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Email: SOincentive@ofgem.gov.uk

Date: 27 February 2015

Dear Colleague

Statutory Consultation on amending Special Licence Condition 4K of National Grid Electricity Transmission Plc's (NGET) transmission licence to allow it to recover costs of payments under tender option contracts for Demand Side Balancing Reserve (DSBR) and Supplemental Balancing Reserve (SBR).

Background

Supplemental Balancing Reserve (SBR) and Demand Side Balancing Reserve (DSBR)[1] are commercial balancing services introduced in 2013 to give National Grid Electricity Transmission (NGET) additional tools to help it balance the system in light of tightening margins.

NGET has highlighted that in exceptional circumstances, it may be in the interest of consumers to agree tender option contracts with potential SBR or DSBR service providers to sharpen competition in a tender. This can occur when a potential service provider is in a position to significantly contribute to meeting the volume requirement at minimum cost but faces a risk of prohibitive and material incremental costs in order to participate in the tender.

If NGET entered into a tender option contract it would agree to pay a share of the additional costs incurred by potential service providers to allow them to tender for SBR or DSBR (only payable if the service provider is unsuccessful in the tender). This would only be applicable to material incremental costs (short-term and non-permanent) that would be avoided if the service provider had not tendered for these services and which are necessary to facilitate the participation in a tender.[2] All costs considered under a tender option contract would be subject to economic tests and financial audit.

NGET believes that tender option contracts may be an important tool in rare and exceptional circumstances, to increase the liquidity of service provision and range of prices available within each tender round. The resulting increase in competition for SBR and DSBR could ultimately lead to a more economic and efficient outcome for consumers.

Special Licence Condition 4K allows NGET to recover the economic and efficient costs incurred with the procurement and use of these services.[3] Currently, this licence condition does not allow NGET to recover costs related to payments made under tender option contracts. NGET has therefore asked for a licence modification to allow them to do so.

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[1]A description of these services can be found here.
[2] For example, a power station that can prove it intends to close would fall into this category, while a plant that intends to stay open in the market is unlikely to incur material "otherwise avoidable" incremental costs which are necessary to facilitate the participation in a tender.
[3] Our final proposals on the funding arrangements for these services can be found here.

Proposals

We agree with NGET's assessment that in rare and exceptional circumstances, tender option contracts may be in the interest of consumers as they have the potential to improve tender liquidity and, hence, ensure reserves are procured at minimum cost.

Hence, we are proposing to amend NGET's licence to allow it to recover economic and efficient costs of payments made under these contracts. For any application, NGET will need to demonstrate to us how these costs meet such criteria and add value to consumers. In particular, NGET will be required to demonstrate how it:

- defines material incremental costs (short-term and non-permanent) that would be avoided if the service provider had not tendered for these services and which are necessary to facilitate the participation in a tender
- verifies the tendering costs for recovery
- ensures non-discriminatory access to participants
- demonstrates a positive cost benefit to consumers

We would assess any application made by NGET under this mechanism and will have the ability to disallow the recovery of costs that do not meet this criteria.

Following discussions with NGET, we are proposing to cap the costs of payments made under tender option contracts for any relevant year at £5 million. However, we propose to allow the Authority to change this cap through a direction, if appropriate. We would only change the cap if there was significant evidence to indicate that this would ensure that the volume requirement could be met at minimum cost.

Funding will be similar to other procurement costs associated with new balancing services[3] in that we are proposing to apply a retrospective review of these costs and disallow any costs which do not meet the criteria above.

We seek stakeholder comments on whether allowing NGET to recover economic and efficient costs of payments made under these contracts is in the interests of consumers. Moreover, we seek views on whether the proposed arrangements are proportionate and provide sufficient confidence and clarity to stakeholders on its use.

In parallel with this consultation, we are issuing a statutory consultation on the licence modification (accessible on this link) and seek views on whether we have appropriately reflected these arrangements in our proposed changes to the licence.

Responses should be received by 27 March 2015 and should be sent to:

Leonardo Costa
System and Wholesale Market Operations
Ofgem, 9 Millbank, SW1P 3GE
0203 263 2764
soincentive@ofgem.gov.uk

Any questions on this document should, in the first instance, be directed to Leonardo.

Regards

Emma Kelso
Partner, *Markets*