

Response to Ofgem Consultation on Inflexible Offers Licence Condition

13 March 2023

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.

EPUKI is investing in new flexible generation capacity in both the UK and Ireland. In February 2023 EPUKI secured 15 year capacity agreements for a combined 1,700 MW high efficiency H-class CCGT power project and a 299 MW 2 hour battery storage project at the site of the former Eggborough coal station in East Yorkshire. This would represent an investment of over £1 billion in the UK's electricity supply. The high efficiency H-class CCGT project will be the single largest flexible generation asset to be commissioned in the UK since 2012, whilst the battery project will also be one of the largest to be built in the UK to date.

General comments

EPUKI is extremely concerned by Ofgem's proposal for an Inflexible Offers Licence Condition (IOLC).

We do not consider that the IOLC meets Ofgem's stated objective that the 'focus of our intervention is to prohibit inflexible generators from undertaking specific behaviours that result in high priced offers being accepted outside of peak periods'. By expanding its proposals, Ofgem's licence condition no longer focuses on specific alleged 'sharp practices', but instead targets all offers where certain generators have submitted a zero MW Physical Notification (PN) regardless of when that PN was submitted and the generator's intention. The proposed licence condition is so widely drawn that it amounts to blanket regulation of offer pricing for technologies such as CCGTs and biomass, which we consider to be an inappropriate use of Ofgem's powers for a licence modification of this kind. The proposed IOLC is likely to have serious market impacts which have not yet been assessed by Ofgem and there is therefore no evidence at this stage that the proposed licence condition would be of net benefit to consumers. Indeed, without a full Impact Assessment, we have concerns that the proposed licence condition may not be in the best interests of consumers, which Ofgem has a duty to promote, as the proposed IOLC will likely affect price signals in the Balancing Mechanism (BM) meaning it does not operate as it should, or generators may seek to recoup lost BM revenues through other means, such as higher pricing elsewhere.

We do not believe that Ofgem has proposed a coherent package of measures to address the high balancing costs that it has observed. The ESO's responsibility for managing the system in a cost-effective manner has not been appropriately recognised in Ofgem's review. Where workable proposals to manage costs efficiently have been proposed, such as Balancing Reserve, which was forecast to deliver a large and swift reduction in balancing costs, Ofgem has rejected these.

We are therefore unclear exactly what Ofgem is trying to achieve by its proposed interventions. We do not believe that Ofgem has clarified the problem it is seeking to address. Ofgem refers to 'sharp practices' by generators but does not adequately explain why those 'practices' are 'sharp' by reference to the market (as opposed to features of the market as structured and at times of scarcity) and by reference to the law, which already provides mechanisms for penalising behaviours which are unlawfully exploitative. Instead, Ofgem's proposed IOLC creates a general restriction on offer pricing for CCGTs and other technologies with longer dynamic parameters. Scarcity pricing is an important and established principle of energy markets, which underpins many of the investments in the power sector. The proposed IOLC, which by Ofgem's own admission is intended to restrict the ability of some technologies to capture scarcity prices, is therefore a major intervention and a change to established competitive principles in the electricity market. We are concerned that such an intervention would be inconsistent with Ofgem's duties and powers and is likely to impact future investment in certain types of generators, as further noted below.

We therefore urge Ofgem to reconsider its proposals to focus them more closely on specific generator behaviours that are of concern rather than attempting to regulate offer pricing in general. We seek reassurance that any further proposals for an intervention would be accompanied by a full Impact Assessment and consultation.

We have outlined our high-level concerns with the proposed IOLC below.

Removal of the within day restriction no longer targets specific behaviours and limits market participants' ability to manage risks

Ofgem's original proposal in its *Call for Input on options to address high balancing costs* was for a licence condition intended to target specific 'sharp practices' that it had observed in the Balancing Mechanism. The particular issue identified by Ofgem and NGENSO was that some generators were revising their PNs from midday onwards to zero at very short notice within day. The short notice nature of these changes coupled with some of the dynamic parameters (ie. MZTs) of certain types of plant left the ESO with limited options but to extend those units through to the darkness peak. Although no finding was made that this behaviour contravened existing market rules (as evidenced by Frontier Economics' report), the implication was that those generators were able to "force the ESO's hand" and have their offers accepted at a high price due to the limited alternative options available to the ESO within day.

