



Making a positive difference
for energy consumers

National Grid Electricity
Transmission Plc and other
interested parties

Direct Dial: 020 7901 7105
Email: paul.branston@ofgem.gov.uk

Date: 7 July 2014

Dear colleague,

Decision on Revenue 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

- We intend to provide NGET with provisional allowances of £5m for the first 20 months of operation – August 2014 to March 2016. We have extended the submission date for NGET's business plan to 12 January, 2015.
- We are launching a statutory consultation on our decision to modify special licence conditions to enable NGET to recover EMR costs from consumers.
- We are outlining changes to the Financial Handbook to reflect the licence changes.

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, the intention is that NGET will be appointed as the EMR Delivery Body from August this year.

In our April consultation¹, 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.
4. Show changes in the licence and Financial Handbook so NGET can recover EMR delivery body costs from customers.

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

5. Show changes in in the licence so that suitable performance incentives are in place when NGET carries out its role as EMR Delivery Body.

A summary of the consultation responses to all questions apart from number 4 (which related to incentives) are included in Appendix 1.

In this letter we summarise our decisions in relation to funding and business plans (points 1, 3 and 4 above). A separate decision letter² has already been issued in relation to incentives (points 2 and 5).

Today we also publish a statutory licence consultation notice alongside this decision letter that proposes to modify Special conditions 1A and 7D of NGET's licence which will allow NGET to recover the allowed EMR costs from consumers.

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.

1. Linking provisional allowances to NGET's business plan

In our April consultation, we proposed to allow NGET a provisional allowance of £5m on condition that it submitted a business plan by 30 September 2014. Most respondents supported this. One respondent objected to the basis on which the allowance was calculated, arguing that the £5m figure was 'arbitrary' and that linking the allowance to the submission of the business plan was 'unreasonable'. Another said that one of the reasons NGET was given this role is because it could achieve cost savings through synergies between its EMR role and other responsibilities. Having taken the responses into account we have decided to allow NGET provisional allowances of £5m (£4.29m in 2009-10 prices) to cover the first 20 months of the EMR delivery role (1 August 2014 to 31 March 2016).

Under the RIIO-T1 price control methodology Ofgem determines funding for transmission companies on the basis of the submission of a well justified business plan. Once we have received such a plan we undertake a detailed analysis, consult on our proposals and then determine final allowances. This is all done before the price control period starts.

Funding of NGET's EMR role will be determined under the RIIO price control frame work following full assessment of a business plan. The full details of NGET's role in EMR will not be formally confirmed until secondary legislation, expected by 1 August 2014, is made. As such as indicated in our April consultation, we expect that the earliest NGET could submit a well justified business plan for their EMR revenues, incentives and outputs is September 2014. Therefore following the usual RIIO process, as above, assessment would likely lead to a final determination on funding in 2015 in time for the 2015 annual iteration process (AIP). Adjustments to NGET allowed revenue would then come into effect from 1 April 2016.

It is unusual for the Authority to agree any funding prior to receipt of a detailed business plan and in most cases costs would be treated as 'logged up' and funded after the event.

² <https://www.ofgem.gov.uk/publications-and-updates/decision-incentives-and-outputs-national-grid-electricity-transmissions-nget-role-electricity-market-reform-emr>

However, EMR is a major Government reform of the electricity market that is, amongst other things, designed to improve affordability for customers. To support a smooth introduction of EMR, we have therefore decided that it is appropriate in the circumstances to provide some provisional funding for the first 20 months of the role in advance of an assessment of a business plan. As discussed in our April consultation, the provisional allowances will be replaced with final allowances following the assessment of the full business plan and adjustments made where appropriate.

Providing provisional funding enables NGET to recover EMR costs from 1 April 2015 (a year earlier than it would otherwise be able to do if funding was only allowed under the normal process following a full assessment of a business plan). In determining the provisional level of funding we have taken the following factors into account:

- NGET's own forecast of £7m;
- The uncertainties surrounding the role and the costs of operation, due to lack of detailed information that would be available in the business plan. Additionally secondary legislation that will provide final details of NGET's role is not yet in place;
- The duty to protect customers from costs that are not fully justified as being economic and efficient;
- Potential that some costs may already have been funded under RIIO-T1;
- Potential efficiencies that NGET can obtain from its existing SO functions in performing its new EMR functions; and
- Provisional allowances will ultimately be replaced by final allowances.

Determining exactly what the figure should be, taking all factors above into account, would be time consuming and, in view of the work we will be carrying out when NGET submits its business plan, is best left until we have the more detailed submission. In view of the reassessment that will commence within six months of this decision, it is therefore considered that a provisional allowance of £5m is a reasonable view at this time given the additional tasks NGET will be completing under EMR. We are not in this decision making a determination that NGET's forecast of £7m is not economic and efficient. If the assessment of the business plan results in higher or lower allowances being deemed appropriate, an adjustment will be made in the final determination.

In our April consultation, we proposed that NGET submit a business plan for its enduring EMR role by 30 September 2014. Our preference remains for NGET to submit its business plan as soon as possible after the start of the enduring role. However, in light of comments we received in response to the consultation, we recognise there may be limited evidence to support a business plan only 2 months after the role has started due to the number of uncertainties still to be determined. We have therefore decided that the submission date should be 12 January, 2015. It is essential that NGET meet this deadline to allow us to assess the business plan and consult with stakeholders before setting revenues, incentives and outputs in time for April 2016. We are also of the view that this extension to the deadline will allow NGET to ensure their business plan is robust, comprehensive and fully justified, taking on board the views of stakeholders (eg on incentives) where possible.

