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Strategy Consultation: Revenue, Incentives and Outputs for National Grid's Role in Electricity Market Reform

Consultation

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Overview:

We are consulting on our proposed assessment of National Grid Electricity Transmission plc's (NGET) allowances, outputs and incentives required to deliver its role under Energy Market Reform (EMR) legislation. We aim to set allowances, outputs and incentives for the period from 1 August 2014 to 31 March 2021 using the RIIO (Revenue = Incentives + Innovation + Outputs) price control model.

The consultation also includes the provisional allowances, outputs and incentives that we are proposing for the first 20 months of EMR.

At the end of this document, you can find details about how to respond to this consultation. This consultation closes on **20 May 2014.**

Context

In December 2012, we published our Final Proposals for National Grid Electricity Transmission plc (NGET) in RIIO-T1 (1 April 2013 to 31 March 2021). This was the first price control to be conducted under our new RIIO model (Revenue = Incentives + Innovation + Outputs). RIIO's objective is to encourage network companies to play a full role in delivering a sustainable energy sector, and to do so in a way that brings value for money for consumers.

At the time of setting Final Proposals there was uncertainty around the scope of NGET's role in the Electricity Market Reform (EMR) and the timing of any involvement. We therefore highlighted the fact that we had not included any allowances, outputs and incentives for EMR. Now NGET is about to take on this role, subject to secondary legislation, we need to determine the allowances that NGET needs to cover this additional activity and the associated outputs and incentives.

This document describes the way we propose to deal with NGET's request for funding of their EMR function (which will be supported by their EMR business plan, due to be submitted to us by the end of September 2014).

Associated documents

Decision on strategy for the next transmission price control – RIIO-T1
https://www.ofgem.gov.uk/ofgem-publications/53833/t1decision.pdf

RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas
https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf

Consultation on funding National Grid Electricity Transmission plc's (NGET's) preparatory costs for its proposed roles in Electricity Market Reform (EMR)
https://www.ofgem.gov.uk/publications-and-updates/consultation-funding-national-grid-electricity-transmission-plc%E2%80%99s-nget%E2%80%99s-preparatory-costs-its-proposed-roles-electricity-market-reform-emr

Decision on funding National Grid Electricity Transmission plc's (NGET's) preparatory costs for its proposed roles in Electricity Market Reform (EMR)
https://www.ofgem.gov.uk/ofgem-publications/86554/decisiononfundingnationalgridelectricitytransmissionplcspreparatorycostsforelectricitymarketreform.pdf

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Executive Summary

Electricity Market Reform (EMR) aims to incentivise investment in secure, low-carbon electricity generation, while improving affordability for consumers. The electricity sector is a critical part of the UK economy and an important driver of growth. EMR is the Government's response to the challenges facing the electricity sector. Although the necessary legislation has not yet been passed, National Grid Electricity Transmission plc (NGET) is currently planning for EMR implementation in August 2014.

We are not able to set outputs and allowances before August 2014 as, once the extent of the role is confirmed, NGET will need time to prepare a business plan. We expect to receive this in September 2014. However, if we wait until NGET submits its business plan for EMR, it will not be able to recover any additional monies until April 2016. NGET is likely to have a significant role to play in the delivery of EMR and hence it is important we have the correct controls and incentives in place from August 2014 to ensure NGET delivers the proposed role in an efficient and timely manner.

This document discusses what NGET expects to have to do to fulfil its role as the EMR delivery body from August 2014 to March 2021. It looks at how we propose to set additional allowances, outputs and incentives for NGET in this the new role.

We propose to set NGET provisional allowances for the first 20 months of operation – August 2014 to March 2016. This will allow NGET to claim these costs from April 2015. If we waited until NGET submits its business plan, this recovery would be delayed until April 2016. NGET has proposed that the provisional allowances for this period should be £7m, and this comprises staff, legal, consultancy and information systems costs.

Given that there is uncertainty surrounding NGET's proposal, we propose a provisional figure of £5m. Once we have received NGET's business plan, we will review this and determine appropriate allowances for the RIIO-T1 period. We expect NGET to provide full justification of its forecasts in its business plan submission.

The outputs (or deliverables) that NGET will deliver during the first 20 months of EMR are crucial to the overall success and credibility of the EMR programme. We are linking the provisional funding that we are proposing to provisional deliverables (such as the timely handling of CfD allocation rounds). Also, recognising the unique one-off circumstances of NGET delivering a significant new role, we are seeking views on provisional reputational and financial incentives. The reputational incentives will be based on public reporting of NGET's performance against its EMR obligations and against Key Performance Indicators (KPIs). The financial incentives we are proposing are intended to focus NGET's attention on dealing with Tier 1 disputes (by a generator against, for example, the decision NGET makes on whether a generator qualifies to participate in a CM auction).

We will need to change NGET's licence so it can recover EMR costs. We will also need to change the Financial Handbook and Price Control Financial Model (PCFM) in time for the annual iteration process in November 2014. This consultation includes an informal consultation on these proposed changes.

1. Introduction

Chapter Summary

How this proposal fits in with the RIIO-T1 Price Control and the background to the new EMR roles that NGET may be performing.

Background

1.1. The Energy Act 2013 makes provision for a range of matters including reforming the electricity market for the purposes of encouraging low carbon electricity generation and ensuring security of supply. The Energy Act provides that the Secretary of State may, through secondary legislation, introduce an electricity capacity market (CM) for the purpose of providing capacity to meet the demands of consumers in Great Britain. He may also, for the purpose of encouraging low carbon electricity generation, introduce contracts for difference (CfDs).

1.2. The Energy Act allows the Secretary of State to confer functions on National Grid Electricity Transmission plc (NGET) in connection with the CM and with CfDs ('EMR delivery functions') through secondary legislation. Should the Electricity Market Reform (EMR) delivery functions be conferred on NGET, it will take on new and enduring obligations in relation to the electricity market. The Government also intends that we will be responsible for regulating NGET in the performance of its EMR delivery functions, including funding economic and efficient costs, setting outputs and incentives where appropriate, and monitoring performance.

Purpose of this consultation

1.3. In the RIIO-T1 Final Proposals we highlighted that allowances and outputs did not include provision for NGET as System Operator (SO) to take on its proposed roles in EMR. The EMR delivery body and the timing of the decision, outputs, and costs associated with the new roles were uncertain at the time of publishing RIIO-T1 final proposals in December 2012.

1.4. This consultation is concerned with the process to set allowances, outputs and incentives for NGET's role as EMR delivery body in the enduring regime (ie after NGET formally assumes the role). It also sets out our proposals to set provisional allowances, outputs, and incentives.

1.5. We have previously consulted on the preparatory costs that NGET will incur to allow it to establish systems and processes in readiness for taking on the EMR delivery functions if it is appointed. [1]

1.6. This is a 4 week consultation to ensure the necessary changes to NGET's licence and Financial Handbook are in place as soon as possible after NGET assumes the role. The changes to be made to the Financial Handbook must be in place by 30 September 2014 to ensure NGET can claim provisional allowances in April 2015.

[1] https://www.ofgem.gov.uk/publications-and-updates/consultation-funding-national-grid-electricity-transmission-plc%E2%80%99s-nget%E2%80%99s-preparatory-costs-its-proposed-roles-electricity-market-reform-emr

2. Provisional allowances for the EMR delivery body

Chapter Summary

Sets out the reason for provisional allowances during the first 20 months (August 2014 to March 2016) of NGET's delivery role and the value of the proposed allowances.

Question box

Question 1: Do you agree that we should allow NGET provisional funding subject to the receipt of a well justified business plan?
Question 2: Do you agree that we should not allow an adjustment to reflect the time value of money if NGET do not meet the September 2014 submission date?
Question 3: Do you agree that the £5m proposed cost allowance is reasonable?

Why provisional allowances

2.1. We are not able to set outputs and allowances before August 2014 as, once the extent of the role is confirmed, NGET will need time to prepare a business plan. We expect to receive this in September 2014. If we wait until NGET submits its business plan for EMR, it will not be able to recover any additional monies until April 2016. We believe it is therefore appropriate to allow NGET to recover some monies before then (from April 2015).

2.2. Our proposal is to set provisional allowances to cover NGET's EMR delivery functions for the first 20 months (August 2014 to March 2016) of the enduring regime.

2.3. The provisional allowances will be replaced with final allowances, in the proposed January 2015 consultation (see table 4), as part of setting allowances for the RIIO-T1 period. There will be no 'trueing up' of actual costs incurred in this period compared with provisional allowances. Costs will be treated as totex[2] and will go through the totex incentive mechanism similar to other price controlled costs.

[2] See link in associated document to Decision on strategy for the next transmission price control - RIIO-T1 for explanation of totex.

2.4. The costs of the first year of the EMR delivery body are likely to be higher than future years due to the initial uncertainty over the best delivery process. In future years we expect NGET will be able to reduce costs through efficiencies as the function becomes more streamlined.

2.5. We are keen that NGET meets the timetable for the overall review of EMR outputs, incentives and costs shown in table 4. Therefore we are minded to only grant NGET the provisional allowances provided it submits its full EMR business plan by 30 September 2014. If NGET is unable to meet this timetable, when we do ultimately provide funding for the first 20 months of operation we propose that this will not include any return to reflect the time value of money (at the prevailing RIIO-T1 cost of capital).

NGET's forecast

2.6. NGET has provided a high level estimate of the additional costs it is likely to incur in delivering it's EMR role for the period from August 2014 to March 2016. The estimate is £7m, in 2013-14 prices. This breaks down as follows:

Table 1: NGET's estimated additional EMR costs (2013-14 prices)

£m	**2014-15 (8 months)**	**2015-16**	**Total**
Staff Costs	2.3	2.7	5.0
Legal / Consultancy Costs	0.3	0.3	0.6
Information System (IS) Costs		1.4	1.4
Total	**2.6**	**4.4**	**7.0**

2.7. The 2014-15 figures include £0.5m additional staff costs for the project team that will remain in place until March 2015 to ensure the smooth implementation of EMR delivery functions.

2.8. NGET have assumed all Information Systems (IS) costs in 2014-15 are included in the preparatory costs that we have consulted on separately. The costs in 2015-16 are the IS costs expected to be incurred in running and maintaining the system.

Our proposals

2.9. As the allowances are only provisional for the first 20 months of EMR and there is uncertainty over what the actual costs may be, especially IS costs, we are not scrutinising them in any detail. These will be replaced by final allowances following full assessment of the detailed EMR business plan.

