System Operators, Transmission and Transportation System Owners, Generators, Shippers, Suppliers, Customers and Other Interested Parties.

Promoting choice and value for all gas and electricity customers

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Dear Colleague

Ofgem's initial comments on National Grid's Electricity System Operator Incentives Initial Proposals

On 24 November 2010, National Grid Electricity Transmission (NGET) released its Initial Proposals (IP) for a multi year electricity System Operator (SO) incentive scheme commencing on 1 April 2011.[1]

NGET's IP outlines its proposal for a methodology to ensure that a multi year SO incentive scheme, which is fit for purpose, is in place from April 2011 (SO 2011–2013). Importantly, NGET has sought to address the issues identified in Ofgem's 2010/11 Electricity System Operator Review – Preliminary Conclusions following Phase 1 (the Preliminary Conclusions).[2] It has proposed mechanisms through which it considers significant improvements can be made to the incentive methodology, including in relation to its modelling approach. However, there is a significant amount of work yet to be completed with regards to aspects of its methodology, including its modelling, particularly around constraints and margin pricing. As a consequence, this limits the response that we and other stakeholders can make at this stage on NGET's IP.[3]

With a view to maintaining a high level of engagement with interested parties, this letter provides our initial comments on those aspects of NGET's proposal for SO 2011–13 that were covered in NGET's IP document published in November. We recognise the valuable contribution that interested parties can make in developing incentive schemes, and are keen to ensure that customers and industry participants fully engage in the current consultation process.

[1] This document is available at: www.nationalgrid.com/uk/Electricity/soincentives/docs/.
[2] The objective of the electricity System Operator Review (SO Review) was the development of an appropriate methodology for SO incentive schemes suitable for application to multiple years. The SO review was split into three phases: (1) Phase 1– relates to the examination of NGET's current methodology, including it models and modelling approach, to put forward preliminary conclusions for the development of an SO scheme covering at least two years; (2) Phase 2 – undertaken by NGET in light of the Preliminary Conclusions from Phase 1, this phase relates to the production of NGET's proposed methodology, including its models and modelling approach, for the development and implementation of an SO incentive scheme covering at least two years; and (3) Phase 3 – relates to the examination of NGET's proposed methodology produced in Phase 2, including its models and modelling approach, to determine its appropriateness for application to an SO incentive scheme covering at least two years. The Preliminary Conclusions following Phase I of the SO Review is available at: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=217&refer=Markets/WhlMkts/EffSystemOps/SystOpIncent
[3] We note that NGET published its constraints addendum on 13 December 2010 and this has limited the scope for us to make any detailed initial comments on its proposed approach to constraints within this letter.

Our final proposal for SO 2011–13 will be made following further analysis, the completion of Phase 3 of the SO review and careful consideration of responses to NGET's consultations. Responses from interested parties on NGET's proposals will be particularly important given the scope of the changes being proposed.

At a high level, our initial comments on NGET's IP are that:
- it appears to have considered the Preliminary Conclusions – we note that since its proposed approach is underpinned by a methodology rather than a specific cost target, agreeing to the inputs and assumptions underpinning the scheme will be fundamental;
- we are encouraged to see that it has proposed a two year scheme, as we consider that this will facilitate a number of benefits being realised;
- the proposed governance arrangements appear reasonable, although our final position on these issues will only be possible following the completion of its proposed methodology; and
- we note that it has not included a Balancing Services Use of System (BSUoS) cost forecast for either year at this stage but we recognise that this will be released separately in early 2011.

These initial comments are explored in more detail below, and we encourage stakeholders to comment on NGET's IP given the level of changes being proposed.

Ofgem's initial comments on NGET's electricity SO initial proposals

The Preliminary Conclusions

In July 2010, the Preliminary Conclusions were published. The Preliminary Conclusions highlighted that NGET's existing methodology and models were not fit for purpose, particularly for developing multi year schemes. We considered that, notwithstanding the inherent difficulty in improving NGET's methodology, significant improvements could be made to the incentive methodology, including the approach to modelling.

The Preliminary Conclusions outlined a proposed approach that would improve the incentivisation surrounding the SO incentive scheme by taking into account the impact of unpredictable and uncontrollable external factors affecting NGET's cost base by adjusting the incentive target at the end of the scheme period for these factors.

