

Consultation

Statutory Consultation on the Inflexible Offers Licence Condition

Publication date: 29 June 2023

Response deadline: 27 July 2023

Contact: Holly MacDonald & Luke McCartney

Team: Domestic Market Management

Email: luke.mccartney@ofgem.gov.uk

We are formally consulting industry on our proposal to introduce a licence condition prohibiting electricity generators from gaining excessive benefit from inflexible offers in the Balancing Mechanism (BM). We welcome views from stakeholders across the industry.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [ofgem.gov.uk/consultation](https://www.ofgem.gov.uk/consultation). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

© Crown copyright 2023

The text of this document may be reproduced (excluding logos) under and in accordance with the terms of the [Open Government Licence](#).

Without prejudice to the generality of the terms of the Open Government Licence the material that is reproduced must be acknowledged as Crown copyright and the document title of this document must be specified in that acknowledgement.

Any enquiries related to the text of this publication should be sent to Ofgem at:

10 South Colonnade, Canary Wharf, London, E14 4PU.

This publication is available at www.ofgem.gov.uk. Any enquiries regarding the use and re-use of this information resource should be sent to: psi@nationalarchives.gsi.gov.uk

Contents

Executive Summary	3
1. Introduction	5
The February Consultation	7
How to respond to this Statutory Consultation	8
Your response, data and confidentiality	8
General feedback.....	9
How to track the progress of the consultation.....	9
2. Proposal to remove the 'within the operational day' requirement for submission of OMW PNs	10
Stakeholder views on the licence condition covering any period in which a generator submits a OMW PN.....	10
Revised scope of licence in response to stakeholder views	11
Scarcity Pricing	12
3. Limiting the scope of the licence condition to units with long MZTs	13
Discrimination	13
Dynamic Parameters	15
REMIT.....	15
4. Proposed licence drafting.....	17
Scope of licence	17
Unaccepted offers.....	17
Schedule 7A trades	18
Excessive benefit.....	18
Paragraph 2.....	18
Minor drafting clarifications	19
5. Approach to considering excessive benefits in the draft Guidance ..	20
Excessive benefit.....	20
Reasonable profit.....	21
Examples of breaches to IOLC	21
6. Beyond the scope of the IOLC	23
7. Next Steps.....	25
Appendices	26
Appendix 1 – IOLC proposed licence condition text	27
Appendix 2 – IOLC Draft Guidance	29
Appendix 3 – Privacy notice on consultations	30
Personal data	30

Executive Summary

On 13 February 2023 we published a consultation¹ (the February Consultation) on our proposal to introduce a new licence condition called the Inflexible Offers Licence Condition (IOLC). It is expected this licence condition would prohibit generators from obtaining excessive benefit from their Balancing Mechanism (BM) offers when their units are operated inflexibly in a manner that limits their responsiveness to market and system conditions. The primary purpose of the IOLC would be to protect consumers from the high balancing costs witnessed in recent years.

Following the February Consultation, and based on the feedback received, we are now publishing this Statutory Consultation proposing the insertion of a new licence condition (an updated version of the IOLC published in the February consultation) to the Electricity Generation Licence. We propose to limit the applicability of the IOLC to times when a generator with a Minimum Zero Time (MZT) of longer than 60 minutes has revised their Physical Notification (PN) from a positive MW value to 0MW within the operational day. In such circumstances generators will be prohibited from gaining excessive benefit from their BM offers in relation to the relevant time period. Therefore, generators' BM offer prices must reflect only their costs plus a reasonable profit. The licence condition will not apply to generators with an MZT of 60 minutes or less, or those which submit non-zero PNs for the relevant settlement period in question. In these circumstances generators will continue to have the ability to efficiently price their BM offers provided that they do so in accordance with the existing regulatory and legislative framework.²

We are aware that units that submit 0MW PNs prior to the operational day could use their inflexibility in a way that leads to high balancing costs. Therefore, we would continue to monitor market behaviour post implementation. We will intervene further if we believe the submission of 0MW PNs at the day ahead stage is creating outcomes and costs that are not in consumers' interests.

The proposed licence text is set out in Appendix 1 of this document. Alongside this Statutory Consultation document, we are also publishing,

- (i) draft Guidance on our approach to interpreting and enforcing the IOLC including the factors we will consider when assessing whether there has been excessive benefit;

¹ [Consultation on the Inflexible Offers Licence Condition | Ofgem](#)

² The Competition Act 1998 ([Competition Act 1998 \(legislation.gov.uk\)](#)) and Regulation (EU) No 1227/2011 (as adopted by the UK) regarding Wholesale energy market integrity and transparency ('REMIT') prevent trading parties from engaging in abusive practices.

