

**System Operator Arrangements for delivery of
Electricity Market Reform**

This Memorandum of Understanding is made this
..... of MAY..... 2012

BETWEEN

(1) National Grid Plc

And

(2) The Department of Energy and Climate Change

MEMORANDUM of UNDERSTANDING

System Operator Arrangements for delivery of Electricity Market Reform

1. Introduction

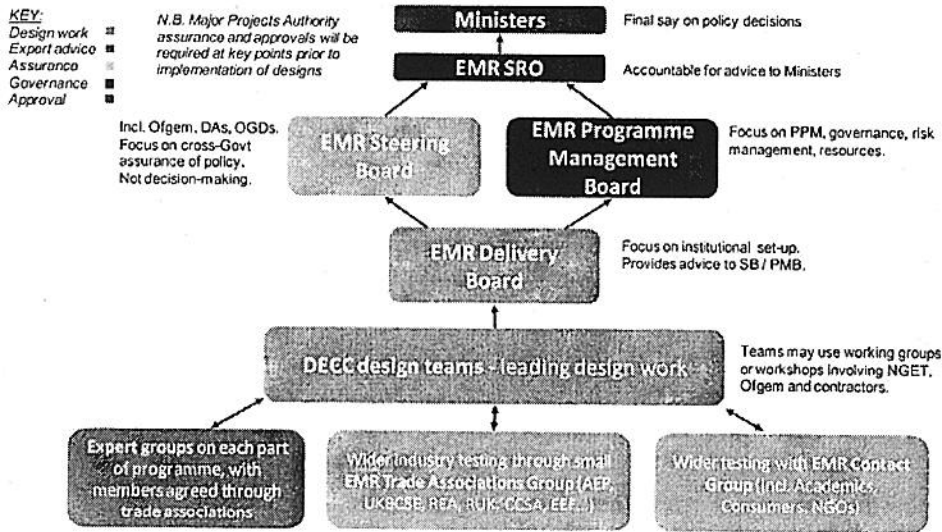
- 1.1 The purpose of this memorandum is to establish clear arrangements and an alignment of expectations between National Grid Plc ("National Grid") and the UK Department of Energy and Climate Change ("DECC") for the role planned for the System Operator ("SO") in delivering policy mechanisms as part of Electricity Market Reform (EMR). Its focus is on the period prior to formal arrangements being put in place through Royal Assent of the relevant legislation.
- 1.2 National Grid senior management have supported the System Operator performing the lead delivery role for EMR. This position has been endorsed by the National Grid Board subject to:
 - No balance sheet risk as a result of the Capacity Mechanism or FIT CfD
 - Adequate funding for both development and initial operation on an "open book" basis with cost recovery including an appropriate margin
 - No downside financial risk for the development and implementation
 - DECC retains responsibility for energy policy but National Grid to take a lead role in the development and implementation to allow management of reputational risk.
- 1.3 This memorandum is not a legally binding document, but is intended to establish the high-level terms of the System Operator's role in the development and implementation of EMR policies prior to the appropriate legislation being put in place. This will be followed by a more specific agreement on balance sheet treatment for National Grid, further clarity on the payment of delivery body development costs, a performance management and accountability framework and working arrangements for delivery of CfDs in Northern Ireland.
- 1.4 This memorandum is not a contract between DECC and National Grid. The EMR delivery role for the System Operator will be established formally via legislation and/or licence conditions. Once those details have been set out it is expected that different arrangements may be put in place via a signed accountability framework.

2. EMR Implementation governance

- 2.1 An EMR Delivery Board will be set up to support the EMR Programme governance. National Grid will sit on this Board to help ensure collaborative policy development. The Delivery Board will review all design work by project teams and ensure that

this has been tested with stakeholders. Overall decision making rests with Government other than where it has been specifically delegated to National Grid or another body.

