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for energy consumers

Initial proposals on setting revenue, outputs and incentives for National Grid Electricity Transmission plc's roles in Electricity Market Reform

Consultation

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Response deadline: 16 June 2015

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Overview:

We are consulting on our initial proposals on setting revenue, outputs and incentives for National Grid Electricity Transmission plc's (NGET) roles in Electricity Market Reform (EMR) from August 2014 to March 2021, based on the RIIO (Revenue = Incentives + Innovation + Outputs) price control model.

This consultation uses the information provided by NGET in its EMR Business Plan submitted to Ofgem in January 2015. It also includes our consultation on funding the costs NGET incurred in preparing to deliver its EMR roles between April 2013 and July 2014.

At the end of this document, you can find out how to respond to this consultation. This consultation closes on **16 June 2015.**

Context

In December 2012, we published our Final Proposals for National Grid Electricity Transmission plc (NGET) in the RIIO-T1 price control (April 2013 to 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 it was uncertain what the scope of NGET's role in the Electricity Market Reform (EMR) would be, and the timing of any involvement. So we highlighted the fact that we had not included any allowances, outputs and incentives for EMR and that we would look at this when there was more certainty about NGET's roles in EMR.

Separately, we gave NGET funding for the costs of preparing for its EMR roles during the April 2013 to July 2014 period. This allowance was to be subject to an ex-post assessment of the actual efficient costs that NGET incurred.

In addition, to cover the period between NGET taking on its EMR roles and us receiving and assessing NGET's business plan, we provided provisional funding and set outputs and incentives[1] for the first 20 months of EMR operation (August 2014 to March 2016). We made it clear that these provisional allowances would be adjusted as required once we had reviewed the business plan and set allowances for the whole of the August 2014 to March 2021 period.

EMR secondary legislation came into force in August 2014 and NGET began its EMR delivery body roles. NGET submitted a business plan for its EMR roles to us on 12 January 2015 covering the August 2014 to March 2021 (the end of RIIO-T1) period.

This document sets out our initial proposals for funding, outputs and incentives for NGET's EMR delivery role for the period August 2014 to the end of the RIIO-T1 price control in March 2021. It also consults – based on our ex-post assessment of the actual costs incurred – on the level of funding for NGET's preparatory costs for EMR from April 2013 to July 2014.

[1] https://www.ofgem.gov.uk/publications-and-updates/modification-nget%E2%80%99s-special-conditions-incentives-and-outputs-national-grid-electricity-transmissions-nget-role-electricity-market-reform

Associated documents

Preparatory costs

Consultation (20 December 2013): https://www.ofgem.gov.uk/ofgem-publications/85367/ngetfundingemrconsultationletter.pdf

Decision (12 March 2014): https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-funding-national-grid-electricity-plcs-preparatory-costs-electricity-market-reform

Provisional funding, outputs and incentives

Consultation (17 April 2014): https://www.ofgem.gov.uk/publications-and-updates/strategy-consultation-revenue-incentives-and-outputs-national-grids-role-electricity-market-reform

Decision (13 June 2014) on incentives: https://www.ofgem.gov.uk/publications-and-updates/decision-incentives-and-outputs-national-grid-electricity-transmissions-nget-role-electricity-market-reform-emr

Direction on incentives (18 July 2014): https://www.ofgem.gov.uk/publications-and-updates/modification-nget%E2%80%99s-special-conditions-incentives-and-outputs-national-grid-electricity-transmissions-nget-role-electricity-market-reform

Decision (7 July 2014) on funding: https://www.ofgem.gov.uk/publications-and-updates/decision-revenue-national-grid-electricity-transmissions-nget-role-electricity-market-reform-emr

Direction on funding (7 August 2014): https://www.ofgem.gov.uk/publications-and-updates/decision-modifications-nget%E2%80%99s-special-licence-conditions-1a-and-7d-enable-nget-recover-costs-relation-electricity-market-reform-consumers

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Executive Summary

Background

In August 2014 the government conferred the role of EMR delivery body on NGET. Ofgem is responsible for overseeing NGET's delivery of its EMR roles.

In line with the regulation of network companies, we are applying the principles of the RIIO (Revenue = Incentives + Innovation + Outputs) price control framework to drive benefits for consumers. Under the RIIO framework, the onus is on companies to demonstrate the cost-efficiency and long-term value for money of their business plans through proposing funding, outputs (or deliverables) and, where appropriate, incentives.

Purpose of this document

On 12 January 2015 we received NGET's EMR business plan for delivering its EMR roles from August 2014 until the end of the RIIO-T1 price control period in March 2021.

This consultation sets out our initial proposals for funding NGET's EMR roles for the period August 2014 to March 2021. This includes a reset of the provisional funding allowance for the first 20 months of EMR (from August 2014 to March 2016) that we decided on in July 2014. It also sets out our proposals for funding NGET's preparation to take on the EMR delivery roles during the April 2013 to July 2014 period based on our ex-post assessment of these costs.

We also set out our initial proposals for outputs and incentives from April 2016 to March 2021.

Ofgem's proposals

Funding

Our initial proposal is that NGET receives a baseline allowance of £44.3m for August 2014 to March 2021. This is £9.8m (18.1%) lower than the funding proposed in NGET's business plan. The reasons for this reduction are in Chapter 1.

Our proposal is that NGET receives £8.9m for EMR preparatory costs incurred between April 2013 and July 2014. This is significantly lower than the £17.3m estimated in March 2014 and the reasons for this are in Chapter 3[2].

Outputs and incentives

In addition to the outputs set out in legislation we propose an EMR Customer and Stakeholder Satisfaction Survey as an additional output for NGET. We are also

[2] £17.1m in 2013-14 prices

proposing four financial and one reputational incentive (as well as continuing the two current reputational incentives) for NGET. The four financial incentives we are proposing are on:

- the accuracy of NGET's Tier 1 dispute decisions.
- customer and stakeholder satisfaction (the survey on satisfaction will be published and that will be the new reputational incentive we are proposing)
- the volume of pre-qualified Demand Side Response (DSR) in the T-1 auction.
- the accuracy of demand forecasting at T-1 and T-4.

We will change NGET's special licence conditions to enable these incentives.

Next steps

We will review the consultation responses received over the summer and will publish our final proposals in the autumn. We will also do a statutory consultation including on any licence changes.

1. Initial Proposals on revenues and uncertainty

Chapter Summary

This chapter sets out our initial proposals for an efficient level of baseline expenditure for the EMR delivery body (NGET) to deliver its outputs from August 2014 to the end of the RIIO-T1 period in March 2021. This also includes a 'true-up' of the provisional allowances given for the period from August 2014 to March 2016

Question box

Question 1: Do you agree that the proposed funding baseline has been set at the appropriate level?

Question 2: Do you agree that there should not be any allowance or uncertainty mechanism for NGET to claim costs in addition to those funded here?

Question 3: Do you agree with our proposed allowances and 'true-up' for the first 20 months of EMR – August 2014 to March 2016?

Introduction

1.1. In the RIIO-T1 Final Proposals for NGET published in December 2012[3], we set out NGET's outputs and allowances for its role as Transmission Owner (TO) and internal cost allowances for the System Operator (SO). Included in these proposals were details of when and how NGET could request additional allowances for uncertain events or costs arising over the eight year RIIO-T1 period.

1.2. One of the uncertain events identified was the possibility of NGET undertaking the EMR delivery body roles. It was uncertain as to whether NGET would be asked to perform the function, what the roles would entail and when during the RIIO-T1 period NGET would be required to begin delivering the roles.

1.3. Now that NGET has been given the EMR delivery body roles, we need to decide the appropriate adjustments to NGET's overall internal electricity SO total expenditure (TOTEX) allowances for the additional incremental costs NGET expects to incur. (We note here that there are certain business separation restrictions placed on NGET in performing the EMR roles, but we would expect it to make savings where functions can be aligned or absorbed with existing SO roles.)

[3] https://www.ofgem.gov.uk/publications-and-updates/riio-t1-final-proposals-national-grid-electricity-transmission-and-national-grid-gas-%E2%80%93-overview

1.4. We have followed the same process that we used when setting the RIIO-T1 price control: the level of assessment has been proportionate to the level of costs involved. The approach we have taken was set out in our 'Decision on Revenue for NGET's Role in EMR', published in July 2014.[4]

Table 1: Summary of EMR Costs discussed within this document

£m, 2013/14 prices	Preparatory cost (April 2013 to July 2014)	Provisional allowances (August 2014 to March 2016)	Remaining 5 years of RIIO (April 2016 to March 2021)
Ofgem allowance	17.3[5]	5.1[6]	-
NGET business plan[7]	11.4	13.0	41.1
Ofgem Initial Proposals (this consultation)	8.9	11.8	32.5

1.5. The numbers in Table1 are discussed in greater detail in this chapter and chapter 3.

NGET's forecast

1.6. NGET's business plan sets out its proposed costs for operating the EMR delivery function from August 2014 to March 2021. In summary its forecast costs are as follows:

[4] https://www.ofgem.gov.uk/publications-and-updates/decision-revenue-national-grid-electricity-transmissions-nget-role-electricity-market-reform-emr
[5] https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-funding-national-grid-electricity-plcs-preparatory-costs-electricity-market-reform
[6] https://www.ofgem.gov.uk/publications-and-updates/decision-revenue-national-grid-electricity-transmissions-nget-role-electricity-market-reform-emr
[7] http://www2.nationalgrid.com/UK/Our%20company/Electricity/Market%20Reform/Announcements/EMR%20business%20plan%20proposal%20public%20document/

Table 2: NGET's EMR business plan costs (August 2014 – March 2021)

£m (2014-15 prices)	Total
Staff	24.0
Business support	5.4
Information Systems OPEX	8.6
Other	5.9
Information Systems CAPEX	10.2
TOTEX	**54.1**

1.7. NGET's plan assumes that total expenditure (TOTEX) will be relatively flat over the RIIO-T1 period. The main difference between each year is the amount of capital expenditure (CAPEX). NGET forecasts the staffing level to be 41.6 full time equivalents (FTEs). NGET considers that this is necessary to provide the functions required to operate the EMR processes, and to manage the expected levels of change required over the period the business plan covers.

