Giuseppina Squicciarini
Head of Regulatory Economics
Ofgem
9 Millbank
London
SW1P 3GE

Send to: so **incentives@ofgem.gov.uk**

21 September 2012

Dear Giuseppina

System Operator incentive schemes from 2013 initial proposals

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

The gas and electricity systems will be going through significant changes over the coming years as a result of the Electricity Market Reform and de-carbonisation of the electricity system as GB moves to a low carbon economy. Meeting these challenges will require the System Operators (SO) to play a key role in planning the development of systems which are robust, economically efficient and sustainable. Playing a full role will require the SO to take a long term approach and be innovative, even at times of uncertainty. To encourage this type of behaviour, the regulatory framework must be clear, transparent and stable. We have assessed Ofgem's initial proposals using these criteria.

The key points of our response are:

- We agree that modelling an appropriate electricity balancing incentive target has become more difficult as a result of the increasing level of constraint costs. However, significant investment is expected over the RIIO period to address these issues.
- We agree the Balancing Services Incentive Scheme (BSIS), the existing incentive model for electricity balancing costs, is complex, opaque and defective. However, the proposal to remove BSIS from April 2013 is challenging; to develop an effective alternative and a robust governance process around this will take some time.
- We believe there is a need to review critically whether a modified version of the existing incentive model will be fit-for-purpose in the long term. We welcome Ofgem's planned internal review to understand better why the improvements to the methodology and models underpinning the incentive scheme have not worked as expected.
- Conceptually, we see merits in a discretionary reward scheme and welcome further consultation to better understand how it might work in practice. As it stands, the proposed regulatory framework for the replacement scheme is not clear or transparent.

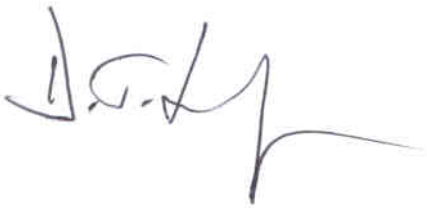
- Any future scheme must be designed in a way that allows lessons to be learned from previous years' challenges and successes, so that improvements can be made for the future rather than changes being made retrospectively.
- Overall, we wish to see an effective incentive on NGET to minimise costs when taking actions to balance the system. We and our customers have exposure to these costs and consider that the proposed way forward requires further debate to ensure that the replacement scheme will provide value for money for consumers.

As it stands, the proposed regulatory framework for the discretionary rewards scheme lacks the necessary clarity and transparency. Its stability will depend on the processes underlying it and the likelihood of potential challenges and appeals NGET might raise to Ofgem decisions and their consequences, e.g. retrospective changes to charges. There are many operational and practical issues to be resolved before any such replacement scheme can be adopted. Instead of removing the financial incentives from April 2013, we suggest that BSIS is retained for the next year until its fit-for-purpose review is completed. We would prefer to have some type of financial scheme in place rather than no financial scheme at all. In parallel, we could work towards developing a robust replacement scheme.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 07875 115499, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,



Denis Linford
Corporate Policy and Regulation Director

Attachment

System Operator incentive schemes from 2013 initial proposals

EDF Energy's response to your questions

SECTION: Four

Question 1: In respect of transmission losses, do you agree with our proposal to put in place a reputational incentive and to remove the current financial incentive?

Yes. We agree with Ofgem's proposal to remove the current financial incentive and replace it with a reputational incentive proposed under RIIO-T1.

As Ofgem highlights, the changing mix of plant types on the GB system will make it increasingly difficult to forecast or control the level of losses. As intermittent renewable generation in the north increases it would not be beneficial to constrain this off to replace with potentially more expensive southerly located thermal plants just to meet this target.

Equally, we do not see any material benefit in creating a complex model to measure transmission losses performance. The proposal of a strategy report assessed annually and additional information on the overall losses, coupled with an explanation of the key drivers of the level of losses, seem more appropriate.

Question 2: Please provide your comments in respect of our proposals for an incentive on renewable forecasting. In particular:

a. Do you agree that an incentive is appropriate?

Yes. We support Ofgem's proposal for an incentive on renewable forecasting. Accurate forecasts at the day ahead and within day stages may help the market to self dispatch plant to ensure that demand is met. Additionally, a more reliable forecast should enable NGET to minimise the costs of operating reserve.

We also note that there may be benefits of this forecast for the operation of the gas system as CCGTs are likely to be affected in future by the level of wind expected across the system.

b. Which renewable output forecast would you like to be incentivised (5pm, 5am, 11am or 11pm)?

We have no firm views.

c. Do you have a view on which error measure should be incentivised and whether the monthly target should be set on an annual or a seasonal basis?

We do not have a firm view on the error measure but believe that NGET should be incentivised on a seasonal basis, to avoid monthly fluctuations.

d. Do you agree with the proposed cap, floor and range of the incentive?

