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for energy consumers

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Date: 5 July 2013

Dear Sir/Madam

Open Letter: Proposed Income Adjusting Events submitted by National Grid Electricity Transmission in relation to the 2011-13 Electricity System Operator Incentive Scheme

Responses requested by 2 August 2013

Introduction

Under paragraph 11 of Special Condition AA5A (Balancing Services Activity Revenue Restriction)¹ of National Grid Electricity Transmission Plc's (NGET's) electricity transmission licence, NGET has given notice to Ofgem that it believes four Income Adjusting Events (IAEs) have occurred in the period from 1 April 2011 to 31 March 2013. A summary of the information included in the notices associated with these proposed IAEs is included in this letter and non-confidential copies of the notices are published on our website²³. The purpose of this consultation letter is to invite views on the proposed IAE notices.

Background

The 2011-13 balancing services incentive scheme expired on 31 March 2013. At the end of this scheme NGET had over spent relative to the scheme target by over £224 million. A sharing factor of 25% is applied to these costs meaning that NGET is liable for 25% while the remainder is recovered by NGET through balancing services use of system (BSUoS) charges. In addition, the scheme has a symmetrical cap and floor of ±£50 million meaning that the maximum return or loss NGET is exposed to is £50 million. Therefore, at the time of expiry of the scheme, NGET's over spend of £224 million would result in NGET was hitting incentive floor of -£50 million. The remainder of £174 million has been passed through to BSUoS charges within the scheme period.

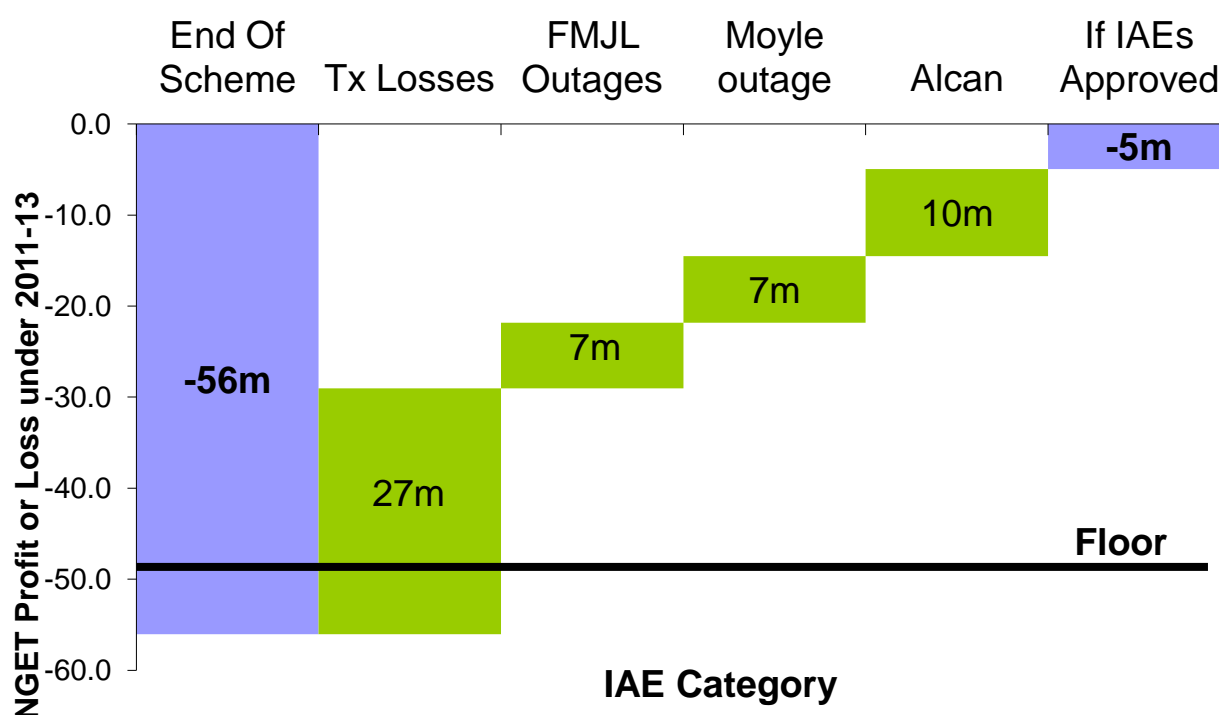
¹ Today, Ofgem also published its decision to modify the National Grid Electricity Transmission Special Licence Conditions. Subject to appeal these changes will take effect on 31 August. These amendments include changes to the income adjustment provisions contained within Special Condition AA5A and to the name of the special condition which is now numbered Special Condition 4C.

