

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

Email: David.Beaumont@ofgem.gov.uk

Date: 20 May 2022

Dear colleagues,

**Decision to approve proposal from the Electricity System Operator for an alternative pricing methodology for settlement of balancing energy for specific balancing products**

On 25 March 2022, we<sup>1</sup> received a proposal from the Electricity System Operator (“ESO”) in accordance with Article 6(4) of the Regulation (EU) 2019/943 (the “Electricity Regulation”),<sup>2</sup> as amended by The Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020<sup>3</sup> for an alternative pricing methodology.

The ESO has developed a GB Pricing Proposal (“PP”) outlining when marginal pricing (pay-as-cleared) should be used for settlement of balancing energy, and the process for determining when an alternative settlement method can be utilised.

This letter sets out our decision to approve the PP as the new GB pricing methodology and outlines the necessary next steps.

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<sup>1</sup> 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.

<sup>2</sup> Regulation (EU) 2019/943 of the European Parliament and of the Council of 5 June 2019 on the internal market for electricity, available here: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0943>

<sup>3</sup> The UK SI amendment of the Electricity Regulation is UK SI 2020 No. 1006 which can be found at: <https://www.legislation.gov.uk/ukSI/2020/1006/introduction/made>

## Background

Article 6(4) of the Electricity Regulation states that 'the settlement of balancing energy for standard balancing products and specific balancing products shall be based on marginal pricing (pay-as-cleared)'.<sup>4</sup>

Prior to the UK's exit from the European Union, Article 26 of the Electricity Balancing Guideline ("EBGL")<sup>5</sup> allowed Ofgem to grant approval for the definition of specific products that were under the obligation to be based on marginal pricing (pay-as-cleared). For example, we approved Short-Term Operating Reserve ("STOR") and the Balancing Mechanism ("BM") as specific products and granted derogations<sup>6</sup> under Article 6(14) as the ESO showed that it was more efficient to use an alternative pricing arrangement (pay-as-bid) for settlement of balancing energy for these existing products. At that time, all other balancing products were deemed out of scope of Article 6(4) as either they were not due to become specific until MARI was implemented, or there were no standard products to align them to.

The EBGL regulation has been retained with amendments in UK law following the UK's exit from the European Union.<sup>7</sup> However, as a result of these amendments, all GB balancing products are now deemed to be specific, being 'different from standard products'. As such, under the retained legislation all GB balancing products should use marginal pricing for settlement of balancing energy, unless they are granted a derogation under Article 6(14). However, the legislation also allows for the ESO to propose, and us to approve, an alternative pricing methodology to be applied to balancing products where it is more efficient to settle differently from pay-as-cleared.

Therefore, the intention of the ESO's PP is to develop a transparent methodology for the pricing arrangement used for the settlement of balancing energy for future balancing products, and accounting for legacy products (particularly those which are non-compliant with the requirements of Article 6(4) of the Electricity Regulation). This will avoid the need for multiple derogations or redesign of legacy products at a time where development of new products is crucial.

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<sup>4</sup> Standard products are products which are uniform across the EU trading area. Specific products are products which are locally defined and locally activated – i.e., a specific country might need a particular feature from a product which isn't met by the standard product.

<sup>5</sup> Commission Regulation (EU) 2017/2195 of 23 November 2017 establishing a guideline on electricity balancing. The EBGL came into force on 18 December 2017. Accessible at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R2195>

<sup>6</sup> Our decision can be found at: [https://www.ofgem.gov.uk/sites/default/files/docs/2020/12/decision\\_to\\_grant\\_the\\_eso\\_a\\_derogation\\_from\\_the\\_requirements\\_of\\_article\\_64\\_of\\_the\\_electricity\\_regulation\\_for\\_stor\\_and\\_the\\_bm\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2020/12/decision_to_grant_the_eso_a_derogation_from_the_requirements_of_article_64_of_the_electricity_regulation_for_stor_and_the_bm_0.pdf)

<sup>7</sup> The UK SI amendment of the Electricity Balancing Guideline is UK SI 2019 No. 532 which can be found at: <https://www.legislation.gov.uk/ukSI/2019/532/contents/made>

The ESO's proposal was submitted to us in accordance with Article 6(4) of the Electricity Regulation. The PP was consulted on between 7 February 2022 and 7 March 2022, in accordance with Article 10 of the EBGL.

