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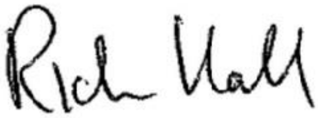
Dear Sujitra

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

Our responses to the questions posed in the consultation named above can be found in the annex to this letter. This submission is entirely non-confidential and may be published on your website. If you would like to discuss any matter raised in more detail please do not hesitate to get in contact.

Yours sincerely



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Annex - responses to consultation questions

Chapter 1: Initial proposals on revenues and uncertainty

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

No, we consider that there is reasonable scope for further cost reduction in the assumptions that you are making on efficiency.

You propose to build on the 1% to 2% efficiency reduction put forward within NGET's proposals with a further 10% reduction - suggesting an efficiency gain of 11-12% over the period. However, you note that the final TOTEX baseline for RIIO-T1 was 'at least' 10% lower than its original business plan figures and that it is currently forecasting to make a further 9% saving against those allowances - suggesting an efficiency gain of at least 19% over the period.

Clearly, the two sets of NGET projections were put forward at separate times, and it is it possible that either the figures it is projecting in relation to its EMR functions contain less fat than those put forward for the wider T-1 settlement, or that its activities within this area contain less scope for efficiency savings than the wider price control. Indeed, these are not mutually exclusive possibilities - both may be true. However, no evidence has been put forward that would suggest a reason for us to conclude that efficiency gains in this area will deviate markedly from those manifest in the wider business. In the absence of such evidence, we would suggest that an efficiency gain of ~19% should be assumed in the determination. As we noted in our recent report, 'Many happy returns', Ofgem has tended to bake-in outperformance to recent price control settlements and we would be uncomfortable if a bar was set that can be outperformed without difficulty.

On the detail of specific headcount and modelling duties etc, we have little comment beyond that we broadly agree with your observations on stakeholder management. Your comment that '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 other team heads when required' - seems correct to us. In practice, now that the EMR legislation is passed, we would expect most stakeholder engagement in relation to it to be the practical nuts and bolts of service delivery, rather than dealing with Government or more distant stakeholders. It seems intuitive that this could be done by existing team heads rather than requiring a significant dedicated stakeholder engagement function.

"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?"

Yes, we do. We would be uncomfortable with an upfront £11m allowance to cover specific larger uncertainties as proposed by NGET, and prefer your approach of reserving the right to adjust NGET's allowances accordingly.

There are several reasons for this view.

First, that the £11m is highly speculative - it may or may not be needed. You highlight that actual costs might be significantly higher or lower which implies a material risk of windfall gains or losses if this funding is determined upfront.

Secondly, no detail has been given on the ‘five speculative events’ that it may be needed to cover. In the absence of any detail on what it is covering, we could not support an allowance. What is it for?

Thirdly, we think that major uncertainties driven by legislation could be adequately handled through ad hoc further review as set out in paragraph 1.25 if they crystallise, and that this is a better approach than assuming they will crystallise. Minor uncertainties should simply be covered by NGET under the terms of its other funding - noting that, as highlighted in our answer to Question 1, some fat appears to exist in the efficiency gain assumptions. Some uncertainty is an inevitable feature of life for any business - regulated or not - and the purpose of regulation should not be to inoculate networks from all possible turbulence; they are better placed to manage those costs than their end users are.

In the event of an upfront award of £11m (or some other figure) to cover uncertainties we would expect to see the inclusion of an adequate clawback mechanism to allow this money to be fully recovered for consumers if not subsequently needed.

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

No, we do not think there is sufficient evidence presented to justify these.

Paragraphs 1.27 and 1.28 suggest that the allowances for the first twenty months of operation will more than double from £5.1m to £11.8m as a result of such a step. This is a very sizeable leap, the justification for which is only covered by a single paragraph (1.29). From that paragraph, we understand that this might be a phasing issue that does not reflect additional consumer costs, but simply the movement of the date on which existing costs are incurred from one time period to another. But the explanation is sufficiently ambiguous that we cannot be certain of this. The reference to Table 4 does not help the reader.

We do not rule out the possibility that this approach is reasonable, but as a stakeholder can only make a judgement based on the information made available to us. Based on the explanation in this chapter, we cannot see a compelling case for your proposals on the allowances and true-up.

Chapter 2: Initial proposals on outputs and incentives

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

We agree with the principle that user satisfaction should be gauged and rewarded/penalised. We are less clear on whether there need to be separate customer and stakeholder satisfaction surveys. In practice, we think that the customers and stakeholders of NGET’s EMR activities may be nearly, or completely, identical. It may be more administratively efficient to simply run a single incentive scheme here rather than have two covering broadly similar ground.

We would like to see further detail published on how the survey or surveys will be conducted.

