Making a positive difference
for energy consumers

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

Email: ESOPerformance@Ofgem.gov.uk

Date: 10 March 2023

Dear colleagues,

Decision to grant the Electricity System Operator a derogation from the requirements of Article 6(9) of the Electricity Regulation and an exemption from the requirements of Article 32(3) of the EBGL for Dynamic Firm Frequency Response

In February 2023 we[1] received two requests from the Electricity System Operator ("ESO"), both relating to the Dynamic Firm Frequency Response ("DFFR") product. The first request was submitted to us by the ESO on 2 February 2023, relating to a request for derogation from the requirements of Article 6(9) of the Regulation (EU) 2019/943 ("Electricity Regulation"),[2] as amended by The Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020[3].

Following this, on 8 February 2023 we received a submission for exemption from the requirements of Article 32(3) of Commission Regulation (EU) 2017/2195 establishing a

[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] 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] 3 The UK SI amendment of the Electricity Regulation is accessible at: https://www.legislation.gov.uk/uksi/2020/1006/contents/made

guideline on electricity balancing ("EBGL"),[4] as amended by The Electricity Network Codes and Guidelines (Markets and Trading) (Amendment) (EU Exit) Regulations 2019.[5]

The ESO have made these requests to allow them to continue to procure DFFR with upward and downward capacity bundled. This is based on the requirements of Article 6(9) of the Electricity Regulation and Article 32(3) of the EBGL, which state that the procurement of upward and downward balancing capacity must be carried out separately. Additionally, the ESO's request for a derogation under Article 6(9) of the Electricity Regulation would allow them to continue to procure DFFR at earlier than the day-ahead stage and grant contracts for periods of longer than one day, both contrary to the requirements in the Electricity Regulation.

This letter sets out our decision to approve the request for derogation against Article 6(9) of the Electricity Regulation and the exemption request in accordance with Article 32(3) of the EBGL. It also outlines the necessary next steps that must be taken by the ESO.

Background

DFFR is an existing product used by the ESO to manage system frequency within operational and statutory limits. This product is currently procured earlier than the day-ahead stage, with the ESO able to procure the upward and downward balancing capacity of providers together and apply contracts of one month duration. These features are contrary to the requirements of Article 6(9) of the Electricity Regulation which states "*The procurement of upward and downward balancing capacity shall be carried out separately*" and "*Contracts for balancing capacity shall not be concluded more than one day before the provision of the balancing capacity and the contracting period shall be no longer than one day*".

DFFR comprises of 3 sub-products: primary, secondary, and high response. Secondary response is classed as a frequency restoration reserve product. As such, DFFR is subject to the requirements of Article 32(3) of the EBGL, which states "*The procurement of upward and downward balancing capacity for at least the frequency restoration reserves and the replacement reserves shall be carried out separately*".

[4] Commission Regulation (EU) 2017/2195 of 23 November 2017 establishing a guideline on electricity balancing. The EBGL came into force on 18 December 2017. Accessible at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R2195

[5] The UK SI amendment of the EBGL Regulation is accessible at: https://assets.publishing.service.gov.uk/media/5c17d6b440f0b60c8d601a2c/ENC_Markets_and_Trading_SI.pdf

Article 32(3) of the EBGL allows the ESO to request an exemption against the criteria to procure upward and downward capacity separately. Per the requirements set out in Article 32(3) of the EBGL, the ESO's submission must include:

(a) the specific period during which the exemption would apply;
(b) the specific volume of balancing capacity to which the exemption would apply;
(c) an analysis on the impact of the exemption on the participation of balancing resources (including demand facility owners, third parties and owners of power generating facilities from renewable energy sources as well as owners of energy storage units); and
(d) a justification demonstrating that such an exemption would lead to lower costs to final consumers.

