



Making a positive difference
for energy consumers

System Operators, Transmission
System Owners, Generators,
Suppliers, Traders, Customers
and Other Interested Parties

Our ref: 106/13
Direct Dial: 020 7901 7000
Email: wholesale.markets@ofgem.gov.uk

Date: 27 June 2013

Dear Colleagues

Consultation on the potential requirement for new balancing services by National Grid Electricity Transmission plc (NGET) to support an uncertain mid-decade electricity security of supply outlook

In our 2013 Capacity Assessment report, published today, we set out the risks to electricity security of supply in Great Britain (GB) and the uncertainties around the outlook for both supply and demand.¹ In light of these uncertainties, the Department of Energy and Climate Change (DECC), NGET and Ofgem² have been working together to explore options that would provide consumers with additional safeguards against the increased risk to mid-decade security of supply. All three organisations agree that it is prudent to consider the case for NGET procuring additional balancing services given the uncertain security of supply outlook.

We are seeking stakeholders' views on the issues we raise in this letter. Please send your views on our consultation by 26 July 2013 to wholesale.markets@ofgem.gov.uk.

In parallel, NGET has agreed to publish an informal consultation on the design, procurement and dispatch of two potential new balancing services.³ We encourage stakeholders to respond to NGET on the questions in that consultation.

Electricity security of supply outlook

Our 2013 Electricity Capacity Assessment report estimates that de-rated electricity capacity margins are likely to decrease faster in the next few years than was expected in our 2012 report. It is difficult to provide a firm view given the significant uncertainties around the outlook for both electricity supply and demand. Nevertheless, our report suggests that the risk of any disruption in the middle of this decade is likely to increase appreciably from current near zero levels. We do not consider that any disruptions to consumers' supply are imminent or likely, providing the industry manages the problem effectively.

¹ <http://www.ofgem.gov.uk/Markets/WhlMkts/monitoring-energy-security/elec-capacity-assessment/Pages/index.aspx>

² In this document the terms "Ofgem", "we", "us", and "the Authority" are used interchangeably. The Authority is the Gas and Electricity Markets Authority.

³ <http://www.nationalgrid.com/uk/Electricity/AdditionalMeasures>

Electricity Market Reform (EMR)

Government has today published further details on the design of the Capacity Market within EMR and has made an announcement that it will hold the first capacity auction in 2014, for delivery in 2018/19. The EMR Capacity Market aims to incentivise industry to address security of supply in the medium term, but is not able to bring forward investment in new capacity in time to offset the projected short-term tightening of de-rated margins in the middle of this decade.

Measures to support mid-decade security of supply through additional balancing services

Today, NGET is publishing an informal consultation seeking views on the emerging design, procurement and use of two potential new balancing services. These services would aim at providing additional reserves to support NGET in balancing the GB electricity transmission system from as early as 2014/15.⁴ The first potential product, Demand Side Balancing Reserve, offers a new opportunity for the demand side to participate in the provision of balancing services. The second, Supplemental Balancing Reserve, is aimed at generators and large users. The intention is that these would be kept out of the market and only be available to NGET as System Operator. NGET would in principle dispatch these reserve products after existing relevant balancing services, but prior to taking emergency actions such as involuntary customer disconnections.

We have not made a final decision on whether there is a need for additional support to security of supply. However, given the current uncertainties, we are of the view that it is prudent to consult on whether we should consider approving any changes to NGET's Balancing Services Procurement Guidelines, so that NGET could be in a position to procure these products in a timely manner if this is necessary.

These balancing services would not provide a substitute to Government's EMR Capacity Market, or indeed Ofgem's proposed reform of cash out arrangements. These new products do not address the challenges of incentivising the industry to invest in providing adequate security of supply. Rather, they would provide a further tool to assist NGET in balancing the system to avoid disruption to customer supply against a background of narrowing margins.

