

Penalty notice

NOTICE OF DECISION TO IMPOSE A FINANCIAL PENALTY PURSUANT TO SECTION 27A(5) OF THE ELECTRICITY ACT 1989

Date: 7 December 2023

Decision of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into EP SHB Limited (“EPSHB”) and its compliance with its obligations under the electricity generation licence (Standard Licence Condition 20A, known as the Transmission Constraint Licence Condition, or “TCLC”).

1. SUMMARY

- 1.1 With this document, we the Authority¹ are giving notice under S27A(5) of the Electricity Act 1989 of our decision to impose a penalty on EPSHB, a licensed electricity generator, in relation to a breach of the TCLC. It follows the publication on 13 October 2023 of our proposal to impose a penalty on EPSHB in relation to that breach (in response to which no representations or objections were received). In this Notice, we have set out the acts or omissions which constitute the relevant contraventions and the other facts which justify the imposition of a penalty on EPSHB and the amount of the penalty chosen.
- 1.2 The TCLC requires that licensees must not obtain or seek to obtain an excessive benefit from a reduction in electricity generation in the Balancing Mechanism (“BM”) in relation to a transmission constraint period. The objective of the TCLC is to protect against the exploitation of market power by generators operating in the presence of transmission constraints. Such constraints routinely lead to generators holding a position of market power in the BM in one or more period, with the Electricity System Operator (“ESO”) having limited options to manage the constraint other than instructing a specific generator to reduce its planned output. If the TCLC did not exist and licensees were free to take advantage of this market power, this would increase balancing costs (which are ultimately passed onto consumers) and create harmful incentives.

¹ In this Notice we use interchangeably “the Authority”, “Ofgem” and “we” to refer to the Gas and Electricity Markets Authority.

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- 1.3 Our investigation into EPSHB was opened in October 2021, and concerns the bid prices submitted in the BM by the licensee for South Humber Bank combined cycle gas turbine (“CCGT”) power station (“SHBA”) between 1 October 2019 and 31 May 2021. Prior to this, EPSHB’s average bid prices for SHBA were in line with the average for CCGT generators, and tracked trends in wholesale gas prices (which increased in 2018, before falling substantially in 2019). However, starting in October 2019, EPSHB began to regularly submit bid prices for SHBA of £0/MWh, indicating that it would no longer pay the ESO to be bid down, despite the substantial benefits it received (particularly in terms of avoided fuel costs, avoided emissions costs, and avoided balancing charges). While it was not the only gas generator submitting bid prices at this level, EPSHB’s prices in this period were significantly more expensive than the CCGT market average, and remained so until the end of May 2021.
- 1.4 The departure in EPSHB’s bid pricing from the market average coincided with a significant increase in the extent to which the ESO needed to bid SHBA down to manage the risk it posed in the event of a credible transmission fault outage which could disconnect it from the transmission network. In particular, the impact that such a disconnection could have upon the Rate of Change of Frequency (“RoCoF”) under certain system conditions. In our view this risk could only be practicably and economically resolved by the ESO by instructing EPSHB to reduce the output of SHBA, and so the ESO had little choice but to accept bids from EPSHB despite its prices being so much more expensive than those of most other gas-fired generators. The ESO ultimately accepted more bids in the BM for SHBA than for any other generator in Great Britain (“GB”) in the period.
- 1.5 Following our investigation, we have concluded that the vast majority of EPSHB’s bids in the period related to a transmission constraint period as defined in the licence condition, and were at a price that resulted in EPSHB obtaining a profit which was significantly greater than that which it would have obtained absent the transmission constraint. On this basis, we have concluded that EPSHB has breached the TCLC. Our view is that the breach is likely to have resulted in significant consumer detriment, by increasing the cost to the ESO of balancing the transmission system in the period in question, ultimately leading to higher balancing charges.

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- 1.6 EPSHB has submitted that it did not during the period of concern know it was being bid down by the ESO for a transmission constraint, or that its bid prices of £0/MWh were excessive. We have in our assessment taken into account the possibility that EPSHB was not aware that it was subject to a transmission constraint, and have found no evidence of intent to breach the TCLC on the part of EPSHB. However EPSHB also recognises that the fact that a high proportion of its bids were system flagged should have made it apparent that those bids related to transmission constraints. In the context of this settlement, it has therefore admitted that it breached the TCLC (a breach which was in its view inadvertent), and has indicated its desire to settle the investigation in line with the process described in our Enforcement Guidelines.²
- 1.7 As set out in section 4 of this Notice, we consider that the imposition of a penalty for the contraventions is justified in this case. Among other reasons, this is because the breach caused damage to the interests of consumers, and because we consider that a penalty is necessary to deliver credible deterrence and visible and meaningful consequences for breaching the TCLC.
- 1.8 In determining the amount of the penalty we have taken into consideration the factors set out in the relevant penalty statement, including the serious nature of the breach and the financial harm suffered by customers as a result of the contravention. The total payment that we have decided on includes both an amount to reflect our estimate of consumer detriment, and a penal component (discounted by 30%). We consider the penalty to be reasonable in all of the circumstances of the case, including in light of EPSHB's submissions regarding what it knew at the time it was submitting its bids.
- 1.9 Having considered all of the circumstances, we consider that a payment into the consumer redress fund³ will be of greater benefit to energy consumers than if a significant financial penalty were to be imposed. Accordingly, we consider it reasonable