1.8. NGET's plan assumes some external legal and consultancy costs each year to assist with the role and levels of change expected. The information systems (IS) OPEX costs are approximately £1.4m per year and cover the set up costs for each Capacity Market (CM) auction, system changes and enhancements, and annual support costs.

1.9. NGET forecasts IS CAPEX to be approximately £1.2m per annum to cover the development of systems as well as system changes and further system development over the period. Towards the end of the period the plan assumes that the administration and auction systems will be refreshed at an additional cost of £2.8m, which is around 85% of the initial build cost.

Initial proposals - baseline allowances

1.10. Since NGET submitted its business plan in January, we have reviewed it in detail. We have raised a number of supplementary questions to seek further details from NGET. In February we visited NGET to discuss specific details of the plan and talk to people involved in the EMR delivery roles.

1.11. While we have reviewed the plan in detail, we have determined the allowances in a manner that we consider is proportionate to the total costs involved. The overall costs are low compared with NGET's Transmission Owner business (£1.7bn for 2013-14). This approach is in line with our strategy decision document published in July 2014.

1.12. Having considered the information available to us we propose the following allowances shown in Table 3 for NGET's EMR delivery roles. Table 4 sets out the variance between our initial proposals and NGET's business plan by year. The allowances are lower than the business plan for the reasons discussed below.

Table 3: Ofgem's initial proposals for NGET's EMR funding (August 2014 – March 2021)

£m (2014-15 prices)	Initial proposals
Total business plan	54.1
LESS	
Staff costs	-2.5
IS costs	-2.8
10% annual reduction	-4.5
Initial Proposals	44.3
Variance from business plan (£) (%)	-9.8 (-18.1%)

Table 4: Ofgem's initial proposals for NGET's EMR funding by year (August 2014 – March 2021)

TOTEX £m (2014-15 prices)	2014-15*	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	Total
Business Plan	3.4	9.6	7.7	7.5	7.6	9.1	9.2	54.1
Initial Proposals	3.4	8.4	6.5	6.4	6.4	6.6	6.6	44.3
Reduction	0	-1.2	-1.2	-1.1	-1.2	-2.5	-2.6	-9.8

* Note that 2014/15 is eight months beginning August 2014

1.13. **Staff costs** – We believe there is duplication in some of the roles. We accept that a stakeholder management function will be required but we believe this can be carried out with a lower number of staff, assisted by the use of other EMR managers and staff. NGET says that it needs six staff for stakeholder management, but we think this could be carried out by four. We do not believe there is a need for full time stakeholder managers to carry out strategic activities and this work can be carried out by the other team heads when required. Now that EMR is becoming 'business as usual', more emphasis will also be placed on ensuring market participants understand how to operate in the market. NGET term this 'tactical stakeholder management' and this would be carried out by the Contracts for Differences (CfD) and CM managers. We have therefore reduced the proposed allowances for staffing in the stakeholder management team by two FTEs from 2015-16, a reduction of £1.3m over the RIIO-T1 period.

1.14. We have also reduced the modelling staff by three from 2016-17, reducing costs by £1.2m over the RIIO-T1 period. We accept that NGET will require additional modelling FTEs to develop the capability to enable interconnectors to participate in EMR (described as the European market model by NGET) as the systems already developed lack this functionality. However once the modelling capability is in place we believe NGET can reduce staff in the modelling team by three as the interconnectors become additional participants in the capacity market and do not add to the complexity of the capacity market overall.

1.15. **IS costs** – We believe that the planned refresh to the administration and auction systems in 2019-20 and 2020-21 may not need to go ahead at this time. It is not clear to us that systems developed in 2014 and 2015 need to be fully refreshed so soon after implementation. Although NGET's planning assumption is to refresh all IS every five years, it accepts in reality not all its systems are refreshed every five years. For example in 2013-14 NGET reported that internal electricity SO CAPEX was lower than the allowance due to delaying some system refreshes that were due in that year. We believe there is no certainty that the refresh will be carried out at the end of RIIO-T1; we think it may be delayed until the start of the next price control period (RIIO-T2 starting in April 2021). The level of expected refresh costs are also not well justified. The costs are based on 85% of the original cost of development, but NGET have not explained why this is a robust figure. Hence the deduction of £2.8m.

1.16. **All other costs** – We propose to make a further reduction of 10% of TOTEX each year from 2015-16 to 2020-21, which is approximately £0.9m in 2015-16 and £0.7m in subsequent years (£4.5m in total). This reduction is applied after the two specific reductions (for staff and IS) have been taken off the business plan figures.

1.17. We believe the level of costs set out in the business plan overall is too high and NGET can deliver its outputs at lower costs. We recognise that NGET have included a 1 to 2% level of efficiency within its business plan already, but propose that the baseline is reduced by a further 10%.

1.18. This additional 10% efficiency reduction is based on these factors:

- Organisations often experience significant efficiencies in the first few years of operating new processes.
- The final TOTEX baseline for NGET's TO business in RIIO-T1 was at least 10% lower than its original business plan figures.
- We also note that NGET is currently forecasting that it's TO business will make a further 9% saving against these TOTEX allowances over the RIIO-T1 period. This is based upon one year's results for 2013-14.

1.19. For these reasons, we think that a 10% reduction in costs is justified. We are keen to adequately fund NGET for the crucial EMR delivery body roles it delivers and help to ensure the success of the Government's plans for encouraging low carbon electricity generation and ensuring security of supply. We believe our proposals do that, while ensuring NGET performs its EMR delivery body role efficiently and consumers are not exposed to excessively high costs.

Uncertainty

1.20. NGET's business plan factors in a number of anticipated changes (to regulations, the allocation framework, the Capacity Market rules etc.) in its baseline costs (£54.1m). It also indicates there may be a number of more significant discrete policy and regulation changes requiring a step change in capability and resources over the RIIO-T1 period for which NGET would require additional funding. NGET also propose a licence term which would trigger a review of the costs funded if a 'material' change to the EMR regime occurred. This is defined by NGET where costs increase or decrease by 20% of TOTEX.

1.21. NGET's business plan discusses four possible ways in which it could be funded for significant discrete policy and regulation changes that may occur to its EMR delivery role in the RIIO-T1 period. These are: using the efficiency incentive rate; base line funding for uncertainties; specific uncertainty mechanism triggers, and; a mid-period review. NGET concludes that giving a specific allowance to cover uncertainties would appear to be the best option. NGET argues this is the most practical option and reduces significantly the administrative and cost burden on NGET and Ofgem of a specific reopener. On this basis, NGET is seeking a specific allowance of £11m to cover specific larger uncertainties.

1.22. When we discussed the uncertainty mechanism with NGET it became clear that the £11m was based on five speculative events, which may or may not happen. It is also possible that the actual costs might be significantly lower or higher than £11m.

1.23. We agree there may be some merit in allowing for uncertainties in the base allowances as proposed by NGET, as this would save ourselves and NGET the time and cost of reviewing what may be relatively small amounts of money. However, we do not believe NGET has provided sufficient evidence to demonstrate that £11m is a reasonable figure to cover such uncertainties.

1.24. For the initial proposals Ofgem has therefore decided that there should not be an allowance for possible uncertain costs and there should not be a specific mechanism for NGET to claim additional funding for EMR in RIIO-T1. We may review this decision if NGET can produce more evidence to support a specific allowance for uncertainty during this consultation.

1.25. We do not see a need for an additional license term to cover any 'material' changes to NGET's EMR roles in the RIIO-T1 period. If there are changes to legislation, which mean the roles change materially, we reserve the right to adjust NGET's allowances accordingly.

Provisional Allowances for the period August 2014 to March 2016

1.26. To support the smooth introduction of EMR, we decided in July 2014 to provide provisional funding for NGET's delivery in the first 20 months of EMR in advance of an assessment of a business plan. We also said that the provisional allowances would be replaced with final allowances following the assessment of the full business plan. Providing provisional funding enabled 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).

1.27. The provisional allowances we provided were £5.1m[8] (against NGET's forecast of £7.1m) to cover the first 20 months of operation – August 2014 to March 2016. We said at the time that we had taken several factors into account when setting the provisional allowances, including uncertainties surrounding the roles and the costs of operation, and the lack of detailed information (that would only be available in the business plan). We noted that the assessment of the business plans may result in higher or lower allowances being deemed appropriate.

1.28. Having reviewed the business plan for efficiency we now propose an allowance of £11.8m (see Table 4) to cover the first 20 months of operation. This is still a forecast for this period; there will be no 'true up' with actual costs incurred. This therefore means that NGET will be allowed to recover an additional £6.7m from consumers to cover the expected costs of this period.

