Ofgem Consultation
System Operator incentive schemes from 2013: principles and policy
AEP[1] Comments

The Association welcomes the opportunity to respond to this consultation.

On a general issue arising from RIIO-T1 where greater levels of investment are anticipated in networks, both electricity and gas, we have concerns over the forecasting or predictability of future transmission charges. We appreciate that costs will be driven by investment which will be uncertain but consider that the provision of more accurate information to support charging forecasts will be important, especially as these costs are ultimately reflected in wholesale and retail prices. Whilst we are not suggesting a specific incentive, appropriate information provision should be ensured and deviations between forecast and actual charges monitored and reported.

Please see below for comments on the specific questions in the consultation document.

CHAPTER: Two – Playing a full role
Question 1: Do you consider that we have captured the full role of the SOs going forward?

Yes, we agree the SOs have a growing and important role going forward and should take a holistic view of issues. In particular, as wind represents a growing fraction of generation capacity innovative solutions and interactions with the TO will be important in minimising overall costs.

Question 2: Do you consider that our minded to position on the length of the regulatory framework is appropriate?

We agree there is some logic in setting the incentive framework duration to coincide with the length of the price control. Longer duration schemes are more likely to work well where the uncertainties are understood and can be modelled or where investment is required to deliver enhanced performance but is not sufficiently remunerated by short duration schemes.

[1]The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for more than 95 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable energies.

However given the challenges both SOs will face as the decarbonisation agenda progresses we welcome Ofgem's recognition that the incentives scheme length will need to be considered carefully for each output and cost incentive scheme taking account of modelling data certainty, predictability of costs and risk. In addition it is important for there to be a mechanism to review targets or the methodology for setting such targets where actual outturns show large variances from the targets that are not clearly linked to NG actions. Transparency will be important here.

Question 3: Do you consider that our proposals regarding SO-TO interactions provide the SOs with sufficient incentive to consider interactions with the TO in a longer term context?

In gas where the TO and SO are under common ownership, we would expect this to be fairly straightforward, however there are likely to be tensions between the SO which is more customer facing and the TO as asset owner. From a stakeholder perspective transparency in decisions over any trade-offs will be important to provide confidence.

In electricity, where the TO and SO is not entirely under common ownership the relationship will be more complex. It will be important to ensure that costs are not simply passed between SO or TO for no overall benefit. Similarly costs should not be passed to specific generators if it is more efficient for the SO to manage from a whole system perspective.

As regarding interactions between electricity and gas SOs we note there is a very brief mention of this at the end of chapter 2. Our current understanding is that under normal operating conditions the SOs are not allowed to exchange commercial information. Therefore we find it difficult to understand how, in respect of short term decisions; the SOs would be able to demonstrate that they are taking account of interactions between the networks.

We consider there may be efficiency benefits to both networks from some sharing of operational information, possibly beyond that which is publicly available, but this must come with safeguards in respect of commercial information and commercial impacts, to ensure end consumers of one fuel are not burdened with the costs for a benefit that is received in the other fuel. The opportunity for NG, as gas and electricity SO, to engage in gaming between their incentive schemes must be prevented.

However we think this merits further exploration and would be interested to understand how Ofgem expects the SOs to demonstrate they are considering the interactions, some examples may be helpful.

CHAPTER: Three – Outputs and output incentives

Question 4: Do you agree with our minded to position on SO outputs and the interactions with SO and TO outputs?

We believe this question relates to tables 3.1 and 3.2, see comments below:

We note that the majority of electricity schemes are to be reputational so timely and accurate reporting will be important.

Gas environmental impact – see question 7

Gas connections – We are not entirely clear what this is looking to incentivise, the preparation of a connection offer or the delivery of the actual physical connection or both? We do recognise the need for the SO and TO to work together to deliver the end to end connections process for connectees and that in the future there could be scope for efficiencies in these processes, but we feel this is more of a TO than an SO activity. If UNC Modification 373 is implemented we are not convinced an incentive is necessary for the delivery of a connection offer as the modification defines the timescales for the connection offer to be provided. Once these timescales are determined developers will be able to build them into their project plans. If NGG does not deliver connection offers in the defined timescales then it will be in breach of the Code. However there may be scope for a penalty only incentive since late delivery of connection offers may have wider impacts on developer's projects.

Unaccounted for gas – remains an area of concern and creates costs for customers. We acknowledge that the sources of UAG have been challenging to identify and accept that a reputational incentive is most appropriate at this time. Clearly reporting to Ofgem and industry will be important to ensure that NGG continues giving this issue due attention.

Demand forecasts – we believe there could be merits in there being tighter targets in the winter months when errors are more costly for suppliers.

Question 5: Do you agree with our minded to position on the period for which the various outputs and associated incentives will be fixed?

See response to question 2

Question 6: Do you agree with our views on incentivising SO outputs?

Broadly yes, although there are a number of areas where proposals are yet to be worked up and we are disappointed not to see any form of incentive relating to gas maintenance planning.

We also note the importance of reporting on the delivery of outputs whether financial or reputational incentives are set.

Question 7: What areas, in addition to DSR, should a broad environmental output cover? What is your view on having a financial (rather than a reputational) incentive on NGET and/or NGG as SOs to encourage them to deliver against a broad environmental output?

