SO incentives – 2006-07

A review of SO incentives for 2007-08 is to be initiated in the Autumn. Ofgem in its open letter of 5 July has sought views on the broad options and approach it should pursue.

This covering letter makes some more general remarks on three fundamental issues relevent to electricity incentive arrangements:

- asymmetrical parameters of risk and reward seen by the SO to date;
- the need for significantly enhanced information disclosure in this area, including the development of timely, reports on performance to the wider market;
- wider institutional matters that should be considered in determining the risk characteristics of the SO, the wider regulatory context and future incentive options.

Answers to specific questions posed in appendix A to the Ofgem letter on electricity matters are attached.

Normalising performance and reward

The experience of the SO incentives regime in the UK has been to date been based on a fundamental paradox:

- annually National Grid has been set targets against which – with the notable exception of 2005-06 – it has ostensibly performed well;
- over a period of years aggregate balancing costs/ delivered MWh have not discernibly decreased and certainly not commensurate with the actual level of efficiencies "achieved";
- consequently, while until 2005-06 NG paints a very rosy picture of performance year on year, the real value of its performance and the efficiencies has been captured by the company through payouts under the incentive scheme, not by consumers; and
- in the first five years since Neta go-live these payments exceeded well in excess of £100mn, which is hugely disproportionate for a business that has assets significantly less than that amount, even though incentivised balancing costs in absolute terms even before change of the baseline with implementation of Betta have increased.

In this context it should be remembered that NG already enjoys a "reasonable" profit element under its revenue allowance for the SO activity under its conventional price control, which is set independently of incentive scheme payouts.

A further contradiction is that:

- NG performance has been attributable in large measure to beating cost targets based in large part on its own forecasts, and out-performance seems to have occurred from windfall events rather than its own documented actions; and

- at the same time the company has sought income adjusting events in circumstances where elements of the outturn have varied adversely relative to its own expectation even though counter-balancing factors have still resulted in significant incentive scheme payouts in most years.

Admittedly since the early years of Neta, when NG earned excessive annual profits of £40mn and £48mn respectively, payouts have diminished. But the have still been at levels that are very generous compared to those available to system operators internationally – especially as the company is already earning a return under its SO price control.

There are four simple ways this asymmetry can be addressed by Ofgem even within the confines of existing strutures:

- capping the payout to National Grid so that it represents a much more reasonable level of return, and basing it relative to the assets associated with the business and the business risk it faces (in this context the system operation activity is the epitome of a natural monopoly);

- achieving the same effect by skewing the sharing factors so that users and consumers receive a greater share of the benefits being shared in any one year;

- setting much less prudent targets (which admittedly is difficult given the information asymmetry enjoyed by NG over Ofgem); and

- establishing a clawback mechanism where performance that is attributable to factors outside of the control of the company (which can be likened to a negative income adjusting event) can be isolated from the profit mechanism.

Experience from 2005-06 when NG was exposed for the first time to a loss does not in any way invalidate these comments. The migration to Betta in April 2005 increased costs and raised a number of uncertainties which, combined with the coincident inversion of coal and gas prices and with the unsatisfactory way constraints are compensated through the energy market but paid for through BSUoS, have created a one off situation in which NG – for the first time in six years – has not received a payout. On the contrary there is every prospect that given the abnormally high baseline in expectations that has been set based on 2005-06, combined with the absence of any real commercial incentive to reduce costs for 2006-07, grid users and therefore customers will see a reversion to double digit payouts because of uncertainty over what constitutes a real baseline.

These comments do not necessarily mean that UK-style approaches to SO incentive setting are wrong, just that the way the mechanisms have been applied has produced exaggerated and asymmetrical benefits to the company. It is clear that the current mechanism is uni-dimensional and requires refinement and targeting. Given Ofgem's desire for a one year arrangement, the time is opportune to refine the current thinking.

