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Dear Stuart

### **GB ECM19: Charging for Large Loss Frequency Response**

Through the recent consultation on the proposed methodology of targeting charges for frequency response, a number of wider issues concerning the impact of the proposal on effective competition between generators were raised by industry participants. National Grid has considered these arguments against the potential improvements in cost-reflectivity that the proposal could reasonably be expected to deliver, and has concluded that proceeding with the proposal at this time would not better facilitate the relevant objectives. This letter sets out in more detail National Grid's reasoning for this decision, firstly in terms of the charging licence objectives, secondly in terms of avoiding a disjointed approach to developing BSUsS charges and thirdly in terms of the wider issue of carbon reduction legislation.

#### **Facilitating Licence Objectives**

Maintenance of system frequency within defined boundaries provides security to all users equally, and therefore is a common service with associated wider societal benefits. However, in the event that costs of particular services are targeted at participants, those participants should have the opportunity to express their views on the value that they place on those services. As different users are not able to procure services such as frequency response to their own particular standard, or to express the value that they place on such services, the opportunity to react to their preferences through a targeted charge does not exist.

Furthermore, in order for users to make informed economic decisions on investment and pricing, they must be able to assess the likely level of external costs such as frequency response to which they would be exposed. Under the existing commodity charge, generators have certainty that their competitors would each be paying the same proportion of the response costs, and hence they would not need to forecast likely levels of response. Under a capacity-based charging regime this principle of equality would disappear, and generators would need to assess both their own and their competitors' likely response costs in order to compete fairly. This requires a simple and transparent methodology with well-defined assumptions.

Any capacity-based charging methodology would be dependent upon a number of variables in order to effectively target response costs, some of which would be commercially confidential and hence difficult for users to estimate. As a minimum, these assumptions would have to include the number of generators operating at a given time, their commercial strategy, the level of risk each was imposing upon the system and the cost of National Grid's actions in obtaining response. These risks would need to be estimated for each half-hourly balancing period and over a number of years, as without this generators would be unable to effectively hedge their investment risk.

In summary, a transparent methodology that resulted in cost signals that users could reasonably forecast and be able to react to may be a benefit to competition. However, such a methodology cannot be identified for frequency response due to the communal nature of the service and the variability in cost and requirement over time. Moving from a commodity charge, where all users can take comfort that their competitors are receiving the same charge, to a charge that users will not be able to forecast for their own plant, let alone for their competitors', will only result in windfall gains and losses. It is National Grid's view that any potential improvement in cost-reflectivity is outweighed by the negative impact on competition between generators that would be caused by these market inequalities.

### **Review of Electricity Charging**

As frequency response is only one part of the common service provided to users by the System Operator, as noted in Ofgem's consultation<sup>1</sup> on the balancing services (BSUoS) arrangements in 1999, National Grid considers that a holistic review of BSUoS charging would be more beneficial than attempting to progress fundamental change on a piecemeal basis. The review of charging announced recently by DECC and Ofgem represents a natural forum for such discussions to take place. National Grid believes that such a review could provide the opportunity for all parties to contribute to developing a charging methodology for balancing services.

### **Decarbonising the Electricity Network**

The decarbonisation of the electricity network to help meet European and Government environmental targets will be a major development in National Grid's transmission business. In order to achieve such a fundamental change in how electricity is generated, transmitted and consumed, National Grid must ensure that the charging arrangements do not unduly hamper developments that could meet these targets.

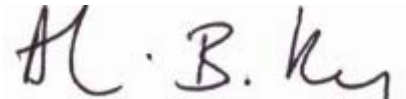
Information received through the recent consultation indicates that increasing costs on larger users could delay the commissioning of large nuclear plant by a number of years, with any shortfall in generation capacity likely to be made up through new CCGT plant. This eventuality would increase the difficulty in meeting European and Governmental environmental targets by delaying essential investment in lower carbon technologies. Whilst such a consideration does not fit within the narrow economic remit of the charging objectives, National Grid considers itself

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<sup>1</sup> [NGC System Operator Incentives, Transmission Access and Losses Under NETA: A Consultation Document](#)

beholden to the wider industry and the country as a whole to highlight the impact of potential developments in the charging regime on future consumers.

If you would like to discuss any of these points further, please do not hesitate to contact me.

A handwritten signature in black ink, appearing to read 'A. B. Kay'.

Alison Kay

Commercial Director, Transmission