

## EXPLANATORY NOTE ON THE TREATMENT OF BALANCING SERVICES USE OF SYSTEM CHARGES IN THE 4<sup>TH</sup> CONTRACTS FOR DIFFERENCE ALLOCATION ROUND (2021-22)

### Purpose and intended audience

1. This explanatory note is intended for the information of developers of renewable electricity generating stations planning to participate in the 4<sup>th</sup> Contracts for Difference (CfD) allocation round (i.e. Allocation Round 4, or AR4). It has been prepared by the Low Carbon Contracts Company (LCCC) and BEIS and presents a number of **illustrative** worked examples to help potential applicants understand the practical implications for strike prices awarded through AR4 if Ofgem decide to implement proposed modifications to the Connection and Use of System Code on the removal of Balancing Services Use of System (BSUoS) charges from generation (code modification CMP308)<sup>1</sup>. Ofgem published its 'minded to' consultation on 8 December 2021 with a closing date of 19 January 2022<sup>2</sup>.

### Context

2. On 25 November 2021, the Government published a response<sup>3</sup> to a consultation on further changes to the Contracts for Difference Standard Terms and Conditions for AR4. The policy response confirmed how BSUoS charges would be treated in AR4 depending on Ofgem's decision on whether or not to remove BSUoS charges from generators.
3. Currently, generators with a CfD who pay BSUoS charges are protected against increases in the cost of these charges over and above the Initial Balancing System Charge set in the contract before actual balancing charges are known. The CfD strike prices for these generators are adjusted annually for changes in balancing system charges and this is applied to both existing and new CfD contracts. This adjustment is designed to make the CfD contract broadly long-term neutral to changes in balancing system charges, which are outside of generators' control.
4. If Ofgem decides that generators should no longer pay BSUoS charges, regardless of when this decision is taken, the strike prices of those successful projects liable to pay these charges will be adjusted downwards after contracts are awarded. This would be done through the annual strike price adjustment undertaken by LCCC to account for the fact that BSUoS is no longer due to be paid. This adjustment will be applied from the date on which Ofgem's decision takes effect.
5. If Ofgem decides that generators should continue to pay BSUoS charges, then the contract will ensure that CfD generators awarded a contract in AR4 and who pay those charges, will continue to be protected against increases in BSUoS costs through a strike price adjustment in the usual way.

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<sup>1</sup> <https://www.nationalgrideso.com/industry-information/codes/connection-and-use-system-code-cusc-old/modifications/cmp308-removal>

<sup>2</sup> <https://www.ofgem.gov.uk/publications/cmp308-minded-decision-and-draft-impact-assessment>

<sup>3</sup> <https://www.gov.uk/government/consultations/contracts-for-difference-allocation-round-4-further-changes-to-the-cfd-contract>

6. In either case, the LCCC will carry out the annual strike price adjustment in respect of BSUoS charges using formulae set out in Conditions 14 and 20 of Version 4 of the CfD Standard Terms and Conditions<sup>4</sup>, published by BEIS on 25 November 2021.

## **Aims**

7. The intention behind the examples in this explanatory note is to demonstrate the potential impact of an Ofgem decision to not remove / remove the requirement on generators to pay BSUoS charges on a hypothetical strike price of a project usually liable to pay these charges, using purely illustrative assumptions.
8. The examples have been simplified in places to aid comprehension. As a result, they are not a replacement for thorough review of the BSUoS policy for AR4 as published in Version 4 of the CfD Standard Terms and Conditions and explained in the Government response of 25 November 2021. Developers should ensure they are familiar with and understand these documents prior to participating in the allocation round.
9. Where this explanatory note quotes 'nominal prices', this is inferred as the price base of the year in which the cost is borne. For example, if the cost is in 2023/24, and is listed as 'nominal prices', then the price base is 2023/24.
10. The examples cover two scenarios:
  - Example A – Ofgem code modification CMP308 **does not** go ahead ('no change');
  - Example B - Ofgem code modification CMP308 **goes ahead** with implementation from 1 April 2023.
11. In addition, a third example is presented (Example C), which explains how the Balancing System Charge Strike Price Adjustment ("BSCSP") mechanism operates.

