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Dear Sirs

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

Thank you for the opportunity to respond to the above consultation. This response is made on behalf of National Grid Electricity Transmission (NGET). NGET was designated as the Electricity Market Reform (EMR) Delivery Body for Contracts for Difference (CfD) and Capacity Market in December 2011, a role which was formally conferred on NGET by the Secretary of State pursuant to secondary legislation made under the Energy Act 2013.

Our role as EMR Delivery Body is fundamental to the success of the enduring EMR mechanisms which will ultimately ensure the UK achieves its climate change obligations whilst continuing to provide security of electricity supply for consumers.

National Grid's Business Plan submission was developed to enable us to successfully deliver on our EMR obligations and facilitate the enduring success of the EMR mechanisms. Throughout the preparation phase of EMR, we developed our internal resources and have continued to build an expert team with the skills and capabilities required to deliver these important responsibilities, the Business Plan allows us to continue to develop our capabilities during the early part of the enduing delivery phase. We have designed efficient processes that allowed the implementation of the mechanisms in 2014 to operate smoothly and ensured all applicants were fully equipped to participate in both the CfD and the Capacity Market. Alongside this we have engaged with a wide range of customers and stakeholders and worked with them to address the issues that impact them.

We welcome the opportunity to comment on the Authority's initial proposals. Our response to this consultation focuses on the questions raised and our view of the proposed arrangements. We have identified a number of areas where there are significant differences between our Business Plan and Ofgem's proposals, we believe our Business Plan fully provided the rationale behind the resources we require to successfully deliver our EMR Delivery Body Role and as such we are keen to discuss these areas more fully, following closure of the consultation window.

Yours sincerely

Duncan Burt

National Grid Electricity Transmission
Electricity Market Reform: Initial Proposals consultation response

1. This document contains the formal response from National Grid Electricity Transmission to Ofgem's consultation on Initial Proposals on setting revenue, outputs and incentives for National Grid Electricity Transmission plc's roles in Electricity Market Reform.
2. The Initial Proposals present a number of items which we will work to resolve over the coming months to ensure that the efficient delivery of the EMR Delivery Body is not adversely affected. These can be summarised into two major areas:
    a. The overall balance of the proposals are more towards funding a steady state set of processes and outputs rather than considering the customer value that we could deliver through being more appropriately incentivised to enhance our overall role as EMR Delivery Body.
    b. There is no doubt the EMR role as currently executed will change over the coming years and some of this change could be substantial. Currently the efficiency assumptions and lack of uncertainty mechanism in the proposals do not enable the funding of this change to ensure it is delivered effectively.
3. We look forward to working with Ofgem to resolve these issues in advance of Final Proposals.

Question 1: Do you agree that the proposed funding baseline has been set at the appropriate level?
National Grid Response: National Grid does not agree that the proposed funding baseline has been set at an appropriate level, specifically in relation to the four areas Ofgem highlighted in their Initial Proposals: Stakeholder Management staff costs, Modelling staff costs, IS costs and Other costs. Our Business Plan submitted on 12 January 2015 set out the full justification for our headcount proposals, explaining in detail the process for arriving at the numbers. This included reference to the number of staff used to run the 2014 processes, any additions to reflect differences for the 2015 processes (i.e. running the DSR Transitional Auction pre-qualification processes in parallel with the T-4 processes) and in all cases we also identified reductions due to either the use of new "enduring" IT systems (more efficient) or due to potential synergies between the CM and CfD teams. The net effect of these calculations is that for both CM and CfD we are proposing to operate the 2015 processes (and all future years) with less headcount than we used to run the 2014 processes, even though we anticipate that the workload will be higher. **Stakeholder Management staff costs** – Ofgem has suggested that there is duplication of some roles and that the stakeholder management activities can be undertaken with 4 FTEs rather than 6. This seems to be a misunderstanding of our Business Plan, as we only proposed that this activity would be undertaken by 2 FTEs. The wider Stakeholder and Support team include an additional 4 FTEs who will undertake EMR Support activities (Legal support, Planning and Project Management, Compliance Management, Resource Management, Facilities support and general Administration) rather than stakeholder activities. Through discussions with Ofgem, there is now a better understanding of our headcount numbers in this area, as well as agreement on the importance of strategic stakeholder management and would anticipate the full headcount costs for this area being reinstated.

Modelling staff costs – We outline below some additional information which may not have been provided with sufficient clarity in our Business Plan. This further granularity has been discussed with Ofgem since their initial proposals document was published.
An integral part of future EMR modelling activities is the development of a pan-European model that can stochastically model interconnector flows across European countries to support security of supply in Europe. This work will be required to support the recommendation to DECC for both the T-4 and T-1 auctions, de-rating factors to be applied to interconnectors for the Capacity Market auctions and any future strike price modelling for low carbon technologies. This analysis will need to be run every year and will involve modelling not just GB and its connected countries but the whole of Europe as flows on german interconnectors, for example, will affect flows in France and other interconnected countries. National Grid doesn't currently own or operate such a model so will not only need to develop a model but will also need to populate it and run it every year to support its EMR licence obligations. To undertake this work National Grid identified a requirement for 3 FTE resources to analyse the demand and generation backgrounds across Europe, generation technology costs in each country, interconnection capacities, network constraints and the different reliability standards across Europe. This will also require significant liaison with European SOs and TOs to ensure common approaches and where possible latest information is being utilised. This type of analysis is new to National Grid and due to its far reaching role cannot be integrated within existing teams. As such new resources are required to undertake the modelling work as well as liaising with other stakeholders from National Grid, DECC's Panel of Technical Experts, DECC and Ofgem officials as part of their roles in scrutinising the work.

IS Costs - Our EMR systems are used by all EMR Delivery Partners and Industry Participants alike and as such we need to ensure they do not become a barrier to participation in EMR. In addition these systems will hold Government and commercially sensitive participant data. It is therefore incumbent upon us to ensure the on-going usability, security and confidentiality of the systems and the data within them.
Our systems are built using the latest available versions of the applicable operating systems and applications. To ensure that our systems remain accessible and secure it is necessary for all components in the overall solution to be supported by the product vendors and for all associated security patches to be applied.
Our Admin system, for example uses Microsoft products at both operating system and application level. The Microsoft Road map for these products indicates that they will go out of support (and therefore will not receive service patches) as follows:

- Operating system, Windows Server 2012 R2; Mainstream support ends in 2018. https://support.microsoft.com/en-gb/lifecycle?p1=17383
- Application, SharePoint 2013; Mainstream support ends in 2018. https://support.microsoft.com/en-gb/lifecycle/search?sort=PN&alpha=sharepoint%20server%202013&Filter=FilterNO

Although it is often the case that these dates are extended by the product provider as they approach, we believe it is inappropriate, and that our user stakeholders and data owners would not be prepared to allow us, to take the risk that our systems are not fully updated and secure.
We anticipate that it is highly unlikely that a four year extension would be provided and as such a refresh within the current RIIO price control period would be needed. For this reason we plan to refresh our systems in 2019 through to 2021, assuming that some extension to the above Microsoft Roadmap occurs. There does remain the possibility that we may need to do this earlier if extensions do not materialise. A further consideration here is the potential for

future rule changes to render our existing systems as not fit for purpose. Whilst we have made every effort to select products that are future proof in this regard, it is not entirely possible to foresee all possible future rule changes and the impact they may have on our systems.

Other costs – Ofgem proposes to make a further reduction of 10% of TOTEX each year from 2015/16, applied after the IS and staff cost adjustments, based on a general view that costs are too high and specifically that savings of this magnitude are "usually" possible in the first few years of operation. Ofgem also based its proposal on the assumption that EMR savings should be comparable to those forecast by NGET's TO business. Taking these points in turn, the Business Plan we submitted in January 2015 was based on our experience of operating the 2014 EMR processes and was produced in good faith, reflecting both an efficient and effective operation of the regime. Through discussions with Ofgem we believe we are aligned on the importance of National Grid continuing to deliver the level of service (and better) that market participants will have experienced in 2014 and that we should not be looking to reduce any areas of activity. Our overall costs are based on this principle and as such they are well justified.

With regard to the suggestion that savings are "usually" possible in the first few years of operation, we would accept that this is true for organisations that are operating processes which are stable, unchanging, repeatable and based on common cycles. This is not the case for EMR as we anticipate significant levels of change over the coming years to both the regime and the processes and IT systems required to operate it. In our submission we set out that expected 1-2% annual efficiencies would be offset by the additional capability/cost requirements of accommodating annual change to the EMR regime as a result of DECC/Ofgem/participant proposed changes to Regulations and Rules.

Ofgem compare potential EMR savings and those forecast for NGET's TO business. The two are not comparable due to the fundamental differences between our TO and SO businesses (EMR is part of the SO business). A better comparison would be between EMR and the broader SO, where we are currently forecasting savings of the order of 0.8% to the RIIO final proposals.

In summary, whilst we accept that it is right to propose a level of annual efficiency saving, we fundamentally believe that opportunities for delivering savings in the operation of our processes are greatly offset by the level and cost of changes we will need to make to those processes in the future.

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?

National Grid Response:

National Grid firmly maintains that there should either be an allowance or an uncertainty mechanism to deal with major EMR regime change which leads to a "step change" in the costs of running the EMR Delivery Body.

In our Business Plan we highlighted several areas of cost uncertainty associated with producing a plan for a seven year period. We also highlighted that the majority of these uncertainties had been factored into our baseline cost assumptions, either in our labour and IT costs (covering input price uncertainty) or in our headcount numbers (covering the

uncertainty over resource requirements to deliver ongoing annual regime/regulation change). The uncertainties which were not included in our baseline costs were those which related to a number of potential major EMR regime/regulation changes which would be more material and would require a "step change" in our costs and headcount numbers if we were required to implement and operate them. The challenge with these uncertainties is to find a fair mechanism for balancing the financial risk (of over or under funding) between consumers and National Grid. No baseline funding and no uncertainty mechanism would clearly place the majority of risk on National Grid and would not represent an equitable balance between risk and funding. In our Business Plan we proposed a number of options for dealing with these major uncertainties and for balancing the financial risk, with a recommendation to include the forecast costs in the baseline funding. Follow-up discussions with Ofgem have identified additional options including an EMR specific mid-period reopener on uncertainty costs. National Grid welcome these discussions which appear to recognise that some form of mechanism is required to deal with these types of major uncertainty and we remain open to finding a mutually agreeable mechanism.
Question 3: Do you agree with our proposed allowance and 'true-up' for the first 20 months of EMR – August 2014 to March 2016
National Grid Response: National Grid agrees with the principle of 'truing up' the provisional allowances for the first 20 months of operation as EMR Delivery Body. As outlined in the initial proposal document the provisional allowances were set taking several factors into account including uncertainties surrounding the roles and costs of operation and the lack of detailed information available at that time. Through the submission of our Business Plan we have set out our requirement for funding to deliver the outputs, capabilities and industry engagement as are required to execute the Delivery Body role effectively and efficiently. The proposed allowance of £11.8m has been subject to the same deductions and efficiency challenges as impacting the remaining period of operation (April 2017 – March 2021). Although we agree to the principle of the 'true up' we do not agree with the proposed allowance value for the reasons as set out in our responses to Question 1 and Question 2.
Question 4: Do you agree with our proposal to introduce EMR Customer and Stakeholder Satisfaction Surveys as an additional output?
National Grid Response: Yes, we do believe that Customer and Stakeholder satisfaction surveys should be included as an additional EMR Delivery Body output. Customer and Stakeholder engagement has formed a considerable amount of our effort since we first started work on EMR in 2011. The range of customers and stakeholders in EMR is extremely diverse ranging from UK Government and the electricity industry in GB to industrial and consumers and DSR providers. Throughout the development of EMR this range of stakeholders has also included industry bodies and organisations across Europe. EMR has now moved into enduring delivery phase and whilst the range of stakeholders for National Grid has more bias towards those taking part in the mechanisms, other stakeholders remain influenced and impacted by the way in which we engage.

Following the 2014 delivery window for both the CfD and the Capacity Market, stakeholders gave good feedback about the level of engagement and customer service afforded by National Grid, the level of support offered to communicate the legislative and regulatory frameworks, the workshops to guide applicants through implementation of the rules and the guidance through the prequalification and auction processes were identified as particular examples of good stakeholder engagement. The requirement for equivalent engagement on an enduring basis was also specified. This feedback was further acknowledged by the assessment of EMR carried out by consultants for DECC and Ofgem's annual report on the operation of the Capacity Market Auction.

We believe that conducting a dedicated EMR annual customer and stakeholder satisfaction survey will provide opportunity for stakeholders to formally report on the success or otherwise of the level of customer service provided by the EMR Delivery Body.

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

National Grid Response:
Yes we agree with the broad structure of the Tier 1 disputes incentive, however we suggest that the increased level of risk to the maximum penalty should be reviewed.
The proposal to maintain a cap of zero on the number of overturned decisions to trigger a financial reward is acceptable. We are concerned about the sharpening of the penalty element of the incentive to four overturned decisions. The EMR regime is a new mechanism that is intended to attract new participants to the electricity market. The 2014 process proved that many of these participants are new to the market and require a significant amount of assistance to understand and successfully comply with the rules surrounding the application and eligibility processes for both mechanisms. During the 2014 process guiding participants through this process had a significant impact on the level of resource from the National Grid team. This incentive is asymmetric, as we agree it should be, however pushing the penalty regime from six to four pushes this more from an incentive position to more of a penalty regime as the cost of additional resource time is outweighed by the incremental penalty. We request that the number of overturned decisions should remain at six.

We propose that the Capacity Agreement Notice and Capacity Market Register accuracy incentive should remain in place. National Grid worked closely with participants during 2014 to ensure the data and information received for participation in the mechanisms was as accurate as possible. This data and information flows through the systems and processes employed and manifests in the Capacity Market Register and the associated Capacity Agreement Notices. We maintain it is important that this information is accurately communicated through the administrative systems. We do not believe that success in this area in 2014 warrants a decision to remove the incentive that guarantees the importance of the accuracy of publishing such information.

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

National Grid Response:
As described above in our answer to Question 4, we agree that a Customer and Stakeholder