1.29. The costs are higher than previously estimated by NGET due to better information available from performing the delivery role between August 2014 and January 2015. The final figures also include capital expenditure and additional costs for changes that have occurred or that NGET assume are likely to occur which were not included its original figures. The main driver of the difference is IS systems development: some of the IS development that was planned during the preparatory stage (April 2013 to July 2014) instead will take place during the first 20 months of EMR. (Note that preparatory costs for the April 2013 to July 2014 period are correspondingly lower – see Chapter 3.)

Financing decisions already made

1.30. The decision on funding in July 2014 set out all the relevant changes to NGET's transmission licence. Changes were also made to the Finance Handbook and Price Control Financial Model to enable NGET to receive the appropriate funding for EMR. It was confirmed that the EMR delivery body costs would be treated in the same way as other internal SO costs incurred by NGET. Therefore the TOTEX capitalisation rate will be at 27.9% and any over / under spending against TOTEX allowances will be shared 53% for customers and 47% for NGET. We do not propose any changes to those decisions in these proposals.

[8] £5m in 2013/14 prices

2. Initial proposal on outputs and incentives

Chapter Summary

This chapter sets our initial proposals for setting outputs and incentives from April 2016 to the end of the RIIO-T1 price control period in March 2021 for NGET's EMR delivery roles. We are of the view that it is important to incentivise NGET to carry out its EMR Delivery Body roles efficiently, effectively and to a high standard.

Background

2.1. The EMR Delivery Body (NGET) has a number of functions set out in relevant legislation. These include assessing eligibility for CM and CFDs[9], reviewing Tier 1 disputes and running the respective auctions and allocation processes.

2.2. In July 2014 we set a financial incentive[10] for NGET to deal effectively with disputes relating to CFD and CM eligibility, Capacity Agreement Notice (CAN), and Capacity Market Register (CMR) disputes. We also set reputational incentives including an annual report by Ofgem on how well NGET has performed its EMR Delivery Body roles. These provisional incentives were set from August 2014 and are due to expire in March 2016. The purpose of this section is to explain our initial proposals and reasons for setting incentives for April 2016 to March 2021, the remainder of the RIIO-T1 price control period.

2.3. In line with the RIIO model we propose linking incentives to outputs. The rationale for introducing incentives is to incentivise NGET to carry out its EMR Delivery Body roles efficiently, effectively, to a high standard and in a transparent manner.

Outputs

Question box

Question 4: Do you agree with our proposal to introduce EMR Customer and Stakeholder Satisfaction Surveys as an additional output?

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[9] https://www.gov.uk/government/publications/contracts-for-difference-standard-terms-and-conditions

[10] See Direction on incentives (18 July 2014): https://www.ofgem.gov.uk/publications-and-updates/modification-nget%E2%80%99s-special-conditions-incentives-and-outputs-national-grid-electricity-transmissions-nget-role-electricity-market-reform

NGET's proposals

2.4. In its EMR Business Plan, NGET set out its role and associated outputs (see Annex 1) as EMR Delivery Body, based on the:

- Electricity Capacity Regulations 2014
- Capacity Market Rules
- Contracts for Difference (Allocation) Regulations 2014
- Contracts for Difference Allocation Framework.

Ofgem's initial proposals

2.5. In addition to these outputs we propose an EMR Customer and Stakeholder Satisfaction Survey as a new output. The aim of the survey is to collect customer and stakeholder views on the quality of engagement and delivery of NGET's roles in EMR, providing transparency on NGET's performance. The areas the two separate proposed surveys (one for CfD and one for CM) will cover include satisfaction of stakeholders with the outputs that NGET delivers including: application, allocation and auction processes, and eligibility reviews.

2.6. We propose that the survey results are published, in the same way as the existing RIIO Customer and Stakeholder Satisfaction Survey results[11]. This will also act as a reputational incentive, to complement the two existing reputational incentives set out in our June 2014 decision on incentives which are:

- Publication of annual reports on NGET's performance, and
- Ofgem actions: If NGET fails to deliver any of its legislative obligations, we may publish, as appropriate, any concerns we have and any steps we may take (including enforcement actions) at other points during the year.

[11] http://talkingnetworkstx.com/Our-Performance.aspx

Incentives

Question box

Financial incentive on accuracy of Tier 1 dispute resolution

Question 5: Do you agree with maintaining the broad structure of the incentive on disputes and the proposed amendments to its parameters, and the increase in the value of the incentive? If you would like to propose an alternative, please provide evidence to support this.

Financial incentive on customer and stakeholder satisfaction

Question 6: Do you agree with the proposed incentive on EMR Customer and Stakeholder Satisfaction, its parameters and value? If you would like to propose an amendment, please provide evidence to support this.

Financial incentive on volume of pre-qualified capacity for the CM auctions

Question 7: Do you agree with the proposed incentive on the volume of pre-qualified DSR in the T-1 auctions, its parameters and value? Do you think the incentive should be based on the absolute amount or the percentage of DSR that prequalifies compared to the benchmark?

Question 8: Do you agree that we do not introduce an incentive on the volume of pre-qualified capacity in the T-4 auctions?

Financial incentive on demand forecasting accuracy

Question 9: Do you agree with the proposed incentive on the accuracy of forecasting demand at T-1 and T-4, its parameters and value? If you would like to propose an alternative, please provide evidence to support this.

General

Question 10: Do you think the value of the incentives (overall and individually) is appropriate for NGET's roles in EMR?

2.7. NGET proposed three new incentives and an amended version of the existing incentive on the accuracy of NGET's Tier 1 dispute resolution decisions. The three new incentives are:

- Customer and stakeholder satisfaction
- Volume of pre-qualified capacity for the CM auctions
- Demand forecasting accuracy

2.8. NGET also proposed several 'secondary incentives' as options that could be discussed as possible future schemes. We do not cover the secondary incentives in this consultation as we are not proposing to introduce any of them at this stage. They are set out in NGET's Business Plan and we would welcome any views from respondents to this consultation on them.[12]

Accuracy of Tier 1 dispute resolution

NGET's business plan

2.9. The existing financial incentive aims to ensure that NGET deals with disputes on its decisions efficiently and to a high standard. In its EMR Business Plan, NGET proposes to maintain the existing incentive on disputes but to amend the parameters as follows: (i) increase value of the cap and floor from +/- £125,000 to +/- £1.25M; (ii) decrease the cap of overturned decisions to which the incentive is applied from 6 to 4, and; (iii) move the neutral incentive threshold from 1 to 2 overturned decisions.

Ofgem's initial proposal

2.10. In the first eight months of EMR (August 2014 to March 2015), disputes were raised on CM prequalification and CfD eligibility decisions at Tier 1 (to NGET) and Tier 2 (to Ofgem). In all the Tier 2 disputes we did not overturn the decisions made by NGET. We propose to maintain this incentive as we are of the view that it incentivised NGET to devote the appropriate quality and quantity of resources to the decisions it made at both the original application and Tier 1 review stages to ensure its decisions were robust. We propose to keep the broad current structure of the incentive, and to make some amendments to the parameters.

2.11. We propose to remove the incentive on Capacity Agreement Notice (CAN) and Capacity Agreement Register (CAR) disputes. There were no disputes of these types in 2014/15 and they are expected only to arise due to administrative errors on the part of NGET. We are of the view that an incentive to not make administrative errors – or to resolve them efficiently where they have been raised – is unnecessary. In any case, we think they are unlikely to arise in practice. We do not propose to introduce an incentive on termination disputes. In our view, these disputes are unlikely to come in at the same time so NGET may not face significant resource decisions when dealing with them. We may reconsider this (and whether an incentive on CAN and CMR disputes is in fact desirable) at RIIO T-2 when we have more experience of disputes.

2.12. On the structure of the incentive, we propose maintaining the cap of zero overturned decisions at which NGET may gain the maximum 'reward'. We propose amending the 'floor' from six overturned decisions for the maximum 'penalty' to four overturned decisions. Given the experience of

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12 http://www2.nationalgrid.com/UK/Our%20company/Electricity/Market%20Reform/Announcements/EMR%20business%20plan%20proposal%20public%20document/

disputes in the first year of EMR, when we did not over turn any of NGET's decisions, we are of the view that moving more quickly to the maximum penalty is appropriate.

2.13. Contrary to NGET's proposal to introduce a 'reward' payment for one overturned decision, we propose to maintain the financial neutral point at one overturned decision (i.e. no reward or penalty). We are of the view that a reward for an eligibility decision made by NGET which we have to overturn would not be in the interest of consumers as it is not appropriate to make an incentive payment for a wrong decision. Experience of disputes in the first year of EMR also suggests that giving an upside for overturned decisions is not appropriate.

2.14. In terms of value of the incentive, NGET propose to increase the value of the cap and floor from the current maximum of +/- £125,000 to +/- £1.25m. NGET's reasons for this increase are: (i) the level and intensity of effort required to deal with disputes in year one of EMR was greater than NGET expected; (ii) an expectation that application volumes will increase as there will be two CM auctions each year from 2015, and; (iii) increased complexity of processes (eg checking applicants do not already hold CM / CfD agreements or contracts). We are of the view that these reasons do not justify this increase in the value of the incentive. Volume issues, and issues with the effort involved, should be addressed through improved processes and appropriate resourcing based on experience. We expect, as NGET gains further experience over time, this will assist its decision making and complexity should, if anything, reduce. Furthermore, we expect that any unnecessary complexity or ambiguity in the legislation will tend to be reduced over time as on-going refinements to the EMR legislation, which NGET can contribute to, are introduced.