Consultation - Statutory Consultation on the Inflexible Offers Licence Condition

- (ii) an Impact Assessment setting out the policy objectives, options assessed and justification of the preferred option to progress the licence condition; and
- (iii) the Notice to amend the Electricity Generation Licence.

Stakeholders have until **27 July 2023** to respond to this Statutory Consultation and can send views on the proposed licence modification to luke.mccartney@ofgem.gov.uk.

1. Introduction

Background: Electricity system balancing

1.1 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.

1.2 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 settlement period 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 closure³ 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.

1.3 NGESO is informed in advance of the generators that are scheduled to run, and at what quantity of generation output, through the submission of PNs. 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 PNs become Final Physical Notifications (FPNs). The period between gate closure and the end of the settlement period is when NGESO accepts bids and offers submitted by BM participants.

The need for action

1.4 Between 2017 and 2020 total NGESO balancing costs for the four months of winter (November to February) averaged just under £500m each winter. For winter 2021/22 this rose alarmingly to over £1.5bn, with record breaking daily costs being experienced during the period. Overall, in 2021/22 the ESO incurred balancing costs of £3.1bn.

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

1.5 The large increase in balancing costs in 2021/22 was primarily driven by increased offer prices, rather than increased volumes having to be purchased by NGENSO. Following record breaking daily balancing costs of over £60million on 24 November 2021, NGENSO initiated an independent review of the BM.⁴ Chapter 4 of the Impact Assessment provides more detail on the history of balancing costs and what we have witnessed in recent years.

1.6 In parallel with NGENSO's review, we carried out our own investigative work to consider how best to address the high balancing costs, and identified that one of the key drivers had been the behaviours of some generators participating in the BM. These behaviours included instances of generators revising their PN to zero, to send a signal to the ESO that the generation unit intended to cease generating electricity. 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 MZT, which is a pre-determined technical capability of the generation unit.⁵ Gas-fired generators typically have an MZT of six hours. In practice, this means once a gas-fired generator has ceased generating electricity, it won't be able to start generating electricity again for at least 6 hours. We observed instances of gas-fired generators informing the ESO (via the submission of revised 0MW PNs), at times with little advance notice, that they would cease generating in the afternoon of that day. Due to the generation unit's MZT, that meant the generator would then be unavailable to generate electricity later that day, for example, during the period of peak evening demand (i.e., when generation is most in need).

1.7 Although a generator may notify the ESO that it intends to cease generating electricity, it is possible for the ESO to take action to ensure the unit continues to generate electricity (in contrast to its stated intention via the submission of the zero PN). This is achieved through the ESO accepting the generator's offers in the BM. We saw repeated instances of generators notifying the ESO that they intended to cease generating electricity for a particular period before significantly increasing the price of their offers to the ESO to continue generating during that period. An example of this is outlined in Figure 4 of the Impact Assessment, and Figure 3 of the Impact Assessment shows a real-time example from the 24 November 2021 of the impact of these actions on balancing market costs compared to the market index price.

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

⁴ [ESO Balancing Market Review](#)

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.

to meet demand and may also incentivise investment in additional generation or demand side response.

1.9 Our concern, and in turn the focus of the proposed licence condition, is on situations where generators with lengthy MZTs revise their PNs to OMW and submit high offer prices for durations that extend beyond the period of peak system demand. This combination of actions has led to the ESO incurring higher costs to balance the system as some generators have been able to take advantage of their inflexible dynamic parameters in a way that results in them obtaining an excessive benefit.

1.10 Our principal objective is to protect consumers' interests. An important aspect of this is ensuring that energy markets function in consumers' interests. We believe it is necessary to intervene to prohibit behaviours that result in generators realising excessive benefits, which are costs ultimately payable by consumers. Moreover, our Forward Work Programme for 2022/23⁶ outlined that one of our enduring priorities is to ensure domestic market arrangements are efficient while maintaining security of supply and facilitating the delivery of net zero objectives.

The February Consultation

1.11 The February Consultation asked for views from industry on the proposed licence condition and draft IOLC Guidance. This was part of our ongoing work to consider options to address high balancing costs following our Call for Input in November 2022 (the Call for Input).⁷ The Call for Input sought views from industry on six options to reduce high balancing costs. Following the Call for Input, and the feedback received from industry, we decided to pursue Option 4 – introducing a new licence condition. This was our preferred option and the one most supported by industry.

