Modification proposal:	**Connection and Use of System Code (CUSC): A Fixed Response Energy Payment option for all generating technologies (CMP243)**		
Decision:	The Authority[1] has decided to reject[2] this modification		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the CUSC, the CUSC Panel and other interested parties		
Date of publication:	31 October 2016	Implementation date:	n/a

Background

Certain generators are required by the Grid Code to provide a Mandatory Frequency Response (MFR) service to assist the System Operator (SO) with keeping the electricity system frequency within a designated band of 50Hz and receive payments for doing so, in accordance with provisions set out in the CUSC. These payments are split between a Holding Payment for being available, and a Response Energy Payment (REP) which is a utilisation payment designed to cover the costs of energy production. Generators submit holding price (HP) tenders on a monthly basis and NGET, as the SO, ranks these tender submissions in economic order and selects providers with the lowest HPs to provide the service. Where generators are instructed to increase their output (Low Frequency Response), they receive a REP payment to compensate for the energy costs incurred. Where generators are instructed to reduce their output (High Frequency Response), they pay NGET, as the SO, the REP for the energy costs saved from reducing output. Under the MFR service the REP is calculated using the Market Index Price (MIP).

Drax (the 'proposer') noted that the REP was designed to be cost reflective, in a period where the providers of the service were, on the whole, thermal generators and would experience changes in their costs when changing output (ie have positive marginal costs). The proposer believes the diverse range of marginal costs for generators on the system, caused by the growth in renewable generation, is likely to have driven and continues to drive increased volatility and may result in uncertainty around the Market Index Price as the MIP is determined by the marginal source of generation[3].

According to the proposer this means that the MIP no longer acts as a good proxy for MFR providers' marginal costs, increasing the frequency and significance of loss-making in this market. This, in its view, could in turn increase the likelihood that generators factor a risk premium in their HP submissions. This increase in HP submissions due to increased risk, in the proposers view, could be having a negative impact on competition within the MFR market.

The modification proposal

The proposer raised CMP243 in May 2015 following on from a CUSC modification also relating to the MFR market (CMP237 'Response Energy Payment for Low Fuel Generators').[4] The purpose of CMP243 is to address what the proposer considers to be a defect not covered in CMP237, i.e. to address the perceived increased volatility and uncertainty around the MIP.

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=8589935185 – CMP243 Final Modification Report, Page 3
[4] More information about CMP237 can be found on NGET's website: http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP237/

The original proposal (the 'Original') seeks to amend the current arrangements, where the REP is calculated based on the MIP at the time MFR is provided, to a fixed monthly REP based on the wholesale power baseload price. Under the proposal, the REP would be set 10 days ahead of the requirement to submit HPs. The REP, under this calculation, would only apply to 'fuel generators', as described under CMP237[5].

The proposer considers that a fixed REP, set in advance, would eliminate the volatility and uncertainty associated with the MIP which would give MFR providers certainty on the price they would receive or pay for providing this service. In turn, this would allow providers to minimise the losses from MFR provision. The proposer considers that this would better facilitate effective competition (CUSC Applicable Objective (b)), encouraging greater MFR provision, and improve the ability for the SO to manage transmission system frequency (CUSC Applicable Objective (a)). Moreover, the proposer considers that there is likely to be scope for keener pricing of MFR HPs.

The workgroup which assessed CMP243 developed two Workgroup Alternative CUSC Modification proposals (WACMs) which applied various alternative market prices to calculate the REP.

WACM1 proposes using a peak and off-peak wholesale price, also set 10 days in advance of the HP submission. A workgroup member put forward this alternative proposal as they considered that that two prices would better reflect the market situation at the time MFR is provided compared with a single price.

WACM2 proposes using a peak wholesale price set 10 days in advance of the HP submission. This proposal was put forward by the WG to try to ensure that the REP more accurately reflects the costs of peak generators.

