

Funding arrangements for new balancing services: Initial Proposals

Consultation

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Overview:

In November 2013, National Grid Electricity Transmission (NGET) made an application to Ofgem to introduce two new balancing services: the Supplemental Balancing Reserve (SBR) and Demand Side Balancing Reserve (DSBR). These services provide NGET with additional tools to help balance the system in anticipation of tighter generation capacity in the middle of this decade. The Authority approved these new tools in December 2013.

This document sets out our initial proposals for the funding arrangements which will allow NGET to recover the economic and efficient costs it incurs procuring and utilising these services, should they be needed. The document sets out how we believe that these arrangements will protect the interests of consumers, and seeks views from stakeholders.

We propose that these funding arrangements will apply up to 31 March 2016. This will allow us to review the arrangements if they are required beyond this date.

Context

This summer, the Department of Energy and Climate Change (DECC), the Office of Gas and Electricity Markets (Ofgem) and NGET agreed that it was prudent to consider the case for NGET to have the option to procure additional balancing services given the uncertain security of supply outlook. Stakeholder responses to our consultation broadly supported our position. NGET designed and consulted on two services: the Supplemental Balancing Reserve (SBR) and the Demand Side Balancing Reserve (DSBR). Following two consultations, NGET applied on 18 November 2013 to modify its procurement guidelines and associated documents to allow it to procure these services. The Authority decided to approve NGET's modification in December 2013.

The existing system operator incentives are set out in NGET's licence conditions. Within these licence conditions, there is currently no mechanism to allow NGET to recover the costs incurred for the procurement and use of any SBR or DSBR services. This consultation sets out our initial proposals on the funding arrangements for these services to allow NGET to recover economic and efficient costs within the period up to, and including 31 March 2016, should the services be needed.

Associated documents

- Decision to accept National Grid Electricity Transmission plc (NGET) application to introduce two new balancing services and subsequent informal consultation on funding arrangements: <https://www.ofgem.gov.uk/ofgem-publications/national-grid%E2%80%99s-proposed-new-balancing-services-decision-letter>
- National Grid's proposed new balancing services: draft impact assessment: <https://www.ofgem.gov.uk/ofgem-publications/84629/nationalgridsproposednewbalancingservices-draftimpactassessment.pdf>
- 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: <https://www.ofgem.gov.uk/ofgem-publications/75221/consultation-potential-requirement-new-balancing-services-support-uncertain-mid.pdf>
- Electricity Capacity Assessment Report 2013: <https://www.ofgem.gov.uk/ofgem-publications/75232/electricity-capacity-assessment-report-2013.pdf>

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Executive Summary

In June 2013, the Department of Energy and Climate Change (DECC), the Office of Gas and Electricity Markets (Ofgem) and National Grid Electricity Transmission (NGET) agreed that it was prudent to consider the case for new balancing services to help NGET to balance the system in the mid-decade period given the uncertain security of supply outlook. In our informal consultation, stakeholders broadly agreed that it would be prudent to consider the introduction of these new tools.

NGET has designed two products, the Supplemental Balancing Reserve (SBR) and the Demand Side Balancing Reserve (DSBR) which it considers should be available to it to help it balance the system. SBR is a supply based balancing service that is available for NGET between 6 am and 8pm on non-holiday weekdays between November and January. SBR providers will not be able to participate in the market for the duration of their contracts. DSBR is a demand-side service that is targeted at non-domestic consumers offering payments to reduce their demand as a last resort balancing service in situations of system stress.

The Authority¹ approved NGET's proposals for both services in December 2013. This approval enables NGET to procure and utilise them. However, no arrangements have yet been set up to fund the costs that NGET incurs in relation to these services. This document sets out our proposals for changes to NGET's special licence conditions to allow NGET to recover costs where they are economic and efficient.

Our proposal

Our proposed funding arrangements will target our approach towards different components of costs that NGET expects to incur which will include internal and external costs² associated with procurement and utilisation of these services.

The external cost components of SBR and DSBR could include availability, set up, testing, pre-utilisation warming and utilisation costs. Availability, set up and testing costs will be more certain upfront, ie at the end of NGET's contracting processes. Warming and utilisation costs can only be ascertained after an instruction has been issued by NGET's control room, and so are less certain. We propose to treat the cost components slightly differently based on the level of certainty available in an approach called a 'targeted efficiency check'.

Internal costs

The RIIO-T1³ price control includes allowances for the internal costs of the SO and has set these for NGET for the 8 year period to March 2021. The RIIO framework includes a provision for a mid-period review of output requirements. The scope of the mid-period review is restricted to changes to outputs that can be justified by clear

¹ The terms 'Ofgem' and 'the Authority' are used interchangeably. Ofgem is the Office of Gas and Electricity Markets. The Authority is the Gas and Electricity Markets Authority.

² Internal costs are considered to be those costs relating to staffing, I.T services, etc. External costs are those relating to NGET's contracting and procurement of services.