1.12 In the February Consultation we proposed some further changes following the Call for Input. We proposed to broaden the scope of the condition (from the version included in the call for input) by removing the 'within the operational day' requirement for the submission of revised OMW PNs and also proposed to limit the scope of the condition to generators with an MZT greater than 60-minutes. We also asked stakeholders' the following questions:

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

⁶ [Ofgem Forward Work Programme 22/23](#)

⁷ [Call for Input on options to address high balancing costs | Ofgem](#)

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.

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?

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?

1.13 We received twenty-two responses altogether from generation companies, storage, industry bodies and the ESO to the February Consultation. In this Statutory Consultation we discuss the responses, and our views by grouping them around the questions asked in the consultation. We explain the revisions we have made to the condition from the version set out in the February Consultation.

How to respond to this Statutory Consultation

1.14 We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.15 We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.16 We will publish non-confidential responses on our website at, www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.17 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.18 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.19 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 3.

1.20 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.21 We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

1.22 You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website, www.ofgem.gov.uk/consultations.

1.23 Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

2. Proposal to remove the 'within the operational day' requirement for submission of OMW PNs

2.1 In the February Consultation we noted analysis showing the top 10 highest balancing cost days between September to December 2021, which showed that high BM costs were incurred following submissions of OMW PNs at the day ahead stage as well as the intraday stage. Therefore, we had proposed to amend the scope of the licence condition to cover any period in which a generator (with an MZT greater than 60 minutes) submits a OMW PN.

Stakeholder views on the licence condition covering any period in which a generator submits a OMW PN

2.2 Most respondents shared concerns with our proposal to cover any time-period in which a generator submits a OMW PN submission through our proposed removal of the 'within the operational day' text from the draft licence condition. Feedback covered a number of areas all of which are interrelated and described below.

Captures a larger proportion of behaviours than initially proposed

2.3 Twelve respondents raised concerns that the broader scope would capture a much larger proportion of behaviours than initially proposed in Ofgem's rationale for intervention. They highlighted their views that there are legitimate reasons why units would have a PN of OMW before the operational day and then seek to respond to a change in market conditions. Three respondents also highlighted the importance of within day renominations, and that arbitrage between the BM and Wholesale Market is standard market behaviour. They noted that generators economically buying back capacity and reducing their PN to OMW within day may increase competition in the BM and could potentially give the ESO additional options to balance the system as it may be a non-BMU party that the generator has bought back from.

Potential unintended consequences

2.4 Respondents also shared concerns regarding a number of unintended consequences, detailed below, that they suggested had not been fully considered. One unintended consequence ten respondents identified was in relation to market distortions which may impact how generators behave in the BM. Greater restrictions on units' ability to respond in the BM to changing market conditions and price signals could impact market participants' behaviour in the day-ahead and intraday markets, as expectations of BM prices influence market prices and therefore willingness to buy or sell in these markets.

2.5 In one respondent's view it could result in buyers of electricity choosing to take short positions if imbalance does not reflect scarcity (as imbalance prices may be cheaper), thus resulting in the ESO having to balance a larger proportion of demand, which may be less efficient. Five respondents also noted that the removal of the 'within operational day' reference would limit generators' ability to efficiently reoptimize their generation portfolios and manage contingency volumes in the BM, which could leave them exposed to greater imbalance price risk.

Investment signals

2.6 Several respondents were also concerned that the broadened scope of the IOLC could impact investment signals due to the requirement that generators' BM offer prices should reflect their costs plus a reasonable profit which is not excessive. There were concerns this may unduly limit generators' ability to scarcity price, and that any intervention which may impact on this will change the established competitive principles of the energy market. Respondents also felt the removal of the 'within operational day' reference risked placing a de facto cap on all offer prices, as assets with an MZT greater than 60-minutes and a 0MW PN would often only be able to price at cost plus reasonable profit.

System Security

2.7 Six respondents raised concerns that the unintended consequences the IOLC could have on system security. A respondent noted that generators returning from outage (with a 0MW PN) would have limited incentive to return quickly during times of system stress if they were prevented by the IOLC from pricing in scarcity. Moreover, respondents believed that in the short-term the IOLC may impact liquidity in the BM, could promote sub-optimal dispatch and have an impact on how interconnectors flow. Whereas in the long-term respondents were concerned that pricing limitations could dampen investment signals, and this could have an adverse effect on the generation mix in the future not becoming more flexible.