2.15. However, now that we have experience in dealing with disputes against NGET decisions we think that the incentive value should be adjusted to take account of the amount of time and effort – and ultimately costs for consumers – NGET's continued thorough work here can save. We thus propose to increase the value of the incentive to a maximum of £100,000 each year for CM prequalification and CfD eligibility disputes (see Table 1). As noted above we also propose reducing the number of over-turned decisions before the penalty cap applies. The draft licence change is set out in Appendix 3.

Table 1 – Structure, parameters and values of the Ofgem's initial proposed EMR dispute incentive (compared to the current incentive)

Number of overturned decisions	CFD Qualification Decisions (£000s)	CM Qualification Decisions (£000s)	~~CAN AND CMR Decisions (£000s)~~
None	~~50~~ 100	~~50~~ 100	~~25~~
1	0	0	~~0~~
2	~~-10~~ -35	~~-10~~ -35	~~-5~~
3	~~-20~~ -65	~~-20~~ -65	~~-10~~
4 or more	~~-30~~ -100	~~-30~~ -100	~~-15~~
~~**5**~~	~~-40~~	~~-40~~	~~-20~~
~~**6 or more**~~	~~-50~~	~~-50~~	~~-25~~

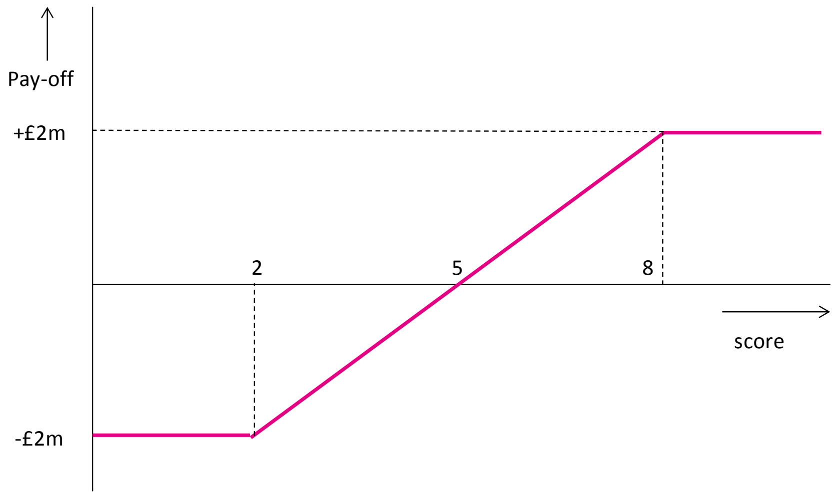
Customer and stakeholder satisfaction

NGET's business plan

2.16. NGET is proposing an incentive relevant to the proposed output on stakeholder satisfaction. The aim of this stakeholder satisfaction incentive is to ensure a high standard of engagement with EMR applicants and participants.

2.17. The structure of the incentive is similar to the existing RIIO Stakeholder Satisfaction survey. The measure will be the annual customer and stakeholder satisfaction scores for the separate customer and stakeholder satisfaction surveys for the Contracts for Difference (CFD) and Capacity Market (CM). Depending on the rating by respondents (0 being very dissatisfied and 10 being very satisfied), NGET may make or lose up to 0.1% of DECC's EMR budget each year (0.1% is around £2m). The neutral break point is proposed at a score of 5 and the proposed incentivised cap and floor are set at 2 and 8 points respectively (see Figure 1).

Figure 1 - Structure of financial incentive on EMR Customer and Stakeholder Satisfaction. Source: NGET Business Plan



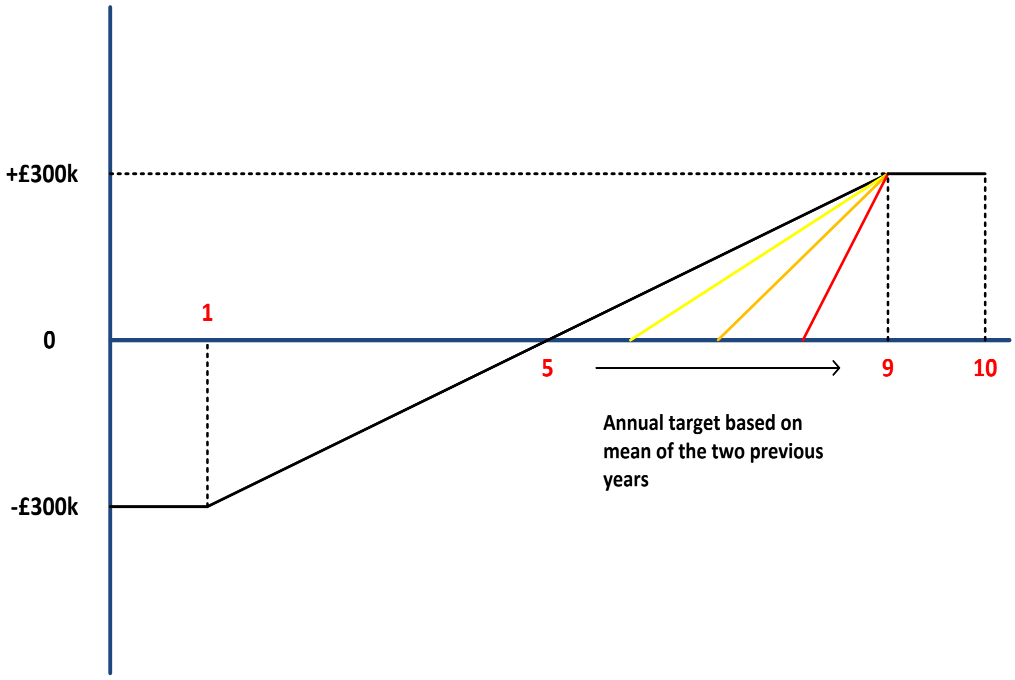
Ofgem's initial proposals

2.18. We are of the view that the proposed EMR Customer and Stakeholder Satisfaction Survey, as an output, is valuable to provide increased transparency to EMR stakeholders on the way NGET discharges its EMR roles. We believe that a financial incentive attached to this output will incentivise good quality delivery and engagement across NGET's EMR roles.

2.19. In terms of structure, we agree with NGET that this should use the principles of the existing RIIO Stakeholder Satisfaction Survey. Given the EMR work is a ring-fenced activity that brings NGET into contact with some stakeholders it would not usually encounter we think it is appropriate not to embed this incentive in the existing RIIO survey or incentive, at least during the RIIO T-1 period.

2.20. We believe that the measure should be the annual customer and stakeholder satisfaction survey scores for the CFD and CM survey. The performance will be measured on a scale of 0 (very dissatisfied) to 10 (very satisfied). We agree with NGET that the incentive structure should be a symmetrical cap and floor (see Figure 2). However, we propose, having reviewed NGET's scores under the RIIO-T1 survey, that the parameters for the cap and floor should be set at 9 (cap) and 1 (floor).

Figure 2 - Structure of the financial incentive on EMR Customer and Stakeholder Satisfaction (£300k for each annual CM and CfD survey): Ofgem's initial proposal



2.21. We propose that NGET is provided with a challenging target to drive performance. There will be no incentive in Year 1 (2015) – the licence condition will in any case not come into effect until April 2016. The result from Year 1 will be used to set the target for Year 2 (2016). For Year 3 (2017) onwards, the target will be the mean of the aggregate scores achieved in the two previous years. For example, if the actual score in 2016 is 6.2 and in 2017 7.0 then the target for 2018 will be 6.6 ((6.2 +7.0)/2). We also propose that the target cannot go below 5.0 so no upside incentive is payable for any scores below 5.0 to ensure poor performance is not rewarded.

2.22. Turning to the value of the incentive, NGET proposes 0.1% of DECC's overall EMR budget. We are of the view that anchoring the value of the incentive to DECC's EMR budget is not appropriate. The value of the incentive should be related to the value to consumers. While that is not simple to estimate, we are of the view that £600,000 (around 10% of annual EMR Total Expenditure) each year split equally between both surveys is appropriate.

2.23. The Customer and Stakeholder Satisfaction Survey Revenue Adjustment ("CSSSRA") will be calculated according to the following formula (see Table 2 for an illustrative example):

If Score ≥ Target, then:

- CSSSRA = MaxIncentive * [Min (Score, ScoreCap) – Target] / [ScoreCap – Target].

If Score < Target, then:

- CSSSRA = - MaxIncentive * [Target - Max (Score, ScoreFloor)] / [Target - ScoreFloor].

Where:

- Score is the Customer and Stakeholder Satisfaction score achieved by NGET in a given year
- MaxIncentive is the maximum monetary amount of the incentive, (proposed: £300,000 per survey, see Figure 2).
- ScoreCap is the survey Score for which MaxIncentive is received by NGET and no further incentive applies for survey scores above ScoreCap, currently set at 9.
- ScoreFloor is the survey Score for which NGET has maximum negative adjustment to revenues at –MaxIncentive, with no further penalties levied for scores below ScoreFloor, currently set at 1
- Target is the target score, currently set at the average of the actual scores achieved in two previous years, except for 2016 when Target equals the 2015 survey result.