We therefore welcome NGET's IP, which appears to have considered the Preliminary Conclusions by taking steps to improve the methodology, including the approach to modelling, and proposing a multi year scheme. We consider that the effective consideration of the Preliminary Conclusions in NGET's IP should generate a number of benefits. Specifically, some of the expected benefits of the new incentive methodology and of setting a multi year scheme are that they will:
- improve transparency, with a longer incentive period leading to increased information discovery on costs that will enable the incentive schemes to become more targeted over time;
- allow stronger incentives to be set for NGET with regard to its contracting strategy;
- reduce administrative burden in the longer term, as the scheme would not be set on an annual basis;
- incentivise NGET to consider actions that have a higher upfront costs which will be paid back over a longer period;
- allow NGET to take a more strategic view of its operation of the electricity system over a longer period; and
- allow for greater alignment with other regulatory decisions, such as RIIO–T1.[4]

[4] Future alignment of TO/SO incentives is desirable as it will help optimise system operations (maintenance and maximum utilisation of the existing system) with long term investment decisions.

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However, as Phase 3 of the SO Review – the examination of NGET's proposed methodology to determine its appropriateness for application to a SO incentives scheme covering at least two years – has yet to be completed, we are not in a position to state if NGET's proposal is fit for purpose. We are, nonetheless, encouraged to see that it has proposed a scheme for two years.

We look forward to the further analysis that NGET will undertake in this area, including with respect to constraints. In addition, we look forward to continuing to work with Frontier Economics in assessing NGET's proposed methodology. This will allow us to complete Phase 3 of the SO review as quickly as possible, following NGET finalising its proposal for SO 2011–13.

A new approach to incentivisation

NGET appears to have undertaken a substantial amount of work with respect to improving its proposed methodology. Specifically, NGET has made some improvements to its proposed incentive methodology, including its models and modelling approach. NGET's proposed approach appears to provide scope for the SO incentive scheme to be set for multiple years and for any incremental benefits to be passed on to consumers.

Importantly, NGET has proposed a specific methodology for calculating SO costs (rather than a specific cost target). This is a significant departure from previous schemes and therefore places great importance on the setting and agreement of the governance arrangements underpinning NET's approach, including those associated with its inputs, and assumptions.

NGET's proposed incentive methodology takes into account the impact of unpredictable and uncontrollable external factors affecting its cost base. NGET's cost target is based on an ex ante forecast which can be adjusted for such external factors into an ex post target. This will be achieved through the use of modelling tools, which will be agreed at the beginning of the scheme, including some ex ante agreed inputs, and outturn values for external, volatile factors falling outside NGET's control.[5] This methodology should ensure that NGET's performance is measured by how efficiently it carries out its actions, taking into account the actual external factors it faces.

While recognising that Phase 3 of the SO review has yet to be completed, we consider that there is merit in allowing greater use of ex post variables in NGET's approach if it will:

- allow better incentivisation for NGET in relation to those factors under its control; and
- provide scope for the benefits of a longer SO incentive scheme to be realised.

We will, however, pay particular attention to what variables NGET proposes ex post treatment for, both in the context of the energy models and the constraints models, to ensure that NGET continues to be appropriately incentivised. In particular, the use of ex post variables should not reduce NGET's incentives to engage into efficient behaviour, such as, for example, entering into efficient contracts to deal with the impact of external factors on its cost base.

We also consider that the linking of NGET's proposed methodology statement and criteria for ex post and ex ante variables to its licence is an important aspect of the scheme, and one which will ensure that appropriate levels of consistency and transparency are achieved. We would be particularly interested in stakeholder's views of the scope and transparency of NGET's proposed approach.

We also note that due to the change in NGET's approach, that it has not included a BSUoS cost forecast for either year at this stage. NGET does, however, acknowledge that it has

[5] Ex ante variables refer to variables that have been estimated or forecast, while ex post refers to values that are based on actual outturn values.

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committed to release a BSUoS cost forecast in early 2011. We look forward to seeing this released as soon as possible.

Governance and scheme design

Our initial comment on NGET's proposed approach to governance is that it appears reasonable. NGET presents options for the design of SO 2011–13 and outlines the arrangements that will underpin the scheme. Importantly, it outlines the criteria for ex ante and ex post data and explores the scheme parameters that it considers appropriate. It does not, however, include a methodology for determining how historical data should be used to address issues relating to the extension of the forecast horizon of the ex ante inputs and the modelling of the relationships between inputs and the relevant cost drivers, and we will be asking NGET to progress this issue in a timely manner.

As noted earlier, the governance arrangements underpinning NGET's proposed approach, including those associated with its inputs, and assumptions, will be fundamental to the success (or otherwise) of the scheme. We agree that there should be a methodology statement and criteria for ex post and ex ante variables and that this should be linked to its licence obligations.

We also consider that transparency in the governance arrangements, including those associated with the proposed inputs, assumptions and methodologies, is important. However, we consider that where this information is market or commercially sensitive, this information should not be made public. As such, we consider that the approach being proposed by NGET with respect to transparency of its governance arrangements are, in general, appropriate. We look forward to stakeholder's views on these issues.

