

# Funding arrangements for new balancing services: Final Proposals

## Consultation

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### Overview:

In November 2013, National Grid Electricity Transmission plc (NGET) made an application to the Gas and Electricity Markets Authority (the Authority) 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. In December 2013, the Authority approved the option for NGET to use these new tools, if required. Following this decision, the process moved on to a consultation on how any potential cost from these services would be funded.

So alongside issuing the decision to allow use of these services, we consulted stakeholders on our initial proposals for the funding arrangements which would allow NGET to recover the economic and efficient costs it incurs procuring and use these services.

This document sets out our final proposals and incorporates stakeholder comments on our initial proposals.

## Context

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Last 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 the introduction of these services. 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 balancing services procurement guidelines and associated documents to allow it to procure these services. The Authority decided to approve NGET's modification in December 2013.

Existing funding arrangements and associated incentives on the system operator are set out in NGET's licence conditions. However, there is currently no mechanism to allow NGET to recover the external costs incurred for the procurement and use of any SBR or DSBR services because they are new. In broad terms we refer to "external costs" as the cost associated with procuring and using balancing services and "internal costs" as the cost of staffing and hardware. So in December 2013, we consulted stakeholders on proposed funding arrangements for these services to allow NGET to recover economic and efficient costs (internal and external) within the period up to and including 31 March 2016, should the services be needed, or later if directed by the Authority. This documents sets out our final proposals after taking on board the stakeholder comments on our funding arrangements.

## Associated documents

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- Initial Proposals consultation on funding arrangements for the new balancing services: <https://www.ofgem.gov.uk/ofgem-publications/85276/informalconsultationonfundingarrangementsfornewbalancingservices.pdf>
- 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/85278/decisiontoacceptngetapplicationtointroducetwonewbalancingservicesandsubsequentconsultationonfundingarrangements.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 (Ref 106/13): <https://www.ofgem.gov.uk/ofgem-publications/75221/consultation-potential-requirement-new-balancing-services-support-uncertain-mid.pdf>
- Electricity Capacity Assessment Report 2013 (Ref 105/13): <https://www.ofgem.gov.uk/ofgem-publications/75232/electricity-capacity-assessment-report-2013.pdf>

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# Executive Summary

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## Our proposals

### *Internal costs*

Our initial proposals did not include any new mechanism to fund internal costs<sup>1</sup>. The RIIO-T1<sup>2</sup> price control includes allowances and tools to fund the System Operator's (SO) internal costs for the eight-year period to March 2021. The RIIO-T1 framework includes a provision for a mid-period review of output requirements in certain circumstances. The scope of any 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.

Stakeholders were broadly supportive of our approach. They also noted that NGET's indicative internal costs seemed high when compared to the overall costs of these services. NGET expressed concern over using the RIIO mid-period review to recover these costs as it was unclear whether the scope of review would include these costs as new outputs.

Our final proposals are consistent with our approach towards other balancing services: that allowances for funding of internal costs sit within the RIIO-T1 regulatory framework. We recognise that the provision of these services are new activities for NGET. Where NGET is able to demonstrate that there are new outputs associated with these activities then, if there are significant additional costs involved, these may be considered under any RIIO-T1 mid-period review.

### *External costs*

Where external costs are certain we propose NGET receives upfront allowances and where there is uncertainty we propose NGET has to apply for allowances after the event. In both cases we have the right to withhold allowances if they have not been incurred economically and efficiently and in accordance with approved methodologies.

In our initial proposals we set out our "targeted efficiency check" approach to allow NGET to recover economic and efficient costs. This approach recognises the different levels of certainty and NGET's control over the different costs components and targets the regulation to each of those components.

We proposed that costs that can be known with a good degree of certainty are passed through the balancing services use of system (BSUoS) as they are incurred. These would include capability costs (payments for a provider to be available during the winter months, previously referred to as availability), set-up costs and testing costs. The Authority would conduct an efficiency check on the costs and disallow any that are deemed not to be economic or efficient.

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<sup>1</sup> Internal costs are considered to be those costs relating to staffing, I.T services, etc.