³ For more information on RIIO-T1 see: <https://www.ofgem.gov.uk/electricity/transmission-networks/network-price-controls/riio-t1-price-control>

changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.

Procurement volume and approach, availability and testing costs

NGET will need to identify a cap on the volume of services that can be procured in total which will require approval by the Authority. NGET will also need to identify the volume of services that it would need to procure to meet the Government's reliability standard within this cap. Again, the Authority will need to approve the methodology used to identify this volume requirement.

NGET will need to demonstrate to us that its procurement processes have been economic and efficient. It will need to provide evidence that it has followed best practice to encourage competition for service provision and has only accepted tenders which it can demonstrate have a benefit for consumers.

For availability/set up and testing costs, we propose that NGET is allowed to recover all of the costs incurred subject to an annual efficiency check by the Authority. The Authority's decision of whether to disallow any costs would be based on a set of ex-ante principles that form part of this consultation. NGET would need to provide supporting evidence to demonstrate that it has adhered to these principles in order for all of the costs to be passed through. Where NGET is unable to demonstrate that it has adhered to these principles, the Authority may disallow any relevant costs.

Pre-utilisation warming and utilisation costs

For pre-utilisation warming and utilisation, our "default" expectation from a funding perspective is that NGET would not need to incur any costs given that the products are reserved as last resort services. If NGET incurs costs here, it should apply to the Authority to allow it to recover those costs. NGET's application should provide evidence demonstrating that it has adhered to the approved methodology for how it would warm and utilise any available services. As long as NGET is able to demonstrate its compliance with the principles and methodology, the Authority will enable it to recover the relevant warming and utilisation costs.

Benefits of our proposal to consumers

We believe that the 'targeted efficiency check' approach provides the optimum regulatory framework with which to fund these new services. It protects consumers from windfall gains and losses by avoiding the requirement for a cost target which would be difficult to set due to a lack of historic data. It is also designed to mitigate potential unintended consequences of the services and provide transparency to both NGET and the industry on the principles that the Authority will use to determine whether it will disallow or allow NGET to recover the costs of these services.

We ask stakeholders for their views on our proposals for funding arrangements and on the ex ante principles on which we propose to base the Authority's assessment of costs.

1. Introduction and Overview

Chapter Summary

In this chapter we summarise our initial proposals and set out the next steps following this consultation.

Question box

Question 1: Do the draft licence conditions published alongside this document appropriately reflect our initial proposals?

Question 2: Do you agree with our assessment that a financial incentive would not be fit-for-purpose at this time?

The new balancing services

1.1. National Grid Electricity Transmission (NGET) is the system operator (SO) for Great Britain (GB). As SO, NGET plays a fundamental role in the functioning of the GB electricity market as it is responsible for balancing the electricity system on a continuous basis. To do this, NGET buys and sells energy and procures associated balancing services.

1.2. The C16 documents⁴, sets out among other things the kind of balancing services that NGET may be interested in procuring. If NGET wishes to amend this framework, it needs to consult on its proposed amendments with industry and submit its proposals to the Authority. NGET may not bring the proposed changes to the statement into effect until a period of 28 days has lapsed (starting from the date the proposed changes were submitted to the Authority) unless the Authority directs NGET not to make the proposed revision or directs NGET to make the changes on an earlier date.

1.3. NGET developed two products, the Supplemental Balancing Reserve (SBR) and the Demand Side Balancing Reserve (DSBR). SBR is a supply based balancing service that is available for NGET between 6 am to 8pm on non-holiday weekdays in the months of November through to January. SBR providers are not able to participate in the market for the duration of their contracts. DSBR is a demand-side service that

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, including the kinds of balancing services it may be interested in procuring, in a form approved by the Authority (the C16 Documents). Where NGET wishes to modify any of the C16 Documents, for example in order to enable it to procure a new kind of balancing service, it 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 SBR and DSBR, NGET has proposed amendments to four of the five C16 Documents: the Balancing Principle Statement; Balancing Services Adjustment Data Methodology Statement; Procurement Guidelines; and the System Management Action Flagging Methodology Statement.

offers non-domestic consumers payments to reduce their demand as a last resort balancing service in situations of system stress.⁵

1.4. Following two consultations, NGET has applied to include both the SBR and DSBR services in its procurement guidelines. The Authority approved NGET's proposals for the inclusion of both services in December 2013.

Initial proposals on funding arrangements

Internal costs: RIIO-T1 mid scheme re-opener

1.5. The RIIO-T1 price control includes allowances for the internal costs of the SO and has set these for NGET for the 8 year period to March 2021. The RIIO framework includes a provision for a mid-period review of output requirements. The scope of the mid-period review is restricted to changes to outputs that can be justified by clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users. The review will start with the publication of a consultation setting out potential issues that may be relevant for triggering the review.

