

ANNEX A

Institutional Framework: Government, the System Operator and Ofgem

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SUMMARY

The Government recognises that a robust, transparent and credible institutional framework is crucial to the success of Electricity Market Reform (EMR), and is important to provide investors with the confidence they need to invest in the EMR mechanisms. In ***Planning Our Electric Future: Technical Update***¹, published in December 2011, the Government announced that the System Operator within National Grid would be the delivery body for the Feed in Tariff with Contracts for Difference (CfD) and the Capacity Market. More detail on the mechanisms is provided in Annexes B and C.

Government, the System Operator and Ofgem will have clear and distinct roles to ensure effective delivery of EMR:

- **Government** will be responsible for the policy approach and policy costs, which includes key decisions such as strike prices or auction volumes for the CfD, volumes for the Capacity Market. Government will also be responsible for defining the functions of the System Operator's delivery role;
- the **System Operator** will provide evidence and analysis to inform the Government's decisions on key policy parameters like the CfD strike prices (then volumes) and the volume of capacity to contract for. The System Operator will also administer these mechanisms, for example running capacity auctions for the Capacity Market, allocating CfDs, and reporting to the Government on delivery; and
- **Ofgem** will continue to regulate the System Operator. We propose that Ofgem oversees the performance of the System Operator in delivering the CfD and Capacity Market, to ensure value for money and incentivise effective performance.

More detail on these roles and responsibilities will be developed over the coming months².

The Government will retain responsibility for EMR policy decisions, policy costs and the functions of the System Operator's delivery role. Ofgem will hold the System Operator to account, against the terms set by Government in regulation, for the System Operator's performance and internal administrative costs. The System Operator will be able to recover its administrative costs through a system building on the existing incentive regime overseen by Ofgem.

¹ Planning Our Electric Future: Technical Update:
http://www.decc.gov.uk/en/content/cms/legislation/white_papers/emr_wp_2011/tech_update/tech_update.aspx

² All of this will be subject to the passage of legislation through Parliament

A series of regular policy decisions will need to be taken by Government in order to deliver the CfD and Capacity Market. Government intends to provide clarity and certainty on those key decisions through a delivery plan, published every five years. The delivery plan will contain long-term objectives, the key policy decisions to support the effective delivery of the mechanisms, and supporting analysis such as the impacts of the policy decisions across the UK and illustrative scenarios for achieving them. The System Operator will report annually to Government on delivery of the mechanisms to enable Government to publish annual updates to the delivery plan.

The decisions published in the delivery plan and annual updates will be informed by evidence and analysis provided by the System Operator, which will enable Government to take robust decisions in a transparent way. The System Operator will work with industry during this process, including through a call for evidence. Government will set up a Panel of Technical Experts to scrutinise the System Operator's evidence and analysis to ensure that the System Operator uses the most up-to-date and objective evidence. The Panel will report to Government at the same time as the System Operator gives its analysis to Government.

The Government will work closely with the Devolved Administrations on the design and delivery of the CfD and underlying institutional framework. The Government will also work with bodies, such as Ofgem and the Committee on Climate Change, and undertake a public consultation on the draft delivery plan.

There are many important synergies from the System Operator taking on the EMR delivery role, but it is possible that conflicts of interest with National Grid's existing roles in the electricity market could arise. DECC and Ofgem are conducting a joint piece of work to assess the extent of the possible conflicts and / or new synergies. Alongside this document we and Ofgem are publishing an initial report on this project, and we are taking powers in the Bill to address any conflicts of interest should mitigation prove necessary.

1. INTRODUCTION

1. This annex provides more detail on the institutional framework that the Government will put in place to deliver the Feed-in Tariff with Contracts for Difference (CfD) and Capacity Market. In the Electricity Market Reform (EMR) White Paper – ***Planning our electric future: a White Paper for secure, affordable and low-carbon electricity***³ – the Government set out its commitment to a transparent, robust, stable and credible institutional framework in order to

³ EMR White Paper: Planning our electric future: a White Paper for secure, affordable and low-carbon electricity http://www.decc.gov.uk/en/content/cms/legislation/white_papers/emr_wp_2011/emr_wp_2011.aspx

deliver EMR in a way which gives confidence to industry and investors. This is critical if EMR is going to achieve the Government's objectives of secure, low carbon, affordable electricity supplies.

2. As set out in the ***Electricity Market Reform: Policy Overview***, published alongside this annex, EMR will introduce two new mechanisms into the electricity market that will be administered by the System Operator:

- **Feed-in Tariff with Contracts for Difference (CfD)** – instruments that provide long term revenue certainty to investors in low carbon generation such as carbon capture and storage, renewables and nuclear; and
- **Capacity agreements (within a Capacity Market)** – which pay for reliable capacity to be available when needed helping to ensure security of electricity supply.

Annexes B and C set out more detail on these two mechanisms.