2.10. Given this uncertainty we propose a provisional allowance of £5m to cover this 20 month period. The IS requirements are still in development and therefore final running costs are particularly uncertain. We believe, taking these factors into account and to avoid any potential double counting with existing NGET SO costs already allowed for in RIIO-T1, £5m seems a reasonable figure for provisional allowances.

2.11. As previously stated this allowance will be reviewed as part of the overall business plan review.

3. Provisional Outputs and Incentives

Chapter Summary

Sets out the reasons we are proposing provisional outputs and incentives during the first 20 months (August 2014 to March 2016) that it is expected NGET will be performing its EMR delivery functions. It also sets out the proposed provisional outputs and incentives.

Question box

Question 4: Do you agree with the incentives we are proposing?

RIIO framework

3.1. The RIIO model explicitly links revenues to outputs and incentives. In line with that, we are of the view that our proposals to provide provisional funding before fully justified business plans are assessed should be linked to the outputs (or deliverables) that NGET will be delivering over that period and, where possible, incentives. Our proposals for provisional outputs and incentives recognise that during the first 20 months of EMR, NGET, if appointed as deliver body, will deliver outputs that are key to the success of the overall EMR programme.

Provisional 'outputs' (the deliverables for the first 20 months of EMR)

3.2. We propose linking the provisional allowances that we are proposing to NGET's high-level deliverables for the provisional period, as set out in Table 2. Note that this list of deliverables is based on NGET's understanding at 7 March 2014 of its role in EMR which is expected to be confirmed, subject to the will of Parliament, when statutory legislation comes into effect.

Table 2: NGET's summary list of key EMR deliverables for the first 20 months of EMR (as at 7 March 2014)

Output	Current planned date	Uncertainties or dependencies which could move the date
Modelling and Analysis to support first Annual Update.	December 2014	Decision from DECC on the timing of the Annual update process.
Modelling and Analysis on Strike Price scenarios to inform draft Delivery Plan.	July 2015	Decision from DECC on the date for revisions to strike prices.
Modelling and Analysis to support second Annual Update.	December 2015	Decision from DECC on the timing of the Annual update process.
Publish guidance document on the CfD allocation process for the first allocation round.	September 2014	Successful passage of Legislation. State Aid approval.
Complete the eligibility assessment for each CfD applicant within the first allocation round [1]. (And subsequently deal with any Tier 1 disputes).	November 2014	Successful passage of Legislation. State Aid approval.
Complete the allocation process for CfD applications within first allocation round.[2]	December 2014	Successful passage of Legislation. State Aid approval.
Prepare Electricity Capacity reports for the Secretary of State.	Annual process. In 2014: March-June	Receipt of winter data. Receipt of Government input assumptions.
Prepare and publish CM Auction Guidelines.	Annual process. In 2014: first version 30 June	Successful passage of Legislation. State Aid approval.
Run capacity auction and associated pre-qualification process. (And subsequently deal with any Tier 1 disputes).	Annual process. First pre-qualification window opens in August 2014. First auction in December 2014	Successful passage of Legislation. State Aid approval.
Run DSR Transitional pre-qualification and auction.	2015 and 2016	Successful passage of Legislation. State Aid approval.
Issue capacity agreements. (And subsequently deal with any Tier 1 disputes).	Annual process. January 2015 for first CM auction	Successful passage of Legislation. State Aid approval.

Proposed provisional incentives (the incentives for the first 20 months of EMR).

3.3. Proposing incentives for NGET's EMR outputs is not straightforward as EMR is a new policy area and a new responsibility for NGET. Hence we do not have historical data to inform what 'good performance' looks like. However, we recognise that the

[1] Subject to there being no eligibility reviews or appeals
[2] Subject to there being no eligibility reviews or appeals

outputs that NGET will deliver during the first 20 months of EMR are crucial to the overall success and credibility of the EMR programme. Recognising the unique one-off circumstances of NGET delivering a significant new role, we are proposing provisional reputational and financial incentives. As EMR is a new role we are proposing a combination of strong reputational incentives, plus a conservative approach to setting financial incentives so that they are proportionate to the provisional EMR revenues. We also note that EMR legislation is expected to be laid before Parliament in June and finalised before 'go live' in August. These incentives are being proposed based on our current understanding of NGET's likely role. We expect that NGET will propose enduring incentives as part of their fully justified business plans.

Financial incentives

Incentives on the accuracy of NGET's Tier 1 dispute resolution for disputes on (a) CM pre-qualification and (b) CfD eligibility.

3.4. NGET's key proposed deliverables include dealing with Tier 1 disputes that it may receive on its assessment of whether applicants pre-qualify for CM auctions or are eligible for CfDs. It is expected that secondary legislation will set timelines within which NGET are expected to deal with these disputes. We are proposing financial incentives to complement the strong reputational incentives that NGET will have, as getting these decisions right is crucial to ensure that:

- Those who are eligible for CM auctions (and where relevant constrained CfD allocation rounds) can take part to ensure the process is as competitive as possible and the costs for consumers are minimised.

- Those that are not eligible are not permitted to take part and do not receive revenues for services they may not be able to provide.

- The process is robust and seen to be robust so investors are confident that applications will be dealt with properly and that the risk of wrong decisions is minimised.

- Disputes are dealt with efficiently and to a high standard so the number successfully challenged at Tier 2 is limited to reduce the legal and administrative costs that the Tier 2 dispute body incurs and passes through to consumers or taxpayers. [3]

[3] DECC expect to appoint Ofgem as the Tier 2 dispute body.

(c) Incentive on the accuracy of NGET's Tier 1 dispute resolution for disputes on NGET's capacity agreement termination decisions.

3.5. Terminating a capacity agreement is a key decision with significant impacts on the affected party and potentially on security of supply. It is therefore important that NGET devotes appropriate resources to ensuring disputes on termination decisions are dealt with properly.

(d) An incentive on the accuracy of NGET's Tier 1 dispute resolution for disputes on NGET's decisions: to rectify the Capacity Agreement Register (CAR), and; to rectify Capacity Agreement Notices (CANs).

3.6. Maintaining an accurate CAR and issuing accurate CANs are important administrative tasks that NGET will perform. These two documents form the capacity agreement, the accuracy of which is important to generators and investors – for example in securing project finance. Dealing with Tier 1 disputes on these documents is expected to be relatively simple – any disputes are likely to be solely on administrative errors – provided NGET has in place robust processes for their assessments, both at the initial decision stage and for dealing with Tier 1 disputes. Provided this is the case, we do not expect many, if any, decisions will be over-turned at Tier 2 (although that is not certain as EMR is untested) and are proposing a single financial incentive for dealing with Tier 1 disputes on both of these documents.

3.7. In proposing financial incentives we have considered:

Whether performance standards are observable

3.8. We have considered whether NGET's performance can be observed easily so it is clear when the incentive applies. We are of the view performance can be observed as any Tier 1 decisions by NGET over-turned at Tier 2 will indicate clearly where NGET have not performed on Tier 1. We propose to use this measure (NGET Tier 1 decisions over-turned at Tier 2) as the driver of incentives.

Proportionality and symmetry

3.9. The proposed financial incentives are proportionate to EMR provisional revenues, and they recognise that EMR is an untested policy area so the exposure of NGET and consumers to additional costs should be limited. Thus we are proposing incentives that specifically seek to encourage NGET to consider carefully Tier 1 dispute decisions to minimise errors that are uncovered at Tier 2. The design also aims to ensure the incentives are broadly symmetrical to offer equal rewards and penalties for performance that goes beyond, and falls short of, 'good' respectively. Nevertheless, our proposed incentives do include a 'step change' between zero and one or more overturned decisions. We could have reduced the height of this step change by, for example, allowing some reward for one / or very low numbers of wrong decisions. However, we are of the view that would mean there was a positive incentive payment for behaviour that does not go beyond the good performance that we expect of NGET. Our view is there should only be a financial upside for each category of dispute if *zero* Tier 1 disputes are over-turned at Tier 2 as this is likely to enhance the reputation of the new EMR arrangements.

3.10. We did consider an incentive based on the proportion of overturned decisions. This recognises that if the number of Tier 1 disputes is high, it may be more likely that some are over-turned at Tier 2. However, in our view, the option we are proposing based on absolute numbers is preferable as it ensures that there is no reward for making decisions that are subsequently found to be incorrect.

Avoiding unintended consequence (eg creating perverse incentives)

3.11. In designing these incentives we are aware that NGET may, when faced with a borderline decision at Tier 1, have some incentive to take the decision that is least likely to lead to a Tier 2 dispute. For example, it may be easier to pre-qualify a generator to the CM auction when their application is not fully evidenced than to reject that application and face the possibility of that decision being over-turned at Tier 2. We are of the view that, irrespective of any financial incentives, there may be some reputational incentive to do this. However, we acknowledge that the financial incentives we are proposing could, at the margin, sharpen this incentive. We propose the following mitigations for this risk:

- The proposed incentives are proportionate and set at a level to encourage NGET to carefully consider Tier 1 dispute decisions to minimise errors that are uncovered at Tier 2, rather than being set at a punitive level.

- We also propose allowing one decision to be over-turned in each category with no financial reward or penalty. It is also possible for the loss on two or more wrong decisions in one category of dispute to be offset by zero wrong decisions in other categories.

- As part of our oversight of NGET's EMR roles we expect NGET to have in place fully documented and robust auditable processes for making reviewable decisions and for dealing with Tier 1 disputes. The introduction of the incentives proposed below will, subject to this consultation, take into account whether this documentation is in place.

Financial incentives: Design

3.12. Table 3 sets out our proposed incentive values and the driver of the incentives:

- The quantum is based on a notional administrative cost of dealing with Tier 2 disputes - this reflects a notional monetary cost that would have been avoided had NGET come to the correct decision in the first place.

For CAN and CAR disputes, which are expected to be relatively straightforward, this quantum is set at a lower level.

- One characteristic of our proposal is that it is possible for losses and gains to offset each other – so, for example, if NGET were to have three CM pre-qualification disputes over turned (-£20k); one CfD eligibility decision over turned (£0), two termination decisions over turned (-£10k) and no CAN / CAR decisions over turned (+£25k), this would net out at -£5k.

