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Guidance

Inflexible Offers Licence Condition – DRAFT Guidance

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This document is our draft guidance to our approach to interpreting and enforcing the Inflexible Offers Licence Condition (IOLC). The IOLC applies to electricity generators and prohibits licensees from obtaining excessive benefit after submitting a zero MW physical notification (PN) when their Minimum Zero Time (MZT) is more than 60 minutes.

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1. Introduction

Purpose

1.1. This document provides guidance to licensees and other interested parties on Ofgem's intended approach to the interpretation and enforcement of the Inflexible Offers Licence Condition (IOLC). For ease of reference the wording of the licence condition is reproduced in full in Appendix 1. In developing this guidance we have built upon and considered the responses received from stakeholders to our Call for Input published in November 2022.[1]

Background

1.2. National Grid Electricity System Operator's (NGESO or 'the ESO') role is to co-ordinate and direct the flow of electricity onto and over the national electricity transmission system (NETS), in an efficient, co-ordinated and economic manner. It does this by procuring balancing services that are subject to transparent, non-discriminatory and market-based procedures.

1.3. The Balancing Mechanism (BM) is NGESO's primary tool to balance supply and demand in real time. In the BM, market participants signal to NGESO for each given 30-minute settlement period[2] the costs they are willing to pay or be paid to adjust their electricity output or consumption, as a deviation from the position they had notified to NGESO ahead of gate closure[3] for that settlement period. For electricity generators, a proposal to increase electricity output or decrease electricity consumption is known as an 'offer' and a proposal to decrease electricity output or increase electricity consumption is known as a 'bid'. NGESO typically takes actions using the most competitively priced bids and offers, however operational and locational factors can sometimes result in more expensive bids and offers being accepted in order to solve a specific network issue.

1.4. NGESO is informed in advance of the generators that are scheduled to run, and at what quantity of generation output, through the submission of a Physical Notifications (PN). These are notifications from generators of the amount of electricity that they intend to produce during

[1] Call for Input on options to address high balancing costs | Ofgem
[2] Whilst electricity transmission is continuous, for the purpose of trading and settlement it is considered to be generated, transported, and consumed within 30-minute blocks throughout the day known as settlement periods. Each offer / bid by participants and corresponding action taken by NGESO in the BM corresponds to a specific settlement period.
[3] Gate Closure is a point one hour prior to the start of a Settlement Period by which time generators submit to NGESO their planned generation for that Settlement Period

a given settlement period (suppliers also submit PNs to notify expected consumption). PNs can be modified until gate closure, which is an hour before the start of a settlement period. At this point, the market closes for that settlement period and a PN becomes a Final Physical Notification (FPN). The period between gate closure and the end of the settlement period is when NGESO accepts bids and offers submitted by BM participants.

1.5. There has been a notable rise in balancing costs in recent years. While energy market volatility and societal impacts of the COVID-19 pandemic were key drivers of higher costs, we also observed higher costs as a result of a combination of behaviours by some generators. This combination included instances of generators with inflexible technical capabilities submitting a PN of 0MW in the run up to and over the evening peak of demand (ie, when generation is needed the most) and then submitting inflated offer prices in the BM when their PN is 0MW. Once a generation unit ceases to generate electricity, it must remain at zero output for a set period of time in order to comply with the unit's 'minimum zero time' (MZT), which is a pre-determined technical capability of the generation unit.[4] To avoid the generation unit from being unavailable for the evening peak the ESO therefore often had to accept these high-priced offers for several hours in advance of the evening peak of demand.

1.6. In certain situations, for example where the margin between available capacity and peak demand becomes tight, we expect a scarcity premium to be included in offer prices. This price rise provides a signal that has an important role to play in orchestrating supply to meet demand and may also incentivise investment in additional generation or demand side response. However, when high offer prices were combined with PNs of 0MW, lengthy MZTs and limited spare generation capacity available to meet peak demand, NGESO often had limited options available and incurred much higher costs than necessary to maintain system security.