<u>Scheme parameters</u>

With respect to the sharing factors, caps and floors in the proposed scheme, we remain concerned with the lack of justification for the levels being proposed by NGET. While an increase in the sharing factors and higher caps and floors was expected under this approach – given the expected improved incentivisation on factors that NGET is expected to have control over – the levels that are being proposed lack justification. Furthermore, given the scope of the modelling that remains incomplete, it is difficult to determine why, for example, a £50m profit cap/loss floor is appropriate.

We note that NGET's view is that there should be no deadband applied to the proposed scheme from 1 April 2011. We consider that the expected improvement in modelling should reduce, if not eliminate, the need for a deadband within the scheme. However, given that NGET's modelling, particularly with respect to constraints, remains incomplete, we consider this conclusion is premature. We look forward to seeing NGET's modelling being completed and its further thoughts on any deadband when this occurs.

With regard to within scheme adjustments, our initial comment is that the adjustments being proposed seem reasonable to the extent that they appear to strike an appropriate balance for allowing changes to the scheme while providing sufficient regulatory certainty. However, for the avoidance of doubt, we consider that an appropriate within scheme adjustment includes one that is due to 'material changes brought about by shifts in regulation or step-changes'.

We look forward to stakeholder's views on these issues.

NGET's approach to modelling

Our initial comment on NGET's approach to modelling is that we consider that it has undertaken a reasonable amount of analysis on energy, but less on constraints. The focus on redefining relationships and ensuring NGET is incentivised on factors that it can control is a welcomed refinement to the regime. We note that NGET's IP was incomplete and note

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that more information on constraints was released through a constraints addendum. More detailed comments on NGET's modelling are outlined below.

Energy models

NGET's energy model appears to have been subject to a number of improvements, including updating the inputs and calculations within its model and consideration of the relationships within its models. NGET has also reconsidered the relationships between key variables and has proposed a number of model inputs which should be adjusted on an ex post basis. These ex post inputs appear to be those variables where NGET does not have any control and which are difficult to predict.

Our initial comment is that the improvements in the energy model are a step in the right direction. We are, however, concerned that NGET's proposed margin pricing model appears to be unable to provide satisfactory predictions of margin prices from April 2010. We look forward to the results of the additional work that NGET will undertake in this area. We also look forward to stakeholder's views on these issues.

Constraints model

With respect to its proposed constraints model, NGET is in the process of replacing its current suite of constraints models with a single model based on fundamentals that considers the GB system as a whole.

We are encouraged to see that NGET appears to be heading in a direction that will enable a GB fundamentals model that will enable an unconstrained and constrained schedule based on the merit order across GB to be derived on an internally consistent basis.

However, while this appears to be consistent with the conclusion from the Preliminary Conclusions, we are yet to fully consider the details of NGET's proposed approach – these details have only recently been published (13 December 2011) in NGET's constraints addendum. That said, we note that NGET has proposed that there may be merit in the balancing mechanism price being considered as an ex post variable. We consider that any input that is used should ensure that NGET continues to be appropriately incentivised. We will therefore continue to examine all NGET's proposed options and their impact on the incentive methodology, including the approach to modelling, to ensure that the proposed approach does not reduce NGET's incentive to act in an efficient way.

We look forward to stakeholder's views on these issues.

Going forward

We recognise the important contribution interested parties can make in developing NGET's IP for SO 2011–13. As such, we are keen to ensure that consumers and industry participants engage in the process for developing the final incentive schemes that will be in place from 1 April 2011. We hope that the initial views provided within this letter will assist interested parties in focusing their consultation responses.

The table below sets out the steps remaining in respect of the development of NGET's SO incentive schemes to be in place from April 2011.

22 December 2010	**NGET Initial Proposals consultation closes**
Late February 2011	**Ofgem publishes Final Proposals document**
March 2011	**Final proposals consultation closes** **Ofgem issues directions (provided NGET consents to proposals)**
April 2011	**Electricity incentive scheme implemented**

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Incentives from April 2013

Given that the proposed incentive schemes will lapse at the end of March 2013, we will need to consider the appropriate arrangements to be put in place from April 2013. Ofgem is considering the interactions between the SO and TO role in order to reach a view on how best to align the SO and TO incentives under RIIO–T1 and SO incentive schemes to apply from April 2013. We expect to be in a position to provide more information on the way forward for this area in our Final Proposals.

If you would like to discuss any aspects of the electricity SO incentive scheme, please contact Giuseppina Squicciarini (Head of Regulatory Economics, GB Markets) at giuseppina.squicciarini@ofgem.gov.uk or Ian McNicol (Senior Economist, GB Markets) at ian.mcnicol@ofgem.gov.uk.

Yours sincerely

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