Table 2: Illustrative example of customer and stakeholder satisfaction incentive payment calculation (note this is for one of two surveys)

	2015	2016	2017	2018	2019	2020
Score	6	6.2	7	7.1	6.9	7
Target	-	6	6.1	6.6	7.05	7
Difference Score to Target	-	0.2	0.9	0.5	-0.15	0
Difference Target to ScoreCap / ScoreFloor	-	3	2.9	2.4	6.05	2
Performance	-	7%	31%	21%	-2%	0%
Total incentive payment (CSSSRA)	-	£20,000	£93,103	£62,500	-£7,438	0

Volume of pre-qualified capacity for the CM auctions

NGET's proposal

2.24. NGET proposed a financial incentive on the volume of conditionally prequalified DSR capacity for the CM one year ahead (T-1) and on the volume of conditionally prequalified capacity for the CM four year ahead (T-4) auctions. NGET is of the view it can increase the volume of prequalified capacity through its stakeholder engagement: 'marketing' the CM and assisting applicants through the processes. NGET's rationale for the incentive is that additional participants may increase competition in the auction and therefore drive down the clearing price in the auction. The proposed structure of the incentive is a symmetrical cap and floor of +/- £2m for the T-4 auction and +/- £1m for the T-1 auction (see Figure 3 and 4).

Figure 3 - Structure of financial incentive on pre-qualified capacity for the T-4 auction. Source: NGET Business Plan

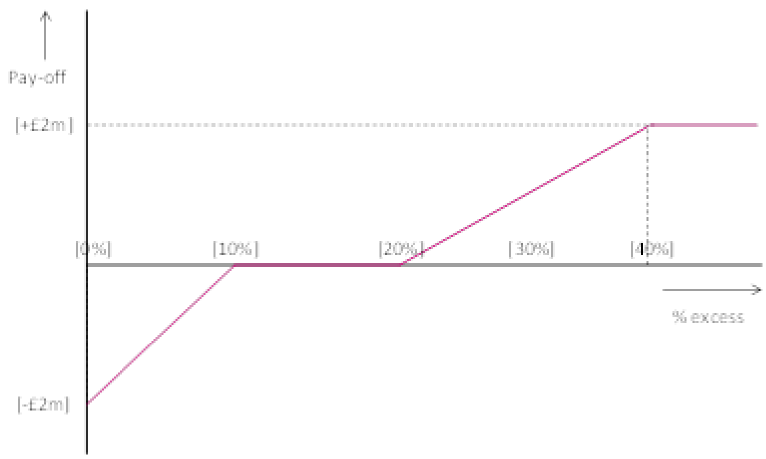
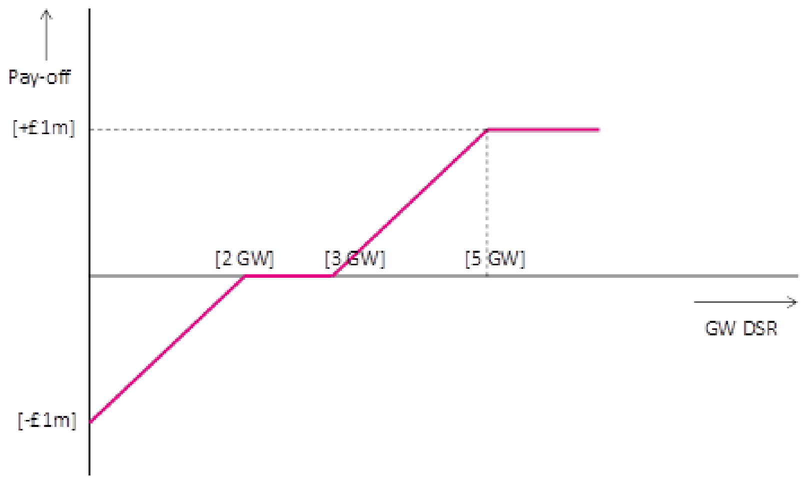


Figure 4 - Structure of financial incentive on pre-qualified DSR capacity for the T-1 auction.
Source: NGET Business Plan



Ofgem's initial proposal

2.25. It is plausible that, as NGET state, increased competition in the CM auction may lead to lower clearing prices. However, we are of the view that it will be difficult to attribute, and thus accurately measure, the value added of NGET's stakeholder management efforts in securing additional volumes in the CM T-4 auctions. Commercial incentives, rather than the marketing and facilitating efforts of NGET, are likely to be the main driver for participation in the T-4 CM auctions. In addition, the 2014 CM auction was 38% oversubscribed so we do not see any evidence of a market failure. Though we note here that NGET expect there may be less capacity coming forward in future auctions, we do not propose to incentivise NGET for the volume of CM capacity that prequalifies for the T-4 auctions.

2.26. Note that the funding we are proposing for NGET is expected to allow a significant amount of stakeholder engagement to help ensure participants in all the auctions are ready to take part in, and are helped through, the qualification and other processes.

2.27. In our discussions of the business plan with NGET, NGET suggested the T-4 incentive could focus solely on new build generators. While we think this may have more merit than an incentive on all capacity (as new build may require more guidance to get through application processes for example) we are not convinced at this stage that the added value of NGET's activities to promote new build participation can be identified.

2.28. We do however think there is merit in NGET's proposal to have an incentive to encourage and facilitate the participation of DSR providers in the T-1 auctions. We note from NGET's Business Plan that it assumes around 300 DSR providers could be coming forward each year, though it is not known how much capacity this would represent. DSR allows industrial and domestic customers to participate in the energy market, and to contribute to system reliability. This may increase the overall efficiency of the energy system. DSR can be particularly valuable at times of system stress and it differs from traditional capacity procured in the Capacity Market as it involves shifting or reducing demand rather than meeting demand through increased supply. It is also likely that at least some DSR providers are less familiar with engaging with NGET, or with government energy policy initiatives, so may benefit more than generators from NGET facilitating their participation in the CM and may be more responsive to NGET's marketing efforts. It is also possible that this incentive will mitigate against any bias, real or perceived, that NGET may have towards generation over DSR (as generation adds value to the network) or towards dealing with larger companies rather than smaller ones.

2.29. We propose to incentivise the amount of additional DSR capacity that pre-qualifies for the T-1 auctions based on NGET's proposals. It is possible that DSR participation will grow over time at least partially because market participants will learn of the new mechanism and its benefits and this knowledge will spread to an increasing number of potential bidders. So we think the benchmark for the incentive should move over time as follows:

- For the 2018 T-1 auction, the benchmark will be the GW of pre-qualified DSR in the 2017 T-1 auction (an option suggested by NGET in its business plan).

- For the 2019 T-1 auction and onward, the benchmark will be the average of the GW of pre-qualified DSR in the two previous T-1 auctions.

2.30. As we are proposing that the benchmark is based on the results of the first (and subsequent) T-1 auctions, we do not propose to introduce a dead-band to the incentive structure. We are of the view that basing the benchmark on experience and setting a cap and floor will manage the risks for consumers and NGET. The structure of the incentive we propose is as follows:

If DSR ≥Benchmark, then
- DSRIncentive = £500,000 * [Min(DSR, Benchmark + 2) – Benchmark]

If DSR < Benchmark, then
- DSRIncentive = £500,000 * [Max(DSR, Benchmark – 2) – Benchmark]

Where:
- DSR is the DSR capacity that pre-qualifies for the T-1 auctions
- Benchmark is set at the average of the GW of pre-qualified DSR in the two previous T-1 auctions, except for 2018 when the benchmark will be the GW of pre-qualified DSR in the 2017 T-1 auction
- DSRIncentive is the revenue adjustment for NGET related to additional DSR capacity that pre-qualifies for the T-1 auction.

2.31. We note that if the volume of pre-qualified DSR capacity falls below 2GW this incentive will become asymmetric – with the floor being hit more quickly. We have therefore considered setting the cap and the floor as a percentage of the Benchmark, rather than in terms of absolute amounts relative to the Benchmark. If, for example, we incentivised the volume of DSR capacity prequalified by 50% around the benchmark the structure of the incentive would be:

If DSR ≥Benchmark, then

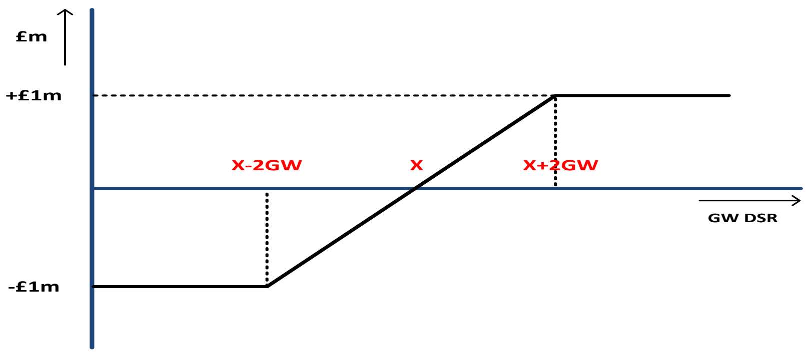
- DSRIncentive = £2,000,000 * [Min(DSR, 1.5 * Benchmark)/Benchmark – 1]

If DSR < Benchmark, then

- DSRIncentive = £2,000,000 * [Max(DSR, 0.5* Benchmark)/Benchmark – 1]

2.32. We also want to ensure that this incentive does not focus on quantity at the expense of quality. We want to avoid it leading to DSR providers who are not actually ready to take part in an auction, or a delivery year, being encouraged to come forward with implications for security of supply. To mitigate this risk we propose that NGET report on the steps that it takes in each T-1 prequalification round to encourage and facilitate DSR participation including setting out how it has ensured DSR providers understand the implications of CM participation. This report will also help mitigate the risk that NGET game the baseline for this incentive in the 2017 T-1 auction.

