

Response to Ofgem Statutory Consultation on Inflexible Offers Licence Condition

27 July 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 400 MW 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 circa £1.5 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 has serious concerns about the proposed Inflexible Offers Licence Condition (IOLC). While we are supportive of stopping abusive market behaviours and welcome the fact that Ofgem has taken on board key industry feedback about its proposals to date, we are concerned that the proposed IOLC would prohibit legitimate and economically rational optimisation activities and responses to changes in market conditions by certain classes of electricity producer. By prohibiting competitive Balancing Market (BM) offer pricing for some plant, such an intervention would be discriminatory and contrary to established principles of competitive energy markets, and therefore inconsistent with the carrying out of Ofgem's principal objective and performance of its statutory duties, and relevant EU legislation.

EPUKI considers that the IOLC, as proposed, fails to achieve the effect that Ofgem seeks to achieve. IOLC clearly goes beyond what is necessary to prevent potential manipulative behaviours in the Balancing Market and, by stopping some generators from capturing scarcity prices within day, will have knock on impacts and serious unintended consequences for the electricity market. The wider impacts on such an intervention on consumer bills and investment in the electricity sector have not been properly assessed.

There are therefore serious potential unintended consequences associated with IOLC. While EPUKI is opposed to the introduction of the IOLC in principle, we consider that Ofgem could mitigate some of these adverse impacts by making changes to the wording of the licence condition and guidance to ensure that the licence condition is more workable, transparent and can be complied with and indeed enforced.

General points of concern

No ongoing requirement for IOLC

EPUKI does not believe that there is a continuing need for a licence condition such as IOLC. The 'sharp practices' that Ofgem identified in its previous consultations appear to have been confined to the Balancing Market in winter 2021. The analysis recently undertaken by LCP for NGESO's Balancing Market Review demonstrated that the total cost of market participants employing a 'delayed de-sync' strategy in winter 2022 was 80% lower compared to 2021, leading to a £199 million decrease in overall costs. Ofgem's clarification of its expectations in relation to this strategy was a key driver in changing the behaviour of market participants. As Ofgem recognises in the Impact Assessment, the conditions which led to high balancing costs in winter 2021 (such as coal units consistently pricing at £4,000/MWh) no longer exist. There is therefore limited ongoing requirement for a targeted licence condition to tackle this issue. While Ofgem states that a few generators are still not acting in line with its expectations, it has not given a compelling explanation for why REMIT or the Competition Act are insufficient to tackle behaviour of this kind if it is considered to be abusive or manipulative. We note that in deciding whether to implement the IOLC, Ofgem must have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed (section 3A(5A) Electricity Act 1989).

Consistency with established principles of energy markets

IOLC is fundamentally inconsistent with established energy market principles, including those which have been accepted by Ofgem. Ofgem is clear in the consultation that 'Occasional high prices in...periods of genuine scarcity can provide an important signal' and states that it does 'not disagree with reoptimizing PNs within day if the market signals imply that it is economic to do so'. However, rather than tackling specific manipulative behaviour, IOLC would place a blanket pricing restriction on a certain class of generator seeking economically to optimise its positions within day and to capture prices which reflect underlying system conditions and margins. Affected generators would therefore be prevented from capturing scarcity prices and IOLC appears to be an attempt by Ofgem to limit scarcity pricing in general, contrary to Ofgem's stated position and the principles and design of the GB energy market.

The nature of the Balancing Market is that it is a pay as bid mechanism that incentivises market participants to price their actions just below the level of the expected accepted marginal priced action. The BM has been designed to ensure sharp prices at times of scarcity, rewarding flexibility and encouraging market participants to balance their positions. However, IOLC would interfere with normal competitive pressures in the BM by limiting the returns that can be made by certain market participants, including over periods of genuine scarcity. IOLC would result in an illogical situation where different generators are able to realise different levels of reasonable profit from Balancing Market offers depending on their dynamic parameters and the timing of when they decided to participate in the BM. This would affect the efficient operation of the BM, with potential unintended consequences in other markets and timeframes.