In its latest consultation, Ofgem states that offers associated with zero PNs submitted day ahead have also been a contributor to high balancing costs. However, we do not consider that a zero MW PN submitted day ahead has the potential to "force the ESO's hand" in the same way as amendments to PNs within day. At the day ahead stage, the ESO has plenty of tools available to manage the system as part of its normal operational planning, whereas we accept that the ESO's options within day may be more limited.

There are many legitimate reasons why a generator may choose not to contract a unit's volume by the day ahead stage, including risk mitigation, and we strongly believe that a generator should not be restricted in its pricing in these circumstances.

As a principle, we consider that all generators should be able to sell their power at a price which reflects the true interaction of supply and demand in the market. If a generator considers that day ahead prices do not reflect expected outturn scarcity then they should be free to attempt to capture that scarcity premium in the Balancing Mechanism, noting that it is the generator's risk that this scarcity may not materialise.

Prudent operators should also manage the risks they face from market participation. If part of an operator's portfolio does not deliver its contracted position, it will be subject to cashout. On days with tight margins, exposure to high cashout prices becomes a significant financial risk for generators. Generators can mitigate portfolio risks or technical risks on individual units by offering some of their output close to real time through the Balancing Mechanism and at prices which reflect the outturn level of cashout which they may incur. This is a legitimate risk management technique which should not be subject to price regulation. The proposed IOLC will interfere with generators' genuine risk management practices, which is likely to have broader implications for the market which have not yet been fully assessed.

We therefore consider that a licence condition which regulates offer pricing where a zero MW PN has been submitted day ahead is inappropriate and that, if Ofgem wishes to proceed with an intervention in this area, any intervention should be targeted at the specific behaviours and 'sharp practices' previously identified in the balancing costs review, ie. parties amending their PNs to 0 MW within day.

Restricting the ability of certain classes of generator to factor in scarcity in their offer prices is discriminatory

As drafted, IOLC would capture any offer activity from a zero MW PN for generators with MZTs greater than 60 minutes regardless of the rationale for the zero PN, the running pattern of the unit or the prevailing system conditions. The circumstances covered could include, for example, early syncs of units first thing in the morning, which is clearly not one of the contributors to high system balancing costs. It is therefore difficult to conclude that IOLC would amount to anything but blanket regulation of offer pricing for certain technologies, such as CCGTs, on a 'cost plus' basis.

Ofgem states that the ability to access scarcity pricing should only be available to units that operate flexibly with shorter dynamic parameters. However, it has provided no rationale for this statement. Scarcity pricing is an important and economically rational principle of the electricity market, which has been embedded in the market design through successive decisions by government and Ofgem. The ability to access scarcity premia is a fundamental part of the investment case for all technologies. Ofgem's proposal would prevent some classes of generator from accessing scarcity prices on the basis of technical dynamic parameters which operators are unable to change. This is likely to impact investment in certain types of electricity generators or in electricity generation more generally, if investors view this kind of licence modification by Ofgem as being overly interventionist and creating significant regulatory uncertainty and risk around what would otherwise be an important part of a generator's revenues.

The proposal implies that Ofgem aims to create a market which favours plant with short Minimum Zero Times. Scarcity pricing should in itself encourage investment in this sort of generation. However, plant such as CCGTs with longer MZTs are a major share of the market at present and will play an important ongoing role on the power system both in the near- and longer-term future. This includes managing the intermittency of wind generation during long periods of low wind output. The investment case for maintaining the life of existing CCGTs and for constructing new ones is dependent on being able to access higher prices in periods of tight margins. Major investments in asset life extension or in new build projects will not proceed if market returns are regulated in the manner suggested by IOLC.

We therefore consider the IOLC proposal to be discriminatory and has the effect of Ofgem making a policy decision designed to curb the revenues of certain types of generators, which we consider to be inappropriate. We note that Ofgem has recently rejected the ESO's proposal for a Balancing Reserve service on the grounds that it discriminated between market participants based on size, despite the large reduction in balancing costs that the service was forecast to deliver. Ofgem stated in its decision that 'it is fundamental that the design of balancing services is not unduly discriminatory'. On this basis, we therefore cannot see how Ofgem could introduce a licence condition that discriminates between Balancing Mechanism participants based on a single dynamic parameter.

