Penny Garner
Head of Market Frameworks
National Energy System Operator
Faraday House, Gallows Hill
Warwick
CV34 6DA

Email: James.Hill@ofgem.gov.uk
Date: 21 September 2026

Dear Penny,

Direction to NESO under condition C9.5 of the Electricity System Operator Licence to review the NTC Commercial Compensation Methodology

Background

Net Transfer Capacity ("NTC") restrictions are a non-frequency balancing tool used by National Energy System Operator ("NESO") to manage the capacity of electricity interconnectors. As NESO considers there to be no efficient market-based means through which NTC restrictions could currently be procured, NESO requires a derogation from the requirements set out in Part C of Condition C1.17 of NESO's Electricity System Operator (ESO) Licence.[1]

To support the efficient use of NTC restrictions, NESO maintains a Commercial Compensation Methodology ("CCM")[2] which establishes the commercial arrangements applicable when NTC restrictions are applied. The CCM sets out the methodologies used to determine compensation and the commercial principles underpinning those arrangements. As NESO considers there to be no viable market-based means through which NTC restrictions can currently be procured, the CCM aims to ensure that, as far as reasonably practicable, parties affected by an NTC restriction are left financially neutral

[1] We granted such a derogation in September 2023 which was due to expire on 30 September 2026. Alongside this letter, we have provided a further derogation out to 30 September 2030.
[2] The current CCM is published on NESO's website, available here: https://www.neso.energy/document/203726/download
We understand that NESO will update this with the new version following publication of our derogation decision alongside this letter.

relative to a scenario in which the restriction had not been applied.[3] This includes both compensating parties for any losses arising from a reduction in capacity[4] and accounting for any gains which may arise as a consequence of capacity becoming scarcer.[5]

As part of the Authority's decision[6] granting NTC restrictions a derogation for September 2023 to September 2026, we set expectations that NESO would continue to review the commercial and operational principles underpinning the NTC framework throughout the derogation period. We expected NESO to engage regularly with stakeholders and to bring forward any changes to the CCM where these were shown to be necessary or appropriate. We also expected any such review to build on operational experience and outturn data from the continued use of NTCs, which was limited prior to our 2023 decisions.

In August 2025, NESO commenced a review through an informal call for input followed by a formal consultation[7] between 6 February 2026 and 17 April 2026. On 24 July 2026, in line with the requirements under ESO Licence Condition C9.4, NESO submitted a report to the Authority setting out stakeholder feedback to the consultation, an explanation of how this feedback was considered, and the resulting amendments to the CCM. This was submitted alongside a request for a new NTC derogation ahead of its expiry in September 2026.

We note that stakeholders have raised concerns with the CCM, and we are disappointed that NESO's review and engagement was only undertaken towards the end of the 2023 – 2026 derogation period. We consider that earlier review would have facilitated better quality of engagement and allowed NESO more time to evidence that the CCM is fully fit-for-purpose.

Ofgem's Assessment

We have reviewed NESO's submission alongside stakeholder responses and the supporting evidence provided during the consultation process. Our view is that the CCM aims to provide an appropriate mechanism by which interconnectors are kept whole and NTCs are compensated in a manner which reflects a market-based approach as best as is reasonably possible.

[3] Known colloquially as a "keep whole" mechanism or "no loss – no gain" approach.

[4] Consistent with commercial principle B of the CCM, compensation is intended to reflect the costs incurred by an interconnector owner as a result of the NTC restriction, including impacts on allocated and unallocated capacity and, where evidenced, other relevant cost impacts.

[5] Consistent with commercial principle C of the CCM, compensation arrangements also aim to take account of circumstances where a reduction in capacity results in additional income for an interconnector owner, including increased congestion revenues, such that net compensation may be reduced or, in some cases, become payable by the interconnector owner.

[6] The decision to grant the Electricity System Operator a derogation from Standard Licence Condition C28.4(h)(i) for Net Transfer Capacity, published by Ofgem on 28 September 2023, can be accessed here: https://www.ofgem.gov.uk/sites/default/files/2023-09/C28_Derogation_Decision_Sept23_Final%20Version.pdf

[7] The documents relating to NESO's current CCM consultation, including consultation papers and draft methodology documents are available on NESOs website here: https://www.neso.energy/what-we-do/energy-markets/interconnectors/what-ntc#Current-Commercial-Compensation-Methodology-Consultation

However, from the information provided, we were unable to fully determine whether the CCM achieves those aims, and whether its methodologies are the most appropriate means of promoting alignment with the requirements under Part C of ESO Licence Condition C1 and the interests of consumers, nor whether the concerns raised by stakeholders have been adequately considered and addressed.

In reaching this position, we have considered feedback provided in response to NESO's consultation alongside wider stakeholder feedback, and the extent to which NESO has explained and evidenced the methodologies proposed for the CCM. Consultation provides an opportunity not only for stakeholders to challenge a proposed approach, but also for the licensee to demonstrate why a particular approach is preferable to alternative options.

While there are several areas where the CCM would benefit from greater clarity and precision, our primary concern is more fundamental: namely that, in some instances, NESO has not adequately evidenced that the underlying methodologies are capable of producing compensation outcomes that are robust, cost-neutral and consistent with the commercial principles of the regime. It is incumbent on NESO, in line with Conditions C1.34 and C1.35 of its ESO Licence, to suitably engage stakeholders on and evidence the decisions it takes.

