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All interested parties,
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Email: Jordan.clarke@ofgem.gov.uk

8 October 2019

Dear colleagues,

Decision on the Transmission System Operators' proposal for the Terms and Conditions related to Balancing

On 4 August 2019, we¹ received an amended proposal from the relevant Transmission System Operator (TSO) for Great Britain (GB), the National Grid Electricity System Operator (ESO)², in accordance with Article 18 of the guideline on Electricity Balancing (EBGL).³ The proposal presents the Terms and Conditions (T&C) related to balancing.

This letter sets out our decision to confirm, upon satisfaction of certain conditions, that the proposed T&C are the terms and conditions for balancing required by Article 18 EBGL. The letter furthermore outlines the necessary next steps that have to be taken.

Background

In accordance with Article 18(1) EBGL, the TSOs of a Member State must develop a proposal regarding the T&C for balancing service providers (BSPs) and balance responsible parties (BRPs).

In accordance with Article 18(2) EBGL, the T&C must also include the rules for suspension and restoration of market activities and the rules for settlement in case of market suspension, once they have been approved in accordance with the Regulation (EU) 2017/2196 (NC ER).⁴

In Great Britain, the Balancing and Settlement Code (BSC), the Grid Code (especially the "Balancing Code" sections), the relevant sections of the Connection and Use of System Code (CUSC) and the Standard Contract Terms (SCTs) already contain provisions related to balancing that are applicable to BSPs and BRPs.

The ESO first submitted the Article 18 proposal to us on 18 June 2018. Following a review of this submission, we published a request for amendment on 4 February 2019⁵, as the proposal could not be

¹ The Gas and Electricity Markets Authority. Ofgem is the Office of the Authority. The terms "Ofgem" and "the Authority," "we" and "us" are used interchangeably in this letter.

² This is in line with our assignment of obligations. See decision letter here: <https://www.ofgem.gov.uk/publications-and-updates/decision-assignment-transmission-system-operator-obligations-under-guideline-electricity-balancing-regulation-within-gb>

³ Commission Regulation (EU) 2017/2195 of 23 November 2017 establishing a guideline on electricity balancing (EBGL). EBGL came into force on 18 December 2018.

⁴ Commission Regulation (EU) 2017/2196 of 24 November 2017 establishing a network code on electricity emergency and restoration (NC ER) NC ER entered into force on 18 December 2017.

⁵ See the first request for amendment here: <https://www.ofgem.gov.uk/publications-and-updates/decision-request-amendment-transmission-system-operators-proposal-terms-and-conditions-related-balancing>

approved in the form submitted. The amended proposal, containing for the first time a proposed exemption from the application of Article 16(6) EBGL, was received by the Authority on 4 April 2019. As the proposal could still not be approved in the form submitted, we published a second request for amendments on 4 June 2019⁶.

The new amended proposal was received by the Authority on 4 August 2019 following a consultation that the ESO undertook on the amended proposal. The EBGL requires us to decide on the amended terms and conditions within two months following their submission, pursuant to Article 6(1) EBGL.

Decision

We have reviewed the amended proposal submitted to us in line with the requirements of the EBGL, the wider objectives of the Regulation (EC) No 714/2009⁷ and our statutory duties and obligations. In making our decisions we have considered the justification for the inclusion or exclusion of views resulting from the consultation on the amended proposal. We furthermore engaged with the ESO to clarify our understanding of the proposed T&C.

Although we are minded to confirm that the proposed T&C are the terms and conditions for balancing as required by Article 18 EBGL, the ESO's approach to ensuring full and timely compliance with the EBGL requirements has not met our expectations.

Some elements of the proposed T&C are not yet fully aligned with the requirements of Article 18 EBGL. We believe that requesting changes through a third request for amendment would not prove to be an efficient use of resources since the ESO has proposed timelines for code modifications which are going beyond the two month timeframe.⁸ It would therefore be very likely that we would receive another proposed T&C which would still not be fully aligned with the requirements of Article 18 EBGL and that this would lead us to issuing a fourth request for amendment.

We understand however that the ESO has initiated the necessary processes to amend the industry codes and SCTs to ensure full compliance with the EBGL. This gives us some comfort that the necessary processes have been initiated and should conclude in a timely manner. We have therefore decided not to issue a new request for amendment but to issue a decision subject to the fulfilment of several conditions.

The main elements of the proposed T&C are assessed below in turn. This assessment constitutes the reasons for our decision.

