ofgem Making a positive difference for energy consumers

Modification proposal:	**Connection and Use of System Code (CUSC) CMP262: Removal of SBR/DSBR costs from BSUoS into a "Demand Security Charge"**		
Decision:	The Authority[1] has decided to reject[2] this modification[3]		
Target audience:	National Grid Electricity Transmission PLC (NGET), Parties to the CUSC and other interested parties		
Date of publication:	4 November 2016	Implementation Date:	n/a

Background

Balancing Service Use of System (BSUoS) charges are the means by which National Grid Electricity Transmission (NGET) as the System Operator (SO) recovers the costs associated with balancing the transmission system. BSUoS charges are levied on both generation and demand on a 50:50 split basis. The value of BSUoS varies in each half hour settlement period reflecting the different costs incurred by the SO in each period.

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).[4] These services provide NGET with additional tools to help balance the system in the event that the market is unable to provide sufficient reserves to do so. The relevant licence condition (Special condition (SpC) 4K of NGET's Electricity Transmission Licence) came into effect on 6 June 2014.[5] The cost recovery arrangements allow for both the capacity and utilisation costs of SBR and DSBR to be recouped via BSUoS charges.

In March 2016 the Government consulted on bringing forward the Capacity Market (CM) by a year. On 1 March 2016 we published an open letter[6] setting out that we would expect a 17/18 CM auction to procure enough capacity to meet the government's reliability standard. Therefore, SBR and DSBR services would not be needed for that year and thus it is possible that cost recovery of SBR and DSBR through BSUoS will only continue for one more winter. In May 2016 the Government confirmed its intent to hold an Early Capacity Auction for delivery year 17/18.

Under the existing CUSC charging methodology, SBR and DSBR utilisation costs are spread across all settlement periods within the day of utilisation on a volume weighted basis.

VPI Immingham (the 'proposer') believes SBR utilisation costs are likely to make BSUoS increasingly volatile and, in its view, virtually impossible to forecast this winter. In the proposer's view this is caused by a lack of transparency as to how SBR plant will be

---

[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.
2 This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
3 'Change' and 'modification' are used interchangeably in this document.
[4]https://www.ofgem.gov.uk/sites/default/files/docs/2013/12/decision_to_accept_nget_application_to_introduce_two_new_balancing_services_and_subsequent_consultation_on_funding_arrangements.pdf
[5]https://www.ofgem.gov.uk/publications-and-updates/funding-arrangements-new-balancing-services-final-proposals
[6]https://www.ofgem.gov.uk/publications-and-updates/open-letter-sbr-and-dsbr-201718-given-government-s-consultation-run-ca-delivery-same-year

despatched and their true utilisation costs. The proposer believes this will result in inefficient despatch and a distortion in competition between generators.

Furthermore the proposer believes that the current arrangements will increase costs to consumers as a result of additional risk premium being applied by generators and create perverse incentives to generate particularly in the event of shoulder periods.[7] The proposer also notes that generators are not able to adjust their contracted amounts to absorb unexpected costs in the event BSUoS charges are in excess of forecasts.

The modification proposal

The proposer raised CMP262 on 10 March 2016. On 31 March 2016 Ofgem accepted a request for the modification to be treated as urgent on the basis that the issue had the potential to have a significant financial and commercial impact on market participants in the lead up to and during winter 16/17. Ofgem also agreed it was appropriate to treat this modification as urgent in order for the issue to be considered ahead of winter 16/17.

The original proposal (the 'Original') seeks to amend the current arrangements so that all SBR and DSBR costs are removed from BSUoS charges and instead they should be recouped from demand side only Balancing Mechanism Units (BMUs) via a 'demand security charge' that, as described in the FMR, is smeared across the winter.

Following workgroup discussions the proposer amended the Original such that the 'demand security charge' would remain within BSUoS and would relate only to SBR and DSBR utilisation costs noting that procurement costs are known ahead of time and should have already been factored in. In addition the proposer amended the Original such that utilisation costs would be recovered from net demand instead of gross to enable the change to be implemented for this winter.[8]

The proposer considers the Original would better facilitate effective competition (CUSC charging objective (a)) and would result in more cost reflective charging arrangements (CUSC charging objective (b)). In particular the proposer considers removing SBR/DSBR utilisation costs from generators would protect them from unforeseen and unforecastable costs from SBR utilisation. The Proposer considers that this in turn should reduce overall costs to consumers due to a lower risk premium being applied by generators and should protect consumers from suboptimal generation despatch as a result of uncertainty. The Proposer believes that demand units are better able to manage the costs and that placing costs on demand units would more economically charge the parties who are benefiting from the product. In addition the Proposer considers that smearing costs over a longer time period should remove volatility and improve competition whilst reducing risks to security of supply.