Considerations relevant to Ofgem's decision

According to its transmission licence, NGET cannot procure any new balancing services without Ofgem approval for modifications to its Balancing Services Procurement Guidelines and other associated documents.⁵

When considering whether to give such approval, Ofgem will act in accordance with its powers and duties. The Electricity Act 1989 requires the Authority, when carrying out its functions, to protect the interests of existing and future electricity consumers, and those interests include "*their interests in the security of supply of electricity to them*". The Authority also has a duty to carry out its functions in the manner "*best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors*".

The Authority will also consider whether NGET's proposals for the procurement and use of the new balancing services are transparent and non-discriminatory, as required by NGET's licence.

⁴ A pilot of the demand side balancing reserve may run before 2014/15

⁵ Balancing Principles Statement, Balancing Services Adjustment Data Methodology Statement, Balancing Services Volume Data Methodology Statement and System Management Action Flagging Methodology Statement

We set out below the factors that we consider important when assessing any proposed changes to documents to allow NGET to procure the potential new balancing services:

- a) NGET's procurement must be economic and efficient and the products must represent value for money to electricity consumers.
- b) NGET's product design and proposed use of the new products must minimise unintended consequences to market participants and the operation of the market.
- c) NGET's procurement process must be objective and transparent.

We are mindful that there would be specific risks associated with the procurement of these new products by NGET, and we must give regard to these factors when making a decision. These include mitigation against any potential distortion of the market. For example, the proposals could lead to incentives for plant to close in pursuit of reserve contracts. We must also be mindful that the products deliver appropriate levels of reliability to ensure value for money to consumers.

There is currently no electricity reliability standard in GB. We anticipate that DECC will publish a draft reliability standard in the summer as part of its draft EMR delivery plan, with a final decision to follow in December. We understand this will be in the form of a Loss of Load Expectation — the expected number of hours per year when demand exceeds supply. Ofgem and DECC are currently undertaking a joint study into Value of Lost Load (VoLL). Our current intention is to publish that study alongside our Electricity Balancing Significant Code Review draft policy decision. We would take into account Government's reliability standard and the VoLL estimates in any decision on whether to approve NGET's methodology for determining the volume and price of any new balancing services it procures.

Questions

This letter invites views from all interested stakeholders on the issues raised above. In particular, we're seeking your views on the following questions:

- 1. Do you agree with our assessment regarding the risk to mid-decade electricity security of supply?**
- 2. If so, do you agree with our view that it is prudent to consider the development by NGET of additional balancing services, which NGET would procure and use if there is a need for them?**
- 3. Do you agree with our assessment of the key factors we should have regard to when considering whether to approve any changes to NGET's Balancing Services Procurement Guidelines and associated documents?**

We also encourage stakeholders to respond to NGET on the questions set out in its informal consultation document about the design, procurement and dispatch of the two potential new balancing services.

Next steps

We will consider responses to this consultation over the summer, during which time we will continue to monitor the security of supply outlook. We will continue to work closely with NGET and DECC as appropriate on this issue.

Subject to the outcome of this consultation and NGET's informal consultation it will publish today, we will develop a timeline for the consideration of any necessary changes to NGET's Balancing Services Procurement Guidelines and associated documents that NGET may propose. Any such changes will first need to be the subject of a further NGET consultation later in the summer. Our initial view is that Ofgem would consider any proposed

amendments in the autumn. This would enable NGET sufficient time to develop, conduct and conclude any procurement activities over the winter but these services would not be for delivery until winter 2014/15.

The security of supply outlook as set out in our 2013 Capacity Assessment Report highlights the importance of Ofgem making progress to improve electricity cash out arrangements through our Electricity Balancing Significant Code Review and to ensure timely moves to implement our further integration into the European electricity market. NGET's procurement of additional balancing services, should it occur, would not be a substitute for continuing with these and other initiatives to improve the working of the GB electricity market.

We welcome stakeholder responses to the above questions in this letter. Please send any comments you may have to wholesale.markets@ofgem.gov.uk by 26 July 2013.

If you have any comments or questions on the content of this letter, please send an email to wholesale.markets@ofgem.gov.uk.

Yours sincerely,

Rachel Fletcher
Interim Senior Partner, Markets