

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

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Dear Colleagues

Decision to approve the sensitivities proposed by NGET in accordance to the volume requirement methodology for tender round three of SBR and DSBR

This letter sets out the Authority's decision to approve the sensitivities listed below for tender round three of the Supplemental Balancing Reserve and Demand Side Balancing Reserve:¹

- Cold winter
- Warm winter
- Low wind
- High plant availability
- Low demand
- Fewer mothballed plant
- Coal closures
- Interconnector imports from Continental Europe (0.75 to 3 GW)

Background

In December 2013, the Authority approved National Grid Electricity Transmission plc's (NGET) 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.

For NGET to recover the economic and efficient costs relating to the procurement and use of SBR and DSBR, they need to comply with their transmission licence condition SpC 4K.² This means NGET has to demonstrate how those payments were incurred in accordance with the approved methodologies. Ofgem is then able to assess NGET's compliance with the methodologies. Depending on the outcome of that review, Ofgem can either direct NGET to recover these costs or to adjust the costs it has already recovered, as appropriate.³

¹ Information on the current tender can be found at <http://www2.nationalgrid.com/UK/Services/Balancing-services/System-security/Contingency-Balancing-Reserve/>

² Came into effect on 6 June 2014. Under SpC 4K, NGET is required to have in place certain approved methodologies which provide detail on how it will procure, including how much to procure, and use SBR and DSBR in an economic and efficient way.

³ In July 2015, we made the decision not to direct any adjustment of the tender option contract payment costs submitted by NGET associated with the procurement and use of the SBR and DSBR. This is in respect of Relevant Year 2014/15. <https://www.ofgem.gov.uk/publications-and-updates/decision-not-direct-any-adjustment-tender-option-contract-payment-costs-sbr-and-dsbr>

The initial cost recovery arrangements were set for 2014/15 and 2015/16, with the intention of NGET reviewing the need for the SBR and DSBR services beyond these years. In July 2015, NGET consulted stakeholders on the appropriateness of maintaining these services for winters 2016/17 and 2017/18.⁴ NGET then asked us to continue the cost recovery arrangements. This was primarily driven by uncertainty in the electricity security of supply outlook.

On 15 October 2015, we consulted on our minded to position to extend the SBR and DSBR cost recovery arrangements for 2016/17 and 2017/18. After carefully considering all of the responses, on 23 November 2015 we published the Authority's decision to continue the cost recovery arrangements for this period.⁵ We agreed with NGET's view that the outlook for 2016/17 and 2017/18 looked uncertain and it would be prudent to continue the cost recovery arrangements for these services, if required.

To allow NGET to apply lessons learned from using these services, the licence includes a mechanism (SpC 4K.12) that allowed it to submit revised methodologies to Ofgem for approval by 31 March 2016. NGET submitted an updated version of the 2016/17 SBR Procurement Methodology, and the 2016-18 DSBR and SBR Volume Requirement Methodology, for the Authority's approval⁶ under their special licence condition 4K.9. The updated methodologies were approved on 4 December 2015.⁷

For the procurement methodology, the three main updates from the previous version related to contract rollovers, capacity de-rating and the load factor rules. On the volume requirement methodology, the major update was to the volume cap. This was increased to equate to a margin of around 6.9%⁸ to better reflect NGET's higher Operating Reserve Requirement caused by an increase in intermittent generation on the system. The higher cap should better enable NGET to meet its balancing needs whilst limiting the market impact of DSBR and SBR.

Authority's role in assessing sensitivities

NGET's volume requirement methodology describes how NGET determines the economic and efficient volume of SBR and DSBR to procure ahead of the winter. NGET assess uncertainty by using a range of sensitivities around key scenarios. A 'least worst regret' approach is then applied to the sensitivities: it identifies areas where a relatively small increase in cost could eliminate significant risk, whilst attempting to avoid incurring significant costs while leaving overall risk to the system largely unchanged.