We have no firm views.

e. Do you agree that the incentive should initially be set for 2 years?

Yes. Given that this will be a new scheme, we agree that it would be appropriate for the scheme parameters to be set initially only for a two year period.

Question 3: In respect of the incentive on energy balancing and constraint costs, do you agree that direct financial incentive should be removed?

BSIS is complex, opaque and deficient. Without doubt, there is a need to critically review whether it is fit-for-purpose for the new environment.

We understood from NGET that the vast majority of the errors were caused by input data rather than the model itself and that their proposed methodology amendments (which were recently accepted by Ofgem) addressed them. We are still uncertain whether the model is now capable of operating effectively within the changing nature of the market and whether it has any longevity. However, we are surprised by Ofgem's proposal to effectively suspend BSIS from April 2013, with little published analysis to support this position. At the very least we would like to understand Ofgem's timescale of its intended review and a view of when the model could be resurrected, if at all.

Ofgem proposes to introduce a discretionary reward scheme under which NGET will be able to earn significant rewards if it takes actions well beyond business as usual (BAU) which lead to clear and quantifiable benefit to customers. We understand that the reward would be paid on an ex post basis – the SO would have to demonstrate both that it has implemented actions that meet the reward scheme criteria and that the actions have delivered measurable net benefits for consumers. In principle, we see benefits in this approach but would like to better understand how this scheme might work in practice, including its likely impact on NGET's process for signing off investment cases. For example, we suspect NGET would need to know in advance how long an innovative solution will be considered innovative before it becomes BAU.

We understand that Ofgem intends to issue another consultation in October 2012 to further explore the discretionary reward scheme; we welcome this. Our immediate concern with removing BSIS from April 2013 is one of timing. A robust governance process must be in place before the replacement scheme can be implemented and this will

take some time to develop. Similarly, to enable Ofgem to scrutinise NGET's balancing costs, some sort of model to (i) provide a baseline against which costs can be determined as efficient and (ii) value of investment decisions / innovative actions would be needed. The development of this model and supporting guidance will also take time to develop.

As it stands, the proposed regulatory framework for the discretionary rewards scheme lacks the necessary clarity and transparency. Its stability will depend on the process underlying it and the likelihood of potential challenges and appeals NGET might raise to Ofgem decisions and their consequences e.g. retrospective changes to charges. There are many operational and practical issues to be resolved before any such replacement scheme can be adopted. Therefore, instead of removing the financial incentives from April 2013, we suggest that BSIS is retained for the next year until its fit-for-purpose review is completed. We would prefer to have some type of financial scheme in place rather than no financial scheme at all. In parallel, we could work towards developing a robust replacement scheme.

Question 4: Do you agree that we should put in place a licence condition to enable us to disallow costs incurred by NGET if they are uneconomic or inefficient?

Without prejudice to our response to question 3, we agree with the principle of disallowing costs incurred by NGET where their behaviour can be proved to be inefficient. However, we note that this again relies on setting a benchmark which could turn out to be incorrect and possibly subject to revision.

Question 5: Please provide you comments in respect or our proposals for a discretionary reward mechanism. In particular:

a. Do you consider that the proposed process for agreeing to a reward is appropriate?

See response to question 3.

b. Who should be the members of the panel that decides upon reward requests?

This is a detailed governance issue which could be further explored in the October consultation/ workshop but it will require people with sufficient expertise in this area.

c. Is the size of the potential reward appropriate?

We have no firm views.

d. Are the examples of behaviours that might lead to a reward being made appropriate?

We have no firm views although the examples appear sensible.

Question 6: Do you consider that a cost incentive on black start should be retained? Do you consider that the proposed parameters for a black start scheme are appropriate?

No, we do not consider that a specific cost incentive on black start is necessary. With black start, the location of the power station plays a crucial role in determining its need. For example, if there is a need for black start capability in a specific region, there are currently very limited service providers who could offer the necessary services. Given that there is an inherent lack of competition in the black start market, there seems little need to allow NGET to challenge the black start cost target. Under the circumstances, it also seems more sensible to retain the current bilateral arrangement, instead of setting up an organised market.

We favour a more global incentive scheme, such as the BSIS, because this allows NGET to have more opportunities to decrease the overall cost of balancing and managing the system.

We finally have some concerns about Ofgem's proposal regarding the interaction between the black start and the STOR markets. Black start units have the opportunity to tender lower in the STOR market than the other units, which leads to a lower overall cost in the STOR market. If Ofgem decides to penalise NGET on the fact that black start units should not also have a STOR availability payment, this would probably increase the overall cost of STOR.

Question 7: What are your views on NGET's proposals for commercial contracts with non-NGET TOs to incentivise them in respect of constraint costs caused by changes to their output plans?

