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Dear Giuseppina

This letter provides our response to Ofgem's 'Electricity System Operator incentive schemes from 2013: Disallowing costs and the efficiency in system operations reward scheme' consultation.

We consider that it is important to implement incentive arrangements for the SO that align our interests with those of customers and consumers. The current Balancing Services Incentive Scheme (BSIS) incentive mechanism offers such alignment, providing a well defined framework within which we can make real time system operation decisions and commercial judgements against considerable uncertainty to deliver value on behalf of end consumers. We acknowledge that there have been issues identified with the 2011-13 BSIS methodology but these have since been rectified through methodology amendments.

The ex-post approach to regulation outlined in the consultation document only serves to increase uncertainty through the review of operating decisions post event coupled with the risk of cost disallowance. We consider that this approach to regulation is not in the best interests of consumers and represents a step in the wrong direction.

Our view is that Ofgem's proposals are inappropriate for the following reasons:

- The package as presented by Ofgem, particularly the disallowance of costs up to a disproportionate level, introduces significant risk and uncertainty to our SO business that is currently not funded;
- The proposed cap of circa £90m is greater than the value of the SO business and is therefore hugely disproportionate;
- Ofgem's ex-post approach to monitoring and potentially disallowing balancing costs, as currently described, introduces enormous uncertainty to system operation that cannot be in the best interest of consumers, with insufficient detail and clarity as to how disallowance may occur; and
- This lack of detail / clarity will create inefficiencies rather than reduce them by fostering a more cautious approach to balancing.

Cost disallowance: unfunded risk and uncertainty

The proposal to disallow inefficient system operator costs subject to an arbitrary threshold of 0.5% represents a significant unfunded risk to the system operator when Ofgem is already able to take enforcement action for breach of licence under licence Condition C16¹. Furthermore the lack of detail on exactly how disallowance will be approached or how inefficiency will be assessed introduces additional uncertainty into the already complex

¹ Licence Condition C16 states that 'The licensee shall co-ordinate and direct the flow of electricity onto and over the national electricity transmission system in an efficient, economic and coordinated manner.'

activity of system operation. In terms of the detail that is provided within the consultation document, we have the following concerns:

Materiality threshold

The 0.5% materiality threshold as proposed by Ofgem, that would trigger an investigation into our costs, is far too low and will be triggered more often than not due to the inherent volatility in balancing costs. The simple application of the threshold to historical monthly outturn costs compared to previous year outturn since April 2011 alone shows that an 'investigation' by Ofgem would have been triggered in 12 out of 18 months. This cannot represent an efficient form of regulation. The materiality threshold would be more effective if set at a significantly higher level of, for example, 20% of the previous year's balancing costs.

Cap / Collars

The proposals rightly suggest the need to cap any disallowance, but the level of increase is large and inconsistent with any levels set under previous incentive schemes. Our exposure under the current 2011-13 Balancing Services Incentive Scheme (BSIS) is capped at £25m per annum (~3% of the previous years costs) with a sharing factor of 25%, whilst the disallowance under the proposals would be capped at circa £90m (or 10% of the previous years cost) with no sharing factor. This represents significant and unacceptable SO risk which is disproportionate to the size of the SO activity (with a Regulatory Asset Value or RAV of circa £60m). It would clearly be impossible to expect a stand alone SO to be able to finance such a risk; this risk would need to be underwritten by the TO activity which would need to be afforded a premium to its allowed return on equity to reflect this.

The extent to which Ofgem is able to disallow costs from the SO should be proportionate to the size of the SO business so as not to impact upon financeability. This is something that Ofgem has recognised elsewhere within the RIIO framework where it has sought to limit exposure on TO incentives such as for the Energy Not Supplied incentive. Ofgem states in relation to this TO incentive in particular that they have applied a 3% of revenue collar to ensure that TO businesses are not exposed to a disproportionate level of risk.

Application of a sharing factor

The principles of cost disallowance, which are ultimately to ensure that costs are incurred efficiently, should align and be consistent with the principles of the wider RIIO framework which seek to achieve the same objective. Ofgem's proposals as published are inconsistent with the RIIO proposals which include a sharing factor of 48% for the electricity TO for inefficient costs. In the interest of consistency, both across RIIO and with previous BSIS schemes where we have faced symmetrical sharing factors, a sharing factor should be applicable for the SO to any disallowed costs.

Lack of clarity and transparency

The lack of clarity and transparency in terms of any published criteria as to how Ofgem will assess uneconomic/ inefficient actions and the standard of performance required to avoid cost disallowance is inappropriate. At the very least this criteria must be clearly set out in the licence condition. The statement "where it appears to the Authority that the licensee may not have procured balancing services in an economic or efficient manner" is too ambiguous.

System Operation is a real time activity, which requires the setting of a clear framework in order to operate the system securely, economically and efficiently. In the absence of an ex ante incentive scheme, which incorporates an implicit view of cost, risk and reward, operators of the system have no clear view of what it means to be "efficient" and may adopt a more risk averse stance - particularly in relation to actions further ahead of real time which carry more uncertainty. Where we face the possibility of disallowance, we would need to constantly seek comfort from the Authority for any significant operational, contracting and investment decisions in order to mitigate our risk. This in itself introduces process

inefficiency that cannot be in the best interest of consumers and cannot represent efficient regulatory policy.

Discretionary Reward Scheme (DRS)

The DRS certainly has potential merit as a regulatory tool to drive longer term initiatives and consumer benefit over the course of the RIIO-T1 period, particularly where funding may be available on an ex-ante basis. Ofgem's consultation document, however, provides no additional clarity or criteria on how we can apply for and obtain a reward through the scheme. Whilst Ofgem's draft licence condition in Appendix 3 refers to a Scheme Guidance document, the absence of this document means that we cannot make an assessment as to the suitability or strength of the incentive that this scheme should create in the absence of a BSIS scheme. The guidance document would need to form part of the licence to promote transparency and provide appropriate governance throughout the scheme.