A workgroup member proposed two Workgroup Alternatives CUSC Modifications (WACMs), retaining the charge on both generation and demand whilst applying alternate smearing options.

[7] The FMR does not define which charges would arise in the shoulder period. Since the report has been amended to reflect the updated understanding of the current arrangements we have inferred the shoulder period would arise in the event SBR utilisation costs were incurred and therefore recovered through BSUoS to enable an SBR plant(s) to be capable of providing SBR in a preceding settlement day.
[8] BSUoS charges are currently allocated among demand-side users on a net demand basis.

WACM1 proposes to smear SBR and DSBR utilisation costs across all settlement periods for the winter period. WACM2 proposes to smear SBR and DSBR utilisation costs across the settlement periods in the SBR utilisation window (6am-8pm) for the winter period.

The workgroup member considered that smearing costs over longer time period than the current arrangements would better facilitate effective competition. They considered that this in turn should mitigate the cash flow issues parties may face, remove the perceived disincentive to generate at times when systems margins are tight and mitigate the risk of increased use of SBR due to inefficient despatch.

Following the Code Administrator's consultation it became apparent that the workgroup did not have a common view of the current arrangements. On 26 August 2016 the Panel directed the workgroup to re-convene to discuss the issues, update the report and vote again on the proposals. A second five day Code Administrators consultation was issued in September 2016. The revised modification timescale to rectify the issues proposes Ofgem makes a decision after the winter period has started (4 November 2016) with an implementation period of not less than 5 working days as opposed to the original implementation timeframe of 10 working days. For clarity the workgroup confirmed that currently SBR and DSBR utilisation costs are smeared across all settlement periods within the day of utilisation on a volume weighted and not to the settlement period in which the costs are incurred.

To provide further information on SBR arrangements, at the Special Electricity Operational Forum in September 2016, NGET also set out in more detail its decision making process for despatching SBR plant, publication of system notices and some scenarios of the costs of SBR utilisation in various weather conditions. The slides are available on National Grid's website.[9]

CUSC Panel[10] recommendation

At the CUSC Panel meeting on 30 September 2016, a vote was taken as to whether the Original and WACMs better facilitated the relevant objectives. The Panel view was split on whether any of the options better facilitated relevant charging objectives (a), (b), (c) or (e). The majority of Panel members considered that both WACM1 and WACM2 better facilitated the objectives overall. In voting on which they considered to be the best option, three members were in favour of the Original, three in favour of WACM1, two in favour of WACM2 and one in favour of no change to the current arrangements. The Panel members' views are set out in detail in the final Modification Report (FMR).

Our decision

We have considered the issues raised by the modification proposal and the final Modification Report (FMR) dated 7 October 2016. We have considered and taken into account the responses to the Code Administrator's consultation on the modification proposal which are attached to the FMR.[11]

[9] http://www2.nationalgrid.com/UK/Industry-information/Electricity-transmission-system-operations/Operational-forum/Electricity-Ops-Forum-Current-Slides-2016/

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

[7] The FMR is available on NGET's website here: http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP201/

We have concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant charging objectives of the CUSC[12] and would not be in keeping with the Authority's principal objective of exercising our functions in a way that protects the interests of existing and future consumers.

Reasons for our decision

We consider that none of the options for this modification proposal better facilitate relevant CUSC charging objectives (a) or (b) and we believe that the Original and WACM2 would not better facilitate CUSC charging objective (e) for the reasons set out below. We consider that all of the options for this modification proposal have a neutral impact on the other relevant CUSC charging objectives.

(a)'that compliance with the use of system charging methodology facilitates effective competition in the generation and supply of electricity and (so far as is consistent therewith) facilitates competition in the sale, distribution and purchase of electricity'

We are concerned that the short implementation timescale for the modification proposals will create uncertainty and will not provide sufficient time for market participants to re-adjust pricing structures to accommodate the change. The impact on individual market participants will therefore be varied and the change could result in windfall gains and losses in generation and supply, respectively, which is likely to have a negative impact on competition and could increase costs to the consumer.

