

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Inflexible Offers Licence Condition – DRAFT Guidance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This document is our draft Guidance to our approach to interpreting and enforcing the Inflexible Offers Licence Condition (IOLC).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 revising their physical notification (PN) from a positive MW value to 0MW within the operational day, 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 document, we have built upon and considered the responses received from stakeholders to our Call for Input published in November 2022¹ and our Consultation published in February 2023.²

1.2. Ofgem will have regard to this Guidance document when carrying out investigations into potential breaches of the IOLC. However, it is the licence condition itself which provides the definite framework against which compliance will be assessed. Our assessments will be inevitably case specific and must take into account the particular circumstances of each case. This means that the particular analytical methods used and evidenced relied upon may vary across investigations.

1.3. In the remainder of this section, we provide an introduction into how National Grid Electricity System Operator (NGESO or ‘the ESO’) use the Balancing Mechanism (BM) to balance supply and demand; describe the rise of balancing costs in recent years; describe when scarcity pricing is acceptable; and summarises what the IOLC prohibits. The next section discusses the specific requirements of the licence condition in greater detail.

Background

1.4. The ESO’s 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.

1.5. The 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 period³ the costs

¹ [Call for Input on options to address high balancing costs | Ofgem](#)

² [Consultation on the Inflexible Offers Licence Condition | Ofgem](#)

³ 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.

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 NGENSO ahead of gate closure⁴ 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'. NGENSO 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.

1.6. NGENSO 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 Notification (PN). These are notifications from generators of the amount of electricity that they intend to produce during 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 NGENSO accepts bids and offers submitted by BM participants.

1.7. 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 behaviours by some generators. This included instances of generators with inflexible technical capabilities revising their PN from a positive MW value to 0MW, to send a signal to the ESO that the generation unit intends to cease generating electricity in the run up to and over the evening peak of demand (ie, when generation is needed the most). The generators would then submit 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.⁵ 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.

1.8. In certain situations, where the margin between available capacity and peak demand becomes tight, a scarcity premium may be included in offer prices. This price rise can provide a signal that has an important role to play in orchestrating supply to meet demand and may

⁴ Gate Closure is a point one hour prior to the start of a Settlement Period by which time generators submit to NGENSO their planned generation for that Settlement Period.

⁵ 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

also incentivise investment in additional generation or demand side response. However, when high offer prices were combined with revisions of PNs to 0MW for units with lengthy MZTs, NGESO often had limited options available to maintain system security and incurred much higher costs.

1.9. The IOLC prohibits generators (with an MZT of longer than 60 minutes) from obtaining an excessive benefit from their BM offers when the generator has revised its PN from a positive MW value to 0MW within the operational day. In such cases, the generator's revision of its PN to 0MW could provide it with the ability to leverage its inflexible dynamic parameters to gain excessive benefit from its BM offers.

Interaction with Competition Law, REMIT and TCLC

1.10. 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.⁶ 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.

1.11. 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 a separate Guidance document. For example, there should be no presumption that a level of 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.

Enforcement

1.12. We will enforce the IOLC in accordance with our enforcement guidelines as they apply at the relevant time. These guidelines can be accessed on our website.⁷

⁶ 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>

⁷ <https://www.ofgem.gov.uk/investigations/ofgems-powers>

1.13. Consistent with the enforcement guidelines, if, on our own initiative or following a complaint, we identify a potential breach under the IOLC, we may write to the licensee concerned, requiring them to provide cost and other relevant data, and asking them to explain the basis for their pricing (and any assumptions underpinning it).

1.14. Also as set out in our enforcement guidelines, we will assess whether it is appropriate to take enforcement action against our prioritisation criteria. For example, where the evidence of a potential breach is weak or any breach is likely to be trivial or there is no or minimal harm to consumers, an investigation would be less likely.

1.15. If a licensee is found to be in breach, it may face a financial penalty. The amount of any penalty imposed will be determined by the Authority in accordance with its published policy on financial penalties for licence breaches.

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 respect of a Settlement Period in relation to which it has revised its Physical Notification (in respect of a unit which has a Minimum Zero Time of longer than 60 minutes) from a positive MW value to zero MW within the operational day.

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 (where each of the other requirements of paragraph 1 is met) if each of the following conditions apply in relation to that Settlement Period:

- 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; and
- 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 the making an offer in the BM, irrespective of whether that offer is accepted.

Assessment of the IOLC

2.4. 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.

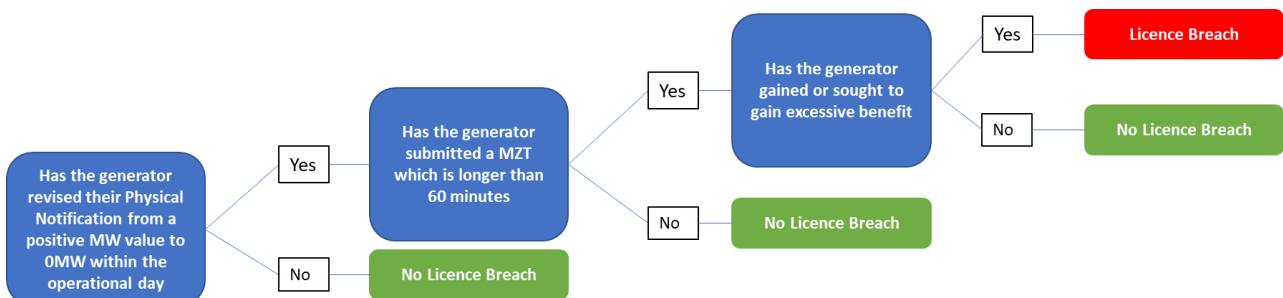


Figure 1 – Pathway of compliance under the IOLC

2.5. Licensees are encouraged to establish their pricing strategy and be ready to provide evidence that they can use to show they have not gained excessive benefit in circumstances where the IOLC is (or may be) engaged.

