

Martin Rodgers
Senior Manager
Cost and Outputs, Transmission
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Mark Ripley
Project Director, Electricity Market
Reform

mark.g.ripley@nationalgrid.com

Direct: +44 (0) 1926 65 4928

Mobile: 07768 106 952

www.nationalgrid.com

20th May 2014

Dear Martin

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

I am writing in response to the above consultation published by Ofgem on 17th April 2014. This response is written on behalf of National Grid Electricity Transmission plc (NGET).

NGET is the national system operator and was also designated by Government as the EMR delivery body in December 2011, a role that will be formally conferred on NGET by the Secretary of State pursuant to secondary legislation to be made under the Energy Act 2013.

Now that the Authority has directed the licence changes that will allow us to begin to recover the costs that we have incurred to date in preparing to take on the EMR delivery body role, we welcome the opportunity to respond to this consultation which focuses on EMR delivery body enduring costs and potential initial incentives.

Below we respond in turn to each of the eight questions that are posed in the consultation document. Should you wish to discuss any aspect of this response further with NGET then we would be happy to do so.

Yours sincerely



Mark Ripley
Project Director, Electricity Market Reform

NGET responses to the specific questions raised in the consultation

Provisional Allowances

Q1: Do you agree that we should allow NGET provisional funding subject to the receipt of a well justified business plan?

We do not agree that the allowance of provisional EMR funding should be subject to the receipt of the EMR well justified business plan. Whilst we recognise the need to submit a well justified business plan in respect of the EMR delivery body functions in due course, this plan will inform the final allowances that will be directed in November 2015 and be recovered from April 2016 and not the provisional allowances.

The provisional allowances are informed by and should be based on the provisional costs submission that National Grid provided to Ofgem on 7 March 2014. There is no suggestion in the consultation that the business plan will be used to adjust the provisional allowances to be directed in November 2014 (although it may be used to “confirm” those allowances). Rather, the business plan will, as acknowledged by paragraph 4.7, provide an opportunity to update the original forecast for the first 20 month period and will inform the final allowances.

Whilst we therefore understand and accept the need for the submission of a well justified business plan in due course we do not agree that the provision of provisional funding (which is evidenced by a separate submission) should be subject to the receipt of the plan. Enduring allowances (which will also revisit and replace provisional allowances) should be subject to the receipt of the plan.

Q2: 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?

For the reasons stated above we do not believe that provisional allowances in respect of the first 20 months of operation are dependent on the submission of a business plan and therefore do not agree that an adjustment in respect of the time value of money should be withheld if the currently proposed plan submission date is not met.

Provisional allowances (including any return to reflect the time value of money) are not, unlike the final allowances, dependent on and informed by the business plan. It is therefore wholly unreasonable to seek to link one to the other and so impose an inappropriate incentive in relation to the delivery of the business plan in order to seek to achieve adherence to timetable requirements.

In any event, we do not believe that it is appropriate to require submission of the full EMR business plan by 30 September 2014 as this will not provide sufficient time after the anticipated EMR Go Live date (1 August 2014) to inform the detail of the plan and the associated scenarios given that many of the key outputs and deliverables (briefly

summarised in Table 2 in the consultation) will not be completed until December 2014 or January 2015. We touch on this further in response to Question 5 below.

Q3: Do you agree that the £5m proposed cost allowance is reasonable?

We do not believe that the £5m proposed cost allowance is reasonable. The proposal to give an allowance of £5m rather than £7m evidenced in our submission is entirely arbitrary and, given that it is unjustified (the consultation merely states that it “seems a reasonable figure for provisional allowances”), the proposal is wholly unreasonable.

As requested by Ofgem, on 7 March 2014 National Grid submitted to Ofgem a breakdown of its anticipated costs associated with its EMR delivery body functions in respect of the period from August 2014 to March 2016. This submission detailed the EMR delivery body outputs (summarised in Table 2 of the consultation) to which the costs related and provided a detailed cost spreadsheet, cost and resource assumptions and associated structure charts. Since that submission we have had no dialogue with Ofgem in relation to the submitted forecast costs and Ofgem has not challenged either the cost figures submitted or the underlying assumptions.

