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Dear Leonardo

Initial Proposal for Updating Incentive Performance in Past Incentive Schemes

We welcome the opportunity to respond to the above consultation that was published on 2nd December 2015. This response is made on behalf of National Grid Electricity Transmission plc (NGET) and we have addressed our response to the specific questions posed by Ofgem in the consultation.

In summary, we support the proposal to introduce an additional term into the NGET transmission licence that would allow for incentive performance to be adjusted for instances where errors are detected and where they could have an impact on incentive payments or penalties for a scheme period. We agree with Ofgem that the inclusion of the new term will further reinforce the existing incentive frameworks and ensure that performance can be more accurately captured where errors have impacted on the incentive target. Furthermore, the new licence term would also mirror the provision already made within the licence to correct for balancing costs that occasionally arise after the last settlement run¹ and so allow for incentive performance to be adjusted for any updates to balancing costs made through this correction process.

We note and support the Ofgem proposal that corrections be allowed to incentive performance which are as a result of third party errors or where an error caused by NGET would result in returning money to consumers. However our view is that the framework should also allow for the correction of errors made by NGET that would be beneficial to NGET, albeit with an additional discretionary element that would enable the Authority to consider mitigating rationale as to why the error occurred. We fully agree with the Ofgem stated view that for incentives to remain effective NGET must be measured against actual performance. In extending the framework to also allow for the correction of NGET caused errors with Authority approval it is our view that this approach would better adhere to the principle of setting an objectively derived incentive target, through the application of agreed models and methodologies.

The remainder of this letter addresses the specific questions raised in the initial proposals document.

¹Occasionally changes to costs for a period may be required as a result of final settlement data corrections and or dispute resolution. The licence provides for this in the ET term.

Chapter 1

Q1. Do you agree that errors affecting incentive payment/penalty should be corrected? Why or why not?

Yes we do agree that errors affecting incentive payments or penalties should be corrected. The current framework for the Balancing Services Incentive Scheme was introduced in 2011 to create a target for balancing costs by using an agreed set of models and underlying input variables in parallel with an agreed set of methodologies. Through this approach, a more robust target is identified which creates an incentive that aligns NGET interests with those of consumers. The methodologies also define the source and time-basis² of each of the input variables in addition to capturing the source of the data used. This not only provides transparency but also focuses the incentive correctly against those costs which NGET has the ability to influence or control. Therefore if costs change or if an error is identified, be that in a data source, model, or indeed application of a methodology, this should be corrected to ensure that the reward or penalty under the incentive scheme is not diluted. Correcting errors, so as to reflect both the intent and design of the scheme will ensure that commercial innovation and risk management is rewarded or penalised more accurately, thus delivering short and long term value to consumers.

Chapter 2

Q1 Do you agree with our proposal to limit the scope of errors eligible for correction based on the party responsible for causing them?

We agree with the proposal that where incentive performance is materially impacted due to a third party error then this should clearly be corrected, subject to satisfactory demonstration to the Authority of the impact of the error. We also fully support the proposal that errors caused by NGET should be corrected where they are beneficial to consumers. However, we do not share the view that the correction of errors which are deemed accountable to NGET and which favour NGET should not be considered for correction. By their very nature, errors are not intentional or always foreseeable and can also arise as a result of a number of different and sometimes complex issues that are not always directly within NGET control. We recognise that the Authority would want to retain some element of discretion in relation to errors caused by NGET, but to ensure that the incentives remain robust and effective we do not believe that introducing asymmetry into the treatment of errors (by excluding NGET caused errors that benefit NGET) would be the best way to proceed.

Q2 What are your views on limiting the scope of errors eligible for correction based on the party responsible for causing them?

Please also see response to Q1 above. The principle of the models that underpin the incentive scheme is that they should provide a robust, objective and effective means of measuring NGET performance in reducing system balancing costs and the current models meet this aim. It is therefore important to maintain this principle even where the error is accountable to NGET, as the incentive is intended to drive behaviours that directly reduce system costs to customers, as opposed to rewarding/penalising NGET on their modelling accuracy. We would note that substantial efforts are already made to ensure that models are designed and implemented in an effective and sustainable manner. However, in order to seek to eliminate all risk of error in the models employed, it would be necessary to deploy additional resources to model development and oversight.

