

To: All interested parties

Email: ESOperformance@ofgem.gov.uk

Date: 27 October 2023

Dear colleagues,

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

On 23 August we¹ received a request from the Electricity System Operator ("ESO") for a derogation under Article 6(14) from a requirement of Article 6(4) of Regulation (EU) 2019/943² (the "Electricity Regulation"), as amended by The Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020³ for its Demand Flexibility Service ("DFS"), a balancing energy product.

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

- (i) that settlement of balancing energy should be based on marginal pricing ("pay-as-cleared"); and
- (ii) 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).

We note that the ESO proposed an alternative pricing methodology for balancing energy which was approved by the Authority in our 20 May 2022 decision⁴ in line with Article 6(4). The ESO's balancing products are to have their balancing energy settled according to the

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) is accessible 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 here: <https://www.legislation.gov.uk/uksi/2020/1006/contents/made>

⁴ Our decision to approve an alternative pricing methodology is accessible 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>

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 for DFS against the second requirement of Article 6(4), to allow it to be procured ahead of gate closure.

The ESO previously requested to be derogated from this requirement of Article 6(4) for the first iteration of the DFS product for use in winter 2022/2023. In our decision of 4 November 2022⁶ we approved this request, however this derogation expired on 30 April 2023. As such, in order to use the newest iteration of the product, the ESO requires another derogation from the requirements of Article 6(4). For the avoidance of doubt this decision refers to the current iteration of DFS only, as the previous iteration of DFS cannot be used.

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

Background

DFS is a product that the ESO previously developed to provide an additional system security tool for winter 2022/2023. The service intends to attract volumes of demand response 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.⁷ The ESO states that this demand turn-down can help them to manage system margins when insufficient upward flexibility is available.

Through its Winter Outlook,⁸ the ESO has stated that it will require DFS for winter 2023/2024 in order to maintain healthy margins and ensure security of supply. In last year's iteration of the product, DFS would only be called upon at the day-ahead timeframe and providers would be able to update offered volumes and prices for the service delivery day until 15:30 at the day-ahead stage. The ESO has updated the service for winter 2023/2024 to also allow dispatch of the service at 09:00 or 12:00 on the day of service

⁵ The ESO's pricing methodology is accessible here: <https://www.nationalgrideso.com/industry-information/codes/european-network-codes-enc/other-enc-documents>

⁶ Our decision of 4 November 2022 is accessible here: <https://www.ofgem.gov.uk/publications/decision-grant-eso-derogation-requirements-article-64-electricity-regulation-demand-flexibility-service>

⁷ Whilst mainly a demand reduction product, DFS does also allow generator turn-up in order to balance the system.

⁸ The ESO's Winter Outlook for 2023/2024 is accessible here: <https://www.nationalgrideso.com/document/289136/download>

delivery. We understand that the decision on whether to dispatch DFS at the day-ahead stage or delay until an intraday time frame will be taken by 14:30 day-ahead.

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. The specific energy balancing product, DFS, has been designed to be procured and instructed at day-ahead timescales and intraday timescales which are ahead of gate closure, the ESO therefore requested a derogation under Article 6(14) from the relevant requirement of Article 6(4) of the Electricity Regulation regarding dispatch timings. 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; and 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. 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,^{9,10} 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:

⁹ COMMISSION REGULATION (EU) 2017/2195 establishing a guideline on electricity balancing ("the EBGL Regulation"), available here: <https://www.legislation.gov.uk/eur/2017/2195>

¹⁰ 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>

i) rationale for procurement timescales

The ESO notes that for DFS it is not feasible for balancing energy gate closure times to comply with the requirement set out in Article 6(4). Whilst the timing of procurement needs to be as close to real time as possible for the ESO to have maximum certainty of its balancing energy requirement, DFS delivery requires a time buffer to account for downstream processes to run and ensure certainty of volume that is available to deliver.