Ofgem has proposed an annual cap of £25m from the DRS, however we consider that, given any reward is at Ofgem's discretion, there is no requirement for a capped level. A cap would potentially incentivise the system operator to manage the roll-out a series of smaller initiatives over time rather than instigate major initiatives with large early benefits. Ofgem might also wish to consider aligning this incentive to the RIIO-T1 control, as per its original intention, with the application of a 48% rather than a 25% sharing factor.

A Balancing Services Incentive Scheme for 2013/14

In the absence of further clarity and detail on cost disallowance, it would be in the best interest of consumers to retain a BSIS scheme for 2013/14. Along with a number of industry stakeholders, we consider there is sufficient time to develop a one year BSIS scheme for 2013/14 using enhanced target setting models and the now refined methodology. In the event that we are unable to commence a scheme from 1 April 2013, it would still be better to have a small period of retrospection or a slightly shorter scheme rather than have no BSIS at all for 2013/14. There is no reason therefore why a BSIS scheme could not commence on say 1 June 2013.

This type of cost incentive arrangement, where the framework is known in advance, clearly encourages the day-to-day SO behaviour that Ofgem wishes us to continue i.e. driving benefit to consumers through trading, contracting and investment decisions. This approach, alongside a longer term discretionary reward scheme in line with Ofgem's proposal, would incentivise both our short and longer term actions. BSIS is also an approach that is already known and understood by both us and the industry.

Further detail in terms of specific responses to the questions posed by Ofgem is set out within Appendix 1 to this letter. We also provide more specific comments on the proposed licence drafting in Ofgem's consultation in Appendix 2 to this letter however this generally needs to include the detail that Ofgem has provided so far within its consultation document.

We look forward to developing these proposals yet further with Ofgem over the coming months, prior to Final Proposals in January 2013. In particular we hope that Ofgem will also consider implementation of a BSIS scheme for 2013/14 in place of its cost disallowance proposal.

Yours sincerely

[by e-mail]

Peter Bingham
Head of Regulatory Frameworks

Appendix 1: Responses to consultation questions

Disallowing Costs

Introduction of a new licence condition

We question the requirement for a new licence condition setting out provisions to disallow inefficient costs. As Ofgem refers to its consultation, Section 5A of the Electricity Act necessitates the use of best regulatory practice and the application of a proportionality test. We would therefore assert that Ofgem's current ability to take enforcement action against NGET for breach of licence is already adequate and that the requirement for additional powers in this regard is not evident. Ofgem sets out that the reason for a further licence condition for the disallowance of inefficient costs is that any fine under breach of licence provisions does not get paid back to consumers. However, there is no guarantee that any disallowed costs will be fed back through to consumers through the BSUoS mechanism. Moreover Ofgem should not be seeking to correct for deficiencies in current enforcement powers through this proposed licence mechanism.

In seeking to design a new licence condition for the disallowance of costs Ofgem has drawn parallels with special licence condition D9 as an established means of disallowing costs on the TO side of our business. However the intention behind this licence condition is something quite different to what Ofgem is trying to achieve with this new licence condition on the SO. Special Condition D9 was designed to implement the electricity revenue drivers that adjust capital expenditure allowances for changes in generation and demand throughout the UK, to determine the capital expenditure incentive adjustment and put in place a capital expenditure safety net. This condition allows for the adjustment of a term within an incentive formula, against a pre-defined benchmark of allowed costs, to ensure that any disallowed costs are not penalised twice by both disallowance as part of any price control review and inclusion within the capex incentive as an overspend. It therefore does not itself seek to retrospectively disallow incurred costs from NGET and so the intentions of the two licence conditions cannot be compared on a like-for-like basis. Hence there is no regulatory precedent for the disallowance of cost in the manner proposed in the consultation.

Determining an efficient level of costs

The presence of a clear and transparent benchmark of an efficient level of costs is a critical, but currently missing, element of Ofgem's proposal if we are to continue to operate in an economic and efficient manner. This clarity is required to enable our assessment of the risk associated with procurement of balancing services, in terms of price and volume uncertainty, ahead of real time. The current Balancing Services Incentive Scheme (BSIS) cost incentive, where there is a clear benchmark of cost, achieves two things in this regard:

- 1) It actively encourages us to contract, trade or invest to earn any profit through the scheme; and
- 2) It rewards or penalises us in equal measure on a real time basis for those contracting, trading and investment decisions depending upon whether it was the 'right' action to take.

Under a cost disallowance mechanism, the incentive structure becomes skewed or unbalanced such that we are only able to break even (i.e. pass through costs) or run the risk of having incurred costs disallowed for these everyday decisions. The risk of taking those contracting, trading or investment decisions becomes greater to us because the chance of us 'losing' from the scheme has also increased as there is no upside. This is particularly the case when the rules surrounding cost disallowance are so subjective and uncertain. In addition, under these proposals we can no longer gain from any day-to-day benefit that we deliver to consumers as Ofgem has eliminated these types of initiatives from the discretionary reward scheme.

These are the reasons why the decisions that we take today under the current scheme cannot be defined as business as usual or even be considered as a baseline for future costs. We have taken those actions or decisions under very different regulatory circumstances. In a world where costs may be disallowed arbitrarily, we are far less likely to take a similar level of risk when assessing alternative options against the BM. This is certainly not in the best interest of consumers and why we consider that the disallowance of costs process is fundamentally flawed as a method of regulation.