External costs: The need for new funding arrangements

1.6. In NGET's current licence conditions which apply Ofgem's balancing services incentive scheme (BSIS), no provisions are included for the funding of the SBR and DSBR services. As a result, any procurement of SBR and DSBR would worsen NGET's performance against the incentives and result in a loss to NGET. Hence, there would be a disincentive for NGET to procure and utilise SBR or DSBR since NGET will suffer a direct penalty for doing so.

1.7. We therefore propose amendments to NGET's licence to allow funding for economic and efficient costs which are incurred by NGET in procuring and using these services. We have considered the optimum arrangements that would protect consumers and mitigate unintended consequences of the services while providing as much transparency as possible to NGET and industry regarding how we will evaluate the costs incurred.

⁵ Further information on the characteristics of each product can be found in NGET's report: SBR <http://www.nationalgrid.com/NR/ronlyres/28E4E307-45CB-42A1-B1CC-06D0F8F6E7F7/63264/SBRReportFinal181113.pdf> and DSBR <http://www.nationalgrid.com/NR/ronlyres/3F8C2A41-F3D7-4847-9CC2-1788F4ADD16D/63265/DSBRReportFinal181113.pdf>.

Our proposals for new funding arrangements

1.8. For all the balancing services covered under BSIS, there is previous knowledge of the costs that NGET is likely to incur to procure and utilise these services. This provides a dataset on which a target can be set against which NGET's actual out-turn costs can be compared. We refer to this approach to funding balancing services activities as 'financial incentives'. We normally like to use financial incentives to align NGET's interests with those of consumers. A financial incentive provides NGET with the opportunity for a return and with the risk of loss depending on the level of costs it incurs. Any savings are shared between NGET and consumers. In the following paragraphs we explain why we believe a financial incentive is inappropriate for these services and we set out our proposal for the use of a 'targeted efficiency check'.

1.9. Both SBR and DSBR are new, untested services. As such, there are no previous tenders or cost information on which to base any analysis on expected costs. Neither do we have any historical information on the volume of each service that NGET may need to procure and how often these services might be used. This creates a risk that a financial incentive (ie setting a target) may not be appropriately set leading to windfall gains or losses and poor incentives on NGET if it does hit any cap or floor⁶ (which would be a realistic possibility). Due to these risks, we do not believe it would be in consumers' best interests to set a financial incentive on these services at this time.

1.10. NGET's SBR and DSBR services are targeted at 2014/15 and 2015/16 and NGET does not currently envisage needing to procure these services beyond that time. In its Supporting Report to the Authority⁷ NGET has committed to review the need for both products. If we and NGET conclude that the SBR and DSBR are still needed, we may seek to incorporate our knowledge from the first two years to consider the design of a financial incentive for both SBR and DSBR

1.11. We are proposing a 'targeted efficiency check' approach to regulate both services for the period until 31 March 2016. The approach is targeted because it recognises the different cost components of these services and identifies tailored and specific upfront principles that will then be used in our ex-post assessments of economy and efficiency.

1.12. The cornerstone of this approach is the tailoring of specific ex-ante principles that NGET will have to meet before being able to pass-through the costs to consumers. We believe that by consulting industry on up front principles, we will help

⁶ A cap or floor would be upper and lower limits for gains or losses NGET makes against a financial incentive target. We use them when setting financial incentives to reduce the magnitude of risk of windfall gains and losses to NGET and to consumers.

⁷ NGET's Supporting Reports to the Authority
<http://www.nationalgrid.com/NR/rdonlyres/28E4E307-45CB-42A1-B1CC-06D0F8F6E7F7/63264/SBRReportFinal181113.pdf> and
<http://www.nationalgrid.com/NR/rdonlyres/3F8C2A41-F3D7-4847-9CC2-1788F4ADD16D/63265/DSBRReportFinal181113.pdf>

protect consumers from the risk of over-procurement and unintended consequences while maximising transparency and confidence to NGET and the industry. We discuss these ex-ante principles further in the next chapter.

1.13. We include more detail on our targeted efficiency check approach in chapter 2 of this document.

Next steps

1.14. In addition to this consultation, we will hold a stakeholder workshop on 8 January 2014. At this workshop we will seek views on our approach and the ex-ante principles that will guide our ex-post assessments. If you are interested in attending this workshop, please send an e-mail to soincentive@ofgem.gov.uk.

1.15. We propose that internal costs of these services are covered within the RIIO-T1 price control mid-scheme re-opener. If NGET considers that it has delivered new outputs which were not included in the RIIO-T1 price control and can be justified by clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users then we propose that it should raise a request under this re-opener.

1.16. The external costs of these services are not included within the current BSIS. We propose amending NGET's licence to allow it to recover the external costs associated with the procurement and utilisation of these services subject to our targeted efficiency check. We publish a draft of the changes we propose to make to NGET's special licence conditions alongside this document for consultation. Following the end of our informal consultation on our proposed policy and on this draft of the licence conditions, we will consider stakeholders' comments and publish our final proposals for both services as well as a statutory consultation on proposed licence changes.