“Question 5: Do you agree with maintaining the broad structure of the incentives on disputes and the proposed amendments to its parameters, and the increase in the value of the incentive?”

Partially.

Capacity Agreement Notice and Capacity Agreement Register disputes

We support the removal of the incentive on Capacity Agreement Notice and Capacity Agreement Register disputes. We note that there have been no disputes in these areas to date, and your views that they are both unlikely in future and that an incentive to avoid administrative errors should be unnecessary. In combination, these factors suggest this incentive can be removed.

CfD and CM qualification decision disputes

We agree with the rationale for tightening the incentive penalty on CfD and CM qualification decisions, however we are not convinced that the proposed configuration is optimal.

You propose to move the floor point at which the maximum penalty could be incurred from six to four, with a neutral position of one, and setting the cap at which the maximum reward could be accrued to zero. In the first eight months of the incentive scheme, no disputes were overturned. We recognise that past performance is not a guarantee of future performance, however it does has some informative value on the difficulty or ease with which a body can hit a target. Further, we consider it reasonable to expect that a scheme will be most difficult to administer in its early days when it is unfamiliar to the administrators, which may suggest that NGET should be better able to manage disputes in the coming period than in the past period. These factors suggest to us that a competent scheme administrator should have a reasonably high likelihood of attaining zero overturned disputes. That this would reflect a normal level of performance, not an exceptional one.

In the circumstances, we would therefore be more comfortable with either an incentive scheme for CfD and CM qualification appeals that is downside-only, or with no scheme being in place. We consider that a downside-only approach could be configured around a nil payment for zero overturned disputes, moving linearly to the penalty cap if two or more disputes are overturned. We recognise that NGET is unlikely to find a downside only mechanism here attractive, but suggest there are several reasons why it should be considered. Firstly, because past performance suggests the risk of penalty is low. It would not have received a penalty under such a scheme if it had been in place in the first eight months. Secondly, because the desired outcome here - no overturned disputes - should really be a deminimis outcome that is priced-in to the baseline revenue, and should not need to be separately bought. In our view, no overturned disputes does not reflect an outstanding level of performance but a basic expectation. We consider that the penalty cap should kick in after two, not four, overturned disputes to provide a stronger incentive effect.

Notwithstanding our anxieties on whether an incentive should exist here, we support your view that moving to a cap and floor or +/-£1.25m would not be justifiable given the concerns we express above - that the maximum incentive payment looks easy to achieve, and that achieving an overturn-free level of performance should already be covered by base revenue. We do not see a strong case for moving from +/-£125k to +/-£200k as proposed, but consider the materiality difference to be sufficiently small that this is not a major issue with the proposals.

"Question 6: Do you agree with the proposed incentive on EMR Customer and Stakeholder Satisfaction, its parameters and value?"

We strongly support the proposed use of a moving average to set the target for incentive payments or penalties, though we are not sure whether the cap and collar are set in the right positions. We are also not clear what the methodology for determining performance markings is. We cover these points in more detail below.

We think the approach proposed by which the target is not fixed in advance across all the years but is effectively a moving average is sensible. This would provide for a continuous incentive and would preclude the possibility of NGET being rewarded for standing still. Because the proposed value of the incentive pot remains the same even as the mark changes, it would appear to create a leveraging effect that means the incremental reward for further improvement increases as its achievement becomes more challenging. This combination of factors seems likely to create a healthy incentive effect on NGET to try to continuously improve its scores. We prefer this approach of dynamic target-setting over trying to set a static ex ante target for all the years at this time, as the latter approach would bring a greater risk of windfall gains or losses.

On the value of the incentive pot, we are open-minded on whether £300k is an appropriate cap. We are mindful that the rolling nature of the incentive means that it is very unlikely that NGET will come close to hitting either cap or collar. For example, and we recognise that it is illustrative data not a prediction, Table 2 suggests that even a significant change in score may result in a reward or penalty that is unlikely to exceed double digit £thousands. We consider it possible that this may result in achievable rewards (or avoidable penalties) that are too small to materially change behaviours or drive management attention.

We think one possible way to address this may be to keep the overall materiality of the penalty/reward pot the same but to draw the cap and collar closer together. There is some precedent for this from past Ofgem RIIO decisions, in this case, from ED-1:

The target and maximum reward/penalty scores[6] for RIIO-ED1 CSS are outlined in Table 1 below. In coming to our decision we have taken account of service levels across a range of industries. The maximum reward/penalty scores are based on 1.75 standard deviations from the mean and will ensure that any DNO that scores significantly above or below the average will incur its maximum reward or penalty. We consider that the package is fair and should ensure that customer service delivered is good compared with other competitive industries.

