Making a positive difference for energy consumers

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

Decision

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Overview:

This document sets out our decisions 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.

We are also publishing statutory licence consultation notices that propose to modify Special Conditions 4A, 4L and 7D of NGET's licence in relation to EMR activities. These statutory consultations will run until 15 October 2015. Once the consultations close, we will review the responses received and issue our directions on the licence modifications.

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Context

In December 2012, we published our Final Proposals for National Grid Electricity Transmission plc (NGET) in the RIIO-T1 (Revenue = Incentives + Innovation + Outputs) price control (April 2013 to March 2021). This was the first price control to be conducted under our new RIIO model. 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 our 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 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. We then consulted on our Initial Proposals for funding, outputs and incentives for NGET's EMR delivery role for this period. We also consulted – 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.

This document sets out our decisions on the revenue, outputs and incentives for NGET's EMR roles from August 2014 to March 2021 following that consultation. We also provide a decision on funding for NGET's preparatory costs.

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 (22 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

Enduring funding, outputs and incentives

Consultation (17 April 2015): https://www.ofgem.gov.uk/sites/default/files/docs/2015/04/initial_proposal_consultation_emr_funding_and_incentives.pdf

Statutory consultation on NGET Special Licence Conditions (September 2015): https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-market-reform-emr

Executive Summary

Overview

In August 2014 the Government gave the role of EMR delivery body to 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 price control framework to drive benefits for consumers in relation to EMR. Under this 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.

On 12 January 2015, NGET submitted a business plan for its EMR roles to us covering the August 2014 to March 2021 (the end of RIIO-T1) period. From April to June 2015, we consulted on our proposals for setting NGET's enduring revenue, outputs and incentives covering this period. We also set out our proposal 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 those costs.

This document summarises the responses to our consultation and sets out our decisions in relation to NGET's enduring revenue, outputs and incentives. We also set out our decision on funding NGET's preparatory costs for the April 2013 to July 2014 period.

In parallel with this document, we are publishing statutory licence consultation notices that propose to modify Special Conditions 4A, 4L and 7D of NGET's licence in relation to EMR activities. If we decide to proceed with the licence modifications they will take effect not less than 56 days after the date of our decision.

Our decisions

Preparatory Costs

Our decision is that NGET receives £8.7m for EMR preparatory costs incurred between April 2013 and July 2014[1].

Funding for the period August 2014 to March 2021

Our decision is that NGET receives a baseline allowance of £46.4m for August 2014 to March 2021. This comprises an amount of £12.7m to cover costs from August 2014 to March 2016, and then £33.7m for the remainder of the period to March 2021. We have also included an uncertainty mechanism to allow NGET to recover efficiently incurred costs in respect of major changes to the scope of EMR during the period or uncertain costs crystallising during the RIIO-T1 period.

[1] For the avoidance of doubt, all of the prices quoted (unless identified otherwise) are in 2014-15 prices, except for the prices in the incentives section which are in 2009/10 prices.

Further details of our decisions on costs and funding are in Chapter 1.

Outputs and incentives

In addition to the outputs set out in legislation we have decided to include an EMR Customer and Stakeholder Satisfaction Survey as an additional output for NGET. We have also decided to introduce four financial incentives and one reputational incentive (as well as continuing the two current reputational incentives) for NGET. The four financial incentives are on:

- the accuracy of NGET's Tier 1 dispute decisions.
- the results of the EMR Customer and Stakeholder Satisfaction Surveys (the survey results will also be published and will be the new reputational incentive).
- the volume of prequalified Demand Side Response (DSR) in the T-1 auctions.
- the accuracy of demand forecasting.

Further details of our decisions on outputs and incentives are in Chapter 2.

Next steps

The statutory consultations on the modifications of Special Conditions 4A, 4L and 7D will be open until 15 October 2015. Once these consultations close, we will review the responses received and issue our directions on these modifications.

1. Decision on revenues and uncertainty

Chapter Summary

We set out our decisions on the allowance for EMR preparatory costs and the efficient level of baseline expenditure for the EMR delivery body from August 2014 to March 2021. We also detail how major changes in the scope of EMR and NGET's more informed view of uncertain costs required until the end of the RIIO-T1 period will be considered.

Introduction

1.1. In the RIIO-T1 Final Proposals for NGET published in December 2012[2], we set out NGET's outputs and allowances for its role as Transmission Owner (TO) and internal cost allowances for the System Operator (SO). These proposals included 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. NGET was given the EMR delivery body role in August 2014. Accordingly, Ofgem has to determine the appropriate level of adjustments to NGET's overall internal electricity SO total expenditure (TOTEX) allowances for the additional incremental costs NGET expects to incur.

1.3. In March 2014[3], following a consultation in December 2013, we decided to give NGET funding for its EMR preparatory costs of £17.3m[4] 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.

1.4. In April 2015, following receipt of NGET's EMR business plan in January 2015[5], we consulted on our Initial Proposals[6] (IP) on both preparatory costs and baseline expenditure costs for the operational period to 31 March 2021. This chapter sets out our decisions on these issues.

[2] https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf
[3] https://www.ofgem.gov.uk/ofgem-publications/86554/decisiononfundingnationalgridelectricitytransmissionplcspreparatorycostsforelectricitymarketreform.pdf
[4] £17.1m in 2013-14 prices – with reference to the December 2013 consultation.
[5] http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=40502
[6] https://www.ofgem.gov.uk/ofgem-publications/94543/initialproposalconsultationemrfundingandincentives-pdf

Preparatory costs

1.5. In our IP, we proposed that NGET would receive £8.9m for efficient and economic EMR preparatory costs incurred between April 2013 and July 2014[7]. This compared to the £17.3m allowance NGET had been given in March 2014 and the £11.4m final preparation costs that NGET included in its January business plan. We also provided our reasoning for proposing this level of costs.