1.17. Depending on the outcome of that consultation we will then publish our final decision on whether to implement the proposed licence modifications to effect funding arrangements. Subject to any challenge, these licence conditions will take effect 56 days after our modification notification. NGET will then need to submit and publish the methodologies proposed in the licence, with GEMA making a decision on whether to approve these methodologies in good time ahead of winter 2014/15. These methodologies will cover:

- the procurement of services (including the volume procured) and availability fees;
- costs of testing of SBR plant; and
- costs of pre-utilisation warming and utilisation of services.

2. Our targeted efficiency check for SBR and DSBR

Chapter Summary

In this chapter, we explain our approach towards setting the funding arrangements for NGET's costs of procuring and utilising these two new balancing services. We ask for stakeholder's views on the principles set out.

Question box

Question 1: Do you agree with our approach towards funding for the internal costs associated with the services?

Question 2: Do you agree with our view that the targeted efficiency check protects consumers and increases transparency to industry?

Question 3: Do you agree with how we have proposed to fund each of the cost components of SBR and DSBR?

Question 4: Do you have any views on NGET's proposed approach towards identifying a volume cap and volume requirement?

Question 5: Do you agree with the principles behind each of the ex ante methodologies and any proposed details that we or NGET has suggested should be included within the methodologies?

Question 6: Are there any other principles or details that should be included within our targeted efficiency check approach?

Internal costs of the SBR and DSBR services

2.1. In its Final Proposals consultation⁸, NGET sets out some indicative numbers of its internal costs. This suggested that development of the two products would cost approximately £1 million with implementation costs in the order of £5 million for DSBR and £2 million for SBR. Annual costs of the products were estimates at around £4 million per year.

2.2. Consistent with our approach towards other balancing services we consider that allowances for funding of internal costs sit within the RIIO-T1 regulatory

⁸ This document can be found here: <http://www.nationalgrid.com/NR/rdonlyres/F3F35BA1-8FCA-4206-9234-85D59B2ADB66/62904/FinalProposalsConsultationDSBRSBR10thOctober2013Final1.pdf>

framework. We note that this framework includes provisions for a mid-scheme review of output requirements. In this review, NGET may apply to recover costs where these can be justified by clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.

External costs of the SBR and DSBR services

2.3. Given the lack of historic data to demonstrate the costs that may be incurred by NGET in procuring and utilising these services, NGET is only able to make indicative estimates of the level of the external costs. In its Final Proposals consultation on the SBR and DSBR services, NGET estimated the costs of the services based on a number of assumptions regarding the volume of service requirement and the utilisation of any service.

2.4. In this document NGET provided an illustrative example in which it assumed the procurement of 1 GW of DSBR service and 2 GW of SBR service. It made a number of assumptions about the availability and utilisation payments and about the hours of utilisation per year. Based on these assumptions, NGET suggested that external costs could be in the order of £75 million per year which it suggested would have an impact of 75 pence on the average household bill.

2.5. In its more recent Supporting Report to the Authority, NGET provided an example of the expected volume requirement to meet the Government's reliability standard in 2014/15 and 2015/16 based on its current proposed approach. This indicated an overall de rated reserve volume requirement across both products of 500 MW in 2014/15 and a volume requirement of 1,300 MW in 2015/16. We would expect costs to be lower under these assumptions than those set out in NGET's Final Proposals consultation.

2.6. Given the potential scale and uncertainty of these costs we deem it appropriate to develop a regulatory structure for funding which sets out a clear process for assessment of costs by the Authority. This would be in addition to NGET's licence requirements to carry out its activities in an efficient, economic and coordinated manner. We set out more detail on our proposed 'target efficiency check' approach below.

Targeted efficiency check

2.7. For the external costs of these services, we propose to use a 'targeted efficiency check' approach. We recognise the different cost components of SBR and DSBR and propose a slightly different approach to how we regulate each. We propose regulation of the services based on the following characteristics:

- Volume of procurement – Authority approval
- Procurement and availability payments – cost disallowance

- Testing – cost disallowance
- Warming and utilisation – cost allowance

2.8. For all aspects of our proposed targeted efficiency check the Authority would carry out an annual review of the costs that are being claimed by NGET to consider whether they comply with the approved principles and methodologies based on the information NGET provides. Where the information provided is not sufficient to convince the Authority that this is the case then the Authority may direct that any costs that it does not deem to have complied with these principles and methodologies are not allowed to be passed through to BSUoS charges.

2.9. We note that this approach differs from NGET's views of how these services should be funded and regulated. NGET agrees that these services should not be funded through the BSIS given the difficulty of establishing an appropriate target. It suggests that its licence obligation to operate the system in an efficient, economic and coordinated manner would set a sufficient and appropriate requirement for it to ensure that costs incurred are economic and efficient. Therefore, NGET argues that all costs should be passed through, with Ofgem having the ability to disallow any costs that NGET cannot justify as economic and efficient. In its report to the Authority, NGET sets out a number of steps it would take to ensure that its procurement and utilisation of any services are economic and efficient.

