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To: All interested parties

Email: esoperformance@ofgem.gov.uk

Date: 4 November 2022

Dear colleagues,

Decision to grant the Electricity System Operator a derogation under Article 6(14) from requirement of Article 6(4) of the Electricity Regulation for the Demand Flexibility Service

On 13 October 2022, we[1] received a request from the Electricity System Operator ("ESO") for a derogation under Article 6(14) from the requirements of Article 6(4) of Regulation (EU) 2019/943 (the "Electricity Regulation"),[2] as amended by The Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020[3] for its Demand Flexibility Service ("DFS"), a balancing energy product. The ESO provided supplementary information to us to clarify some aspects of the testing of this service on 25 October 2022.

Article 6(4) of the Electricity Regulation sets out two requirements:

- that settlement of balancing energy should be based on marginal pricing ("pay-as-cleared"); and
- that market participants should be able to bid as close to real time as possible (where the balancing energy gate closure time shall not be before the intraday cross-zonal gate closure time).

[1] The terms "we", "us", "our", "Ofgem" and "the "Authority" are used interchangeably in this document and refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.
[2] Regulation (EU) 2019/943 on the internal market for electricity (recast) can be accessed here: https://eurlex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0943&from=EN
[3] The UK SI amendment of the Electricity Regulation is accessible at: https://www.legislation.gov.uk/uksi/2020/1006/contents/made

We note that the ESO proposed an alternative pricing methodology for balancing energy, which was approved by the Authority in our 20 May 2022 decision in line with Article 6(4).[4] The ESO's balancing products are to have their balancing energy settled according to the outcomes of assessments conducted following the criteria set out in that methodology.[5] We understand that in the case of DFS, the ESO's assessment means that the service should be settled on a pay-as-bid basis. As this outcome followed from assessment under their approved methodology, the ESO does not require a derogation from the criterion to settle pay-as-cleared. However, the ESO has requested a derogation against the second requirement of Article 6(4) for its proposed DFS, to allow it to be procured ahead of gate closure.

This letter sets out our decision to approve this derogation request in accordance with Article 6(14) of the Electricity Regulation and also outlines the necessary next steps that must be taken.

Background

DFS is a product that the ESO has developed to provide an additional system security tool for winter 2022/2023. The service intends to attract volumes of demand response (potentially aggregated through suppliers or aggregators) that is not currently engaged in other balancing service provision, but which could provide a turn-down service to reduce demand in tight system scenarios. The ESO proposes that this demand turn-down will help them to manage system margins when insufficient upward flexibility is available (or at least when this is perceived to be the case for real time, following ESO assessment at the day-ahead stage).

Although providers can put forward weekly forecasts of available volumes, providers will be informed by the ESO on days when the service will be tendered for. Providers can update offered volumes and prices for the service delivery day until 15:30 at the day-ahead stage. The ESO will accept offered volumes in order of economic merit, and dispatch accordingly following the outcome of the tender analysis.

Article 6(14) of the Electricity Regulation allows the ESO to propose, and that Ofgem may approve, derogations from Article 6(4) for specific balancing products which are activated locally without exchanging them with other transmission system operators.

[4] Our decision to approve an alternative pricing methodology can be accessed here: https://www.ofgem.gov.uk/publications/decision-approve-proposal-electricity-system-operator-alternative-pricing-methodology-settlement-balancing-energy-specific-balancing-products-submitted-accordance-article-64-electricity-regulation

[5] The ESO's pricing methodology can be accessed at: https://www.nationalgrideso.com/industry-information/codes/european-network-codes/other-enc-documents

Given that the specific balancing energy product, DFS, has been designed to be procured and instructed at day-ahead timescales, the ESO is requesting a derogation under Article 6(14) from the requirements of Article 6(4) of the Electricity Regulation. In accordance with Article 6(14) of the Electricity Regulation, the proposal for a derogation must contain the following information:

a) a description of measures proposed to minimise the use of specific products, subject to economic efficiency
b) a demonstration that the specific products do not create significant inefficiencies and distortions in the balancing market either inside or outside the scheduling area
c) where applicable, the rules and information for the process for converting the balancing energy bids from specific products into balancing energy bids from standard balancing products

