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Dear colleagues,

Decision to grant National Energy System Operator a derogation for Net Transfer Capacity restrictions under Licence Condition C9.6

We[1] received a request on 24 July 2026 from National Energy System Operator ("NESO) for a derogation from the Electricity System Operator ("ESO") Licence Condition C9.6,[2] allowing them to procure a non-frequency balancing service, Net Transfer Capacity ("NTC") restrictions, following non-market-based procedures.

This letter sets out our decision to grant NESO a derogation under our powers as described in ESO Licence Condition C9.6 and outlines the next steps to be taken. Our decision to grant this derogation is effective as of 1 October 2026, replacing the derogation[3] currently in place which expires 30 September 2026.

[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] NESO's Electricity System Operator Licence Conditions can be found at: https://epr.ofgem.gov.uk/c/9wgWVKeHRymQ3pBbiptyqA/p/0196c209-4e4c-4e2b-92ae-525b634f2f51/wvp/7feb6a5a-39d2-4e46-ba4e-5b0933ac9e2a

[3] Our September 2023 derogation can be found here: https://www.ofgem.gov.uk/sites/default/files/2023-09/C28_Derogation_Decision_Sept23_Final%20Version.pdf

Background

NESO is responsible for operating the Great Britain ("GB") electricity system securely. As part of this role, it must manage, among other risks, the sudden loss of the largest source of generation or demand, transmission constraints, and operational margins.

Interconnectors ("ICs") between the GB synchronous area and other European countries can significantly affect each of these risks because they represent large flows of electricity. At a given time, depending on the direction and magnitude of electricity flows, ICs can present large losses to the system, either from importing electricity (generation loss) or exporting electricity (demand loss). ICs can also flow electricity into an area which is subject to a constraint at that time.

NESO introduced NTC restrictions in 2021 (following the commissioning of the North Sea Link ("NSL") IC)[4] as a firm means of managing IC flows where unrestricted capacity could present a system-security risk which could not be resolved through existing commercial means.

Under the current NTC arrangements, NESO may apply an NTC restriction to an IC to limit its export or import capacity for a specified period. Unlike trading actions, which seek to influence the final netted commercial flow, an NTC restriction directly limits the transmission capacity of an IC.

However, NTC restrictions are not procured through market-based mechanisms. As this does not meet the requirement under ESO Licence Condition C1.17,[5] NESO requires a derogation from this requirement in order to procure this non-frequency balancing service. NESO has therefore requested, under ESO Licence Condition C9.6, for the Authority to grant a derogation, arguing that market-based provision would not be economically efficient.

We previously approved time-limited derogations for this service, reflecting our expectation that NTC restrictions would only be needed on a temporary basis, pending development of a coordinated cross-border methodology or market-based solution.

Our most recent decision to grant a derogation (September 2023) included continuing expectations on equitable application of NTC restrictions, improved stakeholder engagement and transparency, a review of the commercial and operational arrangements, and the development of alternatives. That derogation is due to expire on 30 September

[4] On commissioning, NSL could represent the largest single point loss of demand or generation. Particularly, including the use of Interconnector Trading Limits ("ITLs") which are similar in nature to NTCs in that they limit interconnector capacity, but which can only be applied to unallocated intraday capacity and do not attract compensation. In 2021, there was no intraday market available on NSL on which an ITL could be applied. NESO therefore required a tool that could be used at earlier timeframes and applied to already allocated volumes.

[5] The ESO Licence Condition C1.17 states "The licensee must procure all Balancing Services through market-based mechanisms and seek to maximise competition in Balancing Services procurement."

2026, however NESO sees continuing need to procure NTCs following non-market-based procedures.

On 24 July 2026, we received NESO's request for a four-year extension to the NTC derogation allowing them to continue to procure NTC beyond the expiry of the current derogation.

Decision rationale

In reaching our decision under Licence Condition C9.6, we have considered the evidence provided by NESO, stakeholder representations, and our statutory duties. The key factors which contributed to our assessment are set out below.

i. the need for NESO to have a tool of last resort for IC capacity management

NTC restrictions provide NESO with a firm means of limiting the capacity available on an IC which NESO considers necessary to ensure secure operations. NESO has demonstrated the continuing operational need for such a tool: in its submission to us, NESO identified network constraints, largest-loss risks and margin shortfalls as the circumstances for requiring a firm IC flow management capability. NESO explained that increased connected IC capacity, variability in generation output and associated forecast redispatch volumes have strengthened that need. IC stakeholders recognised the need for a firm system-security tool used *in extremis*.

