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Generation and Wholesale Market

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

Context

Sembcorp Energy UK (SEUK), a wholly-owned subsidiary of Sembcorp Industries, is a leading provider of sustainable solutions supporting the UK's transition to Net Zero. With an energy generation and battery storage portfolio of over 1.3GW in operation or under development, our expertise helps major energy users and suppliers improve their efficiency, profitability, and sustainability, while supporting the growth of renewables and strengthening the UK's electricity system. Our Wilton International site, within the Teesside Freeport, sits amongst a hub of decarbonisation innovation. At the site, we provide energy-intensive industrial businesses with combined heat and power (CHP) via our private wire network that supplies electricity generated by gas and biomass.

These services are complemented by our fleet of fast-acting, decentralised power stations and battery energy storage sites situated throughout England and Wales. Monitored and controlled from our central operations facility in Solihull, these flexible assets deliver electricity to the national grid, helping to balance the UK energy system and ensure reliable power for homes and businesses.

Response

We understand and wholeheartedly agree with the need to protect customers from high costs and with this focus in mind it is crucial that solutions to high balancing costs need to be viewed holistically. It is vital that market participants are able to price in scarcity and that system tightness is reflected appropriately in the Balancing Market (BM). Scarcity pricing presents a significant investment signal – if that signal is removed, the power generation sector is unlikely to see the investment in highly flexible, responsive assets that will be needed to underpin the net-zero transition and this will inevitably result in higher costs for consumers in the long term. This is also a fundamental premise of the interaction between the Capacity Mechanism and the BM, so adjusting one aspect of the market will need to be considered in a broader context. In the medium term, we believe Ofgem's focus should be on making best use of existing highly flexible assets and encouraging development, rather than adjusting the BM around low flexibility of older assets.

We largely agree with Ofgem's assessment of the options, and so would support a new licence condition, but wider improvements are needed to the BM. For the BM to deliver security of supply at best value for consumers, it is vital that value of the flexibiilty provided by existing assets is recognised.

Currently, the BM does not provide a clear signal for fast-acting assets: assets with slower dynamic parameters are brought on earlier, as the Electricity System Operator (ESO) cannot

be certain they will be available at times of potential system tightness. As well as improved Good Practice in the Grid Code, there is also scope for reform of the BM to improve scarcity pricing signals and encourage flexible assets.

Possible options could include:

- Adjusting gate closure for different classes of assets (to allow flexible assets to respond to the market before the BM),
- Stronger emphasis on the order of merit for bids and offers, and more reflective dynamic parameters, similar to Option 2b).
- Using fast-acting assets more efficiently. This should drive down the immediate cost for consumers and clearer investment signals should reduce the cost of capital and ensure security of supply as industry decarbonises and the market conditions, seen last Winter and already this Winter, continue into the future. REMA highlighted the need for flexibility in the near future and the increasing cost of investment due to lower load factors. At the moment, the BM is a key way for flexibility to be valued in an open market and improvements to the BM must be considered as part of REMA, as trading arrangements evolve.

We agree that a new licence condition (Option 4) would be best in the near term, as it is targeted on the issue identified as the cause of last winter's high balancing costs and therefore less likely to have negative impacts on other parts of trading arrangements. It is also highly flexible, as it will allow Ofgem to take all factors into consideration when deciding if a generator has acted appropriately. It is therefore the most resilient to the changes that will be required as the industry decarbonises.

We agree that further clarity on "Good Practice" in the Grid Code (Option 6) would be useful. Although it is likely to be interpreted as relating to the physical operation rather than commercial decisions, industry has recognised that there is often a connection or trade-off between the two and codifying Ofgem's view on Good Practice would aid that discussion. We agree Ofgem should continue to bear this option in mind, as it has the potential to be broader than just this issue. It is therefore compatible with the preferred option of a new licence condition. We note, however, that there is a lot of industry change underway and resources for all participants, including Ofgem, are stretched. Ideally, Ofgem would direct the Modification to be raised with a clear and explicit aim and with wording already in mind, to allow efficient Workgroup discussion.

We would not support the other suggested options, for the reasons identified in the 'Call for Input' and as explained below. We believe these options are disproportionate, in that they are wide-ranging and would have significant negative impacts in an attempt to mitigate a highly specific issue.