We analyse NGET's sensitivities on a case-by-case basis, meaning they are included or excluded based on their own merit rather than mechanically. The Authority also approves or rejects NGET's submission of sensitivities based on an assessment of credibility. But the onus is on NGET to demonstrate that the sensitivities it proposes to include are economic and efficient and meet the sensitivity criteria as defined in the Volume Requirement Methodology.

Our decision

⁴ NGET consultation on maintaining SBR and DSBR services for winters 2016/17 and 2017/18.

<http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=42010>

⁵ Decision to continue the Supplemental Balancing Reserve (SBR) and Demand Side Balancing Reserve (DSBR) cost recovery arrangements for 2016/17 and 2017/18.

<https://www.ofgem.gov.uk/publications-and-updates/decision-continue-sbr-and-dsbr-cost-recovery-arrangements-201617-and-201718>

⁶ Final versions of National Grid's methodologies.

<http://www2.nationalgrid.com/UK/Services/Balancing-services/System-security/Contingency-balancing-reserve/Methodologies/>

⁷ Decision on the 2016/17 SBR Procurement Methodology and the 2016-18 Volume Requirement Methodology.

<https://www.ofgem.gov.uk/publications-and-updates/decision-201617-sbr-procurement-methodology-and-2016-18-volume-requirement-methodology>

⁸ Assuming a peak Average Cold Spell demand forecast of 54 GW, including any interconnector exports. See National Grid's Demand Side Balancing Reserve and Supplemental Balancing Reserve Volume Requirement Methodology for details.

NGET submitted to the Authority the range of sensitivities⁹ it proposed to include in its modelling for 2016-17, listed below:

- Cold winter
- Warm winter
- Low wind
- High plant availability
- Low plant availability
- High demand
- Low demand
- Additional mothballed plant
- Fewer mothballed plant
- Coal closures
- Interconnector imports from Continental Europe (0.75 to 3 GW)

As described in our decision letter on the revision of the methodologies¹⁰, we assessed the evidence submitted by NGET against the definition of sensitivity defined in the volume requirement methodology.

From this initial assessment, we were able to approve the following sensitivities:

- Cold winter
- Warm winter
- Low wind
- High plant availability
- Low demand
- Fewer mothballed plant
- Coal closures
- Interconnector imports from Continental Europe (0.75 to 3 GW)

In our view, NGET provided evidence that demonstrated that these sensitivities were both credible and reflected a reasonable range of uncertainty that would not necessarily lead to a market reaction.

For example, NGET's evidence supported that there is a natural uncertainty in the weather. So it is credible and reasonable to assume that a cold winter, similar to those observed in the past seven years, could occur again and that the market may be unable to react to this by returning plants to the market. We also agree that it is credible and reasonable to consider the possibility that a generator may increase their availability. This is in light of the tighter margins projected in the outlook, and reforms to cash-out arrangements which have the potential to strengthen incentives for generators not to be in imbalance.

Conclusion on rejected sensitivities

Following an assessment, three sensitivities were rejected. These were low plant availability, high demand and additional mothballed plant. NGET's further analysis indicated that the inclusion or exclusion of any of these sensitivities did not have an impact on the outcome of the "least worst regret", and the volume requirement for 2016-17. These sensitivities could effectively be ignored in the volume calculation as other sensitivities had a higher likelihood of impacting the final requirement.

As such, the Authority has approved the following sensitivities for tender round three:

⁹ The full range of sensitivities that NGET can include in the volume requirement calculation is defined in the volume requirement methodology. To note, NGET did not submit any sensitivities which assumed an export from GB to the continent or no imports from the continent at times of tightness in the market.

¹⁰ Our decision to approve the revised methodologies can be found at <https://www.ofgem.gov.uk/publications-and-updates/decision-approve-revised-sbr-and-dsbr-volume-requirement-procurement-and-operational-methodologies>

- Cold winter
- Warm winter
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- Coal closures
- Interconnector imports from Continental Europe (0.75 to 3 GW)

Next steps

We have written to NGET to confirm the Authority's decision to approve the sensitivities listed above.

If you have any questions regarding the content of this letter, please contact Kristian Marr on 020 7901 7000 or by email soincidentive@ofgem.gov.uk.

Yours faithfully

Emma Kelso
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