2.10. We are interested in the views of stakeholders on the approach we take towards funding and regulation of the costs incurred by NGET in procuring and utilising these services.

Volume of procurement – Authority approval

2.11. The Authority will require NGET to develop proposals for an approach towards identifying a volume cap for the procurement of SBR and DSBR services. NGET will also need to develop an approach for ensuring that it procures an efficient volume and no more, taking into account the Government's reliability standard. The Authority will assess NGET's approach towards identifying a volume cap and a volume requirement and will decide whether or not to approve this approach. NGET will then be allowed to pass through costs for volumes procured based on its economic judgement against the volume requirement which has been identified⁹. The volume requirement shall not exceed the overall volume cap which has been approved by the Authority.

⁹ We note that the volume procured may not meet the volume requirement exactly. There may be reasons of efficiency which suggest that slight under or over procurement is in the best interests of consumers, for example because of the 'lumpy' nature of volumes available to the SO.

Procurement, availability/set up payments – cost disallowance

2.12. Availability and set up payments for both services will be known at the conclusion of the tender process. In addition, since these are incurred regardless of the actual utilisation of the services, they will be fixed for the entire contract period.

2.13. We recognise this certainty and propose that NGET recovers all of the availability and testing costs incurred with the Authority performing an efficiency check and disallowing any cost that is not deemed to be economic and efficient. The Authority will base its decision to disallow any cost on the ex-ante principles that we are consulting on.

2.14. In performing its efficiency check, the Authority will look to ensure that NGET has carried out an economic and efficient procurement process. The Authority will look for confidence that NGET has tendered in a transparent, objective way which maximises the potential for competition. We will consider the procurement processes of NGET in relation to best practice in terms of how it has historically procured other balancing services.

2.15. NGET will submit methodologies for the procurement and set up costs to be approved by the Authority. These methodologies will include NGET's logic for arriving at its approach towards balancing the costs of each of the components of the tender. In doing this we will expect NGET to use its operational judgement of what constitutes efficient processes and costs.

Testing – cost disallowance

2.16. As with availability payments, the costs which NGET will need to incur to carry out testing of services to ensure that they can provide a service will be relatively certain following the procurement process. We therefore propose the same cost disallowance process with NGET being able to recover all of the associated costs subject to an efficiency check by the Authority.

2.17. NGET will be required to submit a methodology for testing which the Authority will need to approve. NGET will then need to demonstrate to the Authority that it has adhered to this methodology. Where it is not able to do this then the Authority may direct that the relevant costs are not recovered.

Warming and utilisation – cost allowance

2.18. Warming and utilisation are the most uncertain costs of these services. They are dependent not only on the conclusion of the tender process but also on the situations of system stress and NGET's actions at those moments. In a situation of system stress, NGET will have to make decisions on whether to warm SBR plants and on the expected level of DSBR response which may be needed. NGET will also need to dispatch those service providers only as a last resort after it has exhausted all other services available to it. NGET suggests that exceptions will be needed for those services required to maintain the integrity of the system, such as frequency response

and STOR. It also suggests that it may need to despatch DSBR ahead of gate closure in order to ensure maximum response is available in anticipation of insufficient BM actions being available.

2.19. We recognise this uncertainty and the role that NGET can play in making these decisions and propose that NGET will need to apply to the Authority to recover these costs. The Authority would then perform an efficiency check and allow any cost that was economic and efficient to be recovered. The Authority's consideration of whether to allow these costs will be made against our ex-ante principles and on the methodologies which will be developed by NGET and approved by the Authority. The Authority will base this decision on the information provided by NGET to demonstrate its adherence to the ex-ante principles and methodologies. If it is able to demonstrate that this is the case then the Authority will approve NGET's recovery of these costs.

Ex-ante principles

2.20. The ex-ante principles are fundamental to the Authority's decision either to allow or to disallow costs. We believe that having ex-ante principles will protect consumers by ensuring that all costs incurred to procure and utilise these services are economic and efficient. The Authority will have the discretion to disallow (or not to allow) any costs to be recovered by NGET where it does not comply with these principles.

2.21. The ex-ante principles also promote transparency and give confidence to both NGET and industry on how costs of the services will be recovered. In our view, NGET will have the confidence that if it follows the principles outlined for procurement, testing, pre-utilisation warning and utilisation, and can provide clear records to demonstrate that this is the case, then it will be able to recover all of the costs incurred. The industry also benefits from the increased transparency and understanding of how the Authority will determine the costs that should be passed through to BSUoS charges.

2.22. The principles that the Authority will use to make this assessment will be aggregated in three methodologies to be prepared and submitted by NGET and approved by the Authority in respect of the SBR and DSBR services. These are a procurement methodology, a testing methodology and an operational methodology. We are interested in the views of stakeholders on this approach in general and on the details of the methodologies which we or NGET have proposed at this stage.