² <https://www.ofgem.gov.uk/publications/enforcement-guidelines>

³ We have appointed an expert independent third party to manage the allocation of voluntary redress payments from licensees to charitable organisations.
<https://www.ofgem.gov.uk/publications-and-updates/authority-guidance-allocation-redress-funds>

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that EPSHB be required to pay a financial penalty of £1, provided it pays the sum of £23.63 million (less £1) in redress.

- 1.10 In these circumstances and mindful of our principal objective to protect the interests of existing and future consumers, we hereby give notice under section 27A(5) of the Electricity Act 1989 of our decision to impose a penalty of £1 in respect of the contraventions set out above. This is subject to EPSHB paying £23.63 million (less £1) into Ofgem's consumer redress fund. The payment of the amounts must be made by 18 January 2024.

2 BACKGROUND

The Balancing Mechanism

- 2.1 The BM is the primary tool used by the ESO to co-ordinate and direct the flow of electricity onto and over the electricity transmission network. Over £2bn was spent by the ESO on balancing in the BM in the year to March 2023,⁴ with the costs eventually recovered from consumers via balancing charges.
- 2.2 In the BM, parties to the Balancing and Settlement Code – including all large electricity generators – submit one or more pairs of bids and offers. Bids represent the price at which the party would be willing to decrease its generation or increase its consumption of electricity for a given unit in a given half-hourly delivery period, while offers represent the price at which the party would be willing to increase its generation or decrease its consumption of electricity. Bid and offer prices are specified in £ per megawatt hour (£/MWh) of reduced or additional output or consumption that the ESO requires that a unit deliver (relative to the unit's expected output or consumption prior to the action being taken).
- 2.3 A unit's expected level of output or consumption in each half-hourly settlement period – prior to any actions taken in the BM – is indicated through parties' submissions of Physical Notifications ("PNs"), made in accordance with the Grid Code. The prevailing PNs at the point which is one hour prior to delivery (referred to as gate closure) are confirmed by the ESO as Final Physical Notifications ("FPNs"), and used for the

⁴ Source: ESO monthly balancing services summary, February 2023.

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purposes of taking any required balancing actions in the BM. For each half-hourly settlement period, the ESO may accept various sets of bids and offers, making payments to (or receiving payments from) different parties in exchange for them agreeing to alter their generation or consumption as compared to their FPNs.

The TCLC

- 2.4 As well as to address any expected energy imbalances, the ESO uses the BM (amongst other balancing markets) to manage other system conditions including any transmission constraints which may arise on the network.
- 2.5 A transmission constraint as defined in the TCLC means any limit on the ability of the national electricity transmission system, or any part of it, to transmit the power supplied onto the national electricity transmission system to the location where the demand for that power is situated, such limit arising as a result of factors such as the thermal rating of assets forming part of the transmission network, or the need to maintain voltage on the system, or the need to maintain the transient and dynamic stability of plant and equipment connected to the system.
- 2.6 Transmission constraints may occur because of design limitations of the transmission network or because of outage patterns, including the need to deal with credible failures of parts of the system or equipment connected to it and to ensure that they do not have serious consequences for safety or security and quality of supply. The ESO will often accept bids and offers in the BM to help resolve transmission constraints, and ensure that power flows across the transmission system remain within the necessary bounds to ensure the security and quality of supply and safe operation of the system.
- 2.7 The TCLC requires that generation licensees must not obtain or seek to obtain an excessive benefit from a reduction in electricity generation in relation to a transmission constraint period. In practice, this means that – where a transmission constraint as defined in the TCLC occurs, and where the generator intends to export power – generators must not submit bid prices in the BM at a level which would result in them obtaining an excessive benefit, were that bid subsequently accepted by the ESO.
- 2.8 The objective of the TCLC is to protect against the exploitation of market power by generators operating in the presence of transmission constraints. Transmission constraints routinely lead to either individual generators or groups of generators in

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particular areas holding a position of market power in one or more settlement periods, with the ESO having limited options to manage the constraint other than reaching an agreement with the owners of those specific units to reduce their planned output in those periods. If generators were free to take advantage of this market power in their agreements with the ESO, this would increase balancing costs (which are ultimately passed onto consumers) and create harmful incentives – encouraging further generation in those same areas or by generators with the same characteristics, exacerbating the constraints, and increasing system costs further.