T&C proposal, general comments

In our second request for amendments, we highlighted that Frequency Containment Reserve (FCR) had not been included within the scope of the proposed T&C. As the FCR SCTs contain terms and conditions related to balancing, we therefore believed that not all of the relevant provisions of the GB regulatory framework setting obligations related to balancing on BSPs and BRPs had been properly included in the scope of the T&C. We believe that the amended proposal now contains the relevant mapping required for FCR and provides sufficient clarity for BSPs and BRPs.

In this regard, the necessary changes to the T&C have been implemented.

Compliance with Article 34 EBGL

Article 34 EBGL states that within the geographical area in which the procurement of balancing capacity has taken place, the TSOs shall allow balancing service providers to transfer their obligation to provide balancing capacity between market participants. The proposed T&C do not allow such transfer. We therefore expect the ESO to ensure that the appropriate changes are implemented to allow for the transfer of balancing capacity. We note that the ESO has already initiated the necessary changes

⁶ See the second request for amendments here:

https://www.ofgem.gov.uk/system/files/docs/2019/06/article_18_final_decision_letter_-_04.06.2019.pdf

⁷ See the Regulation (EC) No 714/2009 here: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0015:0035:EN:PDF>

⁸ In accordance with Article 6(1) EBGL, a request for amendment by the authority would open a two-month window for an amended proposal to be submitted by the ESO.

through a change proposal that is currently being consulted on and expects the changes to be implemented by 18 December 2019.⁹

Decision on Article 16(6) exemption

Article 16(6) EBGL states that the price of balancing energy bids or integrated process bids from standard and specific products should not be predetermined in a contract for balancing capacity, unless an exemption is sought under the national terms and conditions of Article 18 EBGL. Such an exemption should only apply to specific products activated locally without exchange. The exemption must also be accompanied with a justification demonstrating higher economic efficiency.

The ESO first proposed an exemption from the application of Article 16(6) EBGL in its T&C submission on 4 April 2019. We assessed the exemption and concluded that it did not adequately meet the requirements listed in Article 16(6) EBGL. We therefore requested that any new amended exemption submission should demonstrate how it would lead to higher economic efficiency and should explore the following areas:

- (i) the expected changes in utilisation prices per balancing service if those are not contracted in advance, with a description on why the proxy chosen to simulate the change is appropriate;
- (ii) the ESO's expectations on the changes to the availability prices in a market where utilisation prices are no longer fixed and the rationale for such a change;
- (iii) an analysis of alternatives available to the ESO in real time to those services and how this can affect the submitted prices and hence economic efficiency; and
- (iv) a clear articulation of how all the factors considered lead to higher economic efficiency in GB.

The ESO submitted an amended application on 4 August 2019 for exemption for two balancing services: (i) Fast Reserve and (ii) Short Term Operating Reserve. We have reviewed the ESO's justifications for the exemption, which are included in annex 1. The key elements where we disagree with the ESO's reasoning and assumptions are included below:

- (i) The ESO noted that the removal of pre-determined utilisation prices from balancing capacity contracts will lead to greater risk and exposure to volatility in balancing costs. However, there is insufficient analysis and justification for this assertion, particularly in relation to longer-term, dynamic economic efficiency.
- (ii) The ESO procures balancing capacity to ensure that there is sufficient capacity to cover NGESO operating reserve requirements. The ESO has not demonstrated sufficiently that a pre-determined balancing energy utilisation price within balancing capacity contracts, ensures that the most economic action is taken.
- (iii) The ESO noted that the removal of fixed utilisation prices could create gaming opportunities. It believes that a BSP could submit high utilisation prices which are highly unlikely to be accepted, creating the opportunity for providers to collect an availability payment with the intention of never actually being available to provide the energy. We do not believe the ESO has provided sufficient evidence of the likelihood or materiality of this risk. Moreover, we expect that the ESO's prequalification processes and contract terms would act to mitigate this risk and we are confident that we have the tools in place to identify and manage anti-competitive behaviours.
- (iv) The ESO's use of modelling is underpinned by poorly justified assumptions. We are therefore not confident that the results, analysis and conclusions drawn from this are robust.
- (v) The ESO noted that under a variable utilisation price, the price a market participant will achieve for the utilisation of its product is unknown when the availability price is set. As a result, the market participant is exposed to greater risk, which is expected to be reflected in higher availability prices. We do not agree with this assertion. A variable utilisation price does not affect the market participant's knowledge of the utilisation price it will achieve. Moreover, the market participant would be expected to have greater flexibility (and therefore lower risk) as it would have the ability to adjust the price it offers for the utilisation of its product to better reflect real-time market conditions.