Procurement methodology and principles for availability payments

2.23. The procurement methodology encompasses the principles related to the volume being procured, the tender exercise and the consequent availability payment that NGET would incur. We propose that NGET produces a procurement methodology for DSBR and SBR to be approved by the Authority.

Volume of procurement

2.24. NGET has proposed the inclusion of a volume cap to cover SBR and DSBR and have proposed setting this at 5% of average cold spell peak demand. It considers this to be a suitable minimum margin based on operational experience.

2.25. We see merit in the inclusion of a volume cap and believe that NGET should set out how it will identify this in its procurement methodology. This will represent the maximum volume of service provision that NGET would be funded for through BSUoS charges at any time for the duration of the services. This volume cap would help limit consumer liability on the costs of these balancing services. By setting a clear limit on the volume of service which NGET may procure, it will also mitigate the risk of market distortion which stakeholders have raised should a number of plant move from the main market to sign an SBR contract. Once set, this volume cap approach could be applied in the period up to and including 31 March 2016.

2.26. NGET has also provided initial thoughts on its approach towards identifying a volume requirement. It has suggested that it would take into account the prevailing supply and demand outlook and associated uncertainties and would use this to identify the required volume which would be needed to meet the Government's reliability standard. It has suggested that it would draw on information published in Ofgem's Capacity Assessment report and its own Winter Outlook report and Future Energy Scenarios as well as any other available information. NGET proposes constructing a distribution of loss of load expectation (LOLE) using the information available and based on a number of equally likely supply and demand scenarios for each upcoming winter. It would then use this distribution to identify the volume it would need to procure to meet the reliability standard.

2.27. NGET notes that this volume requirement will cover SBR and DSBR. NGET does not propose taking into account the volume of SBR procured when contracting DSBR plant. It would, in theory, procure up to the volume requirement for DSBR alone. However, as NGET is likely to run a tender process for SBR before DSBR, it may need to take an initial view on the amount of DSBR it can expect to procure when tendering for SBR. If less volume becomes available than estimated then it may need to procure additional volumes of SBR following the DSBR tender.

2.28. We also see merit in an agreed methodology for setting the level of volume required and propose that a methodology is agreed to calculate the volume that would be needed to meet the Government's reliability standard within the cap. While the volume cap provides a limit to the volume procured, the volume requirement defines the actual amount of capacity that NGET will look to procure from service providers. This methodology should set out how NGET calculates the volume to be procured based on the benefit it provides to consumers.

Procurement and availability payments

2.29. In addition to setting out how it will determine the volume of service which it needs to procure, NGET will need to demonstrate in its procurement methodology that any procurement of SBR and DSBR provides value for money for consumers. If

this is not the case we would not expect NGET to procure the service even if this results in not meeting the identified volume requirement.

2.30. NGET has suggested that it would not accept any bids where they are considered to be uneconomic. In effect, NGET would identify a cost threshold at which it will no longer procure services, even if it has not reached its volume requirement. NGET has defined uneconomic as where it expects the costs of any contract to exceed the expected reduction of energy un-served (EEU) costed at the volume of lost load (VoLL). It has suggested that it would consider this at domestic VoLL (ie £17/kWh). We are interested in stakeholders' views on whether this is an appropriate approach towards costing expected energy unserved.

2.31. NGET has suggested that it would assess costs of the services based on the 'all in' costs. We propose that NGET will need to demonstrate in its methodology how it will establish the weighting it allocates to the different cost components of the tender when evaluating tender submissions: i.e. weighting availability, testing, pre-utilisation warming (where relevant) and utilisation for every tender. NGET's assumptions of different utilisations and pre-utilisation warming requirements will impact on the result of the tender and the service. NGET needs to demonstrate a robust basis for these assumptions that will form part of the tender assessment criteria.

2.32. NGET has suggested that there may be value in getting support from suppliers and aggregators to act as intermediaries to aggregate smaller consumer sites into material quantities of DSBR. It suggests that an administration fee may be required to make this kind of service sufficiently attractive to aggregators, with these costs being recovered as part of the external costs of the DSBR service. If it is the case that NGET believes it can reduce the costs of procurement of DSBR overall by incurring this type of administration fee, we would expect NGET to set out in its methodology how it will assess the need for, and level of administration fee which may be required. It would then need to provide justification of why any administration fee was needed and how it ensured that this represented an economic method of procurement against the methodology.

2.33. For the procurement of DSBR, NGET has suggested that it would offer an optional set up fee of £10/kWh and would require tenders to be submitted against utilisation rates ranging from £0.25/kWh to £15/kWh. It indicates that this approach is designed to reflect the wide range of values that consumers place on the continuity of electricity supply. We are interested in stakeholders' views on whether this approach is best able to maximise competition for the DSBR service.