Figure 5 - Structure of financial incentive on pre-qualified DSR capacity for the T-1 auction: Ofgem's initial proposal



Where 'x' is the Benchmark GW of DSR (see text)
To note, we have chosen £1m (as proposed in NGET's business plan) as this appears to be appropriate given the structure of the incentive.

Demand forecasting accuracy

NGET's proposal

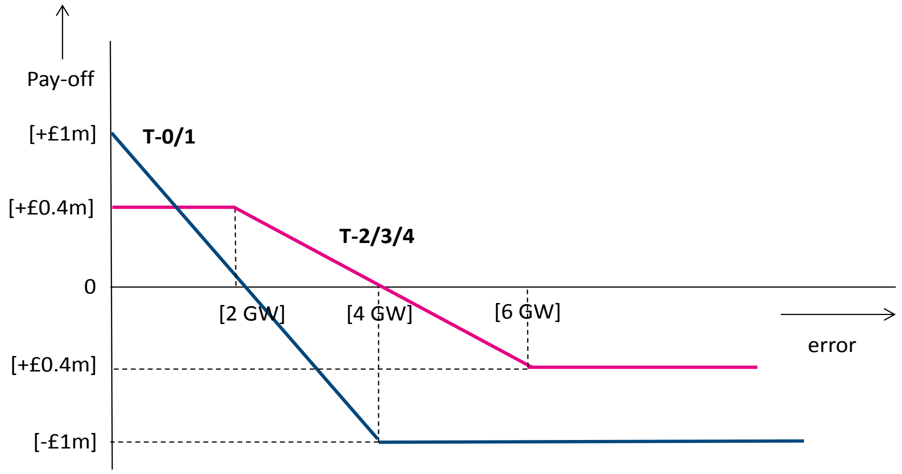
2.33. We agree that demand is a critical factor used in determining the capacity to be procured in the T-1 and T-4 auctions. The rationale for this incentive is that more accurately forecasted demand may result in lower costs to consumers due to a lower risk of under or over procurement of capacity. NGET also proposed that its demand forecasts at T-0, 2, and 3 are incentivised given the relevance of the forecasts to Demand Side and Supplemental Balancing Reserve procurement. However, this consultation focuses solely on the EMR relevant (T-1 and T-4) forecasts.

2.34. The measure proposed is the forecasting error between forecasted peak transmission demand and the Average Cold Spell adjusted outturn data (as defined in the Grid Code[13]). The metered transmission peak demand volumes that NGET proposes to use as an outturn measure do not include demand met by embedded generation or interconnection, in the latter case due to considerable uncertainty in the direction and level of electricity between countries[14].

2.35. The structure of the incentive is a symmetrical cap and floor regime for both the T-1 and T-4 forecast. For the T-1 forecast, NGET propose up to a £1m reward for the forecast being less than 2GW above or below actual demand, capped at a 0GW error, and up to a £1m penalty if the forecast is more than 2GW above or below actual demand, capped at a 4GW error.

2.36. For the T-4 forecast, the structure is similar. NGET propose up to a +£0.4m reward for the forecast being less than 4GW above or below actual demand, capped at a 2GW error, and up to a £0.4m penalty if the forecast is more than 4GW above or below actual demand, capped at a 6GW error. (see Figure 6).

Figure 6 - Structure of financial incentive on demand forecasting accuracy. Source: NGET Business Plan



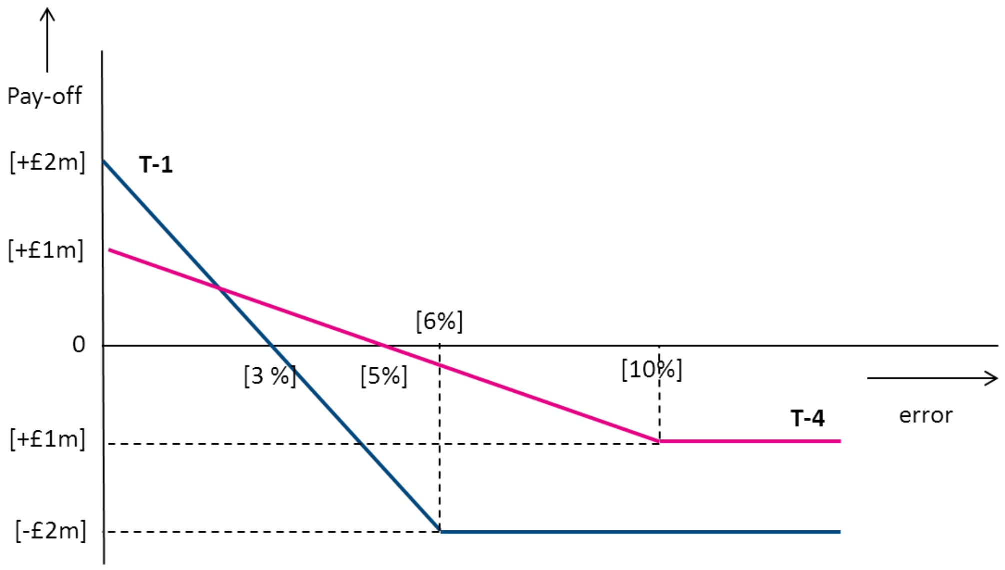
2.37. In discussions with NGET since they submitted their business plan, NGET suggested revised parameters for this incentive. The revised parameters are shown below: NGET propose that the neutral point for the T-1 and T-4 auctions would be 3% and 5% (equal to 1.6 GW and 2.7 GW based on the

[13] The amount of electricity supplied from the Grid Supply Points plus: that supplied by Embedded Large Power Stations, and exports from the National Electricity Transmission System across External Interconnections, and National Electricity Transmission System Losses, and, for the purposes of this definition, includes: the Demand taken by Station Transformers and Pumped Storage Units.

[14] See EMR Capacity Report: http://www2.nationalgrid.com/UK/Our%20company/Electricity/Market%20Reform/Announcements/June%202014%20Auction%20Guidelines%20publication/

weather corrected peak demand of 54.3 GW in 2014/15). The proposed incentive values are also higher.

Figure 7 – NGET's revised structure for the financial incentive on demand forecasting accuracy.
Source: NGET



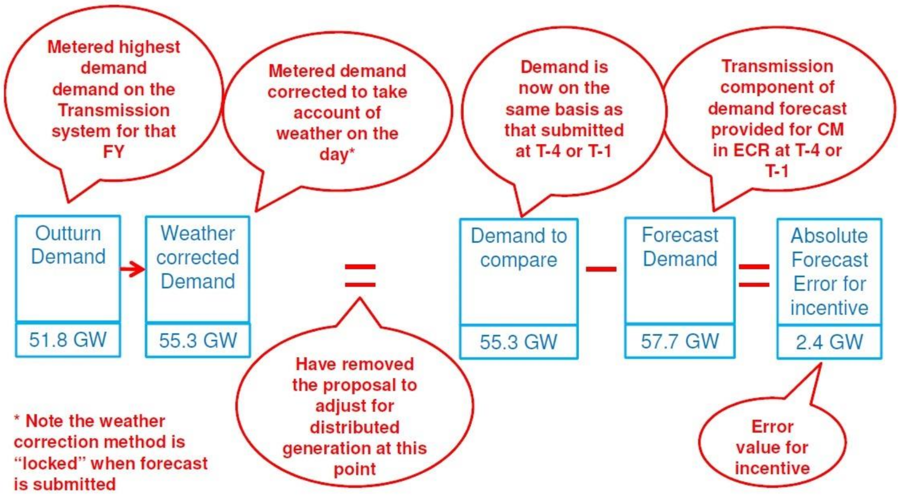
Ofgem's initial proposal

2.38. Given the value of the T-4 Capacity Market contracts of just under £1bn in 2014, we believe that there is a potential for significant savings for consumers from more accurate demand forecasting.

2.39. We are of the view that the measure on which NGET is incentivised on should be the error between the forecasted demand (that is the transmission peak demand[15] for one year (T-1) and four years ahead (T-4)) and the outturn data which is corrected for the Average Cold Spell (see Figure 8). We do not think that NGET should be able to adjust the outturn to reflect embedded generation as it proposes. We think NGET should take the expected level of embedded generation into account when making its forecasts. We agree that the outturn demand should be adjusted for interconnection. For transparency purposes, we propose that NGET publish a methodology statement, including the links to the data used on National Grid's Data Explorer[16].

