

Initial Proposal for Updating Incentive Performance in Past Incentive Schemes

Consultation

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Overview:

This document sets out our initial proposals to amend National Grid's Electricity Transmission (NGET) licence to allow for historic errors in determining the incentive reward or penalty payment to be corrected.

NGET's transmission licence has limited mechanisms in place to correct errors impacting incentive payment/penalty. We are proposing the introduction of a new licence term and corresponding framework to allow for a wider range of historic errors to be corrected. The framework would define what errors can be considered for correction. We propose excluding errors caused and benefiting NGET. Also, we propose setting a range for the materiality of the errors and defining a timeframe for error correction.

Our aim in amending the licence is twofold. First, to return money to consumers when they have been incorrectly charged. As well as to allow for NGET to recover costs when errors occur which result from a third party's actions.

Context

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 on the national electricity grid matches demand on a second by second basis. To do this, NGET buys and sells energy and procures associated balancing services.

The SO has a statutory obligation to act in an economic, efficient and coordinated manner. Ofgem regulates the actions of the SO to ensure that it is encouraged to minimise the costs of balancing the system for market participants. We have historically achieved this through setting financial and reputational incentives.

In this document we consult on our proposals to introduce an additional term into NGET's transmission licence to allow for errors in past incentive reward or payment to be corrected. This licence term will allow us to ensure that payment or penalty is in line with the agreed upon methodologies which outline how the incentive targets are defined.

Associated documents

National Grid Electricity Transmission Plc - Special Conditions:

<https://epr.ofgem.gov.uk//Content/Documents/National%20Grid%20Electricity%20Transmission%20Plc%20-%20Special%20Conditions%20-%20Current%20Version.pdf>

Electricity System Operator incentives 2015-17: Final Proposals:

<https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-incentives-2015-17-final-proposals>

Electricity System Operator Incentives 2011-13: Income Adjusting Events

Determination: <https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-incentives-2011-13-income-adjusting-events-determination>

ELEXON Trading Dispute decisions: <https://www.elexon.co.uk/reference/technical-operations/dispute-decisions/>

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Executive Summary

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 system¹ (BSUoS) charges.

We place incentives on NGET to operate the system as economically and efficiently as possible, rewarding or penalising based on its performance. The costs of balancing the system are compared to a target. If actual costs are below target then the SO receives an incentive payment and if actual costs exceed the target then it faces an incentive penalty.

Background

Currently, if an error is made determining the incentive payment or penalty it can only be corrected within one year following the close of the incentive period. NGET's licence accommodates for the reconciliation of balancing costs for any period without limitation; however, it does not provide a mechanism to adjust incentive performance that may arise as a result of changes in costs.² Consequently, most historic errors cannot be rectified under NGET's current licence conditions.

Proposal

To address this issue, we are setting out an initial proposal to amend NGET's transmission licence by introducing a new licence term. The new term would allow for incentive performance to be adjusted when errors are detected and found to have an impact on incentive payments or penalties. We believe that this amendment will benefit consumers.

There is value in adjusting the incentive payment/penalty when certain types of errors have been detected. When a mistake's correction returns money to consumers it is clear rectifying the error provides value. Correcting a third party error to the benefit of NGET would further enforce the effectiveness of the incentive schemes, ultimately reducing costs for consumers. In order for the incentives to be effective, NGET must be measured against actual performance. If NGET is not appropriately rewarded when it has effectively carried out its role our ability to incentivise their actions is diminished. Over the long-term, the cost of balancing the system would increase as the incentives would become less effective.

¹ Mechanism through which NGET recovers the cost of day to day operation of the transmission system from generators and suppliers.

² NGET's licence, under the ET term, allows for adjustments to costs but not associated incentive performance.

We propose to allow for the correction of errors that arise from a third party's actions as well as errors whose correction benefits consumers. In respect to errors that are both caused by and subsequently benefit NGET performance under the incentive, we do not believe that there should be a mechanism in place for NGET to recover these costs.

In this consultation, we set out a framework to define which errors can be corrected. We propose specific parameters for the materiality of the errors as well as a timeframe in which detected errors can be considered for correction.

