

**Income adjusting event under National Grid
Company's 2003/04 system operator
incentive scheme**

A consultation document

May 2004 108/04

Summary

National Grid Company plc (NGC) owns and operates the high voltage electricity transmission system in England and Wales. NGC has two important functions: transmission asset owner (TO) and system operator (SO). Ofgem regulates both NGC's functions. Ofgem sets annual incentives that cover NGC's role as SO. Under this scheme, NGC is set an annual target level of costs for system operation. Within the terms of NGC's 2003/04 SO incentive scheme ('the SO incentive scheme'), under which this Income Adjusting Event (IAE) falls, NGC stood to keep 50 per cent of any savings below the target and to pay 50 per cent of any costs in excess of the target. NGC's maximum gains or losses under the scheme were subject to a cap of £40 million and a floor of -£40 million. The incentive scheme ran from 1 April 2003 to 31 March 2004.

On 7 April 2004, NGC gave notice to Ofgem¹ that it believes that an income adjusting event (IAE) has occurred under the SO incentive scheme. The IAE provisions are intended to provide protection for both NGC and electricity customers when unforeseen events occur that result in NGC incurring costs (or making savings) against its target balancing costs that were not envisaged at the time that the target was set. As a result, no allowance for these costs or savings arising from such events will have been included within the SO incentive scheme target. NGC and Balancing and Settlement Code (BSC) Parties are able to propose an IAE and the events that amount to an IAE are set out in NGC's transmission licence.

This document outlines the IAE provisions in NGC's transmission licence, the circumstances that have led NGC to notify Ofgem that an IAE has occurred and Ofgem's initial views as to how this IAE should be treated.

Proposed income adjusting event

Ahead of winter 2003/04, NGC, in light of its concerns in relation to its forecast plant margin for the winter period, sought clarification from Ofgem concerning its interpretation of NGC's licence obligations² and the way in which they relate to NGC's procurement of short-term reserve. Short-term reserve is generation capacity (or

¹ Ofgem is the office of the Authority. The terms "Ofgem" and "Authority" are used interchangeably in this document.

² In terms of Ofgem's interpretation of the provisions relating to NGC's role as SO contained within both the Electricity Act 1989 and NGC's transmission licence and how they relate, among other things, to the way in

contracts with large customers that can reduce their demand rapidly) that NGC, as SO, holds to deal with events (such as a sudden loss of a large generator to mechanical failure) within operational timescales. Following clarification of Ofgem's interpretation, which was first published in Ofgem's proposals document for NGC's SO incentive scheme for 2004/05³, NGC has made a subtle but important change to the methodology it uses when procuring short-term reserve.

Following the change in methodology, NGC reassessed its reserve contract holdings for winter 2003/04 and the likelihood of additional reserve being available on the day and initiated a Supplemental Standing Reserve Tender (SSRT) on 14 October 2003. The tender closed on 27 October 2003. NGC received 22 tenders in total. NGC accepted 20 of these tenders and procured a total of 852MW of Supplemental Standing Reserve (SSR) at a total cost of £18.87 million. In NGC's view, 12 of the tenders were accepted as a direct result of the change in methodology. NGC has stated that the incremental costs associated with these 12 tenders are £5.54 million.

On 20 April 2004, Ofgem released a statement highlighting the existence of the notice of an IAE and outlined the process that Ofgem expects to adopt to handle the proposed IAE⁴.

Proposed income adjustment

In order to remove the impact of the incremental costs associated with the IAE from the 2003/04 SO incentive scheme, NGC has proposed that the allowed income adjustment element of its Incentivised Balancing Costs (IBC) should be set at £5.54 million. This would have the effect of reducing its IBC for 2003/04 by £5.54 million.

Ofgem's initial views

Ofgem set the 2003/04 SO incentive scheme, following extensive consultation, on the basis of NGC's forecast costs. NGC's forecast costs were based on the methodology prior to Ofgem's clarification of NGC's obligations. Ofgem therefore considers that no allowance for the incremental costs associated with the change in methodology and the resulting SSRT costs was included when setting the target for the 2003/04 SO incentive

which NGC procures short-term reserve.

³ 'NGC System Operator incentive scheme from April 2004, Proposals and statutory licence consultation', Ofgem, February 2004.

⁴ This statement is available at:

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6826_8604statement.pdf

scheme. Furthermore, Ofgem considers that the IAE provisions contained within the SO incentive scheme and associated licence condition are designed to provide protection for both NGC and electricity customers in the event that unanticipated costs, such as the incremental SSRT costs, or savings occur.

Having carefully considered all relevant information available to date, Ofgem's initial view is to approve the SSRT incremental costs as an IAE in accordance with special condition AA5A paragraph 10 (a) (iv) of NGC's transmission licence. Ofgem has assessed the information provided and has verified that the incremental costs incurred under the SSRT are £5.54 million. However, Ofgem is examining whether the incremental costs linked to procuring reserve in accordance with the revised methodology were to any extent offset by associated savings in relation to other balancing services. If this is the case, the appropriate income adjustment could be lower than the £5.54 million value proposed. On this issue, NGC considers that the assessment price against which the tender was assessed was calculated as the cost of providing that reserve from an alternative source. NGC states that the effect of the SSRT on other categories of balancing costs has as a consequence already been included in the assessment of the SSR tenders and that only those costs in excess of these balancing costs have been included in its application for treatment as an IAE.

However, before making its final decision in relation to the proposed IAE, Ofgem is seeking the views of interested parties on this matter. For the purposes of this IAE proposal, it is appropriate that this assessment should focus on what was known at the time the 2003/04 SO incentive scheme target was set and when NGC decided to hold the SSRT, without taking into account information gained with hindsight. Any views received will be taken into consideration by Ofgem before it makes its final decision. Views are requested by 18 June 2004. Ofgem expects to publish its final decision in early July 2004.