3. Investment in low-carbon generation will also be supported by the Carbon Price Floor and the Emissions Performance Standard. The EMR mechanisms will work within the current electricity market, including the Renewables Obligation and the small-scale Feed-in Tariffs.
4. In ***Planning our Electric Future: Technical Update*** we set out our view that the System Operator, within National Grid, is best placed to administer and deliver the CfD and the Capacity Market. The Technical Update set out the rationale for this decision, weighed against the criteria set out in the EMR White Paper and balanced against other options. The key points are:
 - there are strong **synergies** with the current role of the System Operator and delivery of both the CfD and the Capacity Market;
 - delivery of these two functions by a single organisation will ensure a joined up approach to the CfD and Capacity Market and, combined with the System Operator's current roles, will provide **value for money**; and
 - the System Operator already has relevant **technical expertise**, and **commercial and financial skills** necessary to deliver the CfD in the UK and Capacity Market in GB as well as to provide evidence and analysis to Government on key rules and parameters.
5. Taken together, this framework, with the roles and responsibilities as defined in the Technical Update and set out in more detail below, satisfies the remainder of the White Paper's criteria:

- the split of functions described above balances the **independence** of a private company to administer the mechanisms, with clear **accountability** through Government taking final decisions on key rules and parameters; and
 - the framework will enable robust, stable and **credit-worthy** payment mechanisms.
6. Since the publication of the Technical Update in December 2011, Government has continued to develop this framework in more detail, in particular to ensure sufficient levels of accountability and transparency. This annex provides further clarity on the specific roles that Government, the System Operator and Ofgem will take in delivering these functions, subject to the passage of legislation through Parliament.
7. The Technical Update set out the high-level process by which Government will set the parameters and design details in order to successfully deliver the CfD and Capacity Market. This annex provides further information on how Government will develop a clear delivery plan, and what evidence and analysis Government will need in order to develop this plan and its annual updates. It confirms that Government intends to set up a Panel of Technical Experts to scrutinise the System Operator's evidence and analysis. This annex confirms that in developing the delivery plan and monitoring implementation, the Government will work closely with the Devolved Administrations. It sets out how the System Operator will deliver the mechanisms within the legislative framework and report on the delivery of the mechanism to enable Government to publish annual updates. This annex also indicates the intended timetable for producing the first delivery plan.
8. Finally, this annex provides detail on how the Government is approaching the potential for conflicts of interest in conferring the EMR functions on the System Operator. As highlighted in the Technical Update there is a risk of potential or perceived conflicts of interest between the delivery of the EMR functions and National Grid's other businesses. Work to gauge the scale and nature of any conflicts of interests and possible mitigating actions is the subject of an ongoing, joint assessment by DECC and Ofgem. Alongside this document we and Ofgem are publishing an initial report on this project⁴.
9. As the designs of the CfD and Capacity Market develop over the coming months, we will continue to develop the detail of the institutional framework. This will be crucial for the system to work in a way that delivers the Government's objectives effectively and efficiently. The Government will continue to work with stakeholders throughout the next stage of the design process.

⁴ Electricity Market Reform (EMR): Potential synergies and conflicts of interest: Outcome of the 27 March 2012 workshop and responses to the 8 March 2012 open letter http://www.decc.gov.uk/en/content/cms/consultations/emr_coi/emr_coi.aspx

2. ROLES AND RESPONSIBILITIES FOR DELIVERING EMR

2.1 The roles of the key players

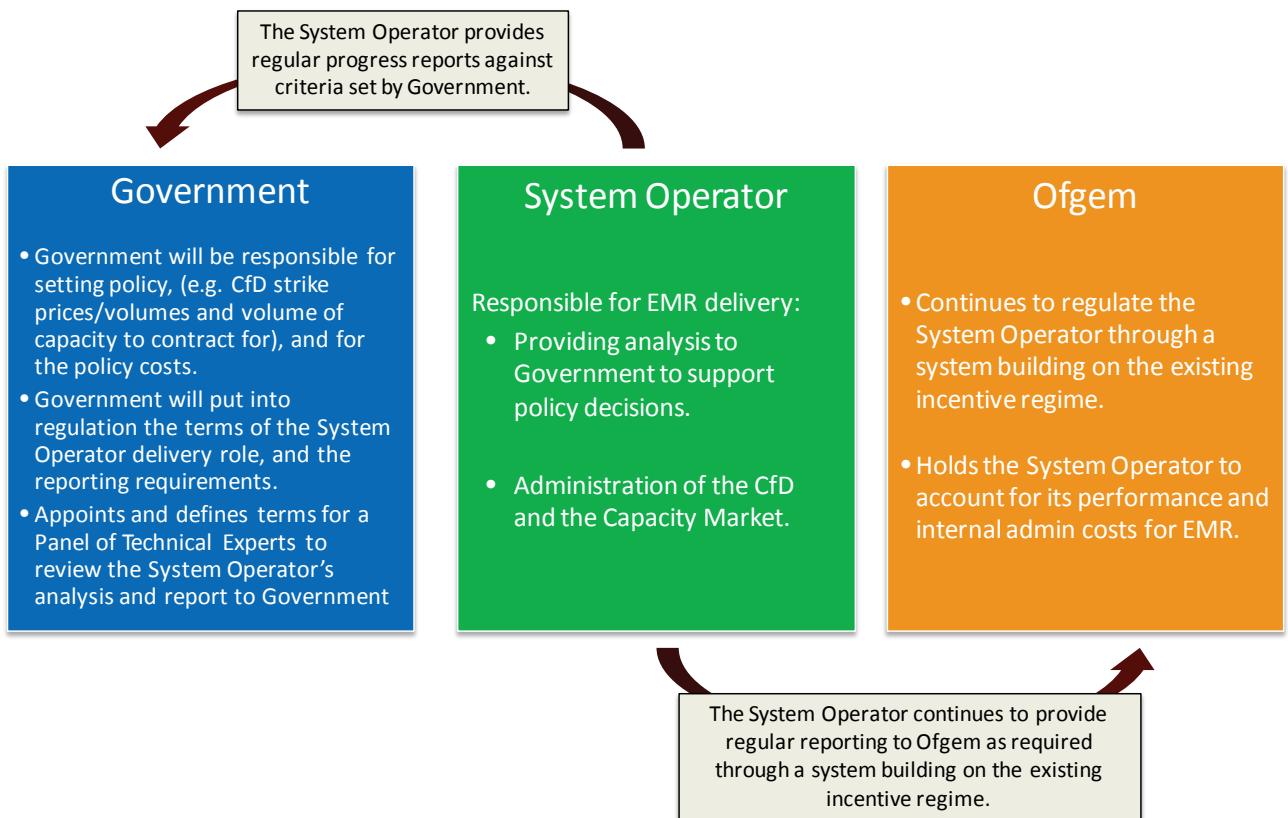
10. Government, the System Operator and Ofgem will all have clear and distinct roles to ensure effective delivery of EMR:

- **Government** will be responsible for the policy approach and policy costs, which includes key decisions such as strike prices or auction volumes for the CfD, and the security of electricity supply objective for the Capacity Market and final decisions on the volume of capacity to contract for. Government will also be responsible for defining the functions of the System Operator's delivery role. As EMR will extend across the UK, the Government will work closely with each of the Devolved Administrations in Scotland, Wales and Northern Ireland. The Government will also work with other bodies such as Ofgem and the Committee on Climate Change as appropriate. More detail on their roles are set out later in the annex.
- The **System Operator** will provide evidence and analysis to inform the Government's decisions on key policy parameters like the CfD strike prices (then volumes) and the volume of capacity to contract for. The System Operator will also administer these mechanisms, for example running capacity auctions for the Capacity Market, allocating CfDs, and reporting to the Government on delivery.
- **Ofgem**, as the independent energy regulator, will continue to regulate the System Operator as well as the generation, distribution and supply companies. We propose that Ofgem oversees the performance of the System Operator in delivering the CfD and Capacity Market, to ensure value for money and incentivise effective performance⁵.

11. An overview of the roles and responsibilities within the Institutional Framework is set out in Figure 1. More detail on the way in which these roles fit together to deliver EMR is described below.

⁵ Note, the role of Ofgem will extend to GB elements of these arrangements. Further discussion is needed between DECC, DETI, Ofgem and NIAUR on the role of NIAUR in ensuring its regulation of the market in Northern Ireland. See section 6 of this annex for further details on what remains to be done.

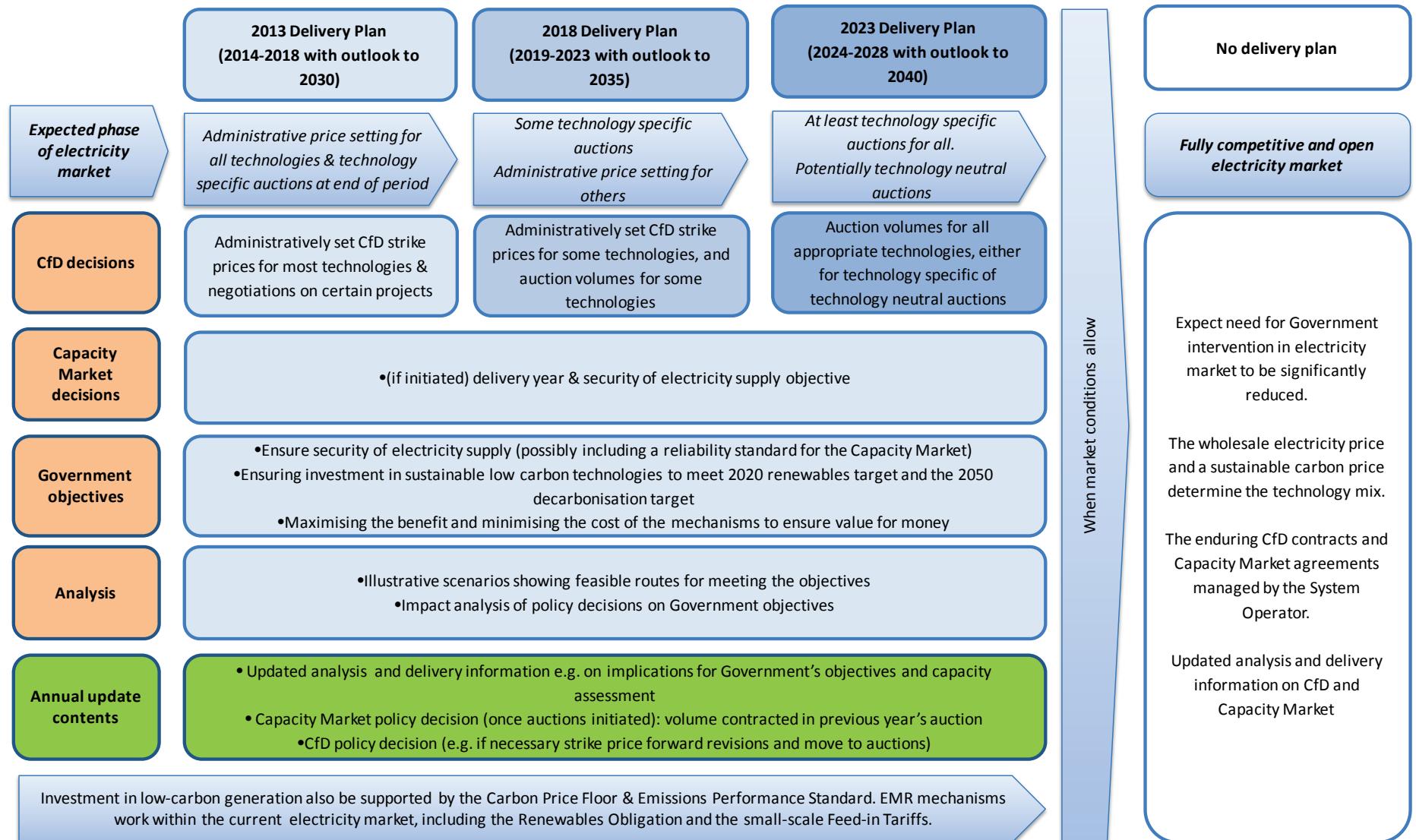
Figure 1: An overview of the EMR institutional framework