1.6. Four respondents, including NGET, commented on this aspect of our IP. All of these were in agreement with the proposal. No new evidence was presented by the respondents, but during our subsequent discussions NGET provided updated information in respect of these preparatory costs. This resulted in a reduction of £0.2m to our view of the costs that should be allowed.

1.7. Our decision is that NGET should be allowed £8.7m for EMR preparatory costs. The reconciliation between this amount and the allowance already given will be dealt with through the price control financial model (PCFM).

EMR delivery function costs

Our proposal

1.8. We proposed to reduce NGET's cost submission for the period of August 2014 to March 2021 by £9.8m to £44.3m. Our reductions related to the following areas of NGET's business plan:

- Staff costs
- IS costs
- Other costs (efficiency)

Staff costs

1.9. In our IP we considered that there was duplication of some staff roles. We proposed to reduce the staffing in the stakeholder management team by two full-time equivalents (FTEs) from 2015-16, a reduction of £1.3m over the RIIO-T1 period.

1.10. We also proposed to reduce the interconnector modelling staff by three FTEs from 2016-17 onwards, reducing costs by a further £1.2m over the RIIO-T1 period.

[7] The preparatory costs also include IS costs up to 31 December 2014, as the IS systems implementation lagged other preparatory activities.

IS costs

1.11. We queried the need for the planned refresh to the administration and auction systems in 2019-20 and 2020-21 respectively. It was not clear to us why systems developed in 2014 and 2015 would need to be fully refreshed so soon after implementation. We believed there was no certainty that the refresh would be carried out before the start of the next price control period (RIIO-T2 starting in April 2021). We proposed the removal of these costs from the baseline allowance, which equated to a reduction of £2.8m.

Other costs (efficiency)

1.12. We proposed to make a further reduction of 10% of TOTEX each year from 2015-16 throughout RIIO-T1, to recognise efficiencies that ought to be achievable over the course of the control period. This resulted in a reduction of £4.5m.

Responses from consultation

1.13. Most respondents who commented on the cost aspects of our proposals stated that although they had no visibility on the detail of NGET's business plan, they were broadly supportive of our proposed reductions. NGET did not agree with the majority of our cost proposals. In addition, Scottish Power noted that setting low allowances for NGET may not deliver the best overall consumer outcome and could adversely impact security of supply and low carbon targets being met.

Our decision

1.14. Following consideration of respondents' views and further discussion with NGET on the detail of its business plan, we have now reached a decision on each of the specific items from IP.

Staff costs

1.15. NGET has clarified that the Stakeholder Management function will be undertaken by two FTEs, rather than the six FTEs identified within that team. The remaining four FTEs will undertake legal and administrative EMR support activities. Stakeholders, including industry participants and DECC, have highlighted the importance of NGET having an effective stakeholder interface to ensure the smooth running of EMR. NGET has given further justification as to why these roles cannot be filled by others in the proposed staffing structure.

1.16. In light of this understanding and in recognition of the importance of NGET's stakeholder activities[8] we have re-instated the two stakeholder management posts in the allowed costs.

1.17. We have maintained our reduction of three FTE interconnector modelling staff from 2016. NGET has provided further detail around the requirement for the interconnector modelling, and noted that the panel of technical experts[9] had identified the need for extra interconnector modelling resource. NGET also has more comprehensive requirements for system modelling of interconnectors through the Integrated Transmission Planning and Regulation (ITPR) work. Our IPs noted that we would expect NGET to make savings where functions can be aligned or absorbed with existing SO roles[10].

1.18. In our view, the ITPR interconnector modelling resource should be able to meet the needs of the EMR interconnector modelling. Accordingly, the interconnector modelling costs should be attributed to the ITPR project rather than the EMR function. However, the requirement on NGET for enhanced EMR modelling exists now, while ITPR obligations and funding are not yet finalised. Therefore, we have decided that we will allow funding for the additional interconnector modelling resource up to and including 2015/16, i.e. the position set out in our IP. The provision of costs for modellers during this period should allow for preparatory data gathering and analysis which will also be of use in meeting NGET's future ITPR obligations.

1.19. As a consequence of this decision, we have removed £250K of model purchase costs from NGET's EMR business plan as this cost will no longer be shared with ITPR.

IS costs

1.20. NGET's justification for including a system refresh in the later part of the price control period is that the administration system uses Microsoft products which are currently anticipated to go out of support in 2018. NGET has recognised that the dates are often extended by the product provider; however, there is a significant degree of uncertainty around this.

1.21. As the date for when the relevant Microsoft products go out of support is uncertain, as are the cost implications should that happen, we are not providing upfront funding for the IS refresh costs. Instead they will be dealt with, if necessary, by way of the uncertainty mechanism. We believe this is a more appropriate method to deal with the system refresh costs and we have removed the £2.8m cost NGET included in their EMR business

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[8] We have also introduced an incentive based on the outcome of a customer and stakeholder satisfaction survey, as detailed in the next chapter.

[9] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/438714/PTE_2015_ECR_Report_final.pdf

[10] See paragraph 1.3 of the Initial Proposals.

plan. We set out our methodology for the uncertainty mechanism later in this chapter.

1.22. We have also removed the IS support costs associated with the ITPR model. This has resulted in a further reduction of £250K over the course of the price control period.

Other costs (efficiency)

1.23. Our IP proposed an efficiency challenge of 10% of gross TOTEX across the period 2015-21. We maintain that these levels of efficiency on TOTEX should be achievable. We have noted NGET's concern over meeting this level of efficiency at the start of the implementation phase when processes are still being refined.

1.24. Accordingly, we have modified our position from IP. We will delay the implementation of the efficiency challenge by one year. We will then impose a 3% compound efficiency requirement per annum from 2016/17, equating to a £3.2m reduction in costs. We believe that this represents a fair balance between setting NGET an efficiency challenge while acknowledging that EMR policy, and NGET's role, will change over the period.