² The notices are published alongside this open letter which can be found on the Income Adjusting Event page of our website at the following link:
<http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/NGInAdj2/Pages/NGInAdj2.aspx>

³ Special Licence Condition AA5A (7)(g) states that the Authority will make public, excluding any confidential information, any notice of an income adjusting event following its receipt.

NGET's transmission licence includes provisions for it (or any other party as defined in the Balancing and Settlement Code (BSC)) to submit a notice to the Authority where it believes that an IAE has taken place.

On 28 June 2013, NGET submitted four notices to the Authority, each of which contained submissions for IAEs which NGET states have taken place within the scheme period (1 April 2011 to 31 March 2013). The total costs of NGET's proposed IAEs is estimates by NGET to be £204.3 million. If, following consultation and consideration of all the evidence, the Authority decides to approve an IAE, the Authority will reflect this by effectively removing the relevant costs from those against which the scheme target is compared. If the Authority was to decide to approve the full costs for which NGET has applied as an income adjustment, NGET's final performance under the 2011-13 scheme would be a loss of £5 million following application of the 25% sharing factor. The diagram below provides a summary of this potential impact:



Summary of proposed IAEs

The following table summarises the proposed IAEs which NGET has submitted to us:

Event	NGET's Description	Cost impact	Proposed Income Adjustment ⁴
Transmission Losses	Costs associated with higher volumes of transmission losses than the target level resulting from increased north-south energy transfers due to swing from gas to coal, increased wind generation and delays to commissioning plant	£107.9m	£27.0m
FMJL Transformer Replacement	Constraint costs resulting from unforeseen and subsequently extended outages to replace assets with safety exclusion zones	£28.9m	£7.2m

⁴ The proposed income adjustment is the overall cost impact multiplied by the sharing factor which is applied to costs incurred by NGET under the scheme (25%).

Alcan Closure	Unforeseen large reserve/response provider closure resulting in more expensive actions being taken	£38.3m	£9.6m
Moyle Outage	Fault of Moyle interconnector in 2011-12 resulting in higher Scottish constraint costs by effectively lowering demand in Scotland	£29.2m	£7.3m
Total		£204.3m	£51.1m

IAE Provisions

The Balancing Services Activity Revenue Restriction (Special Condition AA5A) of NGET's transmission licence is designed to ensure that actual revenues of the electricity system operator do not exceed the maximum allowed revenues that we set. Actual revenues are collected by NGET through balancing services use of system (BSUoS) charges.

Paragraphs 10-12 of Special Condition AA5A Part 2(i) of NGET's electricity transmission licence contain provisions for NGET or any other party to raise notice to Ofgem where it believes an IAE has occurred. The provisions define an IAE as:

- 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 period (as defined in Special Condition AA5 (Revenue Restriction Conditions: Definitions)); or
- An event or circumstance other than listed above which is, in the opinion of the Authority an IAE and is approved by it as such (in accordance with paragraph 12(a) of Special Condition AA5A.

In order to apply as an IAE, the relevant event must also have increased or decreased the costs and/or expenses incurred by NGET to carry out its balancing services activities by at least £2 million.

IAEs are intended to provide protection for both NGET and customers when events (as defined above) occur that result in increased or decreased costs to the SO.

Under paragraph 12 of Special Condition AA5A, the key questions⁵ for the Authority in considering whether an IAE has occurred and the extent to which allowed revenues of NGET should be revised to reflect this are as follows:

- Do the proposed IAEs set out in the notices meet the definition of an IAE included within NGET's transmission licence?
- Were any or all of the costs/expenses referred to in the notice incurred or saved as a result of the proposed IAE?
- Has the IAE increased or decreased the relevant system operator costs by more than the £2 million materiality threshold?
- If the Authority concludes that an IAE has occurred, what would be the appropriate amount of the adjustment so that NGET's financial position is, insofar as is reasonable practical, the same as if the IAE had not taken place?

Under the IAE provisions included within Special Condition AA5A, the Authority has until three months after receipt of an IAE notice to make its determination (28 September 2013). Unless the Authority has given notice that the information provided by NGET and other parties is not sufficient to make its determination ahead of the required date then the full amount of income adjustment would be allowed in the case that the Authority has not made its determination by this time.

⁵ This does not limit the Authority from taking other factors into consideration such as its Principle Objectives and general public law principles of fairness for example.

Initial Considerations⁶

Risk exposure

On 8 July 2011, NGET gave its written consent to the licence modifications which were drafted to implement our final proposals for a 2011-13 scheme. These licence conditions set out the two year incentives under which NGET would operate.