We agree with NESO that it is prudent to retain NTC as a tool of last resort for managing system-security risks, at least until the introduction of a Coordinated Capacity Calculation or similar cross-border methodology is established.

ii. whether procuring NTC using market-based procedures would be 'not economically efficient'

NESO compensates[6] ICs for restrictions following the NTC Commercial Compensation Methodology ("CCM") rather than procuring restrictions through a market-based procedure. NESO considers that market-based procurement would not be economically efficient at this time and has indicated that it considers the conditions for it to become so are not likely to be present in the near future.

NESO commissioned an innovation study which looked at opportunities for a formal NTC market and expanded trading arrangements.[7] The study supported NESO's position by concluding that an NTC restriction market would be unsuitable at this time as there is limited liquidity or optionality for NESO where the need for restrictions arises.[8]

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[6] For clarity, this compensation can be negative, reflecting a payment from the interconnector to NESO. This could occur, for example, where restrictions create scarcity and drive up clearing prices.
[7] The innovation study can be found here: https://smarter.energynetworks.org/projects/nia2_neso097/
[8] Often only one or a small number of feasible providers are able to provide the service which limits the scope for effective competition.

We agree that procuring NTC restrictions through market-based procedures is not currently economically efficient. At present, a formal market would have limited competition across much of GB which could expose consumers to market-power and strategic-bidding risks.

We expect NESO to keep this conclusion under review as new ICs connect and market conditions change, especially as the innovation study showed some theoretical cases where an NTC restriction market could reduce costs.[9] NESO should also remain open to considering whether some use cases of NTCs lend themselves more readily to market-based procurement, and should work to identify the point at which moving to market-based procurement does become economically efficient (including clearly setting out the likely implementation costs of any potential market-based solution).

iii. the use of NTCs and the availability of alternative actions to NESO

NTC restrictions are a tool of last resort – that is, we consider that they should only be utilised once all other (effective) commercial market-based alternatives have been exhausted.[10] We consider that this helps to mitigate the potential harms of procuring it following non-market-based procedures and properly reflects NESO's role as a residual system balancer. We agree with NESO that it has limited access to alternative actions, particularly firm actions on ICs, and thus it is prudent to retain access to NTCs.

When NESO first introduced NTCs, their main application was to cover cases where an IC represented a loss of generation or demand that was beyond securable limits. Through development of its Dynamic Containment service, NESO no longer needs to rely on regular application of NTCs for the purpose of managing the largest loss. However, NESO does still apply NTCs to manage other system risks, yet we did not see evidence in this derogation submission of where NESO had conducted assessment of market-based alternatives to NTCs. NESO should continue working to introduce new services and / or develop existing services to ensure system security such that they do not rely routinely on non-market-based tools and / or tools of last resort. NESO should work with wider market parties to co-create such services, where appropriate.

We also consider that improved clarity within the GB NTC Calculation Policy may facilitate greater confidence in the utilisation of NTCs as a tool of last resort and allow the wider market to offer solutions to the scenarios under which NESO may otherwise limit IC flows. We are therefore directing NESO under ESO Licence Condition C9.5 to review and consult on the GB NTC Calculation Policy, including the POU, alongside this derogation letter.

Additionally, we consider that NESO may currently face a challenge in expressing and ensuring equity of application of restrictions to ICs as some ICs are on different regimes.

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[9] By allowing NESO to select the lowest-priced restrictions in instances where several interconnectors are able to resolve the same system issue.

[10] Note that there may be cases where NESO has commercial actions available, but these might not address the issue in that NESO uses an NTC to resolve, for example, actions may not help in solving constraints depending on their location.

We consider that aligning how NESO restricts IC flows would be valuable, both from a market fairness perspective and the consumer interest. We expect NESO, alongside wider stakeholders, to progress toward a common approach. We consider that NESO may utilise it's IC Framework workstream to facilitate this.

iv. the suitability of the NTC commercial compensation methodology

As there is no competitive market-based price for an NTC restriction, NESO employs a CCM[11] to provide a method of discovering an appropriate price while protecting the consumer from market-power harms. The CCM aims to use observable market and auction data to approximate the value of the restricted capacity, and, so far as reasonably practicable, to leave affected ICs financially neutral. We consider that a CCM developed in such a manner is an appropriate method of compensating parties as a proxy for market-based procedures in this situation.

However, stakeholders have routinely questioned[12] whether the CCM achieves cost neutrality in all cases, particularly with respect to how it predicts the impact of scarcity on auction clearing prices. While we consider that having a CCM in place is beneficial, further assurance is required that the methodology fully achieves its objectives. Therefore, alongside this letter, we are directing NESO under ESO Licence Condition C9.5 to review and reconsult on the CCM.

