Making a positive difference
for energy consumers

All interested parties

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Ofgem response to publication of the final report of the second Balancing Services Use of System (BSUoS) Task Force

We welcome the publication of the final report of the second BSUoS Task Force and the work carried out by industry. This open letter acknowledges this work and sets out our expectations for how reform to BSUoS charges will be delivered.

Background to current BSUoS charging framework

BSUoS charges are the means by which National Grid Electricity System Operator (NGESO) recovers the costs associated with balancing the electricity transmission system. BSUoS is made up of several elements, which include: the costs of constraints, frequency response services, provision of reserve, the costs of actions taken in the Balancing Mechanism and the ESO's internal costs. In 2020/21 these charges are projected to amount to almost £2bn. BSUoS is currently calculated half-hourly and charged to large generators and suppliers as a floating charge levied on a non-locational volume basis (per MWh).

We previously considered BSUoS distortions as part of our work on the Targeted Charging Review Significant Code Review (TCR). We asked the Electricity System Operator (ESO) to launch the first Balancing Services Charges Task Force when the TCR minded-to consultation was published in November 2018. The first Task Force was asked to examine the potential for, and feasibility of, improving the cost reflectivity of some elements of balancing services charges and hence for these charges to provide stronger forward-looking signals.

When assessing the current BSUoS charge, the first Task Force concluded that it "does not currently provide any useful forward-looking signal which influences user behaviour to improve the economic and efficient operation of the market".[1] They concluded that BSUoS should be treated as a cost-recovery charge. This conclusion served as the starting point for the work of the second Task Force.

When we published our decision on the TCR, we accepted that it is not possible, at present, to send useful forward-looking signals through balancing services charges.[2] We asked the Electricity System Operator (ESO) to launch a second industry Task Force to apply the TCR

[1] http://www.chargingfutures.com/media/1348/balancing-services-charges-task-force-final-report.pdf
[2] If this changes in the future, the charging framework can be adjusted accordingly.

principles to assess who should be liable for BSUoS charges and how these charges should be recovered.[3]

The BSUoS Task Force used qualitative analysis to consider how best to apply the Targeted Charging Review (TCR) Significant Code Review principles of:

- reducing harmful distortions,
- fairness, and
- practicality and proportionality.

At the end of September, the second BSUoS Task Force published their final report.[4] The key conclusions were that "Final Demand" should be liable for all BSUoS charges, and that these charges should be set in advance. The Task Force recommended that the total length of the fix and notice period should be around 14/15 months in length, and that BSUoS charges should be recovered on a volumetric basis.

Under the current framework, if charges are fixed for a period of time, this gives greater certainty to consumers and other market participants but exposes the ESO to cashflow/revenue risk. The ESO has expressed strong concerns regarding how fixed charges would represent an un-manageable risk. It has argued that it would only be able to take on this risk, if it were capped. We have a duty to have regard to financeability of the regulated companies, and would need to consider the ability of the ESO to take on this risk and the impacts on the ESO's overall regulatory framework, for example, any additional funding requirements before coming to a decision on how BSUoS charges should be levied.

The BSUoS Task Force have presented a good case that BSUoS should be recovered from final demand and on a flat volumetric basis. However, more work is needed to quantify the costs and benefits of reform.

For example, the Task Force did not quantify the costs, or other potential issues, related to the ESO holding risks related to BSUoS revenue collection. We intend to carry out this work in parallel with development of industry-led code modifications.

Deliverable 1 "who should be liable for BSUoS"

On Deliverable 1, the Task Force recommend that "Final Demand" should be liable for all Balancing Services charges, subject to sufficient notice to industry prior to implementation. This is consistent with the position set out in our Targeted Charging Review decision letter, where we set out the rationale for residual network charges (which are cost-recovery charges), being paid by Final Demand consumers.[5]

In our work on the TCR, we defined Final Demand as being "electricity which is consumed other than for the purpose of generation or export onto the electricity network".[6] Since then, a more detailed definition of Final Demand has been developed through work on the CUSC and DCUSA modifications CMP334 and DCP359[7].

The key reasons behind the Task Force's conclusions on who should be liable for BSUoS are that:

[3] https://www.ofgem.gov.uk/system/files/docs/2019/11/open_letter_on_the_balancing_services_charges_taskforce.pdf
[4] http://www.chargingfutures.com/media/1477/second-balancing-services-charges-task-force-final-report.pdf
[5] See page 105 in TCR decision document https://www.ofgem.gov.uk/system/files/docs/2019/12/full_decision_doc_updated.pdf
[6] See page 55 in the TCR decision documents https://www.ofgem.gov.uk/system/files/docs/2019/12/full_decision_doc_updated.pdf
[7] https://www.ofgem.gov.uk/system/files/docs/2020/09/dcp359_d.pdf

1. Levying BSUoS charges onto Final Demand only will mitigate the existing distortions between GB transmission connected generators who are currently liable for BSUoS charges and interconnected and distributed generation who are not.