## **Decision**

We have reviewed the PP against the requirements of the EBGL, the Electricity Regulation and our statutory duties and obligations. We have also engaged with the ESO to better understand its proposal.

When assessing the request from the ESO for an alternative pricing methodology, we considered whether the ESO has provided, in accordance with Article 6(4), 'analysis demonstrating that an alternative pricing method is more efficient'. The ESO has demonstrated that if certain economic criteria outlined in the PP are not met, an alternative pricing method can be more economically efficient for balancing energy. For example, the ESO has provided the required analysis for two longstanding products within the GB market (STOR and the BM). The ESO has provided evidence, in an explanatory document alongside the PP, that pay-as-bid should be retained for these products as it would be the most economic mechanism for each product.

We believe this approach will enable the ESO to develop products with the most economically efficient payment mechanisms for balancing energy and will provide transparency with industry on how decisions for the payment mechanism for different products are reached.

In addition, the PP enables the ESO to be compliant with Article 6(4), as enacted in UK legislation, enabling existing products to remain on their current alternative payment mechanism. This will avoid the need for multiple derogations or an inefficient redesign of legacy products which are due to be phased out.

We believe this approach will be in the best interest of consumers as, not only will this ensure the most efficient clearing mechanism is in place for each product, but it will also allow the ESO to focus on the continued development of new Reserve and Response products<sup>8</sup>, which are needed to achieve Net Zero operation.

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<sup>8</sup> Details on the ESO's Reserve and Response Reform programmes can be found in their Markets Roadmap publication, accessible at: <https://www.nationalgrideso.com/research-publications/markets-roadmap>

In making our decision, we also took into consideration the engagement with, and responses to the consultation from industry stakeholders. We note the ESO engaged with industry stakeholders through several webinars, bi-laterals and workgroups, which is in line with our expectations. In addition, responses to the consultation were generally favourable towards the ESO's PP. Some stakeholders expressed concerns around the lack of inclusion of frequency containment reserve ("FCR") products within the scope of the pricing methodology and around how legacy products will be reassessed against the criteria in the future.

We note that the PP submitted for approval now includes FCR products in scope. For legacy products, the ESO has made it clear that these will not be subject to reassessment as the ESO believes it is not efficient or economic to review the settlement mechanisms of legacy products as they are due to be phased out. We acknowledge this view, although we expect the ESO to commit to assessing any legacy products if it becomes apparent that they are to be retained for use by the ESO. We expect that the ESO would make this consideration when reviewing the methodology, which we expect to be no later than 3 years from the date of this decision letter, as outlined in Section 4 of the proposal itself.

We also considered how the PP compared with the existing derogation process under Article 6(14). We note the PP includes the same requirements as the current derogation process for information to assess whether it is economically efficient to use a different pricing arrangement. This includes: a description of measures proposed to minimise the use of specific products, subject to economic efficiency; 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 well as, where applicable, the rules and information for the process for converting the balancing energy bids from specific balancing products into balancing energy bids from standard balancing products.

Overall, we are satisfied that that the ESO's PP meets the requirements of Article 6(4) of the Electricity Regulation (as amended), and therefore that its GB pricing methodology will also be compliant. In light of the above, we believe the proposal will enable the ESO to be compliant with current legislation and to use the same process in the future to determine whether pay-as-cleared or the use of an alternative pricing method is more economically efficient, providing greater economic benefit to GB consumers.

We therefore:

- approve the PP as the GB pricing methodology for settlement of balancing energy.

To avoid any doubt, the two products (STOR and the BM) we granted a derogation for in December 2020 are within scope of the PP. As such, the requirement to reassess these products on timelines set out in our original derogation decision are superseded by the requirements in the new pricing methodology.

### **Next steps**

We expect the ESO to publish the GB pricing methodology and any supplementary documents to its website as soon as possible and to be followed as of the date of this decision letter.

If you have any questions about the contents of this letter, please contact James Hill ([James.Hill@ofgem.gov.uk](mailto:James.Hill@ofgem.gov.uk)).

Yours sincerely,

**David Beaumont**

Head of ESO Regulation

Energy Systems Management and Security