<sup>2</sup> For more information on RIIO-T1 see: <https://www.ofgem.gov.uk/electricity/transmission-networks/network-price-controls/riio-t1-price-control>

We also proposed that uncertain costs and utilisation costs should not be automatically passed through BSUoS. These would include availability costs (payments to a service provider to be available to despatch at operational timescales, previously referred to as warming) and utilisation costs. They are uncertain because we and NGET cannot know how often the services will be used, although we anticipate their being used rarely. Also these costs will be dependent on the characteristics of system stress events and NGET's actions in those periods. For those costs, NGET would have to apply to the Authority for recovery of economic and efficient costs. As long as NGET can demonstrate that it incurred those costs in accordance with approved methodologies, the Authority would allow it to pass them through BSUoS (ie *an* "allowance" given after the event).

The "targeted efficiency check" funding arrangements are underpinned by the high-level principles contained in the licence. When the licence conditions take effect, NGET will be required to submit for the Authority's approval three methodologies that must comply with these high-level principles. These methodologies would then be used in the efficiency check process. The Authority would allow NGET to pass all economic and efficient costs through BSUoS charges.

Industry responses were supportive of our approach. Respondents described it as proportionate and appropriate to fund these new services until 2016. Stakeholders also supported our intention to introduce financial incentives if these services are required beyond 2016. In our final proposal, we continue to uphold these commitments and have added a provision that allows the Authority to extend the funding arrangements, which we would also consider exercising in the event of a change in circumstances in advance of 2016.

Both NGET and the UKDRA expressed some concerns over the funding arrangements. While NGET disagreed with treating uncertain costs differently than the certain costs, the UKDRA suggested that the funding arrangements should be expanded to address perceived issues with the DSBR design features, such as amendments to the baseline calculation.

We remain of the view that our targeted efficiency check approach is the most appropriate way to ensure that NGET procures and uses these new balancing services in an economic and efficient manner. In our view, the design and publication of principles and the approval of the accompanying methodologies will ensure transparency and give confidence in operational timescales that NGET can recover economic and efficient costs.

We agree with the UKDRA that any service procured needs to be economic and efficient. We designed our principles to set the high-level criteria for the efficiency check process by the Authority. We would expect questions on design features to be reflected in NGET's methodologies. NGET would need to demonstrate that its methodologies allow for the economic and efficient procurement and use of these services, with the Authority approving or rejecting the submissions as appropriate.

### **Next steps**

This document sets out our final proposals and draft licence conditions for statutory consultation. If you have any comments please direct them to Leonardo Costa by 04 April 2014 (see Appendix 1).

Subject to responses, we intend to issue a determination to amend NGET's special licence conditions to incorporate the funding arrangements for external costs. This would be followed by the usual period of 20 working days in which to submit an appeal. Subject to any appeals process, the licence change would come into effect 56 days from publication of the Authority's determination.

After the licence conditions have come into effect, NGET would then be required to submit three methodologies to the Authority for approval, the volume methodology, the procurement methodology and the operational methodology<sup>3</sup>. We see these methodologies as the cornerstone of the funding arrangements. We expect these documents to set the basis for ensuring procurement and use of these services is economic and efficient, as well as meeting the criteria we expressed in our initial consultation letter on the new balancing services.

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<sup>3</sup> NGET will need to submit a volume methodology, procurement methodology (one for each service) and an operational methodology (one for each service)

# 1. Introduction and Overview

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## Chapter Summary

In this chapter we describe the new balancing services, our approach to funding balancing services and set out the next steps following this consultation.

### 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. NGET designed two new balancing services that would be dispatched as a last resort after all options available in the market have been exhausted. The two services are the Supplemental Balancing Reserve (SBR) and the Demand-side Balancing Reserve (DSBR).

1.3. SBR is a supply based balancing service that is available for NGET between 6am and 8pm on non-holiday weekdays in the months of November to February. SBR providers are not able to participate in the market for the duration of their contracts. DSBR is a demand-side service that offers half-hourly metered non domestic consumers payments to reduce their demand between 4pm and 8pm on winter weekdays.

1.4. In November 2013, NGET applied to amend its balancing services procurement guidelines and associated documents (the C16 Documents)<sup>4</sup> to allow it to procure and use these two additional tools. In December 2013, the Gas and Electricity Markets Authority (the Authority) approved these two new balancing services.

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<sup>4</sup> 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.

## Funding arrangements

1.5. Following the approval of these new balancing services we considered whether there was a need for any new mechanism to regulate the recovery of costs by NGET. In this process, we recognised our approach to funding other balancing services, in particular our treatment of internal and external costs<sup>5</sup>. For all other balancing services, internal costs are funded through the RIIO-T1 price control and are set until 31 March 2021. Under RIIO-T1, NGET is allowed a level of revenue to deliver a set of outputs. The RIIO-T1 process also incorporates mechanisms to deal with uncertainty, such as the potential for a mid-period review of outputs if there are new outputs from clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.