Proposed allowances for August 2014 – March 2016 period

Our proposal

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

1.26. The provisional allowances to cover the first 20 months of operation from August 2014 to March 2016 were £5.1m (against NGET's forecast of £7.1m). At the time that we stated we had taken several factors into account when setting the provisional allowances, including a 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.

1.27. Having reviewed the business plan for efficiency we proposed an allowance of £11.8m to cover the first 20 months of operation. We also stated that there will be no further 'true up' with actual costs incurred; meaning NGET would not receive any additional funding for the period August 2014 to March 2016.

Responses from consultation

1.28. Both EDF and Energy UK agreed with our proposals on costs for the first 20 months of EMR. Citizens Advice stated that there was insufficient evidence in our IPs to justify our proposed allowance and noted this was much higher (£11.8m against £5.1m) than the provisional allowance.

1.29. NGET agreed with the principle of setting an allowance for the first 20 months of operation as EMR delivery body. However, it considered the proposed allowance should be greater than the amount proposed, as it did not agree with the staff and efficiency challenge reductions.

Our decision

1.30. We have revised our view of the allowance as set out in this section. We have decided that the appropriate allowance for the period August 2014 – end March 2016 is £12.7m. The reason that this amount is higher than the provisional allowance of £5.1m, is that a large amount of IS expenditure that was due to take place during the 'preparatory period' (April 2013 to August 2014) was delayed and instead took place between August 2014 and July 2015. Note that the costs for the preparatory phase have been correspondingly reduced (from £17.3m to £8.7m).

1.31. The increased value from IPs reflects the reinstatement of the Stakeholder Management staff costs and the deferral of the efficiency challenge by one year. There will be no further 'true up' with actual costs incurred meaning no additional funding will be provided for the period August 2014 to March 2016.

Summary of EMR cost allowances

1.32. An overview of the cost movements from the NGET's original business plan to our decision on appropriate levels of baseline funding costs is given in Table 1. Table 2 sets out the allowances for each year of the settlement.

Table 1: Summary of EMR cost movements

£m (2014-2015 prices)	NGET Business Plan	Ofgem Initial Proposals	Ofgem Decision
Staff	24	21.5	22.9
Business support	5.4	5.4	5.4
Information Systems OPEX	18.7	16	15.5
Other	5.9	1.4	2.6
Total	54.0	44.3	46.4

Table 2: Allowances by year

Totex £m (2014-15 prices)	2014-15 (8 Months)	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	Total
Business Plan	3.35	9.60	7.65	7.50	7.60	9.10	9.20	54.0
Determined	3.35	9.35	7.15	6.80	6.68	6.66	6.41	46.4
Reduction	0.0	-0.3	-0.5	-0.7	-0.9	-2.4	-2.8	-7.6

1.33. For the avoidance of doubt, EMR delivery body costs will 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.

Uncertainty

Our proposal

1.34. For the IP we did not include a specific mechanism for NGET to claim additional funding for EMR in RIIO-T1. We noted that we may review this decision if NGET produced more evidence to support a specific allowance for uncertainty.

1.35. We made clear in our IP that we reserved the right to adjust NGET's allowances if there are changes to legislation, which mean that NGET's role changes materially. This is still the case.

Responses from consultation

1.36. Three respondents agreed that there should not be an upfront allowance for uncertain costs without further compelling evidence from NGET.

1.37. NGET disagreed with our proposals and thought that there was justification for an uncertainty mechanism to deal with significant EMR regime changes.

Our decision

1.38. We are keen for NGET's EMR function to be funded appropriately for the efficient and effective delivery of EMR. Our concerns at IP were around the provision of upfront sums to NGET to fund scope changes that might not happen; this could provide windfall gains. To address this we are including a mechanism to deal with costs that may arise from scope changes or an IT system refresh during the period but are uncertain at this time.

1.39. Our decision is that a reopener period in 2019-20 is an appropriate method of funding these specific uncertain costs. This re-opener should be a 'light-touch' review of additional costs incurred up to that point in respect of major[11] changes in the scope of EMR not included in the current allowances and NGET's more informed view of uncertain costs required until the end of the RIIO-T1 period.

1.40. We think it is appropriate that NGET should have to seek confirmation from Ofgem before it engages on significant expenditure in relation to such changes outlined above. Therefore, NGET must obtain the written agreement of Ofgem before incurring costs on such changes. In addition, the costs of these major changes (in aggregate) should be in excess of the existing *de minimis* amount included in Standard Licence Condition 7D[12] to be considered as major.

1.41. It is difficult to specify exactly in advance what 'major changes in the scope of EMR' would be and what Ofgem would give written approval to. We would expect each such change to be sufficiently substantive so as to have been subject to discussion with (and possibly consultation by) DECC, NGET, Ofgem and industry stakeholders prior to implementation. We will consider any submission from NGET on a case-by-case basis.

[11] The base allowance already includes funding for scope changes on an ongoing basis.
[12] The aggregate cost, when multiplied by the Totex Incentive Strength Rate (46.89%), should equal or exceed £1.2m.

1.42. NGET's business plan submission included estimates of the likely costs for dealing with specific potential uncertainties. In the event that any of these specific changes are required to be implemented, and they are considered to be major changes, we would expect costs to be in line with these estimates. Any significant variation from these cost levels would need to be backed up with a robust justification. These items are set out in Table 3:

Table 3: Estimated costs of specific potential uncertainties (from NGET's business plan submission)[13]

Potential uncertainty	Costs in 2014/15 prices (£m)
CM delivery monitoring	0.7
Zonal CM auctions	2.4
CfD multi round price discovery auctions	3.9
CfD for NI	0.8
Non-UK CfD	1.0
IS system refresh	2.8

Draft licence conditions

1.43. The introduction of the reopener window to allow uncertain cost submissions requires amendments to the existing Special Condition 7D in NGET's licence. Our statutory consultation on this amendment is published alongside this document[14].

