To: All interested stakeholders

Email: ESOPerformance@Ofgem.gov.uk

Date: 21 November 2024

Dear colleagues,

Decision on the Demand Flexibility Service in relation to an update to the Terms and Conditions related to balancing

On 24 September 2024, we[1] received a proposal from National Grid Electricity System Operator ("NGESO")[2] to amend the terms and conditions related to balancing ("T&C") required by Article 18 of Commission Regulation (EU) 2017/2195 establishing a guideline on electricity balancing,[3] as amended by the Electricity Network Codes and Guidelines (Markets and Trading) (Amendment) (EU Exit) Regulations 2019 ("EBGL").[4] The proposal relates to an update to the T&C to incorporate service documentation for the third iteration of the Demand Flexibility Service ("DFS").

On 27 October 2023, we approved[5] amendments to the T&C to include the second iteration of the DFS. NGESO developed the third iteration of the DFS as a new service replacing the previous iteration, and for the avoidance of doubt this letter considers the third iteration of the DFS only and all references to the DFS henceforth relate to this iteration unless stated otherwise. Following this decision, we no longer consider the mapped service documentation from the second iteration to form part of the T&C. Any mapped references to the DFS service documents refer to the latest version of the documents only.

[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] We received the submission from National Grid Electricity System Operator, which at the time was the holder of an Electricity Transmission Licence and was the body responsible for maintaining the T&C. Since 1 October 2024, National Grid Electricity System Operator has transitioned to become NESO, which holds an Electricity System Operator licence and is now the body responsible for maintaining the T&C. We have confirmed with NESO that it still intends for this amendment to be made.
[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. Accessible at: https://eurlex.europa.eu/eli/reg/2017/2195/oj
[4] The UK SI amendment of the EBGL: https://assets.publishing.service.gov.uk/media/5c17d6b440f0b60c8d601a2c/ENC_Markets_and_Trading_SI.pdf
[5] Our decision of 27 October 2023 is accessible here: https://www.ofgem.gov.uk/decision/decision-demand-flexibility-service-relation-update-terms-and-conditions-related-balancing-202324

The Authority has decided to approve the proposal to amend the relevant sections of the documentation for the DFS, which includes the DFS Service Terms and DFS Procurement Rules, within the T&C, as required by Article 18 of the EBGL.

Background

In accordance with Article 18 of the EBGL, the Transmission System Operator was required to develop a proposal regarding the terms and conditions ("T&C") for Balancing Service Providers ("BSPs") and Balance Responsible Parties ("BRPs").[6] On 8 October 2019, we published our decision[7] to confirm, upon satisfaction of certain conditions, that the T&C proposed are the T&C required by Article 18 of the EBGL. On 25 June 2020, all the necessary conditions were met, and the proposed T&C came into force in Great Britain.

In its Winter Outlook report for 2022/23, NGESO forecasted potential scenarios of tight system margins. NGESO first introduced the DFS to provide an additional system security tool for that winter, allowing for access to additional volume to help balance the system during periods forecast to otherwise experience negative margins. NGESO identified a continued need for a service of this type for winter 2023/24 and proposed some amendments to improve the service, which we approved. The service attracted volumes of demand-side response ("DSR") through suppliers, aggregators and Industrial and Commercial ("I&C") customers to provide a demand turn-down service (or generation turn-up) to reduce demand in tight system forecasts. NGESO utilised DSR to help manage system margins as an enhanced service where traditional flexible electricity generation was not sufficient (enhanced actions are used by NESO after "everyday" actions but before "emergency" actions).

In October 2024, NESO's Winter Outlook 2024/25[8] highlighted higher base case margins and no continuing requirement for the DFS as an enhanced action tool as it had been in the previous iterations. However, NGESO developed a proposal for a third iteration of the DFS, positioning the service as an in-merit margin management tool.

NGESO submitted a proposal to us requesting to amend the T&C to integrate the third iteration of the DFS on 24 September 2024. This proposal followed a consultation period that concluded on 22 August 2024.[9] NGESO's proposal is to embed relevant sections of the DFS Service Terms and DFS Procurement Rules into the T&C. To enhance the clarity of the

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[6] See footnote 2 and our decision of 14 September 2018 https://www.ofgem.gov.uk/decision/decision-assignment-transmission-system-operator-obligations-under-guideline-electricity-balancing-regulation-within-gb
[7] Our decision of 8 October 2019 is accessible here https://www.ofgem.gov.uk/publications/decision-transmission-system-operators-proposal-terms-and-conditions-related-balancing
[8] NESO's Winter Outlook 2024/25 can be accessed here: https://www.neso.energy/document/330221/download
[9] This consultation ran from 22 July to 22 August 2024. Details are available at: https://www.neso.energy/industry-information/balancing-services/demand-flexibility-service-dfs

T&C, NGESO supplied a mapping document alongside the proposal. We note that NESO proposed additional changes to the DFS Procurement Rules to allow megawatt values of unit capacities and bids to be submitted rounded to one decimal place (rather than no decimal places), this updated submission was sent to us on 18 October 2024.