We note that the ESO requested both derogation from Article 6(9) of the Electricity Regulation and exemption from Article 32(3) of the EBGL for Firm Frequency Response ("FFR") previously, and these requests were approved by the Authority on 4 February 2022. FFR comprises of both DFFR and Static Firm Frequency Response ("SFFR"). We decided to approve these requests and FFR was made exempt from the stated requirements until 31 March 2023. Since our decision of 4 February 2022, we have approved a request for the ESO to procure SFFR under alternative contract terms[6] and these procurement terms are now distinct from DFFR. For the avoidance of doubt, this decision refers to DFFR only and does not have any impact on the procurement terms for SFFR.

Analysis of ESO evidence

We have reviewed the requests submitted to us in line with the requirements of the Electricity Regulation, the EBGL and our statutory duties. We have also engaged with the ESO to clarify our understanding of the rationale for their request for derogation and exemption.

<u>Exemption from the requirements of Article 32(3) of the EBGL</u>

a) the specific time period during which the exemption would apply

Article 32(3) of the EBGL requires a specific time period for an exemption allowing upward and downward balancing capacity to be procured together. We understand that DFFR is due

[6] Decision accessible here: https://www.ofgem.gov.uk/publications/decision-static-firm-frequency-response-relation-amendment-terms-and-conditions-relating-balancing

to be phased out by 31 March 2024 and thus the exemption for that product will be limited to that date. We do note that in our decision[7] of 4 February 2022 on MFR and FFR that we expected DFFR to have been phased out by 31 March 2023, however the ESO states that this has not been possible due to operational requirements. As a result, we do not expect any further request to extend the exemption for DFFR beyond 31 March 2024 and that the ESO should have completed phase out of DFFR in advance of this date.

b) *the specific volume of balancing capacity for which the exemption would apply*

The ESO currently procure around 300MW of DFFR, of each of primary, secondary and high leading to a maximum of 900MW of services expected to be procured. The ESO notes that owing to the phase out of DFFR, to be replaced by Dynamic Moderation ("DM") and Dynamic Regulation ("DR"), this would be the maximum volume procured. As we understand the ESO is phasing out DFFR, and the new suite of more efficient dynamic response products will displace and reduce required volumes, we do not expect the ESO to procure more than this volume during the period that the exemption stands. Volume should fall over the time period as DR and DM begin to fulfil more of the ESO's frequency response requirement.

c) *analysis of the impacts of this decision on the participation of demand facility owners, third parties and owners of power generating facilities from renewable sources as well as owners of energy storage units*

The ESO explained that there would be limited impact on the participation of balancing resources were DFFR to be exempt from the requirements of Article 32(3) of the EBGL. This is because providers can currently submit bids to the ESO with the option of providing upward and downward balancing capacity separately. However, ESO analysis shows that 99.6% of DFFR bids in the period of June 2021 to May 2022 were bundled. Furthermore, the ESO states some types of provider preferentially submit bundled bits and that some only have the capability to provide bundled capacity meaning unbundling would preclude these types of technology from participating in the DFFR market. Further, DFFR in its current form is an established market, changing the requirements may limit participation in the near-term, without any expectation of long-term benefit, given the short remaining lifetime of this service.

The ESO notes that the bundling of capacities may provide a barrier for some renewable generation sources. However, owing to the phase out of DFFR, the ESO is not seeking to

[7] Decision accessible here: https://www.ofgem.gov.uk/publications/decision-grant-eso-derogation-requirements-article-69-electricity-regulation-and-exemption-requirements-article-323-ebgl-mandatory-and-firm-frequency-response

attract new providers to DFFR as this may cannibalise participation in the new and more efficient suite of dynamic response products.

We are content with the ESO's assessment, as providers have the opportunity to provide unbundled capacity currently there should be limited impacts on balancing resources. We also expect that any impacts are negligible and transitory as the ESO phases out DFFR in favour of other dynamic response products. Any impacts should be offset by the ability of new providers to participate in DM, DR and Dynamic Containment markets.

d) *justification for the exemption demonstrating that such an exemption would lead to higher economic efficiency*

The ESO states that amending the procurement process for a product that is soon to be redundant is an inefficient use of resource and a cost that would ultimately be borne by the consumer. This is because it would need to create new processes and tools for the change and conduct an industry consultation on any amendments to the current procurement terms. Therefore there may be limited benefits to the consumer compared to the cost of undertaking the change.

