The voice of the energy industry

Energy UK response to Ofgem's Consultation on the Inflexible Offers Licence Condition

17 March 2023

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies right through to new, growing suppliers, generators and service providers across energy, transport, heat and technology.

Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources.

The energy sector supports 700,000 jobs in every corner of the country. Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide taskforce to tackle Inclusion and Diversity across energy.

Summary

Energy UK supports Ofgem's intent to lower balancing costs, which are ultimately paid by consumers. However, there is disagreement between Energy UK members on supporting this licence condition as it is currently drafted.

Some members consider that the changes made following the previous proposal, particularly the removal of the 'within operational day' requirement, have resulted in the licence condition capturing behaviour that is within the normal operation of many generation assets. In their view, this effectively places a cap on offer prices for a large part of the generation fleet, limiting scarcity pricing for these assets. Implementing this change would have major implications for how generators operate in the balancing mechanism, as well as knock on impacts on the forward, intra-day, day-ahead and capacity markets, and all of the assets that participate in them. Some members argue that this market distortion could result in inefficient trading decisions being taken before gate closure which could result in additional costs for customers overall and fundamentally change the business models and investment cases for generation assets in Great Britain.

Other members welcome the expanded scope of the licence condition, and support Ofgem's analysis that it captures more of the behaviour that Ofgem seek to prohibit. The majority of members expressed that there is a need for more detailed guidance, particularly on how Ofgem define 'excessive benefit' and 'reasonable profit'.

Guidance

Energy UK would welcome clear analysis from Ofgem which sets out how the proposed solution addresses the issue they have identified. In particular, it would be good regulatory practice for Ofgem to examine further the costs associated with the 10 highest cost days between September and December 2021. We would welcome a further breakdown of these costs incurred between assets with MZTs of less than 60 minutes, CCGTs and Coal. Some members suggest that Ofgem should consider that coal will not be participating in the BM in the same way that it did in 2021 when evaluating the effectiveness of their proposal.

Following this analysis, any action from Ofgem should be narrowly targeted at the behaviour that they wish to capture. Energy UK looks forward to the impact assessment that will accompany Ofgem's decision, which should analyse the proportionality of their intervention.

Some Energy UK members suggest that rather than Ofgem broadening their remit and increasing their administrative burden by introducing a new licence condition, a set of detailed guidance which identifies the exact behaviour would suffice, given the existing coverage of the REMIT regulation. Others disagreed, but noted that Ofgem said it would continue to consider this option in their previous Call for Input. We also welcome the introduction of the new quick and slow reserve services from 2024, which will strengthen NGESO's ability to respond to scarcity and reduce balancing costs.

Some Energy UK members argued that if Ofgem move forward with a licence condition, they must reintroduce the 'within the operational day' requirement to avoid a raft of unintended consequences. They must also provide much more detailed guidance on how they will define 'excessive benefit', and 'reasonable profit' as the current guidance represents a major compliance risk.

That said, other members consider the current guidance to be sufficient, and suggests that generators having clearly justified pricing strategies should show that they are not seeking excessive benefit.

High Balancing Mechanism Costs

Energy UK would like to see Ofgem recognise National Grid ESO's accountability for balancing the system cost-effectively. Whilst we welcome the changes that are due to be delivered by the Balancing Programme, in the short term, we would encourage Ofgem to review NGESO's use of balancing services in order to cost-effectively balance the system before the necessary upgrades are delivered.

In addition, we'd like to flag again the skip rates and outdated control room systems that currently inhibit low-cost flexibility from accessing the Balancing Mechanism. Whilst we recognise the behaviour that this Licence Condition seeks to prohibit, participants would be less able to gain excessive benefit from the BM if the market was more competitive. In particular, the ESO seems to rely on certain technologies for reserve and margin reasons, when there can be cheaper and more efficient technologies available in the BM. Ofgem must push the ESO to carry out the necessary reforms to increase competition and drive down costs.

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.

