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All interested parties,
stakeholders in GB and beyond,
and other regulatory bodies

Email: ESOperformance@ofgem.gov.uk

Date: 10 February 2023

Dear colleagues,

Decision to grant the Electricity System Operator a derogation for Static Firm Frequency Response under Article 6(14) from the requirements of Article 6(2) of the Regulation (EU) 2019/943 as amended

On 12 December 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(2) of the 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 the updated Static Firm Frequency Response ("SFFR") product.

This request was made to supplement the ESO's request to amend the terms and conditions related to balancing to remove the procurement of SFFR from the existing Firm Frequency Response ("FFR") Standard Contract Terms ("SCTs") and to procure this product under a new framework.[4] This request would allow the ESO to pre-determine the price of balancing energy in the balancing capacity contract for SFFR.

This letter sets out our decision to approve the derogation request for SFFR and outlines the necessary next steps.

[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 of the European Parliament and of the Council of 5 June 2019 on the internal market for electricity, available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0943
[3] The UK SI amendment of the Electricity Regulation is UK SI 2020 No. 1006 which can be found at: https://www.legislation.gov.uk/uksi/2020/1006/introduction/made
[4] The ESO has proposed procurement of SFFR through balancing capacity auctions held at day-ahead, rather than month-ahead, becoming compliant with Article 6(9) of the Electricity Regulation.

Background

FFR, split into Dynamic FFR and SFFR, is a frequency response product for buying primary, secondary and high response.[5] SFFR is dispatched within 30 seconds of the trigger point, which is system frequency dropping below 49.7Hz. Prior to the ESO's request to procure SFFR under a new framework, SFFR was procured at the month-ahead stage. We note that under the new procurement terms SFFR will be procured at the day-ahead stage.

Article 6 of the Electricity Regulation, which became applicable on 1 January 2020, contains a series of obligations on the organisation of the balancing markets which apply to frequency response products. Among others, this includes Article 6(2) which requires that the price of balancing energy shall not be pre-determined in contracts for balancing capacity. The ESO has proposed that the SFFR product should have the price of balancing energy effectively pre-determined at £0/MWh in the balancing capacity contract.

Article 6(14) of the Electricity Regulation allows the ESO, where standard balancing products are not sufficient to ensure operational security, to propose, and the Authority may approve, derogations from Article 6(2) and (4) for specific balancing products which are activated locally without exchange with other transmission system operators.

Given that the specific balancing product SFFR has been designed with a pre-determined price for balancing energy, the ESO is requesting a derogation under Article 6(14) from the requirements of Article 6(2) of the Electricity Regulation.

In accordance with Article 6(14), 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; and
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.

[5] More detail on ESO's FFR services can be accessed here: https://www.nationalgrideso.com/industry-information/balancing-services/frequency-response-services/firm-frequency-response-ffr

The ESO's derogation request was submitted in accordance with Article 6(14) and contained all necessary information. However, we note that the ESO does not intend to convert SFFR balancing energy bids into balancing energy bids for standard products. The ESO has stated that these products will only be activated locally. Therefore, requirement (c) does not apply to this derogation request.

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] and our statutory duties. We have also engaged with the ESO to clarify our understanding of the rationale for the request for derogation. When assessing the ESO's proposal for SFFR, we considered the following aspects:

a) The rationale for pre-determining the utilisation price for SFFR and for this price to be £0/MWh

The ESO has noted that a key feature of the SFFR product is that contracted providers must respond to changes in frequency without manual instruction from the ESO. SFFR providers are contracted to automatically activate within 30 seconds once system frequency drops below 49.7Hz, as manual instruction from the ESO would take too long to allow such a rapid dispatch.

With this in mind, the ESO has argued that not pre-determining the utilisation price for these contacts could lead to excessive costs that would ultimately be borne by the consumer. This is because there is a risk that potential providers could submit artificially low availability payment bids, in order to be successful in the auction, but couple this bid with an excessively large utilisation price. Thus, if system frequency were to drop below the 49.7Hz trigger point the consumer would be at risk at bearing an excessively large cost for this balancing action.

We agree with the ESO and do not deem this to be an economic and efficient use of balancing products for the consumer. As such, we agree that the utilisation price for SFFR should be pre-determined at this point.

