

Annex 1 - Purpose of Locational Signals

Purpose of Locational Signals

The purpose of locational signals in electricity markets is to incentivise efficient use of the network by market participants (both demand and generation). Locational signals do this by internalising the costs and benefits that market participants create for the electricity network into their investment and operational decisions.

This means that efficient locational signals should reflect the forward looking (or avoidable) costs or benefits that a market participant's actions are expected to create for the electricity network. This is because it is these forward-looking costs or benefits that can be influenced by market participants' use of the network, in particular the choice of location for investment.

For example, in general:

- generation investors should face higher expected costs if they connect to a part of the network which is further away from demand; and
- sources of demand should face higher expected costs if they locate further away from sources of generation.

However, it is also important that, in order to drive such efficient responses, the signal must be useful, i.e. investors must have an ability to respond to the signal, which among other things means it should be sufficiently predictable.