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for energy consumers

To: All interested stakeholders

Email: [ESOPerformance@Ofgem.gov.uk](mailto:ESOPerformance@Ofgem.gov.uk)

Date: 07 March 2023

Dear colleagues,

**Decision to reject an amendment to the Terms and Conditions related to Balancing in relation to proposed Balancing Reserve Service**

On 18 January 2023, we<sup>1</sup> received a proposal from the Electricity System Operator (“ESO”) to make amendments to the terms and conditions related to balancing (“T&C”) required by Article 18 of Commission Regulation (EU) 2017/2195 establishing a guideline on electricity balancing (“EBGL”),<sup>2</sup> as amended by the Electricity Network Codes and Guidelines (Markets and Trading) (Amendment) (EU Exit) Regulations 2019.<sup>3</sup> The proposal relates to an update to the T&C to include service documentation for the Balancing Reserve (“BR”) service, a new balancing capacity product.

The ESO has proposed the BR service as they have identified potential cost efficiencies in system balancing through its introduction. These savings can be achieved by providing an incentive, which is not currently present, for plant selling in the wholesale market to also offer capacity to the ESO. Introduction of a BR-type service was one of the options we consulted on in our Call for Input on options to address high balancing costs.<sup>4</sup>

The ESO has requested that the Authority consider the service documentation for BR, the BR Service Terms and BR Procurement Rules, as forming part of the T&C. This letter sets out our decision to reject these proposed amendments to the provisions that form part of the T&C required by Article 18 of the EBGL.

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<sup>1</sup> 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.

<sup>2</sup> Commission Regulation (EU) 2017/2195 of 23 November 2017 establishing a guideline on electricity balancing (EBGL). EBGL came into force on 18 December 2018. Accessible at: <https://eur-lex.europa.eu/eli/req/2017/2195/oj>

<sup>3</sup> The UK SI amendment of the EBGL: [https://assets.publishing.service.gov.uk/media/5c17d6b440f0b60c8d601a2c/ENC\\_Markets\\_and\\_Trading\\_SI.pdf](https://assets.publishing.service.gov.uk/media/5c17d6b440f0b60c8d601a2c/ENC_Markets_and_Trading_SI.pdf)

<sup>4</sup> Our call for input and responses received can be accessed at: <https://www.ofgem.gov.uk/publications/call-input-options-address-high-balancing-costs>

## Background

In accordance with Article 18 of the EBGL, the ESO was required to develop a proposal regarding the T&C for balancing service providers (“BSPs”) and balance responsible parties (“BRPs”). On 8 October 2019,<sup>5</sup> we published our decision to confirm, upon satisfaction of certain conditions, that the T&C proposed by the ESO are the T&C required by Article 18 of the EBGL. On 25 June 2020, all the necessary conditions were met, and the proposed T&C came into force in Great Britain (“GB”).

The ESO requires headroom and footroom<sup>6</sup> available on units that are running to allow it to hold sufficient reserve for system balancing. Currently, the ESO waits until gate-closure<sup>7</sup> to determine if the market has provided sufficient headroom / footroom, and when the market does not out-turn sufficiently, ESO accepts bids and / or offers, as necessary. Offer acceptances usually add cost to system balancing. Where bids are required to be taken to create headroom on units, the energy oftentimes needs to be replaced from alternative units – the offer acceptances on those units likewise can add to costs.

Rising costs of procurement through the BM have led the ESO to develop BR to procure balancing capacity at the day-ahead timeframe. Energy dispatch through BR would still be done post gate-closure. The ESO have stated that securing capacity at the day-ahead stage (and paying units for this availability through a pay-as-cleared auction) can offer units equivalent or higher rates of return than the wholesale market, but without placing the ESO at risk of incurring high balancing costs in the BM in real-time. A cost-benefit analysis conducted by LCP Delta on behalf of the ESO estimates that savings achievable through a service like BR are in the order of hundreds of millions of pounds over the years 2023 to 2025.<sup>8</sup>

The ESO first submitted its proposal to update the T&C to include BR to us on 18 January 2023 following a period of consultation on these changes which concluded on 14 December 2022.<sup>9</sup> The proposal is for the BR Service Terms and BR Procurement Rules to form part of the T&C. To improve visibility of the T&C, the ESO provided an updated

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<sup>5</sup> Our 8 October 2019 decision is accessible at: <https://www.ofgem.gov.uk/publications/decision-transmission-system-operators-proposal-terms-and-conditions-related-balancing>

<sup>6</sup> Headroom and footroom refer to, respectively, capability of a unit to turn up generation (or turn down demand) and to turn down generation (or turn up demand), and therefore a unit must not be at its maximum or minimum operating point if it is to provide this balancing service.

<sup>7</sup> Gate-closure is one hour ahead of the start of a settlement period.

<sup>8</sup> A report of this analysis can be accessed at: <https://www.nationalgrideso.com/document/274691/download>

<sup>9</sup> This consultation ran from 14 November to 14 December 2022. Details are available at: <https://www.nationalgrideso.com/industry-information/balancing-services/reserve-services/balancing-reserve?how-to-participate>

mapping document. The ESO provided updated documents to us on 21 February 2023 to amend some minor drafting errors – these documents are the set we have considered when making this decision.