2.2 Delivering EMR with robust Government decisions and transparent processes

12. Every five years Government will publish a delivery plan to provide certainty and clarity on Government's long-term objectives: ensuring a secure electricity supply; investment in sustainable, low carbon technologies; and maximising the benefits while minimising the costs. To publish the delivery plan, Government will follow the process set out below, including consultation with the Devolved Administrations. The delivery plan will set out Government's key policy decisions to support the effective delivery of the mechanisms and analysis on the impacts of the decisions on the objectives and illustrative scenarios for meeting these objectives. Government will publish annual updates to the delivery plan, which will include policy decisions, for example on the volume of capacity to contract for (assuming the Capacity Market has been initiated), and a summary of information on the delivery of the mechanisms. Figure 2 summarises the contents of the delivery plan and annual updates during different phases of EMR.

Figure 2: the delivery plan in different phases of the CfD



13. The Government is clear that the decisions in the delivery plan and annual updates must be informed by robust evidence and that the decision-making process must be transparent. To this end, the System Operator will provide evidence and analysis to inform the Government's decision-making, for example on the CfD the System Operator will provide evidence both on the technology costs that strike prices need to reflect, and on the likely impacts and outcomes of strike prices. We expect that the System Operator will work closely with industry to gather this evidence and undertake its analysis. The System Operator will also report regularly to Government about the delivery of the mechanisms, including the policy costs.
14. The Government will establish a Panel of Technical Experts, reporting to Government, to scrutinise the System Operator's evidence and analysis, and monitor the process it undertakes to carry out these functions. There will be a role for the Devolved Administrations in the set up and terms of the Panel (for example as part of the appointments process) to ensure that it fully represents wider UK interests. The Panel will scrutinise the System Operator's evidence gathering and analysis, for example by providing constructive challenge to technical assumptions, and reviewing the analysis and the process followed. The Panel will report regularly to Government, and provide a final report when the System Operator presents its analysis to Government. The Panel will report with a view to ensuring the System Operator's evidence and analysis is up-to-date, robust and objective. The Government will then consider the System Operator's analysis and the Panel's report and consult publicly, as appropriate, on the resulting policy proposals. The Panel will remain impartial, and will not advise the Government on what policy objectives it should pursue, or comment on the Government's policy decisions.
15. The experts on the Panel are likely to be independent of industry and interest groups in order to provide an impartial assessment to Government. The panel members are likely to include those with skills and expertise in engineering, project finance, economics, and generation in each of the different parts of the UK (including expertise on the single electricity market in Northern Ireland). At this time the makeup of the Panel has not been finalised, and we intend to work with stakeholders over the coming months to identify who appropriate members might be and what controls would be appropriate, for example on commercially sensitive information. Further information on the makeup and role of the Panel will be provided later in 2012.
16. The Government will consult with the Devolved Administrations on the design and delivery of the CfD. The Government will also work with other bodies, such as Ofgem and the Committee on Climate Change, prior to making these policy decisions. The Government supports a role for the Committee on Climate

Change as early in the process as appropriate to ensure that decarbonisation is properly considered.

17. For the CfD, the key policy decision while prices are set administratively will be the strike prices for low carbon technologies. For most projects, these will be set by Government and published in the delivery plan, informed by evidence and analysis from the System Operator. Strike prices for some projects, for example early stage CCS projects (including those supported under the UK CCS Commercialisation Programme), new nuclear projects and some renewable projects could be determined through a bespoke process that involves cost, risk and price discovery processes and negotiation, for example through the FID Enabling Project. The process for determining the level of support for such projects is set out in more detail in Annex B. Under auctions, the key decisions will be volumes and timing for the auctions. The System Operator may be asked to provide evidence on technologies' readiness for competitive price setting as part of their role. The decisions on volume and timing will be published by Government in the delivery plan and annual updates.
18. For the Capacity Market, the first decision will be on when to initiate the mechanism. Assuming auctions are initiated, the key policy decision that we expect the Government to make annually will be the volume of capacity to contract for. We expect this decision will be published in the delivery plan and its annual updates.

The first delivery plan and annual updates

19. Government will publish the first five-year delivery plan in 2013 with an outlook to 2030 to provide appropriate visibility and transparency in advance of the introduction of the mechanisms. The first delivery plan will set out the following information and decisions for the 2014-2018 delivery period:
 - **the relevant Government objectives for the electricity market:**
 - ensuring a secure electricity supply, which could include a reliability standard for the Capacity Market
 - ensuring sufficient investment in sustainable low carbon technologies, in order to meet existing targets such as the 2020 renewables target, the 2050 decarbonisation target and the carbon budgets;
 - maximising the benefit and minimising the cost of the mechanisms, as part of this Government might set parameters such as a cost envelope;
 - the delivery plan is likely to contain **the security of electricity supply outlook**, based on Ofgem's 2013 capacity assessment, and a decision on

whether a capacity auction will be required in 2014 and if so the volume of capacity to contract for;

- **policy decisions on the CfD** including strike prices for renewable technologies and an indication of when we could move to auctions for certain technologies;
- **supporting analysis** including **illustrative scenarios** showing feasible routes for achieving these objectives (e.g. the technology mix), and **expected impacts of the policy decisions** on Government objectives, for example on the security of electricity supply, decarbonisation and other environmental impacts and any impacts on consumers; and
- the **process and timing** for any decisions that might be necessary within the delivery period 2014-2018, for example the timings, period and process for setting future strike prices and for the introduction of auctions.

