

Proposed revision:	<b>Proposed revisions to Procurement Guidelines (PGs), Balancing Principles Statement (BPS), Balancing Services Adjustment Data (BSAD) Methodology Statement and Applicable Balancing Services Volume Data (ABSVD) Methodology Statement – Incorporation of Short Term Operating Reserve (STOR) service and STOR Weighting Factors</b>		
Decision:	<b>The Authority<sup>1</sup> agrees that National Grid Electricity Transmission Plc (NGET) may modify the PGs, BPS, BSAD and ABSVD Methodology Statements in line with Appendices A, B, D and E of the Authority Report respectively</b>		
Target audience:	<b>NGET Plc, Parties to the BSC and other interested parties</b>		
Date of publication:	<b>26 March 2007</b>	Implementation Date:	<b>1 April 2007</b>

### **Incorporation of Short Term Operating Reserve (STOR) service and STOR Weighting Factors**

The Gas and Electricity Markets Authority (the "Authority") has carefully considered the issues raised by the consultation on National Grid Electricity Transmission's proposed revisions to the PGs, BPS, BSAD and ABSVD Methodology Statements.

National Grid Electricity Transmission ("NGET") recommended to the Authority that the revisions highlighted in Appendices A (Procurement Guidelines), B (Balancing Principles Statement), D (Applicable Balancing Services Volume Data Methodology Statement) and E (Balancing Services Adjustment Methodology Statement for STOR services and STOR weighting factors) accompanying its final report to the Authority should be accepted. NGET also recommend that if the Authority does not accept the revisions highlighted in Appendix E, then the Authority should, in the alternative, accept those highlighted in appendices A, B, C (Balancing Services Adjustment Methodology Statement for STOR services) and D.

The Authority has decided to allow the revisions highlighted in appendices A, B, D and E of the final modification report. This letter explains the background to the revision and sets out the Authority's reasons for its decision.

### **Background<sup>2</sup>**

In late 2004, NGET launched a review of its reserve procurement framework to determine whether the reserve arrangements could be enhanced to ensure that reserve is procured

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority, the regulator of the gas and electricity markets in Great Britain.

<sup>2</sup> NGET is obliged under SLC16 of the transmission licence to have in place the following documents:

- ♦ The PGs, detailing the types of balancing services that NGET may be interested in purchasing, together with the mechanisms by which those balancing services will be purchased;
- ♦ The BPS, setting out the principles and criteria by which NGET will determine, at different times and in different circumstances, which balancing services it will use to assist in the operation of the transmission system; and
- ♦ The BSAD Methodology Statement, setting out the information on relevant balancing services that will be taken into account under the Balancing and Settlement Code for the purposes of determining imbalance prices.
- ♦ The ABSVD statement setting out the volumes of applicable balancing services that will be taken into account under the Balancing and Settlement Code for the purposes of determining imbalance volume.

in an efficient and economic manner. In September 2005, following discussions and consultation with industry participants, NGET published a document outlining its conclusions and potential developments<sup>3</sup> to the arrangements for procurement of within-day and seasonal reserve services. Proposals relating to within-day reserve procurement were implemented via the BM Start Up service which became effective from 1 November 2006.

NGET also proposed to replace the Standing Reserve (SR) service and the Supplementary Standing Reserve (SSR) service with a single Short Term Operating Reserve (STOR) service.

#### *Related modifications*

On 11 December 2006, NGET issued a consultation paper proposing to modify the treatment of SR and SSR availability costs in the calculation of the BSAD. The allocation of availability costs for SR had been based on weighting factors<sup>4</sup> calculated using historic utilisation patterns observed in 2002/03. Weighting factors were not applied to SSR availability costs but instead were simply spread evenly over the service window settlement periods.

The modification proposed to use more recent utilisation patterns (2005/06) to calculate weighting factors for SR and to use these same weighting factors for SSR to ensure that the allocation of availability fees across the settlement periods better reflected utilisation of reserve across each day, in each window.