- 2.9 The TCLC applies irrespective of whether a generator is seeking to be paid by the ESO to reduce its generation – or is willing to pay. A generator may be willing to pay to have its output reduced where – in addition to continuing to receive any revenue earned in relation to the sale of power for the settlement period in question – it is also able to avoid certain costs. For example, a gas-fired generator benefits by – among other things - no longer having to burn as much gas, reducing its fuel costs. Where a generator is willing to pay the ESO to have its output reduced, this is indicated via a positive bid price.
- 2.10 The TCLC applies to bids submitted by a licensee in transmission constraint periods even where those bids are not ultimately accepted by the ESO. This is because, in such circumstances, while the bid in question may not directly lead to higher balancing costs, consumer harm may nevertheless arise. For example, this could be the case where that excessive bid price leads to the ESO reaching an agreement with the same generator to reduce its output via a bilateral trade on less favourable terms than the ESO would have otherwise achieved, or leads the ESO to use a substantially more expensive or less effective alternative to manage the constraint (where such an alternative exists).
- 2.11 The TCLC was first introduced in 2012, and last amended in 2017. One change made at that time was to alter the scope of the licence condition such that the definition of a transmission constraint would capture a broader set of limits on the ability of the transmission system to transmit power. In particular, the original TCLC had defined transmission constraints as capturing only limits on the transmission system arising specifically as a result of the thermal, voltage or stability requirements of the transmission system or equipment attached to it. In 2017 this was widened such that

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the list of factors cited in the licence condition – ie thermal, voltage and stability requirements – was no longer exhaustive. This change dealt with the possibility that as the system evolved, types of transmission constraints beyond those originally listed in the TCLC could arise – and thereby to future-proof the obligation.

South Humber Bank power station

- 2.12 South Humber Bank is a gas-fired power station in North East Lincolnshire in England, operating under the generation licence of EPSHB (company number 02571241). EPSHB is a wholly owned subsidiary of EP UK Investments Ltd (“EPUKI”). Among other assets EPUKI also owns a licensed electricity generation company, EP Langage Limited, which owns and operates Langage gas-fired power station. EPUKI acquired Langage and SHBA as part of the same transaction on 31 August 2017.
- 2.13 SHBA is comprised of two units, with a total of five gas turbines and two steam turbines. It has an overall installed capacity of around 1,350MW, making it one of the largest power stations in GB.

Our investigation

- 2.14 Our investigation focused on the period from 1 October 2019 to 31 May 2021. In this period it was very common for the ESO to need to accept bids from EPSHB to reduce SHBA’s output because of the risk that the ESO considered the unit posed to system frequency in the event of a credible fault outage which could disconnect it from the transmission system. By instructing SHBA to reduce its output, the ESO was seeking to ensure that total generation losses in the event of a such a fault would not exceed the level of frequency response available.⁵ In our view, this risk could only be practicably

⁵ Where there is a significant loss of power generation, sufficient power reserves must be available and activated to replace the lost power quickly enough to shore up the fall in frequency, so that the frequency standards are met. The initial power reserves, known as frequency response, act automatically to rapidly inject additional power as system frequency falls. The ESO can also manually instruct additional reserves to help frequency recover. Frequency response is provided by an increase in the power output from generators, interconnectors, and storage providers. It can also be provided by network users who can offer a temporary decrease in demand.

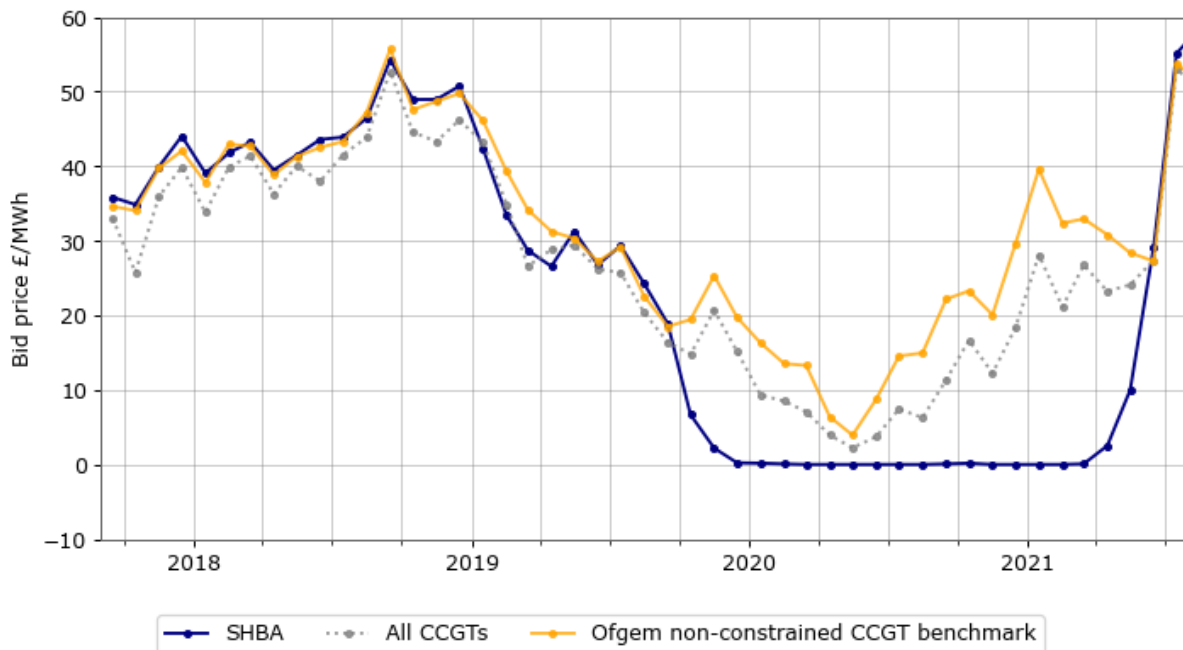
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and economically resolved by the ESO by instructing EPSHB to reduce the output of SHBA.