However, were this approach to be implemented in spite of our concerns then at the very least a number of issues would need to be addressed. These are discussed in response to Ofgem's questions 1-6 below.

Question 1: Do you agree with the way in which we propose to monitor the SO's costs?

Whilst Ofgem's consultation document has sought to set out more information surrounding the process for the disallowance of inefficient costs, there is still insufficient detail as to exactly how Ofgem will monitor costs on an ongoing basis. In particular it is not clear as to whether Ofgem will require more information than it currently receives from us on a monthly basis. And whilst Ofgem mentions that 'a variety of different techniques' will be used to assist this monitoring task, there is no further detail provided.

We would suggest that if the enhanced versions of the 2011-13 BSIS scheme models are to be employed in any part of the cost monitoring process, then we should be using these models to support a BSIS type incentive scheme rather than a means of checking whether costs had been economically and efficiently incurred post event. This would certainly reduce the administrative burden and monitoring role from the regulator's perspective.

As currently drafted, the licence condition in respect of this part in the process means that Ofgem can investigate and potentially disallow costs that merely 'appear' to Ofgem to be uneconomic or inefficient. This introduces a huge amount of risk to our SO business and therefore requires clearer objective measures to be included in the condition to define inefficient costs.

Question 2: Do the various steps of the process we propose to follow to disallow costs seem appropriate?

Again, whilst Ofgem has provided further information as to how the process for monitoring and investigating SO costs will work in practice, the detail surrounding how those costs will be analysed and determined to be inefficient still lacks clarity. This applies to both the informal inquiry and formal investigation stages of Ofgem's process. We will need to understand and be comfortable with the type of information that Ofgem might require under these processes so as to ensure that our internal reporting processes and procedures align with those requirements. This in itself is likely to be highly disruptive to our business and create inefficiency.

When assessing incurred costs, the issue will reside in how both we and Ofgem assess the risk associated with any contracting, trading or investment decision – this view of risk can be distorted particularly when reviewing a decision in hindsight. We might have deemed a contracting decision to be an unacceptable level of risk ahead of real time but Ofgem may hold a different view and subsequently deem costs to be inefficiently incurred. In order to provide Ofgem and ourselves with comfort in this regard, Ofgem would need to become familiar with our forecasting and contract/trading/investment assessment processes thus ensuring that we are fully aligned.

This kind of scheme fosters a culture whereby we would want to seek comfort from Ofgem before making any significant contracting decision. This is clearly not efficient and would go beyond the role of the regulator.

We also note that the additional detail provided by Ofgem on the process for disallowance is not currently reflected in the licence drafting within the consultation document. The licence drafting must specify elements such as cost assessment being made on the basis of information available to the SO at the time that costs were incurred. As we have previously stated, the rules surrounding any potential disallowance of costs are required to be very clear so as to enable the SO to fulfil its obligations effectively.

In addition, it is not clear from the drafting as to how Ofgem will consult with the wider industry prior to deciding to disallow costs. It currently refers to 'such parties as the Authority considers likely to be affected by a direction' but the definition of 'such parties' is not evident.

Formal investigation stage

Ofgem sets out that it will endeavour to send a notice stating that it intends to deem certain costs as uneconomic and inefficient within 4-6 months of receiving data that triggered a breach of the threshold. Any such notice needs to be issued as soon as practicable after any such trigger, following the Informal Inquiry stage. Given the volume of balancing actions and decisions that we undertake each month, any investigation into costs incurred needs to be timely and targeted by Ofgem.

Third party appeal

As it stands there is no explicit third party appeal process available to us if we disagree with the outcome of Ofgem's investigation into costs and subsequent disallowance. The proposed licence drafting should include a formal independent appeal process to ensure that Ofgem follow a robust and objective process on any decision made by the Authority to disallow costs.

Question 3: Is the proposed threshold level, and the way in which it will be applied, proportionate?

It is difficult to ascertain if Ofgem's proposed threshold level of costs is proportionate because it is not clear how it is derived and when it is likely to be triggered. At first glance, Ofgem appears to be proposing a threshold of 0.5% of the previous years balancing costs to trigger an investigation into the efficiency of those costs. However, the consultation also makes reference to the setting of the threshold such that it is sufficient to cause material detriment to consumers. The description of the threshold is clearly too subjective and raises vital questions as to the definitions of 'material detriment to consumers' and 'reasonable level of costs'. There are no definitions of these terms offered by Ofgem.

We observe that this threshold is particularly low in the context of system balancing when, for example, inflation alone would account for a greater increase in costs than 0.5% in any given month. This level of threshold would therefore be triggered on a frequent basis requiring the Authority to spend considerable time and consumer money to investigate whether those costs were efficiently incurred. For instance, applying this threshold retrospectively over the past 18 months alone equates to a threshold trigger in 12 out of 18 months which is clearly not proportionate.

Further, the threshold trigger appears to be applicable on an aggregate balancing cost level rather than, say, a sub-component or balancing service level. This makes the threshold even more arbitrary as there may be high variability at sub-component level in any given month but the total cost could still ultimately be in line with the previous year's costs. However, to

set sub-component level thresholds would prove to be an even more burdensome and intrusive approach to regulation.

Instead the threshold should be set at a clear and quantifiable level, in combination with a definitive set of criteria that Ofgem will use to assess the efficiency of those costs. The alternative is that we will constantly be trying to second guess the regulator as to when costs might be deemed as unreasonable and therefore investigated. This is clearly no way to operate a business that has a licence obligation to be economic and efficient.