On 17 January 2007<sup>5</sup> the modification was approved by the Authority as a temporary measure, whilst NGET developed more enduring proposals for updating the weighting factors in line with changes in reserve utilisation patterns/service windows.

#### **The proposed revisions**

On 22 January 2007 NGET published a consultation document proposing the establishment of a single seasonal reserve service, STOR, to replace SR and SSR and enduring arrangements for updating the weighting factors for STOR.

#### *Replacing SR/SSR with STOR*

The modification proposal seeks to change references from 'Standing Reserve' and 'Supplementary Standing Reserve' to 'Short Term Operating Reserve' and reflect the new service arrangements in the relevant documents.

NGET suggest that the new service should reduce risks to reserve service providers, encourage new parties (particularly from the demand side) to provide reserve services and should promote greater competition in the provision of reserve services. The changes will:

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<sup>3</sup> NGET's conclusions and background to the existing reserve arrangements can be found at: [http://www.nationalgrid.com/NR/rdonlyres/F66EE1F1-3CEB-4095-98AB-4E650EFC6811/1287/0905\\_ReserveReviewConclusions.pdf](http://www.nationalgrid.com/NR/rdonlyres/F66EE1F1-3CEB-4095-98AB-4E650EFC6811/1287/0905_ReserveReviewConclusions.pdf)

<sup>4</sup> A weighting factor is defined for each settlement period to reflect the percentage of the total reserve usage over the day that occurred in each period of that day so that the weighting factors for all the settlement periods sum to a value of one.

<sup>5</sup> The Authority's decision letter published on 17 January 2007 can be found at <http://www.nationalgrid.com/NR/rdonlyres/CFD2833B-35F9-4D18-8BEE-7E1C1A75A760/14452/BSADDecisionfinal170107.pdf>

- introduce a single procurement mechanism for the procurement of seasonal reserve
- increase the maximum Response Time (time from instruction to the delivery of contracted MW) from 20 minutes to 240 minutes
- allow providers to tender for up to two years, providing greater certainty of income
- allow more frequent tenders (3 per year), to give increased opportunity to new service providers, and those unsuccessful in previous tenders

#### *Introducing enduring arrangements for the calculation of weighting factors*

The modification seeks to introduce enduring arrangements to update periodically the weighting factors using an agreed calculation methodology (outlined in BSAD Methodology Statement) and publish the weighting factors on the National Grid website.

NGET suggest that the proposed arrangements will improve cost reflectivity, market signals and will introduce a transparent methodology for calculating the weighting factors that avoids the need for industry-wide consultation each time the weighting factors are updated.

Specifically, NGET will seek to update the weighting factors at least one month in advance of the relevant season to which the weighting factors apply. For example, for the seasons falling in the period from April to October in a given year, the weighting factors will be updated by the end of February in the same calendar year and, for the seasons falling in the period from October to April, the weighting factors will be updated by the end of August.

In order to calculate 2007/08 STOR weighting factors in the absence of STOR historic utilisation data NGET proposes to use SR and SSR 2006/07 utilisation data. For future updates following implementation of the STOR service NGET proposes to use the most recent historic STOR utilisation data. NGET proposes that where there is no historic utilisation data, for example where a new availability window is introduced, it will take into account historic utilisation of other balancing services and assess the appropriateness of this in the calculation of the weighting factors for settlement periods in the new STOR availability window.

#### **NGET's recommendation**

Following consideration of responses to its consultation, NGET recommends that the PGs, BPS, and the ABSVD and BSAD Methodology Statements are modified in line with the changes highlighted in Appendices A, B D, and E of the Authority report respectively. This is on the basis that NGET believes that the STOR service will improve the clarity, consistency and efficiency of seasonal reserve procurement arrangements and periodic updating of the weighting factors will improve the cost reflectivity of imbalance prices.