Next steps

This consultation closes on 8 January 2016. Following our review of responses, we intend to issue a final consultation on the proposed amendment to Special Condition 4C of NGET's transmission licence in January 2016. If appropriate, we will issue a direction to amend the licence by 26 February 2016.

1. Background

Chapter Summary

In this chapter we provide a summary of the SO incentives and consider the current licence provisions to retroactively correct historic errors in the incentive payment/penalty.

Question box

Question 1: Do you agree that errors affecting incentive payment/penalty should be corrected? Why or why not?

System Operator Incentives

- 1.1. NGET is responsible for balancing the electricity system in real-time. The costs that NGET incurs in carrying out this role are passed through to users of the system via Balancing Services Use of System¹ (BSUoS) charges. We regulate the actions of the SO to ensure its operational costs are optimised. Since 2001, we have driven the performance of the SO and shaped aspects of its behaviour through incentives. These schemes have lasted one to two years.
- 1.2. The main incentive on the electricity SO is the Balancing Services Incentive Scheme (BSIS). BSIS incentivises NGET to operate efficiently by setting an overall cost target for its balancing actions.
- 1.3. Models are used to calculate a single BSIS financial target. If actual costs are below target then NGET receives an incentive payment and if actual costs exceed the target then it faces an incentive penalty. The size of the payment is determined by the relevant sharing factor³ and is subject to an upper cap and the maximum penalty it can incur is bounded by a lower collar.
- 1.4. The overall cost target is modelled. The parameters that govern the model are set out in the SO Methodology Statements⁴ prior to the commencement of the

³ NGET's over/underspend compared to the modelled target is shared with industry in order to strike a balance between risks/rewards faced by the SO and customers. The sharing factor determines the proportion the over/underspend is shared.

⁴ The SO Methodology Statements found on NGET's website: <http://www2.nationalgrid.com/UK/Industry-information/Electricity-system-operator-incentives/bsis/>, it sets out the two models which are used to calculate a single BSIS financial target.

incentive scheme. There are two provisions within NGET's transmission licence to adjust incentive payment or penalty after the methodologies have been agreed.

- 1.5. The licence term 'ET' allows for adjustments to costs but not associated incentive performance. It is designed to pass through any costs that are incurred which relate to prior schemes but which were not foreseen or billed when the scheme was live.
- 1.6. Income Adjusting Events⁵ (IAE) allows for NGET to submit a notice to the Authority when it believes an IAE has occurred. Notices to seek IAE payment can be raised up to three months after the end of an incentive scheme, after which no adjustment can be made.
- 1.7. Currently, if an error in the incentive payment or penalty is detected a year or more after the scheme's conclusion, there is no mechanism to allow for its correction.

Occurrence of Errors

- 1.8. NGET is required under its transmission licence to develop models which are approved by the Authority. We are confident in the robust nature of this process, nevertheless, errors can occur. Given the complexity of developing models, in rare instances, mistakes applying the SO Methodologies can occur. As well, data used to determine the targets occurs in two settlement stages, the second of which is 14 months after the date of data collection. Given the timescale of the reconciliation process, it is not unreasonable that the data used in the initial settlement will differ from that in the final settlement.
- 1.9. Recently, three historic errors have been identified. One of which was due to discrepancies in data provided to NGET by a third party over the two settlement stages. The other two errors were a result of mistakes made on the part of NGET. NGET inadvertently omitted a variable in one instance and incorrectly referenced data in another.
- 1.10. Given the current licence arrangement, there is no mechanism to consider correcting such errors if they occurred more than a year in the past.

⁵ An event or set of circumstances can be classified as an IAE when it was not foreseen at the time of setting the incentive scheme and is considered to have led to costs being incurred by NGET that were not allowed for when determining the appropriate level of Incentivised Balancing Costs (IBC).