- 2.2 The Delivery Board will make recommendations to DECC and where these are significant or could impact on agreed policy they will be put to the Steering Board. Where they have a significant impact on the programme plan or business case they will be put to the Programme Management Board.
- 2.3 Each area of design work will use an industry expert group on which National Grid will be represented.
- 2.4 Decisions of a commercial and financial nature impacting National Grid will be referred to the Programme Management Board and on to Ministers as appropriate.
- 2.5 An overview of the new governance arrangements is as follows:



3. Roles and responsibilities – how we will work together

- 3.1 The split of roles and responsibilities was set out in the December Technical Update document and will be established in the legislative framework.
- 3.2 In brief the roles are as follows:

- **Government** will be responsible for setting the policy framework and objectives and for taking final decisions on key rules and parameters. Government will also monitor the System Operator's performance against the objectives set for them;
 - the **System Operator** will provide independent, expert advice to Government on technical rules and parameters and administer the FIT CfD and capacity mechanism; and
 - **The Gas and Electricity Markets Authority ("Ofgem")** will continue its independent regulation of the market, incorporating the new instruments. This could include monitoring the compliance of generators and suppliers with their new obligations and overseeing how the System Operator implements its new functions.
- 3.3 Additionally, as mentioned in section 5, **Elexon** may carry out a settlement role to manage payments for the FIT CfD and potentially the CM. A decision on the role of Elexon and how this relationship is to be managed is yet to be taken but will be made alongside decisions on the payment models for the EMR policies. One option could require National Grid to sub-contract for Elexon to carry out this role.
- 3.4 While the points above describe roles in delivering EMR, the SO will also play an important role in developing the systems, processes and resources to enable the FIT CfD and CM to be delivered in accordance with the policy design work led by DECC. This development role includes:
- a) Contributing to specific mechanism design elements to ensure an outcome that can be effectively operationalised and is accepted by industry (potentially including formal consultation)
 - b) Recruitment and organisational development to put in place appropriate human resources with the right expertise at reasonable cost
 - c) Establishing suitable IT systems to enable efficient, effective and timely mechanism delivery, building on existing SO systems where appropriate
 - d) Building project management capability including a mobilisation plan to achieve a smooth 'Go Live' for delivery of both mechanisms in 2014
 - e) Setting out processes to be followed for FIT CfD and CM participants, in agreement with DECC
 - f) Building appropriate modelling capability to provide in-depth analysis of the UK electricity market and inform decision making by Government on FIT CfD and CM
 - g) Establishing the appropriate contract settlement arrangements
 - h) Establishing reporting capability to inform stakeholders and enable effective monitoring of performance

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The SO will not be required to incur system development and implementation costs in advance of firm agreement on the recovery of EMR development costs.

4. Payment model and National Grid balance sheet management

- 4.1 DECC recognises that National Grid cannot accept any significant impact on its balance sheet or enter into any arrangements that will adversely impact its credit rating as a result of taking on the EMR delivery function. The two parties will therefore continue to work together on the design of EMR payment models with a view to developing an approach that enables the continuing support of National Grid's Board. A decision on the appropriate payment model for the FIT CfD is expected in the spring of 2012 and for the Capacity Mechanism in Q2/3 2012.

5. Potential role for Elexon¹

- 5.1 Whilst recognising that Ministers have not yet taken the final decision on FIT CfD or CM settlement, there may be a role for Elexon to settle and administer the payments for both policies. National Grid will work cooperatively with DECC and Elexon to establish appropriate delivery arrangements if Elexon is asked to perform an EMR delivery function.

6. Costs and Cost recovery

- 6.1 DECC understands National Grid's concern that it does not wish to put development funds at risk as a result of taking on the EMR delivery role.
- 6.2 DECC agrees in principle that National Grid should be able to recover its reasonable development costs for delivery of EMR, subject to prior approval of budgets and plans by DECC (and/or Ofgem as appropriate for the chosen payment process) and subject to DECC having the relevant legal powers and financial delegation. Timing of payments will not be before this point. In addition, only costs incurred after 1 January 2012 in relation specifically to the delivery of EMR CM and FIT CfD will be eligible for approval.
- 6.3 Recovery of development costs incurred by National Grid for EMR delivery is expected to either be from reimbursement via DECC Programme budget and/or from an Ofgem amendment to Special Condition AA5A of NGET's transmission licence, which allows recovery of internal costs. National Grid capital expenditure on assets such as IT and buildings are expected to be recovered under NGET's transmission licence, subject to Ofgem making the relevant amendments.
- 6.4 The intention is that National Grid's reasonable costs, as approved by DECC, should be recoverable as soon as possible after they have been incurred. However, DECC is constrained by rules on government finance which mean that DECC cannot spend or commit to spend until securing Treasury approval after the Bill has been through Second Reading in the House of Commons. DECC will continue to explore with the Treasury and with Ofgem what arrangements might be put in place.
- 6.5 The intention is that National Grid will be paid an appropriate margin in addition to its agreed and documented costs for both the development and ongoing