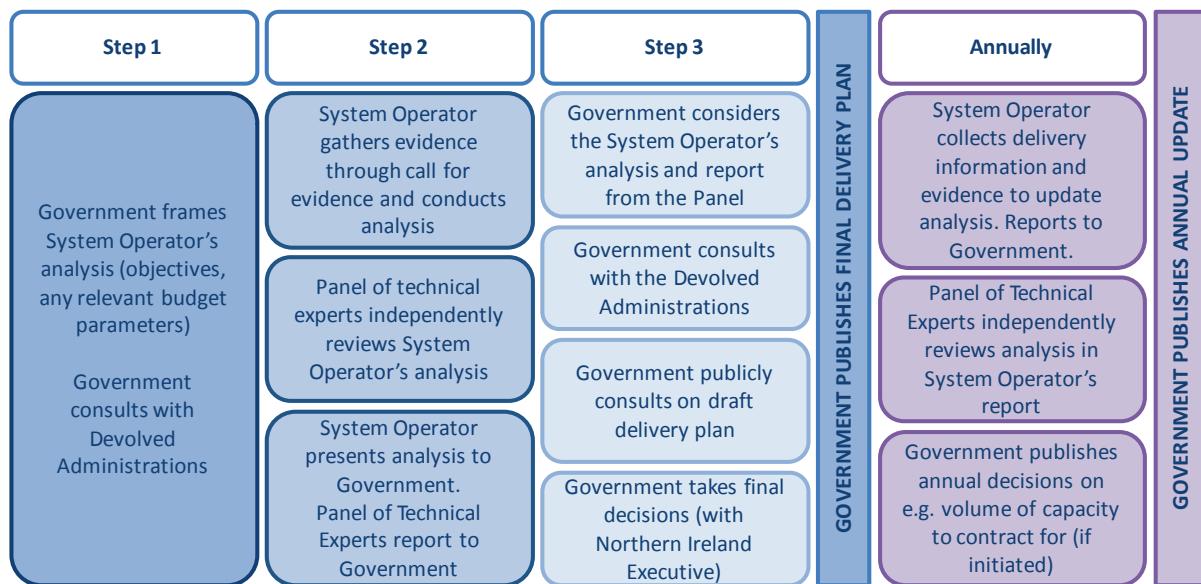
20. In addition to the five-yearly delivery plan, the Government will publish annual updates from 2014 onwards, which will set out:

- a summary of delivery information from the System Operator, for instance the number and type of CfDs allocated;
- once the Capacity Market has been initiated the annual update is expected to contain the volume of capacity contracted in the previous year's auction, the updated security of electricity supply outlook and the volume required for the upcoming auction;
- CfD policy decisions, for example, if necessary, forward strike price revisions or extensions of the administratively set strike prices to 2020. Further details on the price setting process are set out in Annex B;
- potentially any other ad-hoc decisions that might be required, for example changes to the operational details in delivering the CfD or Capacity Market (such as auction rules); and
- the expected impacts of these policy decisions and delivery information on Government objectives, for example on long-term security of electricity supply, decarbonisation and renewable energy targets, and consumer bills.

The decision-making process

21. To produce the delivery plan and annual updates, the Government will follow the three step process set out in Figure 3 and described below.

Figure 3: Process for Government's policy decisions to deliver EMR⁶



22. For the first delivery plan, step 1 will take place over summer 2012, so as to commission analysis from the System Operator in autumn 2012, although the System Operator is expected to start gathering evidence (e.g. on technology costs) in advance of this. We expect step 2 to be completed by mid-2013, so that Government can consult on the draft delivery plan in mid-2013 and publish the final delivery plan in late 2013, in order to provide clear signals to the market and help enable timely investment decisions.
23. We are doing further work on the necessary process, including how long it will take, in order to assess the impact of the proposed timing. We will confirm the timeline, process, objectives and parameters later in 2012.
24. As set out in last year's White Paper and subsequent Technical Update, the Government recognises that the changes to the market proposed under EMR could lead to some investment decisions being delayed and is committed to working with relevant developers to enable early investment decisions, including those required ahead of EMR implementation, to progress to timetable wherever possible. The Final Investment Decision (FID) Enabling Project has been established to take this work forward – see the “Enabling final investment decisions required in advance of implantation of the CfD regime” section in Annex B for further details.

Step 1: framing the evidence

25. The first step in the process is for Government to commission the evidence and analysis that it needs in order to be able to take its decisions on an informed

⁶ This figure summarises the process for the delivery plan and annual updates; not all policy decisions will be subject to consultation with the public or the Devolved Administrations.

basis. To guide the System Operator's analysis, the Government will identify its high-level objectives to which EMR will contribute, such as the UK Renewables Target⁷, the UK's Carbon Budgets⁸ and any security of the electricity supply objective. Government will also inform the System Operator of any parameters within which EMR must be delivered, for instance any budget envelope as part of the Levy Control Framework⁹. Before framing the analysis the Government will also consult with the Devolved Administrations to gather their views on the appropriate objectives and parameters. Government will also define the process by which it, the System Operator and the Panel of Technical Experts will work together.