Reasons to correct errors

- 1.11. In light of the recently identified errors, we believe it is appropriate to introduce a new licence term. We propose that this term would allow for errors in the incentive payment or penalty to be corrected beyond the period allowed for in the current licence. Our view would be to apply this licence term in instances where a third party has made an error or if an error's correction benefits consumers.
- 1.12. When the correction of an error reduces costs to consumers, a provision to allow for its correction provides value to consumers. Currently, errors can unduly benefit NGET.
- 1.13. When a third party is responsible for an error, we believe a correction should be made to the incentive payment or penalty. We encourage NGET to minimise the cost of balancing the system through incentive setting. The incentive scheme is only effective when NGET is measured against actual performance. If NGET is not appropriately rewarded when it has effectively carried out its role our ability to incentivise their actions is diminished. Over the long-term the cost of balancing the system would increase as the incentives would become less effective, ultimately negatively impacting consumers.
- 1.14. We set out more detail on the scope of the proposed licence term as well as our intended process going forward in the next chapter.

Next steps

- 1.15. This consultation closes on 8 January 2016. Following our review of responses, we intend to issue a final consultation in January 2016. If appropriate, we will issue a direction to amend the licence by 26 February 2016.

Your views

- 1.16. We are interested in your views on how the correction of historic errors should be managed and the appropriateness of the proposed changes.

2. Scope of Licence Change

Chapter Summary

This chapter summaries the proposal we are putting forward for how a new licence term could be defined.

Question box

Question 1: Do you agree with our proposal to limit the scope of errors eligible for correction based on the party responsible for causing them?

Question 2: What are your views on the limiting the scope of errors eligible for correction based on the party responsible for causing them?

Question 3: What are your views on including a materiality clause and the parameters we have set out?

Question 4: What are your views on setting out a timeframe in which errors can be corrected? What are your views on our proposed timeframe?

Question 5: Do you believe there is a more appropriate way to manage historic errors impacting incentive payment/penalty than the framework proposed? Please explain.

- 2.1. Considering the errors described in Chapter 1, we consider it appropriate to introduce a new licence term which will allow for incentive performance to be adjusted when material errors are found.
- 2.2. To effectively apply this licence term, we are proposing criteria that must be met in order for an error to be considered for correction. We believe that this framework should exclude certain types of errors depending on the party responsible for the mistake, establish the materiality of an error and limit the correction of errors to a defined timeframe.
- 2.3. We are also proposing that NGET be obliged to report to us any errors they uncover, regardless of impact.

Qualifying errors

- 2.4. We are of the view that there should be a distinction in how errors are treated under the proposed new licence term depending on the party who caused the error. An error can be the result of an error on the part of a third party or the result of actions taken by NGET.

- 2.5. We support introducing a stipulation to any proposed licence change which would render certain errors ineligible for an incentive payment price adjustment, given the party responsible for the error.
- 2.6. We hold the view that if incentive performance is affected as the result of a third party error, adjustments to incentive performance should be allowed. This adjustment would be subject to satisfactory demonstration or explanation to the Authority of the underlying causes and impacts of the error.
- 2.7. In the current methodology framework there are certain parameters used to determine the incentive targets where NGET relies on third party data. In these instances, NGET has limited influence over data reliability. Therefore, in the absence of this correction mechanism, NGET is exposed to actions and competencies of third parties. As discussed in Chapter 1, the incentive scheme encourages NGET to improve its actions to reduce costs. For incentives to be effective, NGET must be measured against actual performance.
- 2.8. We also hold the view that errors should be rectified when their correction will benefit consumers. As the incentives are designed to return value to consumers, not correcting when consumers have been over charged would fail to meet this objective.
- 2.9. In respect to errors that are either caused by or related to an activity which NGET is accountable, and whose correction would be beneficial to NGET, we are of the view such errors should be excluded from consideration.
- 2.10. NGET is obliged by their licence to develop models. We believe if it is within NGET's power to prevent an error there should not be a provision to allow for its correction after the models have been agreed. Omitting this type of error from any licence change would introduce a further incentive for NGET to uphold their model development responsibilities, benefitting consumers.
- 2.11. We seek stakeholder's views on the qualification of errors and the appropriateness of including such distinctions in NGET's licence.

Materiality

- 2.12. We propose to introduce a materiality clause. The new licence term, if introduced, is intended to be used infrequently. A materiality clause would help to minimise the impact on consumers and limit the use of the term to correct only significant errors.
- 2.13. In respect to where it is set, we believe two factors should be considered. First, the cost associated with correcting an error. As well as, the maximum incentive payment or loss under the scheme.

