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To: All interested stakeholders

Email: ESOPerformance@Ofgem.gov.uk

Date: 21 November 2024

Dear colleagues,

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

On 24 September 2024, we[1] received a proposal from National Grid Electricity System Operator ("NGESO")[2] for a derogation under Article 6(14) from a requirement of Article 6(4) of Regulation (EU) 2019/943[3] (the "Electricity Regulation"), as amended by The Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020[4] 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 NGESO proposed an alternative pricing methodology for balancing energy in line with Article 6(4) which was approved by the Authority in our 20 May 2022 decision[5]. NESO'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] We received the submission from National Grid Electricity System Operator, which at the time was the holder of an Electricity Transmission Licence and was the body responsible for maintaining the T&C. Since 1 October 2024, National Grid Electricity System Operator has transitioned to become National Energy System Operator, which holds an Electricity System Operator licence and is now the body responsible for maintaining the T&C. We have confirmed with National Energy System Operator that it still intends for this amendment to be made. Where a reference is historic (ie refers to information, statements, actions, etc prior to 1 October 2024), we have referred to National Grid Electricity System Operator, and otherwise have referred to National Energy System Operator.
[3] 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
[4] The UK SI amendment of the Electricity Regulation is accessible here: https://www.legislation.gov.uk/uksi/2020/1006/contents/made
[5] 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.[6] We understand that in the case of the DFS, NGESO'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, NGESO does not require a derogation from the criterion to settle pay-as-cleared. However, NGESO has requested a derogation for the DFS against the second requirement of Article 6(4), to allow procurement to be ahead of gate closure.

NGESO previously requested to be derogated from this requirement of Article 6(4) for the second iteration of the DFS product for use in winter 2023/24. In our decision of 27 October 2023[7] we approved this request, however this derogation expired on 30 April 2024. As such, in order to use the newest iteration of the product, NGESO requires a further derogation from the requirements of Article 6(4). For the avoidance of doubt this decision refers to the current (third) iteration of the DFS only.

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 to be taken. We note that we have also provided approval for the inclusion of the DFS service documentation into the terms and conditions related to balancing required under Article 18 of the Electricity Balancing Guideline ("EBGL").[8,9]

Background

DFS is a product that NGESO previously developed to provide an additional system security tool for winter 2022/23. NGESO ran a second iteration of the service in the winter of 2023/24 for the same purpose. 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.

Through its Winter Outlook 2024/25[10], NGESO highlighted higher base case margins and, therefore, decided to transition away from utilising DFS as an enhanced action tool to an in-merit margin management service for the third iteration of this service. To operate this service in line with the current proposal, NESO must assess the need for the DFS ahead of real-time to compare it to alternative margin options. At this point, it can be an appropriate way of introducing competition in this area considering the maturity of the DFS. Additionally, NESO

[6] The ESO's pricing methodology is accessible here: https://www.neso.energy/industry-information/codes/european-network-codes-enc/other-enc-documents
[7] Our decision of 27 October 2023 is accessible here: https://www.ofgem.gov.uk/decision/decision-demand-flexibility-service-relation-update-terms-and-conditions-related-balancing-202324
[8] COMMISSION REGULATION (EU) 2017/2195 establishing a guideline on electricity balancing ("the EBGL Regulation"), available here: https://www.legislation.gov.uk/eur/2017/2195
[9] 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
[10] Winter Outlook 2024/25 can be accessed here: https://www.neso.energy/document/330221/download

recognises that dispatching the DFS within post-gate closure timeframes is challenging for most provider types, mainly due to the manual nature of the response. Therefore, NESO expects to dispatch the service at around 12:00 ahead of typical delivery between 16:00 and 19:00. Evidence from previous iterations of the DFS has indicated that dispatch on this notice period balances accuracy of forecasted available volume against total available volume and allows for adequate dispatch timeframes alongside NESO's certainty of need.

Article 6(14) of the Electricity Regulation allows the Transmission System Operator 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, the DFS, has been designed to be procured and instructed at timescales which are ahead of gate closure, and NGESO 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 at least 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.

NGESO's derogation request was submitted in accordance with Article 6(14) and contained all necessary information. We note that at this time NGESO does not intend to convert the DFS balancing energy bids into bids for standard products as, currently, Great Britain does not have access to European balancing product platforms. NGESO has stated that the 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.

Rationale for our decision

We have reviewed the request submitted to us in line with the requirements of the Electricity Regulation, the wider objectives of the EBGL, and our statutory duties. We have also engaged with NGESO to clarify our understanding of the rationale for the request for derogation. In making this decision, we considered:

i) rationale for procurement timescales

NGESO proposed that the notification of the DFS be up to eight hours ahead of actual delivery. NGESO contended that it is not feasible for certain providers within this service to

comply with dispatch after gate closure times as required under Article 6(4). Whilst the timing of procurement needs to be as close to real time as possible for NESO to have maximum certainty of its balancing energy requirement, the proposed dispatch notification timeframe of up to eight hours ahead of real time is needed for two reasons: firstly for alignment with internal processes to allow for comparison with alternative actions (coordination of DFS procurement decisions with other market mechanisms, such as Interconnector trades and the Balancing Mechanism), and secondly to ensure sufficient time to run downstream processes (such as communication from contracted providers to consumers as the ultimate provider of the service, or rescheduling of production operations) and ensure certainty of volume that will be available to deliver.

