

All interested parties,
stakeholders in GB and beyond,
and other regulatory bodies

Email: esoperformance@ofgem.gov.uk

Date: 9 April 2021

Dear colleagues,

Decision to grant the Electricity System Operator a derogation under Article 6(14) from the requirements of Article 6(4) of the Regulation (EU) 2019/943 for Optional Downward Flexibility Management.

On 19 March 2021, we¹ received a request from the Electricity System Operator (“ESO”) for a derogation under Article 6(14) from the requirements of Article 6(4) of Regulation (EU) 2019/943 on the internal market for electricity (recast),² as amended by the Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020 (the “Electricity Regulation”)³ for their Optional Downward Flexibility Management (“ODFM”) product.

Article 6(4) of the Electricity Regulation sets out two requirements: that settlement of balancing energy should be based on marginal pricing; and that market participants should be able to bid as close to real time as possible (balancing energy gate closure time shall not be before the intraday cross-zonal gate closure time). The ESO has requested a derogation against both of these requirements for ODFM.

This letter sets out our decision to approve this derogation request in accordance with Article 6(14) of the Electricity Regulation and also outlines the necessary next steps that must be taken.

¹ The terms “we”, “us”, “our”, “Ofgem” and “the “Authority” are used interchangeably in this document and refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.

² Regulation (EU) 2019/943 on the internal market for electricity (recast) can be accessed here: <https://eurlex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0943&from=EN>

³ The UK SI amendment of the Electricity Regulation is accessible at: <https://www.legislation.gov.uk/uksi/2020/1006/contents/made>

Background

ODFM is a replacement reserve ("RR") product that was developed in 2020 by the ESO to cope with suppressed demand resulting from national lockdowns in response to the COVID-19 Pandemic. ODFM is aimed at small-scale renewable generators (mostly wind and solar generators), allowing them to receive payment for turning down their generation output. There is also the option for demand that can turn-up to provide the ODFM service. The ESO's intention was to replace ODFM after summer 2020 with an enduring downward flexibility product. However, the ESO has not developed an alternative product, and as the lockdown has continued into 2021, the ESO has determined that it is necessary to restart the procurement of ODFM to ensure operational security.

When ODFM was initially designed, it was not subject to the requirements of Article 6(4) as it was not designated as a specific product. The ESO opted to settle the energy payments on a pay-as-bid basis to align with existing processes, allowing the product to be developed at least cost. Due to the changes in legislation, ODFM is now considered to be a specific product and is subject to the requirements of Article 6(4) of the Electricity Regulation. To allow it to continue to be settled as pay-as-bid (rather than on marginal pricing, also known as pay-as-clear), the ESO has requested a derogation for the product.

Article 6(14) of the Electricity Regulation allows the ESO, where standard balancing products are not sufficient to ensure operational security, to propose, and Ofgem may approve, derogations from Article 6(4) for specific balancing products which are activated locally without exchanging them with other transmission system operators.

Given that the specific balancing product, ODFM, has been designed and used on a pay-as-bid basis and is procured at day-ahead, the ESO is requesting a derogation under Article 6(14) from the requirements of Article 6(4) of the Electricity Regulation. In accordance with 6(14) of the Electricity Regulation, the proposal for a derogation must contain the following information:

- a) a description of measures proposed to minimise the use of specific products, subject to economic efficiency;
- b) a demonstration that the specific products do not create significant inefficiencies and distortions in the balancing market either inside or outside the scheduling area; and
- c) where applicable, the rules and information for the process for converting the balancing energy bids from specific products into balancing energy bids from standard balancing products.

The ESO's derogation request was submitted in accordance with Article 6(14) and contained all necessary information. The ESO has stated that ODFM will only be activated locally, and therefore the third requirement of Article 6(14) set out above is not applicable to this request.

Reasons for our decision

We have reviewed the request submitted to us in line with the requirements of the Electricity Regulation, the wider objectives of the EBGL regulation and our statutory duties. We have also engaged with the ESO to clarify our understanding of the rationale for the request for derogation. In making this decision, we have considered:

- i. the economic balance between benefits from pay-as-bid and the costs of changing systems to allow pay-as-bid for these existing products*

The ESO's procurement of ODFM has previously been on a pay-as-bid basis. The ESO has stated that there would be a cost to consumers arising from the costs of converting the ESO's existing systems to allow ODFM to be procured on pay-as-clear⁴ basis.

The ESO has provided us with a cost-benefit analysis which shows that in order for consumers to have a net-benefit – and to justify the cost of converting its existing systems to allow pay-as-clear – there would need to be a reduction in bid prices by over half. The ESO's analysis shows that during the summer of 2020, the majority of ODFM instructions were issued to market participants who were likely to receive a subsidy.

These market participants will want to ensure that they are reimbursed for their lost subsidy and are therefore unlikely to significantly change their bid price. Given the prevalence of market participants in ODFM who may carry subsidised payments, we believe that there is unlikely to be enough downward pressure on providers' bids to warrant procuring ODFM in a pay-as-clear market, rather than the current pay as bid market. In addition, the cost of procuring ODFM as pay-as-clear could be particularly disproportionate given the expected short lifetime of the ODFM product. Therefore, we believe that ODFM is more economically procured on a pay-as-bid basis.