Table 3: Proposed provisional incentive values based on absolute numbers of over-turned disputes

Driver	CM pre-qualification. (per round, assuming one each financial year)	CfD eligibility (per round, assuming one each financial year)	CM Termination (per financial year)	CAN and CAR (per financial year)
No decision over-turned at Tier 2	+£50,000	+£50,000	+£50,000	+£25,000
1 decision over-turned at Tier 2	£0	£0	£0	£0
2 decisions over-turned at Tier 2	-£10,000	-£10,000	-£10,000	-£5,000
3 decisions over-turned at Tier 2	-£20,000	-£20,000	-£20,000	-£10,000
4 decisions over-turned at Tier 2	-£30,000	-£30,000	-£30,000	-£15,000
5 decisions over-turned at Tier 2	-£40,000	-£40,000	-£40,000	-£20,000
6 decisions over-turned at Tier 2 (Ceiling)	-£50,000	-£50,000	-£50,000	-£25,000

Reputational risk (incentives on reputation)

3.13. We see reputational incentives as playing a key role. EMR is a high profile intervention in the market and NGET's role as delivery body is crucial to the success of the overall programme. Likewise it will be important for NGET's own reputation that they are able to demonstrate that they have the strong planning and execution of key processes in place as would be expected of a well performing delivery body.

3.14. In encouraging NGET to perform its proposed EMR delivery functions we expect that we will be required by legislation to report annually to the Secretary of State on how NGET has performed its functions in relation to the CM. We intend to publish some or all of the findings from this report to highlight where NGET has met, exceeded, or fell short of its obligations and, where appropriate, KPIs. We expect that this will include reporting on activities including:

- Timely publication of any relevant auction documentation.
- Timely notification of the pre-qualification outcome.
- Report on timeliness and running of auction.
- The number of decisions that were disputed and, of these, the number over turned at each of the three tiers of dispute.
- Timeliness of dealing with applications, Tier 1 disputes and other tasks.

3.15. We will also seek to publish performance data and our view on where NGET has met, exceeded, or fell short of its obligations for NGET's roles in the CfD processes. The performance data will be collected through the existing Regulatory Information Guidance (RIGs) licence condition (B15).

3.16. As noted, we expect NGET to propose enduring incentives when it comes to us with full business plans and these incentives may include proposals for incentives based on stakeholder feedback.

4. Business Plan and Assessment

Chapter Summary

Sets out how NGET should prepare its business plan and how we will treat the costs under RIIO-T1

Question box

Question 5: Do you agree with our proportionate approach to the assessment of the business plan including provision of different scenarios?
Question 6: Do you agree that the capitalisation rate for internal SO costs should also apply to EMR enduring costs?

Process

4.1. We will follow the same process for assessing NGET's business plan for the EMR delivery body that we used in the RIIO-T1 price control, being proportionate to the smaller costs involved. Chapter 2 of this document consults on our proposal to provide some provisional or advanced funding for the first 20 months of operating the EMR delivery function ahead of the full business plan submission.

Well justified business plan

4.2. In the RIIO-T1 final proposals we set out that NGET should provide notice to Ofgem when, as result of decisions by the Government under its EMR policy, it is necessary for it to undertake new or enhanced activities to those taken into account for the final settlement of the RIIO-T1 price control. In the notice to Ofgem, NGET should include supporting evidence, in the form of a business plan, including:

- a description of the new undertakings NGET is responsible for under EMR
- potential measures of the outputs from these new undertakings
- a description of how NGET intends to carry out the new functions or activities
- the costs that NGET expects to incur as a result
- an explanation of why the relevant costs cannot otherwise be recovered under the revenue allowances provided under the RIIO-T1 price control settlement.

4.3. We expect NGET to submit a well justified business plan for its EMR delivery body role as it did for the whole of the RIIO-T1 price control. NGET will be required to demonstrate that its plan will deliver in the interests of both current and future customers.

4.4. We have already provided funding for NGET's System Operator (SO) functions as part of the RIIO-T1 price control. Therefore we will only provide funding for the incremental costs that NGET incurs in performing the EMR role.

4.5. As we expect the EMR delivery body functions to be integrated within NGET's existing SO roles and responsibilities, the plan should discuss how this will be done and what impact this will have on both the EMR and the existing SO organisation. The business plan must also discuss how NGET will manage any conflicts of interest between its existing SO functions and EMR functions.

4.6. Under the RIIO framework the onus is on NGET to demonstrate the cost efficiency and long-term value for money in its EMR business plan.

4.7. The plan should set out how NGET propose to operate the EMR delivery body over the RIIO-T1 period, the expected running costs from August 2014 to March 2021, and what outputs and incentives it believes are appropriate. The plan therefore also gives NGET an opportunity to update its original forecast for the initial 20 month period if necessary.

Business plan scenarios

4.8. We do not want to review a business plan that is not robust and could change dramatically depending on circumstances. As the EMR delivery body is a new role and we are expecting NGET to produce a business plan only 2 months after the 1 August, 2014 ('go live') date it may be that there are still a large number of uncertainties about the EMR role when the business plan is produced. Early submission of a business plan is required to enable us to confirm the provisional level of funding for November 2014.

4.9. To give the business plan more robustness in these circumstances we believe it is appropriate for NGET to include a number of scenarios. This would enable them to demonstrate the possible uncertainties and changes that may happen. We would suggest a maximum of 3, high, low and best view, scenarios could be used. NGET should also discuss the likely impacts and risks associated with each scenario.

4.10. NGET must document the assumptions that underlie each scenario. We will review all the scenarios as part of the review of the business plan.

4.11. NGET should inform Ofgem, at the latest by 31 December 2014, which scenario it considers is the most representative of running the EMR delivery body.

Treatment of EMR costs within the RIIO Framework

4.12. We recognise that the EMR delivery body is a new work area for NGET and therefore our ability to directly assess the costs against historical and benchmark information is limited. The majority of costs, however, are staff related and we have meaningful data upon which we can draw realistic comparisons.

4.13. Where possible we will also try to identify similar functions within network companies that we could compare against the EMR delivery costs.

4.14. We propose that EMR delivery body costs will be treated in the same way as other internal SO costs incurred by NGET within the RIIO-T1 price control. This means that all costs, capital expenditure (capex) and operating expenditure (opex) will form part of total expenditure (Totex). We also propose that the capitalisation rate of 27.9% already set for internal SO costs will also apply to all EMR enduring costs. Our proposed annual totex, of about £3m, is very low in relation to total internal SO totex allowances of about £100m per annum, set out in the RIIO-T1 final proposals. Given the fact that NGET propose to integrate EMR delivery functions within the existing internal SO functions where possible, and that the costs are low it would seem appropriate to apply the same rate.

4.15. Any over / under spending against allowances will also be treated as Totex and the sharing factor applied. The sharing factor is the mechanism to determine how over / under spend are shared between customers and the licensee.

4.16. The Information Quality Incentive (IQI) was set for NGET as part of the RIIO-T1 price control. We do not intend to alter this as a result of additional EMR allowances.

Timetable

4.17. The proposed timetable to assess the EMR business plan and determine final allowances, outputs and incentives is set out in Table 4.

Table 4: Timetable for the overall review of NGET's EMR outputs, incentives and costs

April 2014	Strategy document issued for consultation. This includes an informal consultation on proposed licence, Financial Handbook, and PCFM changes
April 2014 – June 2014	Discussions with NGET on proposed licence conditions - incentives and outputs - allowances, Financial Handbook, and PCFM changes
May 2014	Strategy consultation and consultation on licence conditions closes
June 2014	Business plan data tables issued to NGET
June 2014	Strategy decision document including statutory consultation on licence conditions changes issued
September 2014	NGET submits its Business Plan for enduring regime
November 2014	PCFM updated with provisional allowances for first two years of the EMR delivery body
December 2014	NGET to inform Ofgem which scenario is being used for the EMR delivery body
January 2015	Consultation on EMR delivery body allowances, incentives and final preparatory costs
April 2015	Final proposals for the EMR delivery body– funding, incentives and outputs
November 2015	Direction into PCFM of enduring allowances

5. Licence changes

Chapter Summary

The licence, Financial Handbook and Price Control Financial Model (PCFM) changes required to enable NGET to recover the costs of the EMR delivery body from customers

Question box

Question 7: Do you agree in principle with the proposed licence changes
Question 8: Do you agree in principle with the proposed Financial Handbook and PCFM changes

Proposals to set new EMR allowances

5.1. The Electricity Market Reform (EMR) incentivises investment in secure, low-carbon electricity generation, while improving affordability for consumers. Although the necessary legislation has not yet been passed, National Grid Electricity Transmission plc (NGET) is currently planning for EMR implementation in August 2014.

5.2. This consultation discusses how NGET expects to fulfil its role as the EMR delivery body from, August 2014 to March 2021. It looks at how we propose to set allowances, outputs and incentives for the new role.

5.3. To enable NGET to recover costs, for performing functions associated with the EMR delivery body, the RIIO-T1 price control would need to be extended to include additional funding through new revenue allowances and new financial incentives.

5.4. To bring this into effect, we propose to amend the licence conditions and the Financial Handbook to incorporate new revenue allowances and incentives. This document sets out the licence and Financial Handbook changes that would be required to facilitate new EMR allowances only.

5.5. This strategy consultation does not include licence changes for new financial incentives discussed in Chapter 3. We will consult on modifying licence conditions to include new incentives during April and May 2014.

5.6. Under the RIIO-T1 price control, revenue allowances are calculated through the Price Control Financial Model (PCFM). At the outset of the Price Control Period, the base revenue figures were calculated by the PCFM, using the variable values subsisting at that time. This constituted the opening base revenue values for the licensee.

5.7. In November of each year, the Authority directs values relating to allowed Totex expenditure on uncertain cost categories that can be varied. The process to arrive at these values is commonly known as the Annual Iteration Process.

5.8. We propose to use the Annual Iteration Process to provide for new EMR allowances, through the licence and handbook changes below. The Annual Iteration Process is an existing mechanism within the RIIO-T1 price control and is consistent with mechanisms for setting other NGET System Operator allowances.

Changes to the licence for new EMR allowances

5.9. To implement EMR allowances we would need to change NGET's licence to provide a mechanism by which it can recover EMR costs. We would also need to change the Financial Handbook and Price Control Financial Model (PCFM) in time for the annual iteration process in November 2014. The proposed changes to the licence conditions are intended to be mechanisms to enable the policy determined as a result of this strategy consultation. They are not intended to pre-empt any decision on whether or not to give provisional allowances for EMR.

5.10. In order to set allowances for EMR delivery, we propose to modify Special Licence Condition 7D to include a new uncertainty cost category for EMR allowances ('SOEMRES') into the Price Control Financial Model (PCFM).