Modifications to the IAE licence drafting

Ofgem considers that the experience gained by Ofgem, NGC and market participants during the progression of the first IAE⁵ offered valuable insight into how the IAE process can be enhanced and improved going forward. Ofgem has reviewed the existing IAE provisions within NGC's transmission licence and has developed proposed revisions

⁵ An IAE was approved by the Authority in June 2003 in relation to a balancing service which NGC entered into with AES Drax in November 2002. Details can be found in the relevant decision document which is

which it considers will improve the operation of these provisions. In addition to consulting on the SSRT IAE, Ofgem wishes to seek views from interested parties in relation to the proposed revisions that it has developed in the context of the existing IAE provisions in NGC's transmission licence. Ofgem is also considering whether equivalent revisions should be made to the IAE provisions in Transco's gas transporter licence, which largely mirror those in NGC's transmission licence. Views on the suggested revisions are also requested by 18 June 2004.

Table of contents

1. Introduction.....	1
Purpose of this document	1
Background	1
Timetable.....	2
Views invited	2
Outline of this document.....	3
2. Income adjusting event provisions in NGC's transmission licence	5
Introduction	5
NGC's SO incentives.....	5
Income adjusting event provisions.....	6
3. Proposed income adjusting event	11
Introduction	11
Background.....	11
Proposed income adjusting event	13
NGC's view	14
Proposed income adjustment.....	16
Ofgem's views	16
Summary and views invited.....	17
4. Suggested modifications to the income adjusting event licence drafting.....	19
Introduction	19
Details contained within a proposed income adjusting event notice	19
Ensuring that a proposed income adjusting event notice is in the public domain.....	20
Consultation in respect of proposed IAEs	21
Housekeeping changes.....	21
Income adjusting event provisions in Transco's gas transporter licence	21
Summary and views invited.....	22
Appendix 1 Incentivised Balancing Cost component breakdown	23

Appendix 2 Suggested modifications to special condition AA5A (Revised restrictions on revenue) of NGC's transmission licence.....	25
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1. Introduction

Purpose of this document

- 1.1. Within the framework of National Grid Company plc's (NGC) 2003/04 System Operator (SO) incentive scheme, NGC has given notice to Ofgem that it believes that an income adjusting event (IAE) has occurred. This document outlines the IAE provisions in NGC's transmission licence, the circumstances that have led NGC to consider that an IAE has occurred and Ofgem's initial views as to how this IAE should be treated.

Background

- 1.2. NGC's SO incentive scheme is designed to provide commercial incentives for NGC to operate the England and Wales transmission system in an economic, efficient and co-ordinated manner. This is in the interest of consumers who ultimately pay for the costs of system operation.
- 1.3. NGC's incentive payment or receipt under its SO incentive scheme is determined by the level of its incentivised balancing costs (IBC) at the end of the incentive period. Adjustments can be made to NGC's IBC in order to take account of any costs incurred or savings arising from an IAE for which no allowance was made when setting the SO incentive scheme parameters. The IAE provisions provide protection for both NGC and customers in the event that an incident results in costs or savings which were not envisaged at the time that the SO incentive parameters were defined. These arrangements are discussed in more detail in Chapter 2.
- 1.4. As discussed in more detail later in the document, NGC considers that the incremental costs incurred as a result of the Supplemental Standing Reserve Tender (SSRT) initiated in October 2003 constitute an IAE. NGC states that the incremental costs associated with the SSRT amounted to £5.54 million and proposes an allowed income adjustment of £5.54 million to remove the impact of these costs from its 2003/04 SO incentive scheme performance. This consultation document sets out Ofgem's initial views as to how this IAE should be treated and invites respondents' views on this approach, which will be

carefully considered when the Authority makes its final determination on this issue.

- 1.5. This document also outlines suggested modifications to the existing IAE provisions contained within NGC's transmission licence which Ofgem considers will improve the operation of these provisions. Ofgem invites views from interested parties in relation to these suggested revisions. Ofgem is also considering whether equivalent revisions should be made to the IAE provisions in Transco's gas transporter licence.

Timetable

- 1.6. NGC submitted its notice of a proposed IAE on 7 April 2004. In accordance with NGC's transmission licence, if within three months of receiving a notice of a proposed IAE the Authority has not published a decision, the income adjustment amount specified in the notice will be made. In this instance, the three month period highlighted above concludes on 7 July 2004. Given this timescale, Ofgem expects to publish its decision by 7 July 2004.
- 1.7. At the same time as it publishes its decision, Ofgem, subject to careful consideration of the views expressed by respondents to this consultation, may issue a statutory notice under section 11 of the Electricity Act 1989 (and potentially also under section 23 of the Gas Act 1986) in respect of the proposed modifications to the IAE licence drafting in NGC's transmission licence (and potentially also Transco's gas transporter licence). Section 11 (and section 23) specifies a period of 28 days during which interested parties can make representations or objections to the proposed licence modification, following which revisions to the proposed licence modification will be made if it is considered appropriate.

Views invited

- 1.8. Views are invited in response to the issues raised in this document. Responses should be submitted in writing by 18 June 2004 addressed to:

Kyran Hanks

Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

1.9. All responses will normally be published on the Ofgem website and held electronically in the Research and Information Centre unless there are good reasons why they must remain confidential. Respondents to the consultation should try to put any confidential material in appendices to their responses. Ofgem prefers to receive responses in an electronic form so they can be placed easily on the Ofgem website. Electronic responses may be sent to:
becky.neale@ofgem.gov.uk

1.10. If you wish to discuss any aspect of this document, 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

Outline of this document

1.11. This document outlines the IAE provisions in NGC's transmission licence, the circumstances that have led NGC to consider that an IAE has occurred and Ofgem's initial views as to how this IAE should be treated. Chapter 2 provides background information in relation to the IAE provisions. Chapter 3 outlines the proposed IAE, NGC's views and Ofgem's considerations to date on this issue. Chapter 4 outlines the proposed revisions to NGC's transmission licence that Ofgem considers to be appropriate following its review of the existing IAE provisions contained therein.

- 1.12. Appendix 1 describes the components of IBC and outlines how an adjustment resulting from an IAE would, if approved by the Authority, feed into the IBC calculation. Appendix 2 provides a version of the IAE provisions that incorporates suggested modifications arising from Ofgem's review of the IAE provisions.

2. Income adjusting event provisions in NGC's transmission licence

Introduction

- 2.1. This chapter provides a background to NGC's SO incentives and summarises the IAE provisions within NGC's transmission licence.