Discrimination against CCGTs and other plants with longer MZTs

EPUKI considers IOLC to be discriminatory against CCGTs and other plants with long MZTs. While we recognise that consistent high pricing by generators is not appropriate, by imposing a blanket pricing restriction on generators that have reduced their PNs to zero rather than allowing them to profile their offers to reflect prevailing market conditions and to price with reference to the marginal offer in a given Settlement Period, IOLC stops affected units from accessing scarcity pricing and treats them differently to plants with shorter MZTs. The Statutory Consultation does not give a reasonable explanation as to why IOLC would not be discriminatory under EU Regulation 2019/943, EU Regulation 2017/2195, the Balancing Guideline, and the EU-UK Trade Cooperation Agreement. These items of legislation require free price formation on the basis of supply and demand. IOLC clearly prevents this by stopping a class of generator from seeking to capture prices within day which reflect prevailing supply and demand. By stopping generators with longer MZTs from accessing scarcity prices in the same way as plants with shorter MZTs, Ofgem appears to be picking winners in the energy market, contrary to established energy policy principles.

Furthermore, we do not consider that Ofgem's argument that IOLC will assist in retaining the availability of larger generation assets to provide headroom at a low cost is a suitable justification for the intervention. We do not consider that the ESO's failure to broaden operational procedures to utilise

upward flexibility from smaller units should be used as a reason to regulate pricing for CCGTs and similar plants. In fact, what Ofgem appears to be proposing is a form of requisitioning of large assets to ensure their availability to provide services through the BM at a below market price.

The problem that Ofgem has identified is that energy policy design to date has encouraged over-reliance of the electricity system on inflexible and unpredictable energy sources, such as interconnectors (which are not available to the ESO via the BM and require periods offline to reverse direction), and that the ESO has not done enough to utilise operationally the sort of short-duration flexible response that Ofgem believes is required. These are fundamental failings of energy policy, not the fault of market participants, and they need to be solved by government. The solution to this issue is not to penalise relatively flexible long-duration energy providers, such as CCGTs, by limiting their returns in the Balancing Market, especially as these plants can assist in dealing with the over-reliance on inflexible plants which has been created by energy policy to date.

Impact on investment

IOLC would undermine investment signals in flexible power generation in Great Britain. The investment cases for existing and new CCGTs are highly reliant on capturing scarcity margins in energy markets when they arise. Owing to system conditions, such scarcity is likely only to materialise within day and such margins are therefore captured primarily in the BM rather than at the day ahead stage. The BM is a fundamental part of the electricity market and if Ofgem interferes in BM price formation there will be unintended consequences in other products and timeframes.

In the Impact Assessment, Ofgem quotes a view from an external consultant in a piece of work commissioned by a third party that 'the BM isn't believed to be a critical factor in investment decisions' because of its variability and lack of predictability and states that 'CM auctions are a stronger, more reliable investment signal to the market'. This view is overly simplistic. When bidding into the Capacity Market (CM), investors will have taken a view on likely market income, including scarcity margins, which they are able to capture. CM clearing prices alone are insufficient to support ongoing investment in CCGTs. For example, EPUKI is currently preparing to reach a final investment decision on a highly efficient new CCGT plant at Eggborough, which is heavily reliant on market income, including scarcity margins, in addition to CM revenues. By altering the returns available to CCGTs in the BM, Ofgem will undermine the bidding decisions made in previous CM auctions, which did not foresee BM price regulation, and therefore the overall economics and profitability of existing and new build CCGTs. This could incentivise early closure of existing CCGTs or prevent new projects from proceeding.

Furthermore, the approach to assessing 'excessive benefit' which Ofgem has proposed in guidance, which caps reasonable profit at a fixed level regardless of the risks which a market participant may be facing at that point in time, does not reflect normal investor expectations and will affect the attractiveness of the GB electricity market to investors.

Enforceability and compliance

IOLC relies on an ill-defined and untested concept of 'excessive benefit'. The proposed guidance issued by Ofgem does not provide sufficient clarity to market participants as to how excessive benefit would be assessed as Ofgem's proposed methodology is confused, full of caveats, relies on factors which a market participant cannot assess ahead of submitting its offer prices, and lists non-exhaustive elements which could be expanded or reinterpreted by Ofgem on a case-by-case basis. We therefore consider that it would be extremely challenging for a market participant to develop a pricing strategy which it could guarantee was compliant with IOLC.