[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. 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

The ESO raised the following rationale for pre-determining the utilisation price for SFFR at £0/MWh:

1) The likely providers of SFFR[7] are not tied to the real-time price of energy, meaning correct market signals to optimise the market can be found in the availability payment.
2) The very low probability of SFFR activating in a given EFA[8] block means any utilisation payment received would be treated as a windfall payment and not contribute to market efficiency. SFFR was activated in just 0.7% of EFA blocks in 2021.
3) ESO does not currently pay for utilisation of its other frequency response products. The ESO states it would therefore need to develop a bespoke settlement process for SFFR, and as it is a product which has a low number of activations per year, this would be disproportionate to the benefits (which are low in any case, per 1) and 2) above).

In general, we agree with the rationale for pre-determining the utilisation price for SFFR at £0/MWh. We note that the large majority of SFFR providers are distribution connected generation that are not part of the Balancing Mechanism ("BM"). These providers tend to be a mixture of diesel generators, biofuel generators, and demand side response services. As these providers are largely not part of the BM and are less impacted by the real-time price of energy, we agree with the ESO's assessment that the optimum market signals for this product should come from the availability payment.

Additionally, as SFFR is a service with a low activation rate, we agree that pre-determining the price at any point over £0/MWh would have no contribution towards an efficient market for this product. Nevertheless, we expect the ESO to review the market development for SFFR and reconsider this if justified.

We further note that SFFR has historically been procured without paying providers a utilisation fee. This, in essence, pre-determines the price at £0/MWh. In our assessment of the ESO's request for derogation, we have found no strong justification to begin incorporating a utilisation price.

b) a description of measures proposed to minimise the use of specific products, subject to economic efficiency

[7] This is based on an ESO assessment of the current providers which are likely to continue providing the service following the move to day-ahead capacity auctions.
[8] Electricity Forward Agreement blocks ("EFA" blocks) are 4-hour periods (6 EFA blocks per day, beginning at midnight Central European Time). This is a common contracting period used by the ESO for its response services.

We understand that there is no standard product that the ESO can access in order to meet this specific frequency response need. We also understand that, despite its low activation rate, SFFR will be required to ensure that the ESO can maintain system frequency within its statutory limits. We note that the ESO will use SFFR in coordination with Dynamic Containment Low ("DC-L"), meaning post-fault frequency response can be procured in a number of ways leading to economic and efficient balancing of the system.

The ESO is required to procure and use all frequency response products, including SFFR, in line with its licence obligations to procure balancing services in an economic, efficient and co-ordinated manner. As a result, we believe that this ensures the ESO will procure only the minimum required amount of SFFR to manage system frequency safely and effectively, ensuring system security.

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

There is no standard product equivalent for SFFR traded across scheduling areas and the ESO only intends to activate SFFR locally. As such, we are confident there will be no distortions or impacts on markets outside the scheduling area. Furthermore, under its new proposed framework, the ESO intends to change procurement of SFFR to the day-ahead stage. This brings SFFR in line with the relevant legislation governing design of these products and should reduce the risk of any inefficiencies.

We also believe it is unlikely that there will be any distortions created within the scheduling area as requirements for DC-L, the product most similar to SFFR, is dependent on the size of the largest loss rather than being frequency based. However, existing DC-L auctions use outturn SFFR volumes as input (SFFR having historically been procured at the month-ahead stage). We understand that the ESO intends to run the day-ahead SFFR auctions prior to the DC-L day-ahead auctions to avoid any inefficiencies in the market. The timings of these markets will allow potential providers to participate in the SFFR market and also participate in the later dynamic response markets.

Based on our analysis of the information submitted to us by the ESO as required by Article 6(14) of the Electricity Regulation, and the current need for fast acting frequency response services to ensure security of supply, we hereby:

- Grant the ESO a derogation under Article 6(14) of the Electricity Regulation from the requirements of Article 6(2) of the same Regulation for SFFR.

Our decision to derogate the ESO from the requirements of Article 6(2) of the Electricity Regulation for SFFR is effective immediately.[9] This derogation from the requirements of Article 6(2) shall apply to SFFR for the duration that the ESO deems it necessary to use that specific product. However, we expect the ESO to continually monitor the SFFR market for the continued relevance of this derogation.

If you have any questions about the information contained within this letter, please contact Chris Statham (Christopher.statham@ofgem.gov.uk).

Yours sincerely,

James Hill
Senior Policy Manager - Electricity System Operation
For and on behalf of the Gas and Electricity Markets Authority

[9] We understand, however, that the ESO does not intend to procure SFFR under the new day-ahead framework until 31 March 2023.