Revised scope of licence in response to stakeholder views

2.8 Following consideration of the concerns raised by respondents, we have decided to reinstate the 'within operational day' requirement to ensure the IOLC better targets the specific harm of excessively benefitting from within day revisions of PNs to 0MW. We understand that broadening the scope of the IOLC to cover any period in which a generator submits a 0MW PN (and an MZT greater than 60-minutes) may increase the risk of unintended consequences, for example on security of supply if generators returning from outage are disincentivised from returning quickly.

2.9 Although we expect a broader scoped licence condition to lead to lower balancing costs, this may come with the potential trade-off of an increased likelihood of the IOLC having consequences on market behaviours, some of which may be legitimate and not the intended target of the IOLC intervention. We think limiting the IOLC's scope to revised OMW PNs submitted within operational day is (at this stage) a proportionate response to address the generator behaviours and the associated higher balancing costs, without undue consequences on wider market operations.

2.10 We are aware that units that submit OMW PNs prior to the operational day could use their inflexibility in a way that leads to high balancing costs. Therefore, we shall continue to monitor market behaviour post implementation. We will intervene further if we believe the submission of OMW PNs at the day ahead stage is creating outcomes and costs that are not in consumers' interests.

Scarcity Pricing

2.11 It is important to clarify and confirm that there has been no change to Ofgem's overall position on scarcity pricing.^{8,9} In the wholesale energy market, we acknowledge that in certain situations, for example where the margin between available capacity and peak demand becomes tight, a scarcity premium may be built into offer prices. Occasional high prices in these periods of genuine scarcity can provide an important signal to support supply meeting demand and may also incentivise investment in additional generation capacity or demand response.

2.12 Nevertheless, we are introducing IOLC because the level and frequency of high prices seen in the BM in winter 21/22 were much higher than those seen in previous years. These prices were often many multiples of the clearing prices in the day-ahead markets and submitted for long durations outside of periods of genuine scarcity. We believe that IOLC will better ensure that scarcity prices in the BM correspond to times of genuine scarcity. This should give a more accurate market signal and promote more efficient investment.

⁸ [Open letter on trends in balancing costs in 2021 | Ofgem](#)

⁹ [Open letter on scarcity pricing and conduct in the wholesale energy market | Ofgem](#)

3. Limiting the scope of the licence condition to units with long MZTs

3.1 Responses to the Call for Input strongly highlighted the concern that the proposed licence condition could capture business-as-usual optimisation practices of storage operators. It is considered normal behaviour – and within consumers’ interests – for storage generation units to submit revised OMW PNs throughout the day to respond to market signals and seek arbitrage from other markets. It was not our policy intent to prohibit these practices through the IOLC.

3.2 Storage units have much lower MZTs meaning the structure of their offers are inherently more flexible and agile in response to system conditions. Moreover, they are also ‘energy limited’,¹⁰ which means their offer volumes are restricted by how much energy they have stored. We have not found evidence of practices in the market by flexible asset operators that would suggest they are accruing excessive benefits at the detriment of consumers’ interests.

3.3 In the February Consultation we proposed to limit the scope of the licence condition to apply to generating units with MZTs above 60-minutes in order to avoid unintended consequences for flexible assets, such as storage. Eleven responses supported this addition to the licence condition. Eight respondents disagreed, the reasons for this are given below.

Discrimination

3.4 Four respondents noted that in their view the IOLC discriminates against plants with an MZT above 60 minutes, and they suggested it does not represent a level playing field for generators. We also note that one respondent who expressed concerns with the exemption for units with MZTs of 60-minutes or less stated that if the scope was limited to PN revisions within the operational day they would accept the inclusion of the exemption. In addition, a few respondents noted that the proposed licence condition conflicts with several existing legal obligations, including Article 3 and 6 of EU Regulation 2019/943 (retained EU law); EU Regulation 2017/2195, the Balancing Guideline (retained EU law); and the EU-UK Trade Cooperation Agreement. These legal obligations include requirements around non-discrimination amongst other things, for example the need to allow appropriate incentives for investment. We have considered carefully these

¹⁰ Energy limited means these generators can only discharge electricity for a short period of time.

obligations and are satisfied that the proposed licence condition is consistent with the legal and regulatory framework.

