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Date: 19 December 2013

Dear Colleagues

Decision to accept National Grid Electricity Transmission plc (NGET) application to introduce two new balancing services and subsequent informal consultation on funding arrangements

Background

Our 2013 Electricity Capacity Assessment report set out the risks to security of supply in Great Britain and the uncertainties around the outlook for both supply and demand.[1] We do not think any disruptions to consumers' supply are likely, providing the industry manages the issue effectively. The Department of Energy and Climate Change's (DECC) Capacity Market aims to incentivise industry to address security of supply in the medium term, but it is not able to bring forward investment in new capacity in time to offset tightening margins in the middle of the decade. As set out in our June 2013 consultation letter in the light of these uncertainties, DECC, NGET and Ofgem all agreed that it is prudent to consider the case for additional balancing services which could assist NGET in balancing the system should these risks eventuate.[2] Respondents to our consultation were broadly supportive of the need to consider extra tools and the factors we would have regard to in considering whether to approve any application from NGET.

NGET's application

On 18 November 2013, following its June and October consultations, NGET made an application to Ofgem to enable it to introduce two new balancing services to support it in balancing the system from as early as winter 2014/15.[3] NGET's application proposed modifications to four of the five documents it is required to have in place by Standard Condition C16 of its electricity transmission licence which governs their balancing services procurement activity (the C16 Documents).[4] Specifically, NGET sought to introduce amendments relating to two new balancing services:

[1] https://www.ofgem.gov.uk/publications-and-updates/electricity-capacity-assessment-report-2013
[2] Our June consultation and stakeholder responses to it are available at: https://www.ofgem.gov.uk/publications-and-updates/consultation-potential-requirement-new-balancing-services-national-grid-electricity-transmission-plc-nget-support-uncertain-mid-decade-electricity-security-supply-outlook
[3] NGET's June and October consultations and other supporting documents are available at: http://www.nationalgrid.com/uk/Electricity/AdditionalMeasures/
[4] NGET is required by Standard Condition C16 of its electricity transmission licence, to prepare five different types of statement dealing with aspects of its procurement of balancing services in a form approved by the Authority. Prior to modifying any of these documents, NGET must first consult on those proposed amendments and receive the approval of the Authority for those amendments. In order to give effect to its current proposals for DSBR and SBR, NGET proposed amendments to four of the five C16 Documents: the Balancing Principles Statement;

- Demand Side Balancing Reserve (DSBR): offers a new opportunity for the demand side to participate in balancing services by shifting or shedding demand when instructed by NGET as the System Operator;

- Supplementary Balancing Reserve (SBR): a service primarily targeting generators that will be held outside the wholesale market and for use only as a last resort in winter periods of high demand.

Assessment of impacts

NGET's application to modify the C16 Documents required the Authority to decide to either accept or reject that application. As set out in our June open letter, we are mindful of specific risks associated with the procurement of these new services by NGET, and we published a draft impact assessment (IA) on 22 November 2013.

That assessment used NGET's application and publicly available information to set out a combination of qualitative and quantitative analysis of the potential impacts, including costs and benefits, of these new balancing services on competition and consumers. The draft IA set out our initial views on the costs and benefits associated with NGET's proposed new balancing services. Overall, respondents broadly agreed with us as to the potential impacts on competition and risks and unintended consequences. Today, as an annex to this decision letter we publish a final IA that incorporates responses to stakeholders' comments that were taken on board in the Authority's decision.

The Authority's decision

The Authority accepted NGET's application to introduce amendments to the C16 Documents enabling it to procure DSBR and SBR for the following key reasons. In reaching a decision, the Authority was required to do so with a view to protecting the interests of existing and future consumers. In this matter, this required the Authority to consider two questions:

a) whether there was a concern that needed to be addressed in the interests of consumers; and

b) whether approval of the proposed new services as a means of addressing that concern, was in the interests of consumers.

Firstly, the Authority maintains the view that the mid decade security of supply outlook remains uncertain, with asymmetric downside risks. The Authority view is that permitting NGET additional safeguards to help it balance the system if margins tighten is in the interests of consumers.