The ESO further notes that the market overwhelmingly opts to submit bundled bids for DFFR, and that this shows that the current procurement methodology does not cause market inefficiencies. While the data does indeed show that more than 99% of bids were submitted bundled, we consider that this could be a feature of the market design rather than bidder preference, and does not prove an absence of market inefficiencies. This evidence confirms that the existing market parties are not overly restricted from providing the service as it is procured now. Nonetheless, given the ESO is able to procure sufficient DFFR through current means, and it is replacing the service with a non-bundled alternative, we agree that it would be inefficient to alter the service at this stage.

We are content with the ESO's analysis against this criteria. We do not believe undertaking the changes required to DFFR procurement represents good economic efficiency for the consumer when DFFR will be replaced by 31 March 2024 and DFFR volumes are expected to drop consistently leading up to this point. However, we again note that the ESO expected to phase out DFFR by 31 March 2023 and this has been unsuccessful. As a result, we do not expect the lifespan of DFFR to extend past 31 March 2024 as our analysis on this point is contingent on the replacement of DFFR with other dynamic response services.

<u>Derogation from the requirements of Article 6(9) of the Electricity Regulation</u>

As well as unbundling, Article 6(9) of the Electricity Regulation states:
"contracts for balancing capacity shall not be concluded more than one day before the provision of the balancing capacity and the contracting period shall be no longer than one day, unless and to the extent that the regulatory authority has approved the earlier contracting or longer contracting periods to ensure the security of supply or to improve economic efficiency."

In this section we consider the ESO's rationale for keeping the DFFR procurement terms at earlier than day-ahead procurement with one month contracts.

As with point d) of the above section, the ESO states amending the procurement process and contract terms for a product that is soon to be redundant is an inefficient use of resource and a cost that would ultimately be borne by the consumer. This is because it would need to create new processes and tools for the change and conduct an industry consultation on any amendments to the current procurement terms. Changing the procurement terms on a product that is soon to be redundant does not offer value for money for consumers.

Our analysis is consistent with the above section, we agree that undertaking the changes required to DFFR procurement would not be economically efficient for the end consumer when DFFR will be replaced by 31 March 2024. Once again, our agreement with the ESO's analysis is contingent on a successful phase out of DFFR completing no later than 31 March 2024.

Decision

Based on our analysis of the information submitted to us by the ESO as required by Article 6(9) of the Electricity Regulation and Article 32(3) of the EBGL we hereby:

- grant the ESO a derogation from the requirements of Article 6(9) of the Electricity Regulation for DFFR; and
- grant the ESO an exemption from the requirements of Article 32(3) of the EBGL for DFFR.

Our decision is effective from 31 March 2023, the date when our decision of 4 February 2022 expires. This derogation and exemption will apply to DFFR for the duration of its expected remaining lifetime and will expire on 31 March 2024. For clarity, this is the final date by which we anticipate the ESO might need to procure DFFR, however our understanding is that the phase out of DFFR to be replaced by new frequency products

could be achieved before 2024. Our expectation is that the ESO will complete the phase out of the DFFR service as soon as is possible, being mindful of system security requirements. As DFFR was expected to be discontinued by 31 March 2023 we do not expect further requests for derogation and exemption for DFFR beyond the point this decision expires.

We also note that the ESO must procure a minimum of 30% of all products used for balancing capacity no more than one day before the provision of balancing capacity and the contracting period be for no longer than one day. Whilst we are aware the ESO is currently exceeding this requirement, this must continue to be monitored to ensure compliance with the derogation for Article 6(9) of the Electricity Regulation.

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.