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Dear David

POLICY DIRECTION FOR THE FUTURE SYSTEM OPERATOR REGULATORY FRAMEWORKS

We are pleased to have the opportunity to respond to this consultation. This response is on behalf of ScottishPower and reflects the views of our renewable generation and energy supply businesses. Our networks business, ScottishPower Energy Networks (SPEN), is responding separately from its perspective as a networks licensee.

Our answers to the consultation questions are in Annex 1 attached. Our main observation is to highlight the need for consumers to have some basic safeguards against significant cost increases by the FSO. As a minimum we suggest these should include:

- automatic Ofgem *ex ante* reviews where propose FSO expenditure exceeds prescribed year on year thresholds with the ability for Ofgem to reduce forecast expenditure accordingly;
- automatic Ofgem *ex post* reviews of FSO actual costs where outturn costs breach prescribed thresholds, poor cost performance could feed into the reputational incentive;
- a smoothing mechanism where an increase in FSO charges over a prescribed threshold is recovered over more than one year to mitigate the impact on consumers.

If you have any questions regarding this response, please don't hesitate to contact me or my colleague Haren Thillainathan (hthillainathan@scottishpower.com).

Yours sincerely,

Richard Sweet

Richard Sweet
Director of Regulatory Policy

Annex 1

CONSULTATION ON POLICY DIRECTION FOR THE FUTURE SYSTEM OPERATOR – SCOTTISHPOWER RESPONSE

Q1. Do you have any views on our proposed financial regulatory framework for the FSO?

The proposed approach to the FSO's financial regulatory framework is set out in para 2.6 of the consultation, in the context of the FSO being a government owned not-for-profit organisation namely:

- The Government as shareholder would not be subject to any enduring return or downside loss including from incentives, disallowance, enforcement penalties or damages imposed from third parties.
- The FSO would be funded by consumers through a 100% fast money allowance allowing the FSO to recover its full forecast expenditure for the year including capital expenditure with no amortisation, there would also be true ups for any divergence between actual expenditure and industry charges.
- The government would help the FSO manage cash flows where expenditure is required ahead of its recovery.
- The FSO would not be allowed to borrow from the private sector and therefore would not require a credit rating.
- There would be no organisational incentives..
- Financial regulation of the FSO including reporting would be based on actual cost instead of the notional company approach used for the electricity system operator.

We broadly agree with the above approach being appropriate for a government owned not-for-profit FSO which has a key objective to create longer term value for consumers. That said, we think it is important to have some safeguards on the financial impacts that consumers could be exposed to under a fast money funding model, regulated solely through reputational incentives. As a minimum we suggest these should include:

- An *ex ante* assessment by Ofgem where any proposed annual expenditure exceeds a prescribed threshold, eg >20% increase on the previous year. The objective of the review would be to establish if the proposed expenditure increase is justified and if not make reductions accordingly. This appears to align with Ofgem's proposed role to continue to verify value for money in the FSO's plans (para 3.22).

- An *ex post* review by Ofgem of the FSO's actual costs where they have exceeded a prescribed threshold in relation to the forecast expenditure for that year, eg 20% above forecast. The objective would be to determine if the increase was efficient and justified; where Ofgem found this was not the case and ordinarily would have disallowed the expenditure, this could instead feed into the reputational performance incentives. This appears to align with Ofgem's proposed continued role in assessment of cost performance.

- A smoothing mechanism whereby increases in FSO charges over a certain threshold due to forecast expenditure or actual costs, are recovered over a number of years to mitigate the impact of any big cost increases on consumers, even if justified. This could be facilitated by the planned government help with managing cash flows.

Q2. Do you have any views on our emerging thinking on how we should regulate the FSO, including our objectives, the case for change, and potential future options?

The key elements the potential regulation of the FSO as set out in chapter 3 are:

- The application of robust reputational incentives through an annual public assessment of the FSO's performance by Ofgem; but moving towards a higher-level assessment approach which is less focussed on detailed outputs.
- Streamlined FSO business plans which are focussed on key priorities and major deliverables, and which are produced annually.
- High-level licence requirements on the FSO to account for Ofgem performance assessment outcomes (and any instances of licence non-compliance) to be reflected in senior staff remuneration decisions.
- An approach to licence enforcement, which creates strong incentives on FSO senior managers through robust reputational consequences and formal recommendations to the shareholder.
- An important continued role for Ofgem in approving and challenging the FSO on its spending and its delivery of value for money.

We broadly agree with the above proposed regulatory framework. We support the primary reputational incentive being an annual public assessment of performance by Ofgem. Within such an assessment we are pleased to see Ofgem's continued role assessing value for money in the FSO's business plans and cost performance; we have commented on these aspects in our response to Q1. It is important that Ofgem's annual assessment is transparent for every area of FSO performance being assessed to ensure the reputational incentive is as sharp as possible across the FSO as an organisation.

We support the principle of linking the assessment outcomes and licence enforcement to remuneration and staff decisions for the FSO senior management. In paragraph 3.30 we note Ofgem is considering extending the current fit and proper persons test under the supply licence to other licence holders including the FSO. While we can see extending such fit and proper persons requirements to the FSO would support the proposed regulatory framework, we don't believe there is any justification for including other non-supply licence holders.

Finally, we would support (as noted in para 3.35), Ofgem exploring ways for its cost regulation and assessment to inform recommendations for further public scrutiny of FSO performance. In this context we think relevant departmental/subject parliamentary select committees could have a suitable incentive effect on the FSO senior management if they were able to pick up on assessments of FSO poor performance by Ofgem. Though Ofgem notes as a public body the FSO could be scrutinised for delivery of value for money by the National Audit Office and Public Accounts Committee, these bodies have finite resources and are unlikely to be able to scrutinise the FSO on more than an occasional basis.

Q3. What role should industry stakeholders and external parties have in holding the FSO to account, and what platforms are needed to achieve this?

We believe external stakeholders including industry participants should have the ability to scrutinise FSO performance if the proposed reputational incentives are to be fully effective. At this stage we don't have views on which platforms or routes to scrutiny are most effective. We believe the important consideration here is to ensure Ofgem develops its annual performance assessment to cover financial and output performance metrics that are valued and accessible to industry and other stakeholders. It is then equally important that the FSO provides clear and accessible performance data that aligns with Ofgem's assessment framework.

Q4. Do you have any views on our approach to implementing changes?

We agree with Ofgem's proposed phased approach to implementation, prioritising the most critical aspects of regulation that are needed to ensure the FSO can effectively operate. We would expect the priorities in the first phase to include regulation of inherited established roles from the ESO, eg system operation, but the first phase should also capture roles and activities required to be in place within the next 2-3 years, eg Central Strategic Network Planning and Spatial Energy Planning, so as not to hold back their implementation.

ScottishPower
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