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Dear Leonardo

## **Funding Arrangements for the new balancing Services: Initial Proposals**

Thank you for the opportunity to respond to the Initial Proposals consultation on funding the new balancing services approved by the Authority in December 2013. Specific feedback to the individual questions posed in the consultation are included in the attached schedule with our key points highlighted below.

**Internal Costs** – The internal costs associated with this activity are not included in our RIIO allowances, and must therefore be funded separately. Whilst we recognise that we could apply for the recovery of these costs as part of a mid-term review, it is not clear that these would qualify, given that existing outputs may be considered to be unchanged by this activity. If this approach is to be adopted, we would need assurance from Ofgem that this activity would be regarded as a new output (possibly linked to supporting the Government's reliability standard) to give us comfort that future funding will follow for relevant efficient costs. If such assurances cannot be provided, we propose that the licence is amended to allow us to apply for the recovery of efficient and economic internal costs associated with this new activity when they are incurred.

**Targeted Efficiency Check:** The current regulatory framework is already capable of providing consumer safeguards in respect of these services. However, given that the external costs will initially sit outside the BSIS incentive scheme, we acknowledge that a targeted efficiency check could provide an additional consumer safeguard associated with these services, with Ofgem having the option of disallowing costs identified as not being economic and efficient. It is important that any such checks are not undertaken with the benefit of hindsight, and only take account of the information available at the time and the environment in which decisions were taken. Consideration should also be given to the provision of an ex-ante allowance to fund the incremental disallowance risk associated with undertaking this activity.

**Operational Costs:** We do not support the proposal for operational costs to be subject to an ex-post application to Ofgem and approval by the Authority. Whilst we recognise that these are more uncertain than the procurement costs, this does not mean that they should be treated any differently and subject to an ex-post justification before they can be recovered. Under the proposed approach, the operational uncertainty associated with funding may

undermine the effective use of these tools, diluting their value and undermining the purpose for which they were developed.

In our view, both procurement and utilisation costs will be subject to ex-ante principles set out in the methodologies approved by the Authority, and both should be treated in the same way when it comes to cost recovery. Service providers would receive capability and utilisation payments under their DSBR/SBR contracts as they become due, and these would be recovered via BSUoS charges as they are incurred. Given the absence of an incentive scheme, Ofgem would have the option of undertaking a targeted efficiency check on all these costs and to disallow those deemed unnecessary, uneconomic or inefficient. We believe that this would provide the operational flexibility to make effective use of these new tools, whilst providing the necessary consumer safeguards against inappropriate procurement or use.

I trust you will find these comments useful. Please contact Peter Bingham on 01926 859511 if you wish to discuss further.

Yours sincerely

*By Email*

**Peter Bingham**  
**Electricity Market Reform**

## National Grid response to the specific questions raised in the consultation

### CHAPTER: One

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

Our comments on the licence drafting are provided separately. The key issues highlighted by these comments are:

- It is not clear how the new condition works with the existing revenue restriction on external balancing services costs, and how these costs are excluded from the balancing services incentive scheme;
- Any contract cost that becomes due will be paid and recovered via BSUoS charges. It may not be practical to split out individual costs components (and there may other cost components e.g. non-delivery charges, DSBR admin fees, fuel holding payments etc). Rather than taking this disaggregated approach, we propose that contract costs are treated as a whole, and a term is introduced to remove costs that are determined by the Authority as uneconomic as part of the targeted efficiency test, and BSUoS charges would be reconciled accordingly;
- The drafting makes suggestions as to what should be included in the methodologies. Some of these are vague and subjective. We propose that this is guidance and should not be included on the face of the licence – we will be bound by the methodologies approved by the Authority;
- The Volume Requirement Methodology should be separate from the Procurement Methodologies – The volume methodology determines the quantity of reserve required and is common to both products, the procurement methodologies determine how much would be economic to buy;
- Testing is an operational activity and we propose to include testing principles within the operational methodologies;
- We do not support the proposal that operating costs (testing, warming, utilisation etc) would be subject to an ex-post application – however, we acknowledge that the Authority should have the option to undertake a targeted efficiency check on these costs, and have the ability to disallow any such costs it considers to have been unnecessary, inefficient or uneconomic.
- The process by which the targeted efficiency test is undertaken should be set out in the licence, including the process for appeal and how any reduction in allowed revenue is made effective; and
- As with the introduction of any new service, the methodologies are likely to evolve quickly though implementation. The licence should set out a clear and expedient process by which changes to the methodologies can be proposed and agreed, so as not to impede implementation.