5.11. The new uncertainty cost category would be used to input the provisional allowances (set out in Chapter 2) to the PCFM as part of the Annual Iteration Process in November 2014. This would enable NGET to commence recovering provisional EMR allowances from April 2015.

5.12. We would reset the SOEMRES value in the PCFM with final allowances for the enduring solution by 30 November 2015 as set out in Chapter 4 (table 3).

5.13. For the avoidance of doubt, this consultation is not intended to constitute a statutory consultation for modifying licence conditions. We will undertake a statutory consultation on modifying the licence conditions during June 2014.

5.14. At this stage, we welcome preliminary views on our proposal to amend the PCFM to include allowances for EMR delivery function. Our changes to Special Licence Condition 7D is set out in Appendix 3 of this document.

Changes to the Financial Handbook and Price Control Financial Model (PCFM) for new EMR allowances

5.15. As well as changes to the NGET's licence, we would need to make consequential changes to the Financial Handbook and to the PCFM.

5.16. We propose to use the Annual Iteration Process of the PCFM to input EMR allowances into the PCFM. Provisional allowances would be input through the Annual Iteration Process in November 2014 and will be reset with final EMR enduring allowances in November 2015. This mechanism would enable NGET to recover provisional allowances from April 2015; and enduring allowances from April 2016 to March 2021.

5.17. The Annual Iteration Process is set out in the Financial Handbook and any changes to the Financial Handbook or the PCFM have to be made following a formal change control process as set out in Special Licence Condition 5A of the Electricity Transmission Licence.

5.18. The changes required to the Financial Handbook and the PCFM were discussed by the Financial Issues Working Group meeting held on 26 March 2014. This meeting included representatives from Ofgem and each licensee group. The meeting decided to recommend that the changes proposed in this consultation should be incorporated into the PCFM.

5.19. The Price Control Financial Model Working Group ('the working group') will be held in June 2014. The working group will be comprised of an Ofgem chair and Ofgem secretary, as well as one representative per licensee. One of the purposes of the working group, as required by Special Condition 5A, is to provide views on the any proposed modifications to the PCFM. The working group will formally make recommendations to the Authority on the proposed changes for an EMR uncertainty cost category; taking account of the recommendations from the Financial Issues Working Group.

5.20. We will undertake a statutory consultation on modifying the Financial Handbook during June 2014. At this stage, we welcome preliminary views on our proposed changes to the Financial Handbook and PCFM are set out in the extract of the Financial Handbook in Appendix 4. This is functional change to the PCFM therefore it must be agreed by 30 September 2014, as per paragraph 1.13 of the Financial Handbook.

Appendices

Index

Appendix 1 – Consultation Response and Questions

1.1. We would like to your views on any of the issues in this document.

1.2. We would especially welcome responses to the specific questions at the beginning of each chapter heading and duplicated below.

1.3. Please send your responses by 20 May 2014 to:

Martin Rodgers
Cost and Outputs, Transmission
Ofgem, 9 Millbank, London SW1P 3GE
Tel: 0207 901 7273
Email: martin.rodgers@ofgem.gov.uk

1.4. All responses will be put in our library and on our website (www.ofgem.gov.uk), unless they are marked confidential. You can ask for your response to be kept confidential, and we will respect this, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. If you do want your response to be kept confidential, please mark it on the document, along with the reasons for confidentiality. Please submit responses electronically and in writing, and put any confidential material in the appendices to your responses.

1.6. Please direct any questions on this document to:

Martin Rodgers
Cost and Outputs, Transmission
Ofgem, 9 Millbank, London SW1P 3GE
Tel: 0207 901 7273
Email: martin.rodgers@ofgem.gov.uk

Provisional Allowances

CHAPTER: Two

Question 1: Do you agree that we should allow NGET provisional funding subject to the receipt of a well justified business plan?

Question 2: Do you agree that we should not allow an adjustment to reflect the time value of money if NGET do not meet the September 2014 submission date?

Question 3: Do you agree that the £5m proposed cost allowance is reasonable?

Provisional Outputs and incentives

CHAPTER: Three

Question 4: Do you agree with the incentives we are proposing?

Business Plan and Assessment

CHAPTER: Four

Question 5: Do you agree with our proportionate approach to the assessment of the business plan including provision of different scenarios?

Question 6: Do you agree that the capitalisation rate for internal SO costs should also apply to EMR enduring costs?

Licence Changes

CHAPTER: Five

Question 7: Do you agree with the proposed licence changes?

Question 8: Do you agree with the proposed Financial Handbook and PCFM changes?

Appendix 2 – Proposed Licence Changes

Special Condition 7D. Arrangements for the recovery of SO uncertain costs (changes shown in red)

Introduction

7D.1 The purpose of this condition is as follows:

(a) to allow the licensee or the Authority to propose, and the Authority to determine, adjustments to the licensee's levels of Allowed Expenditure ("relevant adjustments") in relation to ~~Enhanced Security Costs~~ the categories set out in paragraph 7D.3 of this condition (each "uncertain cost category"); and

(b) to determine any appropriate revisions to PCFM Variable Values necessary to implement relevant adjustments and to determine the Relevant Years to which those revised PCFM Variable Values relate for use in the Annual Iteration Process for the ET1 Price Control Financial Model, as described in Special Condition 5B (Annual Iteration Process for the ET1 Price Control Financial Model).

7D.2 The application of the mechanisms set out in this condition ensures that, as a consequence of the Annual Iteration Process, the value of the term $SOMOD_t$ as calculated for Relevant Year t for the purposes of Part B of Special Condition 4A (Restriction of System Operator Internal Revenue) will result in an appropriate adjustment to the licensee's Maximum SO Internal Revenue in a manner that takes account of Allowed Expenditure levels in relation to the uncertain cost categories specified in paragraph ~~7.1~~ 7D.3 of this condition, determined under Part A of this condition for the purposes of the Totex Incentive Mechanism Adjustment, in accordance with the methodology set out in chapters 6 and 7 of the ET1 Price Control Financial Handbook.

7D.3 The uncertain cost categories referred to in paragraph 7D.1 of this condition are:

(a) Enhanced Security Costs; and

(b) Electricity Market Reform Enduring Solution.

~~7D.3~~ 7D.4 This condition should be read and construed in conjunction with Special Condition 5A (Governance of ET1 Price Control Financial Instruments) and Special Condition 5B.

Part A: Proposal and determination of relevant adjustments

~~7D.4~~ 7D.5 This Part provides for:

(a) the proposal of relevant adjustments by the licensee or by the Authority;

(b) the determination of relevant adjustments by the Authority; and

(c) the deeming of relevant adjustments in certain circumstances.

Proposal of relevant adjustments

~~7D.5~~ 7D.6 In relation to the uncertain cost category Enhanced Security Costs and subject to paragraph 7D.~~8~~10 of this condition, the licensee may by notice to the Authority, and the Authority may by notice to the licensee, propose a relevant adjustment ~~in relation to any cost category~~ for any Relevant Year or Relevant Years from 2013/14 to 2020/21, provided that the proposed change to Allowed Expenditure:

(a) is based on information about actual or forecast levels of efficient expenditure requirements, for an uncertain cost category that was not available when the licensee's SO Opening Base Revenue Allowance was derived;

(b) takes account of any relevant adjustments previously determined under this condition;

(c) in aggregate constitutes a material amount within the meaning of paragraph 7D.~~6~~8 of this condition;

(d) relates to costs incurred or expected to be incurred after 1 April 2013; and

(e) constitutes an adjustment to Allowed Expenditure which cannot be made under the provisions of any other Special Condition of this licence.

7D.7 In relation to the uncertain cost category Electricity Market Reform Enduring Solution adjustments will be directed by the Authority by 30 November following the assessment periods of review, which involve the direction of an initial set of determinations and a subsequent revised set.

~~7D.6~~ 7D.8 A material amount in relation to each uncertain cost category set out in paragraph 7D.3 (a) of this condition, is an amount of change to Allowed Expenditure which, when multiplied by the licensee's Totex Incentive Strength Rate set out in Appendix 1 of this condition, exceeds or is likely to exceed one per cent of the licensee's materiality threshold amount as set out in Appendix 2 of this condition.

~~7D.7~~ 7D.9 A proposal made under paragraph 7D.~~5~~6 of this condition must include statements setting out:

(a) the uncertain cost category to which the proposal relates;

(b) the changes to the licensee's Allowed Expenditure levels that are proposed and the Relevant Years to which those changes relate; and

(c) the basis of calculation for the changes to the licensee's Allowed Expenditure levels referred to in sub-paragraph (b) of this paragraph.

Application windows for relevant adjustment proposals

~~7D.8~~ 7D.10 In relation to the uncertain cost category Enhanced Security Costs, the licensee and the Authority may only propose relevant adjustments during the following application windows:

(a) the first application window which opens on 1 May 2015 and closes on 31 May 2015; and

(b) the second application window which opens on 1 May 2018 and closes on 31 May 2018.

~~7D.9~~ 7D.11 Relevant adjustments relating to ~~any~~ the uncertain cost category Enhanced Security Costs, may be proposed during both the first and second application window provided that each such relevant adjustment proposal complies with the provisions of paragraphs ~~7D.5~~ 7D.6-~~7D.7~~ 7D.9 of this condition.

~~7D.10~~ 7D.12 Relevant adjustment proposals made outside the application windows set out in paragraph ~~7D.8~~ 7D.10 of this condition, other than proposals in respect of Electricity Market Reform Enduring Solutions, will not be determined by the Authority under the provisions of this condition.

Authority's power to determine relevant adjustments

7D.13 Revised variable values in relation to Electricity Market Reform Enduring Solution will be directed by the Authority by 30 November following the assessment periods of review.

~~7D.11~~ 7D.14 For Enhanced Security Costs, ~~W~~where a proposal has been duly made under paragraph ~~7D.5~~ 7D.6 of this condition, the Authority may, within four months after the close of the relevant application window, determine any relevant adjustments that are to be made to the licensee's Allowed Expenditure levels and the Relevant Years to which those changes relate, in such manner as it considers appropriate.

~~7D.12~~ 7D.15 In determining any relevant adjustment under paragraph ~~7D.11~~ 7D.14 of this condition, the Authority will:

(a) consult with the licensee and other interested parties;

(b) have particular regard to the purposes of this condition; and

(c) take no account of the general financial performance of the licensee under the price control arrangements set out in the Special Conditions of this licence.