1.6. External SO costs are funded through the balancing services incentive scheme (BSIS). Under BSIS, NGET faces a cost target for the actions it takes to balance the market through the Balancing Mechanism (BM) or the procurement and use of balancing services. If NGET outperforms the target, it is allowed to retain 25% of any outperformance up to a cap of £25m a year. Similarly, if NGET underperforms the target, it incurs 25% of its underperformance up to a floor of -£25m a year. The target for BSIS is determined by models that use historic and current information to assess the appropriate level of cost against which NGET is incentivised.

1.7. In our initial proposals, we detailed how this analysis led us to not propose any new mechanism to fund internal costs. In our view, the RIIO-T1 price control has all the tools to fund and assess the need for funding of all SO internal costs. On external costs, we believe that the current BSIS does not have a mechanism to allow NGET to recover economic and efficient costs incurred as part of SBR and DSBR. As such, we believe that a new mechanism to allow NGET to recover these costs needs to be implemented.

1.8. On 19 December 2013 we published our initial proposals including our proposed approach to fund the external costs, the “targeted efficiency check.” In addition to the consultation, we held a stakeholder workshop on 8 January 2014 when we explained our funding arrangements. In that workshop we sought views on whether our proposed approach achieved our objectives of protecting consumers from uneconomic and inefficient costs and aiding transparency to NGET and industry.

1.9. Since the end of our initial consultation we have considered the responses and are publishing alongside this document a 28-day statutory consultation on the funding arrangements and the accompanying draft licence modifications.

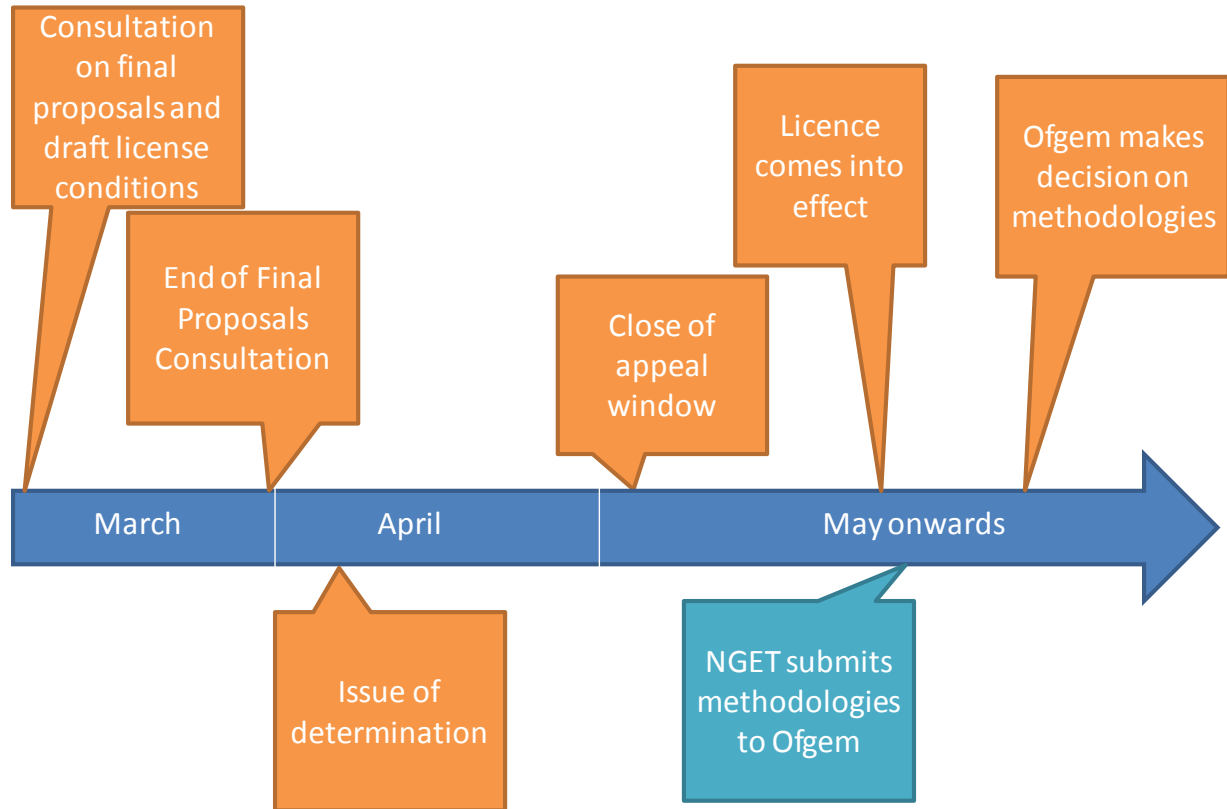
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<sup>5</sup> Internal costs are considered to be those costs relating to staffing, I.T services, etc. External costs are those relating to NGET’s contracting and procurement of services.