3.5 We do not agree that the proposed licence condition is discriminatory in applying only to those generators with an MZT of longer than 60-minutes. The IOLC is targeted at the circumstances in which certain generators are able to act (and indeed have acted) in a manner that results in them obtaining an excessive benefit from their BM offers. Critically, this excessive benefit stems from the ability of those generators to have higher offers accepted in the BM for a number of settlement periods beyond those periods of peak demand and only as a result of their dynamic parameters and their actions to revise their PNs to 0MW.¹¹ These circumstances do not apply in respect of those generators with shorter MZTs.

3.6 It is correct that generators with an MZT of less than 60 minutes are able to scarcity price in peak periods of demand. Such generators, however, are not able to extract higher offer prices in the preceding non-peak periods. Generators with an MZT of longer than 60 mins will continue to be able to submit offer prices that reflect scarcity (in the same way as other generators) in circumstances when they have not chosen to revise their PN to zero, and in this way are as flexible as those other generators at those peak periods. We have designed the scope of the IOLC so that it captures (in a targeted and proportionate manner) those circumstances in which we have evidence of these actions by some generators occurring, resulting in extremely high balancing costs

3.7 As well as the differential treatment (vis a vis the application of the licence condition) being justified on the basis of the relevant difference explained above, it is expected that there is also likely to be technical differences between the capabilities of those generators and their ability to meet the specific technical needs of the system (from an ESO perspective) at those times. The ESO usually requires larger plants (typically with an MZT greater than 60-minutes) to provide positive headroom.¹² To access this headroom, the ESO accepts offers from large thermal generators at their SEL in order to have positive (operating) reserve available in case there are shortfalls in meeting demand, for example due to a demand forecast change or a tripped generator. The provision of reserve services (such as headroom) is not a consequence of long MZTs, and assets with shorter MZTs can also provide reserve services. However, typically the ESO tends to use larger thermal plant to gain access to this headroom as the ESO may be accounting for

¹¹ Examples of these circumstances are in Figure 4 and 5 of the accompanying Impact Assessment.

¹² Headroom is the capacity between a generators Stable Export Limit (SEL) and Maximum Export Limit (MEL).

errors in forecasts of interconnector flows, wind or demand. Therefore, there is a risk that if the large thermal units with long MZTs desynchronise to 0MW, ESO will be unable to call upon them for the period they may be required the most.

3.8 We recognise the concerns from some respondents that plants with MZTs greater than 60-minutes reoptimize within day. To clarify, we do not disagree with reoptimizing PNs within day if the market signals imply that it is economic to do so. We do not agree, however, that excessive benefit should be gained through reoptimizing PNs to 0MW and using the inflexibility created by dynamic parameters to extract high priced BM offer acceptances over a long duration. This is the behaviour the IOLC would target.

Dynamic Parameters

3.9 Several respondents highlighted that thermal units are not able to choose to set their MZT above or below 60 minutes, as it is a technical limitation, meaning they cannot choose to follow a flexible or inflexible path. To confirm we recognise that dynamic parameters, such as MZTs, are required under the Grid Code¹³ to be set at a level which reflects the true operating characteristics of their plant, meaning generators are not able to 'choose' to change their MZT. It is important to note that generators should continue to meet our expectations on the submission of dynamic parameters as set out in our 2020 Open letter.¹⁴

3.10 However, generators do have the ability to take decisions in relation to how and when they choose to operate their units, which directly influences whether their MZT becomes a relevant factor during a period of operation. When a generator forecasts or anticipates a period of system scarcity it may choose to maintain generation output at its SEL or greater to ensure that it can respond flexibly to market and system conditions.

REMIT

3.11 One respondent noted that in their view the IOLC will result in generators with an MZT greater than 60-minutes to be non-compliant with REMIT¹⁵, as current market rules require that traded and offered prices must not be at artificial levels and that the IOLC forces some generators to offer at an artificially low level. We do not agree with this interpretation of REMIT obligations. Units may still revise their PNs from a positive value

¹³ [THE GRID CODE \(nationalgrideso.com\)](https://www.nationalgrideso.com), Grid Code BC2.5.3.1, Grid Code BC1.4.2(e)

¹⁴ [Open letter on dynamic parameters and other information submitted by generators in the Balancing Mechanism | Ofgem](#)

¹⁵ 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>

to 0MW, however they must ensure when doing so that they offer a market reflective BM offer price, made up of their costs to run the plant plus a reasonable profit.

