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Date: 31 May 2016

Dear Colleague,

**Statutory consultation pursuant to Section 11A of the Electricity Act 1989 on proposed modifications to Special Condition 4L of National Grid Electricity Transmission plc's Electricity Transmission Licence to reflect the intended introduction of an Early Capacity Auction for delivery year 2017/18 by the Department of Energy and Climate Change**

Please find enclosed a statutory consultation notice pursuant to Section 11A of the Electricity Act 1989 that proposes to modify Special Condition 4L (Financial incentives on EMR) (SpC 4L) of the Electricity Transmission Licence held by National Grid Electricity Transmission plc (NGET). These licence modifications would place incentives on NGET in delivering its roles under Electricity Market Reform (EMR) for the Early Capacity Auction (ECA) for delivery year 2017/18. In particular, we propose the implementation of incentives to NGET's roles in demand forecasting and dispute resolution.

In our September 2015 statutory consultation,<sup>1</sup> we set out modifications to this SpC 4L that placed incentives on NGET in delivering its roles under EMR from August 2014 to March 2021. Our decision<sup>2</sup> on these incentives, funding, and outputs was published at that time.

SpC 4L provides four financial incentives for NGET in relation to its EMR functions:

- (a) the dispute resolution incentive which adjusts the licensee's revenue depending on how many of the reviewable decisions made by the licensee are overturned by the Authority;
- (b) the demand forecasting accuracy incentive which adjusts the licensee's revenue as a result of the accuracy with which the licensee forecasts Peak National Demand;
- (c) the demand side response (DSR) incentive which adjusts the licensee's revenue as a result of the licensee encouraging and facilitating participation of Demand Side Response providers in the Year Ahead Capacity Auction; and

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<sup>1</sup> <https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-proposed-licence-modifications-nget-s-special-conditions-4a-and-4l>

<sup>2</sup> <https://www.ofgem.gov.uk/publications-and-updates/decisions-modifications-nget-s-special-licence-conditions-4a-4l-and-7d-nget-plc-s-roles-electricity-market-reform>

- (d) the customer and stakeholder satisfaction survey incentive which adjusts the licensee's revenue depending on the licensee's performance as measured by the customer and stakeholder satisfaction survey (CSSS).

We have reviewed these four incentives in light of the Government's decision to run an ECA for delivery in 2017/18.

### *Background*

DECC launched a consultation on 1 March 2016 on an ECA for delivery in 2017/18 . It issued its decision to implement the policy in the Government Response on 6 May 2016. Implementation of the ECA is subject to changes to the Electricity Capacity Regulations 2014 currently under Parliamentary scrutiny. The ECA will be a full capacity auction to procure the entire Capacity Market requirement for that year, as no T-4 auction has been held for delivery year 2017/18. The ECA will be in parallel with the T-4 auction for delivery in 2021/22 and the Transitional Arrangements auction for delivery in 2017/18.

The auction will be open to all types of capacity, including existing and new build generation, storage, DSR, and interconnectors, all of which will be eligible for 1-year capacity agreements to avoid over-procurement for the following years, for which capacity has already been secured through previous T-4 auctions.

### *Proposed modification to SpC 4L*

We have reviewed the four incentives listed above. We propose to apply the dispute resolution incentive (incentive (a)) and demand forecasting accuracy incentive (incentive (b)) to the ECA. As our September decision document made clear, these incentives have been and continue to be important for incentivising NGET to produce adequate outputs in delivering EMR. The dispute resolution incentivises NGET to devote the appropriate quality and quantity of resources to the decisions it made at the application and Tier 1 review stages for dispute resolution. The demand forecasting incentive, meanwhile, is crucial in ensuring lower costs to consumers due to a lower risk of under- or over-procurement of capacity.

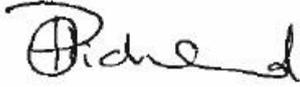
We do not propose applying the DSR or CSSS incentives to the ECA. This is because no benchmark exists yet for these incentives. Further, because these incentives are assessed against benchmarks and previous results, the inclusion of the ECA could skew incentives for future years, resulting in potential windfall gains or losses for NGET.

The effect of the proposed modification is to adjust NGET's allowed revenue either upwards or downwards depending on how well it performs against the incentives. The incentives proposed have almost the same effect as those set out in our 17 September 2015 decision entitled 'Decision on revenue, outputs and incentives for National Grid Electricity Transmission plc's roles in Electricity Market Reform'. The exception is materially similar disputes for the same CMU across the T-4 auction and the ECA will not count against both dispute resolution incentives. We are proposing this to ensure that NGET is not unduly penalised for the mistake.

If we decide to proceed with the licence modifications, they will take effect on 1 June 2016. This is to align with NGET's obligations under Special Condition 2N (Electricity Market Reform) to deliver the Electricity Capacity Report to the Secretary of State for Energy and Climate Change by 1 June, which includes NGET's demand forecasts for the 2017/18 delivery year.

Representation or objections to the proposed modification should be made in writing on or before **30 June 2016**. If you have any queries regarding the information contained within this letter please contact Johannes Pelkonen on 020 3263 2718 or by email [johannes.pelkonen@ofgem.gov.uk](mailto:johannes.pelkonen@ofgem.gov.uk).

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Pickford', written in a cursive style.

**Philippa Pickford, Associate Partner**