~~7D.13~~ 7D.16 A determination under paragraph ~~7D.11~~7D.14 of this condition may confirm, reject, or vary the proposed relevant adjustment.

~~7D.14~~ 7D.17 Without limiting the general effect of paragraph ~~7D.13~~ 7D.16 of this condition, a determination by the Authority of a relevant adjustment may specify changes to Allowed Expenditure levels for the licensee in relation to an uncertain cost category for any Relevant Year from 2013/14 to 2020/21.

~~7D.15~~ 7D.18 The Authority will notify the licensee of any determination made under paragraph ~~7D.11~~ 7D.14 of this condition within 14 days of making the determination concerned.

~~7D.16~~ 7D.19 If the Authority has not determined a relevant adjustment in relation to a proposal duly made by the licensee under paragraph ~~7D.5~~ 7D.6 of this condition within four months after the close of the relevant application window, and the proposal has not been withdrawn, then the relevant adjustment, insofar as it relates to changes to Allowed Expenditure levels for the licensee for Relevant Years specified in the proposal, will be deemed to have been made.

Part B: Determination of revisions to PCFM Variable Values

~~7D.17~~ 7D.20 This Part provides for the determination and direction of revised PCFM Variable Values by the Authority for:

(a) Enhanced Security Costs (SOIAEEPS values); and

(b) Electricity Market Reform Enduring Solution (SOEMRES values).

~~7D.18~~ 7D.21 The Authority will determine whether any PCFM Variable Values should be revised for the purposes of implementing any relevant adjustments determined or deemed to have been made under the provisions of Part A of this condition.

~~7D.19~~ 7D.22 Determinations under paragraph ~~7D.18~~ 7D.21 of this condition are to be made in accordance with the methodology contained in chapter 7 of the ET1 Price Control Financial Handbook.

~~7D.20~~ 7D.23 Where the Authority directs any revised PCFM Variable Values for Relevant Years earlier than Relevant Year t, the effect of using those revised values in the Annual Iteration Process for the ET1 Price Control Financial Model will, subject to a Time Value of Money Adjustment, be reflected in the calculation of the term $SOMOD_t$ for Relevant Year t and, for the avoidance of doubt, no previously directed value of the term $SOMOD_t$ will be retrospectively affected.

Part C: Procedure to be followed for the direction of revised PCFM Variable Values relating to the recovery of uncertain costs

~~7D.21~~ 7D.24 Subject to paragraph ~~7D.24~~ 7D.28 of this condition, revised PCFM Variable Values determined by the Authority in accordance with the provisions of Part B of this condition , in relation to PCFM Variable Values set out in paragraph 7D.20 sub-paragraph (a) of this condition (Enhanced Security Costs), will be directed by the Authority by:

(a) 30 November 2015 (or as soon as is reasonably practicable thereafter), following the first application window; and

(b) 30 November 2018 (or as soon as is reasonably practicable thereafter), following the second application window.

7D.25 Subject to paragraph 7D.28 of this condition, revised PCFM Variable Values determined by the Authority in accordance with the provisions of Part B of this condition, in relation to Electricity Market Reform Enduring Solution (SOEMRES), will be directed by the Authority by 30 November following the assessment period of review.

~~7D.22~~ 7D.26 Before issuing any directions under paragraph ~~7D.21~~ 7D.24 of this condition, the Authority will give notice to the licensee of all of the revised values that it proposes to direct.

~~7D.23~~ 7D.27 The notice referred to in paragraph ~~7D.22~~ 7D.26 of this condition will:

(a) state that any revised PCFM Variable Values have been determined in accordance with Part B of this condition; and

(b) specify the period (which must not be less than 14 days from the date of the notice) within which the licensee may make any representations concerning the determination of any revised PCFM Variable Values.

~~7D.23~~ 7D.28 The Authority will determine the revised PCFM Variable Values having due regard to any representations duly received under paragraph ~~7D.23~~ 7D.27 of this condition, and give reasons for its decisions in relation to them.

~~7D.25~~ 7D.29 If, for any reason, the Authority does not make a direction required under paragraph of ~~7D.21~~ 7D.24 this condition by the date specified in that paragraph, the Authority will direct the values concerned as soon as is reasonably practicable thereafter, consistent with the purpose of paragraphs 5B.11 to 5B.13 of Special Condition 5B and, in any case, before directing a value for $SOMOD_t$ under paragraph 5B.12 of that condition.

Part D: Interpretation

~~7D.26~~ 7D.30 Expressions used in this condition and defined in Special Condition 1A (Definitions and interpretation) are to be read and given effect subject to any further clarification set out in the relevant Regulatory Instructions and Guidance issued by the Authority under Special Condition B15 (Regulatory Instructions and Guidance).

APPENDIX 1: TOTEX INCENTIVE STRENGTH RATE

(see paragraph ~~7D.6~~ 7D.8 of this condition)

Licensee	Totex Incentive Strength Rate (%)
National Grid Electricity Transmission plc	46.89

APPENDIX 2: MATERIALITY THRESHOLD AMOUNT
(see paragraph ~~7D.6~~ 7D.8 of this condition)

Licensee	£m
National Grid Electricity Transmission plc	120.517

Appendix 3 – Proposed Financial Handbook Changes

Financial Handbook Extracts – Changes highlighted in red

Chapter 2 - The ET1 Price Control Financial Methodologies

2.1 The ET1 Price Control Financial Methodologies set out in this Handbook describe the basis for a range of annual adjustments to the licensee's Opening Base Revenue Allowances for the purposes of the RIIO-T1 price control arrangements.

2.2 The main purpose of each methodology is to set out the way in which one or more PCFM Variable Values are to be revised for the purposes of the Annual Iteration Process for the ET1 Price Control Financial Model (PCFM) under which values of the term MOD_t are calculated (see Chapter 1). Any revised PCFM Variable Values determined under the methodologies will replace (over-write) the existing values contained in the PCFM Variable Values Table (blue box) for the licensee in the PCFM as part of the Annual Iteration Process.

2.3 The methodologies are presented in Chapters 3 to 15 of this Handbook and are referenced in the associated Special Conditions of the licence. As constituent parts of this Handbook, the methodologies are part of Special Condition 5A (Governance of ET1 Price Control Financial Instruments) and are subject to the modification provisions set out in that condition.

2.4 The methodologies are subordinate to the Special Conditions of the licence. If there is any inconsistency between a licence condition and a methodology, then the licence condition takes precedence.

Methodologies in this Handbook

2.5 The PCFM Variable Values to be determined under the methodologies in this Handbook are listed in Table 2.1 below. PCFM Variable Values whose names begin with "SO" are applicable to National Grid Electricity Transmission plc only and relate to the System Operator aspects of its business.

Table 2.1 - PCFM Variable Values

No	PCFM Variable Value	Special Condition	Description	Type of variable value
	Specified financial adjustments			
1	EDE SOEDE	6D/7C	Pension Scheme Established Deficit	revenue allowance
2	APFE SOAPFE	6D/7C	Pension Scheme Administration costs and Pension Protection Fund (PPF) levy	revenue allowance
3	TTE SOTTE	6D/7C	Tax liability – tax trigger events	revenue allowance
4	TGIE SOTGIE	6D/7C	Tax liability – gearing/interest costs	revenue allowance
5	CDE SOCDE	6D/7C	Allowed percentage cost of debt	percentage
	Totex Incentive Mechanism			
6	ALC	6C	Actual load related capex expenditure	actual expenditure
7	ARC	6C	Actual asset replacement capex expenditure	actual expenditure
8	AOC	6C	Actual other capex expenditure	actual expenditure
9	ACO SOACO	6C/7B	Actual controllable opex	actual expenditure
10	ANC SOANC	6C/7B	Actual non-operational capex	actual expenditure
	Allowed Totex expenditure adjustments			
11	IAEEPS/ SOIAEEPS	6H/7D	Uncertain costs - enhanced physical site security	allowed expenditure
12	IAEBT	6H	Uncertain costs – BT 21st Century (SHETPLC only)	allowed expenditure
13	IAEWL	6H	Uncertain costs – compensation	allowed

No	PCFM Variable Value	Special Condition	Description	Type of variable value
			costs for land owners for wayleaves (SHETPLC only)	expenditure
14	IAESSCM	6H	Uncertain costs – Exceptional Subsea Cable Fault Costs	allowed expenditure
15	IAEWR	6H	Uncertain costs – workforce renewal (SPTL only)	allowed expenditure
16	IAENLUM	6H	Uncertain costs – non-load related work costs	allowed expenditure
17	WWE	6I	Baseline and strategic wider works expenditure	allowed expenditure
18	IWW	6J	Incremental wider works (NGET only)	allowed expenditure
19	GCE	6F	Generation connections volume driver	allowed expenditure
20	EPIE	6G	Enhancements to pre-existing infrastructure	allowed expenditure
21	IRM	6E	Innovation roll out mechanism	allowed expenditure
22	UCE	6K	Undergrounding volume driver (NGET only)	allowed expenditure
23	DRI	6L	Demand related infrastructure volume driver (NGET only)	allowed expenditure
24	SOEMRES	7D	Electricity Market Reform Enduring Solution	allowed expenditure
	Legacy price control adjustments			
~~24~~25	LAR/ SOLAR	6A/7A	Legacy price control adjustments to allowed revenue	true-up revenue allowance
~~26~~25	LRAV/ SOLRAV	6A/7A	Legacy price control adjustments to RAV	true-up RAV additions

2.6 Specified financial adjustments (numbers 1 to 5 in Table 2.1) relate to the adjustment mechanisms set out in the 'Finance Supporting Document' in the RIIO-T1 Final Proposals[4]. Overviews of the adjustments and the methodologies for determining revisions to the associated PCFM Variable Values are contained in Chapters 3 to 5 of this Handbook.

2.7 The Totex Incentive Mechanism (numbers 6 to 10 in Table 2.1) applies to any overspend or under spend by the licensee against its RIIO-T1 Totex expenditure allowances. An overview of the mechanism and the methodology for determining revisions to the associated PCFM Variable Values is contained in Chapter 6 of this Handbook.

2.8 Allowed Totex expenditure adjustments (numbers 11 to 23 in Table 2.1) cover a range of Totex adjustment schemes under which allowed expenditure can be adjusted under a specified formula or through an application and assessment process. The methodologies for determining revisions to the associated PCFM Variable Values are contained in Chapters 7 to 14 of this Handbook.

