



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

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Dear Colleague

National Grid Electricity Transmission System Operator Incentives from 1 April 2011

On 10 June 2011, Ofgem published its Final Proposals Consultation on National Grid Electricity Transmission's ("NGET") System Operator ("SO") incentive schemes to apply retrospectively from 1 April 2011.¹ This consultation closed on 8 July 2011 and we received five responses from industry participants.²

On 8 July 2011, NGET consented to the licence modifications proposed. NGET has also completed the verification of the accuracy of the proposed constraint cost modelling calculations. This verification process has resulted in one minor change being made to the methodology used to determine the Constraint_Cost_Target. This change concerns the way in which the ex-post fuel prices are represented. We consider this change is an improvement and note that it has a very small effect on constraint costs.

I would like to take this opportunity to thank those who responded to the Final Proposals Consultation and also to those who participated more widely in the development of the SO incentive scheme to apply from 1 April 2011. We have considered the responses to the Final Proposals Consultation and taking those into account we believe it remains appropriate to direct the licence modifications to be made in line with those proposed. We have today issued the relevant direction.

Today we have also, as outlined in the Final Proposals Consultation:

- approved NGET's three methodology statements, the final versions of which have been published on NGET's website; and
- agreed with NGET the specific model parameters and the actual data used by NGET.

We consider that the changes we have implemented today with respect to the incentivisation of NGET's role as SO are a significant step forward, in terms of improving the accuracy and transparency of the electricity SO incentive scheme and reducing the scope for windfall gains and losses. We also consider that the improvements that we have implemented in the 2011 scheme will aid the development and implementation of potentially longer term SO incentives from April 2013. In this regard, on 14 June we

¹ "National Grid Electricity Transmission System Operator Incentives from 1 April 2011: Final proposals", ref 76/11.

² Responses were received from RWE npower, EDF Energy, National Grid, Scottish and Southern Energy and Cornwallenergy. These are available on Ofgem's website: www.ofgem.gov.uk.

published our initial consultation document on the SO incentives to apply from 2013³ and we welcome any responses to the issues raised in that consultation by 26 July 2011.

The five respondents to the Final Proposals Consultation all supported the proposals. Three respondents considered that the proposed methodology would incentivise NGET to more accurately control the costs it faced. A number of detailed points were also raised in the responses. The points raised and our responses are set out below.

Transparency

One respondent raised concerns regarding a lack of transparency regarding the setting of the scheme and the scheme itself, whilst three respondents considered that there was an improvement in the level of transparency, with two considering that the development by NGET of the three methodology statements was an important advantage of the new approach. One respondent also welcomed the report from Frontier Economics on the energy and constraint models. We agree with the respondents regarding the methodology statements and consider that this should assist market participants in understanding NGET's modelling methodology.

Three respondents raised points regarding the lack of transparency in respect of NGET's costs, particularly with respect to constraint costs.⁴ We note that these concerns may be mitigated by the significant amount of information that is available from its website (<http://www.nationalgrid.com/uk/Electricity/Balancing/>) and from the Operational Forum.

We also note that there are limitations to the information that NGET can make available as a result of commercial confidentiality provisions. We request NGET and industry participants consider whether, and if so in what format, further information could be made available to address the concerns raised.

Furthermore, we will be looking at the provision of information by the SO more widely as part of the development of SO incentives from April 2013 and would welcome responses on this issue as part of that process.

Windfall gains or losses during the scheme

One respondent noted that it was difficult for it to comment on the appropriateness of the scheme parameters. It considered that if large windfall gains or losses are observed in the first year of the scheme that Ofgem may wish to reconsider the scheme parameters at the beginning of year two. Another respondent considered that the new scheme design would give a reduced scope for windfall gains and losses. This respondent also considered that it would be good practice for NGET's modelling to be audited or independently witnessed by Ofgem or by another party, as this would provide confidence to the industry.

Another respondent noted that while it supported the new methodology, it should only have been implemented for one year – a year being sufficient time to test the methodology prior to longer implementation. This respondent proposed that a mid point review should be undertaken to ensure the new methodology is robust.

We consider that the revised methodology being implemented under this incentive scheme should reduce the possibility of windfall gains or losses, as the areas to be incentivised are those which NGET has some degree of control over. Whilst we accept that this is a new methodology, we consider it can only be properly tested over a two year period. We will be closely monitoring the effect of the scheme and NGET's performance under it, and if necessary will conduct a detailed review at the end of the first year of the scheme, which could inform any incentive scheme from 2013 onwards. In terms of a possible audit of NGET's modelling, significant work has already been undertaken by Ofgem and an

³ "System Operator incentive schemes from 2013: Consultation", ref 77/11.

⁴ Issues raised included: the availability of information concerning NGET's spend to date and its latest forecasts of costs; and information regarding the volume of constraints.

independent consultant to ensure the robustness of NGET's modelling. Ofgem's ongoing monitoring will continue to confirm whether this remains the case, and if appropriate we will engage external support to assist us in this task.

Further refinements to the incentive methodology – the Supplementary Review

Two respondents noted that further refinements to the incentive scheme will be required under our approach. Importantly, both respondents considered that these improvements would be beneficial, particularly with respect to improving the incentive methodology and facilitating longer term SO incentive scheme.

Retrospective implementation

One respondent did not consider that the scheme should be applied retrospectively, as applying the scheme retrospectively cannot influence NGET's behaviour. Whilst we appreciate that the retrospective application is not ideal, we would note that NGET was aware of the proposal to set an incentive scheme on this basis prior to 1 April 2011 and therefore we expect NGET to have already acted in light of an incentive scheme being in place.

Restrictions on trade – constraint management

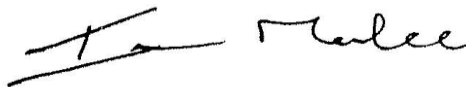
NGET noted the restriction on its ability to contract with Balancing and Settlement Code parties for constraint management services that apply conditions to the submission of bid/offer prices. It considered that this could potentially create inefficiency in how it operates as SO. One other respondent also noted this restriction and considered that it was warranted to ensure the incentive works as is intended.

We considered the imposition of this restriction very carefully when developing the final proposals. We consider that the scope for NGET to enter into price and volume contracts that have conditions on the Balancing Mechanism prices that a generator can submit can create distortions and needs to be addressed. While we are not generally disposed to imposing a temporary restriction to address such behaviour, we consider that the scope for gaming and NGET's indication that it rarely uses such contracts means that this can occur with very limited impact on its day to day commercial activity.

We note the temporary nature of this restriction and we encourage NGET to investigate mechanisms by which this issue can be addressed in time for the 2013 SO incentive scheme.

Should you wish to discuss any aspect of the SO incentive schemes, please contact Giuseppina Squicciarini (giuseppina.squicciarini@ofgem.gov.uk).

Yours sincerely



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