**Q2: Do you agree with our assessment that a financial incentive would not be fit for purpose at this time?**

Given that both volume and costs associated with these activities are uncertain, establishing an ex-ante target as part of an incentive scheme is more likely to result in windfall gains or losses rather than create a focused incentive to minimise costs. Including these within the Balancing Services Incentive Scheme (BSIS) could also dilute the incentive to manage the costs of other balancing services. For these reasons we agree with Ofgem that a financial

incentive would not be appropriate at this time. However, there may be scope for including these services in a future incentive scheme as volume requirements and costs and become clearer.

## **CHAPTER: Two**

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

These new balancing services represent a departure from our core System Operator activities, designed to provide an additional customer safeguard in the unlikely event that the market does not provide sufficient generation to meet demand. These were not envisaged as part of RIIO, hence the internal costs associated with developing and operating these arrangements are not funded within our current allowances. A mechanism to recover such internal costs is therefore required.

The initial proposals suggest that the RIIO framework includes a provision for a mid-term review, where we may be able to apply for the recovery of incremental internal costs associated with material changes to existing outputs justified by changes in government policy or the introduction of new outputs to meet the changing needs of network users.

However, it is not clear that the scope of any mid-term review would include these costs because the Initial Proposals stop short of giving any indication in this direction. The definition of the mid-period review does not make it clear that the introduction of new balancing services would be regarded as a new output or a material change to an existing output. In addition, the SO output to which this activity relates (Balanced system) will not change; we will just be adding to the tools that will support the delivery of that output.

### **Balanced system**

Demand meets supply

*- to balance electricity system demand and supply to ensure the security and quality of electricity supply across the GB Transmission System*

In our opinion the new balancing services would constitute as providing a new output to those envisaged at the time of the RIIO-T1 discussions. The existence of these balancing services themselves should be seen as an output in relation to the wider SO output of market facilitation and the fact that Ofgem have approved their introduction as evidence that an additional output is required. However, we would need assurance that these activities would be regarded as a new output (possibly linked to supporting the Government's reliability standard) to give us comfort that future funding will follow for relevant efficient costs. Without this assurance, we would be delivering new balancing services approved by Ofgem and supported by DECC with the associated internal expenditure at risk of being unfunded.

If such assurances cannot be provided, we maintain that the most pragmatic approach to the funding of the internal costs would be via a term in the SO external revenue restriction within Para 4C.1 of Special Condition 4C of our licence. This term would default to zero unless otherwise agreed by the Authority, allowing us to apply for the recovery of internal costs annually on an ex-post basis. The Authority would have the opportunity to approve the level of costs submitted if they were satisfied that the costs had been efficient and economically incurred, or otherwise reject/reduce the level of cost that could be recovered. This would enable the timely recovery of these costs, whilst protecting consumers by ensuring that only costs incurred in an efficient and economic manner could be recovered.

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

With regard to the costs of the two services, we have an obligation under our licence to procure and use balancing services economically and efficiently. We are obliged to publish the outcome of each tender process, and any despatch instructions associated with the testing warming and utilisation of the two services. This transparency will enable the industry to challenge any of our procurement or despatch decisions. Ofgem has the power to investigate in response to such a challenge, and bring enforcement actions if we breach these obligations. Therefore the current regulatory framework is already capable of providing consumer safeguards in respect of these services.

However, given that these costs will initially sit outside the BSIS incentive scheme, we acknowledge that a targeted efficiency check could provide an additional consumer safeguard, with Ofgem having the opportunity to review the efficiency of costs we incur in the procurement and use of these services. Any such review should be undertaken against the principles in the C16 statements and the various methodologies approved by the Authority. Furthermore, any such review should be undertaken without the benefit of hindsight, assuming only the information available at the time the procurement or operational decision was taken, taking account of the pressures and uncertainty faced by system operators at times of system stress when operational decisions are taken to use these services.

This approach should provide sufficient protection to consumers. However, given that we propose to publish details on the procurement and use of these services, it is not clear that the targeted efficiency check will increase transparency, other than to provide further confidence that our procurement of these services is economic and efficient.

If the option of a targeted efficiency check is introduced, it is important that the process for this is established in the licence, including the scope and timing of any such review, how inefficient costs could be disallowed and the process for appealing any such decisions.

The potential for costs to be disallowed creates a significant financial risk in undertaking this activity. Consideration should be given to the provision of an ex-ante allowance or risk premium if the ability to disallow costs is introduced.