The ESO's derogation request was submitted in accordance with Article 6(14) and contained all necessary information. However, we note that at this time the ESO does not intend to convert DFS balancing energy bids into bids for standard products as, currently, Great Britain ("GB") does not have access to European balancing product platforms. The ESO has stated that DFS will only be activated locally, and therefore this specific requirement of Article 6(14) (as described in (c) above) is not applicable to this request.

Reasons for our decision

We have reviewed the request submitted to us in line with the requirements of the Electricity Regulation, the wider objectives of Regulation (EU) 2017/2195[6,7] and our statutory duties. We have also engaged with the ESO to clarify our understanding of the rationale for the request for derogation. In making this decision, we considered:

i. the need for the ESO to be the counter-party for a demand flexibility product of this nature

The ESO has developed this product to provide contingency for winter 2022/2023, providing an additional security of supply option where upward flexibility is insufficient to provide required margin.

[6] COMMISSION REGULATION (EU) 2017/2195 establishing a guideline on electricity balancing ("the EBGL Regulation"), available here: https://www.legislation.gov.uk/eur/2017/2195
[7] The EBGL Regulation is amended in UK law by UK SI 2019 No. 532 which can be found at: https://www.legislation.gov.uk/uksi/2019/532/contents/made

We understand that the ESO is required to provide a counter-party service to procure this product because current market arrangements do not allow suppliers to benefit sufficiently from providing the service themselves. The ESO is specifically targeting volumes of demand flexibility that is not engaged in its other balancing services through the design of this service, and this product intends to create an economic signal for their participation that does not exist under current market arrangements.

ii. rationale for procuring at day-ahead timescales

Despite being procured at day ahead time scales, the ESO states that this design of DFS means that it will be procured as close to real time as possible, and therefore cannot meet the requirements of Article 6(4). The ESO notes that as a temporary product, the processes for assessment of the need for DFS and instruction to plant for DFS delivery involve manual steps, and so, necessarily, this is done ahead of real time.

DFS is expected to be used predominantly during the periods of highest demand, which tend to be in the evening period, 16:00 – 19:00. We understand that DFS market participants require notice of at least several hours to activate sufficient volume of response. Due to the product being targeted at residential and smaller industrial and commercial demand, providers of the service to the ESO (eg suppliers or aggregators) will need to pass on instructions to those actually delivering the demand response (eg domestic consumers). The ESO have indicated that providers have made representations to them that it is both inappropriate and unproductive to send instructions to demand response of this type outside of business hours.

In addition, there are downstream processes that the ESO needs to provide with the expected change in demand as a result of the outcome of the DFS tender (eg establishing the geographic split of the volumes accepted through the tender), which the ESO needs to conduct ahead of real time.

Dispatching the service ahead of real time means that, at the point at which the ESO tenders for the service, there is uncertainty in how system conditions will outturn, and hence in the actual volume required from the DFS. Therefore, it is in the interests of the ESO to hold the tender as close to real time as possible in order to minimise the amount of uncertainty (eg in forecasts of wind output).

Taking the above into account, we understand that DFS cannot be brought in line with the obligation set out in Article 6(4) of the Electricity Regulation and believe that it is

necessary for the ESO to procure it at day-ahead timescales. We understand that the product is being procured at as close to real time as possible given these limitations.

iii. a description of measures proposed to minimise the use of specific products, subject to economic efficiency

We understand that the ESO intends to use DFS as a product of last resort. The ESO has communicated to the market that DFS should be activated only where the ESO perceives (at the day-ahead stage) insufficient upward flexibility to maintain sufficient energy margin above the generation required to meet demand. The ESO has listed DFS as an 'enhanced action' – that is, it should only be instructed once all 'everyday actions' have been expired.[8]

We note that while the ESO intends to only use the DFS product once all everyday actions have been instructed first, this request is to allow the ESO to instruct DFS at the day-ahead stage, which is necessarily ahead of instruction of its everyday actions which take place in real time. Therefore, DFS might be instructed at the day-ahead stage but real time upward flexibility outturns at a sufficient amount. This is a risk the ESO needs to remain aware of in order to minimise use of DFS and ensure economic and efficient operation of the system.