IOLC would lead to serious unintended consequences which require a full and proper assessment

We consider that IOLC would lead to significant market distortions that have not been considered by Ofgem. We note that Ofgem has not produced an Impact Assessment alongside this consultation and we consider it essential that it does produce one, such that both Ofgem and market participants can understand and quantify the potential consequences of the proposal and the overall impact on consumers.

The impact on cashout price formation and exposure is a major potential impact of the IOLC. There are two potential scenarios which Ofgem should explore in more detail. However, we believe that both of them would lead to an increase in 'missing money' in the electricity market, which is likely to feed through to higher prices in other timeframes and markets. This is likely to eliminate any net benefit to consumers from the introduction of IOLC.

On some low margin days, all BM actions taken by the ESO over the peak have come from CCGTs and the cashout price has therefore been set by CCGT offers. If CCGT offer prices are limited by IOLC, the cashout price will be reduced compared to present. Even where a generator with short dynamic parameters (i.e. not subject to IOLC) is the marginal plant in the BM, it may not set the cashout price as the relatively small volume of offers from such plant could be offset by bid action being taken by the ESO at the same time, meaning that a CCGT covered by IOLC could still set the cashout price at a lower level than at present.

A lower cashout price set by offers covered by IOLC would remove scarcity signals over peak periods. Flexible generators which currently spill for cashout would receive lower revenues and there would be less incentive to invest in additional flexible plant. This outcome is contrary to the original purpose of the Electricity Balancing Significant Code Review.

Alternatively, cashout during peak periods could be set by a unit with short dynamic parameters or an interconnector action. This cashout price is likely to be higher than the price that a CCGT could achieve from its offers during this period as the CCGT offers would be regulated by IOLC. This would create an asymmetric cashout risk for CCGTs, where the revenues they could capture in the BM would never reflect the cashout exposure that they would face from running. The asymmetric risk created by IOLC would exacerbate issues already facing generators in the BM where they feel unable to price at the same level as marginal actions, such as interconnector trades.

A prudent generator should hedge its output at prices reflective of the level of risk they face in the market. We therefore expect that, if unable to price offers fairly in the BM, CCGTs would aim to capture revenues reflective of the fair market price in within day markets as information about outturn wind, demand, and interconnector flows becomes available. However, limited liquidity in within day markets is unlikely to allow large volumes to be traded in this way.

Selling out at a price which does not reflect prevailing scarcity and cashout risk would leave CCGT operators exposed to significant financial risks if a unit tripped, which could potentially lead to the insolvency of one or more generators and decrease the attractiveness of CCGT investments, stopping construction of new CCGT capacity and encouraging early closure of existing CCGT capacity.

To mitigate this, CCGTs would likely price in a risk premium in other timeframes (in particular, day ahead), leading to an overall increase in market prices and an inefficient market where scarcity risk is being factored into pricing decisions in timeframes where imperfect information about market conditions is available.

In both scenarios, CCGTs would need to recover the 'missing money' from not being able efficiently to capture marginal and scarcity prices. This would feed through to higher electricity prices in other timeframes and/or to increased clearing prices in the capacity market (CM). It should be noted that capacity agreements for existing plant have already been entered into through to 2027 and longer for new build projects. Most plant would therefore be unable to recover the increased missing money associated with IOLC through the CM for several years, fundamentally undermining their economics. Higher capacity market clearing prices from the 2027 Delivery Year onwards would be an inefficient outcome because the CM is a pay-as-clear mechanism and therefore a higher clearing price which is set by a generator subject to IOLC would also benefit generators which are not subject to IOLC, allowing them to over-recover and increasing overall costs to consumers. We therefore have significant concerns that the IOLC is not consistent with Ofgem's duties to protect the interests of consumers.

In addition to these scenarios, Ofgem should also consider whether IOLC creates an incentive for CCGTs and other plants with longer MZTs to change their running patterns (eg. by running more often at part load) so that their offers are not covered by IOLC and cashout risks are reduced. Ofgem should consider the impact that this might have on overall system balancing costs, and whether this is consistent with its overall objectives.

The implications of IOLC for the operation of and competition in the Balancing Mechanism in general should also be explored.