¹ Elexon is a not-for-profit organisation, funded by the companies that sign the BSC. It is wholly owned by NGET. It is independently managed and has a separate Board of Directors.

administration of EMR delivery. DECC, National Grid and Ofgem will discuss further how this appropriate margin will be set and linked to delivery performance depending on the funding mechanism chosen. Such payments will be no more than any ceiling agreed in line with paragraph 6.2. In addition to costs identified in 6.2, DECC and National Grid will discuss the development of an appropriate framework for additional incentive payments for the successful delivery of the Government's EMR package.

- 6.6 Subject to the agreement of an appropriate margin under paragraph 6.5 it is not anticipated that any margin will be added by National Grid to external costs, including consultancy, legal advisors or other parties procured by National Grid to provide EMR delivery services.
- 6.7 Any payments to National Grid for EMR delivery will be subject to any State Aid approval that may be required.
- 6.8 DECC (and Ofgem as appropriate) will have the right to review future estimates of EMR delivery costs from National Grid to ensure continued value for money for the programme and consumers. In the event that proposed EMR delivery costs are not believed to represent fair value for money, the matter will be resolved in accordance with section 11 of this MOU.
- 6.9 National Grid has provided initial provisional estimates of its costs as set out in the table below: these are an initial estimate of manpower costs only and do not include, for instance, any allowance for the development of systems (consultancy, modelling and operational), external legal support, the margin to be agreed under paragraph 6.5 or costs relating to the development of Northern Ireland intervention. DECC and National Grid accept that these provisional estimates will be subject to revision as the Project develops (and National Grid will review and update the estimates regularly). Subject to the limitations set out above in this paragraph and final approval as set out in 6.2, DECC acknowledges that National Grid's current provisional estimates are:

Year	Development £m
2011/12	£520,000
2012/13	£3,728,000
2013/14	£3,728,000
2014/15	TBA when scope clearer
2015/16	TBA when scope clearer

- 6.10 DECC and National Grid intend to enter into an agreement governing DECC's right to use IP created, or provided by, or on behalf of, National Grid in the course of the performance of its duties in connection with EMR. The terms of the IP agreement would provide, without limitation, that: (i) DECC and its sub-licensees have a right to use the EMR IP and information (both National Grid owned and wherever reasonably possible third party) created, or provided by, or on behalf of, National Grid in the course of the performance of its duties as System Operator and it will

be agreed between the parties in the IP agreement (and/or on a case-by-case basis) whether such right to use the EMR IP and information will be an exclusive, sole or non-exclusive right and (ii) National Grid (or any relevant third party) will be reimbursed for pre-approved reasonable costs and expenses incurred in respect of the provision of such EMR IP and information in accordance with the reimbursement principles agreed by DECC and National Grid. The IP agreement will expire when the statutory framework governing the EMR delivery role for the System Operator is established formally..

7. Performance management principles

- 7.1 A long term accountability framework is under development to establish how National Grid will be held accountable for its performance in EMR delivery. It is anticipated that this will be enhanced by scrutiny from Ofgem, particularly with regard to National Grid's internal delivery costs. This should be consistent with enabling the reasonable achievement of delivery objectives.
- 7.2 In the shorter term set-up phase, DECC will agree appropriate performance measures with National Grid consistent with the funding approach adopted.
- 7.3 It is expected that National Grid and DECC will meet regularly and at least quarterly to review progress on delivery performance

8. Delivery role in Northern Ireland

- 8.1 DECC and the Northern Ireland Department of Enterprise Trade and Investment ("DETINI") have agreed and committed to running a UK-wide FIT CfD and to enable that through a UK-wide institution. National Grid's delivery role for FIT CfD will therefore include Northern Ireland in addition to Great Britain to ensure a consistent UK-wide approach. Subject to an acceptable approach to funding being agreed with the Northern Ireland Department of Enterprise Trade and Investment ("DETINI") and DECC, National Grid agrees to resource appropriately to meet the specific EMR delivery needs of the Northern Ireland electricity market.

