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

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

Our thinking on setting revenue, outputs and incentives for NGET roles in EMR are broadly aligned with Ofgem's initial proposals. The one exception is the proposal to create a financial incentive on volume of DSR providers in the T-1 auctions.

NGET's role in EMR is to run the process effectively. It is a ring fenced role. These processes are critical for the industry and NGET must be funded and incentivised to undertake their job well. Having an incentive that links to volumes of particular parties in the auction cuts across this and risks providing perverse incentives not to fulfil their critical procedural role effectively (e.g. focussed on increasing the volume of DSR rather than the quality of the service provided). It also may provide windfall gains or losses given their limited control over these volumes. The incentive seeks to use NGET as a means to promote a specific policy outcome rather than focusing them on doing their underlying job. It also risks paying them twice if, as NGET argue, that providing an excellent customer service will in itself promote greater pre-qualification volumes.

Our detailed responses are set out in the attachment to this letter. Our responses are based on the limited information provided in the consultation and NGET's publicly available EMR Business Plan proposals. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 01452 658415, or me.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Angela Piearce
Corporate Policy and Regulation Director

Attachment

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

EDF Energy's response to your questions

Initial Proposals on revenues and uncertainty

Q1. Do you agree that the proposed funding baseline has been set at the appropriate level?

NGET's EMR business plan sets out its proposed costs for operating EMR delivery function from August 2014 to March 2021. Its proposed TOTEX is £54.1m for the total period. Ofgem proposes to reduce staff costs by £2.5m, IS costs by £2.8m and a 10% annual reduction resulting in a TOTEX of £44.3m.

We agree with Ofgem's views that:

- six FTE for stakeholder management appears excessive, and the role and responsibilities could be carried out by four, with the support of other team heads as required;
- once the capability to enable interconnectors to participate in EMR is in place, NGET can reduce the number of staff in the modelling team;
- the planned refresh to the administration and auction systems in 2019-2020 and 2020-2021 seems unnecessary;
- the 10% annual efficiency reduction should be achievable based on NGET's TO business performance in RIIO-T1.

Since we do not have access to the detailed break-down of costs, we cannot comment on whether the proposed funding baseline has been set at the appropriate level. However, we are satisfied with Ofgem's reasoning for the £9.8m reduction.

Q2. Do you agree that there should not be any allowance or uncertainty mechanism for NGET to claim costs in addition to those funded here?

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. The consultation states that NGET comes to the conclusion that giving a specific allowance (£11m) to cover uncertainties would be the most practical option and reduces the administrative and cost burden on NGET and Ofgem of a specific reopener. However, Ofgem further states that when they had further discussions with NGET, it became apparent that the £11m was based on five speculative events, which may or may not happen. If this is the case, we agree with Ofgem that there should not be any allowance or uncertainty mechanism for NGET to claim costs in addition to those funded already.

We have some hesitation, however, because according to NGET's publicly available business plan, they state that the £11m refers to the funding of <u>specific known changes</u>. NGET seems to suggest that these changes will happen but the exact timing is the only factor which lacks certainty.

As a third-party stakeholder, we do not know the details of the discussions Ofgem had with NGET. However, we believe consumers should not have to fund the allowances if the events are purely speculative.

Q3. Do you agree with our proposed allowances and 'true-up' for the first 20 months of EMR – August 2014 to March 2016?

In July 2014, Ofgem decided to provide provisional funding to NGET's delivery in the first 20 months of EMR in advance of an assessment of a business plan to ensure smooth introduction of EMR. The provisional allowances provided were £5.1m to cover the first 20 months; but having reviewed the business plan for efficiency, Ofgem is now proposing an allowance of £11.8m.

We are broadly satisfied with the £6.7m increase because the bulk of the extra cost comes from the cost of the IS system which was planned during the preparatory stage (April 2013 – July 2014) which was delayed until the first 20 months of operation.

As the sums are relatively small, we are satisfied that there will be no 'true up' with actual costs incurred at a later date.

Initial proposal on outputs and incentives

Q4. Do you agree with our proposal to introduce EMR Customer and Stakeholder Satisfaction Surveys as an additional output?