⁴ A pay-as-clear market means that all parties delivered the service within a set window be paid the same price (the market clearing price). This market arrangement incentivises parties to bid into the market at their short run marginal cost to ensure they are dispatched, with profit being made when subsequent parties with a higher short run marginal cost are also dispatched.

ii. rationale for procuring at day-ahead timescales

The ESO states that although ODFM will be procured at day ahead timescales, this is as close to real time as is possible, and therefore the requirements of Article 6(4) of the Electricity Regulation cannot be met. The ESO notes that as a temporary product, assessment of the need for ODFM and instruction to providers for ODFM delivery is a manual process, and so this is done, necessarily, ahead of real time.

ODFM is used during the periods of lowest demand, which tend to be overnight in the period 23:00 – 07:00. We understand that some ODFM market participants require notice of several hours to allow them to turn down. In many cases therefore, the instruction may necessarily be given at day-ahead. Where ODFM is required later in the day, the dispatch instruction will occur on the day of provision, but as the same notice period could be required, we understand that this will still mean that the product will not meet the obligation to occur after the intraday cross-zonal gate closure time.

Taking the above into account, we understand that ODFM cannot be brought into line with the obligation set out in Article 6(4) of the Electricity Regulation at this time and believe that it is necessary for the ESO to procure ODFM at day-ahead timescales.

iii. a description of measures proposed to minimise the use of specific products, subject to economic efficiency

We understand that the ESO intends to use ODFM as a product of last resort, i.e. when all other market-based options have been exhausted. The ESO states that ODFM is needed only when there is insufficient downward flexibility⁵ to be able to access the volume of negative reserve actions needed.

The ESO also provided analysis to us indicating that ODFM is not intended to be used during scenarios purely of low demand, but only when this coincides with reasonable variation in weather away from the ESO's forecast. The ESO has stated that it only intends to use ODFM to prevent emergency disconnection of distributed energy resources, and it will not be using ODFM to displace other negative RR products such as the balancing mechanism ("BM").

We agree that the ESO's proposed approach of only using ODFM as a product of last resort and not in preference to other products or markets will minimise its use.

⁵ For example, downward flexibility provided from the balancing mechanism, exporting on interconnectors, and pumping at pumped storage sites.

- iv. a demonstration that the specific products do not create significant inefficiencies and distortions in the balancing market either inside or outside the scheduling area*

As an RR product, the equivalent standard product to ODFM would be the product provided through the TERRE⁶ platform. Currently, the GB system does not have access to this platform and is unlikely to for the period over which ODFM will be procured by the ESO. Therefore, we have concluded that the product will not create inefficiencies outside of the GB scheduling area.

We understand that ODFM had an impact on cash out prices when it was used in 2020. Both ourselves and industry stakeholders have expressed concerns about this to the ESO, and we understand that the ESO has now taken action to eliminate this impact by including ODFM in the cash out mechanism for 2021.⁷ By including ODFM into cash out and publishing the methodologies for its procurement, we agree with the ESO that ODFM will not cause the same impact to the market as in 2020.

The ESO does not make availability payments for ODFM, paying only for utilisation. We understand this ensures that participants are not attracted away from providing other services such as the BM, ensuring that ODFM remains a product of last resort. The ESO received feedback from some industry stakeholders indicating that ODFM should include availability payments in addition to utilisation payments. However, we agree with the ESO that payment for availability of ODFM would not align with the design of ODFM as a product of last resort, and that the ESO's approach prevents any distortion of other markets and ensures that ODFM is procured most economically.

Decision and next steps

We agree with the ESO that ODFM is necessary for ensuring operational security, and based on our analysis of the information submitted to us by the ESO as required by Article 6(14) of the Electricity Regulation, and the supporting economic analysis we hereby:

- Grant the Electricity System Operator a derogation under Article 6(14) of the Electricity Regulation from the requirements of Article 6(4) of the Electricity Regulation for ODFM.

⁶ TERRE is the Trans European Replacement Reserves Exchange project. Details on the TERRE project can be found at: https://www.entsoe.eu/network_codes/eb/terre/

⁷ We understand that the ESO will include Balancing Services Adjustment Data for ODFM by manually amending an existing electricity trade data file that is sent to Elexon, allowing Elexon to include ODFM data into cash out calculations.

Our decision to derogate the ESO from the requirements of Article 6(4) of the Electricity Regulation is effective immediately. This derogation from the requirements of Article 6(4) shall apply to ODFM for the duration that the ESO deems that it is necessary to use it as a specific product. We understand that this will be a short period of time, and we expect the ESO to utilise the learnings from the use of ODFM in its future development of an enduring downward flexibility product.

If you have any questions about the contents of this letter, please contact James Hill (James.Hill@Ofgem.gov.uk).

Yours sincerely,

Alastair Owen

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