2.34. We agree that NGET will need to establish and demonstrate the volume that it needs to procure and how it will assess whether accepting a tender provides value for money based on this methodology. We are interested in stakeholders' views on NGET's proposed approaches towards this.

2.35. So long as NGET has demonstrated that it has followed an economic tender process based on robust methodologies for assessing the required volume and the efficiency of any tender submissions, we propose that NGET is able to pass-through

the costs of all of the availability payments to BSUoS charges. NGET will have to provide sufficient evidence to the Authority as requested to ensure that the Authority can perform an efficiency check of the costs incurred in line with the approved methodology.

2.36. If any of the costs incurred by NGET in the tender exercise does not adhere to the approved principles and methodology, or if NGET cannot provide sufficient evidence to demonstrate that this is the case, the Authority may determine that those costs are not efficient or economic and exclude these costs from what NGET can pass-through to BSUoS charges.

2.37. We are interested in the views of stakeholders on our funding proposals associated with the identification of a volume requirement and the economy of procurement to meet these volumes. This includes the general process for assessment of costs that we have proposed as well as some of the details that support this, as put forward by us or NGET.

Testing methodology and principles

2.38. The testing methodologies encompass the principles that apply to the testing of SBR and the potential for testing of DSBR. SBR tests will be used by NGET to ensure that contracted plant is able to provide a service if and when called upon. NGET has suggested that the option to test DSBR plant may be useful to gain an understanding of the likely level of response but has indicated that it would consider the costs involved in carrying out any DSBR testing in deciding whether to carry this out.

2.39. In the testing methodology, NGET should set out the frequency it expects to test SBR plant based on plant characteristics. This frequency should provide an appropriate level of security on the supply of the plants at the most economic cost to consumers.

2.40. NGET has suggested that it would need to test SBR plant on a monthly basis over the winter months. It proposes that funding is provided for this relatively high frequency of testing given the older, less reliable nature of plant who are likely to be successful in the tender. NGET proposes that any testing which is required by plant in addition to this can be scheduled but will not be funded under any SBR contract.

2.41. NGET should also set out how it will minimise any impact on the market from testing SBR providers. During testing, these providers may transmit electricity through the transmission system. This might result in market distortions as bids might have to be accepted by NGET to ramp other plant down and some plants might not be called to generate. NGET should endeavour to minimise any distortion to the market of testing these products and must demonstrate to the Authority how it has done so. NGET has initially suggested that it would achieve this by scheduling tests in advance before they are notified to industry. It has proposed scheduling tests at periods when they will create minimal distortion to the market.

2.42. NGET considers that it may be useful to test a proportion of DSBR volume to help understand the likely levels of response which it may receive when called upon. However, NGET has noted that there could be a significant cost associated with the testing of some DSBR services. NGET will therefore need to set out the principles against which it will judge whether testing of DSBR will represent value for consumers. Once approved, it will need to demonstrate that it has complied with these principles and justify any testing it has carried out in order for the Authority to approve passing these costs through to BSUoS customers.

2.43. If NGET has met all of the principles listed above and detailed in the approved methodologies, the Authority shall not disallow any costs. If any of the costs incurred by NGET from testing do not follow the approved principles and methodology, or if NGET cannot provide sufficient information to demonstrate that this is the case, the Authority may determine that those costs were not efficient or economic and exclude those costs from those that NGET can pass-through to consumers. In particular, testing frequency should not exceed that set out in the approved methodology.

2.44. We are interested in the views of stakeholders on our funding proposals associated with testing of plant and potential for testing DSBR services. This includes the general process for assessment of costs that we have proposed as well as some of the details that support this, as put forward by us or NGET.

Operational methodology and principles for pre-utilisation warming and utilisation

2.45. The operational methodology encompasses the principles that will apply for the pre-utilisation warming and utilisation costs incurred by NGET in respect to SBR and DSBR. The operational methodology should include the methodology that NGET will apply to assess the need for pre-utilisation warming and for utilisation itself.

2.46. NGET agrees that in principle, these services should represent last resort despatch mechanisms that are used only once all other relevant balancing services have been exhausted. However, NGET identifies a number of reasons why it does not believe that this will always be the case in practice. While NGET may need to warm SBR plant ahead of despatch, it has now confirmed that this will not result in any electricity 'spilling' onto the system. However, NGET does suggest that it may want to despatch DSBR before gate closure in anticipation of a shortfall in the BM in order to provide as much lead time as possible. Finally NGET considers that it will need to retain the availability of certain services such as operating reserve and frequency response even after utilisation of SBR and DSBR to cope with potential system disturbances.

2.47. We propose that NGET will need to demonstrate how it will assess the needs for different pre-utilisation warming in operational timescales based on market dynamics which trigger a legitimate need for warming. This methodology needs to take into account the costs and benefits of all other options available, including SBR and DSBR options, at the time and in the context of the scale of the risk identified. For example, if NGET has three plants in its portfolio, with one that requires warming and two that do not, we would expect NGET to have a methodology in place to

determine the level of risk and whether it needs to warm the first plant or can depend on the two plants that do not require warming.