NGC's SO incentives

- 2.2. NGC's external SO incentive scheme focuses on NGC's costs of operating the existing transmission system and balancing overall supply and demand (i.e. the costs to NGC of purchasing balancing services from generators, suppliers and large customers). Under successive external SO incentive schemes that have been in place since 27 March 2001, NGC is allowed to recover the actual costs of electricity balancing and system balancing, adjusted by incentive payments or receipts relating to these costs. The value of any incentive payments or receipts depends upon NGC's performance in relation to a cost target that is set in advance by Ofgem following consultation with market participants and other interested parties.
- 2.3. If NGC's costs are below the target, it keeps a proportion (set by the upside sharing factor) of the reduction in costs as an incentive payment. Conversely, if its costs are above the target, NGC is charged a proportion (set by the downside sharing factor) of the costs in excess of the target. NGC's overall gains or losses on its balancing costs are limited by applying a cap on payments and a floor on receipts. This type of scheme is called a sliding scale or profit sharing scheme. In setting incentive scheme targets, sharing factors, caps and floors, Ofgem aims to provide NGC with an appropriate balance of risk and reward in the interests of customers⁶.

⁶ Details of the external SO incentive schemes under which NGC has operated since 27 March 2001 can be

Income adjusting event provisions

- 2.4. The IAE provisions are intended to provide protection for both NGC and customers when events occur that result in NGC incurring costs or making savings against its target balancing costs that were not envisaged at the time that the SO incentive parameters were defined. As a result, no allowance for these costs or savings arising from such events will have been included within the SO incentive scheme target.
- 2.5. The IAE provisions are outlined in paragraphs 10 to 12, inclusive, of special condition AA5A in NGC's transmission licence. The process is summarised below.
- 2.6. An IAE can be any of the following:
- ◆ an event or circumstance constituting force majeure under the BSC;
 - ◆ an event or circumstance constituting force majeure under the Connection and Use of System Code (CUSC);
 - ◆ a security period⁷; and
 - ◆ an event or circumstance which is, in the opinion of the Authority, an IAE and approved by it as such.
- 2.7. In assessing the last type of IAE, which is provided for under special condition AA5A paragraph 10 (a) (iv), Ofgem will consider each case on its individual merits.

found in the following document: 'NGC System Operator incentive scheme from 1 April 2004, Proposals and statutory licence consultation', Ofgem, February 2004.

⁷ The term 'security period' is defined in special condition AA5D of NGC's transmission licence as: a period commencing on the date on which any direction issued by the Secretary of State under Section 34(4)(b) of the Act enters effect and terminating on the date (being not earlier than the date such direction, as varied, is revoked or expires) as the Authority, after consultation with such persons (including, without limitation, licence holders liable to be principally affected) as he shall consider appropriate, may with the consent of the Secretary of State by notice to all licence holders determine after having regard to the views of such persons.

2.8. Aside from an IAE relating to a security period, no event or circumstance can be considered as an IAE unless its impact on NGC's IBC, in terms of costs caused and/or expenses saved, is greater than £2 million.

2.9. NGC, or any other BSC Party, can give notice to Ofgem that it considers an IAE to have occurred. Such a notice must be submitted within three months of the end of the relevant incentive scheme period and must give details of:

- ◆ the event to which the notice relates;
- ◆ the amount of costs and/or expenses considered to have been caused or saved by the event; and
- ◆ the amount of proposed income adjustment as a consequence of the event.

2.10. Following the receipt of a notice of a proposed IAE, the Authority shall determine, after consultation with NGC and other parties considered to be appropriate:

- ◆ whether any or all of the costs and/or expenses given in a notice are caused or saved by an IAE;
- ◆ whether the allowed income adjustment proposed has increased or decreased the value of IBC in the incentive period by more than £2 million⁸; and
- ◆ if so, whether the amount of the proposed income adjustment ensures that the financial position and performance of the licensee are, insofar as is reasonably practicable, the same as if that IAE had not taken place, and if not, what allowed income adjustment would secure that effect.

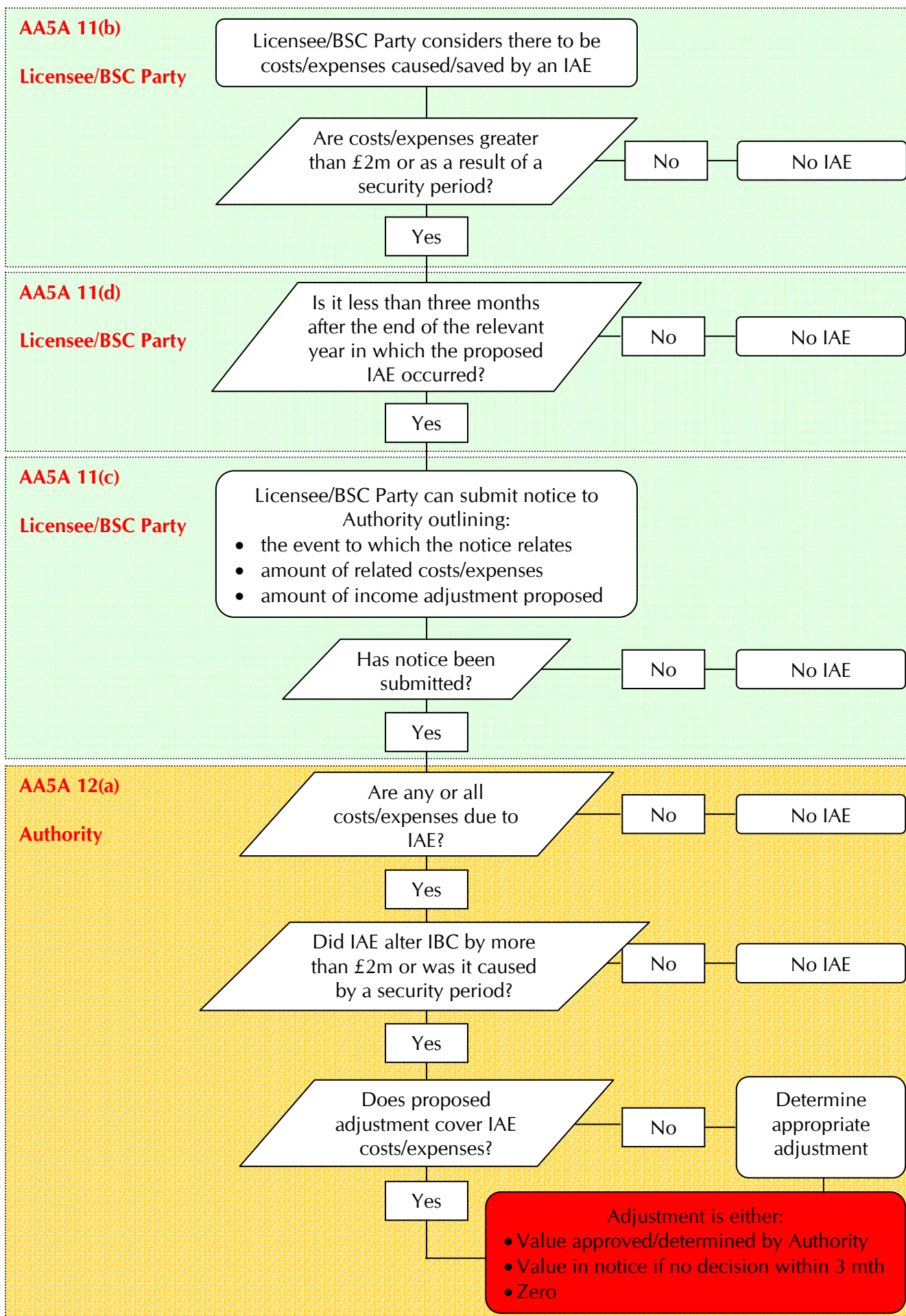
2.11. The allowed income adjustment will be:

- ◆ the value determined by the Authority; or

⁸ Again, the £2 million threshold does not apply if the IAE is a security period as defined in special condition AA5D.

- ◆ the proposed income adjustment if the Authority has not made a determination within three months of receipt of a notice of the event considered to be an IAE; or
 - ◆ zero in any other case.
- 2.12. Appendix 1 describes how an adjustment resulting from an IAE would, if approved by the Authority, feed into the IBC calculation.
- 2.13. Figure 2.1 summarises the process outlined above in the form of a process flow diagram.

Figure 2.1 – IAE process flow diagram (see next page)



- 2.14. In accordance with paragraph 10(c) of special condition AA5A, the Authority's approval of an IAE must be: in writing, copied to the licensee and in the public domain; and the Authority may revoke this approval with the consent of the licensee.

3. Proposed income adjusting event

Introduction

- 3.1. This chapter outlines the proposed IAE, NGC's views and Ofgem's considerations to date on this issue.

Background

- 3.2. Prior to winter 2003/04, NGC had concerns relating to forecast plant margin for the winter period. In light of this, NGC asked Ofgem for further clarification of Ofgem's interpretation of NGC's licence obligations⁹ and how they related to the way that NGC procures short-term reserve. Following clarification of Ofgem's interpretation (which is set out below), there has been a subtle change in the methodology used by NGC when procuring reserve for winter 2003/04. This is explained in further detail below.
- 3.3. In considering when to procure its short-term reserve requirement (i.e. in advance vs. on-the-day), NGC considers the cost of procuring short-term reserve ahead of time versus the expected cost of procurement close to real time. The expected cost close to real time will be affected by the expected availability of plant on the day to provide short-term reserve to meet its requirements and to balance the system. Therefore, there is a trade-off between the degree of certainty that NGC achieves in respect of securing its short-term reserve requirements in view of its wider licence obligations and the balancing costs that it incurs.
- 3.4. Under the pre-winter 2003/04 approach, NGC was procuring short-term reserve based purely on narrow economic trade-offs, without giving explicit consideration to its wider obligations to balance the system in real time ('Approach 1'). Under this approach when procuring short-term reserve via the standing reserve tenders, NGC's assessment was based on consideration of the

⁹ In terms of Ofgem's interpretation of the provisions relating to NGC's role as SO contained within both the Electricity Act 1989 and NGC's transmission licence and how they relate, among other things, to the way in which NGC procures short-term reserve.

relationship between what NGC terms the 'assessment price'¹⁰ and the 'equivalent price'¹¹. Based on this assessment, NGC entered into forward contracts for its reserve requirements up until the point where the equivalent price and the assessment price equalled each other, without giving explicit consideration to its wider obligations to balance the system in real time.

- 3.5. However, following clarification, NGC's current approach to procuring reserve ('Approach 2') now gives explicit consideration to the trade-off between the degree of certainty that it achieves in respect of securing its short-term reserve requirements in view of its wider licence obligations and the balancing costs that it incurs. For example, if NGC forecasts that there is a significant risk of there being insufficient plant available on the day to meet its reserve requirements, it can enter into forward contracts that might not otherwise appear to be economic, based on the narrow assessment outlined in the previous paragraph, in order to reduce the risk that it would not have sufficient short-term reserve available on the day. Therefore, under this approach, NGC procures short-term reserve over different timescales to balance the system in real-time, consistent with its licence obligation to operate the system on an economic and efficient basis. NGC has been operating in accordance with this approach since November 2003 and is expected to continue to do so going forward.
- 3.6. Under both the existing and previous approaches, NGC's procurement of short-term reserve is largely unaffected. However, the subtle differences between the two become apparent primarily when the forecast margin of available generation over the forecast of peak demand is low. These differences first became apparent in the early part of winter 2003/04 when, in response to its concerns in relation to plant margin levels and based on an assessment which included consideration of its wider obligations, NGC procured short-term reserve that it states it would not have procured solely on the basis of the narrow economic trade-offs described above. However, in operating under the clarified approach NGC considered it appropriate, in light of its wider obligations and based on its

¹⁰ The assessment price represents the forecast value of the service to NGC and is the avoided cost of alternative reserve services. It is based on historic price curves with appropriate adjustments for market drivers.

¹¹ The equivalent price represents NGC's estimate of the actual cost of the service. It is based on the total forecast cost of the tender (which is the sum of the availability cost and the forecast utilisation cost) divided by the capacity.

assessment of the prevailing conditions, to procure this level of short-term reserve to ensure that it would have sufficient reserve available on-the-day to balance the system in an economic, efficient and co-ordinated manner.