1.7. The IOLC aims to prohibit generators from obtaining excessive benefit from their BM offers when the generator has submitted to the ESO a 0MW PN and a MZT of longer than 60 minutes. As a result, we believe generators have two options for participating in the BM:

- Generators may either follow the 'flexibility path', through which their units are operated flexibly in response to market and system conditions, and where generators have the ability to efficiently price scarcity into their BM offers. When

[4] Generators' technical capabilities are known as dynamic parameters. The full list of dynamic parameters is set out in the Grid Code at BC1.A.1.5

the margin between available capacity and peak demand becomes tight, we anticipate that the scarcity premium in the price signal should encourage investment in new production or demand side response, which will be to the benefit of energy consumers.

- Or alternatively, generators may follow the 'inflexible path', through which their units are operated in a manner that limits their responsiveness to market and system conditions. In such circumstances we expect generators' BM offer prices to reflect their costs plus a reasonable profit that is not excessive. It is not in consumers' interests for generators to gain excessive benefits as a result of their inflexibility.

Interaction with Competition Law, REMIT and TCLC

1.8. The IOLC does not displace the application of competition law. It is complementary to it and targeted at the behaviour that has been described above. Ofgem does not intend to interpret the scope of the IOLC by reference to competition law and REMIT[5]. The assessment of whether or not there has been a breach of the IOLC will be undertaken with reference to the framework of the IOLC and is different from the analytical framework for establishing unfair pricing under competition law, or price artificially under REMIT.

1.9. It should also be noted that our IOLC proposal to prohibit excessive benefits has similarities to the Transmission Constraint Licence Condition (TCLC), which prohibits excessive benefits being obtained from bids in relation to a transmission constraint period. However, TCLC is separate from IOLC, with separate guidance. There should be no presumption that a benefit which is not considered excessive under TCLC would not be considered excessive under the IOLC (or vice versa). In each case we will assess excessiveness on its merits, taking into account all of the circumstances of the case.

[5] Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency https://www.ofgem.gov.uk/gas/wholesale-market/european-market/remit

2. The Inflexible Offers Licence Condition

Overview

2.1. Paragraph 1 of the IOLC provides that the licensee must not obtain an excessive benefit from electricity generation in relation to a generator who has submitted a PN of 0MW[6] and has a MZT which is longer than 60 Minutes.

2.2. Paragraph 2 of the IOLC further provides that the licensee shall be considered to have obtained an excessive benefit from electricity generation in relation to a settlement period if each of the following conditions apply in relation to that settlement period:

a. *The licensee and the system operator enter into, or have entered into, Relevant Arrangements in respect of a Balancing Mechanism Unit owned or operated by the licensee;*

b. *the licensee has submitted in respect of the same Balancing Mechanism Unit, a Physical Notification of zero MW to the Electricity System Operator;*

c. *The Balancing Mechanism Unit to which the Relevant Arrangements apply has a Minimum Zero Time which is longer than 60 minutes; and*

d. *under the Relevant Arrangements 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.*

2.3. The relevant arrangements referred to in paragraph 2 of IOLC are defined as arrangements entered into between the licensee and NGESO within the BM. The entering of such arrangements includes the making of an offer by the licensee whether or not that offer is accepted by NGESO.

2.4. The circumstances identified in paragraph 2 of the IOLC captures the following behaviour: generators submitting excessive offer prices in respect of a settlement period for which it has submitted a 0MW PN and has a MZT of above 60 minutes. In such circumstances,

[6] Submitted a PN of 0 refers to any settlement period where the FPN is 0

generators may benefit excessively from the inflexibility of their offers and this may result in the ESO accepting excessively priced offers for a longer duration than necessary, ie in the hours in advance of the evening peak demand period.