Step 2: System Operator gathers evidence and conducts analysis

26. The second step of the process is for the System Operator to gather evidence and carry out analysis to inform Government's decisions, consistent with the objectives, parameters and broad process identified by Government in the first step. During this process the System Operator will continue to work with Government following the process defined in step 1.
27. The System Operator will engage industry, other experts and the public as appropriate throughout its evidence gathering and analysis. This could include, for example, a call for evidence, and working with Ofgem and others to ensure that consumer interests, regional, environmental and sustainability implications are appropriately reflected in the analysis. The System Operator will work as necessary with the System Operator Northern Ireland to undertake analysis and provide evidence of the Northern Ireland market in order to inform the Government's final decisions on CfD strike prices. Government will also expect the Panel of Technical Experts to scrutinise the System Operator's analysis.
28. To inform the administratively set CfD strike prices, the System Operator will gather evidence about renewable technology costs (generation costs, system balancing costs, network costs), their deployment potential, assessment of the impacts of different renewable CfD strike prices (for example on Government's objectives, whole system costs and consumer bills) and modelling of plausible scenarios (for example technology mixes and security of electricity supply

⁷ Set out in EC Directive 2009/28/EC, transposed via the Promotion of the Use of Energy from Renewable Sources Regulations 2011 <http://www.legislation.gov.uk/uksi/2011/243/made>

⁸ http://www.decc.gov.uk/en/content/cms/emissions/carbon_budgets/carbon_budgets.aspx

⁹ The control framework for DECC levy-funded spending forms part of the Government's public spending framework, which the Treasury has responsibility for. Its purpose is to make sure that DECC achieves its fuel poverty, energy and climate change goals in a way that is consistent with economic recovery and minimising the impact on consumer bills.

<http://www.decc.gov.uk/assets/decc/11/funding-support/fuel-poverty/3290-control-fwork-decc-levyfunded-spending.pdf>.

outlook) to deliver Government's objectives. The System Operator's evidence and analysis is likely to present a number of scenarios, setting out the implications of different decisions and ensuring Government is able to make the necessary trade-offs between its objectives. For the first delivery plan, the System Operator and Government intend to use the cost data provided as part of the Renewables Obligation banding. Additionally, for the first delivery plan in 2013, Ofgem will continue to be responsible for the capacity assessment as set out in the Energy Act 2011.

29. Once the System Operator has completed its analysis, it will report to Government. At the same time the Panel of Technical Experts will submit their report on the System Operator's analysis to Government. Government could also carry out or seek separate analysis from other sources or bodies if it wishes to.

Step 3: Government considers the analysis

30. The third step in the process is for Government to take policy decisions informed by the robust, impartial analysis provided to it. Once Government receives the System Operator's analysis, there will be an iterative process, so that Government is able to seek clarification and receive updated analysis if necessary. The Panel of Technical Experts will continue to scrutinise the System Operator's analysis during this stage and provide its assessment of any revisions to Government.
31. In taking its final decisions, the Government will also consult with the Devolved Administrations on the CfD, and the decision on CfD strike prices in Northern Ireland will be made in conjunction with the Northern Ireland Executive. To reflect that Northern Ireland Ministers have full decision-making powers over the energy market in Northern Ireland (with the exception of nuclear), before UK Ministers set strike prices for the UK, Ministers will gain the consent of Northern Ireland Ministers for prices in Northern Ireland. Costs will be socialised across UK consumers. If Northern Ireland Ministers could not consent to proposed strike prices, then they would have the power to set different strike prices for Northern Ireland. If this were the case, any additional costs due to differential strike prices in Northern Ireland would be met by Northern Ireland consumers. For further details on the role of the Devolved Administrations see section 4.
32. Government could also consult other relevant experts such as Ofgem or the Committee on Climate Change. Government will consider the impacts of the decisions, including on decarbonisation, security of electricity supply, sustainability and consumers before making a decision. Once the Government has made provisional decisions, it will hold a public consultation on the appropriate sections of the draft delivery plan to inform its final decisions, for example on the cost data and analysis underpinning the draft strike prices. The

intention is to ensure that Government is fully informed of the potential impacts of its decisions before it takes them.

Annually

33. Following the publication of the five-yearly delivery plan, the System Operator will report regularly to Government with information on delivery of the mechanisms (for example, number, type and cost of CfDs allocated, and the volume and cost of capacity contracted for under the Capacity Market assuming it is initiated). The System Operator will also provide updated analysis of the implications of this information and future policy decisions on Government's objectives. This will enable Government to publish annual updates to the delivery plan. Assuming capacity auctions are initiated, the System Operator will provide analysis on the volume of capacity to be contracted for in the Capacity Market. The Government's decision on the volume will be published in the annual update. The evidence and analysis provided to Government as part of the reporting will be reviewed by the Panel of Technical Experts.

Later delivery plans

34. The decision-making process for later delivery plans and annual updates will follow the process described above. The key difference for later delivery plans will be that the CfD will be moving into an auctioning phase. For example, the delivery plan in 2018 (delivery period 2019-2023, outlook to 2035) could set out updated strike prices for some technologies, whereas some technologies will have moved to auctions, so the volume of capacity to auction will be announced. The decisions on which technologies should move to auction according to when market conditions are right will be published in the annual updates or delivery plan. Assuming the Capacity Market has been initiated, the annual decisions on the volume of capacity to procure will be published in delivery plans and annual updates.