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

We agree with Ofgem's proposal that the costs of procuring the services should be recovered as they are incurred, subject to a targeted efficiency check. These should also include any payments to intermediaries associated with the recruitment and administration of smaller DSBR providers, and the provision of meter reads by relevant data collectors. Also, SBR capability payments would be net of any non-delivery payments. As the contracts are developed, other operational costs may be identified where it is more efficient than paying a bundled rate for capability (warming for example), and these too should be include in the recovery of procurement costs.

It may not be practical to split out the individual payments that become due under the SBR or DSBR contracts and treat them differently. All payments (capability or operational) under a given DSBR or SBR contract will be made to the relevant service provider as they become due, and the associated costs recovered via BSUoS charges. Modifying our finance systems to set aside any warming / testing / utilisation costs from BSUoS charges when they are

incurred, account for these differently capability payments and recover at some later date if approved by Ofgem may not be feasible.

In addition, whilst we acknowledge that these costs are more uncertain than the procurement costs, this does not mean that they should be treated any differently and subject to an ex-post justification before they can be recovered. They are just less likely to be incurred. Under the proposed approach, the operational uncertainty associated with their funding may undermine the effective use of these tools, diluting their value and undermining the purpose for which they were developed.

We therefore do not support the proposal for operational costs to be subject to an ex-post application to Ofgem and approval by the Authority.

In our view, both procurement and utilisation costs will be subject to ex-ante principles set out in the methodologies approved by the Authority, and both should be treated in the same manner when it comes to cost recovery. Service providers would receive capability and utilisation payments under their DSBR/SBR contracts as they become due, and these would be recovered via BSUoS charges as they are incurred. Given the absence of an incentive scheme, Ofgem would have the option of undertaking a targeted efficiency check on all these costs and disallowing any costs it deems unnecessary, uneconomic or inefficient. We believe that this would provide the operational flexibility to make effective use of these new tools, whilst providing the necessary consumer safeguards against their inappropriate procurement or use.

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

Our volume methodology is under development, with initial thoughts presented at Ofgem's workshop on 8<sup>th</sup> January 2011. We would welcome any early feedback received by Ofgem through the funding consultation so that we can take account of this in our development work. We acknowledge the importance of a volume cap, but rather than being calculated via a methodology, this may be fixed at a level we believe to be appropriate (e.g. 3GW).

**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?

The principles associated with the procurement and use of these balancing services were approved as part of the changes to the C16 Procurement Guidelines and Balancing Principles Statement. The proposal for an additional suite of methodologies could be regarded as an unnecessary regulatory overhead that could constrain our flexibility to contract for and use these services. However, given that these methodologies would provide more detail on how these principles would be applied, we will support their development if they are considered to add value and aid transparency.

If the licence is to include procurement or operational principles, these should be clear and objective in order that obligations are clearly defined and licence compliance can be achieved.

We do not believe it is appropriate to include detailed criteria of what should be included in the methodologies on the face of the licence. These methodologies should inform the steps or decisions that are to be made by the licensee rather than constituting strict licence obligations. If broad criteria are to be included on the face of the licence, again these should

be clear and objective. The approach taken in relation to the documents that are required to be in place under condition C16 of the licence (Procurement and use of balancing services) is worthy of consideration here as a suitable approach.

The Initial Proposals refer to a testing methodology. However, testing is an operational activity and we propose that this is incorporated into the operational methodology. We are also considering the option of undertake proving tests of individual DSBR sites on a sample basis, to provide confidence in the reliability of the service. The funding arrangements would need to allow for these costs, although we recognise that these may be capped (e.g. at £1/kW of the total contracted DSBR capacity).

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

It is important to define the process for triggering a targeted efficiency check, specifying when such checks would be undertaken, timelines for making a decision and the process through which a decision to disallow costs could be appealed. We would benefit from understanding how frequently these checks would be undertaken – if costs have the potential to be disallowed, checks immediately after a procurement or usage event would enable this risk to be managed in a timely manner. Such checks should not wait until the end of the year, but be undertaken when the facts surrounding an event can be readily recalled.

Also, we suggest that checks should be at Ofgem's discretion rather than being mandatory – given the proposed transparency around the procurement and use of these services, any uneconomic or inefficient actions should be clearly evident, providing a trigger for Ofgem to undertake an efficiency check where there are concurs. Mandatory checks at each procurement or usage event may prove to be an unnecessary overhead.