## **Illustrative assumptions**

12. The following illustrative assumptions are applied for the purposes of the worked examples given below:
  - (i) An illustrative project usually liable to pay BSUoS charges, with an Initial Strike Price of £100/MWh (Base Year price base<sup>5</sup>), i.e. awarded after auction;
  - (ii) An Initial Balancing System Charge ("I") of £4.29/MWh, as set out in the AR4 Standard Terms Notice, published on 25 November 2021<sup>6</sup>;
  - (iii) In the absence of outturn information, an illustrative assumption that the sum of the Balancing System Charge Strike Price Adjustments ("ΣBSCSPA") increases each year by £0.5/MWh from the 2020/21 period (and so would be £1.5 in 2023/24). This increase is

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<sup>4</sup> <https://www.gov.uk/government/publications/contracts-for-difference-cfd-allocation-round-4-standard-terms-and-conditions>

<sup>5</sup> The contract defines the Base Year as 2012, with October 2011 treated as the CPI price base (see 'Definitions' – "Base Year CPI" – in the CfD Standard Terms and Conditions, Version 4, 25 November 2021).

<sup>6</sup> As set out in the [Standard Terms Notice](#), the value is based on a window of 1 October 2020 to 30 September 2021. It is an assessed average of balancing system charges charged to generators over this period. The contract treats August 2021 as the CPI price base for this value (see condition 46.1(D)).

in nominal prices and is therefore assumed to be inclusive of an inflation assumption (see below). See Example C for an explanation of how this illustrative figure would be worked out in the contract;

- (iv) In the absence of outturn information, an illustrative CPI adjustment of 20% from Base Year to 1st delivery year (2023/24) and an ongoing CPI of 3% per annum (for example, in Year 1, the factor is 1.20, and Year 2 is 3% more than that, 1.236). Please note that factual outturn CPI will vary to reflect future changes in the economy;
- (v) Only the first five years of the contract are presented, but the approach in each example would apply until the end of the contract.

13. The formulae<sup>7</sup> that would be applied were CMP308 to be implemented uses the Initial Balancing System Charge in Base Year terms (“I<sup>base</sup>”). Therefore, to translate the Initial Balancing System Charge to Base Year prices, stakeholders should be aware that LCCC will use the following formula<sup>8</sup> for doing this:

$$I^{base} = I \times \frac{CPI^{base}}{CPI_{IBSCW}}$$

14. CPI<sup>base</sup> is the value of the CPI for October in the calendar year immediately preceding the Base Year (October 2011, i.e. 94.5). CPI<sub>IBSCW</sub> is the value of the CPI for the penultimate month of the Initial Balancing System Charge Window (August 2021, i.e. 112.1).
15. The figures used in the above calculation should come from the ONS CPI series over the relevant periods<sup>9</sup>. Based on this series, it is assumed that I<sup>base</sup> **would be approximately £3.62/MWh**. Whilst this value is based on historic CPI data, the actual adjustment would not take place until 2023/24, and would not necessarily be rounded to the whole pence. This value should therefore be considered illustrative, as account cannot be made for any revisions to historic CPI data that may take place in the future.
16. For simplicity, and because they are not affected by the potential implementation of Ofgem’s proposed reform, the Transmission Loss Multiplier (TLM) and other Strike Price Adjustments have been left out of the examples below. Please see LCCC’s existing Strike Price Adjustment guidance for more information on how these additional factors affect annual adjustments<sup>10</sup>.

## Examples

### Example A: CMP308 does not go ahead

17. In this scenario, the Strike Price continues to increase for CPI and the  $\Sigma$ BSCSPA. With illustrative assumptions as set out above, over five years, this would result in the outcome set out in the table below.

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<sup>7</sup> The formulae at Conditions 14.8 and 20.8 in the FiT Contracts for Difference Standard Terms and Conditions, Version 4, 25 November 2021, would be used.

<sup>8</sup> Formula is part of the definition of “Base Year Initial Balancing System Charge” in Version 4 of Standard Terms and Conditions.