9. Conflict of interest potential

- 9.1 National Grid recognises that there is the potential for conflict of interest between its role delivering EMR and other existing parts of its business.
- 9.2 DECC and Ofgem have established a joint project to understand the scale and nature of any conflicts of interest and to recommend appropriate mitigating action.
- 9.3 Mitigating actions to address conflicts may be taken by National Grid itself, by Ofgem in its role as regulator or by Government. National Grid will, in any event, develop appropriate organisational and governance arrangements to address any conflicts of interest.
- 9.4 A conflict of interest policy for National Grid's role in delivering EMR will be developed by National Grid, DECC and Ofgem following conclusion of the current joint DECC/Ofgem project on synergies and conflicts. This policy will include

appropriate procedures for identifying, managing and mitigating conflicts as well as appropriate provisions to review compliance and address non-compliance.

10. Management of information

- 10.1 National Grid recognises that they may have access to information, commercially sensitive or otherwise, in the course of performing the expected EMR delivery role.
- 10.2 Unless authorised by DECC, National Grid commits to not use this information in any way for its own commercial gain or to share it with other parties without the consent of the information source.
- 10.3 In particular, National Grid staff working on EMR delivery will not share information with any other National Grid staff. National Grid, DECC and Ofgem will, by June 2012, develop and implement the necessary policies and processes for information barriers to be put in place by National Grid in support of its confidentiality obligations.
- 10.4 In addition to this MOU, National Grid will by the end of May 2012 sign a legally binding agreement covering confidentiality and management of information for staff and contractors working on EMR delivery. Individuals involved will also sign suitable confidentiality agreements.

11. Conflict resolution and change control

- 11.1 National Grid and DECC will refer any conflicts relating to mechanism design and delivery to the Delivery Board in the first instance.
- 11.2 Senior executives from DECC and National Grid will meet regularly to act as an additional escalation point for resolving conflict.
- 11.3 Any matters of Government policy will ultimately be decided by Ministers.
- 11.4 Changes to these arrangements or changes impacting on them shall be dealt with in accordance with the Change Request Process to be agreed by the signatories to the MOU. As a minimum the Change Request Process shall clearly establish:
 - a) what changes trigger the application of the Change Request Process (whether initiated by DECC or National Grid) including, but not limited to changes impacting on funding, scope, timing and outcomes;
 - b) minimum notice periods for requesting a change
 - c) how DECC and National Grid deal with urgent/mandatory changes;
 - d) a resolution process, for where DECC and National Grid are unable to reach agreement;
 - e) a clear process, which sets out the relevant roles and responsibilities for completing the process

- f) the ability for DECC to obtain alternative quotes where feasible if elements of the EMR delivery costs are not judged to represent fair value for money

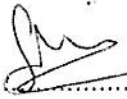
12. Risk management guidelines

12.1 Both National Grid and DECC will exercise due care with regard to managing risks relating to EMR delivery. This includes:

- a) Flagging to any substantive delivery risks as soon as they are recognised
- b) Keeping a risk register and record of mitigating actions
- c) Regular liaison (at least monthly) on the status of project risks
- d) Seeking appropriate Delivery Board support for any significant delivery decisions that carry a moderate to high level of risk or have significant consequences for the EMR programme

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Signed on behalf of DECC:


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Date: 31.5.12

Simon Virley
Director General, Energy Markets and Infrastructure
Department of Energy and Climate Change

Signed on behalf of National Grid:


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Date: 25.5.12

Nick Winser
Executive Director, UK
National Grid Plc