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Direct Dial: 020 7901 7000
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Date: 6 November 2015

Dear Ms Kay,

Direction issued to National Grid Electricity Transmission Plc (NGET) by the Gas and Electricity Markets Authority pursuant to paragraph 4C.37 of Special Condition 4C of NGET's Electricity Transmission Licence.

National Grid Electricity Transmission plc (NGET) has submitted Balancing Services Incentive Scheme (BSIS) modelling methodology statements ('the SO Methodologies')¹ to the Gas and Electricity Markets Authority "the Authority" under paragraph 4C.35 of Special Condition (SpC) 4C of NGET's Electricity Transmission Licence (Licence) for the 2015-17 incentive period.

This letter sets out our decision to approve the SO Methodologies retrospectively from 1 April 2015.

Background

NGET is responsible for balancing the electricity system on a continuous basis. The costs that NGET incurs in carrying out this role are passed through to users of the system via Balancing Services Use of System (BSUoS) charges.² We regulate the actions of the System Operator (SO) to ensure its operational costs are optimised, delivering value for money to the consumer. Building on statutory obligations which require the SO to act in an economic, efficient and co-ordinated manner, we have historically driven the performance of the SO and shaped aspects of its behaviour through incentives.

The main incentive on the electricity SO is the BSIS. We use two models³ to calculate a single BSIS financial target. The financial target also includes a target for black start services.⁴ If actual costs are below target then the SO is permitted to receive an incentive payment and if actual costs exceed the target then it faces an incentive penalty. These models are set out by the SO Methodologies which define how the models should be created.

For each incentive period NGET is obliged to submit to the Authority, for approval, revised SO Methodologies.

¹ NGET website where the published SO Methodologies can be found: <http://www2.nationalgrid.com/UK/Industry-information/Electricity-system-operator-incentives/bsis/>.

² Mechanism through which NGET recovers the cost of day to day operation of the transmission system from generators and suppliers.

³ The constraints model and the energy model, these models use both ex-ante (calculated ahead of the event) and ex-post (outturn data) data to calculate a target.

⁴ Back start services are procured from generators which have the capability to start generation without reliance on external site supplies. These services are employed in the event that there is a total or partial shutdown of the National Electricity Transmission System which has caused an extensive loss of supplies.

NGET submission

On 17 September 2015, NGET submitted three new SO Methodologies to the Authority for approval:

- Modelling of energy costs;
- Modelling the costs of managing Transmission Constraints; and
- Ex-ante or ex-post treatment of modelling inputs.

NGET maintained a similar structure to the 2013-14 SO Methodologies in writing the methodologies for this incentive period, while updating the coefficients taking into account the latest data. The changes include:

- Provisions for the Operating Reserve, Balancing Mechanism (BM) Start-Up Cost and Negative Reserve Costs Models to be reopened if NGET find that they do not closely follow the trend shown by actual spend.
- Refinement of regressions resulting in modelled behaviour more closely following outturn.
- The addition of Rate of Change of Frequency (ROCOF) and Solar PV into the Constraint Model.
- Housekeeping changes.

Our decision

Pursuant to Special Condition 4C.37, having had regard to its principal objective statutory duties we consider that the publication of the SO Methodologies is beneficial to consumers.

We believe it is in the interest of consumers to approve the SO Methodologies as they provide a balanced framework for incentivisation. We have assessed the drivers as suggested by NGET and agree that it is appropriate to keep the models with greater uncertainty open for review in the short term.

As such, we direct that the SO methodologies be retrospectively applied from 1 April 2015, in line with the 2015-17 incentive period.

If you have any queries in relation to the issues raised in this letter, please feel free to contact Leonardo Costa on 0203 263 2764 or via email at Leonardo.Costa@ofgem.gov.uk.

Yours sincerely,

Mark Copley

**Associate Partner, Markets - Duly authorised on behalf of the Gas and Electricity
Market Authority** **6 November 2015**

ATTACHMENT: National Grid Electricity Transmission Plc – Special Conditions

Alison Kay
Group Company Secretary
National Grid Company plc
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CV34 6DA

Direction issued to National Grid Electricity Transmission Plc (NGET) by the Gas and Electricity Markets Authority pursuant to paragraph 4C.37 of Special Condition 4C of NGET's Electricity Transmission Licence.

1. This Direction is issued by the Gas and Electricity Markets Authority (the "**Authority**") pursuant to paragraph 37 of Special Condition (**SpC**) 4C of NGET's Electricity Transmission Licence (the "**Licence**") granted or treated as granted under section 6(1)(b) of the Electricity Act 1989 (the Act) to National Grid Electricity Transmission Plc (NGET) (company number 2366977; the "**Licensee**").
2. Capitalised terms used in this Direction which are not defined in this Direction shall have the meaning given to them in the SpC.
3. Paragraph 35 of SpC 4C provides that the Licensee shall publish SO Methodologies as approved by the Authority for determining Modelled Target Costs.
4. The considerations and rationale of the Authority's decision are set out in the accompanying letter to the Licensee dated 6 November 2015.
5. The Authority hereby directs, pursuant to paragraph 37 of SpC 4C, that the Licensee shall in compliance with paragraph 3 of this Direction, publish the SO Methodology statements submitted to the Authority in July 2015, as described in paragraph 4C.35 of Special Condition 4C of NGET's Electricity Transmission Licence:
 - (a) a methodology for determining the ex-ante or ex-post treatment of modelling inputs;
 - (b) a methodology for modelling the costs of managing Transmission Constraints; and
 - (c) a methodology for the modelling of energy costs.
6. the accompanying letter to the Licensee dated 6 November 2015.
7. The Licensee is required to report any change of circumstances relevant to this Direction to the Authority.
8. This Direction shall take effect retrospectively from 1 April 2015 and shall remain in effect until 31 March 2017.

Dated: 6 November 2015

Mark Copley

Associate Partner, Markets

Signed on behalf of the Authority and authorised for that purpose.