The DFS has been designed to be procured and instructed at timescales such that its balancing energy gate closure is earlier than allowed under Article 6(4) of the Electricity Regulation.[10] As such, NGESO also submitted a request to us for a derogation from this requirement for the DFS. We have approved this derogation request alongside this decision, with the derogation being valid until 31 March 2027. For clarity, NESO cannot procure this service ahead of gate closure regardless of its inclusion in the T&C, without a derogation in place.

Rationale for our decision

We have reviewed the DFS service documents (consisting of the DFS Service Terms and DFS Procurement Rules) submitted by NGESO to be recognised as part of the T&C and submitted to us in line with the requirements of the EBGL, the wider principles of the Electricity Regulation, and our statutory duties and obligations. In order to do this, we engaged with NGESO to better understand its proposals in several areas.

We consider that the service design presented by NGESO identifies a suitable position in the market for bringing forwards DSR volumes which may otherwise be unable to engage meaningfully in the electricity system. Particularly, the service aims to remove barriers to entry (such as the time required for dispatching of, particularly, manual DSR and the half-hourly settlement status required by most markets) while balancing the apparent risk this could present.

We recognise the view of some potential providers that this approach to the DFS provides less certainty for revenue opportunities than previous iterations. However, without the DFS there are few opportunities for flexibility providers to participate in the market. As with all balancing actions, they are subject to system needs (ie the system operator takes on residual balance and redispatch responsibility after the market clears) and therefore there is uncertainty around frequency of requirement. We expect NESO to continue to support industry where appropriate, through providing clear information about expected utilisation

[10] Commission Regulation (EU) 2019/943 of 5 June 2019 on the internal market for electricity ("the Electricity Regulation") dictates that "Market participants shall be allowed to bid as close to real time as possible, and balancing energy gate closure times shall not be before the intraday cross-zonal gate closure time." Where the intraday cross-zonal gate closure time is currently T-1hour. The Electricity Regulation is accessible at: https://eurlex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0943&from=EN, and has been adopted into UK law by UK SI 2020 No. 1006, available at: https://www.legislation.gov.uk/uksi/2020/1006/contents/made

(for example ensuring ongoing clarity as to the types of system condition which lead to a need for the system operator to manage margins within-day).

In reaching our decision, we considered feedback from industry stakeholders in response to NGESO's consultation on the proposed changes. Respondents generally supported the introduction of the DFS as proposed, but there were requests for clarifications in several areas, especially, in relation to in-merit service positioning, and stacking with other services. NGESO addressed these inquiries and amended the T&C to incorporate relevant stakeholder feedback where appropriate.

Key specific aspects which supported our decision rationale are set out below.

The case for a Demand Flexibility Service

NGESO's Future Energy Scenarios 2024[11] and NESO's Clean Power 2030[12] reports set out that flexible demand will play a crucial role in achieving the UK's net zero target. Ofgem's Multiyear Strategy[13] also supports the development of flexible energy demand as a key enabler to an efficient energy system. By continuing to procure DFS volumes, NESO can support these targets by providing a route to market to flexibility assets who are traditionally unable to participate in the electricity markets.

Since there isn't a need for the DFS as an enhanced action, NGESO has proposed to operate the service as an in-merit margin management tool. DFS volumes will only be dispatched when competitive against alternative actions. In its Market Guidance Document,[14] NGESO outlined how DFS bids will be compared to alternative actions: the total cost of activating DFS volumes will be considered versus the total costs of Interconnector or Balancing Mechanism ("BM") actions. This takes advantage of the flexibility of offers, particularly with respect to the duration of an action.

We note that DFS utilisation will be based on NESO's forecast of its margin requirement within day. We expect NESO to be transparent about its margin needs and selection of the service(s) dispatched to address the system balance (noting that this may be a combination of actions across a number of markets). We expect volumes from the DFS to be procured in a manner that is economic and efficient, recognising that costs as well as benefits of the service will ultimately be borne by the consumer.