Beyond that direction, we encourage NESO to continue to review the CCM throughout the derogation period: it is important that the CCM evolves in light of operational experience, stakeholder feedback and changes to the IC landscape and wider market arrangements.

v. the transparency around the use of NTC

Our 2023 derogation decision required NESO to improve the information available to market participants on when and why NTC restrictions are used. Since then, NESO has expanded its reporting and published further information (such as reasons for NTC application covering both directions of restriction) on individual restrictions. This is a positive step as transparency is particularly important given that NTC restrictions directly limit cross-border capacity and are not competitively procured. These improvements support our decision to approve a derogation as we consider there is information provided to the market that helps to identify the purpose of each restriction (e.g. whether for constraint management, covering largest loss risk, etc.).

Nevertheless, stakeholders continue to raise concerns about the information provided on NTC restrictions. In particular, they consider that NESO does not explain individual restrictions or the criteria supporting its decisions in sufficient detail to allow for

[11] We understand that NESO has proposed some amendments to the CCM which we consider to be positive and should be implemented as soon as practicable following publication of this decision.
[12] Including through consultation ahead of NESO's latest submission to us, and in other fora.

replicability. This limits stakeholder ability to understand why NTC restrictions were required, how the restriction volumes were determined and whether their use was consistent with the GB NTC Calculation Policy and the Principles of Use governing the application of NTC restrictions contained within. We agree with stakeholders that this is important transparency that supports the functioning of the wider market.

We note that the GB NTC Calculation Policy and the Principles of Use contained within it have not been subject to a dedicated consultation process in line with ESO Licence Condition C9.2, despite forming an integral part of the specification of this non-frequency balancing service. As such, alongside this letter, we are directing NESO under ESO Licence Condition C9.5 to undertake a review and consultation of these arrangements alongside this derogation approval.

vi. the duration of the NTC derogation

In making our decision to approve this derogation request out to 30 September 2030, we considered the likely continuing operational need for NTC restrictions and the appropriate timeframe over which NESO should have access to this tool.

We recognise NESO's view that NTC restrictions will continue to be needed in maintaining system security as the electricity system evolves out to 2030. Increasing capacity from newly connected ICs and forecasts pointing towards more variable patterns of generation and increasing redispatch requirements place great importance on NESO's ability to maintain system security outside of using emergency actions.

We expect that a date of 2030, with the GB target of a clean power system and other likely changes in the operability landscape across GB and connected markets, represents a sensible latest point at which to re-evaluate the continuing need for this derogation. We also consider that a four-year derogation period provides an appropriate degree of certainty and predictability for NESO, IC operators and wider market participants compared to a series of shorter derogation periods. Shorter derogation periods could create unnecessary regulatory burden and uncertainty without materially changing the underlying operational need for NTC restrictions.

At the same time, the granting of a four-year derogation should not be interpreted as an expectation that alternative solutions will not emerge during this period or that efforts to develop such solutions should not continue. We continue to expect NESO to assess and develop feasible alternative arrangements that may reduce reliance on NTC restrictions, including market-based approaches where these become economically efficient, and to adopt such arrangements where possible. We also expect that NESO will continue to review and update NTC framework in light of continued operational experience, stakeholder feedback and the changing needs of the energy system during this four-year period. This is consistent with the expectations previously set out as part of our 2023 decision.

For the avoidance of doubt, the Authority may, after consulting NESO, review, amend, or revoke this derogation before its expiry.

Decision and next steps

We accept NESO position that NTC is currently required as a tool of last resort for ensuring system security and understand the restrictions faced in procuring this tool with economic efficiency using market-based procedures, therefore we hereby:

- grant NESO a derogation under ESO Licence Condition C9.6 from the requirements to procure NTC follow market-based procedures as required under ESO Licence Condition C1.17.

Our decision to derogate NESO from this requirement of C1.17 is effective as of 1 October 2026, on expiry of the derogation currently in place. This derogation is **valid until 30 September 2030**. For clarity, should NESO see continued need for NTCs to be procured following non-market-based procures beyond this date, a further derogation would need to be requested.

If an alternative to NTC (such as implementation of a Coordinated Capacity Calculation under TCA arrangements) is established within this period, we would review whether this derogation is still required.

We further expect NESO to continue taking steps which improve transparency around NTC use. Finally, NESO should continue to provide evidence to us and the wider market on where it is developing alternative solutions which reduce reliance on non-market-based balancing options throughout the period of derogation.

If you have any questions about the contents of this letter, please contact Zong Yan (Zong.Yan@Ofgem.gov.uk).

Yours sincerely,

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For and on behalf of the Gas and Electricity Markets Authority