² The methodologies define whether an input variable is put into the model on an ex ante (forecast) or ex post basis (known) depending on the level of influence or control that NGET may have.

For any current scheme period, the licence already recognises under Special Condition 4C.38 that should an error be identified that fails to reflect the model methodologies then NGET should inform the Authority and correct them without reference or differentiation as to how the error is caused. The Authority then has 3 months to direct NGET to remove the correction should it deem it appropriate. In the event of an error being discovered during a current or active scheme, corrections to incentive payments can be accommodated within the existing licence term for the recovery of external balancing costs. Since the aim and intent of the proposed licence modification is to ensure incentive payments can be corrected in the event of issues arising after the usual 14 month settlement period for a given year, this would reflect a more consistent approach.

However, we do recognise that the correction of any error caused by NGET and that would be of subsequent benefit to NGET, is distinguishable from the case where such an error is caused by a third party. Therefore, in those cases where correction of an NGET error leads to an NGET benefit, we do believe that some form of generic customer compensation should be considered. Should the licence modification allow for all errors to be considered for correction, we believe this could be achieved by making provision in the licence so that the Authority could direct that a proportion of the value of any approved correction is retained by customers i.e. NGET would receive for example 80% of the full correction, or an amount that is more proportionate to the nature of the error identified.

For clarity, we agree with the approach Ofgem have proposed in the consultation, that all third party errors or for NGET errors where correction would benefit customers should be corrected in full. We suggest that our proposed approach in relation to the correction of an error where NGET is deemed responsible for the error and where NGET would also benefit from the correction maintains consistency across all timescales in respect to error correction and also ensures that the balancing cost incentive is held true to its intention. Also under this approach the impact of an error on customers can be recognised in a more proportionate manner depending on the nature of the error.

Q3 What are your views on including a materiality clause and the parameters we have set out?

We agree that there should be a materiality clause included within the licence condition. Whilst errors are expected to be rare based on historic performance there should be a suitable materiality limit put in place to ensure that there is sufficient value in the correction to warrant the impact on customers' bills. The proposed 1% of the upper limit of the incentive payment range (£300,000 on current scheme) provides a suitable threshold limit.

Q4 What are your views on setting out a timeframe in which errors can be corrected? What are your views on our proposed timeframe?

We agree that setting out a timeframe is sensible so as to limit any potential uncertainty for customers. As already noted, whilst it is expected that errors would be rare and hence the reliance on the proposed correction mechanism would not be used frequently, we agree that limiting the time in which the possibility of a change may occur is in the interests of all stakeholders. The proposal to limit potential adjustments to 6 years would appear to be a good timeframe for two particular reasons. Primarily, as already identified in the consultation, NGET is obliged to retain balancing services data for a period of six years in line with licence condition C16 (Procurement and Use of Balancing Services) meaning that relevant data will be readily available to provide any necessary verification. Additionally however, due to the timeframes over which the settlement process can operate, the timeframe should be long enough to allow for errors that may arise from these processes to be considered, particularly where a third party data provider may be involved.

Q5 Do you believe there is a more appropriate way to manage historic error impacting incentive payment/penalty than the framework proposed? Please explain.

NGET cannot see an alternative approach to managing historic errors which may impact on incentive payments or penalties. This is principally due to the extended timeframes over which the settlement process occurs and as such, incentive performance can be impacted by not only data errors, but also settlement disputes and other valid changes to counterparty positions. As we note earlier in this response, it is important to note that the transmission licence already recognises that as a result of these processes, corrections to external BSUoS revenue³ may be required beyond the current incentive period. However since the introduction of the incentive scheme framework that requires models to derive the scheme target, it is not possible to reflect the impact on incentives of any changes that may occur in the BSUoS revenue position for a given financial year beyond the nominal 14 month process. NGET believes that the introduction of this additional term would provide an effective means of enabling the alignment of incentive performance with fully reconciled costs.

If you would like to discuss this response further, in the first instance please contact Iain McIntosh (iain.mcintosh@nationalgrid.com or 01189 363798).

Yours sincerely

[By E mail]

Cathy McClay
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³ Special Condition 4C.1 explains the formula for external Balancing Services Activity Revenue Restriction on External Costs. The ET_t term refers to adjustments for relevant year t for adjustment in external costs for prior years