In light of the above, we believe that the ESO has not adequately demonstrated that an exemption from the application of Article 16(6) EBGL would lead to a higher economic efficiency. The T&C therefore need to be amended to remove any provision e.g. STOR SCTs Section 3.3, containing a predetermined

⁹ See the consultation page here: <https://www.nationalgrideso.com/balancing-services/reserve-services/short-term-operating-reserve-stor>

price and any services which would have required an exemption should be treated similarly. We note that the ESO has already included the need to remove the predetermined prices in the change proposal that is currently being consulted on and expects the changes to be implemented by 18 December 2019.¹⁰

Market suspension, market restoration and settlement

In accordance with Article 18(2) EBGL, the T&C must include the rules for suspension and restoration of market activities and the rules for settlement in case of market suspension, once they have been approved in accordance with the NC ER. The rules are currently with us for assessment and are not yet approved.

Amendment process

Articles 4 to 7 and 10 EBGL sets out the procedure that must be followed when making changes to the terms and conditions for balancing required by Article 18 EBGL. The industry codes should be amended so that they align with the EBGL amendment process.

The current arrangements require an EBGL amendment process as well as an industry code amendment process for any modifications that would impact the T&C, to run in parallel. This is not an efficient way to progress and also does not recognise the 1-month consultation period required by the EBGL.

We note that the following relevant modifications have been raised within the relevant codes (BSC, CUSC & GC) to address these discrepancies: P374, P371, P392, GC132, CMP322 & CMP323. The authority is also currently unable to approve or reject any changes that affect the T&C that are contained within SCTs. This issue is being addressed through the creation of CUSC mod CMP322.

Decision on the proposed T&C

In light of the foregoing, the Authority has therefore decided to confirm that the proposed T&C are the terms and conditions for balancing as required by Article 18 EBGL, subject to the following conditions being met:

- a) The ESO should amend the proposed T&C to align with the requirements of Article 34 EBGL and thus allow for the transfer of balancing capacity. This condition should be complied with by 31 January 2020.
- b) The ESO should remove from the proposed T&C any provision which provides for pre-determined prices for balancing energy bids or integrated scheduling process bids from standard and specific products e.g. STOR SCTs Section 3.3. This condition should be complied with by 31 January 2020.
- c) The ESO should amend the industry codes to ensure the necessary alignment with the amendment process set in the EBGL. We expect that the relevant modifications to align the EBGL amendment process with current code practices, as well as the process to embed SCT's within the industry codes to be completed by 4 April 2020, as indicated as the latest date in the code modification proposals. This includes: P374, P371, P392, GC132, CMP322 & CMP323. This condition should be complied with by 4 April 2020.

In addition, we note that upon their approval, the rules for suspension and restoration of market activities and the rules for settlement in case of market suspension should be included in the T&C.

Decision not to undertake an Impact Assessment

We have not undertaken an Impact Assessment for this proposal. This is because the majority of the proposed T&C are provisions which are already part of the GB regulatory framework and that the amendment necessary to allow for the transfer of balancing capacity is directly required by Article 34 EBGL, which has already been subject to an impact assessment.¹¹ The prohibition of pre-determined prices similarly stems from the EBGL and could only have been derogated from if the ESO had sufficiently demonstrated a higher economic efficiency. We therefore consider that an impact assessment is unnecessary in this situation.

¹⁰ See the consultation page here: <https://www.nationalgrideso.com/balancing-services/reserve-services/short-term-operating-reserve-stor>

¹¹ See the impact assessment here: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016SC0410>

Next Steps

In accordance with this decision, the T&C will take effect following the fulfilment of all of the conditions listed above, currently expected to take place on 4 April 2020. We expect the ESO to use all the means necessary to complete those conditions as soon as possible. We will continue monitoring the progression of these actions to ensure all processes are clear for BSPs and BRPs.

We note that the ESO's fulfilment of the conditions associated with this decision, and therefore its delivery of its Forward Plan¹² commitments, will be considered as part of our ESO performance and incentives framework.

If you have any queries regarding the information contained within this letter, please contact Jordan Clarke at Jordan.clarke@ofgem.gov.uk.

Yours faithfully

Eleanor Warburton
Deputy Director ESO and Gas Systems, Energy Systems Transition

¹² See Forward Plan here: <https://www.nationalgrideso.com/about-us/business-planning-riio/forward-plans-2021>