Proposed income adjusting event

- 3.7. Following clarification from Ofgem as to its interpretation of NGC's obligations and how those obligations relate to the way in which NGC procures short-term reserve, NGC reconsidered whether its reserve contract holdings were sufficient to meet this clarified role. This led NGC to issue a SSRT for winter 2003/04 on 14 October 2003. The tender was conducted in a non-discriminatory manner, via competitive and transparent processes in accordance with the principles of procurement of balancing services described in special condition AA4 of NGC's transmission licence. The tender closed on 27 October 2003 and was in respect of reserve services to be provided between 17 November 2003 and 1 April 2004.
- 3.8. NGC received 22 tenders in total. NGC has stated that it gave consideration to the degree of certainty that could be achieved in respect of securing its total short-term reserve requirement from existing contracted standing reserve, the Supplemental Standing Reserve (SSR) tenders and reserve that may be available for purchase on the day (via Warming contracts, Pre-Gate Closure Balancing Mechanism Unit Transactions (PGBTs) or in the Balancing Mechanism). The assessment of the SSR tenders based on Approach 2 led to 20 of the tenders proceeding to contract. The two unsuccessful tenders did not meet all of the technical requirements specified, and therefore did not proceed to contract.
- 3.9. The total volume associated with the successful tenders was 852MW¹², comprising:
- ◆ 667MW from Balancing Mechanism participants
 - ◆ 185MW from non Balancing Mechanism participants

¹² The supplemental standing reserve volume was in addition to 1971MW of standing reserve (1400MW from Balancing Mechanism participants and 571MW from non Balancing Mechanism participants) already procured by NGC for 2003/04 in its annual tender round, taking NGC's overall standing reserve holdings to 2823MW for the period from 17 November 2003 until 31 March 2004.

- 3.10. However, NGC states that if the tenders had been assessed under Approach 1, NGC would only have accepted eight of the tenders. Under Approach 1, NGC would only have accepted those tenders which were priced at or below an 'assessment price', which represents NGC's estimate of the value provided by the service based on historic and forward market prices.
- 3.11. The forecast cost associated with the eight tenders that would have been accepted under Approach 1 was £0.87 million. The forecast cost of the remaining twelve contracts that NGC accepted, due to its consideration of wider issues under Approach 2, was £18 million. The total forecast costs associated with the services procured via the SSRT of £18.87 million have been included in the calculation of IBC for 2003/04 in accordance with special condition AA5A paragraph 9 of the transmission licence.
- 3.12. However, the full costs of the contracts that would not have been accepted under Approach 1 do not form the basis of NGC's IAE claim. The costs incurred under Approach 2 at or below the assessment price would have been considered 'economic' under Approach 1 and so do not contribute to NGC's proposed IAE. The IAE focuses on the incremental costs incurred as a result of procuring SSR under Approach 2 as opposed to Approach 1. The incremental costs associated with Approach 2 are only the costs incurred in excess of the assessment price.
- 3.13. NGC has calculated 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 NGC is proposing should be treated as an IAE. Consequently, NGC submitted a notice of a proposed IAE on 7 April 2004. On 20 April 2004, Ofgem released a statement highlighting the existence of the notice of an IAE and outlining the process that Ofgem expects to adopt to handle the proposed IAE¹³.

NGC's view

¹³ This statement is available at:
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6826_8604statement.pdf

3.14. NGC considers that the balancing costs associated with the incremental costs of the contracts signed following the SSRT have been efficiently incurred, but were not taken into account when the 2003/04 SO incentive scheme parameters were set. NGC therefore considers that the action of entering into these contracts should be approved by the Authority as an IAE, and that an adjustment should be made to its IBC for 2003/04 in order to remove their impact from its SO incentive scheme performance. NGC considers that the incremental SSRT contract costs should be approved by the Authority as an IAE for the following reasons:

- ◆ at the time NGC entered into the contracts, the forecast plant margin for winter 2003/04 had fallen to unusually low levels (as compared to most other years since the electricity market was liberalised). Given this and the clarification that NGC has received from Ofgem regarding its obligations, NGC considered that additional standing reserve capacity was required for the winter;
- ◆ the additional considerations that led to NGC entering into the SSRT contracts to ensure security of supply did not form part of NGC's thinking at the time that it submitted balancing cost forecasts to Ofgem as part of the consultation process leading to the setting of the 2003/04 SO incentive scheme target; and
- ◆ no allowance was made for costs associated with agreements of this type in the SO incentive scheme parameters for 2003/04.

3.15. In relation to NGC's proposed income adjustment of £5.54 million, Ofgem is examining whether the incremental costs linked to procuring reserve in accordance with Approach 2 were to any extent offset by associated savings in relation to other balancing services. NGC has stated that it considers that the assessment price against which the tender was assessed was calculated as the cost of providing that reserve from an alternative source. NGC states that the effect of the SSRT on other categories of balancing costs has as a consequence already been included in the assessment of the SSR tenders and that only those costs in excess of these balancing costs have been included in its application for treatment as an IAE. Ofgem is continuing to assess this issue.

Proposed income adjustment

3.16. NGC states that the incremental costs associated with the SSRT amounted to £5.54 million. This value has been included as an element of NGC's Balancing Services Contract Costs (BSCC) with the result that:

- ◆ it has been included in the calculation of the Balancing Services Use of System (BSUoS) charge, enabling NGC to recover the incremental costs of the additional standing reserve contracts it has signed; and
- ◆ it has been included in the calculation of NGC's annual IBC for the 2003/04 SO incentive scheme period, impacting negatively on NGC's performance under its SO incentive scheme.

3.17. In relation to the latter, in order to remove the impact of the SSR contracts from its 2003/04 SO incentive scheme, NGC has proposed that the allowed income adjustment element of its IBC should be set at £5.54 million. This would have the effect of reducing NGC's IBC for 2003/04 by £5.54 million. If the suggested income adjustment of £5.54 million is made, it would lead to a £2.77 million increase in NGC's incentive payment under its 2003/04 SO incentive scheme¹⁴.