[13] Note that some of these potential uncertainties may not in any case be funded by GB consumers.
[14] See https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-market-reform-emr

2. Decision on outputs and incentives

Chapter Summary

This chapter sets our decision on 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 has a number of functions set out in relevant legislation. These include assessing eligibility for the Capacity Market (CM) and Contracts for Difference (CFDs), reviewing Tier 1 disputes and running the respective auctions and allocation processes.

2.2. In July 2014 we introduced a financial incentive[15] 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 CM delivery body role. The provisional financial incentives were set from August 2014 and are due to expire in March 2016. The purpose of this section is to explain our decision, following the consultation on our Initial Proposals, on setting incentives for April 2016 to March 2021.

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

Incentives

2.4. This section summarises our Initial Proposals, summarises responses received[16] and sets out our decision on each of the incentives.

[15] 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
[16] See responses here: https://www.ofgem.gov.uk/publications-and-updates/consultation-initial-proposals-setting-revenue-outputs-and-incentives-national-grid-electricity-transmission-plc-s-roles-electricity-market-reform

Accuracy of Tier 1 dispute resolution

Our proposal

2.5. In our April 2015 Initial Proposals, we proposed to keep the broad structure of the current incentive (which expires in March 2016) and to make some amendments to the parameters. We proposed to (i) remove the incentive on CAN and CMR disputes, (ii) maintain the cap of zero overturned decisions at which NGET may gain the maximum 'reward' and reduce the floor from six overturned decisions for the maximum 'penalty' to four overturned decisions, (iii) maintain the financial neutral point (i.e. no reward or penalty) at one overturned decision and (iv) increase the value of the incentive from a maximum of £50,000 to a maximum of £100,000 per year per type of dispute, resulting in a potential total value of £200,000 for the CM pre-qualification and CfD eligibility disputes incentive per year.

Responses from consultation

2.6. Two respondents (Energy UK and EDF) agreed with our proposal to maintain the broad structure of the incentive on disputes and the proposed amendments. Two respondents did not comment on this incentive.

2.7. One respondent (Citizens Advice) supported removing the incentive on CAN and CMR disputes but felt that no overturned disputes should be a basic expectation (not an outstanding level of performance). Given this, the respondent said we should have either a downside only incentive for CfD eligibility and CM qualification disputes or no scheme at all. It believed it was necessary to consider a downside only mechanism because past performance suggests the risk of penalty is low, and the desired outcome (no overturned disputes) is priced into the baseline revenue already. The respondent agreed that moving to an incentive of +/-£1.25m (as NGET proposed in its business plan) was not appropriate. Although it did not see a strong case for moving from +/-125k[17] to +/-£200k, it considered the difference to be sufficiently small that it was not a major issue.

2.8. Whilst agreeing with the broad structure of the Tier 1 disputes incentive, NGET expressed concern about sharpening the penalty element of the incentive to four overturned decisions. NGET felt that moving the cap from six to four would make it more of a penalty regime. It also said that the CAN and CMR dispute incentives should be kept because success in this area in 2014 does not warrant a decision to remove the incentive.

Our decision

2.9. After considering the responses, we have decided to continue with our Initial Proposals.

[17] This is the current figure and includes the current CAN and CMR incentive.

2.10. We considered carefully Citizens Advice's view that there should be no upside incentive for disputes. However, we will introduce this incentive as we are of the view that in 2014 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. Efficient and effective dispute resolution is an essential part of the overall success of the CM and CfD processes given the tight timelines to which these processes run.

2.11. We have decided to remove the incentive on CAN and CMR disputes for the reasons set out in our initial proposals. We considered the response from NGET but were not persuaded. We acknowledge that careful work is required to ensure the CMR and CANs are accurate, but note disputes here 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.

2.12. We have decided to maintain the cap of zero overturned decisions at which NGET may gain the maximum 'reward', reduce the floor from six overturned decisions for the maximum 'penalty' to four overturned decisions, and maintain the financially neutral point (i.e. no reward or penalty) at one overturned decision. However, given the experience of 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. We have decided to uphold our Initial Proposal to increase the value of the incentive to a maximum of £100,000 per year per type of dispute, resulting in the total value of the incentive for CM pre-qualification and CfD eligibility disputes to be £200,000. We will also ensure that the incentive reward or penalty is paid out a maximum of once each financial year and if the underlying process that could lead to disputes (e.g. CfD eligibility application round or CM prequalification round) does not take place, no incentive reward or penalty will apply.

2.14. Table 4 summarises our decision on the structure, parameters and values of the EMR dispute incentive.

Table 4: Structure, parameters and values of the EMR dispute resolution incentive

Number of overturned decisions	CfD Eligibility Decisions (£000s)	CM Qualification Decisions (£000s)
None	100	100
1	0	0
2	-35	-35
3	-65	-65
4 or more	-100	-100

Customer and Stakeholder Satisfaction

2.15. In our April 2015 Initial Proposals, we proposed to introduce an EMR Customer and Stakeholder Satisfaction Survey as a new output. The aim of requiring the survey as an output is to increase transparency to EMR stakeholders on the quality of NGET's delivery and engagement.

2.16. Almost all respondents supported our proposal to introduce a customer and stakeholder survey as an EMR output. One respondent did not comment on this output. Having considered the responses, we have decided to implement our proposal.

2.17. We will require that the survey results are published on NGET's website, in the same way as the existing RIIO Customer and Stakeholder Satisfaction Survey results. This will also act as a reputational incentive and will complement the two existing (and continuing) reputational incentives set out in our June 2014 decision document[18]:

- Publishing annual reports on NGET's performance of its CM functions. We will include in this a report on how NGET has performed against its relevant EMR incentives.

- Ofgem actions: If NGET fails to deliver any of its legislative obligations, we may publish any concerns we have and any steps we may take (including enforcement actions) at other points during the year.

Our proposal

2.18. In the Initial Proposals, we set out the parameters and value of the incentive on the EMR Customer and Stakeholder Satisfaction Survey.

