

Statement in relation to a proposed Income Adjusting Event under National Grid Company's 2003/04 System Operator incentive scheme

Issue

On 7 April 2004, National Grid Transco (NGT) submitted to the Authority notice of a proposed Income Adjusting Event (IAE) within the framework of National Grid Company's (NGC) 2003/04 System Operator (SO) incentive scheme. This information note is intended to highlight the existence of the proposed IAE to interested parties and to outline the process which Ofgem intends to adopt to handle the proposed IAE.

Background

Details of the proposed IAE are included in the notice provided by NGT, the non-confidential parts of which are included as Annex 1 of this information note¹. In summary, NGT considers that the change in circumstances following Ofgem's clarification of Ofgem's interpretation of NGC's obligations relating to the procurement of short-term reserve constitutes an IAE². Following clarification, NGC revised the way in which it assesses and procures short-term reserve and on this basis considered it appropriate to launch a standing reserve tender round in October 2003 and to procure additional reserve to supplement that already purchased via the annual standing reserve tender. NGT states that the incremental costs associated with procuring the supplemental reserve, in accordance with its clarified obligations, were £5.54m. In order to remove the impact of the proposed IAE, NGT, therefore, proposes an income adjustment of £5.54m.

Proposed process and timetable

NGC's transmission licence specifies a 3 month timetable for the progression of IAEs. If after 3 months, the Authority has not issued a decision to the contrary, the income adjustment proposed in the notice will be applied. The 3 month period in relation to this IAE concludes on 7 July 2004.

Within this 3 month period, Ofgem will consult with interested parties on whether the events outlined by NGC constitute an IAE and, if so, how the costs should be treated. The consultation document is expected to be published in mid May 2004. Following consideration of responses received, Ofgem expects to publish its decision in early July 2004.

As part of the consultation, Ofgem also intends to outline potential improvements to the IAE process set out in NGC's transmission licence with the intention of seeking views on the suggested improvements. The potential improvements are based on experience gained by Ofgem, NGC and market participants during the progression of the first proposed IAE, which

¹ Annex 1 excludes Appendix 1 of NGT's letter as it contains commercially sensitive information.

² Ofgem's interpretation of NGC's obligations is highlighted in the following document: 'NGC System Operator incentive scheme from April 2004, Proposals and statutory licence consultation', Ofgem, February 2004. NGC has agreed that its obligations in respect of procuring short-term reserve will be a topic for discussion at the next Operational Forum on 2 June 2004. Ofgem has offered to attend this meeting and to answer any questions that market participants have about this issue and its interpretation of NGC's role.

offered valuable insight into how the IAE process could be improved going forward³. If appropriate, following consideration of responses received, Ofgem then expects to initiate a statutory licence consultation in relation to proposed revisions to NGC's transmission licence.

Contact details

If you wish to discuss any aspect of this information note, please contact the following people who will be pleased to help:

- Simon Bradbury – telephone number: 020 7901 7249, fax number: 020 7901 7452, email: simon.bradbury@ofgem.gov.uk; or
- David Hunt – telephone number: 020 7901 7429, fax number: 020 7901 7452, email: david.hunt@ofgem.gov.uk

³ The first proposed IAE was progressed between March 2003 and June 2003. It related to costs incurred by NGC when it entered into a balancing services contract with Drax in November 2002. Ofgem's decision in relation to this IAE is contained in the following document: 'Income adjusting event under NGC's 2002/03 system operator incentive scheme: A decision document', Ofgem, June 2003.

Annex 1 – NGC’s notice of a proposed IAE

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7 April 2004

Dear Stephen

Notice under Special Condition AA5A Part 2 (i) paragraph 11 of National Grid’s transmission licence

Terms and expressions used in this notice shall have the same meanings given to them in the transmission licence treated as granted under section 6 (1) (b) of the Electricity Act 1989 to National Grid Company plc (“the Transmission Licence”).