The agreed threshold level, and the exact way in which an investigation will be triggered by Ofgem into costs that have been incurred, will need to be detailed within the relevant licence condition. This detail is missing from Ofgem's drafting.

Question 4: Please provide your views on whether it would be appropriate to introduce a limit on the maximum level of costs that can be disallowed?

In order to maintain an acceptable level of risk to, and financeability of, our SO business, it is absolutely critical that there is a proportionate limit placed on the level of costs that can be disallowed. Ofgem proposes that the level of any disallowed costs should be limited to 10% of the previous year outturn costs which, for last year, would be circa £90m. This level is totally disproportionate and inappropriate due to the size of the SO business, given that the Regulatory Asset Value (RAV) of the SO is only circa £60m and the allowed revenue (internal cost allowance) of the SO is circa £100m per annum. This level of additional risk burden is not financeable by the SO activity and therefore either the limit should be more proportionate or be funded via the introduction of a risk premium. A scenario whereby a business can face losses that are greater than its net worth is not a feasible business model.

Under the current BSIS arrangements a 25% sharing factor is applied to any benefit or disbenefit resulting from the scheme up to a cap/collar of £25m per annum. Ofgem has retained the same level of profit potential through the design of the discretionary reward scheme but has significantly increased the downside through potential disallowance - the proposal is therefore asymmetric. The current scheme collar of £25m is around 3% of last year's costs compared to Ofgem's proposed collar on cost disallowance of 10% which is significantly higher but with no justification. Neither is it recognised that funding would be required to account for the increased risk that the SO activity would face.

The impact of a disproportionate level of exposure through incentives is something that Ofgem has considered on another aspect of the RIIO control in respect of the Energy Not supplied incentive on the TO businesses. Here, Ofgem stated in its March 2011 Strategy Document² that an unlimited collar could have significant revenue impacts on the TO businesses and instead considered that a collar of 3% of revenue provided a reasonable and proportionate level of risk for this incentive. The same proportionality test should be applied to the SO in relation to cost disallowance in order to ensure that regulatory principles are consistent across the RIIO proposals.

Application of a sharing factor

The costs associated with balancing the system are external rather than internal costs and driven largely by external behaviours over which we have limited influence. Volumes are driven by the actions of market participants (including the TOs and OFTOs), and prices are set by balancing services providers and therefore to disallow 100% of any costs deemed to be inefficient would also be a disproportionate response.

² RIIO-T1 Outputs and incentives annex which can be found at (from paragraph 6.64 onwards): <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decisionoutput.pdf>

In its consultation document, Ofgem uses an example of where £19m of costs were disallowed from National Grid Gas in the past on a St Fergus terminal project. However, this level of cost was only 26% of the total project cost of £73m.

We consider therefore that the application of a sharing factor to any identified inefficient costs would be appropriate and that ideally this should align with the sharing factor of the discretionary reward scheme so as to create symmetry within the proposals. The application of a sharing factor would be consistent with the RIIO proposals whereby a 48% sharing factor is applicable to any TO overspend, and is also consistent with previous BSIS incentive arrangements.

Question 5: Do you agree with our examples of uneconomic or inefficient costs? If not, why not?

The examples listed by Ofgem demonstrate actions that we would deem to be an **efficient** method of operating the system if possible rather than examples of uneconomic or inefficient costs. It is also worth noting that four out of the five examples provided are scenarios directly related to the management of derogated boundaries in Scotland over which the NETSO has very little control.

Most of the examples seem reasonable in terms of what should be expected of an economic and efficient system operator and the types of activities listed are those that we already undertake as part of our day-to-day operations. However, the examples are overly simplistic, when operation of the system is much more complex than Ofgem's examples suggest. As an economic and efficient system operator, we will strive for the most cost effective solution, however, it should be stressed that this will not always be realised by contracting ahead of time.

It should also be noted (in respect to example 5), that whilst we facilitate and have a role to play in Code modification processes, they are industry processes over which we have limited control. There is no guarantee that we can raise and implement a particular modification to amend industry frameworks that will reduce costs on behalf of consumers. Ofgem will ultimately determine as to the outcome of these modification processes.

Question 6: Should any disallowed costs be clawed back retrospectively or prospectively?

We consider that any costs deemed to be inefficient and uneconomic by Ofgem through the proposed disallowance process should be treated accordingly within the relevant year. This means that charges are timely and targeted at those parties who were operational at the time the costs were incurred.

We understand, however, that industry parties hold a different view and prefer that charges are not amended retrospectively. In addition, as Ofgem acknowledges, the amendment of charges retrospectively is a more complex task and therefore carries a higher administrative burden than a prospective charging process.

Discretionary Reward

Question 7: Do you agree with the proposed process for granting rewards?

It is difficult to comment on whether we agree with the proposed process given the lack of detailed information contained within the consultation document. The key aspects of the Discretionary Reward Scheme (DRS), including the application and assessment criteria, look

like they are to be set out in the scheme guidance document which has not yet been published by Ofgem. This is an integral part of the scheme and needs to be published as soon as possible. The guidance document will also need to form part of the licence condition itself to provide sufficient transparency and governance for the DRS given the important role it will play in incentivising longer term innovation by the SO.

In the absence of the guidance document, we have a number of ongoing concerns which are explained in more detail below.

Defining business as usual

As we set out in our response to Ofgem's Initial Proposals³, business as usual does not include everything that we do under the current scheme. This is because for contracting decisions that we take under a BSIS scheme, we face immediate and equal upside and downside exposure in terms of profit or loss (resulting from the cost outturn position in relation to the scheme target). The current scheme design thus encourages us to take more contracting risk with the aim of delivering benefit to consumers and earning a higher return.

