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for energy consumers

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Direction to National Grid Gas plc to implement the Demand Side Response Methodology, pursuant to Special Condition 8I of the Gas Transporter Licence;

Notice of Reasons for our Decision under section 38A of the Gas Act 1986

In this letter, we set out our decision to approve National Grid Gas plc (NGG's) amended methodology for a gas demand-side response (DSR) mechanism. We have considered NGG's methodology, and the consultation conducted by National Grid¹. We are satisfied that the methodology has been developed in line with the principles set out in Special Condition 8I of NGG's gas transporter licence. We now direct NGG to proceed with the implementation of the proposed amended DSR mechanism, as set out in NGG's final DSR methodology.

Background to the DSR mechanism

On 23 September 2014 we concluded our Gas Security of Supply Significant Code Review (Gas SCR). Our Gas SCR reforms will make changes to the market during a gas supply emergency. The reforms were summarised in our Gas SCR Conclusions document² and took effect on and from 1 October 2015.

During the development of our Gas SCR reforms we found substantial evidence that the gas market could benefit from large consumers, in return for a payment, reducing demand voluntarily ahead of a possible (but very unlikely) gas supply emergency.

We therefore saw merit in a DSR mechanism if it could overcome some of the barriers identified by stakeholders, whilst not distorting or foreclosing any market for commercial DSR. As such, when we published our Gas SCR conclusions document we also placed an obligation on NGG to develop, trial and implement a DSR methodology in accordance with a set of principles and in consultation with interested parties.

On 26 August 2015 we received NGG's final DSR methodology and results of their DSR trial³. We approved this methodology on 21st September 2015, and in February 2016 we

¹ <http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=8589935216>

² <https://www.ofgem.gov.uk/publications-and-updates/gas-security-supply-significant-code-review-conclusions>

³ Available at:

<http://www.gasgovernance.co.uk/sites/default/files/Gas%20Demand%20Side%20Response%20Methodology%20Final%20V1.pdf>

approved a subsequent modification to the UNC which mandated that gas DSR would be implemented by 1st October 2016.

Proposed amendments to the methodology

During the detailed design of the DSR mechanism, several issues were identified with the methodology which were not envisaged during development of the methodology.

Firstly, potential cost and regulatory barriers to the 7-day rolling profile functionality were highlighted by ICE Endex, the operator of the OCM⁴. In addition, it was proposed that creating a separate Locational Market would be a more appropriate method of differentiating DSR offers, as opposed to the 'DSR flag' previously envisaged. There were also several minor grammatical and housekeeping changes proposed to the methodology.

In May 2016, NGG issued a consultation proposing revision of the DSR methodology to address these points. Specifically, the proposed changes were:

- Removal of the DSR Flag to differentiate DSR offers;
- Removal of the 7-day rolling profile; and
- Housekeeping amendments – removal of references to DSR framework

The majority of responses to NGG's consultation were supportive of the proposed amendments.

Our assessment of the amended methodology

Potential benefits and costs

Our previous publications on the Gas SCR outlined the potential benefits and costs of a DSR mechanism. We concluded that a DSR mechanism could help ensure large consumers calculate their Value of Lost Load (VoLL) ahead of any (very unlikely) emergency or tight gas market. It could also improve the efficiency of disconnections by ensuring more interruptions happen in price order rather than size order (as would be the case with involuntary load shedding).

Our Gas SCR conclusions highlighted the key benefits of voluntary DSR. We also identified a number of risks and potential unintended consequences associated with the adoption of a centralised DSR mechanism. Our Impact Assessment⁵ showed that the benefits of a DSR mechanism could outweigh the costs if the mechanism was carefully designed.

Assessment of the methodology against the principles

In order to mitigate against these costs and risks, and to ensure the DSR mechanism delivers the net benefits we anticipate, we set out a range of principles in Special Condition 8I.4 that NGG must consider in developing the mechanism. As part of our decision on 21st September 2015, we concluded that all of our principles were met by the methodology in its then form.

We have assessed the proposed changes to the methodology against the principles. Given the limited nature of these changes, we consider that the amended methodology remains consistent with these principles and with our assessment in September 2015.

⁴ Further details are available in NGG's consultation:

<http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=8589935216>

⁵ <https://www.ofgem.gov.uk/publications-and-updates/gas-security-supply-significant-code-review-impact-assessment-final-policy-decision>

Our decision and next steps

In our previous publications, we identified that introducing a DSR mechanism would be in the interests of consumers if it met the principles we set out in Special Condition 8I. Our view on this remains unchanged. We are satisfied that the amended methodology was developed in accordance with the principles. As a result, we now direct NGG to proceed with the implementation of the proposed DSR mechanism, as set out in NGG's amended DSR methodology.

NGG may raise a modification to the UNC to implement this change. We will make a decision on this modification in due course. The DSR mechanism is scheduled to be implemented by 1st October 2016.

In our SCR conclusions and previous direction, we highlighted that we did not necessarily view this mechanism as enduring. We will monitor participation and any use of the mechanism, so that we can evaluate its effectiveness. NGG also has an obligation to review the methodology annually and suggest any changes they consider necessary.

THE AUTHORITY HEREBY DIRECTS National Grid Gas plc to implement the Demand Side Response Methodology, pursuant to Special Condition 8I of the Gas Transporter Licence.

If you have any questions about this letter, please contact David Hall (david.hall@ofgem.gov.uk)

Yours sincerely

Emma Kelso

Partner, Wholesale Markets

Duly authorised on behalf of the Gas and Electricity Markets Authority