<sup>9</sup> See here for the latest data: <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/d7bt>.

<sup>10</sup> See here for the latest guidance: <https://www.lowcarboncontracts.uk/publications/strike-price-adjustment-spa-guidance-july-2020>.

18. The table applies the following formula:

$$\text{Initial Strike Price} \times \text{Inflation Factor} + \Sigma \text{BSCSPA} = \text{Adjusted Strike Price}$$

Adjust Period	Initial Strike Price (£/MWh, Base Year prices)	Inflation Factor (Base Year to nominal prices)	ΣBSCSPA (£/MWh, nominal prices)	Adjusted Strike Price (£/MWh, nominal prices, nearest pence)
2023/24	100	1.2	1.5	121.5
2024/25	100	1.236	2	125.6
2025/26	100	1.273	2.5	129.8
2026/27	100	1.311	3	134.1

Example B: CMP308 goes ahead from 1 April 2023

19. In this scenario,  $I_{base}$  is removed from the Strike Price in Base Year prices, leading to a reduction in the Initial Strike Price (Base Year prices) to £96.38/MWh (Base Year prices), which is then inflated to nominal prices. This adjustment then occurs each year for the remainder of the contract. ΣBSCSPA no longer forms part of the Strike Price Indexation Adjustment formula and does not feature in the table below.

20. The table applies the following formula:

$$(\text{Initial Strike Price} - I_{base}) \times \text{Inflation Factor} = \text{Adjusted Strike Price}$$

Adjust Period	Initial Strike Price (£/MWh, Base Year prices)	$I_{base}$ (£/MWh, Base Year prices)	Inflation Factor (Base Year to nominal prices)	Adjusted Strike Price (£/MWh, nominal prices, nearest pence)
2023/24	100	3.62	1.2	115.656
2024/25	100	3.62	1.236	119.126
2025/26	100	3.62	1.273	122.692
2026/27	100	3.62	1.311	126.354

21. It can be seen that the Adjusted Strike Price for 2023/24 and the subsequent adjustment periods shown in Example B would be lower than in the corresponding periods in Example A. If CMP308 were implemented, but came into effect later than 1 April 2023 (e.g. 1 April 2024), the Strike Price would be adjusted in line with the approach in Example A until the financial year of implementation, from which it would be adjusted in line with the approach in Example B.

Example C: Explaining the Balancing System Charge Strike Price Adjustment

22. The Balancing System Charge Strike Price Adjustment (“BSCSP”) feeds into the Strike Price Indexation Adjustment formula performed each year by LCCC. Thus, as demonstrated above, the sum of the Balancing System Strike Price Adjustment forms part of the resulting Strike Price and is the sum of all of the Balancing System Charge Strike Price Adjustments that have applied to that CfD since the start of the contract.

23. The BSCSP indexes the Initial Balancing Charge using CPI up to the year of the relevant adjustment. For illustrative purposes, a uniform ongoing CPI of 3% per annum has been applied (even where the actual adjustment period will not be a full year). Further, it has also been

assumed that the Actual Balancing Charge has increased by that 3% CPI plus £0.5/MWh (nominal prices).

24. The table uses these two formulas:

$$(ABC - IBC) = BSCD$$

$$BSCD_i - BSCD_{(i-1)} = \text{Balancing System Charge Strike Price Adjustment}$$

25. All values in the table below are illustrative, and presented in £/MWh, nominal prices.

Adjust Period	Indexed Initial Balancing Charge (IBC)	Actual Balancing Charge (ABC)	Balancing Services Charge Difference (BSCD)	Balancing Services Charge Difference (BSCD (i-1))	Balancing System Charge Strike Price Adjustment	ΣBSCSPA
<b>Initial</b>	4.29	4.29	0	0	0	0
<b>2021/22</b>	4.419	4.919	0.5	0	0.5	0.5
<b>2022/23</b>	4.551	5.551	1	0.5	0.5	1
<b>2023/24</b>	4.688	6.188	1.5	1	0.5	1.5

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Comments or questions about this explanatory note should be sent to via the [Contact Us](#) section of the Allocation Round 4 resource portal.