CUSC Panel[6] recommendation

At the CUSC Panel meeting on 29 April 2016, the Panel considered that all of the options (Original, WACM1 and WACM2) better facilitate the CUSC Applicable Objectives when compared to the current arrangements. The majority of Panel members considered that the modification does not better facilitate objectives (a) or (c) but facilitates objective (b). A majority of the CUSC Panel considered that WACM1 would best facilitate the CUSC objectives. The Panel recommended the approval of all the options. The full views of the Panel are set out in the Final Modification Report (FMR). [7]

The majority of the Panel considered that all of the options would lead to a reduction in the risk premium added to HPs and should result in enhanced competition in the market. One member was of the opinion that WACM1 best reflects market prices and another that it would provide a better outcome in the long run. Regarding a single price compared to a dual price, one Panel member considered that the former was better as it would be less complex.

One Panel member was of the opinion that the current arrangements better facilitate the objectives than all the proposals in that the MIP, used to calculate the REP, reflects the price the market put on energy in each settlement period. As none of the options better reflect this, the Panel member felt that the current arrangements are the better option specifically in terms of promoting competition.

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[5] http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP237/ – CMP237 Final Modification Report, Page 25

[6] The CUSC Panel is established and constituted from time to time pursuant to and in accordance with section 8 of the CUSC.

[7] BSC modification proposals, modification reports and representations can be viewed on the Elexon website at www.elexon.co.uk

Our decision

We have considered the issues raised by the modification proposal and the FMR dated 13 May 2016. We have considered and taken into account the responses to the industry consultation on the modification proposal which are attached to the FMR. We have concluded that:

- implementation of the modification proposal will not better facilitate the achievement of the applicable objectives of the CUSC.[8]

Reasons for our decision

We consider that none of the options for this modification proposal have been demonstrated to better facilitate CUSC objective (b) and all have a neutral impact on the other applicable objectives. We have therefore decided to reject the modification proposal.

(b) 'facilitating effective competition in the generation and supply of electricity, and (so far as consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity'

We have set out below our views on a number of issues we consider are relevant to our assessment against this objective. For the reasons set out below, we consider we have not been provided with sufficient evidence to demonstrate that the original proposal or any of the alternatives better facilitate CUSC objective (b).

The defect

We are concerned that the analysis provided to support this modification does not demonstrate that the identified defect exists and that any of the proposals better facilitate the CUSC objectives as a result.

One of the key arguments presented in the report is that the MIP has become more volatile[9]. To illustrate this, the proposer provided a graph showing MIP volatility between January 2010 and January 2015. The proposer considers that this shows an increase in volatility since September 2014. It is our view however that volatility has not been demonstrated in this analysis. The graph does show 3 periods, post September 2014, where volatility exceeds other periods in the analysis. However the frequency of these increases cannot be seen as evidence to demonstrate that the MIP has become more volatile. We are also of the view that the analysis is limited as it only extends to January 2015.

HP Submissions

The report presented several pieces of analysis to demonstrate that MIP volatility has resulted in an increase in HPs, both accepted and submitted. Having assessed this evidence however, we are of the view that HPs have shown no discernible change in the time periods considered. For instance, analysis on the frequency of HP submissions at various price ranges (e.g. £5/MWh, £10/MWh etc.) over 3 separate months between

[8] As set out in Standard Condition C3(3) of NGET's Transmission Licence, available at: http://epr.ofgem.gov.uk

[9] http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=8589935185 – CMP243 Final Modification Report, Page 7

2014 and 2015 does not demonstrate that HPs have increased over time. The analysis shows that there has been no significant change in HP submissions at the lower end (e.g. £5/MWh, 6/MWh and £7/MWh) and at the higher end (£100/MWh onwards). Further analysis in the FMR showed that the average accepted HP submissions had increased between April 2011 and March 2015. However we note the increase is minimal. Our view therefore is that the analysis does not demonstrate that perceived MIP volatility is impacting submitted and accepted HPs.