2.6. We are aware that on occasion some generators might price high in the BM in order to not be taken by the ESO. In such cases, we would expect the generator to be able to provide evidence that this was their intention rather than there being any attempt to obtain an excessive benefit. However, wherever possible and in accordance with Grid Code rules, a generator should reflect that it is unavailable via its dynamic parameters, for example through a reduction in Maximum Export Limit (MEL).

Is the price excessive?

Overview

2.7. The IOLC requires that generation licensees must not obtain an excessive benefit from electricity generation in relation to a revised PN from a positive MW value to 0MW within the operational day, and if they have an MZT above 60 minutes. In practice this means that when a generator has revised its PN to 0MW within the operational day and where a generator offers to export power for those settlement periods – generators must not submit BM offer prices at a level which would result in them obtaining an excessive benefit were that offer subsequently accepted by the ESO.

2.8. In order to assess whether a price was excessive, we will consider whether that price was set at a level which meant that the benefit that the licensee either obtained or sought to obtain in relation to a revision of its PN to 0MW within the operational day was significantly greater than the benefit they would have obtained had they not revised their PN to 0MW (ie, the profit the generator would have obtained had it generated in line with the positive PN previously submitted).

Costs and benefits having an offer accepted

2.9. The benefit⁸ that a licensee obtains or seeks to obtain through its offer prices is the profit associated with those offers (or implied profit, had those offers been accepted). That is, the

⁸ Prior to April 2023, a significant further benefit across all generation types was avoided Balancing System Use of System charges - [CMP308: Removal of BSUoS charges from Generation | Ofgem](#)

revenue obtained less the cost incurred to run the plant which includes opportunity costs of the licensee increasing its generation.

2.10. Given this, one consideration in our assessment of whether a licensee's offer prices have breached the IOLC will be the costs and benefits incurred by the generator as a result of having an offer accepted.

2.11. The bullets⁹ below set out some examples of the potential costs of having an offer accepted in the BM. This list is not intended to be exhaustive, nor is it the case that all costs listed will necessarily apply to all generation units that will be collectively taken into account when assessing if an offer is 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, and the opportunity cost of exceeding emissions limits.
- **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, including, for example, the number of starts/running hours the plant may have each year.
- **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.

2.12. In addition to the costs noted above, licensees may seek to recover a reasonable level of profit via their offer prices. While what is reasonable will be dependent on the circumstances

⁹ 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.

of the case, we consider that it would not be reasonable for a generator to obtain a total margin in pounds (£) that is significantly greater than that which would have been expected had the generator not revised its PN to OMW within the operational day and had instead generated in line with its positive PN.

2.13. To help us assess whether or not the profit margin obtained by a generator is reasonable we may consider a range of different evidence including (but not limited to):

- The prices (and implied profit margin) at which the unit's output had been sold prior to the PN being revised to OMW within the operational day.
- The prices and profit margin of comparable generators which have not revised their PN to OMW within the operational day.
- The profit margins of other units operated by the same licensee which have not revised their PN to OMW within the operational day.
- Historic prices and profit margins of the same generator when it has not revised its PN within the operational day (where prices are not uniform).
- Any profit targets or other internal benchmarks used by the licensee or affiliated companies.
- The specific pricing strategy of the generator – and the extent to which this appears designed to limit profits to a level which would approximate those which would be obtained absent a revision of a PN to 0 within the operational day.

2.14. For the price or margin of another generator to provide a useful benchmark, the comparator price should not have been submitted by a generator which revised its PN to OMW within the operational day. This is because the objective of our benchmarking assessment is to form a view on the benefit the licensee would have likely obtained from revising its PN to OMW within the operational day.

2.15. We will also consider whether offers of the potential comparator generator were system flagged. Where this is the case, that generator may not be a useful benchmark as they will have been accepted by the ESO for other reasons.

2.16. When comparing offer prices, typically only generators of the same technology type will be comparable. This is because different generation technologies are likely to incur significantly

different costs. It may not be appropriate to compare generators even of the same technology type if they are operating in different ways or subject to different operating conditions.

2.17. When carrying out our analysis, we will generally avoid comparisons with any single generator or in any single period. This is because it can be difficult to fully observe the conditions under which offers are being submitted by different generators, and so to form a view on their comparability. Instead, we will typically focus on differences in average prices over sustained periods of time.

2.18. 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 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 20B. 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 it has revised its Physical Notification (in respect of a unit which has a Minimum Zero Time of longer than 60 minutes) from a positive MW value to zero MW within the Operational Day.
 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 (where each of the other requirements of paragraph 1 is met) 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; and
 - b. 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.
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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 unit of trade within 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 ¹⁰
“Minimum Zero Time”	means either the minimum time that a Balancing Mechanism Unit which has been exporting must operate

¹⁰Currently the Grid Code definition is “A period of 30 minutes ending on the hour and half-hour in each hour during a day.”

	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;
“Operational Day”	has the meaning given in the Grid Code ¹¹

¹¹ Currently the Grid Code definition is “The period from 0500 hours on one day to 0500 on the following day.”