### Proposed next steps

1.10. Following this consultation and subject to any stakeholder responses we propose to follow the timeline below:



1.11. Subject to responses, we intend to issue a determination to amend NGET's special licence conditions to incorporate the funding arrangements for external costs. This would be followed by the usual period of 20 working days in which to submit an appeal. Subject to any appeals process, the licence change would come into effect 56 days from publication of the Authority's determination.

1.12. Once the licence came into effect, NGET would be required to submit to the Authority for approval, the volume, procurement and operational methodologies. These methodologies would set out how NGET would procure and use the services and would form the basis for Ofgem to assess whether NGET's actions are economic and efficient. The Authority would then assess these documents and either approve or reject the proposed methodologies.

## 2. Final proposals

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### Chapter Summary

In this chapter we describe our final proposals on the funding arrangements for SBR and DSBR and how we have taken into account stakeholder feedback.

### Question box

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

**Question 2: Do you have any further comment on our proposal for funding NGET's internal and external costs?**

### Internal costs of the SBR and DSBR services

2.1. In our initial proposals we stated, that consistent with our approach towards other balancing services, we considered that allowances for funding of internal costs sit within the RIIO-T1 regulatory framework. We noted that the RIIO-T1 price control included provisions for a mid-scheme review of outputs. If such a review is triggered, NGET may apply to recover additional costs where these are significant and can be justified by a clear change in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.

#### *Industry views*

2.2. Industry was supportive of our proposal that RIIO-T1 be the framework to allow any funding for internal costs associated with these services. Some stakeholders noted that the indicative internal costs of these services seemed high in comparison with total indicative costs. A stakeholder also noted that any increase in revenue allowance in the RIIO-T1 final proposals should be taken into account during a potential mid-period review. Finally, one stakeholder stated that to aid transparency and prepare industry to face potentially higher costs during the mid-period review period, NGET should publish annually the internal costs it would seek to apply for during the RIIO-T1 mid-period review.

#### *NGET's views*

2.3. NGET believed that these costs were not envisaged during the RIIO-T1 incentive review and as such were not funded. It was also concerned that it was unclear whether the scope of any mid-period review of outputs would consider these costs as delivering new outputs. Hence, NGET proposed that we indicate that the internal costs associated with the procurement and use of SBR and DSBR would be treated as new outputs or to allow the recovery of internal costs through the external revenue restriction formula.

### *Final Proposals*

2.4. We recognise that the provision of these services are new activities for NGET. Where NGET is able to demonstrate that there are new outputs associated with these activities then, if there are significant additional costs involved, these may be considered under any RIIO-T1 mid-period review. Recognising the scope for significant changes in outputs during an eight year price control period, the RIIO-T1 framework included provision for a mid-period review of output requirements in which we would consider whether changes to outputs are necessary.

2.5. As set out in the RIIO-T1 documents, the scope of any mid-period review would be tightly 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.

### **External costs of the SBR and DSBR services**

2.6. In our initial proposals we recognised the potential scale and uncertainty of the costs that could be incurred for these services. This is a result of the lack of historic data and the fact we expect these services to be used only rarely. This uncertainty translated to NGET only being able to make indicative estimates of the level of external costs for these services.

2.7. Our proposed funding arrangements recognise this uncertainty and seek to set out a clear process for the assessment of costs by the Authority. These arrangements would be in addition to NGET's licence requirements to carry out its activities in an efficient, economic and coordinated manner. We set out our final proposals for these funding arrangements below.

