scarcity via the Balancing Mechanism is a rational response to these market conditions and such scarcity revenues are the basis of many investment cases in the sector. Ofgem recognises in the Call for Input the important role that scarcity pricing plays in encouraging and recovering investments and has previously stated that 'rules on market conduct are not intended to interfere with the proper application of market forces, nor do they prohibit a rise in market prices reflective of scarcity in the market'.

While we recognise that the dynamic parameters of plant may mean that the ESO is required to accept unit offers for longer than may be considered desirable, no evidence has been provided that generators are using these dynamic parameters strategically to secure offer extensions. Furthermore, the ESO has available to it a range of response products and a large amount of flexible plant with short duration start times (peaking plant and batteries), which it could call upon on days with tight margins. We are therefore unclear whether the ESO had utilised all the resources available to it on the days in question.

Ofgem recognises that 'Last winter the energy markets and geo-political landscape was volatile and uncertain'. We note that, other than the review of a small number of high balancing cost days in winter 2021, no overall review of generator behaviour in the BM has been undertaken. We are therefore unclear whether the behaviour that Ofgem has identified is part of an ongoing trend or just a response to volatile markets with high levels of scarcity in an exceptional winter. The presence of coal plant in the market in winter 2021 pricing at £4,000/MWh set a benchmark for scarcity pricing on tight days. It is possible that generator behaviour may change this winter in response to differing market conditions (including coal plant being held outside the market under the Winter Contingency Contracts) and following Ofgem's statement of its concerns about potential abusive behaviour. We consider that Ofgem should wait for further evidence regarding generator behaviour in winter 2022 before deciding whether to proceed with any intervention.

We therefore do not consider that Ofgem has proved that there are actually 'sharp practices' that need to be addressed immediately. Even if there are, we are unclear why additional regulation is required in this area. If the behaviours identified by Ofgem are abusive, they could be addressed via existing regulation, including REMIT and the Competition Act 1998. We are unclear why these avenues are not considered suitable for pursuing enforcement. We note that Ofgem has recently reminded generators of their obligations under their licences and the Competition Act but has not yet attempted to enforce these regulations with respect to the 'sharp practices' outlined in the Call for Input. The case for the failure of existing regulation and the requirement for a new licence condition has therefore not been made.

The proposed licence condition appears to be closely modelled on the Transmission Constraint Licence Condition (TCLC). However, we consider TCLC to be a fundamentally flawed piece of regulation and we are concerned that any licence condition modelled on TCLC would be similarly flawed. The proposed licence condition prevents a generator from receiving an 'excessive benefit' in relation to its offer activity after submitting a zero MW PN. However, excessive benefit is not an established concept and generators would struggle to assess whether they are likely to be compliant. 'Excessive benefit' is currently only used in the TCLC, but there is no precedent for how Ofgem assesses whether revenues are excessive, and the factors taken into account in this proposed new licence condition may be different to those under TCLC. Although Ofgem has committed to providing guidance alongside the licence condition itself, our experience is that providing a non-exhaustive list of high-level factors that can be interpreted broadly does not provide any confidence to generators to allow them to assess whether they are compliant or whether Ofgem will consider the issue of excessive benefit in the same way as the generator. The accompanying guidance provided under TCLC has not provided sufficient transparency to market participants on the application and interpretation of that licence condition. For example, the TCLC guidance provides minimal information to help a generator identify when it may be behind a constraint. Guidance accompanying the new licence condition on offer pricing would therefore need to provide explicit detail on the behaviours and actions which would be considered in breach of the licence condition, rather than leaving it to the subjective assessment of the generator.

The proposed licence condition is therefore likely to introduce significant compliance risk for generators, which may lead to them to limit their offer prices in general, contrary to current market design principles. The market's reliance on scarcity revenues is the result of successive market design decisions by government and Ofgem. Introducing new regulation which has the potential to target legitimate responses to scarcity creates a high level of risk for generators and may lead to BM prices not responding as they rationally should do on days with tight margins, suppressing overall revenues for generators. If a generator is unable to realise the full value of scarcity, there is a risk that the full option value of an investment cannot be returned. To allow generators to recover their investment costs, this lost revenue will need to be recovered elsewhere and intervention in the BM is therefore likely to push up prices in intraday and day ahead markets and in the capacity market, which is a pay as clear mechanism. This could lead to higher prices across a range of markets, increasing costs to consumers. If generators are unable to recover their costs, plant closures will lead to a further reduction in margins and increased risks to security of supply.