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

2.19. We proposed that the survey results from year 1 are used to set the target for year 2 and from year 3 onwards the target would be equal to the average of the aggregate scores achieved in the previous years. We proposed 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. We recommended an incentive structure with symmetrical cap (performance score = 9) and floor (performance score = 1) parameters, where NGET's performance will be measured on a scale of 1 (very dissatisfied) to 10 (very satisfied), which is consistent with the RIIO Special Condition 3D: Stakeholder Satisfaction Output survey.

2.20. The value of the incentive we proposed was £600,000 (around 10% of the annual EMR total expenditure) each year, to be split equally between both CM and CfD surveys.

Responses from consultation

2.21. Almost all respondents recognised that good stakeholder engagement is key to the successful delivery of EMR and supported our proposal to introduce an EMR Customer and Stakeholder Satisfaction Survey incentive to encourage NGET to deliver good quality engagement and performance in all its EMR roles.

2.22. One respondent (Energy UK) noted that given that there are several customer surveys in existence and it is unclear how this customer feedback on SO and TO performance is taken into account, it was important to ensure that NGET provided an update on how it has taken on board the key issues raised by stakeholders.

2.23. Citizens Advice highlighted that the customers and stakeholders of NGET's EMR activities may be nearly identical and suggested that it may be more efficient to run a single incentive scheme, rather than having two schemes covering broadly similar areas. It also wanted further detail published on how the survey(s) will be conducted.

2.24. Citizens Advice agreed with our proposal to introduce a moving target. The respondent believed this should encourage NGET to continuously improve its scores. The respondent noted the moving target meant that it was unlikely a reward/penalty would reach the cap or collar, possibly making it too small an amount to materially change behaviours or attract management's attention. The respondent suggested replicating the RIIO T-1 approach by bringing the cap and floor closer to the target, thus strengthening the incentive per unit of improved score. The respondent also stated that it was important that NGET's performance and earnings in relation to EMR activities are reported to stakeholders in a clear, timely and accessible manner

2.25. The view that we should construct the customer and stakeholder satisfaction survey based on the RIIO Customer and Stakeholder Satisfaction Survey was shared by EDF. EDF also agreed that performance scores below 5 should not be rewarded and an annual target based on the mean of the two previous years would be a challenging target to drive performance.

2.26. NGET agreed with our proposal to introduce a customer and stakeholder satisfaction survey but disagreed with the parameters and values which we proposed. It pointed out that the proposed revenue formula did not allow for the maximum incentive to be earned each delivery year and said that this incentive should reflect the same principles of the existing incentive arrangement in the RIIO T-1 framework, where the customer and stakeholder satisfaction target score is not reset on an annual basis. NGET said this would give regulatory certainty to allow for longer term strategies to be developed and implemented, which would drive customer and stakeholder benefit.

2.27. While recognising that it is difficult to measure the impact and influence that the delivery body's stakeholder engagement has on an applicant's ability to participate in the CM auction, NGET believed that customer and stakeholder satisfaction had a significant impact. The respondent suggested that the value of the incentive should better reflect the level of resource and effort employed by the delivery body on customer service and stakeholder satisfaction and proposed that the value of this incentive should be increased to a maximum of £1m per annum; i.e. £500,000 per mechanism.

Our decision

2.28. Having considered all responses, we have decided to implement our proposal and introduce an EMR Customer and Stakeholder Satisfaction Survey incentive. We also decided to modify the way in which the target, the floor and the cap are set for this incentive.

2.29. The EMR Customer and Stakeholder Satisfaction Survey will provide increased transparency to EMR stakeholders on the way NGET discharges its EMR roles. A financial incentive attached to this output is intended to incentivise quality delivery and high standard of engagement across NGET's EMR roles. We view these as important to the successful delivery of EMR.

2.30. Given that the EMR work is a ring-fenced activity that brings NGET into contact with some stakeholders it may not usually encounter, we do not think it is appropriate to embed this incentive in the existing RIIO survey or incentive, at least during the RIIO T-1 period.

2.31. We consider that the target, the cap and the floor should be defined to incentivise performance beyond business as usual, whilst ensuring that under-performance is not rewarded. As a result, we uphold our proposal that the target cannot go below 5, so no upside incentive is payable for any scores below 5 to ensure that poor performance is not rewarded.

2.32. We have decided that in year 1, there will be no financial incentive related to the result of the EMR Customer and Stakeholder Satisfaction Survey. The results of this survey will instead be used to set the target, the cap and the floor for subsequent years. These parameters and the survey questions used for the purpose of this incentive will be fixed for the RIIO T-1 period (up to March 2021) so that:

- Target will be equal to the higher of: (i) the Survey Score achieved in Year 1, rounded to one decimal place, and (ii) 5.0;

- Floor will be set at one standard deviation of the Year 1 Survey Scores (rounded to one decimal place) below the Target but in any event must not be higher than Target-1; and

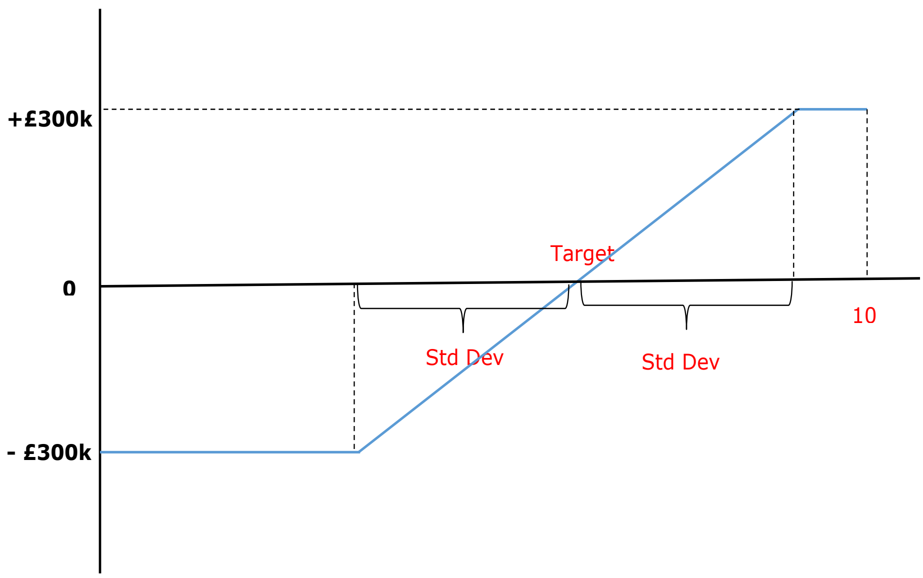
- Cap will be set at one standard deviation of the Year 1 Survey Scores (rounded to one decimal place) above the Target but in any event must not be lower than Target+1