[15] See definition of "National Demand" in Grid Code, page 24, http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/Grid-Code/
[16] http://www2.nationalgrid.com/UK/Industry-information/Electricity-transmission-operational-data/Data-explorer/

Figure 8- Illustrative comparison of forecasted demand to outturn data



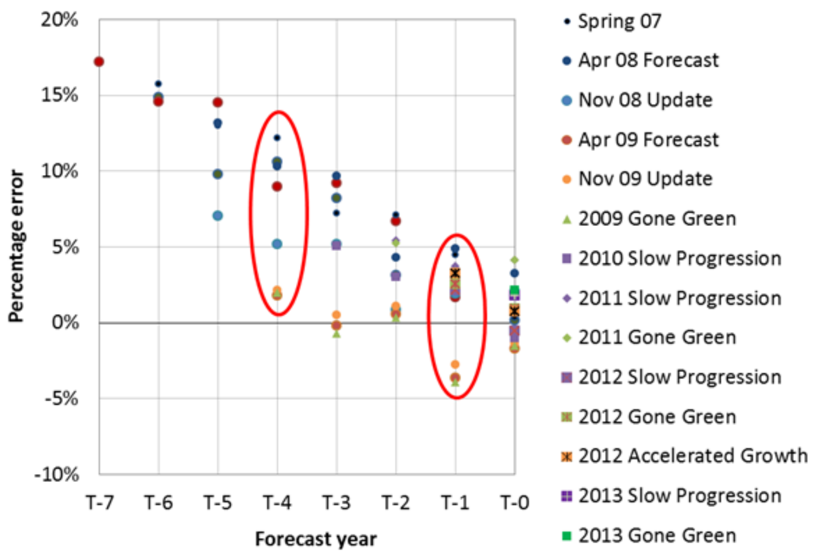
Note that we propose that the outturn is also adjusted for interconnection

2.40. In terms of structure we believe that a cap and floor regime is appropriate, providing an appropriate balance of risk and reward. We believe that the structure should apply to both over and under forecasts of demand as we think both instances can impose material costs on consumers – of paying too much for unnecessary capacity or of an increased risk of disconnection.

2.41. As stated above, NGET has, since submitting the EMR Business Plan, proposed in discussions with us a revised set of baseline forecasting errors of 3% and 5% for the T-1 auction for the T-4 auction respectively. NGET have based these revised parameters on their historic performance for their previous Winter Outlook and Future Energy Scenarios work (see Figure 9)[17]. It suggests that NG had a tendency to over-forecast demand – though it should be noted that that a number of the forecasts were affected by the 2008/09 recession and the fact that demand did not 'bounce back' after this recession as NGET expected based on past recessions.

[17] http://www2.nationalgrid.com/UK/Industry-information/Future-of-Energy/Future-Energy-Scenarios/

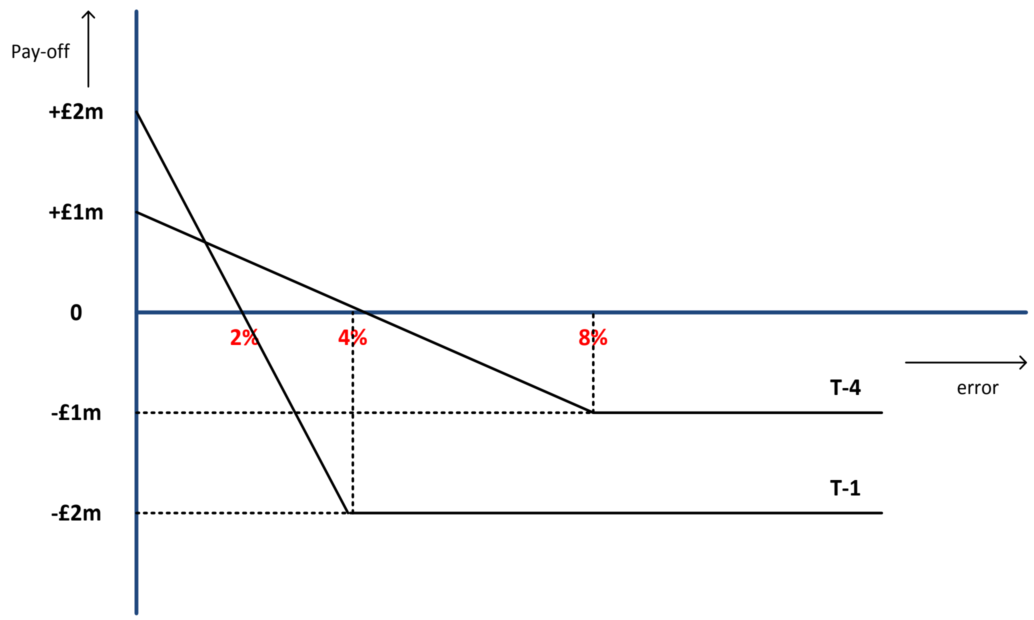
Figure 9 - Comparison of historic NG demand forecasts and scenarios; Source National Grid



2.42. Having reviewed the data we are of the view that the neutral point should be lower than NGET propose: 2% (equivalent to around 1.1 GW based on the weather corrected peak demand of 54.3 GW in 2014/15) for the T-1 forecast and 4% for the T-4 forecast (equivalent to around 2.2 GW). For the T-1 forecast a simple rule of thumb 'next year's demand will be the same as this year's' would produce an error of 3% or less in eight of the last 13 years for which data is available. We think NGET can do better than this rule of thumb and our proposal of a 2% neutral point for the T-1 forecast reflects that expectation. Our proposal for the T-4 forecast may be more challenging. A simple rule of thumb 'demand in four years' time will be the same as this year's demand' would produce an error of 5% or less in only one of the last 10 years for which data is available. However, an error of 5% (around 2.7GW) could impose significant costs on consumers so we do not think setting the neutral point at 5% would serve consumers interests. Instead we propose to set the neutral point at 4% to drive improved T-4 demand forecasts. Recognising the greater downside risk to NGET, we propose setting a lower value incentive on the T-4 forecast, of £1m, in-line with NGET's proposals.

2.43. We propose the maximum incentivised forecasting error for T-1 is a deviation of 2% from the neutral point of 2% (so NGET will receive the maximum payment for a zero error and lose the maximum amount for an error of 4%). For T-4 we propose the maximum incentivised forecasting error will be 4%. This means the maximum penalty of £1m is reached if NGET's error is 8% and the maximum gain would be where NGET's error is zero (see 10).

Figure 10 - Proposed structure of the T-1 and T-4 demand forecasting accuracy incentive



2.44. We also propose that NGET report annually on the steps it has taken to improve demand forecasts so we can seek to ensure this incentive rewards actions rather than chance.

2.45. We considered an asymmetric incentive; setting a bigger downside for under-forecasting demand for example. However, we found it difficult to value under and over forecasts more accurately to allow this and we also think that an asymmetric incentive may result in NGET being motivated to bias its demand forecasts upwards (and we note that there is a perception that NGET may have a tendency to do that)[18].

2.46. We also considered setting an annual forecasting error efficiency target to provide NGET with a challenge to improve over time. We believe there are two possible options. Firstly, the target could be administratively reduced by a set efficiency factor – eg 0.05% each year. An alternative would be the use of an econometric model as used in setting the incentive on the accuracy of gas demand forecasting. While the model approach could be more accurate than administrative reductions it does require a substantial amount of time series data, which is not available. In any case, we do not propose changing the target during the RIIO-T1 period.

Summary of proposed incentives

2.47. The financial incentives we have proposed would lead to a maximum upside or downside of £4.8m in any one year (though note that not all the

[18] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/324976/EMR_Panel_s_Final_Report_on_National_Grid_s_ECR.pdf

incentives will pay-out immediately). This is high relative to the EMR revenues that we are proposing. We think this is justified given, as NGET notes in its business plan, by 2020 the CfD and CM schemes which NGET deliver could process £2-£4bn of transactions each year. It is important that NGET delivers its EMR roles efficiently and effectively to ensure EMR is delivered in the interests of consumers.

Table 3 – Summary of proposed incentives

	Value each year[19]
Annual report on performance	Reputational
Publishing specific concerns we have with performance and any enforcement actions ad-hoc	Reputational
Accuracy of Tier 1 dispute resolution	£0.2m
Customer and stakeholder satisfaction	£0.6m[20] (Also reputational)
Volume of pre-qualified DSR capacity for the T-1 CM auctions	£1m
Demand forecasting accuracy (T-1)	£2m
Demand forecasting accuracy (T-4)	£1m

Draft licence conditions

2.48. All four incentives will require amendments or additions to the existing Special Licence Conditions of NGET. As previously stated, we are – at the Initial Proposals stage – only consulting on the draft licence condition for the incentive on the accuracy of dispute resolution (see Appendix 3).

[19] Note that all the financial incentives are symmetric.
[20] To be split equally between the CM and CfD surveys.

3. EMR preparatory costs

Chapter Summary

This chapter sets out our assessment of the actual costs NGET incurred in preparing for its EMR delivery roles and what adjustments should be made to the funding already granted to NGET for this work.

Question box

Question 11: Do you agree with our proposed adjustments to NGET's preparatory costs incurred between April 2013 and July 2014?

Preparatory Costs

3.1. In March 2014, following a consultation in December 2013, we decided to give NGET funding for its EMR preparatory costs of £17.3m[21] to cover staff, information systems (IS), legal and consultancy costs that it anticipated to incur between April 2013 and 'EMR go live' in August 2014. We also said that we would reconcile the costs that were funded against actual efficient and economic incremental costs incurred, and consult on the total costs proposed for remuneration.

3.2. NGET reported to Ofgem as part of the business plan submitted in January 2015 that its final preparation costs were £11.4m. The main reasons for the £5.9m underspend were:

- Staff numbers (£0.5m) – EMR project staff were 29 at the end of July 2014 and not 35 as NGET had forecast.
- Lower IS expenditure (£5.1m) – expenditure was £5.3m against an estimate of £10.4m due to some elements of the systems implementation being delayed and a transitional administration system being implemented instead of an enduring one. Also the forecast level of systems integration with the SO systems was not required.
- Other under spends (£0.3m) – these were due to lower business support costs as a result of lower staff levels

3.3. Although overall costs were lower than originally estimated, legal costs incurred were higher, £2.1m instead of £1.7m. The majority of the legal expenditure (£1.3m) was incurred in drafting and redrafting of the Capacity Market Rules.