We believe Options 1a) and b) could have significant negative effects on price signals and competitive behaviour. Should similar circumstances appear again, there is a risk that parties who behave inappropriately would form a 'race for the top' to reach the cap. This

could limit the increase in balancing costs but not necessarily address the fundamental market conditions that prompted this behaviour.

Setting the appropriate level of the cap would be technically challenging, as it would be dependent on a number of external factors. In practice, we believe this would have to be 'adjusted' in response to external factors, such as the price of gas, in order to avoid negative impacts on security of supply and be cost-reflective of system tightness. Given any adjustments are likely to occur at times of high uncertainity (and therefore high risk), this would not be efficient or good regulatory practice.

Option 2 would reduce transparency in the operation of the system and would be a far reaching change that would not directly address the behaviours that caused the high prices. It was clear in the conclusion of BSC Issue 98[1] that altering dynamic parameters was not a practical solution in the immediate term, but should be considered as part of wider BM reform to utilise fast-acting plants in the most cost-effective manner.

A new reserve service (Option 3) would need to interact sucessfully with the ancilliary service reform that is currently underway and would require significant consultation to be cost-effective for consumers. It seems unlikely that a new service to procure reserve will be more efficient than the BM for the majority of situations, and so would only be justified when there is the combination of external factors and behaviours that appeared last winter.

If a new reserve is to be developed, it should be with a wider brief than this issue alone, and so the ESO should take a holistic view when developing new products. This will take time, especially as the ESO (and wider industry) are facing significant challenges elsewhere. This is therefore likely to take a number of years before implementation, similar to Option 2.

Option 5 would present a backwards step in encouraging flexibility and would affect the ability of generators to respond to price signals, thus weakening the system generally. It woud effectively limit the ability for highly flexible plant to respond to near-time price signals and so would require more work by the ESO to balance the system through the BM and ancilliary services. This is unlikely to represent best value for the consumer and may increase balancing costs in 'normal' circumstances. This option therefore feels disproprotionate to the issue identified.

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.**

We believe it is likely to mitigate the behaviour identified, but it is vital that generators continue to be able to price in scarcity at times of system tightness. This is a strong investment signal that needs to be preserved, so "excessive" should not be restrictive. With that in mind, parties may find the definition of "excessive" troublesome – not all scenarios

[1] https://www.elexon.co.uk/smg-issue/issue-98/

will be able to be benchmarked as suitable and the burden of justification is placed onto BM participants. The licence condition will give clear grounds for the Authority to have those discussions with generators, but commercial sensitivities may mean information is not able to be shared more broadly with industry. This could create a situation where parties are percieved to have acted in breach of the licence condition but private information, such as sensitive projections of market scenarios, makes it clear to the Authority that they have not. This information imbalance between different parties could be viewed as unfair regulatory practice.

The rationale also needs to consider capital recovery, i.e. long-run marginal cost, not just short-run marginal cost. As new flexible, low carbon generation is built to facilitate the transition to Net Zero, investors need to earn a return on total capital deployed not just to cover their short-run marginal cost. Investors will also have different perceptions of risk, particularly for new assets highly dependent on scarcity pricing, to justify investment. This all needs to be factored into the pricing being offered in relevant conditions.

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 agree the text is clear.

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 should consider dynamic data when giving guidance around 'excessive' prices and when investigating potential breaches of this licence condition. The ESO may need to 'lock in' a long duration trade well ahead of potential tightness, due to a plant's lower flexibility. One of the aims of BM reform should be to allow the ESO to utilise fast-acting assets most efficiently.

We believe any statements or publications by the ESO or respected sources of market authority (acedemic thinktanks, market analyst bodies etc) may be taken into consideration by the Authority. It is possible that a generator has acted in good faith, based on implied information within public announcements, expecting circumstances which do not come to pass. In that situation, Ofgem may wish to consider that, whilst the result was similar to the situation this condition attempts to avoid, the motivation was different. This would be at Ofgem's descretion and of less importance when determining whether the condition has been breached than other, market-based factors.

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?**

Examples of dynamic data must be considered in the guidance, as they are likely to be fundmental to judging the technical/commercial balance of an offer and the flexibility it gives to the ESO.