where Survey Score is arithmetic average of all CfD or CM Customer and Stakeholder Satisfaction Survey Scores.

2.33. We have decided not to have a moving target, as we believe it would make penalties and rewards at the extremes of the range unlikely, and this would blunt the incentive. The tightening of the cap and floor compared to our original proposal will also increase the financial penalty or reward per unit of survey score, sharpening the incentive. Figure 1 illustrates this.

2.34. The value of the incentive will be £600,000 each year, to be split equally between the CM and CfD surveys. It should be noted that if no results of a CfD allocation round are published and/or no CM auctions are held in any given year, then the incentive for the corresponding survey does not apply for that particular year.

Figure 1 - Structure of the financial incentive on EMR Customer and Stakeholder Satisfaction (£300k for each annual CM and CfD survey)



Volume of pre-qualified capacity for the CM auctions

Our proposal

2.35. In our Initial Proposals we proposed to set an incentive for NGET to maximise DSR capacity that pre-qualifies for the T-1 auction. Given that DSR participation may grow over time as market participants learn of the new mechanism and DSR develops, we proposed that the target for this incentive moves over time, reflecting the volumes of pre-qualified DSR capacity in the previous T-1 auctions.

2.36. We also proposed that NGET reports on the steps that it takes in each T-1 pre-qualification round to encourage and facilitate DSR participation, including how it has ensured that DSR providers understand the implications of CM participation. This would help to reduce the risk of attracting DSR providers not ready to take part in an auction and show what behaviours the incentive was encouraging.

2.37. We proposed to not set any incentives for NGET for the level of participation in the T-4 CM auctions. Although increased competition between generators in the T-4 CM auctions may lead to lower clearing prices, we were 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.

Responses from consultation

2.38. Three respondents (Scottish Power, EDF and Citizens Advice) disagreed with our proposal to set an incentive for NGET to increase the DSR capacity that pre-qualifies for the T-1 auctions. The respondents' points fell into two broad categories. Firstly, there was a concern that the value added of NGET's stakeholder engagement with DSR providers could be low as the volume of DSR that qualifies for an auction would be heavily dependent on other factors. As a result, the incentive could produce windfall gains or losses for NGET. Secondly, the respondents challenged our proposal to focus the incentive on DSR, arguing that it would cut across NGET's main duty of having to run EMR process effectively. One respondent said the proposed incentive appears to use NGET as a means to promote a specific policy outcome rather than focusing NGET on doing its underlying job. One respondent thought the EMR Customer and Stakeholder Satisfaction Survey incentive could mean that NGET is rewarded twice for the same activities.

2.39. One of the three respondents (Citizens Advice) opposed to this incentive did recognise that there may be benefits to DSR participation if NGET provided targeted assistance through unfamiliar processes to DSR providers. Citizens Advice suggested that this should be captured through the EMR Customer and Stakeholder Satisfaction Survey incentive. It argued that the survey would directly measure the quality of stakeholder interaction with DSR participants in T-1 CM auctions.

2.40. NGET said that it was appropriate to have an incentive that drives increased volume of DSR in the T-1 auctions. However, NGET said that a participant's decision to apply to take part in an auction will not only be driven by NGET's efforts. Given the other commercial factors influencing DSR participation, NGET recommended a dead-band of +/- 200MW to be included in the incentive to protect itself and consumers against unnecessary financial risk.

2.41. Five respondents agreed with our proposal not to introduce an incentive on the volume of pre-qualified capacity in the T-4 auction. One of these respondents proposed that the benefit to consumer is reflected in the value of the customer and stakeholder survey incentive. One respondent did not comment on the T-4 incentive.

Our decision

2.42. Having considered all responses, we have decided to maintain an incentive focused on the participation of DSR providers in the T-1 CM auction.

2.43. We think that an incentive designed to increase DSR participation in the CM is appropriate. DSR is different to generation in that it can allow industrial and domestic customers to participate in the energy market. This may increase the overall efficiency of the energy system.

2.44. We have also considered carefully the view that it is not clear that NGET's efforts can materially drive DSR participation and, if it can, that the value-added of this will be difficult to separate from other factors. We are of the view that NGET can play a larger part in driving DSR participation than it can in driving generator participation. We think 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 and may be more responsive to NGET's engagement efforts. It is also possible that this incentive will mitigate against any tendency, 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. However, we note that there is uncertainty here and while we are keen to incentivise NGET's efforts we have decided to include the dead-band suggested by NGET.

2.45. We note the view that NGET's stakeholder engagement efforts could alternatively be measured through the EMR Customer and Stakeholder Satisfaction Survey. However, our stakeholder survey incentive is based on a survey of all CM participants to encourage wide-ranging efforts by NGET to satisfy its stakeholders. The DSR incentive is intended to motivate NGET to engage with potential DSR bidders who may not otherwise engage in the CM and to ensure that those that do engage can do so effectively.