The consultation cites particular uncertainty in relation to IS costs. The IS costs that were included in our 7 March submission were fully justified and relate to the known IS costs associated with auction support and auction services required in the period in question.

Whilst we recognise that there is inevitably a degree of uncertainty around certain categories of the forecast costs given that the EMR Delivery Body role is a new function and certain activities will be driven by and depend on currently unknown volumes of applicants, our forecast costs and underlying assumptions have been evidenced to Ofgem without challenge. Accordingly it is wholly inappropriate and unreasonable for Ofgem to apply an arbitrary 30% discount to our submitted forecast in the absence of any evidence to support such a discount.

Given that the provisional allowances will be replaced by final allowances (as evidenced by the EMR business plan) in November 2015 which will be recoverable from April 2016, we see no reason for setting the provisional allowances at a level other than our submitted cost forecast of £7m in the absence of any evidence that such a forecast is unreasonable. Given the uncertainties that currently surround EMR costs this forecast represents a reasonable estimate of National Grid’s expenditure in relation to the EMR delivery body functions during the first 20 months of operation. As the provisional allowances will subsequently be replaced by final allowances in November 2015, consumers will be afforded a mechanism to ensure that they are protected from any exposure to inappropriate costs.

Provisional Outputs and Incentives

Q4: Do you agree with the incentives we are proposing?

EMR is a key government policy and, as a consequence, National Grid’s role as the EMR delivery body brings with it strong reputational incentives to ensure that the regime is

delivered fully in accordance with the requirements of the regulatory framework that governs EMR.

We understand that any initial financial incentives must recognise that EMR is an as yet untested regime with the result that National Grid and consumer exposure to additional costs should be limited. Given this position we welcome the intention to bring forward certain financial incentives from the outset of EMR and we believe that using the driver of Tier 1 decisions overturned by the Authority at Tier 2 represents a reasonable starting point given that the disputes resolution procedure is well defined. Financial incentives in this context will further sharpen the reputational incentives that already apply in respect of the delivery body's role in considering redeterminations.

Paragraph 3.9 states that the proposed financial incentives are proportionate to EMR provisional revenues. As proposed, the maximum potential upside and downside of the incentives is £175k, being approximately 3.5% of the proposed provisional allowance of £5m referred to in paragraph 2.10. Given the points that we make above in relation to the proposed provisional allowances, we believe that increasing the potential upside and downside of the incentives to a figure closer to £200k is appropriate. Such a figure represents approximately 3% of £7m which we believe represents the more reasonable and justified provisional allowance.

We also believe that, given the untested nature of the EMR regime and the unknown volumes of disputes that may be brought in relation to delivery body decisions at Tier 1, a more symmetrical upside and downside to the incentive regime is appropriate. Such an approach would allow for some upside incentive if one decision was overturned at Tier 2 but would also mean that the capped downside would be reached more quickly if there were multiple Tier 1 decisions overturned at Tier 2. We do not believe that such an approach would incentivise behaviour that does not go beyond the good performance that Ofgem expect of National Grid but, rather, recognises the untested nature of the EMR regime and the unknown volume of potential Tier 1 and Tier 2 disputes.

Taking our proposals as set out above, Table 3 in the consultation document which summarises the incentive regime would look like this:

Driver	CM prequalification	CfD eligibility	CM termination	CAN and CAR
No Tier 2 overturn	+£60,000	+£60,000	+£60,000	+£25,000
1 Tier 2 overturn	+£30,000	+£30,000	+£30,000	+£12,500
2 Tier 2 overturns	£0	£0	£0	£0
3 Tier 2 overturns	-£30,000	-£30,000	-£30,000	-£12,500
4 Tier 2 overturns	-£60,000	-£60,000	-£60,000	-£25,000

Business Plan and Assessment

Q5: Do you agree with our proportionate approach to the assessment of the business plan including provision of different scenarios?

We agree that it is reasonable to adopt the same process for assessing our business plan in respect of the EMR delivery body functions as was used by Ofgem in the RIIO-T1 price control process but in a manner that is proportionate to the smaller costs that are naturally associated with the EMR delivery body functions.