IOLC presents a significant compliance risk for licensees

Ofgem has provided no explanation why existing regulation (eg. REMIT or the Competition Act) is insufficient to tackle the sorts of 'sharp practices' by market participants which it has identified. Although Ofgem has noted that REMIT and the Competition Act use different analytical frameworks, it is not clear what this means or why this precludes such frameworks being used to regulate certain types of practices in the market which Ofgem considers need further regulation. Ofgem must be clear about the problem it is seeking to address so that generators can understand why and how similar types of behaviour could lead to breaches under one framework but not another and why REMIT or the Competition Act are not appropriate frameworks to deal with such a problem.

The proposed IOLC prevents generators from making an 'excessive benefit' from offers, but the concept of excessive benefit is not an established one and the draft guidance does not define it in any detail. Although the concept of 'excessive benefit' also exists in the Transmission Constraint Licence Condition, Ofgem suggests that the interpretation of excessive benefit under IOLC will not necessarily be the same as under TCLC and that excessiveness will be considered on its merits. This suggests a flexible and subjective approach by Ofgem which is not appropriate given the potential scope and penalties which may be involved in an IOLC breach. It is not clear, based on the proposed guidance, how excessive benefit under the IOLC would differ from excessive benefit under the TCLC or how differences between the two should be considered.

Under IOLC, BMUs would effectively be restricted to cost pass through plus a 'reasonable profit' with no clear criteria on what is or is not reasonable. The draft guidance states that 'reasonable' profit will be defined by the average for GB electricity generation rather than what might be reasonable for certain types of plant or technology. We are unclear how a market participant could assess what the average profit of the sector is or over what timeframe this assessment should be made, for example whether this for an individual Settlement Period or over the course of one or several seasons. Generators that are further down the order of merit, or that expect to run only limited hours in a year, or which have suffered losses previously will need to charge a higher price to achieve the same level of long-run profitability as other market participants.

We do not believe that a market participant could ever guarantee that its pricing methodology would be compliant with IOLC as there is scope for the excessive benefit factors to be interpreted broadly, subjectively and retrospectively on the basis of information not available to a generator at the time. IOLC would therefore introduce significant compliance risk for market participants, who may price themselves over a prolonged period in a manner which they believe to be compliant only later to be told by Ofgem that this was not compliant. The potential to have to justify pricing decisions to Ofgem more regularly as a result of IOLC would introduce a significant compliance burden and potentially lead to a large resource requirement for both market participants and Ofgem. The only way for a generator to overcome the compliance risk associated with IOLC would be always to price as conservatively as possible, effectively making IOLC an ongoing price control for generators and also disrupting price signals in the Balancing Mechanism more generally.

We consider that all regulation should be targeted, clear and easy to comply with. IOLC does not meet these tests.

Potential alternatives to IOLC

As discussed above, we consider that IOLC is too wide-ranging an intervention, is discriminatory in its effect and will have a range of unintended consequences and that Ofgem should instead focus on the specific 'sharp practices' that it previously identified. We do not believe that a new licence condition is necessarily required to tackle these practices. If the behaviours identified by Ofgem are abusive, they could be addressed via existing regulation, including REMIT and the Competition Act 1998. In addition, an open letter from Ofgem clarifying its expectations would provide certainty to generators as to which behaviours may or may not be acceptable.

However, we understand Ofgem's desire to act where it believes there may be market practices which are negatively impacting consumers. We consider that any intervention should be targeted only at within day amendments to PNs and, given our concerns regarding legitimate risk management techniques outlined above, should not impact offer pricing when a generator has scheduled itself not to run at the

day ahead stage. The intervention must be easy for market participants to comply with and must not rely on vague, subjective concepts such as 'excessive benefit' or 'reasonable profit'.

In the spirit of assisting Ofgem in its thinking, EPUKI has developed a potential alternative to Ofgem's IOLC proposal. However, we reserve our position on the suitability of this proposal as we have had limited time to assess any unintended consequences that may arise from it.

This option would be to apply a licence condition to plant which amend their PN for a Settlement Period from a positive value to 0 MW at any time on the same operational day. The plant would only be allowed to submit offers in the BM for those affected Settlement Periods at a price which would allow it to realise the same profit margin as it would have made by selling its output for that Settlement Period at the day ahead stage.

