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Dear Lewis,

We welcome the opportunity to respond to the consultation on **Electricity System Operator Incentives: Incentives from 2015** that was published on 17 June 2014.

The Balancing Services Incentives Schemes have consistently played an important role in supporting the reduction or minimisation of the external costs incurred by the System Operator and therefore benefitting the consumer through lower BSUoS charges. The incentive framework ensures a sharp focus is maintained on driving down costs through both the development of market frameworks and innovation, to drive competition in balancing services.

The framework that supports the current scheme has been developed and improved since its inception in 2011 and as noted in OFGEM's consultation, through using the modelled approach, clear evidence on how costs have been controlled through National Grid's actions can be clearly demonstrated.

The challenges faced by the System Operator in the coming years are numerous, as the electricity transmission system transitions to one that has an increasing element of renewable generation. In addition the introduction of European Codes and EMR has the potential to impact significantly on the operation of the transmission system. In light of this, a well understood incentive scheme and framework would provide a sound basis of understanding, to capture the impact of these changes on system operation costs.

The remainder of this letter addresses the specific questions raised in the consultation document.

## **Background**

### **Q. Do you have any views on how the current incentive scheme is functioning?**

We believe that the current incentive scheme is functioning well, in part as a result of learning from the previous 2011-2013 scheme which helped National Grid and Ofgem to improve and develop further, the models that underpin the scheme. We believe that the models reflect operational costs accurately and through the application of ex ante and ex post input variables, focus the incentives on those areas of cost that National Grid can influence in a significant manner. The additional provisions made for the current scheme to allow mid scheme updates and if and where necessary make changes to the methodologies, has ensured that the scheme models reflect the operational environment more appropriately and thus provides a more robust measure of NGET's performance.

**Q. What are your views on our proposal to introduce a two year incentive scheme consistent with the current framework?**

We believe it to be an appropriate and prudent approach to introduce a two year incentive scheme on the basis of the existing framework for two principal reasons. The potential impact of the numerous changes outlined in the consultation document, such as EMR, SCR, ITPR and FTA, in addition to the implementation of European codes is not yet fully understood. We would agree with OFGEM's view that the current framework provides a range of mechanisms that would allow existing models to be adapted to account for the impact of those market changes described in the consultation. The models that underpin the current incentive scheme have been developed and improved over the past 3 years and as such, they provide a robust and reliable basis to measure our performance.

As noted in the consultation document<sup>1</sup>, the models and the existing framework have aided the monitoring activity undertaken by OFGEM to challenge NGET's balancing activities and the efforts undertaken to drive down balancing costs. Furthermore, we believe the current framework is well understood by industry stakeholders, which was supported by the extensive consultation initiatives undertaken by ourselves and OFGEM in late 2012 and early 2013. We believe that this broad level of understanding across stakeholders assists in providing the necessary transparency in respect to NGET's activities and provides a stable basis of comparison for all parties. This will be particularly important in providing context and explanation of balancing costs to stakeholders, in respect to any impacts that may arise from the previously mentioned impending market changes, in addition to broader challenges faced by the SO.

We believe that the additional incentives placed on NGET for the 2013-2015 frameworks are valuable additions to the main BSIS. The wind generation incentive drives us to improve performance in the day-ahead forecasts that are published to market and whilst we recognise that market participants have well developed forecasting capabilities of their own, our forecasts provide a whole market view which we believe that market participants, particularly those without wind generation assets, use to assist their own balancing activities. As wind generation penetration increases, it will have an increasing influence on balancing costs, either directly, for example in constrained areas of the network, or through second order impacts that result from a changing system paradigm. The wind generation incentive therefore not only drives improved forecasting performance to assist market balancing but also will further drive future performance in managing system balancing costs.

It was recognised for the 2013-2015 frameworks, that NGET as the SO has limited influence on transmission losses as these are functions of market dispatch and longer term asset investment. However we recognise that it is important to inform market participants of existing and longer term trends in regards to transmission losses and explain to customers the underlying reasons for them and what mitigation may be pursued. We therefore believe that this remains an appropriate reputational incentive.

NGET support the underlying principal of the innovation roll out mechanism, to bring forward and assist technologies that have the capability to reduce costs to consumers in the medium term but that may not have a payback period within the incentive period. We have demonstrated our willingness to develop and use innovative approaches to balancing; however it is often difficult to provide the required level of commercial support to new technologies within existing competitive market mechanisms. The roll-out mechanism provides NGET with the means of introducing proven technologies in the interests of consumers that would otherwise not be possible if a short term view in respect to economic viability within existing market or commercial frameworks. We can play an important role in

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<sup>1</sup>Electricity System Operator Incentive: Incentives from 2015 - Paragraph 1.8 p 8

facilitating the introduction of new technologies and services to the longer term benefit of consumers and broader policy objectives. NGET submitted two proposals under the mechanism in March 2014 for implementation in 2014-15. Whilst they were not successful in receiving funding, OFGEM recognised the potential of both submissions<sup>2</sup>. However, in the event that this incentive is extended, we would like to work with OFGEM to make changes to the mechanism, particularly in respect to the impact on the resource of the SO in identifying proposals in addition to the subsequent development of robust applications under the mechanism.

We support the objectives of the model development licence condition (MDLC) to continue developing models that underpin the current scheme but also in regards to the broader objective of informing and helping stakeholders understand the drivers of balancing costs beyond the immediate time horizon of an incentive scheme.

### **Scope of changes to a 2015-17 Scheme**

In respect to the scope of any changes to a 2015+ scheme, we have used the questions provided within the consultation document.