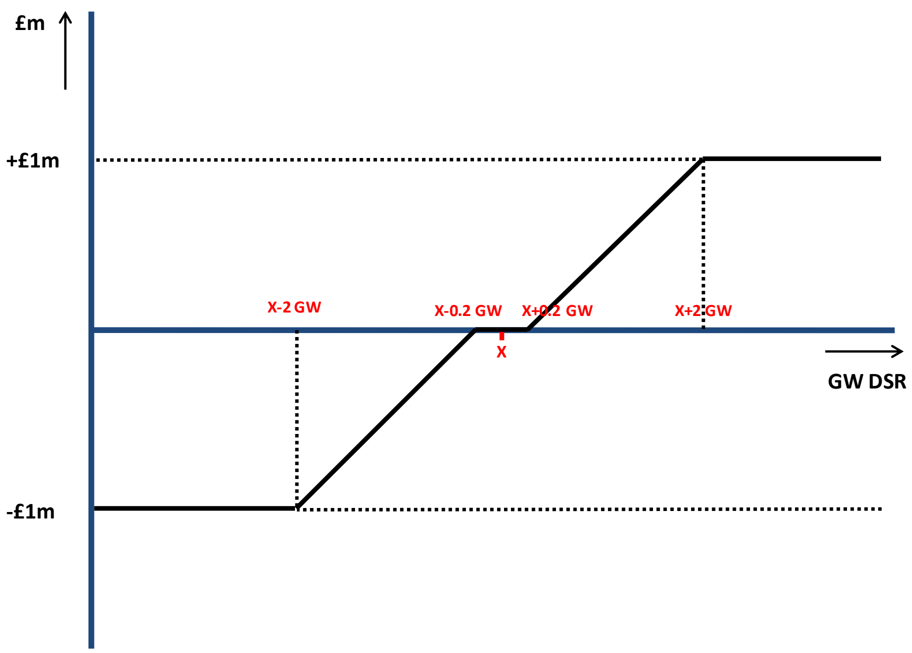
2.46. The following key parameters will apply for this incentive:

- Target: As DSR participation may grow over time, we will set the benchmark to be equal to the average of the gigawatts of pre-qualified DSR in the two previous T-1 auctions, except for the second T-1 auction when the Target is equal to the gigawatts of pre-qualified DSR in the first T-1 auction. The value of this incentive for the first T-1 auction is nil.

- Cap and Floor: We will set the Cap and Floor for the incentive 2GW above and below the Target. We recognise that setting cap and floor as absolute numbers makes this incentive asymmetric for any level of Target below 2GW (where the potential maximum upside will exceed the potential maximum downside). However, we have decided that this potential asymmetry is acceptable and preferable to basing the Cap and Floor on a percentage of the target which could, if the Target is very low, expose NGET and consumers to large changes in incentive payments arising from small changes in DSR participation.

- Dead-band: We have decided to set the Dead-band at 0.2GW above and below the target. The purpose of the Dead-band is to protect consumers and NGET from windfall gains and losses arising from the – as yet unknown – 'natural' variability in the volume of DSR that prequalifies.

Figure 2 - Structure of financial incentive on pre-qualified DSR capacity for the T-1 auction



Where 'x' is the Target GW of DSR

2.47. We will also require that NGET writes to us within three months of each T-1 pre-qualification round on the steps that it took to encourage and facilitate DSR participation, including how it has ensured that DSR providers understand the implications of CM participation. NGET will also be required to publish this letter on its website. The main purpose of this letter is to reduce the risk of attracting DSR providers not ready to take part in an auction and to show whether the incentive is succeeding in encouraging appropriate behaviours.

2.48. We are not setting any incentive for NGET in relation to the pre-qualified capacity in T-4 auctions.

Demand forecasting accuracy

Our proposal

2.49. Given that demand is a critical factor used in determining the capacity to be procured in the T-1 and T-4 auctions, we proposed this incentive as more accurate forecasts of demand may result in lower costs to consumers due to a lower risk of under- or over-procurement of capacity. We proposed that the measure on which NGET is incentivised should be the error between the forecasted demand: Peak National Demand[19] for one year (T-1) and four years ahead (T-4) and the outturn data corrected for the Annual Average Cold Spell Conditions[20]. We proposed that the outturn data should not be adjusted to reflect distributed generation[21]; instead NGET should take the expected level of distributed generation into account when making its forecasts. We proposed that the outturn demand should be adjusted for interconnection. We proposed that NGET publishes a Weather Correction Methodology Statement[22]. We also proposed that NGET reports annually on the steps it has taken to improve demand forecasts.

Responses from consultation

2.50. All respondents agreed that the accuracy of demand forecasting is very important given the security of supply and cost implications of over- and under-procuring in the auction. Respondents broadly supported the introduction of this financial incentive.

2.51. One respondent (Citizens Advice) thought that there is a risk that this type of an incentive could expose NGET to windfall gains or losses. The example given was of T-4 forecasts being vulnerable to risks associated with the economy growing faster or slower than expected. Nevertheless, the

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[19] See definition of 'National Demand' in the Grid Code. http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/Grid-Code/

[20] As defined in the Grid Code.

[21] 'Embedded generation' refers to electricity from generators which are connected to, and therefore export their power onto, distribution networks.

[22] Weather Correction Methodology refers to the methodology used by NGET at the time a Peak National Demand Forecast was produced to correct the associated outturn Peak National Demand to Annual Average Cold Spell Conditions – this is covered in detail in our statutory consultation of Special Condition 4L, see https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-market-reform-emr

respondent supported the incentive, and noted there is a strong case for setting a higher reward/penalty at T-1 than T-4, as we had proposed.

2.52. Scottish Power supported the introduction of the incentive in principle and suggested that consideration should be given to setting incentives at a more granular level, but did not provide specific suggestions. The respondent also believed that the majority of consumer benefits are likely to arise from dealing with the greater uncertainty at T-4; they believe that the bias of the incentive towards T-1 should be given further consideration.