4. Proposed licence drafting

4.1 In the February Consultation we included an updated draft of the IOLC licence condition text following the proposed amendments to the scope of the licence condition to,

- (i) cover any period in which a generator (with an MZT greater than 60 minutes) submits a OMW PN, and
- (ii) apply to generating units with MZTs above 60-minutes.

4.2 We asked for stakeholder views on whether the proposed licence condition drafting was sufficiently clear, and for feedback on any edits or additions we should consider. These are outlined below along with our responses, and a further updated draft of the licence condition is in Appendix 1 of this Statutory Consultation, as well as the accompanying statutory Notice.

Scope of licence

4.3 Four respondents raised concerns that the wording of the licence condition is too broad, and that it should revert back to the 'within the operational day' version of the text. As mentioned in response to question one, we have decided to reinstate the 'within operational day' requirement and we have amended the proposed licence drafting in Appendix 1 to reflect this.

4.4 In one respondent's view we should narrow the application of the IOLC only to those settlement periods in which wholesale prompt prices are insufficient to dispatch a unit economically, and in their view that this would sufficiently improve the proposal. We have decided to reinstate the 'within operational day' requirement to ensure we are able to target the specific harm of excessively benefitting from within day revisions of PNs to OMW. Narrowing the application further as suggested would in our view add a further level of complexity and may result in less clarity on when the IOLC applies.

Unaccepted offers

4.5 Three respondents highlighted their view that the IOLC should not apply to offers which are not accepted by ESO in the BM as guidance from the ESO and Ofgem to date has been to use pricing as a signal not to run, and under the IOLC that may be difficult to prove that a generator did not seek excessive benefit even if it does not run in the BM. The respondents believe there should be another way to indicate the unit does not want to run in the BM. Separately a respondent noted that they did not think it was clear if submitting a high offer in and of itself is a signal that a generator is seeking excessive benefit.

4.6 We are aware that some generators will price themselves at a high price in the BM in order to not run. We expect that those generators will be able to provide evidence to support that position if circumstances suggested a potential breach and Ofgem was looking to assess whether their behaviour was in line with the IOLC. We also note that under the licence condition generators will only be in breach if they have revised their PN to OMW within-day. This should limit this concern as most units who price high not to run will have a OMW PN prior to the operational day.

4.7 We have seen instances where units may have submitted high priced offers which would have resulted in gaining an excessive benefit but did not have their offers accepted by the ESO. Gaining excessive benefit is not in consumers' interests and, as a result, we think that the IOLC should apply even if the offer is not accepted by the ESO.

Schedule 7A trades

4.8 One respondent asked for clarification on whether Schedule 7A trades are included within the scope of the IOLC as these could be considered as 'Relevant Arrangements'. We have only witnessed the behaviour we are trying to prohibit from offers taken in the BM. As a result, the IOLC will specifically be for offers that have been submitted in the BM.

Excessive benefit

4.9 One respondent requested a clear definition of 'excessive benefit' within the licence condition supported by examples in the draft Guidance document. We do not consider it appropriate to seek to include a prescriptive definition of the term 'excessive benefit'. We consider it more appropriate that the draft Guidance sets out the various factors that will be considered in making our assessment as to whether the level of benefit has been or would be excessive. This approach is consistent with other regulatory obligations, such as those in the Transmission Constraint Licence Condition¹⁶ and in competition law.

Paragraph 2

4.10 One respondent noted that it believed the conditions within Paragraph 2 of the licence to be contradictory, as condition (a) required relevant arrangement to be entered into between the licensee and system operator while condition (d) applies to either to being paid or seeking to be paid excessive benefit. They requested further clarity on when the condition will apply.

¹⁶ <https://www.ofgem.gov.uk/publications/final-decision-guidance-transmission-constraint-licence-condition> Final decision: Guidance for the Transmission Constraint Licence Condition | Ofgem

4.11 We have further clarified the drafting of paragraph 2 of the licence to be clear that the licensee shall be considered to have obtained such a benefit if,

- (i) the licensee and the system operator enter into, or have entered into, relevant arrangements and,
- (ii) the licensee is paid or seeks to be paid an excessive amount by the system operator.

Minor drafting clarifications

4.12 We also received suggestions for a few clarifications in the licence drafting, which we have taken into account, including not referring to Final Physical Notifications, the definition of a BMU, and references to the system operator.