- 2.15 The risk was particularly heightened because, in the event of a transmission fault causing output from SHBA to be lost, the size and timing of the intended generation from the power station often meant that the resulting RoCoF could rise above 0.125Hz/s, causing further generation units connected to the distribution system to trip due to their protection settings. A secondary loss of distributed generation of this type was a contributing factor to the significant power outage of 9 August 2019, where over 1 million consumers in GB were affected by interruptions to their electricity supply.
- 2.16 In total, SHBA had around 2.9TWh of bids accepted between October 2019 and May 2021, of which around 2.5TWh were for the purposes of managing the risk that a fault affecting SHBA could result in secondary losses of distributed generation ("RoCoF management"). This extremely high volume of bids made SHBA the generator with the largest volume of bids accepted in the BM in the period by some distance. One reason that the volume of bids that the ESO accepted for SHBA in the period was so large was that, starting in October 2019, there was a change to SHBA's generation pattern, whereby EPSHB began running the station for significantly longer stretches of time, such that on most days it would generate both overnight and during the middle of the day, in addition to the peak hours with the highest demand (and highest prices).
- 2.17 As shown in Figure 1, prior to October 2019, EPSHB's average bid prices were in line with the CCGT market average, tracking trends in wholesale gas prices (which increased in 2018, before falling substantially in 2019). However, from October 2019 onwards – coinciding with the increase in bid volumes – EPSHB began routinely submitting an average bid price of around £0/MWh – reflecting that (unlike most other gas generators) it was no longer willing to pay the ESO in the event that it was instructed to reduce generation at SHBA, despite the avoided fuel, emissions and balancing costs of being bid down.

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FIGURE 1: **Monthly average bid prices, SHBA vs market averages, Sep 2017 to Aug 2021**



Source: Ofgem analysis of BMRS

Notes:

1. The navy line shows the weighted average monthly price of accepted bids for SHBA. It includes both system flagged and non-system flagged bids, and is restricted to bids with pair id of -1. Accepted bid volumes are used as weights.
2. The grey dashed line shows the weighted average monthly price of accepted bids for all CCGT generators other than SHBA, specifically in those same periods in which the ESO also accepted bids for SHBA. Again, accepted bid volumes are used as weights. The average is restricted to bids with pair id of -1. It includes both system flagged and non-system flagged bids.
3. The orange line shows the weighted average monthly price of accepted bids for selected CCGT generators other than SHBA, specifically in those same periods in which the ESO also accepted bids for SHBA. Again, accepted bid volumes are used as weights. Importantly, the average includes non-flagged bids only (indicating that those bids were not accepted specifically for system management reasons – see paragraph 3.5). It is restricted to bids with pair id of -1. It excludes smaller generators (defined for these purposes as generators with capacity of ≤ 100 MW). It also excludes selected other units which frequently had system flagged bids accepted. This average has been our preferred comparator for the purposes of assessing the excessiveness or otherwise of EPSHB's bid prices.

2.18 While it was not the only gas generator submitting bid prices at this level in the period, as the Figure shows, EPSHB's prices were significantly more expensive than the CCGT market average excluding SHBA (shown in grey). The difference in prices is even greater when EPSHB's prices are compared to Ofgem's preferred CCGT bid price benchmark in this investigation (shown in orange), intended to approximate the average bid price of those larger gas generators which were not subject to a transmission constraint.

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- 2.19 In April 2021 we contacted EPSHB to ask for information relating to its bid pricing policy in the period, given the licensee's obligations under the TCLC. On 4 October 2021, we opened a formal investigation into whether EPSHB had failed to comply with the requirements of the TCLC.
- 2.20 In the period from October 2021 to June 2022 we issued a number of notices to EPSHB requiring it to provide information to allow us to assess whether there had been a breach of the TCLC. In August 2022, we issued to EPSHB a summary statement of initial findings setting out that we had reached the provisional conclusion that it had breached the TCLC in relation to the bid prices submitted for SHBA in respect of the period from October 2019 to May 2021.
- 2.21 In October 2022, EPSHB submitted its response to the summary statement. Subsequently, it contacted Ofgem to enter into settlement discussions.