- 2.14. We propose that the two following criteria be met in order for the Authority to approve an adjustment resulting from an error:
- That the value of the correction would need to be 1% of the upper limit of NGET's incentive payment range.
 - That the threshold be linked to the difference between MT⁶ and IBC⁷ such that adjustment to the incentive payment or penalty could only be made when an error's correction impacts the gain or loss against the incentive. That is, the difference between MT and IBC would need to lie within the bounds of the scheme created by the scheme cap and scheme collar either before or after a proposed adjustment.
- 2.15. This criteria sets a threshold above which the cost associated with correcting an error is worthwhile. We believe providing a minimum threshold is sensible. When an adjustment would sit above the cap or below the collar, its correction would be immaterial and not worth considering. If the threshold was set too low the cost of correcting a mistake could be higher than the value of the error. Consequently, correcting such an error would not be beneficial to any party.
- 2.16. Finally, we believe there should be a stipulation in the licence that other values outside the thresholds could be considered, as directed by the Authority. This provision is intended to allow for situations where an error slightly outside of the agreed thresholds could be considered material.
- 2.17. We seek stakeholder views on the inclusion of a materiality clause and views on the parameters we have set out.

Timeframe

- 2.18. We propose that there be a six year limit for error correction. This timeframe is based on data availability as NGET is obliged to maintain balancing services related information for a six year period.
- 2.19. Correcting errors past a point where data is not readily available could lead to unreliable results which are challenging to validate. This timeframe would prevent corrections to errors which could not be rigorously validated.
- 2.20. We do recognise that there are limitations within the six year timeframe. Modelled coefficients are developed using past performance data. In validating the errors recently detected, data outside of the range of data stored in

⁶ The licence term for the target for Balancing Services Activity incentivised external costs.

⁷ The licence term for the cost of balancing services on which NGET is incentivised.

NGET's data warehouse was needed. Although, NGET was able to source and validate the data unavailable in the warehouse establishing confidence in the reliability of the data was difficult. This demonstrates that as we move further in the past, even when the incentive period is within a six year timeframe, it becomes challenging to have confidence in the available data.

- 2.21. However, being overly conservative in the timeframe could result in material errors enduring. Consequently, a balance needs to be struck between the ability to obtain reliable data while not overly limiting the range in which corrections can be made. We believe that forward looking, extending the length of the time data is stored maybe appropriate.
- 2.22. We seek stakeholder views on if they deem a timeframe necessary, and if so, their views on what an appropriate timeframe should be.

Error Reporting

- 2.23. We are proposing that in addition to the error correction provisions, a reporting obligation be included in the amendment. NGET would be required to alert the Authority as soon as an error affecting incentive penalty/payment is detected. The impact or time when the error occurred would be immaterial to the reporting requirement.
- 2.24. A formal report would then follow, within a timeline determined at the Authority's discretion. A provision would be included to allow for the Authority to request more information.

Next steps

- 2.25. We are interested in your views on our proposed addition of a new licence term.
- 2.26. This consultation closes on 8 January 2016. Following our review of responses, we intend to issue a final consultation in January 2016. If appropriate, we will issue a direction to amend the licence by 26 February 2016.

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 8 January 2015 and should be sent to:

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soincentives@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish a consultation on proposed licence changes. Any questions on this document should, in the first instance, be directed to:

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CHAPTER: One

Question 1: Question 1: Do you agree that errors affecting incentive payment/penalty should be corrected? Why or why not?

CHAPTER: Two

Question 1: Do you agree with our proposal to limit the scope of errors eligible for correction based on the party responsible for causing them?

Question 2: What are your views on the limiting the scope of errors eligible for correction based on the party responsible for causing them?

Question 3: What are your views on including a materiality clause and the parameters we have set out?

Question 4: What are your views on setting out a timeframe in which errors can be corrected? What are your views on our proposed timeframe?

Question 5: Do you believe there is a more appropriate way to manage historic errors impacting incentive payment/penalty than the framework proposed? Please explain.

Appendix 2 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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