In doing this we consider there to be obvious areas within the mechanics of the current approach that should be addressed, including:

- much of the variability in the current arrangements seems to flow from external factors such as wider energy and commodity price movements, with many key developments occurring over 12 months after initial forecasts were set. This points to a need for within-year indexation of key external drivers (most obviously with regard to the need for a dynamic reference price for transmission losses and other external price assumptions);

- a single target provides too much diversity benefit for the company and does not facilitate detailed targeting or reporting of performance. Some degree of unbundling is important (and is essential for transmission constraints), but the question is how much.

Combined with the more robust approach to setting the scheme parameters outlined above, these structural changes should go a long-way towards aligning performance and profit to more appropriate levels. Their implementation is essential before any longer-term, multi-year arrangement – which remains a legitimate medium-term objective – should be contemplated.

Enhancing information disclosure

A related matter is that the root cause of much of this misalignment seems to be the availability of continuous, consistent information from the company to the regulator, and the reliance on the company for technical analysis. Gaining a coherent up-to-date view of the SO function in Britain and its operation is simply not possible other than at the highest level (e.g. year on year changes in balancing cost and outturn scheme performance) and after beyond the point at which such information is useful. This position is best illustrated by the disclosure under the incentive scheme itself, where information on NG's performance is made available largely at NG's discretion, and which is usually anecdotal and lacks analytical rigour.

It was, for instance, only with regard to target setting in 2005-06 that information based on the BSIS model was made publicly available, and even then it was very limited. There is no structured, routine or prescribed *performance reporting* to the market, and the BM audit is held as confidential by the company with no attempt made to provide highlights to the market. Details of quantities and amounts paid have their use in terms of understanding procurement trends, but qualitative comment is almost wholly absent. Fundamentally there is no understanding in the market of why particular decisions are made and the trade offs between the many choices available to the system operator at any particular point in time.

This position is in stark contrast to the performance reporting of the central energy settlements processes and other market agents acting on behalf of market participants, which is carried out on a much more comprehensive basis and against explicit service lines and performance measures. It is to be acknowledged that NG has improved some reporting on monthly balancing service performance and operational data after the event. But these improvements should not obscure the reality that there remains a veil between NG and its operational performance that inhibits user and customer understanding.

The development of agreed performance measures to routinely track information is therefore essential if meaningful trends in cost drivers and performance are to be established. In this context it is noticeable that no serious benchmarking is carried out or seems to be contemplated in this area, which is in significant contrast to work on the transmission ownership activity and other monopoly functions within the electricity supply chain where information and incentive schemes abound.

It may be that the needs of the current 2006-07 arrangement with no scheme in place is enabling a much clearer definition by Ofgem of the information it needs to identify cost drivers and validate its judgements. Emphasis should be placed on developing such a reporting framework, which should remain in place even though "business as usual" is likely to be restored from April next year with implementation of a new scheme.

Attention should also be directed by Ofgem at identifying what elements of this information should be made available to the wider market to supplement the useful but essentially limited information made available by NG. Transparency of operations would also be significantly enhanced by routine reporting to grid users through a standing item at NG's Operational Forum supported by a right for participants to ask questions - and of course have them answered.

Institutional framework

The concept of regulatory separation of the SO activity in the UK has developed organically over a period of ten years. It started with uplift schemes in the late 1990s, through regulatory separation in 2001 to formal legal separation at least in

Scotland from April 2005. While the establishment of a separate regulatory price control for SO costs in England and Wales in 2001 was a watershed, it does not appear to have resulted in a clean separation of costs and cost allocations to the SO activity with costs identified largely on an incremental basis. Taken in the round the consequence of these changes is that we have a hybrid arrangement for organising and regulating system operations. In Scotland there is complete separation between transmission owners and the system operator, but an integrated system south of the border.

At the very least there needs to be clearer functional separation between SO and TO functions in England and Wales. This of itself is a critical step to enabling greater transparency, including frequency and granularity of information disclosure of financial and operational performance.