IOLC therefore appears to be unenforceable and it does not seem that Ofgem has tried to make it enforceable. Ofgem's approach instead appears to be to create a regulatory burden for market participants by introducing a wide-ranging power which it can utilise to investigate parties and impose the threat of a fine when it does not like their BM pricing strategies. We consider this to be an inappropriate use of regulatory powers and inconsistent with principles of good regulation, which encourage clear, consistent and predictable regulation to facilitate competition in markets.

Ofgem's powers

IOLC proposes to regulate price formation in the Balancing Market in a way which is contrary to the legislation underpinning the competitive electricity market and which could have significant implications

for investment in existing and new CCGTs. We believe that Ofgem is therefore obligated to seek Parliamentary approval for a change of this nature. We note that Ofgem has previously sought Parliamentary approval for pricing restrictions in the retail market and for the introduction of the Transmission Constraint Licence Condition (TCLC). We do not consider that Parliamentary consent for previous interventions such as the TCLC, which was approved to deal with the specific issue of the exercise of market power behind thermal constraints, set a precedent for the general BM offer pricing restriction which IOLC would introduce. Ofgem must justify why it has the powers to make an intervention of this nature.

Impact Assessment

The overall costs and consumer benefits associated with IOLC have not been properly quantified. By preventing certain classes of generators from taking economically rational decisions and reoptimising within day to capture the best available prices, IOLC will dampen scarcity signals in the market and fundamentally undermine investment cases in existing and new CCGTs and similar flexible plants with longer MZTs. This will result either in higher prices in other markets, such as the Capacity Market, or in early closure of these types of plant. The costs arising from these potential outcomes have not been quantified in the Impact Assessment and we therefore cannot agree that IOLC will 'prevent higher than necessary bills for consumers'.

As recognised by Ofgem itself, the analysis in the Impact Assessment undertaken to support IOLC is primarily qualitative. We are disappointed that Ofgem has made little effort to quantify the impacts of IOLC and do not consider that 'the complex nature of assessing the impact this licence condition could have prior to its introduction' is a reasonable excuse for not attempting this analysis given Ofgem's duty to undertake meaningful Impact Assessments for interventions of this nature. For example, Ofgem recognises in the Impact Assessment that the Capacity Market is designed to resolve the 'missing money' problem in the market, but has not considered the impact on consumers of increased CM clearing prices if returns for CCGTs in the BM are reduced. The Impact Assessment therefore falls well below the quality of analysis that we would expect to accompany an intervention of this nature.

Proposed changes to licence condition and guidance

While EPUKI has serious concerns about IOLC as a piece of regulation and its compatibility with free market principles, we consider that at the very least it is important to incorporate the following changes to the licence condition itself or the guidance to attempt to move closer to achieving the stated effect that Ofgem seeks to achieve, and we note that there is scope to make drafting changes to the IOLC that are necessary to achieve the stated effect of the proposed modification under section 11(7)(d) of the Electricity Act 1989:

1. IOLC should not penalise economically rational risk management behaviour

We welcome the fact that Ofgem has responded to industry feedback and amended the IOLC proposal such that it only applies to within day changes to PNs. While this addresses the unintended consequences of the day ahead provision suggested in the last consultation, we still consider that market participants should be free to manage forecast, portfolio, and technical risks as they see fit and, where necessary, reoptimise their positions within day without restriction on their subsequent offer prices.

In general, we consider that generators must be able to respond to factors such as plant trips, gas price changes, or cashout risk in an economically rational manner without risk of investigation or penalty over their BM pricing. If within day prices suggest that it is logical to buy back a position rather than deliver it, generators should be free to do this without the risk that their subsequent BM offers will be capped if system conditions subsequently change. We therefore consider that Ofgem should clarify that IOLC will not apply where a generator can demonstrate that the decision to buy back its position and reduce its PN to zero MW within day was economically rational without reference to any expected revenues from subsequent BM offer activity in those Settlement Periods. This would mean that economically rational risk management behaviour is not captured by the IOLC and generators that respond to these market signals are not bound by historic decisions regarding profit margin which are no longer relevant within the context of current market conditions.

2. Allowing generators to price in response to market conditions in periods of genuine scarcity

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 and we consider that all market participants should have the ability to respond to and capture scarcity pricing in the Balancing Market should it arise.