5. Approach to considering excessive benefits in the draft Guidance

5.1 In the February Consultation we included a draft of the supporting Guidance on our approach to interpreting and enforcing the IOLC. This included criteria we will consider assessing whether excessive benefit has been obtained.

5.2 We asked for stakeholder views on our approach to considering excessive benefits, and for views on further factors we need to consider for inclusion in the supporting draft Guidance. These are outlined below along with our responses, and a further updated draft of the Guidance is published alongside this Statutory Consultation.

Excessive benefit

5.3 Several respondents raised concerns that 'excessive benefit' was not clearly defined in our draft Guidance published on 13 February 2023 and there was insufficient clarity on whether scarcity pricing was to be allowed. As mentioned above, we consider it appropriate that the draft Guidance sets out the various factors that will be considered in making our assessment as to whether the level of benefit has been or would be excessive. This approach is consistent with other regulatory obligations, such as those in the Transmission Constraint Licence Condition and in competition law. We also believe that since the February Consultation, we have improved the draft Guidance as it is now clearer on how we would assess any potential breach of the licence condition.

5.4 The draft Guidance document sets out the costs we would expect to be factored into the formulation of their offer price, whilst also setting out how we determine a reasonable profit. The licence condition will not apply to generators with an MZT of 60 minutes or less, or any generators that submit non-zero PNs for the relevant settlement period in question, or any generators that submit OMW PNs before the operational day.

5.5 One respondent raised their concern that the list of factors determining excessive benefit was non-exhaustive and that the definition of excessive benefit is open ended in scope resulting in Ofgem to change the determination from time to time. It is important to note that Ofgem would have regard to the Guidance 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 would be assessed. Our assessments would be inevitably case specific and must take into account the particular circumstances of each case. The non-exhaustive nature of the list should also give generators confidence that they could show Ofgem other reasoning on why they have not gained / sought to gain an excessive benefit.

Reasonable profit

5.6 Many respondents raised similar concerns on the definition of 'reasonable profit.' Respondents noted that the draft Guidance should further explain what is meant by 'generator benchmarks' and requested more clarity over the timescale Ofgem would use to assess. Respondents also noted that using the 'average' rate of return was not appropriate as generating units run under different business models and that generators will be unaware to a certain extent when making comparisons to other businesses' profit levels.

5.7 Following consideration of these concerns we have revised the draft Guidance on how we will assess a reasonable level of profit. We have set out in the draft Guidance a non-exhaustive list of different types of evidence and comparators that we intend to use to assess whether the prices and profit margin made by the generator is reasonable or not. While what is reasonable will be dependent on the circumstance of each case, we consider that it would not be reasonable for a generator to obtain a level of profit 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.

Examples of breaches to IOLC

5.8 Four respondents noted that clear examples of circumstances where Ofgem would investigate a breach of the licence condition would be helpful additional information in the draft Guidance document. Figure 1 in the draft Guidance document, highlights when a licensee could be in breach of the IOLC, we believe this figure coupled with the revised draft Guidance text on how we would plan on assessing excessive benefit and reasonable profit gives licensees the information required in order to comply with the IOLC.

Opportunity costs

5.9 A few respondents highlighted certain opportunity costs that they believed should be included in the draft Guidance document. These were mostly risk-based factors that would go into the formation of an offer price. Five respondents noted they will consider the cash out risk at a portfolio level when determining an offer price for a generator with a OMW PN i.e. licensees will use this unit as a contingency which is priced to cover any imbalance charge a generator in their portfolio would incur if it was to trip. We believe that adding back in the provision of revising PNs to OMW within the operational day will mitigate this concern. This is because the unit would have had a PN of OMW prior to the operational day if it were planned to be used to cover any potential trips and thus imbalance penalties.

Maintenance risks

5.10 Three respondents also highlighted maintenance risks as being something which should be considered in our draft Guidance. This includes generators taking into account the number of starts or operating hours they are limited to when calculating their offer prices. We believe that we have included reference to each of these in the draft Guidance document.

Variable costs

5.11 A few respondents also highlighted that they use an expectation of what the imbalance price will be when formulating their offer price. We are aware that generators do this by assessing the risk of their plant tripping. This is also covered in the draft Guidance as the expectation of imbalance price would be considered by the 'anticipated costs of plant failure' in the assessment of a unit's variable costs.

Emission limits

5.12 One respondent highlighted that opportunity costs on exceeding emission limits could be a reason for submitting high offer prices, when having a OMW PN. We have now added direct reference to this in the draft Guidance.