### **Targeted efficiency check**

2.8. In our initial proposals, we proposed to use a "targeted efficiency check" approach to regulate the costs incurred on the procurement and use of the new balancing services, SBR and DSBR. Our approach recognises the different cost components of SBR and DSBR and proposes a slightly different approach to how we regulate each (summary of our approach on each cost component can be seen in Appendix 2). We also explained the reliance of the approach on ex-ante principles and the role of the four methodologies against which the separate cost categories would be assessed by the Authority:

- Volume of procurement and volume cap– Authority approval of volume methodology
- Procurement and capability payments – Authority approval of procurement methodology (cost disallowance)

- Testing payments – Authority approval of testing methodology (cost disallowance)
- Availability and utilisation payments– Authority approval of operational methodology (cost allowance)

### *Industry views*

2.9. Stakeholders were overall supportive of our “targeted efficiency check” approach. The majority noted that it was an appropriate and proportional framework to regulate the costs incurred by NGET. The majority of stakeholders stressed that if implemented correctly, this approach should protect consumers and enhance transparency. One stakeholder disagreed with our proposals, citing potential financial gains under BSIS as the main reason behind their views that financial incentives should be developed for SBR and DSBR. Another stakeholder noted that we should ensure that we have the technical expertise to assess the methodologies and reporting of costs incurred on these services.

### *NGET’s views*

2.10. NGET agreed with our assessment that the level of uncertainty on external costs meant that a financial incentive was not appropriate at this time. NGET stated that its licence conditions already included requirements that it act economically and efficiently in its procurement and use of balancing services. However, it believed that the “targeted efficiency check” provided further information on the principles that the Authority would use to make its assessment. However, NGET did not agree with our cost allowance approach, believing that it would lead to less reliability of the services due to the higher operational uncertainty it would cause.

2.11. NGET also asked for more clarity on the mechanics of the “targeted efficiency check.” In particular, NGET sought more clarity on the timelines for the Authority’s decisions and the triggers to initiate an efficiency check. It proposed that the trigger should not be automatic, but rather that an efficiency check should only be carried out as needed, with any checks being made soon after any event occurred.

### *Final proposals*

2.12. The broad support from the industry for our “targeted efficiency check” approach supports our belief that these arrangements protect consumers and promote transparency. We continue to believe that a financial incentive is not appropriate at this time due to the risk of erroneously setting a target due to the lack of historic data. If products are considered to be needed beyond 2015/2016, we will consider whether introducing financial incentives is in the best interest of consumers. Nevertheless, we are proposing to include the flexibility for the Authority to extend the “targeted efficiency check” funding arrangements beyond 2015/2016, if we consider in 2016 that the products are still needed or if circumstances change in advance of that. In that case, we would intend to consult stakeholders on our

intention to extend the funding arrangements before the Authority decides whether to issue such a direction.

2.13. We note that assessment of the methodologies might require a high level of technical expertise. Nevertheless, the onus is on NGET to demonstrate to the Authority that the methodologies proposed and the costs incurred are economic and efficient, including that they provide value for money to consumers. Moreover, we will consider, if needed, the use of consultants to conduct technical assessments.

2.14. We continue to believe that the ex-ante principles and methodologies minimise the risks to NGET by setting a clear framework within which any costs incurred will be considered by the Authority. As long as NGET can demonstrate that it has complied with the approved methodologies and ex-ante principles it will be able to recover the costs incurred.

2.15. We agree with NGET on the importance of clarity on the mechanics of the efficiency check. We propose that NGET submits an annual report for the certain costs and an annual application for the uncertain costs by 31 March of every year. However, if cumulative costs for either certain or uncertain costs exceed a threshold of £2.5m before then, we propose to give NGET the discretion to submit additional applications before the annual submissions. The Authority will also have the discretion to lower this threshold in order to accept applications for smaller amounts. We would consider exercising this if there are clear learning benefits to be had. In addition, these services are expected to be used very rarely. As such, we believe that there is a learning benefit from NGET submitting an application after the first instance that uncertain costs are incurred. Hence, we are proposing to allow NGET to submit such an application. We believe that this will appropriately balance the need to minimise the time between actions and the efficiency check with the appropriate time for NGET to prepare and submit a detailed report on the costs incurred and for the Authority to make a decision.

2.16. Following the receipt of any application or report, we propose that the Authority has 28 days to issue a determination, with the option to extend time for a decision where we consider that due to the nature and extent of the information we are required to consider as well as the materiality of the amount under consideration, we think we need further time to reach a decision. Ofgem is proposing this (28 day turnaround) with the specifics of this case very much in mind: the novelty of the services (so the value for NGET in "learning" quickly as they go along – to reduce risks to both themselves and customers), and the fact this is expected to be time limited and "last resort". It also reflects the fact we will be assessing a (broadly) pre-defined type of event against an agreed methodology (ie, a very different set of circumstances than IAEs).