2.3 Administering the mechanisms

35. The System Operator will administer the mechanisms once Government has taken these decisions, published them in the delivery plan or annual update and, where necessary, set them out in legislation. The Government will confer the relevant delivery functions on the System Operator in secondary legislation, on which we will consult in late 2013. The Government will engage with the Devolved Administrations in Scotland, Wales and Northern Ireland on the scope and operation of this secondary legislation to implement CfD delivery functions and roles.

36. These functions will include:

- allocating CfDs and, when we move to competitive price setting, running the auctions;
- administering any investment instruments issued under the FID Enabling process or post-implementation CfDs issued by the Secretary of State (see Annex B for more detail); and
- Running the auctions for the Capacity Market.

37. The System Operator will carry out these functions within the legislative framework set by Government. For example, Government will set the eligibility rules and criteria, and the System Operator will decide which projects meet them.

38. Alongside administering the CfD and Capacity Market, the System Operator will also report regularly to Government, as described in the annual update process above and the accountability section below.

39. Given the longevity of the CfD, it is necessary to ensure that the appropriate contract terms can be adjusted in response to certain market and regulatory changes as agreed within the contract terms. The Government is considering establishing an independent expert function in order to, for example, review the validity of reference prices or resolve disputes that may arise from time to time during the contract period of the CfD. Further information is provided in Annex B.

2. ACCOUNTABILITY

40. The Government will retain responsibility for EMR policy decisions and policy costs. In particular Government will:

- take all policy decisions, as set out above;
- set the terms of the System Operator's delivery role in regulation; and
- maintain oversight of policy effectiveness. To do this Government will receive regular reports from the System Operator on delivery, and regular information from Ofgem on the performance of the System Operator in delivering the EMR mechanisms.

41. The System Operator's delivery functions and the associated tasks will be set out in secondary legislation. The System Operator will report regularly to Government against criteria set by Government on the effectiveness of delivery, which will include the policy costs of the mechanisms. It is expected that the System Operator will be able to recover its administrative costs, through a system building upon the existing incentive regime overseen by Ofgem. As the regulator,

Ofgem will be responsible for holding the System Operator to account - against the terms set by Government in regulation - for the System Operator's performance and internal administrative costs (e.g. costs such as IT equipment and pay) by:

- imposing cost-controls and setting incentives for the System Operator to incentivise effective performance; and
- monitoring and scrutinising the System Operator's costs and delivery performance on an ongoing basis.

This framework ensures sufficient Government oversight of the System Operator's performance in delivery, and uses the existing expertise and powers of the regulator in the proper way. As above, the Government will engage with the Devolved Administrations in Scotland, Wales and Northern Ireland on the secondary legislation.

42. In addition to setting incentives, Ofgem's powers to ensure compliance include the issuance of enforcement orders (which effectively prohibits a particular course of conduct), and the imposition of financial penalties. As Ofgem is accountable to Parliament, it will provide an annual report to Parliament on its activities and progress, as well as reporting to Parliament during the year.
43. As set out above, a Panel of Technical Experts will be responsible for scrutinising the analysis provided to Government by the System Operator. It will scrutinise the System Operator in parallel to the System Operator performing its analysis. The Panel will be accountable to Government. Government will appoint the Panel and determine its role and scrutinise any costs. Further information on the role and makeup of the Panel will be provided later in 2012.
44. The Devolved Administrations will be consulted throughout the CfD decision making process, including on setting the objectives and parameters that frame the analysis that the System Operator will carry out, on the illustrative scenarios, impacts and CfD strike prices for renewable technologies, and on the governance framework for the System Operator. The Government and Northern Ireland Executive will work in conjunction to take a decision on the CfD strike prices for Northern Ireland.
45. If Government took the view that delivery of the EMR functions was not effective, it would have various options for action available, including: making amendments to EMR policy, changing the terms of System Operator's delivery role, or ultimately transferring delivery functions to another body.

4. DEVOLVED ADMINISTRATIONS

Northern Ireland

46. Energy policy is transferred to the Northern Ireland Executive (with the exception of most elements of nuclear power). The Northern Ireland Executive has agreed that extension of the CfD, Investment Instruments and EPS provisions will apply to Northern Ireland, while taking into account both devolved competencies and Northern Ireland's position within the Single Electricity Market (SEM).
47. We will continue to involve Northern Ireland Ministers in further design and development work to ensure that the Northern Ireland Executive's devolved competency is respected. As well as involvement in decision making on the CfD strike prices, Northern Ireland Ministers will also have a consultative role set out in statute on the design and delivery of the CfD and accompanying institutional framework.
48. Market conditions within Northern Ireland are different to those in GB. UK-wide strike prices are preferable but in the event relevant differences in market conditions require it, CfD strike prices in Northern Ireland may be slightly different to those in GB to reflect those differences.
49. To reflect that Northern Ireland Ministers have full decision-making powers over the Energy Market in Northern Ireland (with the exception of most areas of nuclear power), we have agreed with the Northern Ireland Executive that before UK Ministers set strike prices for the UK, Ministers will gain the consent of Northern Ireland Ministers for prices in Northern Ireland. Costs will be socialised across UK consumers. If Northern Ireland Ministers could not consent to proposed strike prices, then there would be a mechanism for strike prices for Northern Ireland to be determined by Northern Ireland Ministers. If this were the case, any additional costs due to differential strike prices in Northern Ireland would be met by Northern Ireland consumers. The decisions on the strike prices in Northern Ireland, alongside the impacts and considerations for the CfD operating in the Single Electricity Market will be set out in a section of the delivery plan and the annual updates.