#### **The Authority's decision**

The Authority has considered the issues raised by the respondents to the consultation, of which there were three<sup>6</sup>, and NGET's report to the Authority in relation to the proposed incorporation of the STOR service and STOR weighting factors. The Authority has concluded that:

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<sup>6</sup> The consultation responses can be found at:  
<http://www.nationalgrid.com/uk/Electricity/Balancing/consultations/>

1. implementation of the proposed amendments will better facilitate NGET's ability to operate the system in an efficient, economic and co-ordinated manner in accordance with its licence<sup>7</sup>, and
2. approving the implementation is consistent with the Authority's principal objective and statutory duties<sup>8</sup>.

## **Reasons for the Authority's decision**

### *Replacing SR/SSR with STOR*

Ofgem has carefully considered NGET's proposal to replace the current SR and SSR services with a single STOR service. We believe that the new service represents an enhancement on the current arrangements for securing reserve which in turn will better facilitate NGET's ability to operate the system in an efficient, economic and co-ordinated manner.

For example, we would expect that the increased frequency of tender rounds will encourage new services providers to participate in tenders for reserve services. All other things being equal, this should promote greater competition in the provision of reserve services. In addition, with service providers able to tender for up two years ahead and the contract lead time between tender and service provision reduced, the new service should provide increased income certainty to service providers, potentially encouraging participation in the provision of reserve services.

Increasing the maximum response time (time from instruction by NGET to the delivery of contracted MW) from 20 minutes to 240 minutes may also encourage participation from industry participants, including demand side participants, who may have been unable to meet the current response time requirements of SR.

Respondents to the consultation were generally supportive of the introduction of STOR although the view was expressed that the new service arrangements could result in a reduction in the capacity offered on the short term market because of the increase in response time from 20 to 240 minutes. However, we would note that it is a commercial decision for industry participants whether they wish to provide reserve to NGET or to make generation capacity available in the short term market.

Finally, Ofgem believes the introduction of a single STOR service, replacing SR/SSR, addresses the concern highlighted in the Authority's 17<sup>th</sup> January decision letter with respect to the impact on BPA (Buy Price Adjuster) where the service windows for SR and SSR do not coincide<sup>9</sup>.

### *Introducing enduring arrangements for the calculation of weighting factors*

Ofgem has carefully considered NGET's proposal to introduce enduring arrangements for the calculation of weighting factors. Ofgem believes that the proposed changes to the

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<sup>7</sup> Standard licence condition C16 (1).

<sup>8</sup> The Authority's statutory duties are detailed primarily in 3A – 3D of the Electricity Act 1989.

<sup>9</sup> The weighting factors for the SSR availability fees are based on the service windows for SR and these do not precisely coincide with those for SSR. Consequently, in a small number of periods the current weighting factors could influence the BPA.

weighting factors represent an enhancement on current arrangements and hence should be implemented.

In determining electricity cash out prices an adjustment to the System Buy Price (SBP) is made via the BPA which, amongst other things, incorporates the costs (option fees) relating to the availability of SR and SSR contracts. The mechanism by which these costs are allocated to individual settlement periods is specified in the BSAD Methodology Statement.

The purpose of the BPA is to include the availability fees from energy balancing contracts in a way that reflects the costs that NGET incurs in each settlement period. Ofgem continues to believe that option fees should be included in the calculation of energy imbalance prices and that all costs of balancing services should be appropriately targeted at those parties who are out of balance. By updating the weighting factors periodically to reflect more closely actual reserve usage patterns we believe that the proposed changes should provide more accurate and more cost reflective pricing signals to market participants in respect of the costs they impose on the system by being out of balance. This should improve the incentives on participants to balance their positions, relative to the current arrangements, which, in turn, should enhance NGET's ability to operate the transmission system in an efficient, economic and co-ordinated manner.

Respondents to the consultation were generally supportive of the principle of periodically updating the STOR weighting factors, the placement of the weighting factor calculation in BSAD and publication of the updated weighting factors on NGET's website. However, respondents raised a number of concerns with respect to some aspects of the proposed methodology.

