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National Grid Electricity
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interested parties

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Date: 13 June 2014

Dear colleague,

Decision on Incentives for National Grid Electricity Transmission's (NGET) Role in Electricity Market Reform (EMR) and Statutory Consultation on Proposed Licence Modifications to NGET's Special Conditions

Summary of Decision

- Recognising how crucial the outputs that NGET will deliver during the first 20 months of EMR are, we intend to financially incentivise NGET. We have modified the incentives we proposed in April following consultation and our improved understanding of NGET's role in EMR.
- We are also setting out the strong reputational incentives we have decided on in this letter.
- We are also launching a statutory consultation on our decision to modify special licence condition to introduce the financial incentives.

Background

EMR aims to incentivise investment in secure, low-carbon electricity generation, while improving affordability for consumers. Although the necessary legislation has not yet been passed, DECC's intention is that NGET will be appointed as the EMR Delivery Body from August this year.

In our April consultation[1], we set out how we would assess NGET's allowances, outputs and incentives required to deliver its roles under EMR from August 2014 to March 2021. These would be implemented using the RIIO price control model. We proposed to:

1. Make provisional allowances of £5m for the first 20 months of operation – August 2014 to March 2016, provided NGET meets the timetable for submitting its full EMR business plan.
2. Financially incentivise NGET to deliver effectively and deal with disputes in its first 20 months of operation. This is in addition to a reputational incentive.
3. Show how NGET should prepare a well-justified business plan for EMR delivery and how we would treat the costs under RIIO-T1. We suggested that NGET should submit three scenarios within its plan to cater for the uncertainties of planning for a new role.

[1] https://www.ofgem.gov.uk/publications-and-updates/strategy-consultation-revenue-incentives-and-outputs-national-grids-role-electricity-market-reform

4. Show changes in the licence and Financial Handbook so NGET can recover EMR delivery body costs from customers.
5. Show changes in the licence so that suitable performance incentives are in place when NGET carries out its role as EMR Delivery Body.

We summarise our decision in relation to incentives (points 2 and 5 above) in this letter. A separate decision letter will be published in relation to the other issues (points 1, 3 and 4) set out above. A summary of the consultation responses, in relation to the question we asked on incentives, is included in Appendix 1.

Today we also publish a statutory licence consultation notice alongside this decision letter that proposes to modify Special Conditions 4L (EMR Dispute Resolution Incentive) and 4A (Restriction of System Operator Internal Revenue). This provides financial incentives for NGET in resolving disputes effectively.

If we decide to proceed with the licence modification, it will take effect not less than 56 days after the date of our decision.

The decisions in this letter are subject to NGET being formally granted the delivery role by secondary legislation in August 2014. If, for any reason, the legislation is delayed or NGET is not given the role, these decisions will need to be reviewed.

Our Decision

These are the decisions we reached, after we considered all the consultation responses.

Financial and reputational incentives for the first 20 months of EMR delivery

Based on the responses to the consultation we have decided that the proposed financial and reputational incentives are appropriate. We are making some adjustments to our initial proposals to reflect the fact that EMR policy has been further clarified during the consultation period. This means that we have a better understanding of when disputes (which will drive incentives) are likely to arise.

Two respondents agreed with our proposed incentives. Three respondents raised specific points on the financial and the reputational incentives. Our decision and our responses to the consultation responses are outlined below.

Financial incentives

In our April consultation we proposed an incentive of £175k each financial year, split between four separate financial incentives. Two respondents raised concerns about the value of the incentives. One respondent felt that they appear 'overly generous'. Another respondent proposed that they should be increased to £200k.

We have considered these responses in light of the better understanding we now have of EMR disputes (which are the driver of incentives) as the EMR legislation is now closer to its final form. It seems unlikely that there will be any termination decisions in the first 20 months of EMR. As such, it is also unlikely there will be any disputes on termination decisions. We have concluded that incentivising an activity that is unlikely to take place is not appropriate and may put consumer's money at risk. Therefore, while noting that EMR is an untested area of policy, we are not including the incentive for termination disputes. We are now only proposing incentives on Capacity Market and Contract for Difference qualification decisions, and Capacity Agreement Notice and Capacity Market Register decisions. In total this amounts to an incentive of £125k for each of the two financial years, split between three separate financial incentives (see Table 1).