However, as stated above, we do not agree that it is appropriate to require the submission of the business plan by 30 September 2014. Submitting a plan at this time, just two months after EMR has gone live, will not provide sufficient time to inform the detail of the plan and the associated scenarios given that many of the key outputs and deliverables (briefly summarised in Table 2 in the consultation) will not be completed until December 2014 or January 2015. Two months gives us insufficient time to understand the challenges and opportunities that the EMR delivery body role presents and so inform the plan and the high, low and best scenarios that are discussed in the consultation.

We do not accept that submission of the plan by 30 September is required in order to enable Ofgem to confirm the provisional level of funding for November 2014. This level of funding can be set now based upon the evidence that National Grid has already provided given that the intended process is to correct and update these allowances in November 2015.

Delaying the requirement to submit a business plan in order to allow sufficient time to ensure that it is robust and informed by experience of EMR in operation, whilst also allowing sufficient time for appropriate consultation ahead of the associated PCFM direction in November 2015, represents the most economic and efficient way to proceed.

Paragraph 3.16 of the consultation document also envisages that the business plan should contain proposals in respect of enduring incentives which may include proposals for incentives based on stakeholder feedback. Providing a plan two months after EMR go live will not afford sufficient time for National Grid and other industry participants to experience EMR, establish where incentives would add value to consumers and stakeholders, develop incentives and propose them in a plan. We suggest that a “reopener” to propose additional incentives 1-2 years later in the RIIO –T1 mid period review represents a better option for implementing enduring incentives.

Q6: Do you agree that the capitalisation rate for internal SO costs should also apply to EMR enduring costs?

We believe that this proposal, as set out in paragraph 4.14 of the consultation document, is reasonable.

Licence Changes

Q7: Do you agree with the proposed licence changes?

We have the following comments on the proposed licence changes:

In Special Condition 7D.3(b) the term “Electricity Market Reform Enduring Solution” needs to be defined in Special Condition 1A (in the same way that “Enhanced Security Costs” is). We suggest a definition along the following lines:

“Electricity Market Reform Enduring Solution – for the purposes of Special Condition 7D (Arrangements for the recovery of SO uncertain costs) means costs incurred, or expected to be incurred, by the licensee for the purposes of delivering the EMR Functions (as defined in Chapter 5 of Part 2 of the Energy Act 2013*)”

*“EMR Functions” has been defined in this manner in Part E of Special Condition 4A (Restriction of SO Internal Revenue) in respect of EMR preparation costs and will be similarly defined in standard condition A1 of the NGET licence (via special condition 1C) as part of the suite of EMR consequential licence changes to be directed by the Secretary of State under the Energy Act 2013. The words in brackets could therefore be retained for clarity or reliance could be placed on the definition to be introduced into standard condition A1 of the NGET, depending on the timing of those changes.

The drafting of Special Condition 7D.7 is not clear and the condition would benefit from further modification in order to clarify the following points:

- that the adjustments are to Allowed Expenditure;
- in what years the adjustments will be directed by the Authority. We presume that this is by 30 November 2014 in relation to the provisional EMR allowances and 30 November 2015 in relation to the enduring EMR funding level but it would be helpful if this could be clarified on the face of the licence;
- what are the “assessment periods of review”. These concepts should be defined in the licence condition; and
- what is meant by the “initial set of determinations and a subsequent revised set” and how these relate to the 30 November directions referred to above.

Special Condition 7D.6 sets out a mechanism as to how adjustments in respect of enhanced security costs can be proposed. There is no such mechanism in respect of EMR adjustments (despite the heading of the section) so it is not clear how the adjustments that are contemplated in 7D.7 and 7D.13 are proposed in the first place. The licence drafting should be clarified to address this.

Special Condition 7D.13 also needs further clarification in order to reflect the issues raised above in relation to 7D.7. In particular to confirm:

- that variable values will be applied to Allowed Expenditure; and
- in what years the adjustments will be directed by the Authority.

Special Condition 7D.15 should apply to a direction made under 7D.13 in relation to EMR adjustments as well as 7D.14. Add “ 7D.13 or” in front of “7D.14” in line 1.

In Special Condition 7D.17, the words “under paragraph 7D.14” should be added after “adjustment” in line 2.

In relation to Special Condition 7D.25, please see our comments above in relation to 7D.7. The drafting should clarify in which years the directions will be given and relies on the term “assessment period of review” being defined within the condition.