3 THE BREACH

- 3.1 Following our investigation, we have concluded that between October 2019 and May 2021, EPSHB's bid prices for SHBA resulted in it obtaining an excessive benefit during periods in which a transmission constraint occurred, in breach of the TCLC. In this section, we describe the breach and the likely impact on consumers.

Did the bids relate to transmission constraint periods?

- 3.2 For the TCLC to place a limit on the bid prices that a generator can submit, the licensee's bids must relate to a transmission constraint period. As set out in section 2 of this Notice, the vast majority of bids accepted for SHBA between October 2019 and May 2021 were accepted for the purposes of RoCoF management. A key question for our investigation was whether these bids related to a transmission constraint as defined in the TCLC.
- 3.3 The definition of a transmission constraint that is included in the licence condition only refers explicitly to thermal, voltage and stability limits. However as set out in section 2 of this Notice, the definition was widened in 2017 such that these factors were no longer exhaustive, and the TCLC would now apply to limits other than just these three examples. This change was made so as to ensure that the TCLC would remain fit for purpose as different types of constraint emerged or became more prevalent.

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- 3.4 We considered that bids accepted for the purposes of RoCoF management fell within the definition of a transmission constraint included in the TCLC since 2017. This was because:
- Under the TCLC a transmission constraint is defined as any limit on the ability of the transmission system, or any part of it, to transmit the power supplied onto it to the location where the demand for that power is situated. Bids accepted by the ESO from SHBA for the purposes of RoCoF management fall within this definition, because had the ESO not reduced the maximum potential loss of generation from SHBA and a relevant transmission fault disconnected SHBA from the network, absolute system frequency would have fallen below the statutory minimum level, and customer disconnections would have been required to reduce system demand and arrest the fall in system frequency; and
 - Under the TCLC, transmission constraints only include those limits that are used by the ESO to operate the transmission system in accordance with its obligations. We found that prior to 25 May 2021, the ESO was accepting bids for the purposes of RoCoF management in accordance with its obligations under Standard Condition C16 of its electricity transmission licence, which required it to *“co-ordinate and direct the flow of electricity onto and over the national electricity transmission system in an efficient, economic and co-ordinated manner. This includes but is not limited to...: considering the impact any action would have on the total system”*. After this date, the ESO managed the limit in line with the Frequency Risk and Control Report of April 2021.
- 3.5 As with bids accepted due to thermal, voltage or stability constraints, the bids in question were subsequently “system flagged” by the ESO, indicating to EPSHB and other market participants that they were being accepted specifically for system management reasons.⁶

⁶ System flagging refers to the process by which the ESO determines which balancing actions have been taken for system management reasons, and subsequently ‘flags’ them in public balancing data in accordance with its methodology statement.

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3.6 Given the above, we concluded that when EPSHB submitted bids for SHBA which were accepted and subsequently system flagged by the ESO between the start of October 2019 and the end of May 2021, it entered into relevant arrangements with the ESO to reduce SHBA's generation in relation to periods in which a transmission constraint occurred for the purposes of the TCLC.⁷ We found that, as with other types of transmission constraint, the ESO's need to bid SHBA down for the purposes of RoCoF management resulted in the EPSHB enjoying considerable localised market power. This is because the risk posed by EPSHB's planned generation could in our view only be practicably and economically resolved by the ESO by instructing EPSHB to reduce the output of SHBA.

Did EPSHB obtain an excessive benefit?

3.7 Having established that the bids related to a transmission constraint period as defined in the TCLC, we next considered whether the bid prices submitted by EPSHB for SHBA in the period were excessive. In doing so, the test we applied was to assess whether those prices were set at a level which meant that the benefit (ie profit) that EPSHB obtained or sought to obtain in relation to transmission constraint periods was significantly greater than the benefit it would have obtained in the absence of any transmission constraint.

3.8 The evidence that we collected indicated that EPSHB made its bid prices more expensive in the period of concern compared to the CCGT average bid price, and that it was only able to consistently have such a large volume of bids accepted at this price due to the existence of the transmission constraint that SHBA was subject to, and the resulting market power. In particular, we found that:

- Compared to earlier and later periods, EPSHB's bid prices were significantly more expensive and more uniform in the period of concern (see Figure 1). This

⁷ Note that while the vast majority of these bids related to RoCoF management, a very small proportion of system flagged bids accepted for SHBA in the period (less than 1%) were accepted in order to manage a thermal limit in the Humber area. These bids we also found to relate to a transmission constraint period for the purposes of the TCLC.