## **Rationale for our Decision**

We have reviewed the BR service documentation proposed by the ESO to be recognised as part of the T&C submitted to us in line with the requirements of the EBGL Regulation, the wider objectives of the EBGL and the Electricity Regulation (“ER”),<sup>10,11</sup> and our statutory duties and obligations. In making our decision we considered the responses to the consultation from industry stakeholders and engaged with the ESO to better understand its proposals.

Overall, we recognise the drivers for the ESO to introduce a service of this type: there are potential operational benefits and reductions in balancing costs which could result in consumer benefit. However, these benefits were outweighed significantly by the concerns related to the barriers to enter the BR market for small flexible providers and an insufficient deterrent to prevent non-delivery. These concerns are explained further, below.

### Barriers to entry for small flexible providers

The ESO has set a minimum volume requirement of 50MW for units to offer to turn up or turn down. We note and agree with the concerns of many respondents to the consultation that this is unduly discriminatory against the involvement of units of smaller size.

We note that under Article 6 of the ER, the ESO’s balancing services are required to comply with the following:

1. *Balancing markets, including prequalification processes, shall be organised in such a way as to:*
  - (a) *ensure effective non-discrimination between market participants taking account of the different technical needs of the electricity system and the different technical capabilities of generation sources, energy storage and demand response;*

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<sup>10</sup> 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>

<sup>11</sup> 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>

Additionally, an objective of the EBGL is “...fostering effective competition, non-discrimination and transparency in balancing markets;”.<sup>12</sup> And the ESO’s licence also requires that “procurement of balancing services is subject to transparent, non-discriminatory and market-based procedures”.<sup>13</sup>

However, under the principle of proportionality, limited discrimination may be necessary in some cases, for example, where there are technical limitations of the system which constrain the ESO. Therefore, it is fundamental that the design of balancing services is not unduly discriminatory.

Based on the information submitted to us from the ESO, we have not been able to assess this product as non-discriminatory. We do not agree with their position that the need to dispatch units in a short period of time is sufficient rationale to justify a 50MW minimum bid size, and that this has significant negative market effects, including reduction of liquidity in the BR market potentially elevating prices and affecting the mid-to-long term investment signal for smaller units.

We did agree with the ESO’s underlying assessment of a technical system limitation – that is, the ESO must be able to issue dispatch notifications to its reserve units in a timely fashion to ensure system security. This limitation is expected to be alleviated once ESO control room IT upgrades allow for improved dispatch protocols, but until such a point, we understand that the ESO is bound by a limit on the number of units which it can dispatch to provide reserve.

However, we are firm in our view that this should not mean a direct discrimination of units based on their size, especially where this limits the ESO’s access to potentially cheaper providers without breaching the maximum number of units that the ESO can dispatch efficiently.

We believe design of a BR-type product that does not directly restrict access to the market for certain units based on their size could be feasible, and may offer consumer value through a reduction in balancing costs. It is clear however that small flexible providers form a key part of the present and future energy system, and as such, attempts should be made to prevent barriers to their market entry, wherever possible.

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<sup>12</sup> Found at Article 3(1)(a) of the EBGL.

<sup>13</sup> See standard condition C28(4)(h)(i) of the ESO’s transmission licence, accessible at: <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20transmission%20full%20set%20of%20consolidated%20standard%20licence%20conditions%20-%20Current%20Version.pdf>

## Cap on reimbursement

The ESO has put forward in the BR Service Terms that the cap on payments to reimburse the ESO per BR contract is the larger of £250,000 or the value of availability payments due for that BR contract. This is payable, for example, if a unit fails to make available the energy they have been contracted for, during the contracted period.

The ESO failed to provide sufficient rationale for the £250,000 figure, which we are concerned is not high enough. We did not find their argument that this was a consistent figure across services to be sufficiently powerful. Without a sufficiently high deterrent, providers may be able to take advantage of a change in market conditions between the day-ahead auction for BR capacity and real time which would negate the benefit of the service without providing commercial detriment to providers.

While we recognise that the cap can be higher than £250,000 for large contracts, we expect that availability payments for most BR contracts will be far below £250,000, and hence this alternative figure for the cap would have little effect.

Therefore, we believe that this cap could invalidate the ESO's main reason for introducing BR, which is to reduce high costs seen during periods of generation scarcity.

## **Decision**

In light of the above, the Authority hereby:

- rejects the proposal that the BR Service Terms and BR Procurement Rules form part of the T&C required by Article 18 of the EBGL.

## **Next Steps**

There is no change to the terms and conditions relating to balancing, and therefore no need for the ESO to update any documentation.

We commend the ESO's intent to take action to develop a service which could reduce balancing costs and hence be of consumer value. However, we expect the ESO to be mindful of its obligations to develop services which are non-discriminatory and to provide strong market signals that align with the goals of government, Ofgem and the ESO itself, which include opening access to markets for flexible units. This rejection of the ESO's

existing proposal does not prevent them from putting forward an updated design and alternative set of terms and conditions for a service with the same name. We note that this would require a further period of industry consultation, and we would expect our concerns as outlined in this letter to have been addressed.

If you have any queries regarding the information contained in this letter, please contact James Hill ([James.Hill@Ofgem.gov.uk](mailto:James.Hill@Ofgem.gov.uk)).

Yours Sincerely,

**Grendon Thompson**

Acting Deputy Director – Institutions for Net Zero

For and on behalf of the Gas and Electricity Markets Authority