We agree with NGET's proposals for commercial contracts with non-NGET TOs to incentivise them in respect of constraint costs caused by changes to their output plans. However, we would go further and suggest that the agreement should extend to actions beyond planned outages. For example, if through poor management by a TO, an event happens that causes disruption, then the TO should be incentivised to minimise these events.

We have noticed that the approach to system maintenance and planning practices varies considerably between TOs and see quantifiable benefits arising from NGET's proposals.

SECTION: Five

Question 8: In respect of an incentive on greenhouse gas emissions, is your preference for Option 1 (penalty only) or Option 2 (upside and downside payment) and why?

As we have noted in previous consultation responses, National Grid has ambitious corporate targets for its carbon footprint that its shareholders have signed onto and so arguably expect to fund. We therefore support Ofgem's minded to position to introduce a penalty only scheme.

Question 9: Please provide your comments in respect of our proposals for a residual balancing incentive. In particular, do you agree that by fixing the targets for the eight year period this will provide NGG with an incentive continuously to improve its performance in this area?

The benefit of setting an eight year incentive is that it provides certainty to National Grid, and so supports any investment opportunities that National Grid may identify which have a longer pay back period. Conversely, there is also a danger than an eight year target will be set too leniently representing a cost to consumers, or too harshly, reducing the incentive on National Grid to improve performance. However, given that experience of this incentive regime has been developed over several years we would support the introduction of an eight year scheme.

Question 10: Do you agree that we should continue to put in place a reputational incentive on NGG in respect of investigating the drivers of UAG? Do you support the proposed industry workgroup to assist the investigation of the drivers of UAG?

We recognise that it may not be appropriate to place a financial incentive on National Grid for UAG as generally this has been caused by errors on meters that National Grid does not own or is responsible for. At the same time we are also aware that National Grid is the contractual counterparty for all of these meters, either through the UNC or the specific entry or exit agreements that it has signed. As such we support the introduction of a reputational incentive on National Grid to investigate and identify the drivers for UAG. However clear and transparent reporting is required to ensure that this incentive is effective.

We therefore support the industry workgroup and believe that, in addition to the roles identified, National Grid should work with this group to identify what reporting parameters would be useful to help inform the industry of performance in this area. These reports should be made publicly available on National Grid's website and should be presented to the Transmission Workgroup, NTS TCMF and Offtake Workgroup. This will help to ensure that the reputational incentive is effective by demonstrating good or poor performance in this area by National Grid.

Question 11: Please provide your comments in respect of our proposals for demand forecasting incentives. In particular:

a. Do you agree that by fixing the targets for the eight year period in respect of the D-1 forecast this will provide an NGG with an incentive continuously to improve its performance in this area?

As previously noted there are advantages and disadvantages with setting an eight year incentive scheme. However, given the lengthy experience of this incentive target we believe that an eight year scheme is appropriate.

b. Do you agree with our proposal to amend the calculation of the error target, including increasing the weighting for days of higher demand?

Given the correlation between demand and prices, and the impact that National Grid's forecasts can have on this we believe that this is appropriate.

c. Do you agree with our proposals for the D-5 to D-2 forecast incentive?

These appear appropriate.

d. Do you agree that the improvement in the NDM forecast should be taken forward by the DNs?

Although we agree that the NGM forecast is predominantly a GDN issue, we note that National Grid has significant experience in this area. In deed National Grid NTS is a named member of the Demand Estimation Sub-Committee (DESC) whose remit is the NDM forecast. It would therefore appear appropriate to expose National Grid in an incentive in this area to encourage engagement and improved performance of these forecasts. If it is not appropriate that National Grid be incentivised in this area, then we would question why they are involved in DESC as a voting member.

Question 12: Do you consider that our proposals in respect of maintenance could address the concerns that you have in respect of NGG's behaviour in this area? Are our proposals appropriate and likely to be effective?

We are aware of industry concerns in this area, and believe that Ofgem's proposals should address these concerns.

Question 13: In respect of Operating Margins, do you agree with our proposal to put in place a reputational incentive and to remove the current cost incentive?

As previously noted a reputation incentive will need to be combined with clear and transparent reporting guidelines to ensure that this has the desired effect.

Question 14: Please provide your comments in respect of our proposals for a shrinkage incentive, in particular:

a. Do you agree that it is appropriate for NGG to have in place a volume methodology statement?

This appears appropriate.

b. Do you agree that the proposed changes to the reference prices are appropriate?

This appears appropriate.

c. Do you agree with the proposed sharing factor? Do you agree with increasing the cap and floor of the incentive?

This appears appropriate.

SECTION: Six

Question 15: Do you agree with our proposals for uncertainty mechanisms and on not including a risk premium?

EDF Energy supports Ofgem's proposals for uncertainty mechanisms and to not include a risk premium. In particular we note that the incentive regime should be designed to encourage appropriate actions and performance from National Grid, and as such should not be viewed as an additional income stream to supplement their business as usual processes.

EDF Energy
September 2012