Scotland

50. All of the policies in EMR extend to Scotland and energy, generation and supply are classed as reserved matters. Because the interface between reserved and devolved areas of competence for Scotland is not straightforward, we will continue working closely with the Scottish Government in both finalising primary legislation and in framing further detail in secondary legislation, to deliver a coherent set of reforms and ensure a smooth transition to the new arrangements.

51. The Scottish Government will have a consultative role – set out in statute – in the design and delivery of the CfD and underlying Institutional Framework. DECC will continue to involve Scottish Government officials in ongoing policy development at working level on other aspects of EMR such as the Capacity Market and involve them in the FID Enabling process.

Wales

52. All of the policies in the EMR extend to Wales and energy policy is non-devolved in respect of Wales. Because the interface between reserved and devolved areas of competence for Wales is not straightforward, we will continue working closely with the Welsh Government in both finalising primary legislation and before setting out further detail in secondary legislation, to ensure a smooth transition to the new arrangements.

53. The approach agreed with the Welsh Government is that it will have a consultative role – set out in statute – in the design and delivery of the CfD and underlying Institutional Framework. DECC will continue to involve Welsh Government officials in ongoing policy development at working level on other aspects of EMR such as the Capacity Market and involve them in the FID Enabling process.

5. ADDRESSING POTENTIAL CONFLICTS OF INTEREST

54. There are many important and valuable synergies from the System Operator taking on the EMR delivery role. However, it is also possible that it could give rise to conflicts of interest with National Grid's existing roles in the electricity market, for example as owner of the transmission network in England and Wales, or its other commercial interests.

55. DECC and Ofgem are conducting a joint piece of work to assess the extent to which the System Operator performing the EMR delivery role creates new conflicts of interest and/or new synergies for National Grid from when National Grid formally takes on the delivery role. As part of this work we published an open letter on 8 March 2012 and held a stakeholder workshop on 27 March 2012. We are publishing a report¹⁰ on this project in parallel with this document that sets out the main conclusions and themes that were raised in response to the open letter and in the workshop. The Government is taking the conclusions of this process into account in the proposed legislation and its ongoing policy development and design work. As there needs to be further detail on the System Operator's EMR delivery functions before synergies and conflicts can be fully

¹⁰ Electricity Market Reform (EMR): Potential synergies and conflicts of interest: Outcome of the 27 March 2012 workshop and responses to the 8 March 2012 open letter
http://www.decc.gov.uk/en/content/cms/consultations/emr_coi/emr_coi.aspx

identified and appropriate mitigations designed, we will seek the views of stakeholders again before the end of the year.

56. We have designed the System Operator's delivery role in order to minimise the risk of conflicts of interest arising by:

- ensuring that the evidence and analysis that the System Operator provides to Government is transparent and open to rigorous scrutiny;
- limiting the discretion of the System Operator in delivering the mechanisms, with key decisions made by Government; and
- Ofgem continuing to regulate the System Operator, including ensuring that all network expenditure is economic and efficient.

57. The project is also considering synergies between the System Operator's new role and National Grid's other interests and activities in the energy market. As we set out in the Technical Update, these synergies were important considerations in identifying the System Operator as preferred EMR delivery body. For example its knowledge of the electricity system will be important in the analysis that will inform Government's decisions. We need to ensure that these synergies are maximised through this project, while also addressing any potential conflicts of interest.

58. We will ensure that where conflicts are identified, Government and Ofgem are able to take the necessary mitigating action. Potential mitigating action could include: the use of Ofgem's existing powers within the current regulatory framework; including specific steps or processes in the EMR delivery arrangements (e.g. increasing scrutiny of the System Operator's analysis and further limits on the discretion of the System Operator); and various forms of separation between National Grid's businesses.

59. Without pre-judging the result of this work, Government is seeking powers through the Energy Bill to ensure there is an adequate range of mitigating measures available, including those relating to business separation described above. While ownership unbundling remains an option for mitigation, DECC is of the view that there is not enough evidence at this stage to justify the granting of powers to impose such a measure, and so is not seeking such powers in the Second Session Energy Bill. However, DECC would be prepared to return to Parliament to seek the necessary powers if the need arises as a result of further analysis by DECC and Ofgem.

60. Any use of these powers will be subject to the findings of the Ofgem / DECC report, and would be implemented through secondary legislation. The inclusion of

these powers in the Bill does not pre-empt any decisions on whether there is a need to take any mitigating measures.

6. WHAT REMAINS TO BE DONE?

61. Further work is required over the coming months to continue to develop the detail of how the institutional framework will operate alongside the detailed design of the CfD and Capacity Market.
62. Throughout this process, Government will work with relevant stakeholders, including the System Operator and Ofgem, and in particular through the newly formed expert group on institutions, which includes a range of stakeholders from industry and consumer groups. We will also continue to work with the Devolved Administrations, particularly on their involvement in setting up the Panel of Technical Experts, framing the evidence needed from the System Operator, and on how the regulatory role will be extended to Northern Ireland.
63. We will publish further details on the process and milestones for the first delivery plan later in 2012, including the scope of the System Operator's analysis, the process Government, the System Operator and the Panel of Technical Experts will follow to produce the analysis to inform the delivery plan, and the makeup and role of the Panel of Technical Experts within the final decision-making process.