[21] £17.1m in 2013-14 prices

Efficiency of costs

3.4. In setting the overall funding for preparatory costs we said that only costs NGET incurred additional to those funded for SO in the main RIIO-T1 price control would be allowed.

3.5. Throughout the EMR preparation period April 2013 to July 2014 we collected monthly information on costs incurred by NGET and held meetings with NGET and DECC at which we discussed and scrutinised costs incurred. We also checked that the costs incurred were for preparing to deliver EMR. This meant that the final figures were as expected when NGET reported them, and we knew most of the reasons for the costs being lower than originally estimated. Nevertheless we did ask NGET some additional questions to ensure we had a fuller understanding.

3.6. Given that the overall preparation costs are lower than originally estimated and the total costs are small in relation to the transmission owner (TO) costs we do not propose to review the costs in any greater detail than we have already. We are content that staff costs are reasonable given the number of staff within the project, and the positions of the staff seconded from regulated TO and SO businesses have been filled by additional staff. Legal costs are higher than estimated, but this is due to the number of changes in the rules governing the capacity market and the fact that many these changes were made late in the process. IS costs are lower than expected and relate to the implementation of an auction system and a transitional administration system and appear to be reasonable.

3.7. Therefore we are not proposing any reduction in the overall costs for further efficiencies, though we are proposing reductions of £2.5m for the following reasons.

- Lower business support costs (£0.4m). The amount allowed for business support costs was 40% of total staff costs. In reviewing the costs at the end of the preparatory period NGET have agreed that using 27% better reflects actual additional costs incurred.

- IS costs to be recovered from NGET's IS suppliers (£2.1m) for a system that was not delivered. This figure has been confirmed by NGET.

Costs to be recovered

3.8. NGET were originally allowed to recover £17.3m costs from consumers for costs incurred in preparing for the EMR role. The final figure we propose to allow NGET to recover from consumer is £8.9m ie £11.4m less the adjustment of £2.5m as above.

Appendix 1 – Outputs

#	Outputs
1	An update on previous Delivery Plan analysis to support the DECC Annual Update
2	A "call for evidence" data collection exercise
3	Modelling and Analysis work & initial report on Strike Price scenarios to inform DECC's draft Delivery Plan
4	Modelling and Analysis work & final report on Strike Price scenarios to inform DECC's final Delivery Plan
5	CfD Guidance document to help applicants through the application process
6	CfD Valuation report to DECC on value of applications (after application window closes + after Appeal/review deadline date)
7	Completed CfD eligibility assessment for each CfD applicant
8	Completed CfD allocation process for CfD applications within an allocation round
9	Completed CfD eligibility Review process
10	CfD reports to DECC post allocation
11	CfD allocation Auditor report for the Secretary of State
12	Electricity Capacity report for the Secretary of State
13	CM T-4 Auction Guidelines (Initial & Final)
14	Completed pre-qualification for the CM T-4 auction
15	CM T-4 pre-qualification report to the Secretary of State
16	Completed CM T-4 Auction
17	CM T-4 Auction Monitor report for the Secretary of State
18	CM T-4 Auction Results published
19	Issue T-4 Capacity Agreements
20	Completed CM DSR Transitional pre-qualification, auction, reporting and agreement issue
21	Completed CM T-1 pre-qualification, auction, reporting and agreement issue
22	Maintained/Updated Capacity Market Register
23	Review of new & refurbishing plant milestones

#	Outputs
24	Confirmed eligibility of physical secondary trades
25	Information and data to the Settlement Agent before and during the CM Delivery Year
26	Annual EMR Customer and Stakeholder Satisfaction Survey on CFD and CM.

Appendix 2 – Consultation Response and Questions

1.1. We would like to your views on any of the issues in this document. We would especially welcome responses to the specific questions at the beginning of each chapter.

1.2. Please send your responses on or by 16 June 2014 to:

Sujitra Krishnanandan
EMR Team
Markets Directorate
Ofgem, 9 Millbank, London SW1P 3GE
Tel: 020 3263 9832
Email: Sujitra.Krishnanandan@ofgem.gov.uk

1.3. 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.

1.4. 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.

1.5. Please direct any questions on this document to the contact above.

Appendix 3 – Proposed Licence Changes

Special Condition 4L: Financial incentive on dealing with EMR disputes

Introduction

4L.1 The purpose of this condition is to establish arrangements to determine an adjustment to the licensee's SO Opening Base Revenue Allowance in Relevant Year t by means of the term $SOEMRDRI_t$ for the purposes of paragraphs 4A.3 and 4A.4 of Special Condition 4A (Restriction of System Operator Internal Revenue) as a result of the financial incentive placed upon the licensee to accurately determine certain disputes referred to it under the Regulations.

4L.2 The adjustments to the licensee's SO Opening Base Revenue Allowance (either positive or negative) in Relevant Year t derived under this condition will depend on how many of the Reviewable Decisions made by the licensee in Relevant Year t-2 under the Regulations are overturned by the Authority.

4L.3 The "Regulations" for the purposes of this condition are:

(a) The Contracts for Difference (Allocation) Regulations 2014 (the "CfD Regulations"); and

(b) The Electricity Capacity Regulations 2014 (the "CM Regulations")

Part A: Calculation of $SOEMRDRI_t$

4L.4 For the purposes of paragraphs 4A.3 and 4A.4 in Special Condition 4A, and subject to Part B of this condition, $SOEMRDRI_t$ has the value zero in all years except for 2016/17 and 2017/18 when it is derived in accordance with the following formula:

$$SOEMRDRI_t = (CfDQD_t + CMQD_t \cancel{+ CANMR_t})$$

4L.5 In the above formula $SOEMRDRI_t$:

$CfDQD_t$ means the amount shown in column 1 of the table in Schedule 1 of this condition against the number of decisions made in relation to CfD Qualification Decisions under the CfD Regulations in Relevant Year t-2, which have been overturned by the Authority under regulation 46 of the CfD Regulations.

$CMQD_t$ means the amount shown in column 2 of the table in Schedule 1 of this condition against the number of decisions made in relation to CM Qualification Decisions in Relevant Year t-2, which have been overturned by the Authority under regulation 71 of the CM Regulations.

~~$CANMR_t$ means the amount shown in column 3 of the table in Schedule 1 of this condition against the number of decisions made in relation to CM Capacity Agreement Notice ("CAN") Decisions and CM Capacity Market Register ("CMR") Decisions in Relevant Year t-2, which have been overturned by the Authority under regulation 71 of the CM Regulations.~~

The values of the terms in the table in Schedule 1 of this condition are expressed in 2009/10 prices.

Part B: Determination of $SOEMRDRI_t$

4L.6 The Authority shall, after consultation with the licensee, and having regard to Part A of this condition, direct the value of $SOEMRDRI_t$ for the Relevant Year t.

4L.7 The direction made pursuant paragraph 4L.6 shall be made by the Authority on or before 30 November in the year preceding Relevant Year t.

Part C: Definitions

4L.8 The Definitions in this condition will have the following meaning:

~~**Capacity Agreement Notice**~~	~~as defined in regulation 2 of the CM Regulations;~~
~~**Capacity Market Register**~~	~~as defined in regulation 2 of the CM Regulations;~~
CfD Qualification Decisions	means decisions made by the licensee under regulation 20(4) of the CfD Regulations to uphold Non-qualification Determinations;
~~**CM Capacity Agreement Notice ("CAN") Decisions**~~	~~means decisions made by the licensee under regulation 69(3) of the CM Regulations to uphold the decision not to amend the Capacity Agreement Notice;~~
~~**CM Capacity Market Register ("CMR") Decisions**~~	~~means decisions made by the licensee under regulation 69(3) of the CM Regulations to uphold the decision not to rectify the Capacity Market Register;~~
CM Qualification Decisions	means decisions made by the licensee under regulation 69(3) of the CM Regulations to uphold Prequalification Decisions;
Non-qualification Determinations	as defined in regulation 19(2)(b) of the CfD Regulations;
Prequalification Decisions	as defined in regulation 2 of the CM Regulations;

Reviewable Decisions means CfD Qualification Decisions~~,~~ and CM Qualification Decisions~~, CM Capacity Agreement Notice Decisions and CM Capacity Market Register Decisions~~.

Schedule 1

Components of the term $SOEMRDRI_t$ in 2009/10 prices

	(1)	(2)	~~(3)~~
Number of overturned decisions	**$CfDQD_t$ £000s**	**$CMQD_t$ £000s**	**~~$CANMR_t$ £000s~~**
No overturned decisions	~~50~~ 100	~~50~~ 100	~~25~~
1 overturned decision	~~0~~	~~0~~	~~0~~
2 overturned decisions	~~-10~~ -35	~~-10~~ -35	~~-5~~
3 overturned decisions	~~-20~~ -65	~~-20~~ -65	~~-10~~
4 or more overturned decisions	~~-30~~ -100	~~-30~~ -100	~~-15~~
~~5 overturned decisions~~	~~-40~~	~~-40~~	~~-20~~
~~6 or more overturned decisions~~	~~-50~~	~~-50~~	~~-25~~

Appendix 4 – Feedback Questionnaire

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.

Please send your comments to:

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