2.9 Legacy price control adjustments relate to activities which took place in the Price Control Period prior to RIIO-T1 but in respect of which a financial adjustment is required because:

- the outturn data for Relevant Year 2012/13 was not available when Opening Base Revenue Allowances for the Price Control Period were set;
- cost totals for items subject to true-up or logging-up were not available when Opening Base Revenues Allowances for the Price Control Period were set;
- it is possible for pre-RIIO-T1 expenditure allowances to be adjusted under the terms of a RIIO-T1 Special Condition; or
- there is an anomalous position, acknowledged by Ofgem and the licensee that needs to be corrected.

Processing of different types of PCFM Variable Value under the Annual Iteration Process

2.10 In general terms, the different types of variable value specified in Table 2.1 are processed under the Annual Iteration Process for the PCFM in the following ways:

<u>Allowed expenditure</u>

These amounts are modelled, subject to Totex Capitalisation Rates, as:

[4] For Scottish Power Transmission Ltd (SPTL) and SHE Transmission Plc (SHETPLC) see covering letter with licence consultation [Licence consultation letter]

(i) fast money – flowing directly to the recalculated base revenue figure for the Relevant Year to which the allowed expenditure relates; and

(ii) additions to the licensee's RAV in the Relevant Year to which the allowed expenditure relates, generating a slow money adjustment to allowed revenues through the allowed return and depreciation.

Revenue allowance

6. These amounts flow directly to the recalculated base revenue figure for the Relevant Year to which the adjustment circumstance relates (although there will also be ancillary financial effects under the modelling treatment).

Percentage

7. This type of variable value applies to the cost of corporate debt. As well as return, interest and tax calculations, corporate debt costs influence net present value calculations. Revised values for Relevant Year t will flow into calculations of the return on RAV.

Actual expenditure

8. This type of variable value applies to the Totex Incentive Mechanism only and revised values affect fast and slow money calculations for the Relevant Years concerned. These values will be obtained from the licensee's Regulatory Instructions and Guidance (RIGs) data tables relating to Relevant Year t-2. Since the RIGs data tables contain values in nominal prices, these will be deflated to a 2009-10 price base using published RPI data (as set out in paragraph 1.7), so that they are consistent with the 2009-10 price base used in the PCFM. The price base calculation will be made prior to direction into the PCFM.

True-up revenue allowance

9. These amounts will flow directly to the recalculated base revenue figure for Relevant Year 2013-14, because they relate to activity levels or outturn values for the Price Control Period prior to RIIO-T1 except for NGET where they will be spread over the RIIO-T1 period (on an NPV neutral basis).

True-up RAV additions

10. These additions to the licensee's RAV generate a slow money adjustment to allowed revenues through the cost of capital return and depreciation.

Consequential adjustments

2.11 During the Annual Iteration Process, appropriate automatic adjustments are also made as a consequence of revisions to PCFM Variable Values. For example, in some circumstances, as a result of automatic updates to the licensee's net debt and RAV figures under the Annual Iteration Process, updated equity issuance allowances could also be included in recalculated base revenue figures for the Relevant Years concerned.

A typical revision

2.12 The ET1 Price Control Financial Methodologies describe the normal timing sequence for each PCFM Variable Value. For example, in relation to the generation connections volume driver (item 19 in Table 2.1) the normal sequence would be:

- activity level takes place in Relevant Year t-2;
- activity level reported to Ofgem by 31 July in Relevant Year t-1;
- revised PCFM Variable Value used in Annual Iteration Process to take place by 30 November in Relevant Year t-1 or as soon as reasonably practical thereafter (the variable value in the column equating to Relevant Year t-2 on the PCFM Variable Values Table is the one which is revised, since that is when the activity level took place); and
- incremental change to recalculated revenue position for Relevant Year t-2 flows through to value of MOD_t ie it affects base revenue in Relevant Year t.

2.13 A number of the Special Conditions provide for PCFM Variable Values to be directed for Relevant Years outside the normal sequence. Where this is the case, the procedures are explained in the relevant methodologies in this Handbook.

Chapter 6 - Totex Incentive Mechanism – financial adjustment methodology

6.1 For RIIO-T1 Final Proposals Opening Base Revenue Allowances will have been modelled on the basis that actual Totex[5] expenditure levels are expected to equal allowed Totex expenditure levels (allowances). If actual (outturn) expenditure differs from allowances, for any Relevant Year during the Price Control Period, the Totex Incentive Mechanism (TIM) provides for an appropriate sharing of the incremental amount (whether an overspend or underspend) between consumers and licensees.

6.2 The ET1 Price Control Financial Model (PCFM) contains values for both actual Totex expenditure and allowed Totex expenditure levels which, as mentioned above, are initially equal to each other. Both the actual and allowed expenditure values contained in the PCFM can be varied for the purposes of applying the TIM through the Annual Iteration Process.

[5] See Glossary

Actual Totex expenditure

6.3 Actual Totex expenditure is divided into several sub-divisions to facilitate varying tax pool treatments under the Annual Iteration Process calculations. This Chapter sets out the process by which the actual Totex expenditure values in the PCFM can be revised. It also describes the way in which revised figures for Totex flow into the calculation of the terms MOD_t and $SOMOD_t$[6].

6.4 Special Conditions 6C (Determination of PCFM Variable Values for Totex Incentive Mechanism Adjustments – Transmission Owner) and 7B (Determination of PCFM Variable Values for Totex Incentive Mechanism Adjustments – System Operator) provide for the Authority to determine revised PCFM Variable Values for the licensee relating to actual Totex expenditure levels. They also set out the procedures for the direction of those values so that they can be used for the Annual Iteration Process.

Allowed Totex expenditure

6.5 The procedures for determining and directing revised PCFM Variable Values relating to allowed Totex expenditure levels are covered in the Chapters of this Handbook shown in Table 6.1 below:

Table 6.1 – Special Conditions with provisions to revise PCFM Variable Values relating to allowed Totex expenditure levels

Special Condition	PCFM Variable Value	Relating to	Handbook Chapter
6E	IRM	Innovation Roll-out allowed expenditure	12
6F	GCE	Baseline generation connection outputs and generation connections volume driver	10
6G	EPIE	Enhancement to Pre-existing Infrastructure	11
6H	IAEEPS	Enhanced Physical Site Security Costs	7
	IAEBT	BT 21st Century Costs (SHETPLC[7] only)	
	IAEWL	Wayleave compensation costs (SHETPLC only)	
	IAESSCM	Exceptional Subsea Cable Fault Costs (SHETPLC only)	

[6] For National Grid Electricity Transmission plc (NGET) only
[7] SHE Transmission plc

	IAEWR IAENLUM	Workforce renewal (SPTL only)[8] Non-load related work costs (SPTL only)	
6I	WWE	Wider Works allowed expenditure	8
6J	IWW	Network development policy and the Wider Works volume driver (NGET[9] only)	9
6K	UCE	Undergrounding uncertainty volume driver (NGET only)	13
6L	DRI	Demand related infrastructure volume driver (NGET only)	14
7D	SOIAEEPS SOEMRES	Enhanced Security Costs Electricity Market Reform Enduring Solution	7

Description of the Totex Incentive Mechanism

6.6 In the remainder of this Chapter, references to the term MOD should be taken to include SOMOD and references to Special Condition 6C should be taken to include Special Condition 7B.

6.7 The Totex Incentive Mechanism (TIM) applies adjustments to the Totex figure used in the fast/slow money modelling of recalculated base revenue figures under the Annual Iteration Process. The adjustments reflect the amount of under or over expenditure by the licensee against Totex allowances and the Totex Incentive Strength Rate (incentive strength) for each licensee. The incentive strength is a percentage figure specified in Special Condition 6C for each licensee. It represents the percentage that a licensee bears in respect of an overspend against allowances or retains in respect of an underspend against allowances. The adjustment that is made to the Totex figures is the Funding Adjustment Rate (often called the 'sharing factor') which is calculated as 1 – incentive strength. Applying the Funding Adjustment Rate to the over (or under spend) gives the amount that is added to (or subtracted from) the Totex allowances included in recalculated base revenues. Wherever the term "Totex Incentive Mechanism Adjustment" is used in the Special Conditions, it means an adjustment under the mechanism described in this paragraph.

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[8] SP Transmission Ltd
[9] National Grid Electricity Transmission plc

6.8 The TIM uses the actual Totex expenditure values reported to Ofgem by 31 July each year (subject to any revisions that may be required for corrections of data or for expenditure that is not regarded as efficient) and adjusts revenues in the following Relevant Year via the MOD term. The incentive mechanism therefore operates with a two year lag.

6.9 Totex, once ascertained under the TIM, is apportioned using the Totex Capitalisation Rate applicable to the licensee, as:

- fast money – flowing directly to the recalculated base revenue figure for the Relevant Year to which the allowed expenditure relates; and
- slow money - additions to the licensee's RAV in the Relevant Year to which the allowed expenditure relates; the return on RAV and depreciation flowing to the recalculated base revenue figure for the Relevant Year.

6.10 Totex Capitalisation Rates are specified at Appendix 1 to Special Conditions 6C and 7B and are hard coded into the PCFM as fixed input values for the licensee. The SO has its own Totex Capitalisation Rate.

6.11 Under the Annual Iteration Process, the effects of this modelling treatment, (including any ancillary effects in respect of eg tax allowances) are reflected in the value of the term MOD_t.

Totex Incentive Mechanism - illustrative examples

6.12 Basic, illustrative examples of the calculation approach are set out below:

Opening position:

allowed Totex expenditure:	100
assumed actual Totex expenditure:	100
over/underspend:	nil
Totex amount for fast/slow money treatment	100

Revised position – scenario 1:

allowed Totex expenditure:	110
actual Totex expenditure	90
underspend:	(20)
incentive strength say 40% (or 0.4)	
Totex adjustment (1 - 0.4) X (20)	(12)
Totex amount for fast/slow money treatment 110 – 12	98

Revised position – scenario 2:

allowed Totex expenditure:	110
actual Totex expenditure	120
overspend:	10
incentive strength say 40% (or 0.4)	
Totex adjustment (1 – 0.4) X 10	6
Totex amount for fast/slow money treatment 110 + 6	116

6.13 The reduced Totex amount for fast/slow money treatment in scenario 1 represents a clawback of part of the underspend achieved by the licensee to benefit consumers. The increased Totex amount for fast/slow money treatment in scenario 2 represents a reimbursement of part of the overspend incurred by the licensee.