Assessment of the IOLC

2.5. The remainder of this chapter discusses in detail the behaviour that is prohibited by the IOLC. The diagram in Figure 1 provides a high-level illustrative example of the steps Ofgem would expect to take in considering whether a breach of the IOLC has occurred.

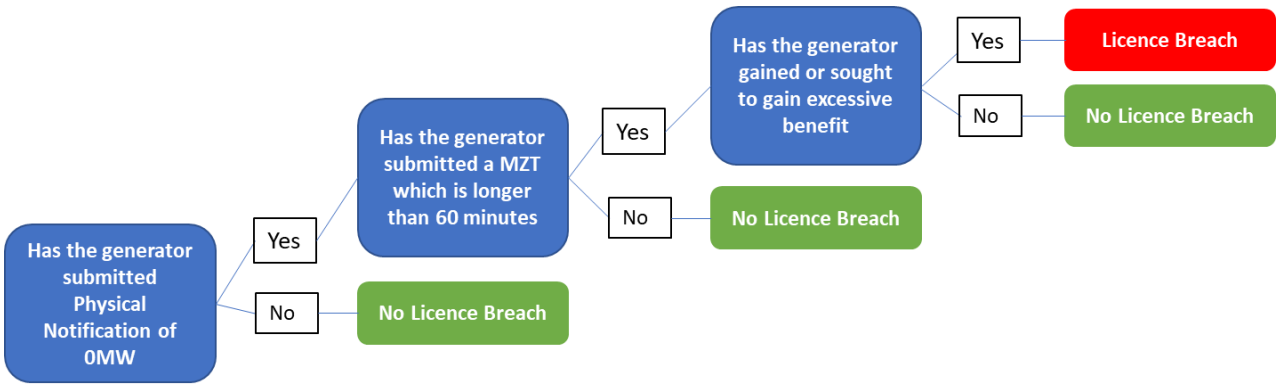

Figure 1 – Pathway of compliance under the IOLC

2.6. Licensees are encouraged to establish their pricing strategy and be ready to provide evidence that they can objectively justify that they have not gained excessive benefit.

2.7. Ofgem would prioritise and undertake any enforcement action taken in accordance with its most recent enforcement guidelines at the relevant time. Although each case will be considered on its own facts, there may be situations in which Ofgem would be less likely to take action than others. For example, whilst the IOLC permits enforcement action where the generator has submitted an excessive offer, Ofgem generally expects to focus on whether a generator has an excessive offer accepted. Nonetheless, Ofgem retains the option of taking action against generators if excessive offers are submitted but not accepted.

2.8. The IOLC is aimed at preventing generators from gaining an excessive benefit as a result of the behaviour described in Chapter 1 of this guidance. The factors[7] below are a non-

[7] We do not expect these factors to have fixed values. The values may vary over time. We would expect any variance to be fully explained and objectively justified.

exhaustive list that will be collectively taken into account when assessing if an offer is objectively justified or excessive:

- **Variable costs** – these are the costs that vary with the level of generation output. They can be considered as the opportunity cost of input associated with each increment of output. Typical examples of variable costs include fuel, operating costs, emissions, wear and tear on plant and government subsidies. Variable costs also include the anticipated costs of plant failure, which is the probability of plant failure multiplied by the cost of plant failure.

- **Avoidable fixed costs** – these costs are not variable but must be born if the plant generates output. These costs should not be confused with sunk costs. Sunk costs cannot be avoided in the short run even if the plant generates zero output. Therefore avoidable fixed costs can be considered as the opportunity cost of the inputs that could have been avoided if generation output was zero. A typical example of avoidable fixed costs are the costs of starting the plant.

- **Shutdown costs** – these are the costs of reducing a plant's generation output to zero when generating immediately prior to the settlement period under consideration. They can be considered as the opportunity cost of resources required to cease generation output, including any lost revenue that could be avoided if the plant had continued with a non-zero level of generation.