Secondly, the Authority thought that the introduction of DSBR and SBR were appropriate safeguards to address the above concern, but remained mindful of the associated risks of their introduction.

Thirdly, after considering stakeholders' responses to our draft IA and our own further analysis the Authority noted that measures were being developed to mitigate the risks associated with the new products.

The Authority saw NGET's development of robust methodologies for determining the volume of products to procure in any year and for determining the overall cap that should be applied to the products, as key to mitigating several of the risks identified in the draft IA. This will form part of the funding arrangements for DSBR and SBR. We believe that these arrangements will ensure NGET's procurement and use of the new services is economic and efficient, objective and transparent, and provides value for money to

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Balancing Services Adjustment Data Methodology Statement; Procurement Guidelines; and the System Management Action Flagging Methodology Statement.

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consumers, whilst minimising unintended consequences and distortions. This will apply to all aspects of the services from determining the volume of each service to procure, to ensuring any procurement process is as competitive as possible and minimises the "all in" costs of procuring the services, as well as the efficient use of the services themselves.

As such, the assessment of impacts did not raise concerns that were sufficient to outweigh the interest of consumers in approving the relevant amendments to the C16 Documents for both DSBR and SBR.

Therefore, after taking account of all relevant matters (including the criteria set out in our June open letter) and the regulatory framework, the Authority was of the view that there was a concern that needed to be addressed in the interests of consumers, and that it was in the consumers' interests for NGET to have the ability to procure DBSR and SBR in order to address that concern.

This decision enables NGET to procure DSBR and/or SBR. This provides consumers an additional safeguard against the increased risk to mid-decade security of supply if those risks eventuate. It does not mean there is a definitive need to procure let alone utilise either DSBR or SBR.

Our initial proposals for funding arrangements for DSBR and SBR

The Authority's decision to accept NGET's application requires that we consider the funding arrangements for DSBR and SBR as NGET's licence does not currently include any such provisions. As set out above, we consider that having effective funding arrangements in place will help mitigate the risks associated with these products. Alongside this letter we have published an informal consultation setting out our initial proposals on the funding arrangements including a draft licence condition.[5] These arrangements would apply up to and including 31 March 2016.

Next steps

We would welcome stakeholder responses to the questions in our initial proposals for the funding arrangements for DSBR and SBR. Please send any comments you have to soincentive@ofgem.gov.uk by 16 January 2014. We will be hosting a stakeholder workshop on our initial funding proposals on 8 January. Further details and an invitation to that event will be available soon.

Yours sincerely,

Rachel Fletcher
Interim Senior Partner, Markets

[5] https://www.ofgem.gov.uk/publications-and-updates/funding-arrangements-new-balancing-services-initial-proposals

Annex: National Grid's Proposed New Balancing Services: Final Impact Assessment

On 22 November 2013 we published and consulted on a draft IA to assist the Authority in its decision on whether to accept or reject National Grid Electricity Transmission plc's (NGET) proposed amendments to the C16 Documents (see further above) enabling it to procure either or both new balancing services. The consultation closed on 6 December 2013.

Seven generators and the UK Demand Response Association responded. The Authority considered their responses to the draft IA when it decided to approve NGET's proposal (see the decision letter for details on this decision). The draft IA and stakeholders' non-confidential responses are published on the consultation website.[6]

Our draft IA considered the impacts of NGET's proposal under four headings: impacts on competition, risks and unintended consequences, impacts on consumers and other impacts. The respondents discussed only impacts on competition, risks and unintended consequences. We have received no further information since our draft IA which has given us reason to change our view on the remaining impacts.

The respondents broadly agreed with us regarding some of the potential effects on competition and potential risks and unintended consequences set out in the draft IA. Stakeholders raised some issues which we had not covered in our draft IA. In particular, they commented on whether to have a sunset clause or review, on how the services should be reflected in changes to cash-out arrangements, and on the proposal not to require SBR suppliers to hold transmission entry capacity rights (TEC). They also commented on some details of the DSBR. The Authority noted our draft IA showed that the trade-off between costs and benefits was likely to be finely balanced. It considered stakeholders' responses and our own updated analysis and thought that the outlook for the mid decade remains uncertain and that the risks are asymmetric. The Authority also noted the important role the funding decision will play in helping to mitigate some of the risks we and stakeholders have identified. The Authority concluded that the benefits to consumers were sufficient to outweigh the negative impacts NGET's application.