Ofgem's views

3.18. Ofgem's principal objective when carrying out its functions under Part I of the Electricity Act 1989 is to protect the interest of consumers (present and future), wherever appropriate, by promoting effective competition¹⁵. Subject to the principal objective, Ofgem is required to carry out its functions under Part I in the manner which it considers is best calculated to achieve a number of other objectives, including securing a diverse and viable long-term energy supply¹⁶.

3.19. In April 2003 Ofgem modified NGC's transmission licence to introduce a new SO incentive scheme. Prior to the licence modification Ofgem conducted a

¹⁴ Under the 2003/04 SO incentive scheme, NGC receives 50 per cent of the reduction in costs below the target of £416 million as an incentive payment, up to a maximum of £40 million. On this basis a £5.54 million reduction in IBC corresponds to a £2.77 million increase in NGC's incentive payment.

¹⁵ Section 3A(1) of the Electricity Act 1989.

¹⁶ Section 3A(5)(c).

number of consultations with interested parties¹⁷. The cost data that NGC provided to Ofgem, which formed the basis of these consultations, were based on Approach 1 rather than Approach 2. Accordingly, Ofgem considers that no allowance for incremental costs associated with operating under Approach 2, i.e. the incremental SSRT costs, was included in the 2003/04 SO incentive scheme and that these costs were, therefore, not intended to be included within the scope of IBC.

- 3.20. Furthermore Ofgem considers that the IAE provisions contained within the SO incentive scheme and associated licence condition are designed to provide protection for both NGC and customers in the event that unanticipated costs, such as the incremental SSRT costs, or savings occur. Ofgem's initial view, therefore, is to accept that the action of entering into the SSRT contracts constitutes an IAE.
- 3.21. In relation to NGC's proposed income adjustment of £5.54 million, Ofgem has assessed the information provided and has verified that the incremental costs incurred at the SSRT are £5.54 million. However, Ofgem is examining whether the incremental costs linked to procuring reserve in accordance with Approach 2 were to any extent offset by associated savings in relation to other balancing services. If this is the case, the appropriate income adjustment could be lower than the £5.54 million value proposed.
- 3.22. In addition to conducting its own assessments, before making its final decision in relation to the proposed IAE, Ofgem is seeking participants' views on this matter. For the purposes of this IAE proposal, it is clear that this assessment should focus on what was known at the time the 2003/04 SO incentive scheme target was set and when NGC decided to hold the SSRT, without taking into account information gained with hindsight. Any views received will be taken into consideration by Ofgem before it makes its final decision.

Summary and views invited

¹⁷ See: 'NGC system operator incentive scheme 2003/04 – 2005/06, Initial consultation document', Ofgem, October 2002, 'NGC system operator incentive schemes from April 2003, Initial proposals', Ofgem, December 2002 and 'NGC system operator incentive scheme from 1 April 2003 – 31 March 2004, Final Proposals and Statutory Licence Consultation', Ofgem, March 2003.

3.23. The decision that Ofgem proposes to adopt is to:

- ◆ approve the incremental costs associated with the standing reserve contracts negotiated by NGC following the SSRT as an IAE; and
- ◆ to make an appropriate income adjustment to IBC under the 2003/04 SO incentive scheme having considered whether the incremental costs linked to procuring reserve in accordance with Approach 2 were to any extent offset by associated savings in relation to other balancing services.

3.24. Ofgem invites views on any of the issues raised in this document by 18 June 2004.

4. Suggested modifications to the income adjusting event licence drafting

Introduction

- 4.1. Ofgem considers that the experience gained by Ofgem, NGC and market participants during the progression of the first IAE¹⁸ offered valuable insight into how the IAE process can be enhanced and improved going forward. In response to the comments made by the industry during this process, Ofgem has reviewed the existing IAE provisions within NGC's transmission licence and has developed proposed revisions which Ofgem considers enhance these provisions.
- 4.2. This chapter outlines the proposed revisions to NGC's transmission licence that Ofgem considers to be appropriate following its review of the existing IAE provisions contained therein. The main revisions are described below. In addition, there are some changes of a housekeeping nature. A marked up version of the revised drafting is provided in Appendix 2.

Details contained within a proposed income adjusting event notice

- 4.3. Under the current IAE provisions, an IAE notice must give details of:
- ◆ the event to which the notice relates;
 - ◆ the amount of costs and/or expenses considered to have been caused or saved by the event and the method of calculating such costs and/or expenses; and
 - ◆ the amount of proposed income adjustment as a consequence of the event.

¹⁸ See footnote 5.

4.4. Ofgem considers that, in order to enhance the transparency of the IAE process, it is appropriate to require additional relevant information to be supplied in any notice of a proposed IAE. Ofgem considers that as additional requirements a notice should:

- ◆ outline the reason(s) why the party submitting the notice considers the event to be an IAE;
- ◆ outline the method used to calculate the proposed income adjustment; and
- ◆ provide supporting analysis which is considered by the party submitting the notice to be sufficient to enable both Ofgem and market participants to assess the proposed IAE. Ofgem would have the ability to request that the supporting analysis be appended with additional information that it considers appropriate for the assessment of the event. Ofgem considers that this additional requirement should not in any way serve to limit its ability to request and make use of confidential information in its assessment if required.

Ensuring that a proposed income adjusting event notice is in the public domain

4.5. The existing IAE provisions do not stipulate any requirement for an IAE notice to be in the public domain. Ofgem considers that, in the interests of transparency, such a requirement should exist in order to highlight that an IAE has been proposed. Furthermore, Ofgem considers that an IAE notice should be put into the public domain as soon as is reasonably practicable following its receipt by the Authority. Ofgem has acted consistently with this approach in relation to the current IAE when on 20 April 2004 it released a statement highlighting the existence of the IAE and outlining the process that Ofgem expects to adopt to handle the proposed IAE¹⁹.

¹⁹ See footnote 4.

- 4.6. Going forward, Ofgem considers that the IAE provisions should require IAE notices to be in the public domain. It is proposed that publication will be by Ofgem but in close conjunction with the submitter of the notice.
- 4.7. Placing the IAE notice in the public domain will result in the disclosure of all information contained within the notice which is not genuinely confidential or commercially sensitive. The proposed revisions include drafting intended to address any concerns associated with information disclosure.