2.17. The Authority may also request further information from NGET as part of its assessment. The Authority may disallow or not allow costs if NGET is unable to demonstrate how these costs are compliant with the approved methodologies.

## **Proposed approach to fund each cost component**

2.18. In our initial proposals we proposed to treat the certain costs (capability, previously referred as availability, set-up and testing) in a cost disallowance process. For these cost items, NGET is allowed to pass through the costs it incurs to BSUoS charges. The Authority then performs an ex-post efficiency check on these costs. In this efficiency check, the Authority would have the discretion to disallow any costs where evidence is not provided by NGET to demonstrate compliance with the methodologies. We proposed to treat these costs in this fashion since they are certain after the tender, constant for the entire duration of each contract, and independent of NGET's actions to manage the system.

2.19. We also proposed to treat uncertain costs (availability, previously referred as pre-utilisation warming and utilisation) in a cost allowance approach. Under this approach, NGET would need to apply to the Authority for recovery of the costs. The Authority would approve the costs that NGET can demonstrate have been consistent with the approved methodologies. We proposed to treat these costs in this fashion since these costs are uncertain, expected to be rarely incurred, and dependent both on the number of system stress situations and NGET's actions to manage the system at those times.

### *Industry views*

2.20. Stakeholders found our approach reasonable and proportionate. They stated their belief that this approach should protect consumers and ensure value for money. One stakeholder was concerned over the impact of the cost allowance process on service providers if NGET attempted to share the risk of not having a cost item allowed with them when procuring services.

### *NGET's views*

2.21. NGET agreed that the costs incurred should be subject to an efficiency check. However, it believed that it was not optimal or practical to split the different cost components and target regulation through different approaches to each of them. In its view this created additional operational risk which could undermine the effectiveness of the services. Hence, NGET proposed that all of the costs should be subject to an ex-post cost disallowance approach.

### *Final Proposals*

2.22. We continue to propose a "targeted efficiency check" to regulate the funding of SBR and DSBR. Under this approach, costs that will occur independently of the actual utilisation of the services and are known after the tender will be passed through to consumers with the Authority performing an annual efficiency check on those costs. For uncertain costs, those that are dependent on the situations of system stress and NGET's actions in those periods, we propose that NGET apply for its recovery to the Authority.. We believe that targeting the regulation to each cost component will protect consumers, ensuring that they only pay for the economic and

efficient costs required to procure and use these services. It will also give confidence to NGET that as long as it complies with the methodologies, it will be allowed to recover those costs.

### **Ex-ante principles**

2.23. Under our initial proposals, the “targeted efficiency check” approach is centred on our ex-ante principles and the methodologies that will aggregate them. The ex-ante principles are the foundation of the approach, since they serve as the basis for the Authority’s decision to either allow or disallow costs. These principles, described in our initial proposals aim to ensure that the procurement and use of the services is economic and efficient including by providing value for money to consumers, for example by requiring NGET to have an economic and efficient process to decide whether to make a plant available in operational timescales or the volume to be procured in each year.

2.24. In our initial proposals, we set out how these principles would protect consumers by ensuring that all of the costs incurred to procure and use these services would have to be economic and efficient in order for NGET to recover them. Under our approach, NGET would be required to aggregate these principles into four methodologies to be submitted for approval: the volume methodology, procurement methodology, testing methodology and operational methodology. We also proposed that the Authority would have discretion to disallow (or not to allow) any costs to be recovered by NGET where it does not comply with these methodologies.

### *Industry views*

2.25. Industry was very supportive of our ex-ante principles. In particular most respondents saw the volume methodology, which includes a volume cap and volume requirement as vital for ensuring value for money of these services. Most stakeholders believed that the volume cap should be low to prevent distortions to the market from the introduction of these new services.

2.26. Industry also stressed the role that the operational methodology plays in ensuring that the services are only warmed (made available in operational timescales) as a last resort. Stakeholders believed that NGET should demonstrate how it will make these assessments.

2.27. Two stakeholders raised further questions on the methodologies. The UKDRA believes that we include design features as part of our ex-ante principles. In its view, this would counteract what they see as DSBR deficiencies and ensure that any procurement or use of DSBR would be economic and efficient. EDF proposed that industry should be consulted on the methodologies before they are approved and asked for any party to be able to challenge NGET’s actions.