As you are aware, in the lead up to winter 2003/04 we had concerns in relation to the forecast plant margin for the winter period. This led us to seek clarification from Ofgem as to its interpretation of our obligations as residual balancer, and how those obligations related to the way in which we procure short-term reserve. Following the clarification of our obligations, which have subsequently been outlined in the recent statutory licence consultation on SO incentives⁴, I am writing to inform you of the consequential change in circumstances affecting the balancing services activity. This change in circumstances has resulted in balancing costs being incurred which were not envisaged when the SO incentive scheme for 2003/04 was agreed and set, and which should therefore, in our view, be treated as an Income Adjusting Event.

This letter therefore constitutes notice under Special Condition AA5A Part 2(i) paragraph 11(a) of the Transmission Licence that we are of the view that costs have been caused as a result of an Income Adjusting Event which have increased by more than £2,000,000 the value of IBC_t during the relevant period 1st April 2003 – 31st March 2004.

The following particulars are given in satisfaction of paragraph 11(c) of Special Condition AA5A.

Previous Approach to Short-term Reserve Procurement

⁴ NGC System Operator incentive scheme from April 2004. Proposals and Statutory licence consultation, February 2004 (39/04)

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6060_3904.pdf

Under our pre-winter 2003/04 approach to short-term reserve procurement, decisions were based purely on narrow economic trade-offs. In considering when to procure reserve to meet a short-term requirement, the economic trade off was between the cost of procuring reserve in advance (via tenders for Standing Reserve) versus the cost of procuring reserve close to real time. This was the basis on which the 2003/04 SO incentive scheme was set.

This narrow economic trade off was measured by comparing the “equivalent price” of a Standing Reserve tender (which represents an estimate of the total cost of the service) with an “assessment price” (which represents the forecast avoided cost of alternative reserves). Only short-term reserve with an “equivalent price” which was less than or equal to the “assessment price” would be procured in advance via the Standing Reserve tender. For the purposes of this letter this approach to the assessment and procurement of reserve will be known as “*Approach 1*”.

However, our concerns over low plant margins in the lead up to winter 03/04 and the effect this may have had on our ability to secure our requirement for short-term reserve led us to seek clarification from Ofgem as to its interpretation of our obligations as residual balancer, and how those obligations related to the way in which we procure short-term reserve.

Current Approach to Short-term Reserve Procurement and the Proposed Income Adjusting Event

Following clarification from Ofgem as to its interpretation of our obligations and how those obligations relate to the way in which we procure short-term, changes have been made to the approach we take in the assessment and procurement of short-term reserve⁵. The key difference is that we now give explicit consideration to the degree of certainty achieved in respect of securing the short-term requirement. This may mean that we enter into forward contracts based on the prevailing information and conditions at the time, which do not appear economic, in order to reduce the risk (to a 1 in 365 level) that there will not be sufficient short-term reserve available on the day to meet the requirement. For the purposes of this letter this approach will be known as “*Approach 2*”.

Whilst we will continue to operate under the current approach (*Approach 2*) to reserve procurement going forward, the change in approach following clarification of our obligations by Ofgem in November 2003, has resulted in us entering into reserve contracts which we would not otherwise have done when operating under *Approach 1*. It is our view that the balancing costs associated with these contracts have been efficiently incurred as a result of Ofgem’s clarification of our obligations, but were not taken into account when the 2003/04 SO incentive scheme parameters were set. As such we believe the change from *Approach 1* to *Approach 2* should be treated as an Income Adjusting Event. Further details of the costs incurred are provided below.

Costs Associated with the Proposed Income Adjusting Event

Against the background of our concerns over low winter plant margins, and following Ofgem’s clarification of our obligations, we issued an open invitation to the market to tender for the provision of short term reserve on 14th October 2003. This additional reserve

⁵ Further details can be found in Chapter 1, NGC System Operator incentive scheme from April 2004. Proposals and Statutory licence consultation, February 2004 (39/04)
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6060_3904.pdf

supplemented that already purchased ex-ante via the annual Standing Reserve Tender round, and was therefore termed “Supplemental Standing Reserve” (SSR). Services procured via the SSR tender would be effective from 17th November 2003 to 1st April 2004.