Consultation in respect of proposed IAEs

- 4.8. The current IAE provisions state that Ofgem shall reach its decision in relation to a proposed IAE after consultation with the licensee and such other persons as considered desirable. Ofgem considers that the consultees should be more specifically defined to ensure that those market participants that are affected by the approval of an IAE are referred to in the IAE provisions. Therefore, Ofgem suggests that the licensee, BSC Parties and CUSC Parties should be specifically mentioned as being amongst those to be consulted.

Housekeeping changes

- 4.9. In addition to the specific changes outlined above, Ofgem's suggested drafting also includes a number of housekeeping changes. These include minor revisions to the wording and alterations to the ordering of the IAE provisions to more closely reflect the process flow associated with IAEs. These changes are not being suggested in order to change the intent of the IAE provisions but rather to improve upon the way in which the IAE provisions are outlined.

Income adjusting event provisions in Transco's gas transporter licence

- 4.10. The IAE provisions contained in NGC's transmission licence are largely mirrored in paragraph 14(11) of special condition 28B of Transco's gas transporter licence. Ofgem considers that the suggested improvements discussed above in relation to NGC's electricity licence are also likely to be beneficial in terms of

Transco's gas transporter licence. Therefore, Ofgem would also welcome views upon the appropriateness of making equivalent changes to Transco's licence.

Summary and views invited

- 4.11. In this chapter, Ofgem has outlined its suggested revisions to the IAE provisions within NGC's transmission licence. Ofgem considers that the proposals, if implemented, will serve to enhance the transparency surrounding proposed IAEs and to clarify the process associated with the progression of proposed IAEs. Ofgem welcomes views in relation to the revisions proposed and also suggestions for any further enhancements to the IAE provisions in respect of NGC's transmission licence by 18 June 2004.
- 4.12. As mentioned above, Ofgem is also considering making equivalent changes to the drafting of the IAE provisions in Transco's gas transporter licence. Therefore, Ofgem also welcomes comments from market participants upon this initiative by 18 June 2004.

Appendix 1 Incentivised Balancing Cost

component breakdown

1.1 NGC's SO incentive scheme payment or receipt is determined by the level of its Incentivised Balancing Costs (IBC) at the end of the incentive period. IBC are calculated from a number of different components that are outlined below:

- ◆ the cost of bids and offers in the Balancing Mechanism accepted in the relevant period less the total non-delivery charge for that period. This is referred to as Daily System Operator Balancing Mechanism Cashflow (CSOBM);
- ◆ the costs of contracts for the availability or use of balancing services, excluding costs covered by CSOBM (but including charges made by the SO for the provision of balancing services to itself), i.e. this component consists of the costs of balancing services not procured through the Balancing Mechanism. This is referred to as Balancing Services Contract Costs (BSCC);
- ◆ the volume of transmission losses multiplied by the Transmission Losses Reference Price (TLRP) for each Settlement Period, summed across all Settlement Periods. This is referred to as the Transmission Losses Adjustment (TLA);
- ◆ the system imbalance volume multiplied by the Net Imbalance Volume Reference Price (NIRP) for each Settlement Period, summed across all Settlement Periods. This factor, the Net Imbalance Adjustment (NIA), is deducted from CSOBM to reflect the fact that NGC has little control over the extent to which participants choose not to balance their positions;
- ◆ the revenue from the provision of balancing services to others (OM) during the relevant incentive period; and
- ◆ the amount of any allowed income adjustment (RT) during the relevant incentive period.

- 1.2 It is through the last component listed that an income adjustment resulting from an IAE would be factored into IBC. RT is subtracted from the IBC calculation, therefore, an income adjustment assigned a positive value will lead to a reduction in IBC, and vice versa.

Appendix 2 Suggested modifications to special condition AA5A (Revised restrictions on revenue) of NGC's transmission licence

This appendix contains a modified version of the IAE provisions contained within NGC's transmission licence which incorporates Ofgem's suggested modifications. The inclusion of this suggested drafting represents an informal consultation at this stage and does not constitute a statutory licence consultation. However, submissions received in response to these suggested modifications will be used to inform any statutory consultation that may be carried out in respect of the proposed modifications, should Ofgem maintain the view that such modifications would be desirable.

No amendments are proposed to paragraphs 1 – 9 inclusive of this Special Condition and nothing in this text alters the operation of paragraphs 1 – 9 inclusive of this Special Condition.

10. Income adjusting events under the balancing services activity
 - (a) An income adjusting event may arise from any of the following:
 - (i) an event or circumstance constituting force majeure under the BSC;
 - (ii) an event or circumstance constituting force majeure under the CUSC;
 - (iii) a security period as defined in special condition AA5D; and
 - (iv) an event or circumstance which is, in the opinion of the Authority, an income adjusting event and is approved by it as such in accordance with paragraph 12 of this special licence condition

where the event has, for relevant year t , increased or decreased the value of IBC_t by more than £2,000,000 (the “threshold amount”). This threshold does not apply in respect of sub-section (iii) above.

- (b) For the purpose of relevant year t commencing on 1 April 2004 and ending on 31 March 2005, events or circumstances arising directly from the implementation or otherwise of the following proposed amendments and modifications listed in tables 1 and 2 below shall not qualify as an income adjusting event for the purpose of sub-paragraph (a) above:

Table 1: Proposed amendments to the CUSC

CUSC Amendment Proposal	CUSC Amendment Title (as entitled by the proposer of the amendment)
CAP049	Alternative Amendments
CAP050	Review Process for implemented Urgent Amendment Proposals
CAP051	Initiation of the Amendment Procedures by the Amendments Panel
CAP052	Removal of Land Charges
CAP053	Revision of Site Specific Maintenance Charges
CAP054	Adoption of Year Round TNUoS Charges
CAP055	Users’ Demand Forecasts
CAP056	Incorrect Reference to the Grid Code in Section 11 – Definitions
CAP057	Removal of References to TSUoS Charges
CAP058	Reinstatement of words lost from Legal Text following implementation of CAP043
CAP059	Addition of word “Paragraph” to Paragraph 2.17.9
CAP060	Incorrect spelling of “Judgment” in Paragraph 6.6.4
CAP061	Addition of “CUSC Panel Secretary” to Exhibit F, Note 10
CAP062	Amendment to National Grid address in various exhibits
CAP063	Amendment to National Grid address in various exhibits
CAP064	Minor Reference error in Paragraph 7.2, Schedule 2, Exhibit 3
CAP065	Removal of various paragraphs referring to NETA Go Live
CAP066	Removal of historic transitional provisions that no longer have any application
CAP067	Clarification of Contractual Relationship Required for Embedded Generation (CUSC 6.5.1)
CAP068	Competing Requests for TEC
CAP069	Users' Forecasts Used in the Calculation of TNUoS Charges
CAP070	Short Term Firm Access Service