### *NGET’s views*

2.28. NGET stated that in principle, there is no need to include principles associated with the procurement or utilisation for these services since these are restricted under the C16 documents. Moreover, NGET stated that it has an underlying obligation to be economic and efficient. Nevertheless, NGET was supportive of having ex-ante principles if these added value and aided transparency.

2.29. NGET also believed that if principles were to be incorporated into the licence they should be clear and objective but not detailed. In its view the methodologies should inform the steps or decisions rather than constitute licence obligations. Moreover, NGET proposed that testing should be incorporated into the operational methodology, since it sees it as an operational activity.

### *Final Proposals*

2.30. In our final proposals, we continue to propose that NGET be assessed against ex-ante principles and methodologies which are approved by the Authority. Stakeholders have supported our view that these methodologies need to ensure value for money to consumers who should only pay for these services to be used as they were designed, that is, as last resort tools to balance the system.

2.31. On the design features of DSBR, our principles are intended to set the high level parameters for the Authority's analysis. We would expect questions on design features to be reflected in NGET's methodologies. The onus is on NGET to demonstrate that its methodologies allow for the economic and efficient procurement and use of these services, with the Authority approving or rejecting the submissions as appropriate. Nevertheless, when considering any methodology submission by NGET, we will take regard to the concerns expressed by the UKDRA.

2.32. Under our funding arrangements NGET would need to prepare and submit to the Authority for approval three methodologies<sup>6</sup>. To be approved, NGET will need to demonstrate that these methodologies comply with the requirements set out in new special condition 4K. We encourage NGET to continue to engage with industry to set out its proposed approach to the methodologies, so that it can take into account industry views.

2.33. We acknowledge that since these are new services, there would be a considerable level of learning by NGET once these are procured or operated, if needed. To capture this learning, we are proposing to allow NGET to review the methodologies, with the exception of the volume cap, and submit any proposed changes to the Authority by 31 March of each year. We believe that since the volume cap determines the maximum volume of the services that would potentially be procured, it should be set with regard to the duration of these funding arrangements. Once the proposed adjustments are submitted, the Authority would have three months to consider these changes. If the Authority approves the adjustments, NGET will then be allowed to adjust its methodologies.

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<sup>6</sup> NGET will need to submit a volume methodology, procurement methodology (one for each service) and an operational methodology (one for each service).



2.34. We agree with industry that it is important that NGET is held accountable for their expenditure on the new balancing services. We believe that the best way to do this is by Ofgem carefully assessing whether NGET's procurement and use of the services is consistent with the methodologies approved by us. Where we think it is appropriate to aid our "challenge" function, we will engage with stakeholders as part of this process. We have, for example used a similar approach of stakeholder engagement when considering income adjusting events.

2.35. We agree with NGET's proposal to incorporate testing within the operational methodology, and have amended our draft licence conditions accordingly. We also agree that the ex-ante principles should be clear and objective to aid transparency with NGET and industry and have aimed to ensure that the licence conditions achieve this.

# Appendices

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## Appendix 1 - Consultation Response and Questions

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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 04 April 2014 and should be sent to:

- Leonardo Costa
- System Operation
- Wholesale Markets Performance, Ofgem, 9 Millbank, SW1P 3GE
- Address
- 020 3263 2764
- [soincentive@ofgem.gov.uk](mailto:soincentive@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](http://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, Ofgem intends to issue a determination to amend NGET's licence conditions. 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
- Address
- 020 3263 2764
- [soincentive@ofgem.gov.uk](mailto:soincentive@ofgem.gov.uk)

### **CHAPTER: Two**



## Funding arrangements for new balancing services: Final Proposals

**Question1:** Do the draft licence conditions published alongside this document appropriately reflect our final proposals?

**Question2:** Do you have any further comment on our proposal for funding NGET's internal and external costs?

## Appendix 2 – 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, capability (previously referred as availability), set up and administration 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 the operational 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: Final Proposals

Cost area	Cost component	Approach	Our assessment
External costs	Availability (previously warming) and utilisation	Cost allowance	<p>The default assumption will be that NGET does not need to incur costs to make service providers available 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 making a service provider available or utilisation of the services are needed for approval by the Authority. If NGET needs to make a service provider available or use the services 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 3 - Feedback Questionnaire

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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