2. Expanding the charge base to include distributed generation would create a new distortion boundary between behind-the-meter generation and network connected generation and have a negative impact on the business case of new distributed and community generation which is overwhelmingly renewable or low carbon.

3. The first Task Force concluded that BSUoS should be a cost recovery charge, the addition of BSUoS related risk premia and transaction costs into both wholesale and retail prices is an inefficient method of cost recovery.

The effects of reform to BSUoS charges are complex, while in principle we agree with the TF recommendations, we will require further quantitative analysis to inform a final decision on any modifications to the charging arrangements. This may require whole systems modelling, which we intend to undertake in early 2021. Any reports prepared by independent consultants will be published and may aid development of solutions through industry-led work groups.

Our previous assessment – CMP201

It is not the first time we have considered this issue - CMP201 was a CUSC modification, initially raised in 2011, which sought to move Balancing Services Charges wholly onto final demand.[8] In our 2014 decision to reject CMP201, we stated that "we support the fundamental economic principle that increasing competition should lead to lower wholesale prices in the long run" however we were "concerned that at this time the potential benefits this would bring would not be material enough to offset the potential costs to consumers from implementing the modification". There have been many changes since CMP201 came to us for decision.

Decarbonising at lowest cost

The Task Force concluded that a move to recovery of BSUoS from Final Demand would result in a reduction in imports over interconnectors, which for the purposes of GB carbon accounting are treated as zero-carbon. This means that levying BSUoS charges on final demand only, resulting in the displacement of some interconnector import by domestic transmission connected generation, may be treated as a more carbon intensive outcome, should those imports be replaced by fossil fuel generation.

The Task Force argued that in reality the impact would be carbon neutral and the apparent impact is an outcome of carbon accounting rules. They argued that the marginal plant in connected countries is a similar carbon intensity to that in the UK.

Our decision on potential solutions put forward through the code modification process will consider the expected impacts of this reform on carbon emissions. We will assess effects against "net zero" targets and consider also how this fits with our approach to decarbonisation at least cost and the wider potential benefits of these reforms.

Our view as to who should be liable for BSUoS charges

The current BSUoS charging arrangements mean that, generation that is embedded has an advantage over large generators in Great Britain in that they do not face BSUoS charges. We appreciate that in principle, this harms competition and pushes up costs for end

[8] https://www.nationalgrideso.com/industry-information/codes/connection-and-use-system-code-cuscold/modifications/cmp201-removal

consumers and we agree with the Task Force's recommendation that BSUoS should be recovered from Final Demand only.

Implementing the Task Force recommendations could impact both positively and negatively on different network users, depending on their business model. Although we recognise this, we note that these charges were not intended as a policy support mechanism to incentivise certain types of generation. If additional measures to reduce carbon emissions from the GB power sector are warranted, delivering this through targeted policy measures would be a more efficient approach. The Task Force have recommended implementation two years following our response to their final report. Based on the information available at this time, our view is that April 2023 would be an appropriate target for this element of the reform.

Deliverable 2 – how BSUoS charges should be levied

The Task Force recommendation

On Deliverable 2, the Task Force have concluded that a volumetric fixed BSUoS charge would deliver overall industry benefit, and that the total length of the fix and notice period should be around 14/15 months in length.

We have acknowledged that it is not currently feasible to charge any of the elements of the BSUoS charge in a way that will positively influence behaviour and so reduce overall costs to end consumers. The current floating charge can send unhelpful signals and we accepted urgent code modifications to defer BSUoS costs over summer 2020, these highlighted the need for an enduring solution.[9]

The Task Force agreed that reforms to BSUoS charges should aim to reduce both uncertainty and industry financing costs. The key reasons for this are as follows:

- Businesses struggle with uncertainty as it adds to costs and makes it more difficult to plan. A known charge can be factored into pricing plans accurately and does not attract risk premia as the payee has confidence that the charge will not change.
- Minimising industry financing costs should reduce costs to consumers as the financing costs won't be passed through prices and tariffs.

The consensus amongst Task Force members was that a 6-month fixed period was the minimum required for suppliers to begin to unlock the benefits associated with increased certainty. They also argued that the ESO should be able to manage BSUoS risk more cheaply compared with suppliers or customers because the ESO could be given the regulatory authority to recover cash-flow shortfalls from suppliers, but suppliers and customers would have to absorb unexpected BSUoS costs.

The Task Force took the view that the ESO should be able to borrow money to cover payments to service providers if a fixed balancing services charge did not cover the costs incurred in a given period. The ESO would be able to fully recover any financing costs incurred.