Yes. This should encourage NGET to deliver good quality engagement and performance across NGET's EMR roles.

Financial incentive on accuracy of Tier 1 dispute resolution

Q5. 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.

We agree that the broad current structure of the incentives should be retained.

The existing financial incentive aims to ensure that NGET deals with disputes on its decisions efficiently and to a high standard. NGET proposes to maintain the existing incentive on disputes but to amend the parameters as follows:

- Decrease the cap of the overturned decisions to which the incentive is applied from 6 to 4.
- Move the neutral incentive threshold from 1 to 2 overturned decisions.
- Increase the value of the cap and floor from +/- £125,000 to +/- £1.25m

We agree with both NGET and Ofgem that the current floor of 6 overturned decisions for the maximum penalty can be reduced to '4 or more' overturned decisions.

Contrary to NGET's proposal to introduce a reward payment for one overturned decision we agree with Ofgem that the financial neutral point should be maintained at one overturned decision.

We agree with Ofgem that NGET's reasoning for increasing the value of the incentives from +/- £125,000 to +/- £1.25m is not justified. However, we think that the incentive value should be adjusted to take account of the amount of time and effort spent. Therefore, we are satisfied with Ofgem's proposal to increase the value of the incentive to a maximum of £100,000 each year for CM prequalification and CfD eligibility disputes.

Financial incentive on customer and stakeholder satisfaction

Q6. 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.

Yes. It seems sensible to base the structure on the existing principles used in RIIO Stakeholder Satisfaction Survey. In terms of parameters and value, we agree with Ofgem that scores below 5 (on a scale between 0 – 10) should not be rewarded and an annual target based on the mean of the two previous years should be a challenging target to drive performance.

We do not have a strong view on the value of the incentive but Ofgem's proposed figure (£600,000 each year split equally between CfD and CM surveys) is around 10% of their costs which is a material upside.

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

Q7. 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?

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 T-4 auctions. NGET is of the view that it can increase the volume of prequalified capacity through its stakeholder engagement and that the additional participants could increase competition in the auction and therefore drive down the clearing price in the auction.

Like Ofgem, we are not convinced that the added value of NGET's activities to promote new build participation can be identified. However, Ofgem thinks that 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 disagree for the following reasons.

NGET's role in EMR is to run the process effectively. It is a ring fenced role. These processes are critical for the industry and NGET must be funded and incentivised to undertake their job well. Having an incentive that links to volumes of particular parties in the auction cuts across this and risks providing perverse incentives not to fulfil their critical procedural role effectively. It also may provide windfall gains or losses given their limited control over these volumes. The incentive seeks to use NGET as a means to promote a specific policy outcome rather than focusing them on doing their underlying job. It also risks paying them twice if, as NGET argue, that providing an excellent customer service will in itself promote greater pre-qualification volumes.

Q8. Do you agree that we do not introduce an incentive on the volume of pre-qualified capacity in the T-4 auctions?

Yes.

Financial incentive on demand forecasting accuracy

Q9. 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.

We are satisfied with Ofgem's proposal that the neutral point should be lower than what NGET propose: 2% (equivalent to around 1.1GW based on the weather corrected peak demand of 54.3GW in 2014/15) for the T-1 forecast and 4% for the T-4 forecast (equivalent to around 2.2GW).

We also agree with Ofgem's proposal for the maximum incentivised forecasting error for T-1 to be 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, Ofgem proposes the maximum incentivised forecasting error to 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 0. Again, we are satisfied with this proposal.

General

Q10. Do you think the value of the incentives (overall and individually) is appropriate for NGET's roles in EMR?

Yes.

EMR preparatory costs

Q11. Do you agree with our proposed adjustments to NGET's preparatory costs incurred between April 2013 and July 2014?

Yes. The consultation states that NGET were originally allowed to recover £17.3m costs from consumers for costs incurred in preparing for the EMR role but following NGET's revised submission based on actual costs of £11.4m, Ofgem proposes to adjust the original figure. Ofgem proposes to further deduct £2.5m (£2.1m for an IS system that was not delivered and £0.4m in lower business support costs) resulting in £8.9m.

We agree that NGET should only be allowed to recover £8.9m from consumers.

EDF Energy
June 2015