Within the scheme provisions, it was recognised that in setting up-front incentives, there is a certain amount of inherent risk regarding the potential for out-turn costs to be different to the scheme target. NGET accepts a balance between risk and potential for reward in its approach to improve performance and minimise costs against the scheme target. A number of risk sharing mechanisms were included within the scheme to ensure an appropriate balance of risk between the SO and consumers (BSUoS charges are reflected in their bills). These risk sharing mechanisms included a sharing factor and a 'cap and floor' which limited the exposure of NGET to any over or underspend against the scheme target to 25% subject to a maximum of £50 million over the scheme period. In addition, we included IAE provisions to reflect the uncertainty of certain events, for example where we deem these events to constitute force majeure⁷ or result in the declaration of a security period.

However, under any incentive scheme it is considered appropriate that NGET is exposed to a certain level of risk. We will consider the balance of risk between NGET and consumers in our assessment of these notices.

Specific Issue: FMJL transformer replacement notice

The notice submitted by NGET in relation to FMJL transformer replacement includes the costs associated with two separate outages, one at Smeaton substation and one at Strathaven substation. The total costs submitted by NGET is £28.9 million of which £25.14 million is included in relation to the Smeaton substation and £3.75 million in relation to Strathaven.

The provisions for IAEs which are set out in Special Condition AA5A allow a notice to be submitted where a party believes that costs have been incurred or saved as a result of a single event. In its notice, NGET states that the original FMJL transformer failures which led to the proposed IAEs occurred in 2009 and 2010. Following this, a programme of outages was initiated to replace FMJL transformers including at Smeaton and Strathaven. NGET states in its notice that it did not expect FMJL replacements at Smeaton and Strathaven to be needed at the time of scheme agreement but that the requirement for these outages became apparent within the scheme period. As a result, it is possible that the driver for any overspend within the 2011-13 scheme period may be different for the Smeaton and Strathaven events.

We are interested in the views of stakeholders on whether there is a sufficient link between these two incidents to constitute a single event or whether the events should be considered separately. In the case that they are considered separately, the costs associated with each event would need to exceed the materiality threshold of £2 million for an IAE to be approved by the Authority.

Consultation Questions

In order to inform the Authority's views on whether the IAEs proposed by NGET constitute an IAE under the licence provisions, and in order to determine the amount of the

⁶ In making its decision in relation to these IAE notices the Authority will take a large number of factors into account. We include the two examples of our initial considerations below as we consider these relevant for providing context to stakeholders in order to inform their responses to our consultation questions set out later in this document.

⁷ The IAE provisions refer to force majeure as defined under the BSC and the CUSC.

adjustment (should the Authority take the view that an IAE has occurred), we are seeking views on the notices published alongside this letter. In particular we are looking for views on the following questions:

- Do you consider that an IAE has occurred? What is the basis of your conclusion?
 - Do you consider the proposed IAE to constitute force majeure as defined in the BSC or in the CUSC?
 - Do you believe there to be any other reason why the Authority should take the opinion that the proposed IAE constitutes an IAE?
- Do you believe that the FMJL transformer replacement IAE notice should constitute two different proposed IAEs, one for Smeaton and one for Strathaven?
- Do you consider that any or all of the costs included within NGET's notice result from the relevant IAE? Are there any interactions between costs incurred under the different IAEs which may not have been taken into account?
- Has each proposed IAE increased the costs and/or expenses incurred by NGET in balancing the system by more than the threshold amount of £2 million?
- Are there any additional factors or evidence which you think we should take into account to inform the Authority's decision on whether the proposed IAE constitutes an IAE and what the level of income adjustment should be in the case that the Authority determines that an IAE has occurred?

Next Steps

We would like to hear the views of any interested parties regarding the issues raised in this letter. Following closure of this open letter consultation, and careful consideration of the respondents' views, the Authority may make a determination under paragraph 12 of Special Condition AA5A or may seek and consider further information before making a decision.

If a determination is made, the Authority will publish a notice stating the income adjustment allowance and giving reasons for this determination. In the case that the Authority considers that the information that has been provided by the relevant parties is insufficient to reach a determination, it will inform the relevant parties of this and the income adjustment allowed under the relevant notice will be zero. If the Authority has not made a determination and has not informed the relevant parties that insufficient information is available to make a determination within three months of receiving an IAE notice, the full income adjustment proposed by NGET under the notice will be allowed.

All responses will be published on Ofgem's website. However, if respondents do not wish their response to be made public then they should clearly mark their response as not for publication. Ofgem prefers to receive responses in an electronic form so that they can be placed easily on the Ofgem website.

Responses should be made on or before 2 August 2013 to:

James Soundraraju
Head of Cross Fuels
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Or by e-mail to

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