This proposal would address Ofgem's concerns by ensuring that generators that have already sold their output prior to the day are prevented from scheduling themselves not to run at late notice within day and then charging a price to the ESO to keep them on which is not reflective of how the market valued scarcity at the day ahead stage. However, it would still allow those generators who have not contracted output at the day ahead stage in order to manage forecast, portfolio, and technical risks to price their offers in the BM at a level which is reflective of the prevailing scarcity at that time.

By referring to the margin that could be captured day ahead, the proposal would ensure that generators have a clear reference price for comparison rather than relying on subjective concepts such as 'excessive benefit', but would still allow for changes in key elements such as the gas price.

We believe that this proposal could be applied to all generators, which would avoid the need for discrimination between those parties with longer and shorter MZTs.

Response to questions

1) Do you agree with our proposal to remove the 'within the operational day' requirement for submission of 0 MW PNs? Please provide reasons for your answer.

No. As outlined in our general comments above, the removal of the 'within the operational day' requirement broadens the scope of Ofgem's proposed intervention so that it is no longer focussed on 'sharp practices' by generators, but instead targets the price that certain types of generators can offer into the BM in a broad range of circumstances. This creates a lack of clarity of the problem that Ofgem is actually seeking to address. If Ofgem's issue is about certain types of inappropriate behaviour, our view is that Ofgem's proposal is not addressing this. Instead, the proposed IOLC effectively acts as a price control mechanism on certain types of generators, which appears to be a deliberate policy decision aimed at restricting the revenues of CCGTs and other similar plant. As outlined above, generators have good reasons for submitting zero MW PNs at the day ahead stage and it is crucial that generators can manage their risks by responding fully to price signals. Ofgem's proposed intervention risks making the market uninvestable for CCGTs and similar technologies due to the creation of significant regulatory uncertainty and risk around what would otherwise be an important part of a generator's revenues.

2) Do you agree with our proposal to limit the scope of the condition to generators with an MZT of greater than 60 mins? Please provide reasons for your answer.

No. We consider the restriction of the licence condition to generators with an MZT greater than 60 minutes to be discriminatory. The 60 minute threshold is arbitrary and no analysis has been undertaken as to how this would affect generator behaviour and outturn costs in the BM. The proposed MZT requirement suggests that Ofgem has made a policy decision to restrict the revenues of certain types of generators, which we consider to be inappropriate.

3) Is the proposed licence condition drafting in Appendix 1 sufficiently clear? Are there any drafting edits or additions that you would encourage us to consider?

The draft IOLC wording is not clear. In particular, paragraph 2 is circular, with excessive benefit defined by reference to the trigger criteria in paragraph 1 and being paid or seeking to be paid an excessive amount. This wording does not provide clarity to licensees as to what is acceptable. The effect of this drafting will simply be for CCGTs and similar generators to price with a low margin in order to avoid

falling foul of the IOLC with no real clarity through the proposed guidance as to what margin would be considered too high.

4) Do you agree with our approach to considering excessive benefits, as set out in the draft guidance? Are there any other factors we need to consider for inclusion in the supporting guidance?

We do not believe that the guidance as drafted will be helpful for generators covered by IOLC. The draft guidance does not provide sufficient clarity to help generators understand how Ofgem would determine whether a benefit is excessive. The key question for licensees is what counts as a 'reasonable profit', but this is not explained or defined at all in the document. We consider it essential that licensees are provided with additional detail as to what is considered reasonable to help them comply with any licence condition.

The guidance states that Ofgem will consider comparable generator benchmarks when assessing compliance with the licence condition, but generators that have submitted zero MW PNs are likely to have different circumstances to those that have submitted non-zero PNs and so we are unclear how comparable offers will be assessed and over what timeframe.

We note that the list of factors that Ofgem would take into account when determining whether an offer is objectively justified is non-exhaustive. This means that the definition of excessive benefit is potentially open-ended in scope and could allow Ofgem to change its determination of what is excessive over time. Ofgem must commit to update its guidance or provide examples of what it has considered to be excessive on a regular basis to give licensees a complete understanding of the factors to which Ofgem currently has regard. Otherwise, Ofgem is free to determine retrospectively what is 'reasonable' and what is 'excessive' on a case-by-case basis and on a year-on-year basis, which makes compliance with the IOLC an impossible task. Given the potential consequences of an IOLC breach, generators need to have absolute clarity at the time of making offers in the BM as to what would constitute a breach and what behaviours are acceptable.