Application of the TIM under the Annual Iteration Process

6.14 For the purposes of Special Condition 6C and this Chapter, "Relevant Year t" means the Relevant Year in which a value for the term MOD calculated through a particular Annual Iteration Process, is used in the formula for the licensee's Base Transmission Revenue[10].

6.15 The opening values for actual Totex expenditure contained in the PCFM will be revised to reflect outturn values (in 2009-10 prices) reported by the licensee in its annual cost reporting submission, subject to review by Ofgem. The normal revision cycle will be:

Relevant Year t-2:	Totex expenditure incurred;
Relevant Year t-1:	Outturn expenditure levels reported to Ofgem by 31 July;
Relevant Year t-1:	31 October – cut off date for making revisions (that may be required for corrections of data or for expenditure that is not regarded as efficient) to outturn expenditure levels to be taken account of in that year's Annual Iteration Process
Relevant Year t-1:	Revised PCFM Variable Values for actual Totex expenditure determined and directed by the Authority by 30 November;

[10] See Special Conditions 3A (Restriction of Transmission Network Revenue).

	[and, as applicable, revised PCFM Variable Values for categories of allowed Totex expenditure determined/directed – see relevant Handbook Chapters]
Relevant Year t-1:	Value for MOD_t directed by the Authority by 30 November;
Relevant Year t:	Value for MOD_t effective in formula for licensee's Base Transmission Revenue.

6.16 The Authority can determine and direct revised PCFM Variable Values for actual Totex expenditure for years earlier than Relevant Year t-2 for use in any Annual Iteration Process, but only where necessary to address a restatement of, or correction to, price control cost information submitted by the licensee.

6.17 Allowed Totex expenditure levels will be revised in accordance with the provisions of applicable scheme licence conditions and the associated methodologies in this Handbook. In instances where allowed Totex expenditure levels are revised for Relevant Year t-1 or later (in relation to the timeline set out in paragraph 6.15), the PCFM will automatically update expected actual Totex expenditure levels to equivalent amounts for those years. This is consistent with the modelling rationale described in the opening paragraph of this Chapter.

6.18 It should be noted that:

- each Annual Iteration Process re-runs the TIM calculations for each Relevant Year up to Relevant Year t-2 (for later years the TIM is neutral – see paragraph 6.17);
- the outstanding effect of those calculations is reflected in the value of MOD_t; and
- the PCFM works in constant 2009-10 prices, but applies adjustments to ensure that the effect of PCFM Variable Value revisions are NPV neutral with respect to Relevant Year t.

Total expenditure ("Totex")

6.19 In the following section the term 'Totex' refers to both TO Totex and SO Totex.

6.20 In summary Totex consists of all the items of expenditure required for the licensee to carry on the transmission business with the exception of:

- costs relating to de minimis activities;
- costs relating to excluded services activities (with the exception of capex relating to sole use exit connections);

- pension deficit repair payments relating to the Established Deficit and for the avoidance of doubt, all unfunded early retirement deficiency costs (ERDC) post 1 April 2004;
- Pension Scheme Administration and PPF levy costs;
- The non-cash element of current service pension costs charged to the income statement in accordance with accounting standards;
- costs associated with specific incentive schemes as detailed in the RIGs (eg TIRG);
- statutory or regulatory depreciation and amortisation;
- profit margins in payments to related parties (except where permitted);
- costs relating to rebranding a company's assets or vehicles following a change of trading name or logo;
- fines and penalties incurred by the licensee (including all tax penalties, fines and interest) except if, exceptionally, Traffic Management Act penalty costs can be shown to be efficient;
- compensation payments made in relation to standards of performance;
- bad debt costs and recoveries (which are subject to separate review);
- costs relating to the network innovation allowance;
- costs reported other than on a normal accruals basis;
- costs in relation to pass-through items including:
  - business rates (except for business rates on non-operational buildings), and
  - Ofgem licence fees;
- interest, other financing and corporation tax costs;
- other items of expenditure as detailed in the RIGs.

6.21 Further details on the reporting of expenditure items which are eligible for Totex treatment is given in the Cost and Revenue Reporting Regulatory Instructions and Guidance (RIGs) document referred to in Standard Condition B15 (Regulatory Instructions and Guidance) of the licence. The RIGs also detail other requirements for expenditure to be able to qualify as RAV additions.

6.22 It should also be noted that:

- any change in the Totex amount for the licensee under the TIM is included as an adjustment to fast/ slow money;
- pension deficit repair payments relating to any incremental deficit (ie not part of the Established Deficit) are considered to be part of the licensee's labour costs and as such are part of Totex; and

- customer contributions (which mainly relate to connection works) and other proceeds received (including from legal and insurance claims) that relate to the transmission business are treated as an offset to Totex expenditure, unless specifically subject to different treatment under the Cost and Revenue Reporting RIGs.

Determination of PCFM Variable Value revisions for actual Totex expenditure

6.23 Following a review by Ofgem, the Authority will, by 30 November (or as soon as reasonably practicable thereafter) in each Relevant Year t-1, determine that the PCFM Variable Values for Relevant Year t-2 (and prior RIIO-T1 years if necessary), shown in the first column of Table 6.2 below, should be revised to match the equivalent actual expenditure values in the licensee's annual cost reporting submission after any necessary adjustments.

6.24 As noted in paragraph 6.15, the Authority can also determine and direct revised PCFM Variable Values for actual Totex expenditure for years earlier than Relevant Year t-2 where that is necessary to address a restatement of, or correction to, price control cost information submitted by the licensee (including costs amended following any efficiency review by Ofgem).

Table 6.2 – PCFM Variable Values for actual Totex

PCFM Variable Value	Totex sub-division
ALC	Actual load related capex expenditure
ARC	Actual asset replacement capex expenditure
AOC	Actual other capex expenditure
ACO	Actual controllable opex expenditure
ANC	Actual non-operational capex
SOACO[11]	Actual controllable opex expenditure (system operator)
SOANC[44]	Actual non-operational capex expenditure (system operator)

6.25 The expenditure totals for each of the Totex sub-divisions set out in Table 6.2 will be ascertained from the cost and outputs reporting templates submitted by the licensee.

[11] NGET only

Notification and direction of revised PCFM Variable Values

6.26 The PCFM exists as a constituent part of Special Condition 5A (Governance of ET1 Price Control Financial Instruments). It has an input area for each licensee containing both fixed values and variable values. The values that can vary are contained in the PCFM Variable Values Table 6.1 for allowances and Table 6.2 for actual costs.

6.27 During each Relevant Year t-1, the Authority will determine whether any PCFM Variable Values for the licensee relating to actual Totex expenditure should be revised. Part C of Special Condition 6C (and 5B), requires the Authority to give the licensee at least 14 days notice of any such proposed revisions, to allow for any representations or objections. The Authority is required to have due regard to any representations received from the licensee and to give reasons for its decisions in relation to them.

6.28 The Authority is required to direct any PCFM Variable Value revisions by 30 November in Relevant Year t-1, so the notice of proposed values will be given no later than 15 November in the same year. In practice, the Authority will give notice of the proposed values as soon as practicably possible in Relevant Year t-1.

6.29 The Authority will carry out the Annual Iteration Process in accordance with Special Condition 5B (see Chapter 1).

Chapter 7 - Uncertain costs allowed expenditure – financial adjustment methodology

Part 1 - Overview

7.1 Appropriate levels of allowed Totex[12] expenditure for some transmission business activities/requirements, were uncertain at the time of the RIIO-T1 Final Proposals. For RIIO-T1 Final Proposals, Opening Base Revenue Allowances have been modelled using forecast values relating to these uncertain cost categories.

7.2 The ET1 Price Control Financial Model (PCFM) contains values relating to allowed Totex expenditure on uncertain cost categories that can be varied for the purposes of the Annual Iteration Process. This means that the term MOD_t included in the formula for the licensee's Base Transmission Revenue (and the term $SOMOD_t$ included in the formula for internal costs revenue) can take account of up to date allowed expenditure levels for uncertain cost categories for the purposes of the Totex Incentive Mechanism described in Chapter 6 of this Handbook.

[12] See Glossary

7.3 PCFM Variable Values relating to uncertain cost categories are stated in constant 2009-10 prices, consistent with the price base used in the PCFM and the values for the terms MOD and SOMOD. The allocation of allowed expenditure for uncertain cost categories into the Totex sub-divisions referred to in paragraph 6.3 of Chapter 6 is handled automatically under the Annual Iteration Process using fixed attribution rates contained in the PCFM.

7.4 Special Conditions 6H (Arrangements for the recovery of uncertain costs) and 7D (Arrangements for the recovery of SO uncertain costs)[13] provide for the Authority to determine relevant adjustments to allowed Totex expenditure on uncertain cost categories following a proposal made either by the licensee or the Authority.

7.5 Special Conditions 6H and 7D also provide for the Authority to determine revised PCFM Variable Values for uncertain costs categories in accordance with the methodology set out in this Chapter to give effect to adjustments which have been determined. They also set out the procedures for the direction of revised PCFM Variable Values so that they can be used for the Annual Iteration Process.

7.6 The uncertain cost categories are set out in Table 7.1 below, alongside the applicable licence condition. Table 7.1 also shows the licensee(s) to whom each uncertain cost category applies and the name of the associated PCFM Variable Value.

Table 7.1 – Uncertain cost categories

Uncertain cost	Licence Condition	Licensees affected	PCFM Variable Value name
Enhanced Physical Site Security Transmission Owner	6H	All	IAEEPS
Enhanced Security Costs - System Operator	7D	NGET	SOIAEEPS
BT® 21st Century Related Costs	6H	SHETPLC	IAEBT
Compensation Costs for Landowners for Wayleave	6H	SHETPLC	IAEWL
Exceptional Subsea Cable Fault Costs	6H	SHETPLC	IAESSCM
Work Force Renewal	6H	SPTL	IAEWR

[13] For National Grid Electricity Transmission plc (NGET) only

Non-load related work costs	6H	SPTL	IAENLUM
Electricity Market Reform Enduring Solution	7D	NGET	SOEMRES

Overview of uncertain cost categories

7.7 Special Conditions 6H and 7D specify that any proposal for a relevant adjustment to an uncertain cost category must:

- be based on information about actual or expected costs that was not available when the licensee's Opening Base Revenue Allowances were calculated;
- take account of any prior relevant adjustments;
- relate to a material amount;
- relate to costs incurred or expected to be incurred after 1 April 2013; and
- constitute an adjustment that cannot be made under the provisions of any other Special Condition of the licence.