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coincided with the significant increase in the extent to which the ESO needed to bid SHBA down to manage RoCoF; and

- Evidence collected from EPSHB indicated that it was the licensee's self-imposed lower limit on bid prices of £0/MWh and its expectation of the most expensive bid price that the ESO would be willing to accept for SHBA given prevailing system conditions, rather than the net costs of SHBA reducing generation or other generators' bid prices, that were the key determinants of EPSHB's bid prices during this period. This suggested that it enjoyed considerable market power.

- 3.9 We also placed weight on evidence which showed that the bid prices submitted by EPSHB were significantly more expensive, more uniform, and less correlated with variations in wholesale costs than those of most other gas-fired generators which were not subject to a transmission constraint in the period. This included the other large gas-fired power station owned by SHBA's parent company, Langage. In contrast, outside of the period of concern (when the ESO was not required to frequently bid SHBA down to manage RoCoF), EPSHB's bid prices were similar to those which were on average submitted for other gas-fired power stations, and varied from period to period in a way that was reflective of trends in wholesale costs (and so the benefit to the generator of having a bid accepted).
- 3.10 We found that EPSHB earned a profit in relation to system flagged bids in the period of concern which appeared very significant when compared to a number of possible benchmarks, including EPSHB's avoided costs of reducing generation; the historic gross profit margin earned by EPSHB on bids accepted by the ESO for SHBA; EPSHB's own profit targets; and our estimates of the average gross profit margin earned on non-flagged bids in relevant periods by other gas-fired power station that were less likely to be subject to a transmission constraint.
- 3.11 Absent a transmission constraint, we would not have expected EPSHB to have been able to (i) earn a profit that was significantly higher than its own historical trends; (ii) earn a profit that was significantly in excess of the average equivalent profit earned by other gas-fired power stations from non-flagged bids during the period of concern; or

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(iii) so consistently set bid prices independently from its net costs of reducing generation, whilst still having such significant bid volumes accepted by the ESO.

- 3.12 In light of the evidence described above, we concluded that EPSHB had obtained an excessive benefit from reductions in electricity generation in relation to transmission constraint periods, in breach of the TCLC. It did so by seeking to pay (and in fact paying) an excessively low amount to the ESO in the BM to reduce SHBA's electricity generation in the period from 1 October 2019 to 31 May 2021.

Consumer impact of the breach

- 3.13 We considered the impact of EPSHB's excessive pricing, and particularly what EPSHB gained as a result of the breach and, related, the likely detriment suffered by consumers and other market participants.
- 3.14 The most direct impact of the breach was the cost to the ESO – and ultimately consumers – arising from EPSHB having a large volume of bids accepted at more expensive prices than would have been expected absent any transmission constraint. This is distinct from any indirect effects of the breach arising as a result of the potential impact of EPSHB's pricing policy on other generators' bid prices. The impact is equivalent to the gain earned by EPSHB in relation to its excessive bids.
- 3.15 To assess this direct impact, we considered what EPSHB's prices might have been, had those prices not been excessive. For the purposes of this investigation, we approached that assessment by using a benchmark based on our estimates of the costs and benefits to EPSHB of having a bid accepted at SHBA, plus a level of profit that was equivalent to the gross profit margin earned on bids on average in the period by other gas generators that were not routinely subject to a transmission constraint.
- 3.16 In deriving our estimate, we took into account evidence which suggested that – even if SHBA had not been bid down for RoCoF management – EPSHB was likely to have had a material volume of bids accepted for SHBA at expensive prices which would not have been flagged as relating to system management. In addition, we excluded from our calculations the bids submitted by EPSHB for SHBA at the very start of the breach period.

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- 3.17 Based on our methodology, we estimated a direct impact of the breach of £19.43 million. This reflects both the direct consumer detriment, and – equivalently – the excessive gain to EPSHB. This estimate was subject to uncertainty, due (among other things) to the uncertainty as to the volume of bids that SHBA would have had accepted absent the transmission constraint, and the prices at which those bids would have been accepted, as well as the simplifications and assumptions used when estimating the costs and benefits to EPSHB and other gas-fired generators of being bid down.
- 3.18 In addition to this direct detriment, we considered that the excess pricing could have led to another market distortion. In particular, in our view there was a risk that as a result of EPSHB submitting expensive prices in the period of concern, other generators may have on occasion also submitted more expensive prices than they otherwise would have, pushing up balancing costs for consumers further.

4 PENALTY

Whether a financial penalty should be imposed in this case

- 4.1 In deciding whether it is appropriate to impose a financial penalty on EPSHB, and the amount of any penalty, we have had regard to the Statement of Policy with respect to Financial Penalties and Consumer Redress published in 2014 (the “2014 Penalty Policy”).⁸
- 4.2 We are required to carry out our functions under Part 1 of the Electricity Act 1989, including the taking of any decision as to the imposition of a penalty, in the manner that we consider best calculated to further our principal objective set out in section 3A of the Electricity Act 1989, having regard to our other duties. In formulating our decision as to whether it is appropriate to impose a financial penalty, we have considered all the circumstances of the case presently known including, but not limited to, EPSHB’s representations and the specific matters set out in the 2014 Penalty Policy.