Most Energy UK members do not agree with this proposal, on the grounds that it does not align with the problem identified. It is not unusual for assets to change their running profile in response to any number of short-term signals, such as price signals, weather changes, or a large fluctuation in forecasted demand. This proposal introduces a compliance risk that any offer these assets could then submit in the BM could be deemed unacceptable. In turn, this could fundamentally change the behaviour of the assets in the BM, intra-day, and day-ahead markets. Some members suggest that unintended consequences could include displacement of flexible and intermittent assets in other markets, increased carbon intensity in the BM, as well as disrupting business models and investment cases for any assets that operate in GB.

Furthermore, if the licence condition leads to a large number of assets responding differently to such conditions, this could lead to NGESO having to take a larger number of actions at greater cost, which would run contrary to the intention of this change to reduce balancing costs.

However, there is a minority of Energy UK members that supports Ofgem's analysis that the 'within the operational day' requirement should be removed. They agreed that expanding the scope of the licence condition could target the high balancing costs associated with high offers submitted at the day-ahead stage.

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

Some members welcome the inclusion of the minimum zero time requirement, as it ensures the licence condition doesn't capture the normal practices of storage providers and other flexible assets. However, other members believe that this effectively results in a large proportion of capacity in the BM being unable to scarcity price even if those generators are not participating in the sort of behaviour which Ofgem is seeking to prevent.

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?

Most Energy UK members agree that the licence condition should not apply if the offer is not accepted, since some assets submit high offers to signal they do not intend to generate. Under this licence condition, that asset may well get punished, despite having no intention to seek excessive benefits, or even operate, in the BM. In this circumstance, paragraph 2.d. would not apply, and therefore the licence condition should not apply, but we are concerned that it may be difficult to prove that a generator did not seek excessive benefit.

Other members agreed with Ofgem, that offers not accepted should be compliant with the condition. This would follow the model of the Transmission Constraint Licence Condition, with the proviso that Ofgem should clarify to suppliers how they will be able to signal the intention to not generate without falling foul of the licence condition.

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 note that Ofgem has not tried to define excessive benefits in this guidance, and instead places a burden of proof on licensees to demonstrate that they have not sought excessive benefit. Most members suggest that this licence condition would introduce a compliance risk for generators that is difficult to mitigate, and it is essential that Ofgem provide greater clarity on how they will define excessive benefit in order that participants are able to comply. Assessing excessive benefit on a case-by-case basis further increases the compliance risk for market participants, particularly given the lack of case history.

Other Energy UK members suggest that if Ofgem were to investigate, it would be clear from each generator's defined trading processes whether they intended to seek revenue in the BM or not. Having clear processes in place for Ofgem to scrutinise would simplify compliance with the licence condition.

Having clearly defined circumstances under which an investigation would take place would reduce the administrative burden of enforcing this licence condition for Ofgem and for licensees. In addition, providing some historical evidence of periods when specific actions have unduly increased BM costs would help industry identify the behaviour that Ofgem seeks to prohibit.

With regard to measuring reasonable profit, Ofgem suggests that there is a calculation that all parties will be required to do to determine reasonable profit across the generation sector. We would welcome clarification on the calculation, the time horizon it will be applied to and whether it will be technology-specific. If the licence condition is to proceed, generators must be able to understand what is meant by 'reasonable profit' to price their offers in compliance with the condition.

We would encourage Ofgem to consider the timeframes over which generators may make profit, as it would be difficult to deem profit to be excessive on a period-by-period basis. While a generator might receive large profits for a particular settlement period, in the context of an extended period of low or no profits, this should not necessarily be considered excessive. It will also be important to consider which generators a licensee's profits are to be compared to, as business models and risk profiles vary considerably across the sector.

Some members suggest that Ofgem should also consider how generators responding to the potential for a high cash out price and pricing to mitigate the risk of imbalance cash out would be treated under the proposed licence condition. An expectation that the cash out price could be high could be brought on by the ESO scheduling the Demand Flexibility Service, or accepting trades across interconnectors at high prices, for example. A generator could also raise its offer price because other generators have had highly priced offers accepted. These members would welcome clarity on whether the IOLC will capture pricing in response to this 'first mover'. There should be equity of treatment for all generators who change their offer price in response to a cash out signal, which, in their view, is a legitimate response to managing risk.