We summarise the main points below, in turn for overarching issues, comments on the SBR and comments on the DSBR. For each, we set out the issue raised, and our view on the issue.

General issues raised

Alternatives to the proposed new services: Two generators thought that the short term operating reserve (STOR) would be a possible alternative and might be cheaper than SBR. Another one suggested that an earlier introduction of the capacity market which is part of Government's Electricity Market Reform (EMR) would be preferable. The Authority considered these comments. Moreover, it noted NGET's arguments that it did not see STOR as a preferable alternative due to concerns that included potential distortions to the market. The Authority thought that a STOR product was also likely to have some potential negative impacts. In addition, it noted that it did not have the existing power to direct NGET to bring forward a STOR proposal nor to direct the design of the services, or alternatives. The Authority concluded there was nothing in the responses on the STOR issue that would change its view on the DSBR and SBR services.

Time limit for these services: A number of generators thought that a time limit was necessary to minimise distortions and expressed a preference for a sunset clause instead of the proposed review of the services in 2016. They argued that if Ofgem were to agree with NGET's proposal for a review as opposed to a sunset clause, the review should be by

[6] The draft IA, non-confidential responses and the decision letter are available here: https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/system-operator-incentives; One stakeholder's response was confidential.

Ofgem, as opposed to NGET. We agree with NGET that a review is preferable to a sunset clause. While NGET is targeting the DSBR and SBR products at the winters of 2014/15 and 2015/16, we note it is possible that the new balancing services may be needed beyond this date. For this reason, we do not think an automatic sunset clause is appropriate. Ofgem plans to review these services in 2016 with NGET. At that point Ofgem could withdraw funding approval for these services if we felt that they were no longer needed, or if we felt that the design of the services needed to be revisited.

Imbalance arrangements/cash-out prices: Several generators said that using the new balancing services should be factored into cash-out prices. One of these was concerned that rushing the code modifications, needed to make these changes, in the event of an SBR tender might be problematic, but did not comment on this detail further. They highlighted that modifications should be made to avoid large and possibly unpredictable changes in the cash-out prices. We agree that modifications are needed to incorporate the new balancing services and that consideration should be given to these modifications in a separate process in addition to the electricity balancing significant code review.

Transparency of procurement: One generator raised the concern that the publication of the SBR procurement volume pre-tender may lead to a price shock since this volume may differ significantly from the volume expected by market participants. In any case this volume would be market sensitive information and would affect prices. Therefore, NGET should be required to announce which volume it plans to tender for (as well as how much is offered and which plant is successful). Others pointed out that the procurement tenders would need to be transparent. Some generators argued that transparency would also be helpful to ensure low procurement costs. We believe it is important that NGET's procurement process is transparent, and that the methodology NGET will use to establish the volumes to procure is also transparent. Ensuring that NGET has a clear process for establishing the volumes it will procure, in an economic and efficient manner, will form a key part of our considerations on the appropriate funding arrangements. We are consulting on these arrangements alongside this letter.

Cost recovery: One generator suggested that the costs of these services should be treated as a targeted cost in the balancing service incentive scheme rather than a pass-through. We will consider the treatment of those costs in our consultation and decision on funding arrangements.

Issues raised regarding SBR

Additionality: In its submission to us NGET dropped its earlier proposal that SBR suppliers should provide a declaration from their board of directors that the SBR plant would otherwise not participate in the markets for electricity or balancing services. Only one generator welcomed dropping this declaration. Several others thought that the proposed design of SBR would not ensure that this service would be procured from plant that is currently not in the main market. They thought some SBR plant might leave the main market leading to an increase in electricity prices. They also pointed out that the resulting further tightening of margins might require further procurement of these balancing services (see the more detailed discussion in section 3 of the draft IA). We agree it is possible that plant currently in the market may bid for SBR contracts. These concerns are partly mitigated by the proposed volume cap and a clear methodology to determine the procurement volume. We plan to continue to engage with NGET on this methodology as part of discussions on the funding arrangements. We note that NGET has retained its proposal that plant holding an SBR contract cannot participate in the main market for the duration of that contract.