One respondent stated that the incentives were skewed towards the upside and would be better combined into a single incentive. In their view this would also address the potential

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they saw for a distortionary impact of 'large step changes' in the incentive payments on performance. We did consider a single combined incentive, and are still of the view that separate incentives are more appropriate. A combined incentive, unless it offered upside for some incorrect decisions which we think is inappropriate, would have a large step change.

One respondent proposed introducing an upside incentive for one Tier 1 dispute being overturned and introducing a neutral incentive (£0) for two overturned decisions at Tier 1 to 'reflect the untested nature of the EMR regime.' Our original proposal – that offering upside for wrong decisions sends the wrong message – is, for these provisional incentives, we think still appropriate. So we have decided not to introduce a further upside incentive for one overturned decision and instead reflect the untested nature of the EMR regime by ensuring the incentives we propose are proportionate.

Table 1 - Financial incentives for NGET to deliver effectively and deal with disputes in its first 20 months of operation

Number of overturned decisions	CfD Qualification Decisions in £',000s	CM Qualification Decisions in £',000s	CAN and CMR Decisions in £',000s
No overturned decisions	50	50	25
1 overturned decision	0	0	0
2 overturned decisions	-10	-10	-5
3 overturned decisions	-20	-20	-10
4 overturned decisions	-30	-30	-15
5 overturned decisions	-40	-40	-20
6 or more overturned decisions	-50	-50	-25

Reputational incentives

Reputational incentives are expected to play an important part in incentivising NGET to perform its role as the EMR delivery body efficiently and effectively. EMR is a high profile government policy and NGET are playing a key role in delivering that policy. Given this, and taking into account responses to the consultation, we have set out below further details on the reputational incentive. We will concentrate on the following areas at this stage:

(i) Reporting annually on NGET's EMR performance

We will publish an annual report showing how well NGET has performed its EMR delivery functions. We will outline where NGET has met, exceeded, or fallen short of its functions and, where appropriate, provide assessments in relation to key performance indicators. We expect that this will include reporting on activities such as:

- timely publication of any relevant auction documentation,
- timely notification of the pre-qualification outcome,
- report on timeliness and running of auction,

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- the number of decisions that were disputed and, of these, the number over turned at each of the three tiers of dispute, and
- timeliness of dealing with applications, Tier 1 disputes and other tasks.

We note here that it is important for NGET's reputation that it can demonstrate that it has robust planning and execution of key processes in place as would be expected of a well performing delivery body.

(ii) Enforcement

If NGET fails to deliver its obligations as set out in the legislation, we will consider publishing our concerns and steps we take in response, including potential enforcement action according to Ofgem's enforcement guidelines[2], in addition to any financial incentive penalties or other appropriate measures.

As the annual report is a yearly publication, we may consider other ways of drawing attention to NGET's performance at other points during the year.

Incentives for the enduring regime

We have decided that it is appropriate not to delay the setting of enduring incentives for one to two years (as suggested by one respondent). Given the significance of EMR, it is important, and in the interest of the consumer, that NGET's performance as EMR delivery body is incentivised as soon as is reasonably possible. This is in line with our approach with the RIIO regulatory framework.

Please send your responses to the statutory licence notice consultation to sujitra.krishnanandan@ofgem.gov.uk by 14 July 2014.

If you have any questions, please email Sujitra Krishnanandan at the address above or call on 020 3263 9832.

Yours faithfully,

Rachel Fletcher
Senior Partner, Markets
Duly authorised on behalf of the Gas and Electricity Markets Authority

[2] We have recently consulted on the proposed changes for the enforcement guidelines, and we expect the final version will be published later this year https://www.ofgem.gov.uk/publications-and-updates/consultation-ofgems-draft-enforcement-guidelines . In the meantime, the guidelines apply https://www.ofgem.gov.uk/ofgem-publications/37567/enforcement-guidelines-2012.pdfc

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Appendix 1 – Responses to the Consultation

We received five responses to the consultation, which have been summarised below. Some respondents did not comment on some questions.

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

Two respondents agreed with the proposed incentives. One respondent agreed in principle with the financial incentives but is not fully persuaded by the reputational incentives. One respondent raised concerns about the value of the incentives being too generous and the structure of the incentives; the respondent proposes that all deliverables should be incentivised as a whole. One respondent agreed with the incentives but proposes (i) to increase the cap and a structural change to make the up- and downside incentives more symmetrical. The respondent proposes to introduce an upside payment for one overturned decision at Tier 1 (previously £0), a neutral payment (£0) for two overturned decisions at Tier 1 and capping the number of overturned decisions to four instead of six.

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