However, the introduction of a cost disallowance mechanism significantly increases the risk that contract costs will be deemed inefficient and therefore disallowed post event. Under this scenario we are only able to break even (i.e. pass through costs) or be disallowed costs that are deemed as inefficient. The risk profile of contracting decisions is therefore increased and means that business as usual in this context will not include those contracts that we perceive to be higher risk.

Therefore the types of balancing services that we currently procure, particularly where these carry more commercial risk or where we procure services well in advance of real time, should be eligible for reward from the DRS. The procurement of such services in their current form are likely to become more challenging as we are required to accommodate different types of provider on the system.

Timescales

The process as drafted, provides no defined timescales as to when Ofgem is required to make decisions on ex ante project funding following an application from us. Nor does it clarify how frequently during the year we can make an application for the scheme, particularly for the ex-ante funding option. This scheme should not be limited to an annual application process as this would hinder rather than encourage innovation.

Scheme parameters

We consider that the cap and sharing factor proposed by Ofgem (at £25m and 25% respectively) are too low given that, in theory, any action that could qualify for such a reward should be in the control of, and facilitated by, the NETSO. With BSIS costs of circa £800m per annum and growing, the scope for achieving significant cost savings could be suppressed by the cap proposed or in fact any cap.

An annual cap of £25m could provide a perverse incentive on us to manage the 'roll-out' of initiatives over a longer period so as not to lose benefit from the scheme. This would clearly be to the detriment of consumers and we should be incentivised to carry out innovation as soon as possible. Given that any reward is at Ofgem's discretion, there should be no requirement for a cap.

Furthermore the sharing factor associated with the level of reward should be consistent with RIIO sharing factor at 48% ensuring that SO internal and external cost incentives are

³ Our response can be found on our website at: <http://www.nationalgrid.com/NR/ronlyres/73EDC3A6-98FB-4E3B-9616-2824C1099DA9/56856/FullResponsetoSOIncentivesInitialProposals.pdf>

aligned. This would also equalise incentives across the SO and TO which is something that Ofgem aspired to achieve in its 'System Operator incentive schemes from 2013' consultation document published in June 2011⁴, ensuring that efficiencies are maximised across the system. Any project that we undertake that is over and above business as usual, particularly where some of Ofgem's provided examples are concerned, will be much more difficult to implement and not within the full control of the SO. Therefore the value of reward should be proportionate to the level of additional effort, achievable through a higher sharing factor.

At the very least, where projects compete (and potentially take the level of reward beyond the cap) in any particular year then the project that did not make it through the scheme in one year should be assessable in the following year. However, this issue would again be resolved by removing the reward cap so that we are incentivised and rewarded as the scheme intends.

We are encouraged to learn from Ofgem's proposals that a project which has been funded through either the Network Innovation Competition (NIC) or Network Innovation Allowance (NIA) can still qualify for a reward via the DRS. More specifically, this addresses our concerns regarding the lack of the SO's access to the Innovation Roll-out Mechanism (IRM). The DRS means that a project can be taken from conceptual stages through to implementation but that the appropriate rewards for undertaking those stages are achievable.

As currently set out, the function of the discretionary reward scheme is to encourage the SO to develop the use and procurement of relevant balancing services so as to facilitate a sustainable decarbonised electricity market. Rather, this should instead align with the wider objective of the SO to facilitate an economic, efficient, reliable, safe and secure system.

Question 8: Is it appropriate to include an "ex ante" option for granting rewards, when significant up-front costs for the SO are involved?

We consider that the ability for the SO to have access to some ex ante funding ahead of investment that may (or may not) result in a reward under the scheme as a fundamental requirement. This should be available regardless of the level of spend associated with any initiative that may result in cost savings for consumers. The ex ante option significantly reduces the risk that an initiative undertaken by us is later denied any reward and ensures that both us and Ofgem/the expert panel are more certain as to what constitutes a value-creating project before implementation.

In fact the SO should be able to apply for up to 100% of any upfront project costs attributable to a project that might be eligible for a reward under this reward scheme to provide the right and strength of incentive on longer term initiatives. It would also balance the risk that incurred costs, or stranded investments, could be deemed inefficient and disallowed at a later date through the cost disallowance condition.

Ofgem sets out that following implementation, we would need to demonstrate that we had delivered the project on-time and to cost in order to qualify for the reward payment. We consider that an assessment as to whether the project was on-time or to cost should not be key criteria for reward qualification so long as the project has delivered in terms of benefits to consumers. In addition, following implementation, there should be an opportunity to reassess the net benefit that the project provides to consumers so as to include the latest and most up-to-date analysis of value-added.

⁴ Ofgem's consultation can be found at:

<http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/SO%20incentives%20from%20April%202013%20Initial%20Views%20Consultation.pdf>

There is, however, also a risk that the time involved with the process of 'pre-sanction' in the ex ante option affects the ability to implement the initiative in a timely manner and so this process for seeking up-front costs needs to be efficient and timely. Ideally we should also be able to apply for up-front funding at any point throughout the year (as opposed to just once per year) so as not to hinder shorter term innovation and ensure that benefits are delivered to consumers as soon as possible.

Question 9: How should the net benefit to consumers be measured?

Benefit should be measured based on a cost benefit analysis of the initiative in question. In addition, assumptions will need to be agreed as to what costs would have been incurred by end consumers in the event that the initiative had not been implemented. This issue becomes compounded when the benefit falls over a number of years and the benefit becomes more difficult to assess.

In theory, the enhanced BSIS models could be used as an objective measure for this purpose, however, these have already been dismissed by Ofgem as a robust means of measuring value through an incentive scheme. It is difficult to see how else this benchmark of cost might be determined.