Distortion of competition: One generator stressed that non-additionality would imply that some plant would leave the main market leading to rising wholesale prices and thus a distortion to the electricity wholesale market. Other generators argued the reverse, that this service would undermine the economics of other plants in the market by dampening peak prices and by replacing some maximum generation. Moreover, the possibility that SBR may not be despatched as measure of last resort concerned respondents (again we

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discuss this in section 3 of the draft IA). NGET's proposal confirms that SBR would only be used as a "last resort" tool (before emergency measures) in circumstances where it was already clear to NGET that it would be unable to balance supply and demand based on bids and offers from the balancing market. If NGET did not follow this process, Ofgem could disallow funding of any warming and utilisation costs on the basis of it not being economic and efficient. NGET has confirmed that for operational reasons, it is likely that SBR plant would be called to warm before it is actually needed, but that plant would not need to generate during this warming period.[7]

Transmission Entry Capacity rights: Generators pointed out that NGET's intention not to require TEC from SBR plant[8] would imply that other TEC holders would effectively pay for that SBR plant's TEC in such cases. They suggested using alternative existing TEC products or procuring SBR only from plant not holding TEC. We consider that this argument must be balanced against the need to ensure the tender process is as liquid (and therefore competitive) as possible; the fact that SBR plant will be expected to run only very rarely; and the fact that SBR plant will be prevented from participating in the main market for the duration of their contracts.

Issues raised regarding DSBR

The few respondents commenting on this service all saw room for improving its design.

Take-up: One respondent commented that poor design may lead to poor take-up and/or a poor response on despatch. It expressed concern that this might tarnish the reputation of demand-side products. We discuss this in the draft IA at paragraphs 3.7-3.10.

Payments: A generator thought that the values at the bottom of the range of utilisation payments would be too low. They argued that this would create a conflict of interest with existing services in the balancing mechanism which would be priced higher. It suggested that the payments for DSBR should be benchmarked against other balancing services and that payments should be made over the delivery period rather than up front. A demand side response organisation commented that programmes with an emphasis on availability payments rather than delivery payments would typically be more successful. We note that the level of payments available to those bidding for DSBR contracts is relevant to the consultation on funding that we are launching today.

Demand baseline: A demand side response organisation noted that DSBR was designed to support new demand response which would require investment. It suggested that this could be resolved by changing the demand baseline (presumably to generate higher payments to DSBR providers helping to finance investments). In addition, a change to the baseline would ensure that suppliers of DSBR could participate in other services, such as triad avoidance, which would, the organisation argued, reduce the costs of demand side services to NGET and thus to consumers. We will work with NGET during the consultation on funding to ensure that details of their procurement process meet the economic and efficient test including delivering value for money for consumers.

Additionality: A generator said that suppliers of DSBR should participate in this service on an exclusive basis and that there should be clear rules for their participation in other energy-related services. We noted that NGET designed DSBR to achieve this.

Premium flexible STOR: A generator pointed out that NGET intended to procure this new STOR product from April 2014. The Authority considered this in its decision as suggested by the generator.

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[7] In its proposal NGET clarifies that it does not expect to deplete its operating reserves and frequency response reserve before despatching SBR, as this could remove its ability to manage system disturbances thus making the transmission system insecure. These alternative balancing services would continue to be required to deal with any short-term operational issues that might arise (regardless of the de-rated margins).
[8] A generator thought that a CUSC amendment would be required to implement this.

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Transparency: Lastly, a stakeholder was concerned that market participants might not be able to observe the volume of DSBR despatched. NGET intend to publish the volumes, price and duration of any DSBR tranche that was despatched, but did not indicate the timings of this publication in its application. Moreover, this concern will likely be addressed in considering amendments to the cash-out arrangements discussed above.

Respondents' views regarding the Authority's decision

Two generators supported approving NGET's application, two opposed approving the SBR service and one preferred to leave it to the market to address the expected tighter de-rated margins mid-decade (they argued that policy measures such as the new services would undermine the workings of the market). The remaining respondents did not express a preference.

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