These downstream processes, for example providers contacting domestic or industrial providers, must necessarily occur ahead of real time. As DFS is targeted at residential and smaller industrial and commercial demand, these processes are critical to DFS and would potentially be hampered if DFS were conducted at the intraday cross-zonal gate closure time as required by Article 6(4). Furthermore, providers have made representations to the ESO that it is both inappropriate and unproductive to send instructions to demand response of this type outside of business hours.

On the other hand, 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 ESO's interest to hold the tender as close to real-time as possible in order to minimise the amount of uncertainty. The ESO intends to use the two intraday procurement times in this iteration of DFS to continue to improve the product, including by testing the efficacy of different procurement timelines in order to dispatch DFS as close to real time as possible.

We note that the ESO will only use one dispatch time when a DFS procurement event is held. The ESO states that it will look to use the procurement time that is as close to real time as possible that still meets the system balancing requirement. The ESO does not expect to dispatch DFS intraday in a live event until all the initial lead time test events have been completed.

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 ahead of the intraday cross-zonal gate closure time. We understand that the product is being procured at as close to real time as possible given these limitations and we support the ESO in moving toward intraday procurement timeframes.

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

We note that DFS has been developed as an enhanced action, meaning it will only be called upon once all other relevant 'everyday' balancing actions available to the ESO have been exhausted. The ESO has communicated that DFS should be activated only where the ESO perceives insufficient flexibility to maintain sufficient energy margin above the generation required to meet demand.

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 for this iteration of DFS the ESO will again run a series of tests to gain operational confidence in the service, the efficacy of its proposed procurement times, and to maximise participating volumes. The ESO has stated that they believe they have opted for a testing regime that balances this need to test the service against the need to minimise its use.

We expect the ESO to conduct testing in a way that ensures economic and efficient operation of the system and reduces impacts on other markets. Nevertheless, we also expect the ESO to use learnings from these tests to improve the DFS product for any continued use beyond winter 2023/2024.

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

Given DFS is an enhanced action, ESO will only dispatch DFS when other markets have been unable to provide the necessary flexibility to meet system requirements. This inherently limits the potential distortive impacts of DFS as, theoretically, the large majority of market services that can offer the required system balancing outcome should have already been exhausted. We do note that DFS being called will send a strong signal of scarcity to the market and have the potential to cause upward pressure on market prices. However, this should only be the case where scarcity is already anticipated and the majority of other services will have been exhausted so any distortive effects are expected to be minimal.

By design, the ESO intends for this service to only attract volume from participants not engaged in other balancing services and is therefore not available to the ESO through its everyday routes. Therefore, DFS only utilises additional volumes of flexible demand and does not distort other markets by attracting providers away from them. As DFS does not

allow 'stacking' of services where providers from other markets could withdraw their position to participate in DFS, we are comfortable that DFS should not cannibalise other markets in this manner.

We note that in this iteration of DFS, the ESO has designed the service such that all providers, except for participation via domestic boundary meters, are required to be half-hourly settled. The intention of this change is to expose the majority of volume to half-hourly price signals and disincentivise potential gaming of the baselining methodology.

Finally, we consider that testing of the service may cause some disruption in other markets. This is especially pertinent with the current testing regime continuing to offer a guaranteed acceptance price for the second iteration of DFS. We accept that testing and gathering learnings to improve the service is necessary, but we nevertheless expect the ESO to mitigate the potential impact it may have on other markets. The ESO should review its testing regime regularly and adjust as necessary if market impacts are identified.

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

Based on our analysis of the information submitted to us by the ESO as required by Article 6(14) of the Electricity Regulation, the dispatch timeline processes shared with us, 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. **Our decision to provide this derogation shall apply until 30 April 2024.** For clarity, any subsequent product or continuation of this product beyond that date would require the ESO to request further derogation from the requirements 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 ESOperformance@ofgem.gov.uk.

Yours sincerely,

James Hill

Principal Policy Expert – Electricity System Operation

For and on behalf of the Gas and Electricity Markets Authority