We note that some workgroup members highlighted that a considerable volume of energy had already been traded for winter 16/17 and that generators may have already included a risk premium in their prices based on existing arrangements. Under the Original this could lead to additional costs to suppliers and ultimately consumers. This is because suppliers could be exposed to additional BSUoS costs through the 'demand security charge' as well as already having paid the same cost in the price paid for energy purchased to date. We concur with this risk identified in the FMR and believe it also extends to the WACMs which will result in a change to charging base.

During the workgroup discussion, as summarised in the FMR, when considering the extent to which generators may have already included a risk premium in their prices based on existing arrangements, it was noted that the announcement of the SBR tender results in December 2015 did not have a notable impact on wholesale prices. We do not believe this assessment is enough to reach a conclusion that a risk premium has not already been applied as there are a number of variables that impact on the wholesale price at a given point in time.

We also consider that the modification proposals will not address uncertainty associated with SBR and DSBR utilisation costs by smearing costs. In particular we note the overall charge would remain the same in the event SBR was used this winter and that changing the charging base will redistribute costs between generation and supply under the Original or within generation and supply under the WACMs with minimal time for market participants to respond. The risk was identified in the FMR with some workgroup members considered smearing costs may work better for suppliers who offer variable

[12] As set out in Standard Condition C5(5) of NGET's Transmission Licence, see: https://epr.ofgem.gov.uk//Content/Documents/Electricity%20transmission%20full%20set%20of%20consolidated%20standard%20licence%20conditions%20-%20Current%20Version.pdf

priced contracts whereas baseload generators may incur proportionally more of the costs if smeared over a longer time period under the WACM proposals.

The impact of the modification proposals on individual market participants is therefore likely to be varied depending on the nature and type of contracts market participants have entered into and the extent to which SBR is used. We note that the workgroup was not able to quantify the impact the proposal would have on various sectors for winter 16/17 as to do so would require information on trading contracts and risk premiums already in place. The workgroup was also not able to quantify the ultimate cost to end consumers.

We believe the analysis provided to support the Original proposal does not demonstrate that transferring costs to suppliers would reduce the risk premium and therefore a concomitant reduction of costs to consumers or that suppliers are better able to manage the costs at short notice. In particular the FMR notes that Suppliers would also have to factor in a risk premium. In addition some suppliers provide a fixed, 1, 2 and 3 year contract to their customers and in these circumstances it is unclear how these additional costs could be recovered.

Our view is therefore that the Original and WACMs would not better facilitate this objective and would not be in keeping with our principal objective to protect existing and future consumers.

(b)'that compliance with the use of system charging methodology results in charges which reflect, as far as is reasonably practicable, the costs (excluding any payments between transmission licensees which are made under and in accordance with the STC) incurred by transmission licensees in their transmission businesses and which are compatible with standard condition C26 (Requirements of a connect and manage connection)'

We believe that none of the modification proposals would better facilitate objective (b) by smearing costs over a longer period than the current arrangements. We note that BSUoS costs are allocated to the half hour in which they occur and not to specific network users that drive costs. We believe that consideration more generally of the merits of smearing BSUoS costs would be more appropriate as part of an overall BSUoS modification. We understand that the merits for such a change are being developed in a separate modification which will presented to the Authority early next year and as such we will consider the case for such a change in the near future.

(e) 'promoting efficiency in the implementation and administration of the system charging methodology'

We have considered the implementation approach set out in the FMR. In particular we note that due to the short implementation timeframe the Original and WACM2 would require the charge to be manually calculated for hundreds of consumers and manually invoiced on a monthly basis. This would create more complicated manual handling of the data and potentially lead to increased risk of human errors compared to the current arrangements. Our view therefore is that the Original and WACM2 would not better facilitate CUSC charging objective (e).

In comparison we note that while WACM1 would require more additional manual processes relative to the current arrangements, the solution is relatively simple and does not require manual invoicing to individual consumers therefore minimising the risk of human error. Our view therefore is that WACM1 overall has a neutral impact on CUSC charging objective (e).

Decision Notice

In accordance with Standard Condition C10(1) of NGET's Transmission Licence, the Authority hereby directs that modification proposal CMP262: 'Removal of SBR/DSBR costs from BSUoS into a "Demand Security Charge' not be made.

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