System operators, transmission system owners, generators, suppliers, traders, consumers, aggregators and other interested parties

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Date: 2 July 2015

Dear Colleagues

Decision not to direct any adjustment of the tender option contract payment costs submitted by National Grid Electricity Transmission plc associated with the procurement and use of the Supplemental Balancing Reserve and Demand Side Balancing Reserve

The Gas and Electricity Markets Authority (the Authority) has considered the notice submitted by National Grid Electricity Transmission Plc (NGET) under Special Licence Condition (SpC) 4K.28 on 4 April 2015 setting out the costs of tender option contract payments it considers it incurred in respect of Relevant Year 2014/15 (and which it has therefore recovered via the Balancing Services Use of System (BSUoS) charges). Ofgem has decided not to direct an adjustment to the recovery of these costs.

Background

In December 2013, the Authority approved NGET's application 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 the rare event that there is insufficient capacity in the market to meet demand in the mid-decade period.

NGET 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.

We agreed with NGET's assessment that in rare and exceptional circumstances, tender option contracts may be in the interest of consumers and opened a consultation on whether to amend NGET's licence to allow it to recover economic and efficient costs of payments made under these contracts.[1] On 8 April 2015 we directed the change to NGET's licence to allow it to recover these types of costs.

On 4 June 2015, NGET submitted to the Authority a notice under SpC4K.28 on the costs it considers it incurred on tender option contract payments for 2014/15 in total £972,995.12

[1] Our decision on the cost recovery mechanism can found at https://www.ofgem.gov.uk/publications-and-updates/decision-cost-recovery-mechanism-tender-option-contracts

Our Determination

SpC4K.30 requires that in its notice, NGET sets out how the tender option contract payments were economic and efficient (including how they provide long term value to consumers). This includes submission of evidence on a number of criteria. Below we provide the evidence submitted against each criteria:

Events to which the contract relates

NGET presented evidence of a contract it entered ahead of winter 2014/15. In its submission, it described how as winter 2014/15 approached, there was significant uncertainty on the generation outlook due to fires at power stations as well as nuclear unavailability due to inspections following a fault at Heysham 1.

Due to this uncertainty, it concluded that it was prudent to launch a tender for SBR on 2 September 2014. At that time, it was concerned that the proximity with the winter would translate to an insufficient volume to meet the volume requirement being tendered. In addition, there was a risk that lack of liquidity would mean significant costs to consumers.

At the same time, it was approached by a market participant with, in NGET's view, material avoidable costs that prevented it from participating in the SBR tender. This market participant was unavailable to the market.

NGET then assessed the benefit to consumers of having sufficient reserves and competitive pressure under SBR against the cost and risk of not entering into this contract. It concluded it was a net positive to consumers to enter into this contract to ensure there was enough volume to meet the requirement and enough competitive pressure to minimise costs to consumers.

Criteria applied by NGET to assess eligibility for Tender Option Contract Payments

NGET presented evidence of the criteria it set for tender option contract payments and how its contract met it:

Criteria defined by NGET	Evidence of compliance to criteria
Contract brings participants into the tender that would otherwise not been available	NGET provided evidence that the relevant party was already committed to exiting the market and would not be able to enter the SBR tender due to the material avoidable costs of doing so.
Costs paid were avoidable if the participant was not submitting a tender	NGET provided evidence of the costs being those required to prevent closure to allow tender participation
All potential service tenders being aware of this facility	NGET provided evidence of its issuance of a clarification notice[2]
It assessed whether entering into this contract would lead to a net benefit to consumers given the uncertainties on the overall generation outlook.	NGET provided evidence that the benefit of reducing risk to consumers of insufficient volume requirement or liquidity outweighed the low cost of entering into this contract.

How the amount of those payments have been calculated

NGET reviewed the proposed costs submitted by the generator. In its review process, it lowered the proposed contract from £1.2m to £814k a month. Of these costs, £739k were fixed verified costs, £15k were fixed unverified costs and £59k were variable costs. NGET

[2] SBR Clarification note 1 available at http://www2.nationalgrid.com/UK/Services/Balancing-services/System-security/Contingency-balancing-reserve/SBR-Tender-Documentation/

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also noted that the £15k cost was not verified in the appropriate timescale and as such were not invoiced or settled.

NGET then calculated the daily pro-rata value against these costs and agreed to pay them at cost from the date the contract entered into force until it was notified by NGET. In total, this contract was in force from 19 September 2014 to 28 October 2014.

Steps taken to verify the costs.

NGET performed a financial audit of the fixed costs proposed by the relevant party when agreeing the contract. For the variable cost, it received evidence and validated those costs at the end of the contract. It submitted to the Authority evidence of this financial audit.

Hence, the Authority is satisfied, having reviewed the information submitted in accordance with SpC 4K.28 that the costs incurred by NGET were economic and efficient and met the criteria set out in the licence. Accordingly, the Authority has written to NGET to state that it has decided not to direct an adjustment to the costs of tender option contract payments that NGET has recovered through BSUoS charges. As a result, NGET is able to recover the £972,995.12 of costs incurred.

Yours sincerely,

Emma Kelso
Partner, Markets

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