#### **Q. Do you agree with the proposed scope of changes to the 2015-17 scheme?**

We support the retention of BSIS within a future incentive framework for the reasons outlined earlier in this response and would agree that the effort and resources of all stakeholders should be focused on how incentive frameworks may need to evolve beyond 2017. NGET would welcome the opportunity to work with OFGEM and other interested stakeholders in those areas where OFGEM believes that there is some potential for improvements to the current framework. We would agree that any changes should be targeted and limited in scope to avoid unintended consequences that may arise from substantive changes.

#### **Q. Do you consider NGET's modelling to be sufficiently transparent? How could this transparency be improved?**

NGET undertook extensive stakeholder engagement prior to the start of the 2013-15 scheme to explain the modelling approach and the rationale behind this. In addition, we publish the scheme outturn and target figures in the MBSS report, in which we describe how costs have been incurred across the many areas of system operation<sup>3</sup> and the detailed methodologies<sup>4</sup> of target derivation and scheme parameters are published on the National Grid website. However we would welcome any additional feedback stakeholder may wish to provide, that would improve transparency around the models.

#### **Q. How do you think that the additional incentives that sit alongside BSIS could be improved?**

We believe that the additional incentives introduced in 2013-2015 have proven to be appropriate in focusing our activities in those areas that our customers and stakeholders find useful and beneficial in driving down balancing costs. We noted in our previous answers that the wind generation incentive aligns NGET's activities with the interests of stakeholders through more accurate wind forecasts. We believe that there may be benefit in extending the wind incentive to include other renewable energy sources and would welcome the opportunity to explore this further. In respect to the SO-IRM, we believe that it should be retained as it provides a bridge to the market for technologies that could play an important

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<sup>2</sup> <https://www.ofgem.gov.uk/ofgem-publications/88464/electricitysystemoperatorincentives2013-14-systemoperatorinnovationroll-outmechanismdetermination.pdf>

<sup>3</sup> [MBSS Homepage](#)

<sup>4</sup> [Link to methodologies](#)

role in reducing costs to consumers beyond the time horizon of shorter term incentive schemes. It could also further assist understanding as to how these types of initiative could be integrated into a broader enduring SO incentive scheme. We do however think that there is the potential to improve the application process and provide greater explanation as to how proposed projects would be assessed. We believe the current scheme has provided a valuable learning opportunity to NGET and OFGEM and would welcome the opportunity to work with all interested stakeholders to develop the roll out mechanism further and thus deliver real and enduring benefits to the consumer.

**Q. Is there a need for additional SO-TO financial mechanisms to facilitate whole system consideration of outage planning (i.e. taking account of the impact on constraint costs)?**

We believe that there is merit in developing financial mechanisms to facilitate provision of TO services that might reduce operational costs. The current scale of investment and thus required access to the National Electricity Transmission System (NETS) is unprecedented and the cost of securing the access can be considerable. Transmission Owners are clearly obligated to consumers to deliver a lowest cost delivery solution<sup>5</sup>, however they are not in a position to effectively balance this against the costs that may arise to secure the access to the system. We believe that there would merit in developing financial mechanisms that recognise a more optimal solution to the consumer, however it will be necessary to provide clear and demonstrable evidence, that such an approach to whole of system costs would be beneficial to consumers and stakeholders. We would agree with the statement in paragraph 2.40 that such mechanisms are delinked from the current incentive scheme, but this should not preclude developing TO services that would not incur additional build costs. We do think however, that consideration could be given to them being included in a future enduring scheme, albeit, it would clearly be important that financial incentives are appropriately reflected across both the SO and TOs.

**Q. Is there sufficient transparency of the SO's actions? If not, where are improvements needed?**

We work hard to provide transparency through a variety of formats including MBSS and our Operational Forum but we are always seeking to improve however we would highlight a number of initiatives and reports that we do provide to industry. One of our aims is to assist the development of deep and liquid markets for the provision of balancing services at minimum cost, which we recognise can be aided by the appropriate level of transparency. As the consultation notes in paragraph 2.48, NGET provides a large amount of information to the industry, through the website and industry engagement such as the operational forum.

Whilst it is important that all stakeholders have sufficient information in respect to how the SO makes decisions around procurement and utilisation of services, this has to be balanced against commercial considerations. Ultimately, NGET is obligated to minimise costs to the consumer and should therefore provide sufficient transparency that drives competition and enables the efficient functioning of the market, whilst ensuring consumer interests are reflected in its procurement activities. It is important to note that we provide detailed reports in respect to our procurement of services through publications such as the Monthly Balancing Services Report (MBSS), Procurement Guidelines report (PG) and the Balancing Principles Statement (BPS). Notwithstanding this, we would welcome feedback from our stakeholders to understand how transparency can be improved to better facilitate understanding in respect to balancing activities.

In summary, NGET believe that an extension to the current framework for a two year period is a realistic and prudent approach. In limiting the scope for changes whilst addressing those areas identified for potential improvements, it will provide a robust and tested framework that

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<sup>5</sup> As set out in Section 9 of the Electricity Act

is well understood by industry. It will also allow for limited resources, in particular across NGET and OFGEM, to be focused on developing a longer term, enduring incentive framework beyond 2017 that will align with the second half of RIIO-T1. As highlighted in the consultation document and in this response, there are a number of important industry changes that will be implemented within the next few years, thus we believe there is value to consumers and stakeholder in continuing with a broadly stable SO incentive framework.

If you would like to discuss this response further, in the first instance please contact Iain McIntosh ([iain.mcintosh@nationalgrid.com](mailto:iain.mcintosh@nationalgrid.com) or 0118 936 3798).

Yours sincerely



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