We do not consider that any initiative for consideration under the reward scheme should necessarily have to provide enduring benefits to consumers. There will be projects that are able to deliver huge benefits to consumers, for example, within a one or two year period that should not be discounted from this scheme. Ofgem provides a good example of this in its consultation document whereby the SO may work with the TO to install equipment on its network that might not otherwise be required as part of its RIIO baseline e.g. to reduce constraints. This type of installation might not necessarily be permanent and therefore may only provide time-limited, but significant, benefit to consumers and so should not be overlooked.

Question 10: Have you any views on the composition of the independent Expert Panel?

The independent expert panel should comprise participants that are other than BSC parties so as to avoid any conflict of interest and facilitate impartial assessment. There will be perverse incentives for panel members if they are ultimately the parties who are required to fund any reward that we receive through the scheme. System operation is a complex activity and thus the panel would benefit from some members having a background in operating transmission systems.

The expert panel will also need to be a defined term within the discretionary reward licence condition.

BSUoS Charge Incentive and Model Development

Question 11: Do you agree with our proposal to introduce a financial incentive on the accuracy of the SO's forecasts of BSUoS charges produced by the SO?

We consider that financial incentives are an appropriate and effective regulatory tool to drive desired behaviours and industry outcomes where these provide a suitable balance of risk and reward. We can see the merit of introducing a forecasting incentive on us to forecast the BSUoS charge on behalf of the industry in terms of providing greater predictability. This is despite our understanding, however, that it is also the volatility of the charge that customers do not like and this would not change under the incentive. However, this incentive also

carries a risk of windfall gains and losses and has the potential to create a perverse incentive in the absence of BSIS.

This incentive carries with it a risk of windfall gains and losses in the same way as historic (pre-2011/13) BSIS schemes as we would be required to forecast a number of inputs to the BSUoS charge on an ex-ante basis. This was the reason for Ofgem’s review of this incentive approach in 2010 which led to an assessment of either ex-ante/ex-post treatment of modelling inputs according to the extent that we could control or forecast those inputs.

For those inputs that were assessed as ex-post, it was deemed that we do not and should not have the ability to forecast them accurately at the year ahead stage. These same inputs will affect the accuracy of the BSUoS charge forecast making the output of this incentive heavily dependent on factors that are outside of our control such as wholesale power price or wind generation output.

Furthermore, Ofgem’s proposed new incentive could create perversities in the absence of a BSIS scheme. More specifically we could be in a position under this incentive where the reduction of balancing costs in the interests of consumers within year would actually cost us money (as the reduction of balancing costs could be taking us further away from our year ahead cost forecast). At best we would be trading off a certain loss on BSUoS forecasting vs a very uncertain reward via the discretionary reward scheme and/or an even more uncertain risk of penalties via the disallowance scheme. This misalignment of incentives would be rectified with the reintroduction of a BSIS scheme.

It should be noted that this incentive, in terms of the outturn charge, would need to discount the effect of any disallowed costs or discretionary reward from the total costs for the year so as not to influence the outcome. We would not be able to forecast what these two areas of cost might be.

Question 12: To what forecasting time period should the incentive apply? (We have proposed the incentive should apply to a year-ahead forecast)
Question 14: Do you have a preference for the timing of the submission of the forecast to the Authority? (We have proposed 14 days before commencement of the scheme year).

The uncertainty of inputs to any model of the costs of system operation will reduce nearer to real time therefore it would be preferable to use a forecast as close to real-time as possible. Given the stated desire to provide a long term forecast i.e. at year head then a greater degree of inaccuracy should be anticipated.

Question 13: Do you agree with the proposed parameters for the scheme?

The parameters of the scheme as suggested by Ofgem appear to be reasonable. However the formulation of the incentive does not provide a linear scheme shape as shown in the consultation document. This could be resolved with a minor modification to the formula as shown below (where the term BCF_t becomes a denominator within the equation):

$$BCFIR_t = \text{Max} \left[\begin{array}{l} BCFCAP_t - \left(BCFIF_t * \frac{|BCO_t - BCF_t|}{BCF_t} \right) \\ , BCFFLO_t \end{array} \right]$$

Ideally, the parameters of the scheme should be aligned with the value that its output creates and therefore the cap/collar should be set at a level aligned to the value created to the industry of more accurate BSUoS forecasting. We would consider that this is possibly greater than £5m per annum.

Question 15: Is it appropriate to require NGET to continue developing its models?

Given that our primary objective with regard to incentives development has been to retain a Balancing Services Incentive Scheme and that Ofgem has not dismissed this as an option in the medium term, it is very much in our interest to continue the work we have undertaken to date on model development. We therefore do not consider that a further licence condition obligating us to continue this work is necessary.

It should be noted however that this work will not necessarily lead to more accurate BSUoS forecasting in line with the proposed forecasting incentive. The models could be 100% accurate but if the inputs are inaccurate or forecast significantly ahead of real time (e.g. year ahead) then the output of the models will also be inaccurate. This is something we have seen with the 2011/13 scheme where inaccurate ex-ante inputs have resulted in windfall gains and losses and hence led to the publication of our industry consultation in July 2012⁵.

In the event that we are obliged by licence to undertake this model development work, this obligation should be funded via an explicit allowance through the BSUoS mechanism. Given the resource involved with model development and testing, and the extent to which Ofgem requires verification and testing by external and consultant companies, we would require additional funding to fully comply with the new licence obligation.

We would welcome further engagement with Ofgem on the current model development work prior to moving forward with additional work to ascertain that we are moving forward in line with Ofgem's expectations in this area.