5.13 One respondent highlighted that opportunity costs on fuel supply risk is not included in the draft Guidance. They noted fuel supply risks could occur due to fuel shortages or logistical issues and thus the opportunity cost of this may need to be included in their offer price. We believe that we have covered this concern in the draft Guidance as fuel cost and anticipated cost of plant failure are noted in the variable costs assessment.

Start-up costs

5.14 One respondent also felt that we should be more explicit about start-up costs in the draft Guidance as a unit may have a number of starts with a risk premium for exceeding these, tolling arrangements limiting the number of starts or manufacturer guarantees that only apply for a set number of start conditions or running hours. We believe that this has been covered in the 'avoidable fixed costs section' however we have added extra clarity on running hours/number of starts.

6. Beyond the scope of the IOLC

Other drivers of balancing costs

6.1 Many respondents to the February Consultation noted in their response other drivers of high balancing costs for further consideration. These included:

- a general lack of competition in the balancing mechanism,
- efficiency and transparency of decisions taken in the control room by the ESO,
- accuracy of the ESO's forecasting of demand and margin at day ahead stage; and
- the development and introduction of Balancing Reserve.

6.2 We agree that these are important considerations related to balancing costs and, if addressed, would likely reduce balancing costs associated with the behaviours that are the subject of this consultation.

6.3 We expect the ESO to ensure that its systems do not provide barriers to market participation and to provide accurate forecasts with (at least) continuous incremental improvements to forecasting accuracy. Moreover, by the end of the RIIO2 period (i.e., 2021-2026) we expect the ESO's Balancing Programme¹⁷ to have replaced its legacy IT systems with new systems that are fit for purpose in the future energy system. We will continue to use the ESO's performance and incentives framework to ensure the ESO delivers against our expectations.

6.4 In addition, we recognise that the ESO is currently developing a new Balancing Reserve product and expect the ESO to consider the impact of our proposed licence condition on their assessment of the design and need for this. We believe that our proposed new licence condition and the ESO's Balancing Reserve product do not conflict with each other and may operate successfully in parallel.

Role of existing legislation/other tools that could be utilised

6.5 Some respondents felt we should be addressing this behaviour by using existing legislation and regulatory tools, for example provisions in REMIT and/or the Competition Act. The intention of IOLC is to protect consumers by placing an additional restriction on licensees in relation to how they set their offer prices. Ofgem does not intend to interpret the scope of the IOLC by reference to competition law or REMIT. The assessment of whether or not there has been a breach will be undertaken with reference to the framework

¹⁷ [Balancing programme | ESO \(nationalgrideso.com\)](https://www.nationalgrideso.com/balancing-programme)

of the IOLC and is different from the analytical framework for establishing unfair pricing under competition law, or artificial pricing under REMIT.

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

6.7 It was also suggested that we could issue guidance on best practices or an open letter that clarifies our expectation from licensees, similar to our previous open letter on dynamic parameters. It is our view that a new licence condition, with supporting Guidance, provides clearer obligations that are necessary to protect consumers' interests and ensure that energy markets function in consumers' interests.

7. Next Steps

7.1 Following the conclusion of this Statutory Consultation, we will review and fully consider the responses we receive on the proposed draft licence condition, accompanying Impact Assessment and draft Guidance. If we decide it is appropriate to proceed with the licence change, we will publish a decision outlining our reasons for doing so accompanied with the final licence drafting and supporting Guidance. The licence change will take effect following a 56-day statutory notice period to industry, with the intention for IOLC to be in place ahead of winter 23/24.

Appendices

Index

Appendix	Name of appendix	Page no.
1	IOLC proposed licence condition text	26
2	Draft Guidance	28
3	Privacy notice on consultations	29

Appendix 1 – IOLC proposed licence condition text

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.
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
"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;
"Operational Day"	has the meaning given in the Grid Code ¹⁸
"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 ¹⁹

¹⁸ Currently the Grid Code definition is "The period from 0500 hours on one day to 0500 on the following day."

¹⁹Currently the Grid Code definition is "A period of 30 minutes ending on the hour and half-hour in each hour during a day."

Appendix 2 – IOLC Draft Guidance

Please see the standalone Appendix 2 document for the final version of the draft Guidance on the application and enforcement of the Inflexible Offers Licence Condition.

Appendix 3 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR").

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer.

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data.

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data.

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. Your personal data will not be shared outside of Ofgem.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for 12 months after the consultation has closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data

- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas.

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information

For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".