In Special Condition 7D.26 the words “or 7D.25” should be added after “7D.24” in line 1. The Authority should give notice to the licensee of the revised values that it proposes to direct in relation to EMR. Furthermore, 7.D.25 is subject to paragraph 7D.28 which in turn relies on a direction having been given under paragraph 7D.26.

Special Condition 7D.29 should apply to a direction under paragraph 7D.25 as well as D.24. Add “or 7D.25” after “7D.24” in line 2.

Q8: Do you agree with the proposed Financial Handbook and PCFM changes?

We have the following comments on the proposed Financial Handbook and PCFM changes:

In paragraph 2.8, the reference to “23” in line 1 should refer to “24” in order to capture the new SOEMRES term in Table 2.1.

Paragraph 6.20 (exceptions from totex) needs to include reference to the licensee’s EMR preparatory costs which are the subject of the section 11A direction dated 9 May 2014 (ie SOEMR as adjusted by SOEMRCO).

Paragraph 7.16 would benefit from further clarification as it suggests that the costs incurred in delivering EMR will be set out in relevant legislation which will not be the case. Referring to the comments above in relation to Special Condition 7D.3(b) of the licence, we suggest amendment so as to read:

“...means the costs incurred, or expected to be incurred, by the licensee for the purposes of delivering the EMR Functions (as defined in Chapter 5 of Part 2 of the Energy Act 2013).”

The proposed amendments to paragraph 7.22 and the title above it are not clear. There is now specific reference to and a linkage between Enhanced Security Costs (only) and Special Condition 6H. However, Enhanced Security Costs (as opposed to Physical Site Security) are subject to Special Condition 7D, not 6H.

Refer to “Solution” in title above paragraph 7.25.

Paragraph 7.25 requires further clarification in order to reflect the comments made above in relation to Special Condition 7D.7 of the licence (which are repeated here) in order to clarify:

- in what years the directions will be made by the Authority. We presume that this is by 30 November 2014 in relation to the provisional EMR allowances and 30 November 2015 in relation to the enduring EMR funding level but it would be helpful if this could be clarified in the Financial Handbook;
- what are the “assessment periods of review”; and
- what is meant by the “initial set of determinations and a subsequent revised set” and how these relate to the 30 November directions referred to above.

Paragraph 7.25 states that proposals in respect of EMR can only be made by the Authority. We made the point above in relation to the proposed licence changes that the licence should clarify how proposals in relation to EMR should be made. Whilst we understand that the Authority will direct the changes, it must be for the licensee to propose the changes and for the Authority to determine and direct on these following the “assessment periods of review”. The Financial Handbook and licence should be further amended to clarify this proposal, review and determination / direction process in relation to EMR costs.

In paragraph 7.26. “7.22 to 7.26” should refer to “7.22 to 7.24”. Also in 7.26, the final sentence should be clarified in order to reflect the comments made above in relation to 7.25.

In the heading above paragraph 7.26, the proposed new words are not required as the section applies to all cost categories in Table 7.1 and is not limited to enhanced security costs and EMR.

In paragraph 7.29, the proposed new bullet point is not clear. This currently suggests that the Ofgem team will liaise with the Ofgem team so the intention is not clear.

In paragraph 7.35 it would perhaps be clearer to confirm that there will be no determination in November in years in which there is no window and where no proposal has been made in respect of the EMR Enduring Solution. We suggest the drafting could read:

“..in years in which there is no application window and in which no proposal has been made in respect of the Electricity Market Reform Enduring Solution.”

Filename: EMRstratcon
Directory: C:\Documents and Settings\clare.mason\Local
Settings\Temporary Internet Files\Content.Outlook\M9BGXUBD
Template: C:\Documents and Settings\sarah.walden\Application
Data\Microsoft\Templates\Paul's letterhead - NG plc 2012.dot
Title: Addressee
Subject:
Author: sarah.walden
Keywords:
Comments:
Creation Date: 14/01/2014 09:44:00
Change Number: 41
Last Saved On: 20/05/2014 14:59:00
Last Saved By: clare.mason
Total Editing Time: 1,408 Minutes
Last Printed On: 20/05/2014 14:59:00
As of Last Complete Printing
Number of Pages: 8
Number of Words: 3,314
Number of Characters: 16,883 (approx.)