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https://www.ofgem.gov.uk/sites/default/files/docs/2014/03/penalties_and_redress_policy_statement_31_march_2014.pdf

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No representations were received in response to the notice setting out our proposal to impose a penalty on EPSHB, published 13 October 2023.

4.3 In this case we have decided that a financial penalty is appropriate. This is because:

- As set out above, the breach extended over a considerable period of time and caused significant damage to the interests of consumers, by increasing balancing charges. Consumer redress will help obtain a fair outcome for consumers;
- The breach also damaged, or could have damaged, consumer and market participants' confidence in the market, given the crucial role that the TCLC plays in protecting against the inherent market power that is enjoyed by generators operating in the presence of a transmission constraint;
- A penalty is necessary to deliver credible deterrence and visible and meaningful consequences for breaching the TCLC; and
- The chosen pricing strategy which gave rise to the breach was wholly within the control of EPSHB.

4.4 These factors are discussed in further detail below where we describe the level of the penalty.

Level of penalty

4.5 Having considered the circumstances of the case we have required EPSHB to pay an amount of £23.63 million as a consequence of the breach. In what follows we discuss how we have arrived at this amount, working through each of the steps set out in the 2014 Penalty Policy, and discussing how they apply to this case.

Step 1: Calculate detriment and gain

4.6 It is inherently difficult to estimate the direct detriment and gain from the breach. Among other reasons, this is because we do not know how EPSHB would have priced its bids absent any transmission constraint; nor the volume of bids that the ESO would have accepted for SHBA. There are also various unknowns attached to our estimates of the costs and benefits of reductions in generation for SHBA.

4.7 Notwithstanding this, we note at 3.17 above our estimate of the "direct" impact of the breach of £19.43 million. This is an estimate of the cost to the ESO – and ultimately

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consumers – directly arising from EPSHB having a high volume of bids accepted at more expensive prices than would have been expected absent any transmission constraint. It is distinct from any indirect effect of the breach via the potential impact on other generators' bid prices. It is equivalent to the gain earned by EPSHB in relation to its excessive bids.

Step 2: Assess seriousness

- 4.8 As per sections 5.10 to 5.14 of the 2014 Penalty Policy, the seriousness of a breach depends on the nature and impact of the breach and whether or not the contravention was deliberate or reckless.
- 4.9 As set out in section 3, it is our view that the breach is likely to have resulted in significant consumer detriment, by increasing balancing charges in the period in question. There is also a risk that it had a further impact on the market – and ultimately consumers – that has not been quantified, by distorting pricing in the BM more widely. These factors increase the seriousness of the breach.
- 4.10 The breach extended over a considerable period of time. It also had the potential to damage consumer and market participants' confidence in the market. This is because the TCLC plays a crucial role in protecting against the inherent market power that is enjoyed by generators situated behind a constraint. Again, these factors add to the seriousness of the breach.
- 4.11 EPSHB has submitted that it did not know it was being bid down due to a transmission constraint in the period. It told us that for the majority of the period of concern the ESO did not explain to EPSHB why SHBA was being bid down (ie to manage RoCoF), and that in the absence of this explanation, its belief at the time was that the bids it was having accepted were to provide upward flexibility and upward reserve during periods of increased wind generation. It stated that RoCoF is a system wide constraint that only the ESO had visibility of. Further EPSHB told us that it did not consider system flagging to be necessarily indicative of the presence of a transmission constraint, since the definition of transmission constraint used within the system management action flagging methodology remained in line with the original 2012 version of the TCLC.

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- 4.12 EPSHB also submitted that even after it became aware that the ESO was regularly accepting bids for the purposes of RoCoF management, EPSHB did not believe these bids were subject to the requirements of the TCLC, because it interpreted the TCLC based on the three types of constraint listed within the definition of a transmission constraint, to which it did not consider RoCoF management was sufficiently similar in nature to be captured by the amendment made to the TCLC in 2017.
- 4.13 EPSHB also told us that it had believed that even if its bids were accepted during a period of transmission constraint, its approach to pricing its bids meant that it could not be deemed to have earned an excessive benefit from the ESO's acceptance of those bids. This was because it based its bid prices on the prices at which it had bids accepted in the period which were not subsequently system flagged, and regularly benchmarked these prices to the marginal (ie most expensive) bid prices of other CCGT generators, and the prices paid by the ESO to certain other generators to reduce their output under bilateral contracts.
- 4.14 Having reviewed the evidence collected during the course of the investigation, we consider that it is possible that EPSHB may not have been aware that the ESO was accepting so many bids for SHBA in the period as a result of a transmission constraint. We have also not seen any evidence of intent to breach the TCLC on the part of EPSHB. In our view, the lack of such evidence and the possibility that EPSHB may not have been aware that its bids related to a transmission constraint period reduced the seriousness of the breach, compared to how we might otherwise have viewed it.
- 4.15 Notwithstanding this, we consider that with the possible exception of the very start of the period of the concern, the fact that its bids related to transmission constraint periods should have become apparent to EPSHB from the fact that such a high proportion of these bids were system flagged, as well as EPSHB's ongoing ability to have far more bids accepted in the BM than other gas generators over the period, despite its prices being so expensive. While we did not see any evidence based on the materials collected during the investigation that EPSHB knew in setting its bid prices that it was breaching the TCLC, the evidence did show that at least some members of the team responsible for setting SHBA's bid prices recognised the general relevance of system flagging to TCLC compliance. If – as it has submitted – EPSHB was not aware of