[11] Future Energy Scenarios 2024 report can be accessed here: https://www.neso.energy/publications/future-energy-scenarios-fes#Energy-consumer-and-demand-side-flexibility
[12] Information about DSR in the Clean Power 2030 report can be found in Chapter 2.1 Electricity demand and demand flexibility: https://www.neso.energy/document/346651/download
[13] Ofgem's Multiyear strategy can be found here: https://www.ofgem.gov.uk/sites/default/files/2024-03/20240328%20Ofgem%20Multiyear%20Strategy%20%28FINAL%20v2%29_0.pdf
[14] The Market Guidance document can be accessed here: https://www.neso.energy/document/322501/download

Service design aspects

The consultation on the DFS service design received significant stakeholder attention. General sentiment toward the service was supportive, however, NGESO received a substantial amount of feedback regarding the service positioning, stackability with other services, and the methodology for baseline calculation. Moreover, several parties sought clarity on various aspects such as the performance incentive structure and within-day procurement.

We set out our views below on the main points raised throughout the consultation.

Service positioning

Concerns were raised by a few respondents that using the DFS as in-merit service could have a dampening effect on market participation affecting the development of demand flexibility. Some respondents also argued that loss of certainty in utilisation frequency (previously provided by a testing regime with a guaranteed acceptance price ("GAP") and number of tests) makes it more difficult to build an investment case for involvement in the DFS. There were suggestions from respondents to maintain a testing regime with guaranteed prices or for the system operator to pay for service availability in addition to utilisation.

In response, NGESO clarified that they do not see a case for availability payments as there is no firm need of the service unlike for other NESO services, such as the Short-Term Operating Reserve (which is specifically procured to secure against large generation losses). NGESO also contended that there is no clear price reference against which to compare availability payments for the DFS and thus no way to identify where this would be an economic action.

We agree with NGESO's position of deciding not to proceed with availability payments despite strong feedback from some providers. We consider that it would not be in the consumer's interest to provide revenue certainty through this method.

We note that NESO does retain the ability to run tests of the DFS and to use a GAP when doing so (although testing may be done with the GAP set to £0/MWh, ie without a GAP). We believe that testing should not be used to supplement revenue in case of low utilisation of the service. NESO should only use tests to learn about new aspects of the service (eg if moving to use the service for demand turn-up or to shorter dispatch notice times than currently set out). Ofgem would expect testing only to be considered where it represents consumer value.

Within-day procurement

NGESO proposed to remove the option of day-ahead dispatch notification and move the procurement to within-day to integrate DFS procurement needs into its existing operational decision-making procedures.

Respondents had mixed views on this proposition. Some noted that it aligns better with system operation needs and is a positive step towards establishing demand flexibility as a business-as-usual tool. Others highlighted that this approach risks losing access to some volume as domestic and I&C participants could struggle to respond within day due to demand scheduling and shorter response time.

We are comfortable with NESO's rationale as the results of DFS procurement over the winter of 2023/24 show that participants achieved higher accuracy in delivery of contracted demand response for within-day dispatch notifications compared to day-ahead notifications.

Stacking of the Demand Flexibility Service with other services

NGESO proposed for the DFS to be stackable with the Capacity Market ("CM") and Distribution Network Operator ("DNO") Flexibility Services as this can increase the revenue opportunities available to market participants. We recognise that this received strong support from industry, though we acknowledge feedback from some providers that CM and DNO Flexibility Services have some differing requirements (such as baselining approaches) and we expect NESO to work with industry to establish complementary rules which lead to broad market access. While we expect this to become more established once the Market Facilitator[15] is live, this should not be seen as a reason to delay making progress on this important matter.

We are comfortable with NGESO's rationale and expect them to resolve challenges and improve stacking feasibility of the DFS with other services. We understand some providers' preference would be to allow stacking with the BM. However, given the possibility of BM distortion, currently the risks outweigh the benefits of BM stacking. We note that a few market participants raised that the parameters on which NESO will decide to allow stacking with additional services are unclear. We believe NESO should allow as much stackability as practical as a way forward, while managing risks. We expect to see NESO undertake further work to allow stacking of as many services as practicable to ensure that all market parties have access to revenue opportunities and that NESO has the maximum volume available to efficiently solve system needs.

[15] Information about Market Facilitator can be found here: https://www.elexon.com/what-we-do/what-we-manage/market-facilitator-for-distributed-flexibility/

Classification of the Demand Flexibility Service as a Relevant Balancing Service

Although stacking with the CM was viewed as a positive step, some respondents noted that NGESO should distinguish the DFS as a Relevant Balancing Service ("RBS"). This would ensure that DSR CM units had clarity on their delivery requirements during System Stress Events when also providing the DFS in overlapping periods. NGESO clarified that it planned to designate the DFS as an RBS in the future but considered that it was more relevant to potential use of the service for demand turn-up.