The April consultation proposed that NGET submit 3 scenarios as part of the business plan to cope with the possible uncertainties. NGET would then inform Ofgem by 31 December 2014 which scenario it considered was the most representative of running the EMR delivery body. Extending the submission date allows time for the major uncertainties surrounding NGET's EMR role to be settled. As we are extending the submission date beyond the 31 December date by which NGET was to nominate the most likely scenario out of the three, the new submission date means that it is no longer necessary for the business plan to address alternative scenarios. Instead, we are requiring one comprehensive and robust scenario for the EMR delivery role. The later submission will still enable us to determine funding in time for the AIP in November 2015.

In our April consultation, we proposed that if NGET did not submit its business plan by 30 September 2014 it would not be allowed any provisional allowances nor be allowed any adjustment to reflect the time value of money for any costs in its business plan for the first 20 months of EMR. We proposed these as incentives for NGET to meet our timetable for assessing the business plan and determining the enduring funding. All except one of the respondents supported including these as financial incentives for NGET to submit the business plan in time. Given that we have decided to extend the submission date of the business plan until after the 2014 AIP, it is no longer sensible within the RIIO framework to make granting provisional allowances conditional on the timely submission of the business plan. In addition, because NGET will have been granted allowances through the 2014 AIP, if NGET submits the business plan late, the possible loss of the time value of money could only be applied to any change between the provisional and final allowances. By itself, this is unlikely to have any incentive value. Therefore we have decided not to retain these incentives.

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

The decisions relating to incentives have already been published³.

3. Business Plan

All respondents agreed to our proportionate approach to assessing the business plan. They also all agreed that the RIIO-T1 capitalisation rate for internal SO costs should also apply to EMR enduring costs.

Having decided to allow NGET more time to prepare its business plan we expect NGET to submit a well justified business plan. The business plan should identify any overlaps with its existing internal System Operator (SO) functions. As set out in the consultation document we will only provide funding for additional incremental costs NGET incurs in the performance of its EMR role. The business plan must include proposals for incentives and outputs as well as costs. This is in line with the RIIO principles. It would be wrong for Ofgem to set financial allowances for the EMR delivery role without setting appropriate incentives and outputs.

³ <https://www.ofgem.gov.uk/publications-and-updates/decision-incentives-and-outputs-national-grid-electricity-transmissions-nget-role-electricity-market-reform-emr>

The revised timetable for the overall review of NGET’s EMR outputs, incentives and costs is as follows:

November 2014	Price Control Financial Model (PCFM) update with provisional allowances for first twenty months of the EMR delivery body
12 January 2015	NGET submits its business plan for the enduring regime
May 2015	Consultation on EMR delivery body allowances, incentives, outputs and final preparation costs
September / October 2015	Final proposals for the EMR delivery body – funding, incentives and outputs, including statutory consultation on licence changes for incentives
November 2015	Direction into PCFM of enduring allowances
Winter 2015	Direction of licence changes for incentives
April 2016	Enduring funding and incentives and outputs take effect

4. Changes in the licence and Financial Handbook

All respondents agreed with the need to change the licence and Financial Handbook. We have taken the comments made on these documents into account in drawing up revised versions for statutory consultation. We have also made revisions to reflect the decisions described above.

The proposed licence changes are attached in the statutory consultation. The proposed Financial Handbook changes relate mainly to chapters 2, 6 and 7 and reflect the proposed licence changes. The full handbook is published alongside this letter. Changes to the Financial Handbook are subject to an annual formal consultation process as per special condition 5A.

Please send your responses to the statutory licence notice consultation to martin.rodgers@ofgem.gov.uk by 5 August 2014.

If you have any questions, please email Martin Rodgers at the address above or call on 020 7901 7273.

Yours faithfully,

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Paul Branston
Associate Partner, Costs and Outputs, Smarter Grids and Governance
Duly authorised on behalf of the Gas and Electricity Markets Authority

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. Responses are available on our website⁴

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

Most responses agreed with the approach. One respondent did not comment. One respondent did not agree that the allowance of provisional EMR funding should be subject to a well justified business plan, as these provisional allowances were not informed by the 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?

Most responses agreed with the approach. One respondent did not comment. One respondent did not agree with this approach saying it was unreasonable to impose an inappropriate incentive in relation to the delivery of the business plan.

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

Most respondents agreed that the proposed allowance seems reasonable (but mention the lack of detailed information). One respondent did not agree with the proposed allowance of £5m per annum as it seems 'arbitrary'.

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

A summary of responses were given in an earlier decision letter.⁵

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

Three respondents agreed with the approach. One respondent did not comment. One respondent did not agree with the submission date for the business plan saying many deliverables and outputs will not be completed until January 2015. One respondent also suggested delaying setting enduring incentives for 1 to 2 years after the EMR delivery function is created.

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

Most respondents agreed with the approach. One respondent did not comment.

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

All respondents agreed with the approach. One respondent provided various comments to improve clarity of the drafting.

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

⁴ <https://www.ofgem.gov.uk/publications-and-updates/strategy-consultation-revenue-incentives-and-outputs-national-grids-role-electricity-market-reform>

⁵ <https://www.ofgem.gov.uk/publications-and-updates/decision-incentives-and-outputs-national-grid-electricity-transmissions-nget-electricity-market-reform-emr>

All respondents agreed with the approach. One respondent provided various comments to improve clarity of the drafting.