7.8 The stipulation that proposals must take account of any prior relevant adjustments is intended to ensure that relevant costs are not ignored on the one hand, or double counted on the other.

Enhanced Physical Site Security – Transmission Owner

7.9 This category means the costs incurred, or expected to be incurred, by the licensee for the purposes of implementing any formal recommendation or requirement of the Secretary of State to enhance the physical security of any of the sites within the licensee's Transmission System.

Enhanced Security Costs - System Operator

7.10 This category is applicable to National Grid Electricity Transmission plc (NGET) only and means the costs incurred, or expected to be incurred, by the licensee for the purposes of implementing any formal recommendation or requirement of the Secretary of State to enhance the security of any of the IT systems required to operate the licensee's Transmission System.

BT® 21st Century Related Costs

7.11 This category is applicable to SHETPLC only. It means the costs incurred, or expected to be incurred, by the licensee for upgrading operational telecommunication systems resulting from the introduction of BT's 21st Century Networks programme, or such other BT Next Generation Network programme intended to have similar effect.

Compensation Costs for Landowners for Wayleave

7.12 This category is applicable to SHETPLC only. It means the costs incurred, or expected to be incurred, by the licensee in relation to the payment of reasonable claims to the parties to Wayleave Agreements and/or Deeds of Servitude held by the licensee, where such costs are reasonably incurred under the terms of Wayleave Agreements and/or Deeds of Servitude and which were not reasonably foreseen at the time of agreeing the relevant Wayleave Agreement or Deed of Servitude.

Exceptional SubSea Cable Fault Costs

7.13 This category is applicable to SHETPLC only. It means the costs incurred, or to be incurred by the licensee for the purposes of repairing exceptional faults that have been caused by third party or by environmental damage of subsea cables within the licensee's Transmission System, where these costs cannot be recovered from elsewhere.

Work Force Renewal Costs

7.14 This category is applicable to SPTL only. It means the costs incurred, or expected to be incurred, by the licensee in recruitment and training to ensure a sustainable work force that are not included in allowed Totex or recoverable through another Special Condition.

Non-load related work costs

7.15 This category is applicable to SPTL only. It means the costs incurred, or to be incurred by the licensee for the purposes of completing non-load related works that form part of the licensee's Transmission System that are triggered by the commencement or coordination of works to deliver a relevant wider works project.

Electricity Market Reform Enduring Solution

7.16 This category is applicable to National Grid Electricity Transmission plc (NGET) only and means the costs incurred, or expected to be incurred, by the licensee for the purposes of delivering the Electricity Market Reform delivery body function as set out in relevant legislation.

Temporal conventions

~~7.16~~ 7.17 For the purposes of Special Conditions 6H, 7D and this Chapter, "Relevant Year t" means the Relevant Year in which a value for the term MOD, calculated through a particular Annual Iteration Process[14], is used in the formula for the licensee's Base Transmission Revenue[15]. References to Relevant Year t-1 etc should be construed accordingly.

~~7.17~~ 7.18 A reference to, for example, *the IAEEPS value for 2015-16* means the IAEEPS value in the 2015-16 column of the PCFM Variable Values Table for the licensee contained in the ET1 Price Control Financial Model.

~~7.18~~ 7.19 Where revisions to PCFM Variable Values are directed for Relevant Years earlier than Relevant Year t, the effect of using those revised values in the Annual Iteration Process for the ET1 Price Control Financial Model will, subject to a Time Value of Money Adjustment, be reflected in the calculation of the term MOD, or as applicable, SOMOD for Relevant Year t and, for the avoidance of doubt no previously directed value of the term MOD or SOMOD will be retrospectively affected.

~~7.19~~ 7.20 Revisions to PCFM Variable Values directed for Relevant Years later than Relevant Year t do not feed into the calculation of the term MOD_t (or $SOMOD_t$) but (subject to further determinations) have status as values determined under the provisions of Special Condition 6H or, as applicable, 7D.

Part 2 - Determination of PCFM Variable Value revisions for uncertain cost categories

~~7.20~~ 7.21 In the remainder of this Chapter, references to the term MOD should be taken to include the term SOMOD and references to Special Condition 6H should be taken to include Special Condition 7D, with respect to NGET.

Determinations in relation to proposed adjustments – Enhanced Security Costs only

~~7.21~~ 7.22 Proposals for relevant adjustments in Enhanced Security Costs ~~respect of uncertain cost categories~~ can only be made by the licensee or the Authority specified in Special Condition 6H. Proposals must be made in the form of notices given by the licensee to the Authority or vice versa.

~~7.22~~ 7.23 Following the end of each application window the Authority has four months to confirm, reject or vary the proposed adjustment in a determination decision. In reaching that decision the Authority will:

- consult with the licensee concerned and other interested parties;

[14] and/or SOMOD for NGET

[15] See Special Condition 3A (Restriction of Transmission Network Revenue).

- have particular regard to the purposes of the licence condition; and
- take no account of the general financial performance of the licensee under the price control arrangements.

~~7.23~~ 7.24 If the Authority does not make a determination decision in relation to a duly submitted adjustment proposal within the four month period referred to in paragraph ~~7.22~~ 7.23, then the adjustment is deemed to have been made.

Determinations in relation to proposed adjustments – Electricity Market Reform Enduring Solutions

7.25 Proposals in respect of Electricity Market Reform Enduring Solution can be made by the Authority only, at any time, and will be directed by 30 November following the assessment periods of review, which involve the direction of an initial set of determinations and a subsequent revised set.

Determination of PCFM Variable Values – Enhanced Security Costs and Electricity Market Reform Enduring Solution

~~7.24~~ 7.26 It follows from the timetable outlined in paragraphs 7.~~21~~22 to 7.~~23~~26 above that the Authority will only determine revised PCFM Variable Values relating to uncertain cost categories (as set out in Table 7.1) for use in the Annual Iteration Processes in the year in which an application window arises. For Electricity Market Reform Enduring Solution revised PCFM Variable Values determined by the Authority will be directed by 30 November following the assessment periods of review.

7.27 The Annual Iteration Process will take place by 30 November, eg following the first reopener window in May 2015 the Annual Iteration Process will take place by 30 November 2015 in order to calculate the value of the terms MODt and SOMODt for Relevant Year 2016-17.

~~7.25~~ 7.28 It should be noted that the determination can amend PCFM Variable Values for any years in the RIIO-T1 period.

~~7.26~~ 7.29 The following procedures will be carried out by the responsible Ofgem team to facilitate the determination of any revised PCFM Variable Values relating to uncertain cost categories for the Annual Iteration Processes referred to in ~~paragraph 7.24~~ paragraphs 7.26 and 7.27:

- following receipt of a notice proposing an adjustment, liaison will be maintained with the Ofgem team responsible for the review of proposed adjustments and any determination made by the Authority will be noted;
- on or shortly after 1 June, a check will be made on whether any relevant adjustments were proposed during the application window which has just closed and the position noted;

- liaison will be maintained with the Ofgem team responsible for the review of proposed adjustments and any determination made by the Authority will be noted;
- on or shortly after 1 October the aggregate net adjustment (whether upward or downward) for the licensee in respect of each uncertain cost category will be ascertained by totalling the amounts of:
  - any determinations of relevant adjustments made by the Authority;
  - any adjustments duly proposed by the licensee, and not withdrawn, which have not been determined by the Authority; and
- each aggregate net adjustment will be rebased to the 2009-10 price base used in the PCFM in accordance with paragraph 1.7 of this Handbook.

~~7.27~~ 7.30 Each aggregate net adjustment ascertained under paragraph 7.~~26~~ 29 will be added to the equivalent pre-existing PCFM Variable Value contained in the PCFM for the licensee and the resulting figure will be determined by the Authority to be the revised PCFM Variable Value for that uncertain costs category.

~~7.28~~ 7.31 For the avoidance of doubt, under the procedures outlined in paragraphs 7.~~21~~22 and 7.~~22~~23 the Authority can determine a revision to the PCFM Variable Value relating to an uncertain cost category for any Relevant Year during the Price Control Period, where that is necessary to reflect the determination (or deeming) of a relevant adjustment in respect of that uncertain cost category.

Part 3 - Notification and direction of revised PCFM Variable Values

~~7.29~~ 7.32 Special Condition 6H provides for the licensee to be notified of any relevant adjustment determinations within 14 days of the making of the determination. However, consistent with the provisions of other Special Conditions providing for the determination of PCFM Variable Values, there is an additional formal procedure for the notification and direction of revised PCFM Variable Values, set out in Part C of Special Condition 6H.

~~7.30~~ 7.33 The Authority will give notice of the PCFM Variable Value revisions that it proposes to direct by 15 November, being at least 14 days before the deadline date for the direction of revised PCFM Variable Values which is 30 November. The notice will confirm that:

- any revised PCFM Variable Value determinations have been made in accordance with Part B of Special Condition 6H, which cross refers to this Chapter of the ET1 Price Control Financial Handbook; and
- the licensee has 14 days from the date of the notice in which to make any representations concerning the proposed PCFM Variable Value revisions.

~~7.31~~ 7.34 The Authority is required to have due regard to any representations or objections made by the licensee and to give its reasons for any decisions in relation to them.

~~7.32~~ 7.35 Further to paragraph ~~7.24~~ 7.26, the Authority will not determine PCFM Variable Value revisions for uncertain cost categories by November in years in which ~~there is no application window~~ no proposal has been duly made by the licensee or the Authority. However, the overall direction issued in those years will include a facsimile of the PCFM Variable Values Table(s) for the licensee showing the post direction state of all PCFM Variable Values. This will serve to confirm the state of the PCFM Variable Values relating to uncertain cost categories.

Delay in direction of revised PCFM Variable Values

~~7.33~~ 7.36 If the procedures set out in Special Condition 6H and in Parts 2 and 3 of this Chapter call for the Authority to direct revised PCFM Variable Values for uncertain cost categories by 30 November and if the Authority does not make such a direction, then Special Condition 6H requires that the values should be directed by the Authority as soon as is reasonably practicable to facilitate the notification and direction of the value of the term MOD_t under Special Condition 5B (Annual Iteration Process for the ET1 Price Control Financial Model).

Appendix 4 – Feedback Questionnaire

1.1. We believe that consultation is at the heart of good policy development. We will consider any comments or complaints about how this consultation has been conducted. We are also keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand? Could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments.

1.2. Please send your comments to:

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