On 27th October 2003 (‘Market Day’) a total of 22 discrete tender submissions were received representing thirteen sites from eight companies (including Agents). Consideration was given to the degree of certainty that could be achieved in respect of securing our total short-term reserve requirement from existing contracted Standing Reserve, the Supplemental Standing Reserve tenders and reserve that may be available for purchase on the day (via PGBT or in the Balancing Mechanism). Assessing the Supplemental Standing Reserve tenders on this basis led to 20 of the tenders proceeding to contract. The two unsuccessful tenders did not meet all of the technical requirements, and therefore did not proceed to contract.

The total volume associated with the successful tenders was 852MW, comprising:

- 667MW from BM Participants
- 185MW from Non BM Participants

Further details can be found in the SSR market report:

http://www.nationalgrid.com/uk/indinfo/balancing/pdfs/Supplemental_Standing_Reserve_Report_Jan2004.pdf

When determining whether a tender was economic to procure, an ‘assessment price’ was used which represented our estimate as to the value provided by the reserve. Under *Approach 1*, only tenders priced at or below this assessment price would have been accepted, with this being the basis on which the 2003/04 SO incentive scheme parameters were set. Under *Approach 2*, by accepting tenders that were priced in excess of the assessment price, costs have been incurred which were in excess of those envisaged when the incentive scheme parameters were set. It is these costs that form the basis of this proposed Income Adjusting Event.

If the tenders were assessed under *Approach 1*, it would have only been economic to accept eight out of the 22 tenders. The forecast cost associated with these eight tenders is £0.87 million, comprising £0.33 million in availability payments and £0.54 million in forecast utilisation costs.

In procuring a total of 852MW of reserve under *Approach 2*, we forecast the total cost to be £18.87 million. This total comprises £13.22 million in availability payments, and £5.14 million in forecast utilisation costs.

However it is not simply the difference in costs between *Approach 1* and *Approach 2* that forms the basis of the Income Adjusting Event. A proportion of the costs incurred when procuring SSR under *Approach 2* still appeared economic (those that were less than or equal to the assessment price). Hence the incremental costs incurred as a result of procuring SSR under *Approach 2* as opposed to *Approach 1*, were only the costs incurred which were in excess of the assessment price.

We calculate that the incremental costs incurred as a result of procuring reserve under *Approach 2*, (i.e. those in excess of the assessment price) were £5.54 million. It is this cost which we are proposing should be treated as an Income Adjusting Event. Supporting evidence, which is commercially sensitive, is included in Appendix 1 of this notice.

The total costs associated with the services procured via the Supplemental Standing Reserve tender have been included in the calculation of Incentivised Balancing Cost (IBC_t) for 2003/04 in accordance with Special Condition AA5A Part 2(i) paragraph 9 of the Transmission Licence.

The Amount of Allowed Income Adjustment

IBC_t has been increased by £5.54 million as a result of the change in approach to reserve procurement following Ofgem's clarification of our obligations as residual balancer. In order to remove the impact of this change from the incentive scheme, it is proposed that the allowed income adjustment (RT_t) should also be set to £5.54 million.

Next Steps

In light of Ofgem's clarification of our obligations as residual balancer, we would ask the Authority to approve the consequential change in approach to short-term reserve procurement as an Income Adjusting Event pursuant to Special Condition AA5A Part 2(i) Paragraph 10(a)(iv) of the Transmission Licence, and to determine the value of allowed income adjustment pursuant to Special Condition AA5A Part 2(i) Paragraph 12 of the Transmission Licence.

If you require any further information on the issues discussed above, please do not hesitate to contact me. I look forward to hearing from you on this issue.

Yours sincerely

Tim Tutton