With respect to gas, we note that there is to be a reputational incentive for broad environmental outputs, but that a financial incentive is being considered for venting. Such an incentive has been in place for a few years but there have been difficulties in setting the target appropriately and the target has in the past had to be adjusted to account for errors in its determination. We are not convinced that a specific SO incentive for venting is appropriate, since NG as a responsible corporate entity is committed to reducing its emissions[2] such that financial incentives in this area should not be necessary, and reputation incentives sufficient. This is particularly the case since methane is more damaging than carbon dioxide by a factor of 60 in the short term, so that NG should already be focussing on such emissions.

Question 8: What is your view on having a financial output incentive on the accuracy of NGET‟s forecast of wind generation and the timeliness and availability of that information on its website?

Given the growing role of wind generation on the system there could be merits in such a forecast although the benefits through improvements in self balancing may be limited if only a single national forecast is provided. We also note that NGET is already incentivised in this area, albeit indirectly, through the balancing cost incentive and that it is seeking SO internal cost funding in this area. So we have some concerns over double incentives and await some more detail on the proposals.

Question 9: What is your view on introducing an incentive based on the total cost of NGG‟s balancing actions? Should such a total cost incentive replace or be in addition to current incentives for NGG to minimise the impact of its balancing actions?

The Association recognises the importance of appropriate incentives in this area since NGGs balancing actions can influence short term market prices, hence any changes need careful consideration. However the current incentive seems to have worked reasonably well in recent years and the financial sums involved are not large, we do not feel there is a compelling reason to change the incentive structure.

[2] http://www.nationalgrid.com/corporate/Our+Responsibility/2010_11CRReport/

However if an incentive to minimise the costs of NGG's balancing actions were to be developed we believe it may have the potential to replace both the current incentives. Indeed one incentive may be preferable to there being two or even three incentives trying to influence this area of activity. Minimising the balancing costs would incentivise minimal actions in terms of volume and at prices close to market, it may also reduce actions taken purely to manage the linepack position to within the limits defined in the current linepack incentive. Consideration would need to be given as to whether and how balancing services that might be procured outside of the OCM could be incorporated, how revenues from system sell actions are handled and how gas price movements could be taken account of. However as the incentives are not yet scoped out it is difficult to comment further at this time.

Given this would be a new incentive structure we are not convinced that setting the incentive target, cap and collar for eight years would be appropriate - new incentive schemes often need fine tuning in the early years.

CHAPTER: Four – Cost incentives and SO – TO interactions

Question 10: Do you agree that the cost incentives we are minded to apply are appropriate? Please explain your reasoning.

With respect to SO-TO interactions we agree that transparency will be key to providing stakeholders with confidence that these interactions have been taken into account.

Electricity balancing cost incentive; we have reservations over further changes to this relatively new incentive scheme structure. The fact that Ofgem is working with NGET and considering revisions to the cost methodology demonstrates that moving to a 4 + 4 scheme may not be appropriate at this time. Each time changes are made to any methodology time should be give to determine the effectiveness of any such changes before codifying them for a longer period.

Gas Cost incentives – we agree that the gas cost schemes should not be further bundled. We broadly agree with the proposals for the shrinkage scheme and recognise this is an area where there is a clear interaction between SO and TO. In particular the plans for further roll out of electric driven compressors; care will be needed to ensure this is properly reflected in the targets and that consumers are not paying twice. We agree there are uncertainties in the target setting process and wonder if the modelling approach will be robust across the eight year period. The sharing factors would seem reasonable.

With respect to OM costs we are not entirely clear what is proposed. Table 3.2 suggests a reputational incentive for meeting OM requirements as these are related to safety whilst Chapter 4 contemplates a cost incentive for OM Costs. We would support a cost based incentive and think it may be helpful if NGG is allowed to enter into longer term contracts. In recent years setting targets for OM costs has been challenging, going forward we do not envisage setting OM cost targets to be any easier and are not quite convinced that setting the methodology for eight years is appropriate. The 20% sharing factor seems reasonable.

Question 11: Do you agree that the parameters (scheme length, sharing factors etc.) we have proposed for the cost incentives are appropriate? Please explain your reasoning.

See response to question 10

Question 12: Do you agree with our proposals to introduce a payment mechanism to encourage efficient SO-TO interactions?

In principle this sounds reasonable, but it will need careful design and monitoring. Experience will determine whether it is cost efficient and effective or not.

CHAPTER: Five – Risk and uncertainty mechanisms

Question 13: Do you agree with the factors we propose to consider when deciding on the role of uncertainty mechanisms?

Yes as listed in 5.9

Question 14: Do you agree with our initial view that the caps and floors on SO incentive payments could undermine the SO taking long term decisions and could undermine alignment of incentives between the SO and TO?

Yes, but this must be balanced against placing more risk with the SO.

Question 15: Are there any areas where you think specific uncertainty mechanisms should be introduced into the regulatory framework?

It is already proposed to include an uncertainty mechanism as part of the shrinkage cost incentive that adjusts the target volume in relation to flows at St Fergus, and a methodology to determine the balancing cost target, these would seem appropriate.

We would be happy to discuss these issues further, to do so please call Julie Cox on 01782 615397.

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