Our decision

2.53. Having considered all responses, we have decided to continue with our Initial Proposals. We agree that there are more uncertainties predicting T-4 demand (and have reflected that in the lower incentive value at T-4), though we do not think it is necessary for NGET to control a variable – such as economic growth – to be able to take it into account when forecasting demand.

2.54. We have considered further exactly what forecast of demand NGET should be incentivised on. Our criteria have been that the forecast of demand that is incentivised: (i) is, or is as close as it can reasonably be to, the forecast of demand in the relevant Electricity Capacity Report, and (ii) is objectively measurable on the outturn or, to the extent it is not, a clear methodology for measuring outturn demand is in place.

2.55. In our consultation we proposed that peak demand on the transmission system[23] (weather corrected for the Annual Average Cold Spell Conditions at the outturn) as the appropriate measure of demand. This has the advantage of being objectively measurable on the outturn. We have also considered if 'total peak demand in the system' (which is peak demand on the transmission system (Peak National Demand) plus peak demand met by distributed generation and peak demand reduction by DSR) could be used. This forecast of demand is used in the Electricity Capacity Report but is not objectively measurable at the outturn. This is because total peak demand in the system is not metered, as most end users of demand (eg; homes, offices) are not metered at peak (they are metered annually), neither are all distributed generators metered at peak. This means there is currently no objective way to measure outturn total peak demand in the system, either as end user demand or its component parts of transmission demand and distributed generation.

2.56. We have decided to continue with our proposal of incentivising peak demand on the transmission system (Peak National Demand). Peak National Demand, is net of interconnector flows so no adjustment for interconnector flows needs to be made to the outturn. The only adjustment to the outturn data, before comparing it to the forecast, will be the weather correction for the Annual Average Cold Spell Conditions.

[23] This is peak National Demand as defined in the Grid Code.

2.57. We did consider if the incentive on peak demand on the transmission system that we are introducing could lead to NGET paying too much attention to getting the forecast of this correct and, in doing so, neglecting total peak demand in the system. However, we have been reassured by NGET that to properly forecast Peak National Demand at the transmission level it is necessary to seek to fully understand and forecast *all* the elements of total peak demand.

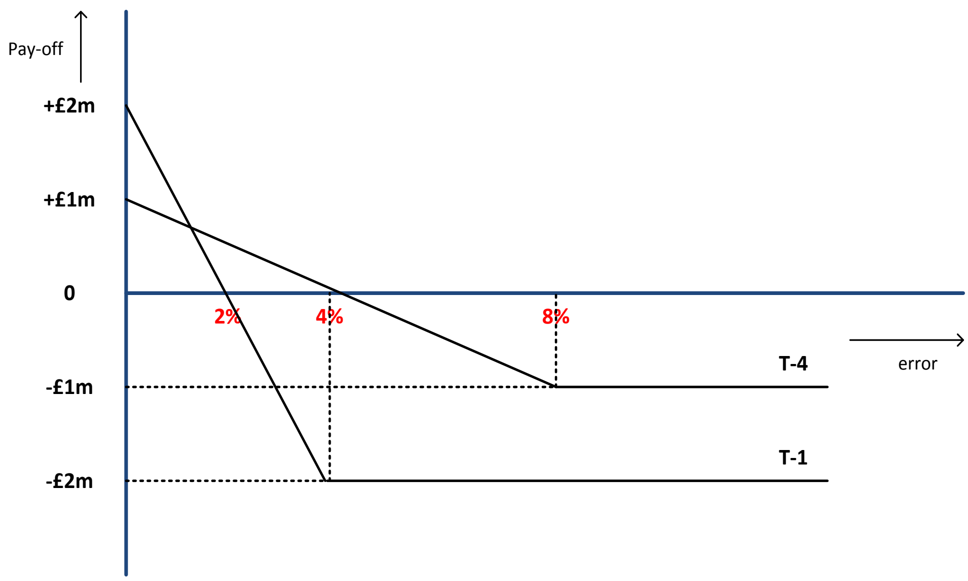
2.58. To further ensure that this incentive encourages the right behaviours, we will require NGET to write to us at the same time it publishes the Electricity Capacity Report each year. The letter should include, with reference to this incentive:

- the steps NGET has taken to improve demand forecasts (including forecasts of: Peak National Demand at the transmission level; peak demand met by distributed generation, and; peak demand reduction by DSR).

- how the most recent outturn of peak demand at the transmission level compares to the corresponding T-1 and T-4 forecasts (where these forecasts are available).

2.59. It is possible that developments such as the roll out of Smart Meters *may* mean that total peak demand outturns become observable in future. We will consider if this is the case and what difference it may make when reviewing these incentives ahead of the RIIO-T2 period. Figure 3 shows the structure of the T-1 and T-4 demand forecasting accuracy incentive.

Figure 3 - Structure of the T-1 and T-4 demand forecasting accuracy incentive



2.60. NGET will also be required to publish the Weather Correction Methodology Statement in effect at the time of each forecast and to use that methodology to correct the incentivised outturn.

Summary

2.61. The financial incentives that we have decided on will lead to a maximum upside or downside of £4.8m in any one year (though note that not all the incentives will apply in the initial years). Table 5 summarises the incentives and parameters.

Table 5: Summary of incentives

Incentives	Value per year
Annual report on performance	Reputational
Publishing specific concerns we have with performance and any enforcement actions	Reputational
Accuracy of tier 1 dispute resolution	+/-£0.2m
Customer and stakeholder satisfaction surveys	£0.6m (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
Total (financial incentives)	**+/-£4.8m**

2.62. We expect NGET to report on its performance against its incentives, including setting out revenue gains and losses. We would expect this reporting to take place at the quarterly Electricity Operational Forum. We also expect that performance data are published at least annually on NGET's website as performance against its Electricity SO incentives are at present.

Draft licence conditions

2.63. All incentives require modifications to the existing Special Conditions 4A, 4L and 7D of NGET's licence. Our statutory consultation on these modifications are published alongside this decision document[24].

[24] See https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-market-reform-emr