⁵ This document can be found on our website at: http://www.nationalgrid.com/NR/rdonlyres/37E1065A-227B-4613-B673-76ED6AF41D0F/54943/2011_13BSISmethodologyconsultation_July2012Final_Industry.pdf

Appendix 2 – Comments on Licence Drafting

Special Condition [X]: Balancing Services Activity Revenue Adjustment on External Costs

1. Where it appears to the Authority that the licensee may not have procured or used the Balancing Services, ~~as~~ specified in the notice issued pursuant to paragraph 3, in an economic or efficient manner, the licensee will be assessed in accordance with Part A.

[Reference to the threshold trigger level is required here]

Part A: Determination of Balancing Services Activity Revenue Adjustment on External Costs

2. The Authority shall notify the licensee that it will issue a Balancing Services Activity Revenue Adjustment direction where the costs of procuring and/or using the Balancing Services ~~as~~ specified in the notice issued pursuant to paragraph 3 appear to the Authority to not be economic or efficient.
3. Before issuing a direction, for the purposes of paragraph 6, the Authority shall issue a notice to the licensee and such parties as the Authority considers likely to be affected by a direction:
 - i. specifying ~~which the particular~~ Balancing Services that appear to the Authority may not have been procured or used by the licensee in an economic or efficient manner;
 - ii. explaining the reasons why the Authority considers that the Balancing Services referred to in sub-paragraph i may not have been procured or used by the licensee in an economic or efficient manner; and
 - iii. specifying the date, being no less than ~~[56X]~~ days from the date of the notice, by which the licensee and such parties as the Authority considers likely to be affected by a direction may make representations to the Authority.
4. The Authority shall have regard to any representations made by the licensee and such parties as it considers likely to be affected in response to the notice referred to in sub-paragraph 3 (iii) before making a direction as to whether the Balancing Services specified in the notice were not procured or used by the licensee in an economic and efficient manner.
5. If the Authority considers that any analysis, information or representations provided pursuant to sub-paragraph 3 (iii) above is insufficient to enable the Authority to make a determination and issue a direction, the Authority may request such further information as it considers necessary for the purposes of this condition. Such a request shall be made in writing and shall specify the date by which information shall be provided being not less than ~~[28X]~~ days from the date of the request.

6. The Authority shall, within 3 months from the close of the ~~notice~~ period referred to in paragraph 3(iii) or paragraph 5, whichever date is later:
 - i. determine which (if any) of the Balancing Services specified in the notice were procured or used by the licensee in an efficient and economic manner;
 - ii. specify the reasons why the Authority considers those Balancing Services were not procured or used by the licensee in an economic or efficient manner; and
 - iii. issue a direction specifying the amount of the adjustment to the licensee's Balancing Services Revenue as set out in [AA5A].⁶

7. ~~{~~The total amount of any adjustment directed by the Authority in respect of Relevant Year t shall not exceed a figure which represents that part of the cost incurred by the licensee in procuring the balancing services identified pursuant to paragraph 6(i) which was inefficiently incurred by the licensee, and in any event shall not exceed 10% of the total costs incurred by the licensee in procuring and using ~~those~~ Balancing Services in the Relevant Year t-1.~~}~~

8. This condition shall cease to have effect from such date as an incentive payment in respect of the total costs under the Balancing Services Activity ~~Revenue~~ ~~Restriction~~ under Part 2 of special condition AA5A on external costs is reintroduced into this licence

9. For the purposes of this condition:
"Balancing Services" has the meaning given in Standard Licence Condition C1

⁶ Or a successor condition to Special condition AA5A. As part of the re-structuring being proposed to the Electricity Transmission licence as part of the RIIO-T1 project, Special Condition AA5A will be split into two – one condition for SO external costs (which will be developed as part of this SO 2013 project) and one for SO internal costs (which will be developed as part of RIIO-T1).

Special Condition [X]: Efficiency in system operations Reward Scheme

1. The purpose of this condition is to:
 - i. establish arrangements, to be known as the Efficiency in system operations Reward Scheme, for determining the amount of the Efficiency in system operations Reward (ESOR) term; and
 - ii. make provision for arrangements relating to administration, governance and revision of the ESOR Scheme.

Part A: Function of the ESOR Scheme

2. The function of the ESOR Scheme is to encourage the licensee to develop the use and procurement of relevant balancing services so as to promote efficiency in system operations in a sustainable decarbonised electricity market.

Part B: Determination of the amount of the ESOR term

3. In each Relevant Year t , as provided for by the ESOR Scheme Guidance, the Authority will determine and, by direction given to the licensee, specify, in accordance with the appropriate provisions set out in the ESOR Scheme Guidance, the amount of the ESOR term for the licensee for the Relevant Year.
4. The form of the application under the ESOR Scheme, assessment, implementation of, and other relevant matters relating to, the ESOR Scheme are provided for in or pursuant to the ESOR Scheme Guidance issued by the Authority under Parts C and D below.

Part C: The ESOR Scheme Guidance

5. The ESOR Scheme Guidance is a document published, and from time to time revised by the Authority in accordance with Part D for the purposes of setting out the application requirements, assessment process and procedures, administration and governance of the ESOR Scheme.
6. The ESOR Scheme **Guidance** may, without limitation, make appropriate provision about or impose requirements in respect of:
 - i. the licensee's application to the Authority under the ESOR Scheme including the type of information and evidence to be provided, and the format of the submission;
 - ii. the Authority's process for assessing the licensee's submission, including assessment criteria, how benefits to consumers may be measured and the role **and composition** of the Expert Panel ~~as set out in the ESOR Scheme Guidance~~ **Guidance**;
 - iii. the process and procedures by which the Authority will determine the amount of the ESOR term for each Relevant Year t including any reward allocation rules in relation to the licensee's overall level of performance;
 - iv. the procedures by which the Authority will notify the licensee with respect to any direction in relation to the amount of the ESOR term; and

- v. any other matters relating to the administration and governance of the ESOR Scheme.