All respondents expressed concerns that NGET had discretion in determining the frequency of updates to the weighting factors, with some respondents stating that the number of these changes should be explicitly limited. Ofgem appreciates that a trade-off exists between stability and cost reflectivity with respect to how frequently the weighting factors are changed. However, we believe that, on balance, the benefits of improved cost targeting and more accurate imbalance prices outweigh any increase in uncertainty for industry participants. Ofgem also notes NGET's reassurance, in their final report to the Authority, that the weighting factors, for a given day type, in each season, will only be updated once in a year<sup>10</sup>. Finally, NGET state that any changes to the methodology for calculating the weighting factors will require industry consultation.

Respondents also argued that the proposal would allow NGET the freedom to take into account the historical utilisation of other balancing services if historical utilisation data is not available for any settlement period(s) in an availability window (this may occur if NGET has introduced a new window). Respondents argued that the proposal did not make clear what these services might be and how their utilisation would be used to calculate the weighting factors. Ofgem understands that under the current arrangements there is no mechanism in place to determine weighting factors, for example, if a new window is introduced. This means that NGET may be unable to target appropriately reserve costs to relevant settlement periods which could cause distortions in the calculation of BPA. Under the proposed modification NGET will be able to determine weighting factors for periods within a service window for which no historical data is

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<sup>10</sup> NGET also notes that the weighting factors will be published well in advance of the relevant seasons on NGET website which will provide the market with sufficient notice regarding any changes to the factors.

available. Therefore, we believe that the proposed changes represent an improvement on the current arrangements.

Notwithstanding the above, Ofgem would expect NGET to publish, on its website, the methodology it has used to develop weighting factors in instances where no historic utilisation data is available, for example upon the introduction of a new window.

Respondents also suggested that two years worth of data may be a more appropriate basis for calculating weighting factors rather than the proposed one year. Ofgem believes that using the most recent historic utilisation data should ensure that the weighting factors closely reflect the current year's availability windows. In turn, this means that option fees are likely to be better reflected in appropriate settlement periods, potentially resulting in a more cost-reflective BPA. We also note that, in NGET's final modification report, NGET provided analysis using historical utilisation data for two years. The results were similar to the weighting factors calculated using one year of historical data.

One respondent expressed the view that weighting factors should be "forward looking" to reflect the prospective requirement for reserve. Ofgem believes that such a development may further enhance the principle of accurate cost targeting and would encourage more analysis into this as a potential further enhancement to the arrangements. However, we recognise this would represent a significant change to the manner in which reserve availability costs are reflected in cash out prices and as such would require further industry discussion (possibly as part of the cash-out review).

Overall, Ofgem notes respondents concerns with respect to the discretion these proposals give NG, for example, in setting weighting factors in the absence of historic utilisation data for example. Ofgem is currently undertaking a review of the electricity cash out arrangements in collaboration with market participants where some of the issues raised by this proposal may be considered further.

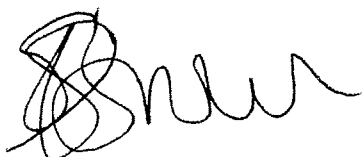
#### *Transparency*

The Authority considers that it is important for there to be transparency in the provision of information in relation to the procurement of reserve and the calculation of the relevant weighting factors. This is to ensure that participants are aware of NGET's utilisation of the service and the costs involved, enabling participants to make informed decisions with respect to, for example, pricing of tenders. The Authority considers that the proposal to publish the weighting factors after each update on National Grid's website will improve the transparency of the methodology for calculating the weighting factors.

#### **Decision notice**

**In accordance with Standard Condition C16(8)(b) of NGET's electricity transmission licence**, the Authority agrees that NGET may modify the PGs, BPS, the ABSVD and the BSAD Methodology Statements in line with Appendices A, B, D and E of the Authority report respectively, and that such modification will take effect from 1<sup>st</sup> April 2007 in respect of the incorporation of STOR service and STOR weighting factors.

Yours sincerely



**Sonia Brown**  
**Director, Wholesale Markets**

**Signed on behalf of the Authority and authorised for that purpose**