2.48. NGET will also need to demonstrate in the operational methodology how it will ensure that utilisation of SBR and DSBR is a last resort, called on only before emergency services (eg maximum generation requests). This should also describe the balancing services that NGET believes it needs to have available to maintain system safety even when utilising SBR and DSBR services (eg frequency response) along with justification of why this is the case.

2.49. The expectation is that with positive margins, plants would only be warmed or utilised on rare occasions. As any services procured are last resort services only to be utilised after the rest of the market is exhausted, our default expectation is that NGET will not need to incur any costs to warm or utilise these services. In the case that NGET does need to warm or utilise plants, it will need to apply to the Authority to pass-through those costs. The Authority will then assess whether the evidence provided by NGET was sufficient to demonstrate that the costs were incurred following the operational methodology. If the Authority considers this to be the case, it will allow NGET to pass-through those costs to BSUoS charges.

2.50. We are interested in the views of stakeholders on our funding proposals for the operation of any services. This includes the general process for assessment of costs that we have proposed as well as some of the details that support this as put forward by us or NGET.

Future approach to funding these services

2.51. Overall, we believe that our proposed regulatory approach is a balanced and proportional framework to regulate these two new balancing services. In the case that these services are still deemed to be required in NGET's review of the requirement for the services in 2016, we propose to also review these funding arrangements. At that time we would consider the case for financial incentives on these services similar to the approach used for other balancing services incentives.

Appendices

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Appendix 1 – Summary of our ‘targeted efficiency check’ proposals

Cost area	Cost component	Approach	Our assessment
Internal costs	All internal costs of SBR and DSBR services	RIIO-T1 mid scheme review	NGET will need to demonstrate that the services have required the delivery of new outputs in line with the terms of the RIIO-T1 mid scheme outputs review
External costs	Volume procured	Authority approval	NGET will need to submit proposals for derivation of a volume cap and a volume requirement needed to meet the Government's reliability standard. The Authority will need to approve this methodology and funding will only be provided for NGET based on the identified requirements.
External costs	Procurement approach and availability payments	Cost disallowance	<p>NGET must develop a methodology to demonstrate how it will ensure that its procurement process will be economic and efficient and encourages competition for services. It must also set out how it will assess tenders and ensure that it only accepts those which are in consumers' best interests.</p> <p>NGET will then need to provide evidence to demonstrate that it has complied with these principles in order for the Authority to approve the recovery of costs.</p>
External costs	Testing costs	Cost disallowance	<p>NGET must set out in a methodology how it will ensure that testing is carried out economically and efficiently and has minimal impact on the market.</p> <p>NGET will then need to provide evidence to demonstrate that it has complied with these principles in order for the Authority to approve the recovery of costs</p>

Funding arrangements for new balancing services: Initial Proposals

Cost area	Cost component	Approach	Our assessment
External costs	Warming and utilisation	Cost allowance	<p>The default assumption will be that NGET does not need to incur costs to warm or utilise available services given that these are designed as last resort mechanisms.</p> <p>NGET will need to develop a methodology demonstrating how it will assess whether warming or utilisation of the services are needed for approval by the Authority. If NGET needs to carry out warming or utilisation then it will have to request funding for this, demonstrating that it has adhered to the ex ante principles and methodology. If it can provide evidence to the Authority to demonstrate that this is the case then the Authority will approve the pass-through of these costs.</p>

Appendix 2 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 16 January 2014 and should be sent to:

- Leonardo Costa
- System Operation
- Wholesale Markets Performance, Ofgem, 9 Millbank, SW1P 3GE
- 020 3263 2764
- soincidentive@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, we intend to publish our final proposals. Any questions on this document should, in the first instance, be directed to:

- Leonardo Costa
- System Operation
- Wholesale Markets Performance, Ofgem, 9 Millbank, SW1P 3GE
- 020 3263 2764
- soincidentive@ofgem.gov.uk

CHAPTER: One

Question 1: Do the draft licence conditions published alongside this document appropriately reflect our initial proposals?

Question 2: Do you agree with our assessment that a financial incentive would not be fit-for-purpose at this time?

CHAPTER: Two

Question 1: Do you agree with our approach towards funding for the internal costs associated with the services?

Question 2: Do you agree with our view that the targeted efficiency check protects consumers and increases transparency to industry?

Question 3: Do you agree with how we have proposed to fund each of the cost components of SBR and DSBR?

Question 4: Do you have any views on NGET's proposed approach towards identifying a volume cap and volume requirement?

Question 5: Do you agree with the principles behind each of the ex ante methodologies and any proposed details that we or NGET have suggested should be included within the methodologies?

Question 6: Are there any other principles or details that should be included within our targeted efficiency check approach?

Appendix 3 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk