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Dear Colleagues

Final Proposals for updating incentive performance in past incentive schemes

This letter sets out our Final Proposals on amending National Grid Electricity Transmission's (NGET) licence to allow it to correct historic errors in determining the incentive reward or penalty payment. Today we also publish our statutory consultation on the licence modifications we propose to make to implement our Final Proposals.

Background

NGET is the electricity System Operator (SO) for Great Britain (GB). As the SO, NGET plays an important role in the functioning of the GB electricity market. It is responsible for balancing the electricity system by ensuring that generation matches demand second-by-second. To do this, NGET buys and sells electricity and procures balancing services.

NGET has a statutory obligation to act in an economic, efficient and coordinated way. Ofgem regulates NGET's actions to ensure it minimises the costs of balancing the system for market participants. We have done this by setting financial and reputational incentives.

Currently if there is an error in determining the incentive reward or penalty payment, it can only be corrected before the Reconciliation Final (RF) Balancing Services Use of System charges billing. And although NGET's licence accommodates reconciling balancing costs for any period, it doesn't include a way to adjust incentive performance a result of changes in costs.¹ Consequently, most historic incentive errors cannot be rectified under NGET's current licence.

In December 2015, we consulted on our proposal to introduce an additional term in NGET's transmission licence. This would allow it to correct errors in past incentive reward or penalty payments.² It would let us ensure that reward or penalty payments are in line with the methodologies that define the incentive targets. We wanted to allow errors to be corrected if they arose from a third party's actions, and if correcting them benefitted consumers. We didn't propose to allow errors caused by NGET if correcting them would benefit NGET under the incentive. This is because we believe NGET should prevent errors when designing and applying the incentive scheme.

We also proposed to have a de minimis threshold of 1% of the cap of the scheme (in absolute terms, currently £300k) for any adjustment.

¹ NGET's licence, under the ET term, allows for adjustments to costs but not associated incentive performance

² Our Initial Proposals consultation can be found at the following link: <https://www.ofgem.gov.uk/publications-and-updates/initial-proposal-updating-incentive-performance-past-incentive-schemes>

Consultation responses

We received only one response to our consultation.³ NGET supported introducing the mechanism, but disagreed with our proposal to exclude errors caused by NGET if correcting them would benefit it under the incentive scheme. NGET said that allowing those types of errors to be corrected would keep incentives robust and effective. In those instances, NGET said it would be appropriate to apply generic consumer compensation, for example with NGET recovering 80% of the benefit.

Final Proposals

We are not proposing to change our Initial Proposals. We believe that they provide the appropriate protection to consumers and ensure that NGET is measured against a robust and effective target.

We continue to believe that it is appropriate to exclude from the new mechanism errors caused by NGET, if correcting them would benefit NGET. NGET can and should ensure it has quality assurance to avoid errors. It should also ensure that any error is identified and corrected using the current mechanism. We think it is appropriate that when consumers would benefit from the correction, NGET should amend the incentive reward or penalty payment, but that it cannot benefit from these errors.

In addition, excluding those adjustments would further incentivise NGET to ensure no errors are identified after reconciliation. Table 1 below summarises the key features of the proposed mechanism.

Table 1: Key features of the proposed mechanism

Area	Description	Final Proposals
Qualifying errors	Types of errors that are covered by the new mechanism	<ul style="list-style-type: none"> • Errors from third party • Errors by NGET where correction would benefit consumers
Materiality	Materiality criteria for this mechanism to apply	<ul style="list-style-type: none"> • Minimum threshold of 1% of the cap of the incentive scheme in absolute terms (currently £300k). • Error adjustments are limited by the cap or floor of the incentive scheme for the year when the error occurred.
Timeframe	Retrospectivity of the adjustments	<ul style="list-style-type: none"> • Six years in line with data storage requirements
Reporting	Obligation on NGET to report any error identified to the Authority	<ul style="list-style-type: none"> • NGET to report any error within 10 working days of identifying the error. • NGET to submit a report to the Authority describing the error and the proposed correction within two months.
Governance	Powers of the Authority over this mechanism	<ul style="list-style-type: none"> • Authority has three months from NGET's submission to reject change. • Authority can ask for further information from NGET if report does not have enough information to assess validity of error and NGET's correction

³ In our Initial Proposals there was an error in the Ofgem e-mail address for responses. We have not been contacted by anyone saying they could not submit a response as a result. But if you believe you have submitted a response which we have not considered, please do not hesitate to contact us.

The statutory consultation on the proposed licence modifications to implement our Final Proposals is also published today and closes on **Wednesday 16 March 2016**. Please send any representations to:

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Next steps

If you have any questions about this decision letter, please contact Leonardo Costa on soincentive@ofgem.gov.uk or 0203 263 2764.

After we have reviewed any representations, and subject to that review, we intend to modify NGET's licence to introduce the new licence provisions to implement our Final Proposals.

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Mark Copley
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For and on behalf of the Gas and Electricity Markets Authority