Ofgem states in the Statutory Consultation that:

“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.”

However, Ofgem argues that:

“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.”

Scarcity can arise within day for a large number of reasons, such as wind and solar forecast error, changes in plant availability, demand forecast error, or changes in interconnector flows. These factors may arise close to real time and therefore would not be captured in day ahead prices. We therefore do not consider that BM offers prices being ‘many multiples of the clearing prices in day-ahead markets’ should be a concern if they are genuinely reflective of system and market conditions.

While we accept that it would not be appropriate for such high offers to be submitted for long durations outside of periods of genuine scarcity, IOLC would place a blanket pricing restriction on units in Settlement Periods in which they had amended their PN to zero within day, even if those periods are ones of genuine scarcity. IOLC would therefore limit certain market participants’ ability to capture scarcity when it does arise and does not reflect Ofgem’s stated view on scarcity pricing.

We consider that the IOLC should allow generators to profile their offer prices to be higher in Settlement Periods in which it can be demonstrated that there is genuine scarcity in the electricity market (that is scarcity created by the true margin between demand and available supply) and that offers made in such Settlement Periods will not be considered to have resulted in an excessive benefit. Ofgem should assess excessive benefit with reference to the marginal offer in each Settlement Period to ensure that generators are able to capture scarcity premia where they arise. We believe that such an amendment to the IOLC would mean technologies with a long MZT would compete on a level playing field with other flexible technologies, with both able to capture BM pricing reflective of supply and demand balance in each Settlement Period.

3. IOLC should not unfairly capture issues beyond a licensee’s control or normal market practices

We have identified several examples where IOLC could unfairly restrict a generator’s ability to capture returns reflective of market conditions where they are acting logically with no intended manipulative behaviour:

a. Units unable to transact day-ahead

IOLC has the potential unfairly to restrict the ability of plants to reoptimise their positions and capture prevailing market prices within day where they were unable to buy back their positions and amend their PNs accordingly at the day ahead stage. This could arise, for example, through paradoxical rejection in the day ahead auction (ie. where a trade is rejected due to market liquidity even though it should have been accepted at the given price) or where there are restrictions on a market participant’s ability to participate in the market (eg. credit limits). These units may then have no option but to buy back their positions within day and would then be captured by IOLC, restricting their ability to price freely compared to competitors that were able to trade at the day ahead stage.

We therefore consider that IOLC should not apply to any unit that can demonstrate that it intended to buy back its position day ahead but was unable to due to factors outside of its control.

b. Portfolio management

Market participants with a portfolio of generating units may choose not to contract output on all units in advance of a day and may then reassign PNs between units within day to deliver contracted positions based on prevailing operational or technical factors and risks associated with each unit. This is a normal risk management practice. However, under IOLC, which applies to individual licensees, this behaviour would introduce an offer price restriction as the original unit which had been scheduled to deliver the contracted position would have its PN amended to zero within day, even though the original PN is still being delivered by a different licensee in the same portfolio group.

This is not behaviour which the licence condition is designed to capture and we consider that IOLC should recognise this as legitimate and clarify that IOLC will not apply where a PN has been reduced to zero MW within day but a corresponding increase in PN has been submitted by a related licensee.

4. The assessment of excessive benefit should allow pricing with reference to marginal offers

Ultimately, should a licensee derive “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, this may result in enforcement action by Ofgem and potential penalties imposed. Where a penalty is to be imposed, the prohibited conduct must be precisely defined so it is clear what is and what is not prohibited. An imprecise statement of the prohibited conduct may lead to inconsistent enforcement, uncertain application of the IOLC, unintended changes in behaviour, or failure to preclude conduct that the IOLC was intended to prohibit. Therefore, the rules for assessing what is “excessive benefit” should be sufficiently and clearly defined such that the generator can fully understand the prohibited behaviour. The meaning of “excessive benefit” in the IOLC and guidance fail in this respect.

We welcome the additional clarity that Ofgem has provided around how it would assess excessive benefit under IOLC. However, we consider that Ofgem’s approach to assessing excessive benefit is illogical, confused, and takes into account a non-exhaustive list of factors which could be subject to change. We are concerned that by relying on the ill-defined and untested concept of ‘excessive benefit’ IOLC will replicate the failings of the TCLC. Recent enforcement cases have shown that the nebulous nature of ‘excessive benefit’ under TCLC has presented challenges to market participants in adopting BM pricing strategies which match Ofgem’s interpretation and expectations.