We understand that there is minimal, if any, impact based on the service design and payment structure for participants who stack DFS with the CM. However, there is value in clarity and transparency of market rules and obligations, especially under stressed system conditions, and thus we expect NESO to consult at an appropriate juncture on the list of RBS and whether inclusion of the DFS is required.

Baseline methodology calculations

NGESO proposed to continue to use a baselining approach derived from the baselining calculation method 01 ("BL01") which was the first baselining methodology introduced to the Balancing and Settlement Code ("BSC") under Section S13. The DFS baselining methodology is based on the same "historic use" basis, selecting recent similar days to the dispatch day. Unlike in BL01, NESO does not make use of within-day adjustments. The DFS baselining methodology also sets out additional factors which can count to exclude historic days, such as delivery of certain DNO Flexibility Services.[16]

Respondents generally supported the proposed baseline methodology. However, a few respondents raised concerns that it may not be suitable for capturing demand shifts for all types of flexible assets. We consider that the selected baseline methodology, having been adapted from the approach used in earlier versions of the DFS and within the BSC, is a sensible starting point. We do agree that it may not be the best option for all provider types, just as the baselines currently included within the BSC may not suit all provider types. We encourage NESO to continue to work with industry to establish where alternative approaches to baselining would be a better fit and to propose to add to or amend the current methodology where appropriate.

Performance incentive structure

Respondents mostly supported the proposed performance incentive window for DFS delivery (full payment for delivery between 50% – 120% of contracted volume) and commented that it should promote bid accuracy and delivery accountability. However,

[16] That is, those dispatched more than 48 hours ahead of delivery.

some respondents variously suggested that the window was too strict and too lax. One respondent suggested that increasing the upper limit could encourage participation.

We are content that the proposed performance window is appropriate and understand that the nascency of the service and anticipated provider maturity means it is challenging to set a range with confidence. We therefore agree with the view of some respondents that the window must be kept under review, and we therefore expect NESO to monitor the incentive structure and make necessary revisions if appropriate.

Lack of visibility of Provider offers to consumers

Some respondents asked for clear guidelines on the distribution of rewards from the service providers to individual households and whether the service provider or NESO is expected to conduct DFS settlement calculations. It is clear that it is at the Provider's discretion as to the reward structure they offer the end consumer. We expect the market to mitigate any risk of consumer detriment as we understand consumers should be able to freely move between DFS providers and are not obligated to take part in the service. Additionally, we understand that providers have used distinct brand names for signing up consumers to the DFS. We expect them to clearly communicate to consumers which service they are participating in to avoid the risk of multiple registrations.

Further, consistent with the previous iterations of the DFS, NESO will publish a list of registered providers, allowing consumers' confidence in the genuineness of offers. We further understand that providers who are signed up to HOMEflex[17] will be identified within that list. We consider that this, along with the ability for consumers to move between providers means there are protections in place to ensure that consumers receive fair compensation for providing their flexibility to the system. We further note that no consumer should be forced to participate in the DFS.

<u>Alignment with our Statutory Duties</u>

We consider that the DFS has the potential to increase competition in NESO's margin management and thus could reduce costs of system balancing, with any savings ultimately passed on to consumers. By accessing flexible demand, this has potential to be achieved in a low carbon manner, thus furthering the United Kingdom's net zero ambitions, particularly with respect to Great Britain's clean power targets. Achieving a zero-carbon power system

[17] HOMEflex is a code of conduct between Flexibility Service Providers and Consumers that promotes transparency, inclusivity, and respect. The Code sets common standards for organisations delivering energy flexibility services to domestic and micro-business customers, encouraging good practice and accountability. More information about HOMEflex can be found here: https://www.flexassure.org/images/HOMEflex_Code_Final_web_Ver1.pdf

at low cost while maintaining reliable supply is crucial, and we consider that this service is a step toward delivering this.

Decision

Considering the above, the Authority hereby:

- approves that the DFS Service Terms and DFS Procurement Rules as mapped form part of the T&C required by Article 18 of the EBGL.

Next Steps

We expect NESO to publish the DFS Service Terms and DFS Procurement Rules alongside an updated Article 18 mapping document as soon as practicable.

We expect NESO to provide further transparency around enabling stacking with additional services as soon as practical. We expect NESO to maintain a collaborative dialogue on the DFS with stakeholders following this decision.

We expect NESO to keep the service design under review where appropriate and to put into practice learnings from the service across other markets to help unlock the full potential of flexible demand.

If you have any queries regarding the information contained in this letter, please contact Shubh Mehta (shubh.mehta@ofgem.gov.uk).

Yours sincerely,

James Hill
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For and on behalf of the Gas and Electricity Markets Authority