We do not consider that NESO's response to stakeholder feedback adequately demonstrates how the concerns raised through the consultation process have informed the final design of the CCM. In several instances, the response to the consultation feedback focused on whether stakeholders had provided sufficient evidence to justify a change, rather than clearly explaining why the existing methodology should be retained despite the concerns raised. Accordingly, whilst we do not conclude that the current CCM is necessarily inappropriate, we are not satisfied that NESO's consultation response and supporting submissions sufficiently demonstrate why the methodologies contained within the CCM are the most appropriate approaches in light of the evidence and stakeholder feedback received through the consultation process.

Ofgem's Decision

Under ESO Licence Condition C9.5, we are directing NESO to undertake a further review of and consultation of the CCM by 30 September 2027.

The purpose of this direction is not to prescribe a particular compensation methodology, nor to conclude that the current methodology is inappropriate – we remain open to the possible conclusion that the existing arrangements remain the most suitable and proportionate means of achieving the objectives of the CCM.

However, having reviewed NESO's C9.4 submission, stakeholder responses, supporting evidence and NESO's consideration of that feedback, we are not satisfied that the consultation process has sufficiently demonstrated why the existing methodologies remain

The Office of Gas and Electricity Markets
10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000
www.ofgem.gov.uk

the most appropriate means of delivering the objectives of the CCM, alignment with the commercial principles that underpin it and the requirements under Part C of ESO Licence Condition C1 and the interests of consumers.

We therefore consider that NESO must undertake a further review and consultation of the CCM, including the areas identified by stakeholders during the consultation process. This review should be comprehensive in scope and supported by meaningful stakeholder engagement. In undertaking this review, NESO should ensure that stakeholders are provided with sufficient information and evidence to enable effective scrutiny of the CCM. The resulting CCM should clearly articulate:

1. the objectives of the compensation methodology, including how they contribute to leaving affected parties financially neutral as far as reasonably practicable;
2. the assumptions underpinning the methodology and the evidence supporting those assumptions;
3. how the methodology seeks to estimate the market outcome that would have emerged in the absence of the restriction, including its treatment of scarcity effects that may materially influence market outcomes;
4. how operational experience and data from the application of NTC restrictions have been considered in the development of the methodology;
5. alternative approaches considered and the rationale for accepting or rejecting them;
6. how the methodology promotes alignment with the requirements under Part C of ESO Licence Condition C1, the interests of consumers, and alignment with the commercial principles defined in the CCM.

We expect NESO to engage meaningfully with stakeholders as part of this exercise and to provide a clear explanation of how stakeholder views have been considered and the reasons why particular approaches have been accepted, modified or rejected. We expect that NESO would engage relevant stakeholders ahead of formal consultation as part of this process, and to consider both the consultation feedback already received and any additional evidence and views either already submitted by stakeholders or that emerge as part of this review.

In carrying out this review and consultation of the CCM, NESO should ensure that the resulting arrangements are informed by operational experience and data gathered through the application NTC restrictions to date, reflecting the experience gained since the CCM was first developed. NESO should also ensure that the resulting arrangements remain consistent with its wider regulatory obligations and relevant interconnector arrangements.

We are directing NESO to complete the review, consultation and all associated activities no later than 30 September 2027, unless otherwise approved by the Authority. This date represents the latest date by which the work must be completed and the Authority informed of the outcome of that work in accordance with ESO Licence Condition C9.4. NESO should commence the work as soon as reasonably practicable and take all reasonable steps to complete it before this date. For clarity, our Direction does not set the deadline for implementation of any potential changes to the methodology, only for identifying and confirming them. However, we do expect any updates to be implemented in a timely fashion with transparent timelines.

Yours sincerely,

James Hill
Principal Policy Expert – Electricity System Operation

For and on behalf of the Gas and Electricity Markets Authority

Annex 1 – Direction on Condition C9.5 in relation to the NTC Commercial Compensation Methodology

For and on behalf of the Gas and Electricity Markets Authority

DIRECTION PURSUANT TO PARAGRAPH 9.5 OF STANDARD LICENSE CONDITION C9 OF NATIONAL ENERGY SYSTEM OPERATOR'S ELECTRICITY SYSTEM OPERATOR LICENCE IN RELATION TO THE PROCUREMENT AND USE OF BALANCING SERVICES

Whereas:

1. National Energy System Operator ("NESO") is the holder of an Electricity System Operator Licence (the "Licence") granted or treated as granted under section 6(1)(da) of the Electricity Act 1998 (the "Act").
2. Licence Condition ("LC") C9 (Procurement and use of balancing services), sub-paragraph 9.5 allows the Authority to direct NESO to reconsult with relevant parties.
3. For the reasons set out in the letter to which this Direction is attached, the Authority has decided to direct NESO to undertake a review and consultation of the NTC Commercial Compensation Methodology by 30 September 2027.

Therefore:

In accordance with paragraph 9.5 of LC C9, the Authority hereby directs NESO to undertake a review and consultation on the NTC Commercial Compensation Methodology and to confirm the outcome of that review and consultation to the Authority no later than 30 September 2027.

This Direction and the letter to which it is attached constitutes notice of the reasons for the decision pursuant to section 49A of the Act.

This Direction may be amended or revoked by the Authority, after such consultation as is required by the licence.

James Hill
Principal Policy Expert – Electricity System Operation
For and on behalf of the Gas and Electricity Markets Authority
21 September 2026