There was extensive debate at the Task Force as to whether the charge should be similar to the TCR residual methodology (i.e. £/site, based on size) or volumetric (i.e. £/MWh). The Task Force discussions are laid out in a table in the body of the report which shows assessment of each approach against the TCR principles. Ultimately, the distributional impacts of a banded charge and the complexity it introduces led The Task Force to agree by majority that the most appropriate way of recovering the charge is through a volumetric (£/MWh) charge. The Task Force noted that this is particularly relevant for a charge that is recovering costs related to an energy service.

Our previous assessment – CMP250

[9] CMP345 and CMP350: https://www.ofgem.gov.uk/system/files/docs/2020/08/cmp350_decision_letter_0_0.pdf

CMP250 was a CUSC modification, which sought to fix the value of BSUoS for a period of time, with a notice period in advance of this. The original proposal sought to fix the BSUoS price for 12 months with a 12-month notice period. The CMP250 Workgroup agreed to support four alternative modification proposals, which all proposed a fixed BSUoS price but with varying fixed and notice periods. A majority of the CUSC Panel considered that CMP250 would better facilitate the relevant charging objectives and should be implemented. However, we rejected CMP250 as we did not consider that the evidence provided in the final modification report was sufficient to allow us to determine whether the solutions presented would have had a positive or negative impact on the relevant charging objectives. With regard to enabling competition, we were not satisfied that a case has been made that the proposed changes facilitate more effective competition leading to lower costs to consumers. This was before the findings of the first BSUoS Task Force, that BSUoS should be treated as a cost recovery charge and the further analysis carried out by the second Task Force.

Under the current BSUoS charging framework financing costs to parties are passed through to end consumers. Setting BSUoS charges in advance would reduce uncertainty for suppliers helping them to maintain financial stability. Reductions in risk premia for market participants will be passed on to consumers where markets are competitive as will other savings, such as reduced forecasting costs.

Changes to BSUoS would flow through automatically under our current Energy Price Cap. The allowance in the cap for BSUoS charges would increase (reflecting the cost increase for suppliers), but this should be largely offset by a decrease in the wholesale cost allowance. The overall effect should therefore be largely neutral. However, we might need to consider any transitional impacts of moving from our current approach (recovering BSUoS charges in arrears) to passing through a fixed charge.

Setting BSUoS charges in advance and so making BSUoS into a non-floating charge will eliminate perverse price signals to demand to turn down when demand is low on the system and/or when renewable output is high – in principle this will lead to efficiencies that support decarbonisation at least cost.

Our view as to how BSUoS charges should be levied

We accept that there are clear advantages to charging BSUoS in a more predictable way. We also agree that, in principle, setting BSUoS in advance would reduce both uncertainty and industry financing costs. More work is needed to understand the wider costs of setting BSUoS in advance and on the best way to deliver this and to manage the risk of BSUoS charges as the energy system evolves.

We accept the Task Force recommendation in principle that BSUoS charges should be recovered on a flat volumetric basis (on the basis of £/MWh), subject to a formal impact assessment. While volumetric charges encourage potentially out-of-merit on site generation, charging bands can also create distortionary incentives in the form of boundaries. We also agree that, in principle, a volumetric charge reflects BSUoS as a cost of flowing electricity (which is different to the fixed nature of transmission & distribution network residual charges). As set out in our work on the Targeted Charging Review, all cost recovery charges are to some extent distortionary. The combination of volumetric BSUoS charges with banded fixed residual charges may be beneficial in terms of limiting avoidance and effectively serving as a form of hybrid cost-recovery charge.

The TF proposed the notice period of the first fixed charge be included within the two-year notice of implementation. We are aware that consumers may benefit from earlier implementation of this part of the reform and are prepared to consider such proposals. But we will need to consider any changes alongside our assessment of the overall benefits of reform, including the mitigation of any potential windfall gains or losses, alongside the practical challenges of cashflow exposure of the ESO.

Next steps

We expect that industry will develop refined solutions in line with the Task Force recommendations through the code modification process. We will evaluate these solutions on a holistic basis, taking into account our understanding of the potential impact on consumers, as well as different categories of market participants. This will likely form an important part of our assessment of the modification against (i) the relevant Code Objectives and (ii) our Principal Objective of protecting the interests of existing and future energy consumers and our other statutory duties. For the avoidance of doubt, nothing in this letter fetters our discretion in respect of these proposals when they come to us for decision.

The Task Force have recommended that the ESO should manage risk of BSUoS under and over recovery. We will carry out further work to explore the cashflow exposure of the ESO under a range of charging options for the ESO and any alternative options for which party bears this risk. We will explore how this cashflow exposure could be funded and mitigated by reforms to the existing industry arrangements, in parallel with the CUSC code modifications.

We will also undertake quantitative work to assess the overall net benefits of these reforms to inform our final decision on the solutions put forward through the code modification process. As part of our further work, we will consider further the potential impact on energy intensive industries. The quantitative work will be progressed in an open and inclusive way, with all interested parties having the chance to engage.

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