As recognised by Ofgem itself, and in accordance with Ofgem’s duties under section 3A(5A) of the Electricity Act 1989, it is good regulatory practice that there should be a clear, consistent and predictable framework of rules for competitive markets to allow participants to compete effectively. Licence conditions must be easy for market participants to interpret and understand how they can comply, especially if they could be subject to financial penalties for non-compliance. We consider that the definition and assessment of ‘excessive benefit’ under IOLC, which is unclear and open to reinterpretation by Ofgem on a case-by-case basis, does not meet these standards.

This presents significant compliance risks 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.

A key factor is how Ofgem would assess what is a reasonable profit for a generator to make through its offers. Ofgem states it will have regard to ‘The prices (and implied profit margin) at which the unit’s output had been sold prior to the PN being revised to 0MW within the operational day’. Assessing reasonable profit based on the total profit margin in pounds that would have been realised by running the original PN is illogical as:

- Licensees may have sold their positions over widely diverging timeframes (season ahead, month ahead, week ahead, day ahead), and thus have very significant differences in the margin achieved for running in the same Settlement Period;
- As previously noted, underlying system conditions can change significantly between the day ahead and within day stages, which means that Day Ahead pricing may not be reflective of the actual balance of supply and demand within day; and
- It is reasonable and normal investment practice that an energy market participant should be able to realise a level of profit which reflects the scale of the risks which it is taking on. Where generators face costs and market risks which are greater than those envisaged when the output was originally sold, it is reasonable that the profit which they can realise should increase accordingly. Capping the profit that a generator can realise without reference to the costs and risks which it is incurring could disincentivise investment in the sector. We therefore consider that reasonable profit should be considered as a percentage of reasonable generator costs rather than as a fixed figure.

Ofgem appears to allow a reasonable profit margin to be defined by reference to the profit margins of other generators. We are unclear how a market participant could accurately assess the level of profit being realised by a competitor given commercial confidentiality, let alone carry out this analysis in advance for every Settlement Period. We therefore consider that a generator can only set its offers with reference to the submitted prices of its competitors. However, Ofgem appears to exclude comparator prices of generators to a subset of units which (a) have not reduced their PN to 0 MW within day, (b) are not system flagged, (c) are of the same technology type and (d) are operating in a similar manner to the generator under investigation. Most of these factors cannot be assessed accurately in advance of submitting an offer. For example, it is very difficult to assess whether a competitor set its PN to zero MW at the day ahead or within day stage. Given the caveats applied by Ofgem, it would be practically impossible for a generator to understand which competitor offers are legitimate benchmarks for setting its own offers and this approach would subject licensees to significant compliance risk as generator benchmarks which they considered legitimate could be excluded after the event.

Ofgem states that it 'will generally avoid comparisons with any single generator or in any single period' and instead 'will typically focus on differences in average prices over sustained periods of time'. We do not consider that this approach is compatible with the nature of the Balancing Market, which encourages market participants to price close to the level of the expected accepted marginal offer in any Settlement Period. Looking at average prices over sustained periods would not take account of specific system conditions at any given point in time.

In general, we do not consider it necessary to exclude comparators or focus on averages in this way. Through unflagged BM offers, the ESO is obtaining the same service from all generators, ie. energy. This energy should be valued identically regardless of the plant which provides it. We therefore consider that any offer submitted by a unit which at or below the marginal offer submitted by a competitor unit should be considered reasonable and not to have resulted in an excessive benefit. The IOLC guidance should be updated to reflect this position.

5. IOLC should be time-limited

The IOLC represents a significant intervention in the functioning of the energy market and we do not consider that the behaviours it is intending to tackle are of significant concern on an ongoing basis. We therefore do not consider it appropriate for Ofgem to introduce a restriction of this nature without committing to a full post-implementation review on a defined timetable. We note that Ofgem itself recognises that the government's Review of Electricity Market Arrangements could affect the ongoing need for IOLC. As a safeguard, we therefore recommend that a sunset clause is included in the licence condition to ensure that it will be removed from the licence should it no longer be justified.