To be eligible for payment under the ESOR Scheme, the licensee must follow the applicable provisions of the ESOR Scheme Guidance.

Part D: Modification of the ESOR Scheme Guidance

- 7. The ESOR Scheme Guidance may be modified by the Authority by direction.
- 8. Before issuing a direction to modify the ESOR Scheme Guidance under paragraph 7, the Authority shall:
 - i. give notice to the licensee and such parties as the Authority considers likely to be affected by the modification that it proposes to modify the ESOR Scheme Guidance;
 - ii. specify the date on which it proposes that the provisions of the modified ESOR Scheme Guidance will take effect;
 - iii. set out the proposed modifications to the ESOR Scheme Guidance and the Authority's reasons for proposing the modifications; and
 - iv. specify the time (which must not be less than 28 days from the date of the notice) within which representations may be made; and
 - v. consider any representations in response to the notice that are duly made and not withdrawn.
- 9. The provisions of this special condition operate without prejudice to the [ETC11 Special Condition [x] on The Network Innovation Allowance (NIA)] and [ETC10 Special Condition [x] on The Network Innovation Competition (NIC)].⁷

- 10. For the purposes of this condition:

“Efficiency in system operations Reward Scheme” means the arrangements as set out in this condition and the Efficiency in system operations Reward Scheme Guidance for determining the amount of the Efficiency in system operations Reward term;

“Efficiency in system operations Reward Scheme Guidance” means the document published and from time to time revised by the Authority in accordance with Part D of this condition;

‘NIA’ means the Network Innovation Allowance as defined in ETC11 Special Condition [X] of the draft transmission licence conditions; and

‘NIC’ means the Network Innovation Competition as defined in ETC10 Special condition [X] of the draft transmission licence conditions.

“Expert Panel” means....

⁷ The NIA and NIC draft licence conditions published in the July consultation can be found in ‘Supporting Document 1: Draft RIIO-T1 Electricity Transmission licence changes’ at <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Supporting%20Document%201%20Draft%20RIOT1%20Electricity%20Transmission%20licence%20changes.pdf>

Special Condition [X]: Requirement to conduct a review and to develop enduring balancing cost models for the purpose of introducing an enduring scheme

1. The licensee shall cooperate with and assist the Authority for the purpose of developing enduring models in respect of the costs of procuring and using Balancing Services (being the external costs of the Balancing Services Activity) and shall prepare and submit a draft Scheme of Work as to how it will fulfil this obligation to the Authority by 1 June 2013.
2. The licensee shall make any consequential amendments to the draft Scheme of Work as may reasonably be directed by the Authority by 1 August 2013 or such date as the Authority may reasonably direct.
3. Unless the Authority directs otherwise, the licensee shall undertake the activities set out in the Scheme of Work within the timescales set out in the Scheme of Work or such other timescales as the Authority may reasonably direct.
4. The licensee shall comply with all the requirements of this condition in a timely fashion and in good faith.
5. For the purposes of this condition:

“**Scheme of Work**” means a specification of work for the purposes of developing enduring models in respect of the costs of procuring and using Balancing Services. This includes the review, development, testing, validation and external peer review of the models as well as development of enduring methodology statements. The Scheme of Work shall comprise an approach and timetable for the development, or further development, of a methodology, including inputs, assumptions and modelling methodologies, together with an approach for the validation of models, to facilitate a decision by the Authority as to whether it would be appropriate for it to re-introduce an incentive scheme in respect of the total costs under the Balancing Services Activity ~~R~~revenue ~~R~~restriction under Part 2 of special condition AA5A on external costs is reintroduced into this licence.

Special Condition [X]: BSUoS Charge Forecast Incentive

1. The purpose of this condition is to establish a BSUoS charge forecast incentive.
2. The maximum BSUoS charge forecast incentive revenue (in £) allowed to the licensee in respect of Relevant Year t (BCFIR_t) shall be derived from the following formula:

$$BCFIR_t = \text{Max} [BCFCAP_t - (BCFIF_t \times \text{Abs}\{BCO_t - BCF_t\} / BCF_t), BCFFLO_t]$$

~~w~~here:

Max [x,y]	is the value which is the greater of x and y;
Abs {x-y} x<=y;	is the value which is equal to x-y when x>y and equal to y-x when x<=y;
BCFIF _t	means the BSUoS charge forecast incentive factor in respect of Relevant Year t and shall take the value £20,000,000;
BCFCAP _t	means the BSUoS charge forecast incentive cap in respect of Relevant Year t and shall take the value £5,000,000;
BCFFLO _t	means the BSUoS charge forecast incentive floor in respect of Relevant Year t and shall take the value -£5,000,000;
BCO _t	means the BSUoS charge earned by the licensee in respect of Relevant Year t; and
BCF _t	means the forecast of BCO _t produced by the licensee in accordance with paragraph 3.

3. The licensee shall submit the BCF_t to the Authority and publish it on its website no later than [X] days before the commencement of the Relevant Year t.
4. For the purposes of this condition:

“BSUoS charge” means Use of System Charges recovered by the licensee in respect of the Balancing Services Activity (as both terms are defined in Condition C1 Interpretation of Section C and as set out in the Connection and Use of System Code, Paragraphs 14.29-14.32). Such charges shall comprise both the external and internal costs of the Balancing Services Activity but shall not include charges made or levied or to be made or levied for the provision of Transmission Network Services.