- **Reasonable profit** – the above factors relate to the costs we expect generators to build into their offer price. For this factor we would expect the offer price in the settlement period under consideration to allow for reasonable profit to be earned, commensurate with a level of profitability that is in line with an average for the GB electricity generation sector.

- **Other factors** – we will use general market monitoring to consider comparable generator benchmarks, for example, comparing offers submitted after a 0MW PN to those submitted after a non-zero MW PN, as well as historic and average GB-wide offers. It should be noted that while these are useful indicators, we will consider the cost and profit of the generation unit before looking at these factors.

2.9. If any circumstances suggest a potential breach, Ofgem may write to the licensee concerned, giving them an opportunity to respond. Licensees are invited to provide an explanation, including objective justification in support on how they have not gained excessive benefit from their pricing. Supporting evidence should be submitted to Ofgem for assessment.

3. Appendices

Annex 1– Licence Condition

Condition XX. Inflexible Offers Licence Condition

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 and has a Minimum Zero Time which is longer than 60 minutes.

2. For the purposes of paragraph 1, the licensee shall be considered to have obtained an excessive benefit from electricity generation in relation to a Settlement Period if each of the following conditions apply in relation to that Settlement Period:

    a. the licensee and the system operator enter into, or have entered into, Relevant Arrangements in respect of a Balancing Mechanism Unit owned or operated by the licensee;

    b. the licensee has submitted in respect of the same Balancing Mechanism Unit, a Physical Notification of zero MW to the Electricity System Operator;

    c. The Balancing Mechanism Unit to which the Relevant Arrangements apply has a Minimum Zero Time which is longer than 60 minutes; and

    d. under the Relevant Arrangements 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.

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 an increase in comparison to the licensee's Physical Notification of zero MW.

4. This licence condition shall be interpreted and enforced in accordance with guidance published by the Authority.

5. Before this condition comes into force the Authority shall publish the guidance referred to in paragraph 4.

6. Before the Authority publishes the guidance referred to in paragraph 4 the Authority shall consult:
    a. the holder of any licence under section 6(1)(a) of the Act; and
    b. such other persons as the Authority thinks it appropriate to consult.

7. The Authority may from time to time revise the guidance referred to in paragraph 4 and before issuing any such revised guidance the Authority shall consult such person as specified in paragraph 6 setting out the text of, and the reasons for, the proposed revisions.

8. The licensee shall provide to the Authority, in such manner and at such times as the Authority may reasonably require, such information as the Authority may require or deem necessary or appropriate to enable the Authority to monitor the licensee's compliance with this condition.

9. In this condition:

"Balancing Mechanism"	means the mechanism for the making and acceptance of offers and bids to increase or decrease the quantities of electricity to be delivered to, or taken off, the total system at any time or during any period so as to assist the system operator in coordinating and directing the flow of electricity onto and over the national electricity transmission system and balancing the national electricity system pursuant to the arrangements contained in the BSC;
"Balancing Mechanism Unit"	means a trading unit in the Balancing Mechanism
"Physical Notification"	means a notification of the intended level of generation made by the licensee to the system operator for a period pursuant to the notification arrangements established by BETTA and the BSC;
"Relevant Arrangements"	means arrangements entered into by the licensee and the system operator within the Balancing Mechanism, and the entering of such arrangements shall include the making of an offer by the licensee whether or not that offer is accepted by the system operator.

"Settlement Period"	has the meaning given in the Grid Code[8]
"Minimum Zero Time"	means either the minimum time that a Balancing Mechanism Unit which has been exporting must operate at zero or be importing, before returning to exporting or the minimum time that a BM Unit which has been importing must operate at zero or be exporting before returning to importing, as a result of a Bid-Offer Acceptance, such minimum time being as per the most recent notification by the licensee to the ESO pursuant to the Grid Code;

[8]Currently the Grid Code definition is "A period of 30 minutes ending on the hour and half-hour in each hour during a day."