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the transmission constraint, this indicates a failure of the company to exercise proper due diligence and a significant weakness in its compliance procedures.

- 4.16 On balance, irrespective of what EPSHB knew as to the application of the TCLC to its bids, we consider the breach to have been serious given the significant impact on balancing costs.

Step 3: Consider aggravating or mitigating factors

- 4.17 As per sections 5.15 to 5.20 of the 2014 Penalty Policy, the next step is to consider any aggravating or mitigating factors which affect the level of penalty that is required.
- 4.18 In this case, we consider there to have been one aggravating factor – and specifically the absence of evidence of internal mechanisms or procedures maintained by EPSHB that were intended to prevent breaches of the TCLC. We noted in this regard that EPSHB did not have any substantive written policy or procedure setting out its approach to bidding in transmission constraint periods, and how it would ensure compliance with the TCLC. In fact the only written policy EPSHB appeared to have in place in the period was guidance that the trading team should (with certain limited exceptions) avoid submitting negative bid prices. While EPSHB retrospectively described to us an unwritten policy which it said it had followed when setting its prices, it was unclear what if any steps had been taken to assess whether it was bidding in relation to transmission constraint periods, or to ensure compliance with the TCLC more broadly.

Step 4: Consider whether the penal element ensures deterrence

- 4.19 As per sections 5.21 to 5.22 of the 2014 Penalty Policy, the next consideration is what level of penalty would be required to ensure that the penalty has sufficient deterrent effect.
- 4.20 In light of the need to ensure a credible deterrent, the indirect detriment described above (which has not been quantified), the seriousness of the breach and the aggravating factor described above, we consider that a further payment of £6m is reasonable in all of the circumstances, after having regard to the level of consumer redress.

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4.21 We note that this amounts to only a small share of EPSHB's total revenue (and operating profit) for the period in question. Nevertheless, we consider that a penalty of £6m is sufficiently material to provide a credible deterrent signal to the market.

Step 5: Apply any settlement discount to the penal element

4.22 EPSHB agreed to settle the investigation within the 28 day settlement window, and therefore has obtained a 30% discount as provided for under Ofgem's Enforcement Guidelines. This reduces the penal element from £6m to £4.2m.

Step 6: Establish the total financial liability

4.23 Having considered all of the above matters, we have required EPSHB to pay a total amount of £23.63 million, reflecting both the consumer detriment we have quantified, and a further penal element.

4.24 We have decided to impose a financial penalty of £1 on the condition that EPSHB pays the balance of the £23.63 million to Ofgem's consumer redress fund. This approach is preferred because we consider that a payment into the consumer redress fund will be of greater benefit to energy consumers than if a significant financial penalty were to be imposed. We consider the penalty to be reasonable in all of the circumstance of the case.

5 THE AUTHORITY'S DECISION

5.1 We consider that EPSHB has breached the TCLC as set out in section 3 of this Notice. Having considered all of the relevant facts and circumstances in its possession and having regard to the 2014 Penalty Policy, we therefore have decided to impose a penalty of £1 on EPSHB which we consider to be an amount which is reasonable in all the circumstances of the case for the reasons set out in section 4 of this Notice.

5.2 The penalty takes into account that EPSHB will pay £23,630,000.00 (less £1 penalty), into the consumer redress fund. The payment of the amounts will be made no later than 18 January 2024.

5.3 In reaching this decision, we have taken the relevant factors under the 2014 Penalty Policy into account, including:

- The serious nature of the breach

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- The financial harm suffered by customers as a result of the contravention
- The aggravating factor described above.

5.4 We hereby give notice under section 27A(5) of the Electricity Act 1989 of our decision to impose a penalty of £1 on EPSHB in respect of the contraventions set out above.

5.5 EPSHB has agreed to settle the investigation on the basis of paying a financial penalty of £1 and to pay the sum of £23,630,000.00 (less £1 penalty) by way of consumer redress.

Gas and Electricity Markets Authority, Date: 7 December 2023