We note that members of the workgroup highlighted two concerns with analysis of the HP submissions. Firstly, that MIP volatility is a relatively recent occurrence and, as such, these graphs would not demonstrate a rise in HPs. Secondly, the proposer noted that there are many factors that influence the HP submissions and that trying to isolate the impact of increased volatility on HP submissions would be almost impossible. Our view is that, in the absence of evidence to demonstrate an increase in MIP volatility and any subsequent increase in HP submissions as a result, we cannot make a judgement on whether a defect exists, or therefore whether any of the proposals better facilitate competition than the current arrangements.

Price proposal

We have concerns in that setting a price ahead of time diminishes the value of accurate forecasting of the MIP. These proposals would therefore negatively impact generators who are better able to forecast the impact volatility will have on their operation.

One respondent to the Code Administrator Consultation raised the issue that the proposals have the potential to reduce risk to a greater extent for some providers more than for others. If, for instance, a baseload price was applied this would result in a REP that more accurately reflects the marginal costs of off-peak providers in comparison to peak time providers. Likewise, applying a peak price would result in off-peak providers receiving or paying a REP that does not reflect their marginal costs. We agree and therefore are of the view that these proposals do not provide any greater certainty, for some providers, than the current system.

As discussed above, we note that some workgroup members considered that, it is impossible to demonstrate how greater volatility is impacting competition in the MFR market. However, even viewed on a principles basis it is not clear to us that MIP volatility is hampering competition. In principle, parties better able to forecast and manage this volatility are rewarded in the MFR market at the expense of parties less able to do so. As such, evidence to demonstrate that, as a rule, volatility cannot be predicted or assessed is fundamental to demonstrating that any of the proposals better facilitate the CUSC objectives when compared to the current arrangements.

Interactions with CMP237[10]

In the FMR, it was highlighted by a member of the workgroup that approving one proposal (CMP237) without the other (CMP243) would move away from a level playing field in the MFR market, thereby distorting competition. We have carefully considered this argument in reaching a decision on CMP237 and CMP243 and, on balance, do not consider this to be the case.

The REP, under the CUSC, is designed to cover the energy production costs incurred or avoided, when providing MFR. Non-fuel generators do not incur or avoid costs when

[10] Our decision to approve CMP237 can be found on our website here: https://www.ofgem.gov.uk/licences-codes-and-standards/codes/electricity-codes/connection-and-use-system-code-cusc

providing this service, while fuel generators do.[11] So, the change under CMP237 makes the REP for non-fuel generators costs more cost reflective and our reasons for approving CMP237 are set out in our separate decision letter published today.[12] However there is no evidence that the proposal under CMP243 (a fixed REP value for each month) would make the REP more cost reflective when compared with the current approach.

We do not agree that approving CMP237 and rejecting CMP243 will distort competition but rather that it will result in a more level playing field between renewables and thermal MFR market participants. For thermal generators, while the REP is not fixed in advance, there is greater certainty that the REP will reflect the cost of generation at that time when compared with the current arrangements. This greater certainty should reduce pricing in the risk of windfall gains and losses. For renewables, CMP237 will remove the current distortion that could result in renewable generators paying NGET when incurring costs, and being paid when receiving benefits from generating. This again should reduce the risk premium added to the HP tenders. Combined, HPs should become more reflective of actual costs and increase competition. As such, in our view, approving CMP237 and rejecting CMP243 improves the level playing field of the MFR market.

Decision notice

In accordance with Standard Condition C10 of NGET's Transmission Licence, the Authority has decided that modification proposal CUSC CMP243 *'A Fixed Response Energy Payment option for all generating technologies'* should not be made.

Mark Copley
Associate Partner – Wholesale Markets
Signed on behalf of the Authority and authorised for that purpose

[11] In fact, non-fuel generators as defined in CMP237, also receive renewable subsidies (e.g. RO, CfD and FITs) meaning they have negative marginal costs when generating.