We note that NESO intends to use one time for DFS procurement, with dispatch notifications to successful participants issued at 12:00. This means that the period ahead of real time will vary depending on the actual time of system need for delivery (which is anticipated to usually fall within the period 16:00 – 19:00) but will align with the processes of alternative actions (including NESO expecting not to need to take actions). We further note that some providers suggest that having fixed auction times encourages greater participation, as participants can better plan around a predictable schedule. We consider that this process is therefore appropriate, and that NESO is targeting procurement close to real time given downstream constraints and the need to ensure provider certainty.

Taking the above into account, we understand that DFS procurement cannot be brought in line with the obligation set out in Article 6(4) of the Electricity Regulation and agree that it is necessary for NESO to procure ahead of the intraday cross-zonal gate closure time.

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

NGESO has proposed to transition DFS procurement from its previous function as a last resort balancing option into an in-merit margin management tool. NGESO outlined that the DFS will only be dispatched when it is competitive against the forecast cost of taking alternative actions for margin management, such as Interconnector trades and BM actions.

We agree with NGESO's proposed approach of using the DFS as an in-merit margin service. We are content that this will minimise use of the DFS, subject to system need and offered prices, and will therefore ensure that operation is economically efficient (both in terms of specific usage of the DFS, but also overall system efficiency).

We also note that while NESO retains the ability to run tests of the DFS (including with the possibility of using a guaranteed acceptance price), tests should only be used to gain further, targeted learnings about the service (for example, if NESO intended a move to

closer to real-time dispatch or considered use of the DFS as a demand turn-up service, these may benefit from testing).This approach differs from previous iterations of the DFS where testing was used outside of direct system need for the service. We do not consider this an appropriate route for supplementing low utilisation of the service under the current service design and consider that limited testing supports this requirement of the Electricity Regulation. For clarity, Ofgem would expect testing only to be considered where it reflects consumer value.

Our view is that the current design provides a service which meets this requirement of Article 6(14) by utilising the DFS only when it provides an economically efficient system balancing option.

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

Previously, concerns around inefficiencies and distortive effects stemmed from two main areas of the DFS service design: dispatch timings and the testing regime. For the updated service design, we consider that both factors are less impactful on markets than previously, explained below. We also note some other key rationale on the potential inefficiencies and distortions from the service and their mitigations.

Dispatch timings

The DFS dispatch time will coincide more closely with NESO's alternative actions than in previous iterations. While dispatch is still ahead of real time, distortions should be mitigated as in the event of having no access to the DFS, NESO would still take actions in some cases to manage positive margins. Dispatch of the DFS will only be in-merit, and thus provides competition in this area. We also consider that transparent publication of the DFS tender results will support industry in understanding NESO's margin management needs and the types of system condition where this is more prevalent.

In some instances, the DFS may help the system operator ensure a more efficient outcome by targeting delivery to specific settlement periods where other options may have longer delivery durations.

Testing

With no prescribed testing regime, the DFS will be used only when a system requirement triggers it. Pricing should become more transparent without testing in place.

We note that some respondents to NGESO's consultation on the DFS service design considered that a distortive effect exists between participants in the DFS and those in other

markets who may be in receipt of additional payments (such as contracts for difference). Our view is that introduction of the DFS closes, rather than exacerbates, this distortion (by removing some barriers to market entry), and that establishing a payment structure that is not solely based on the need identified through the DFS should not be part of the service design.

Other considerations

We note that the Applicable Balancing Services Volume Data Methodology[11] ("ABSVD") only applies to half-hourly settled volume entered into the DFS. We anticipate that the majority of Meter Point Administration Numbers ("MPANs") entered into the service will be half-hourly metered (and not half-hourly settled). While ideally all volume should be adjusted appropriately to ensure accuracy and efficiency of imbalance signals, we understand that the expected impact of not applying ABSVD to any non-half-hourly settled volume delivering the DFS will be small.

NGESO proposed that the DFS can stack with the Capacity Market ("CM") and with Distribution Network Owner ("DNO") Flexibility Services (that is, providers can be active in the DFS and the CM and DNO Flexibility services concurrently). This minimises distortions which could arise by volume shifting between markets or being excluded from providing certain services. We believe NESO should allow as much stackability as practical as a way forward, while managing risks. We expect to see NESO undertake further work to allow stacking of as many services as practicable to ensure that all market parties have access to revenue opportunities and that NESO has the maximum volume available to efficiently solve system needs.

Furthermore, NGESO proposed for the DFS to be stackable with the CM and DNO Flexibility Markets to increase revenue opportunities for market participants while limiting stacking with its core balancing services. We believe this decision was made to minimise the risk of losing volume from the BM and to avoid any distortive effects on real-time system balancing.

We consider that the proposed design of the DFS does not introduce significant distortions or inefficiencies. Where there are residual small impacts on market activity, we expect NESO to continue to refine the service as appropriate to minimise these.

[11] The latest version of this methodology is available at: https://www.neso.energy/industry-information/codes/balancing-settlement-code-bsc/c9-statements-and-consultations

Decision

Based on our analysis of the information submitted to us by NGESO 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 Transmission 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 NESO from this requirement of Article 6(4) of the Electricity Regulation is effective immediately. Our decision to provide this derogation shall apply until 31 March 2027. For clarity, any subsequent product or continuation of this product beyond that date would require NESO to request further derogation from the requirements of Article 6(4) of the Electricity Regulation if not brought into compliance.

If you have any queries regarding the information contained in 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