In some developed electricity markets the concept of an independent SO entrenched in some instances contractually has been implemented. These types of arrangements have tended to evolve much more complex accountabilities than a single performance target, and various indicators can be used for evaluating and rewarding performance. There are no absolute “right” models or indeed any agreement between commentators on “best” practice, but there is much greater diversity in practice than the approach to the GBSO would suggest. A discernible theme in some markets, especially in North America and also in Australasia, is increasing focus on measuring performance and reporting it to stakeholders, and Ofgem should analyse practice in this area.

Ofgem should also use this opportunity to consider how good regulatory practice has evolved in other jurisdictions and assess whether there are any lessons to be learned. In doing this it is salutary to remember that when the GBSO appointment was initially made by Ministers it was done on the basis that the role was contestable.

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SO Issues – Annex A questions

1. Is the form and scope of the previous incentive scheme still appropriate?

Yes, though there is a case for setting discrete sub targets and caps to ensure a better correlation between performance and payment. An unbundled approach should also enable reporting and understanding.

2. Are there ways in which the process of setting incentive scheme proposals could be improved?

There is an evident informational asymmetry enjoyed by NG. Despite this, there is a reluctance by NG to release information especially within year and especially on its own performance against the target. There should be routine reporting on performance against IBC within year both in the form of monthly reports and through the Operations Forum.

3. Has there been a permanent change in the distribution of BM costs or is the apparent change in 2005-06 likely to have been due to one-off factors?

It is clear that the system is becoming increasingly constrained as a result of levels of connection in remote areas, especially in the North of Scotland. Over winter 2005-06 the associated costs seem to have been exacerbated by the switch between coal to gas plant for peaking/balancing purposes. The sharp incentives for participants created by stress on the gas system and record gas prices in November and March also created unprecedented shocks and disturbance on the electricity system. Some of these factors caused learning effects, but in some cases (e.g. constraints) it is likely that costs could well remain above historic levels.

As an initial step Ofgem should define the cost drivers and their sensitivity to change. A further step should then be to reach a view on what elements of costs are controllable and within the scope of management actions.

4. Is a bundled incentive scheme still appropriate, or would there be merit in separating constraint costs into a separate incentive?

We think there is a very strong case for unbundling the incentive scheme, and that constraints should form one of the sub components. The interaction between the different discrete cost elements also needs to be better understood.

5. What prospects are there for reducing ancillary services costs?

In general increased contestability and product diversification and refinement (e.g. the new STOR product) should lead to cost reductions. Competition will work, though, only where there is real contestability, and introducing it for the sake of it (e.g. frequency response) can lead to costs being higher than they should be to the customer's detriment.

6. Has there been any underlying trends in NGET's procurement of ancillary services that merit consideration?

At least two specific matters require consideration:

- the interaction between use of ancillary contracts, BM call-offs and energy purchases, together with NG's criteria for selection; and

- the increasing tendency towards locational purchases should be examined, together with the information benefits enjoyed by NG's counter-parties in such circumstances.

7. Is a transmission losses incentive appropriate?

Yes. NG's decisions have a direct bearing on the volume of losses on the system, and there should be an incentive to reduce them. Arguably NG has a much stronger degree of control over this than any other party or group of parties, and the incentive could be strengthened rather than through adoption of spatially differentiated loss charging through the energy market (e.g. P198). However, a dynamic reference price is essential if this arrangement is to create clean incentives.

8. Should a dynamic reference price be used?

Yes. See above.

9. Does industry believe any price uncertainty should be reflected in the 2007-08 incentive scheme?

Yes. Movements in power prices can have a direct bearing on the outturn, though not necessarily for all elements of IBC.

10. Would price indexation be a desirable mechanism to manage these risks, if so can different options for price indexation be identified?

Probably. This is a complex matter that requires further investigation. Different indices should be examined to ensure they cause minimum dilution to management incentives to pursue efficiencies.

11. What is the potential impact on NGET's incentives and risks to customers?

A significant element of windfall risk would be removed. Empirically, in a market that rises much more strongly than assumed in forecast, this would seem to provide insurance to the company; in the case of a sharp unexpected fall in the market, the protection would be enjoyed more by customers.