Table 2: Proposed modifications to the BSC

BSC Modification Proposal	BSC Modification Title (as entitled by the proposer of the modification)
P124	Revision of mandatory half-hour metering criteria
P131	Further provisions relating to Trading Disputes
P132	Redefinition of Credit Cover requirements for reconciliation charges
P136	Marginal Definition of the 'main' Energy Imbalance Price
P137	Revised Calculation of System Buy and System Sell Price
P139	Removal of Trading Unit Restriction on Interconnector Users
P140	Revised Credit Cover Methodology for Interconnector BM Units
P142	Allow Level 2 Default Cure Period in Defined Circumstances
P146	New Participation Category to the BSC - Clearing House
P147	Introduction of a Notified Contract Capacity
P150	Targeting costs of PNE appeals to unsuccessful appellants
P151	Housekeeping Modification
P152	Reduction of Credit Cover for a Trading Party in Default
P153	Support Competition in Distribution Networks
P154	Rectification of Inconsistencies in the Change Process
P156	Zonal Allocation of Transmission Losses
P157	Replacement of current Supplier Charges rules

11. Notice of proposed income adjusting event

- (a) Where the licensee considers, and can provide supporting evidence thereof, that, in respect of relevant year t, there have been costs and/or expenses that have been incurred or saved by an income adjusting event, then the licensee shall give notice of this event to the Authority.
- (b) Where any other Party (as defined in the BSC) considers, and can provide supporting evidence thereof, that, in respect of relevant year t, there have been costs and/or expenses that have been incurred or saved by an income adjusting event, then that Party may give notice of this event to the Authority.

- (c) A notice provided to the Authority under subparagraphs (a) and (b) shall, in the case of the licensee, and should, in so far as is practicable in the case of any other Party, give particulars of:
- (i) the event to which the notice relates and the reason(s) why the person giving the notice considers this event to be an income adjusting event;
 - (ii) the amount of any change in costs and/or expenses that can be demonstrated by the person giving the notice to have been caused or saved by the event and how the amount of these costs and/or expenses has been calculated;
 - (iii) the amount of any allowed income adjustment proposed as a consequence of that event and how this allowed income adjustment has been calculated; and
 - (iv) any other analysis or information which the person submitting the notice considers to be sufficient to enable the Authority and the relevant parties to fully assess the event to which the notice relates.
 - (v) If the Authority considers that the analysis or information provided in sub-paragraphs (i) to (iv) above is insufficient to enable both the Authority and the relevant parties to assess whether an income adjusting event has occurred and/or the amount of any allowed income adjustment that should be approved, the Authority can request that the supporting evidence be appended with additional information that it considers appropriate.
- (d) A notice of an income adjusting event shall be given as soon as is reasonably practicable after the occurrence of the income adjusting event, and, in any event, not later than three months after the end of the relevant year in which it occurs.
- (e) The Authority shall ensure that any notice of an income adjusting event is in the public domain as soon as is reasonably practicable following its

receipt. In light of this any notice submitted to the Authority under either subparagraphs (a) or (b) above should clearly identify whether any of the information contained in the notice is of a confidential nature. The Authority shall make the final determination as to confidentiality having regard to:

- (i) the need to exclude from disclosure, so far as is reasonably practicable, information whose disclosure the Authority considers would or might seriously prejudicially affect the interests of a person to which it relates; and
- (ii) the extent to which the disclosure of the information mentioned in subsection (i) is necessary for the purposes of paragraph 11(c)(iv).

12. The Authority's determination

- (a) Following consultation with relevant Parties, including the licensee and Parties to the BSC and parties to the CUSC, the Authority shall determine:
 - (i) whether any or all of the costs and/or expenses given in a notice pursuant to paragraph 11 are caused or saved by an income adjusting event;
 - (ii) whether the amount specified for the purpose of paragraph 11(c)(iii) has increased or decreased the value of IBC_t by more than the threshold amount, save in the case of paragraph 10(a)(iii) where the threshold amount shall not apply; and
 - (iii) if so, whether the amount of the proposed income adjustment ensures that the financial position and performance of the licensee are, insofar as is reasonably practicable, the same as if that income adjusting event had not taken place, and if not, what allowed income adjustment would secure that effect.

- (b) In relation to the relevant year t , the allowed income adjustment RT_t shall be:
- (i) the value determined by the Authority under subparagraph (a); or
 - (ii) if the Authority has not made a determination under subparagraph (a) within three months of the date on which notice of an income adjusting event was provided to the Authority, the respective value given to the Authority in the notice under paragraph 11(c)(iii); or
 - (iii) in all other cases zero, including situations where the Authority considers that the analysis or information provided in accordance with paragraph 11(c) is insufficient to enable the Authority and relevant parties to fully assess whether an income adjusting event has occurred and/or the amount of any allowed income adjustment.
- (c) The Authority's decision in relation to any notice given under paragraph 11(a) or paragraph 11(b) shall be in writing, shall be copied to the licensee and shall be in the public domain. The Authority may revoke an approval of an income adjusting event and allowed income adjustment with the consent of the licensee, following consultation with the licensee and relevant parties. Revocation of any income adjusting event and allowed income adjustment shall be in writing, shall be copied to the licensee and shall be in the public domain.

No amendments are proposed to paragraphs 13 – 16 inclusive of this Special Condition.

Nothing in this text alters the operation of paragraphs 13 – 16 inclusive of this Special Condition.