By regulating offer prices, the proposed licence condition would represent a significant intervention in the functioning of the energy market and a move away from established principles of energy market price formation. This could substantially reduce the attractiveness of the GB market to investors. We consider that any intervention of this nature, which amounts to a form of price control, should only be made via primary legislation with the consent of Parliament, which would be consistent with the original approach taken to TCLC. As outlined above, a considered intervention would be preferable to one that is rushed with potential for unforeseen and unintended consequences. We do not consider that any intervention is required urgently as it is unlikely that the new licence condition proposed by Ofgem would be ready for implementation until after the end of this winter in any case.

## **Response to questions**

### **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.**

No. As outlined above, Ofgem has not made a compelling case that the generator behaviour in question resulted in excessive benefits rather than being a legitimate response to market signals on days with tight margins. Furthermore, it is clear from the Frontier Economics report that high balancing costs last

winter were driven by a complex mix of factors rather than just one generator behaviour. Ofgem's proposed intervention would therefore only address one element in a complicated picture. We believe that a more holistic review of the functioning of the market in tight periods is required, including the impact of ESO forecasts and actions. The ESO may be sending mixed signals to the market about the level of scarcity and its margin requirements. For example, day head derated margin/LOLP forecasts are issued after the market has already cleared OTC or in auction. Forecast interconnector flows are also a significant factor in balancing the system, but the ESO is sending confusing signals on these, for example by issuing and then cancelling Capacity Market Notices once interconnector flows are confirmed.

We also consider that, although Ofgem's preferred option may reduce costs in the BM, it would likely result in higher prices in other markets to ensure that generators can recover their costs. This may limit any benefit for consumers. A full Impact Assessment of the licence condition must therefore be carried out to justify any intervention.

**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?**

We consider that the drafting should more accurately specify the circumstances that Ofgem is intending to capture. For example, the drafting of 2(a) should state that the condition applies where a licensee has revised a positive PN to zero on the same Operational Day as the Settlement Period in question. Given that Ofgem's concerns appear to centre around the late notice revision of PNs and the length of time for which offers need to be accepted to maintain plant availability, it may be appropriate to include more specific time periods within the licence condition. A more focussed and precise licence condition would ensure that generators can fully understand which behaviours are captured.

**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 consider that the factors that Ofgem have identified would need detailed expansion in order to be of use to generators in understanding the application of the licence condition. Factors that require further detail and consideration are:

- The usefulness of 'publicly forecasted system margin' in assessing overall system tightness. Generators may use their own view of system margins which, while informed by public forecasts, may differ for a number of reasons (eg. wind forecast sources, views on continental prices) and this will affect generator decision making. Generators will also be forecasting margins against upside and downside sensitivities, which could result in widely differing assessments by each generator of market conditions, price and technical risks. As noted in recent reviews, there are deficiencies in NGESO's forecasting which may mean it is not always seen as a reliable source of information.
- How benchmarking against prices in similar market and system conditions would be performed and over what timeframe such benchmarks would be considered appropriate.
- How a comparison against day ahead and intraday prices would be performed given that expectations of system tightness may change in that timeframe and whether historic trends in the differences between these prices would be taken into account. We note that during recent tight days the movement in prices between OTC, EPEX, N2EX and half hourly auctions across the day has been dramatic.
- Ofgem's view of opportunity costs, including whether this includes the opportunity cost of lost value if a generator offers below the marginal price. It is natural that offer prices should tend towards VoLL when margins are tight.
- Over what period excessive benefit would be assessed as some generators will be seeking to recover their costs and make a reasonable return in a limited number of Settlement Periods. It is clearly not reasonable to look at a single Settlement Period when assessing whether generators are pricing excessively. Ofgem must consider the overall level of return made by a generator, especially as many of the assets in question will be on a declining revenue trajectory due to the influx of renewables on the system.

**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?**

Any guidance must provide absolute clarity to market participants on the application and interpretation of the licence condition. As stated above, 'excessive benefit' is not a well-understood concept and there is little precedent for how this will be assessed. Ofgem must therefore provide as much detail as possible on their interpretation and assessment of 'excessive benefit'. The factors listed in guidance must be the only ones which will be taken into account by Ofgem rather than treating them as an indicative list. The guidance must also provide explicit detail on the behaviours and actions which would be considered in breach of the licence condition, rather than leaving it to the subjective assessment of the generator.