We agree that the ESO's proposed approach of only using DFS as a product of last resort and not in preference to other products or markets will minimise its use.

We also note that the ESO will run a series of tests of this service to gain operational confidence in its use and maximise participating volumes. The ESO has put forward to us that they believe they have opted for a testing regime that balances this need against the need to minimise its use.

We understand the need for testing of the product. We expect the ESO to conduct testing in a way that ensure economic and efficient operation of the system and to reduce impacts on other markets.

iv. a demonstration that the specific products do not create significant inefficiencies and distortions in the balancing market either inside or outside the scheduling area

[8] The ESO disseminated this information at its September 2022 Markets Forum, recordings of which can be accessed here: https://www.nationalgrideso.com/research-publications/markets-roadmap/markets-forum-events

By design, this service only attracts volume from participants not engaged in other balancing services, and is therefore not available to the ESO through its 'normal' routes, such as through the balancing mechanism ("BM"). Therefore, DFS only utilises additional volumes of flexible demand and does not distort other markets by attracting providers away from them.

Further, as a last resort tool, the DFS product should only be used when other markets have been unable to provide the ESO with sufficient upward flexibility. As the product is dispatched at day-ahead timescales, there will be a strong market signal of scarcity ahead of real time. However, this should only be the case where scarcity is expected and so any distortive effects are expected to be minimal.

Testing of the service may cause some disruption in other markets (ie the BM). Testing of the service is deemed necessary, and we expect the ESO to mitigate the impact this has. Particularly, the ESO needs to ensure it publishes clear and timely information about the procurement of the service (in all use cases; real and test) available to all market parties – we understand that the ESO will publish the outcome of DFS procurement events on its data portal once the successful bidders have been informed. The ESO should review its testing regime regularly and adjust as necessary if market impacts are identified.

The ESO has also proposed to system flag DFS actions taken in tests, such that any onward distortive effects (ie distorting cash-out prices) are minimised.

We agree that these steps minimise the distortive effect of testing the service and of using the service in real need cases, while still ensuring a viable service of sufficient volume.

Decision and next steps

We agree with the ESO that DFS is a prudent tool to be made available to provide additional operational security at times of need, and, based on our analysis of the information submitted to us by the ESO as required by Article 6(14) of the Electricity Regulation, the supporting economic analysis, and the technical requirements of such a product designed in this manner we hereby:

- Grant the Electricity System Operator a derogation under Article 6(14) of the Electricity Regulation from the requirement of Article 6(4) paragraph 2 of the Electricity Regulation for the Demand Flexibility Service.

Our decision to derogate the ESO from this requirement of Article 6(4) of the Electricity Regulation is effective immediately. We understand that the ESO initially expect to require DFS until 31 March 2023. We also note that the ESO has included an option to extend DFS beyond that expected end date.

Our decision to provide this derogation from the requirement of Article 6(4) paragraph 2 shall apply to DFS for the period that the ESO has deemed it necessary to have it available as a specific product, but no later than 30 April 2023. For clarity, any subsequent product or continuation of this product beyond that date would require the ESO to request further derogation from this aspect of Article 6(4) of the Electricity Regulation if not brought into compliance.

If you have any questions about the contents of this letter, please contact James Hill (James.Hill@Ofgem.gov.uk).

Yours sincerely,

Eleanor Warburton
Deputy Director – Institutions for Net Zero
For and on behalf of the Gas and Electricity Markets Authority