Table 1: RIIO-ED1 CSS maximum penalty/reward score and target

Maximum Penalty Score	Target	Maximum Reward Score
6.8	8.2	8.9

Setting a cap and collar with reference to realistically achievable proxies from other competitive industries as was done on ED1 would remove the issue you have if they were set at 9 and 1 respectively whereby those may represent unachievable extremes (particularly - we hope - in the case of 1). This could allow you to create a greater incentive effect without having to increase the maximum reward/penalty beyond £300k - because each percentage point of improvement/deterioration would count for a greater tranche of that capped amount.

We found it very hard to tell from the consultation document how the marks for both the customer and stakeholder incentive payments would be calculated. We would like to see more detail on this in the final decision as it is not possible to reach a view on how robust the scoring methodologies may be. While not an issue specific to EMR - a similar question is relevant to other price controls - we would be worried if markings on the two separate schemes were markedly divergent. This is because we consider the overlap between the two disciplines - stakeholder engagement and customer satisfaction - to be so great that scores awarded for them should naturally show a high level of correlation.

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

We will answer these questions in reverse order. Regarding Question 8, yes, we agree that you should not introduce an incentive on the volume of pre-qualified capacity in the T-4 auctions. This is because we agree with your 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 of participation'.*

But we do not agree with the proposed incentive for pre-qualified DSR in the T-1 auctions - i.e. Question 7 - because we do not see why this situation would be any different. T-1 or T-4 is not really the issue at hand here, but whether NGET's actions can materially drive the outcome. NGET is not a DSR provider. It can advertise the service, and try to make it easier to engage with the auctions process, but it cannot bid in to the capacity mechanism itself, and it does not set the market rules. It is therefore very likely that the success, or failure, of the capacity mechanism in attracting DSR will not be meaningfully driven by NGET - it may influence it around the edges, but it will not drive it. In view of this, we think that an incentive or penalty here is quite likely to result in windfall gains or losses that are driven by the business decisions of DSR providers, not NGET. This would be inefficient.

We note that there may be benefits to DSR providers if NGET provides them with targeted assistance - 'hand holding' - through unfamiliar processes. But we think that this could, and probably should, be captured through other incentives such as those relating to customer and stakeholder satisfaction incentives. NGET is more able to ensure the quality of its stakeholder interactions (because these are entirely within its control) than the quantity of DSR coming forward (because this is principally a business decision for the potential provider) and we therefore think it would be more appropriate to incentivise DSR support through the former than the latter.

"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?"

On balance, yes.

As with the proposed DSR incentive there are risks that this kind of incentive could expose NGET to the potential for windfall gains or losses that are outside its control. For example, T-4 forecasts are particularly vulnerable to risks associated with wider economic growth occurring faster or slower than expected. This kind of noise in the data means that any reward or penalty NGET receives may be only partially due to the effectiveness (or not) of its modelling and could be partly (or mostly) driven by external factors.

Notwithstanding this concern, we are supportive of the inclusion of a forecasting incentive. This is because the materiality of EMR is so large - as you highlight, the first T-4 auction resulted in contracts of just under £1bn being struck - that even marginal gains in demand forecasting accuracy could have significant efficiencies in total scheme costs. So whilst recognising the risk that factors outside NGET's control could pollute the level of reward or penalty it receives, we think the scale of the potential consumer benefits that could be driven by accurate demand forecasting are sufficient to justify a scheme of this nature. Because the risk of factors outside its control affecting forecasting accuracy are greater at T-4 than T-1 we think there is a stronger case for setting a higher reward/penalty cap at T-1 and are pleased that this appears to be the approach you are adopting.

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

The value of incentives (up to £4.8m/year in rewards or penalties) looks very large in the context of annual base funding of ~£6.5m/year. We note that this is principally driven by the forecasting incentive and consider that to be merited given the potentially material benefits to consumers of accurate forecasting.

We are not convinced it is appropriate to put in place a DSR incentive given that NGET may have little control on how much comes forward. For further detail see our answer to Questions 7 and 8.

In relation to the satisfaction surveys, we think the value is probably of the right order of magnitude but that a stronger incentive could be generated from the same nominal amount by pulling in the cap and collar so that each percentage point of improvement/deterioration counts for a greater reward/penalty. These caps and collars could be set with reference to benchmarks from competitive industries, much as it is with ED1 - see our answer to Question 6. Conceptually, we see a great deal of potential overlap between a customer satisfaction survey and a stakeholder satisfaction survey - NGET's customers and stakeholders are likely to be largely, or possibly entirely (depending on how a customer is defined), identical. For the purposes of simplicity, it may therefore be preferable to simply run a single scheme rather than two separate schemes covering inherently similar territory.

Chapter 3: EMR preparatory costs

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

Yes. It is appropriate to claw back monies not spent, it represents a significant saving to consumers and the existence of these savings does not appear to be in dispute.