satisfaction survey is appropriate, however we do not agree with the parameters and values set out in the initial proposals document. The incentive structure as described in the initial proposals document states that a maximum income of up to £300,000.00 per mechanism is available annually through high performance in customer service and stakeholder engagement. There appears to be an error in the incentive as presented. The revenue adjustment formula presented in paragraph 2.23 on page 23 and 24 of the initial proposals document does not allow for the maximum incentive to be earned in each delivery year. We advocate that the Customer and Stakeholder satisfaction incentive should reflect the same principles of the existing incentive arrangement in the RIIO T-1 framework. As such this incentive should not reset the customer and stakeholder satisfaction target score on an annual basis. This will give regulatory certainty to allow for longer term strategies to be developed and implemented which will in turn drive increased consumer, customer and stakeholder benefit. In addition we suggest that the value of this incentive should better reflect the level of resource and effort employed on customer service and stakeholder satisfaction. The feedback received from the 2014 process has demonstrated that National Grid delivered high quality outputs in this area and that industry considers this to be an important part of the successful delivery of the EMR mechanisms. We have previously suggested an incentive structure that develops the influence that National Grid's stakeholder engagement has on applicants' ability to participate in the Capacity Mechanism auction, bringing forward more eligible capacity to participate in the T-4 auctions and hence increase liquidity and competition in the auction ultimately reducing costs to the consumer. We recognise at this stage the impact that National Grid has is difficult to measure accurately, however we believe customer and stakeholder satisfaction has a significant impact on this. We propose that the financial structure for this incentive should be increased in value to reflect the value to consumers of increased performance, which ensures maximum opportunity provided to participants driving a more competitively priced auction. We suggest the value of this incentive should be increased to a maximum of £1m per annum, £500,000.00 per mechanism.
Question 7: Do you agree with the proposed incentive on the volume of pre-qualified DSR in the T-1 auctions, its parameters and value? Do you think the incentive should be based on the absolute amount or the percentage of DSR that prequalifies compared to the benchmark?
National Grid Response: We agree that it is appropriate to have an incentive that drives increased volume of Demand Side Response in the T-1 auctions, and that increased participation in this auction will improve the financial visibility of a route to market for developers of new DSR resources and as this market develops, increased competition will ensure increased value for money to consumers. We do not believe the structure of the incentive as proposed represents value for money to consumers and we suggest it places increased financial risk on the delivery body that cannot be avoided. The DSR market is small compared to the wider wholesale energy market and bringing forward new DSR resources to compete alongside established or conventional forms of generation is difficult to forecast and success is highly sensitive to financial market

conditions. We do not believe that participant's investment decisions to bring forward new DSR resources in an uncertain market will only be informed by the delivery body's systems and processes. We recommend that dead-band of +/- 200MW should be included in this incentive to protect against unavoidable financial risk.
Question 8: Do you agree that we do not introduce an incentive on the volume of pre-qualified capacity in the T-4 auctions?
National Grid Response: The way in which National Grid conducts its EMR Delivery Body role has a significant impact on the success of the Capacity Market and CfD mechanism. As described above in our answer to Question 6, we maintain that operating the application processes smoothly, efficiently and in a customer focused way provides increased opportunity for participation in the mechanisms, which increases liquidity and increases value to the consumer through lower clearing prices in the auctions. We agree that this incentive is difficult to measure at this early stage in the delivery of the EMR mechanisms. Therefore at the current time we propose this benefit to the consumer should be reflected in the value of the Customer and Stakeholder satisfaction survey, as described in Q6. However we also suggest that the performance of future auctions should be monitored carefully to identify possible future opportunities to introduce a measurable T-4 volume based incentive mechanism.
Question 9: Do you agree with the proposed incentive on the accuracy of forecasting demand at T-1 and T-4, its parameters and value? If you would like to propose an alternative, please provide evidence to support this.
National Grid Response: Our proposal was based on mean historical forecasting performance; however, this proposal assumes lower neutral points of 2% for T-1 and 4% for T-4 which come into effect immediately. Whilst this may be challenging we believe it is achievable over the medium term with the modelling improvements planned and therefore provides a reasonable balance around risk and reward that will be in the interest of consumers.
Question 10: Do you think the value of the incentives (overall and individually) is appropriate for NGET's roles in EMR?
National Grid Response: National Grid's role as EMR Delivery Body is fundamental to the success of the enduring EMR mechanisms which will ultimately ensure the UK achieves its climate change obligations whilst continuing to provide security of electricity supply for consumers. As such we believe the incentive arrangements should encourage the delivery body to strive for the success of the mechanisms through performance of its role. The incentives proposed focus on the correct areas of National Grid's responsibilities. However the overall balance of the incentive portfolio does not consider the additional customer value that we could deliver through being more appropriately incentivised to enhance our overall role as EMR Delivery Body. In our response we have suggested some alternative approaches to the design and structure and in some cases we have suggested an increased value to reflect opportunities for increased consumer value.

Question 11: Do you agree with our proposed adjustments to NGET's preparatory costs incurred between April 2013 and July 2014?
National Grid Response: National Grid agree with the proposed adjustment to preparatory costs funding to £8.9m to reflect actual costs incurred between April 2013 and July 2014.