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System Operator incentive schemes form 2013: Principles and Policy
January 2012

Dear Giuseppina,

Thank you for the opportunity to comment on this consultation. This response is provided on behalf of the RWE group of companies, including RWE Npower plc and RWE Supply and Trading GmbH.

Consistent with RIIO principles, Ofgem propose to set the System Operator (SO) regulatory framework for eight years and has set out which SO outputs should be covered by an incentive scheme, whether the incentives should be reputational or financial and the potential scheme parameters.

Our response to the detailed questions is included in Attachment 1 below, but we would make the following comments:

- We agree that there should be benefits from aligning the gas and electricity SO incentives with the regulatory framework being established for the TOs;
- Recognising SO-TO trade-offs in delivering certain outputs is important and we welcome the introduction of a mechanism to facilitate this interaction. Transparency of decisions taken between the SO and TO and the benefit to customers will be key;
- It may be appropriate to set reputational incentives for eight years;
- We are not convinced that financial incentives should be set for eight years. Extending the length of incentive schemes requires the introduction of uncertainty mechanisms and other reopeners to manage the increased risk faced by the SO due to changing market conditions. This has implications for how those risks are shared. Frequent revisions of the framework may not deliver continual year on year improvement in SO performance over the period and will increase the unpredictability and volatility of charges. Our preference would be to retain twelve or twenty-four month incentives;

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We hope these views are helpful and if you wish to discuss any aspect of them in further detail, please do not hesitate to contact me.

Yours sincerely,

By email so unsigned

Charles Ruffell
Economic Regulation

ATTACHMENT 1: CONSULTATION QUESTIONS

CHAPTER 2: PLAYING A FULL ROLE

Question 1: Do you consider that we have captured the full role of the SOs going forward?
Ofgem has identified the key elements of a "full role" in delivering and operating a sustainable energy sector, integrated with EU markets and this includes both "core" and "wider" activities. There is also recognition that the SOs may also be given more formal roles in respect of security of supply, both in electricity under DECC's Electricity Market Reform (EMR) proposals and following conclusion of the gas Security of Supply Significant Code Review.

Question 2: Do you consider that our minded to position on the length of the regulatory framework is appropriate?
We agree it is important that the design of the gas and electricity SO incentives are aligned and consistent with the principles of the RIIO regulatory framework being put in place for the Transmission Owners (TO). Regulatory commitment to the framework will also aid the SOs' decision making processes. However, within the overarching eight-year framework, individual incentive elements will be subject to differing scheme lengths and uncertainty mechanisms. The detailed outputs, methodologies for setting them and incentive parameters are still to be agreed. Given the uncertainty of the period to 2020 and the requirement for the regulatory framework to be adaptable in light of these uncertainties it may be challenging to set meaningful schemes that deliver continual improvement in SO performance for durations in excess of 12 or 24 months.

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?
We agree, in principle that it would be of overall benefit to consumers to better align the incentive structures of the SOs and the TOs to explicitly recognise SO-TO interactions in their decision-making processes. In particular, the proposals seek to introduce a mechanism to address the situation where the TO and SO are not under common ownership. The SO-TO interactions and associated trade-offs are necessarily transparent at the time of regulatory reviews as there is a requirement to submit business plans. A comparable level of transparency during the regulatory period about how SO decisions are made and how trade-offs between SO and TO have benefited consumers will also be needed.

CHAPTER 3: 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 agree with Ofgem's general approach to avoid duplicating incentives on outputs that are already covered by legal requirements, licence obligations or included under RIIO-T1. A mix of reputational and financial incentives also seems appropriate although reporting on outputs covered by reputational incentives will be needed to demonstrate that costs are being minimised. The summary set out in tables 3.1 and 3.2 in the consultation document appear to be consistent with this approach. We agree that gas connections are important, but do not see the benefit of introducing a financial incentive on NGG. Its obligations will be set out in the UNC (assuming modification proposal 0373 is implemented). This is surely comparable to the situation for NGET, where the CUSC obligations, backed up by licence conditions, are deemed to be sufficient. A reputational incentive on NGG could be considered.

Question 5: Do you agree with our minded to position on the period for which the various outputs and associated incentives will be fixed?
We agree that setting the framework for eight years is helpful in providing some stability and that reputational incentives might credibly be set for this period. We are not convinced that it is possible to set meaningful financial incentives for eight years.

Question 6: Do you agree with our views on incentivising SO outputs?
Ofgem has set out a mix of reputational and financial incentives. We have yet to see the baseline against which performance will be reported so it is difficult to provide a view at this stage.

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?
Our preference is that NGG and NGET should only be funded to meet environmental outputs required under legislation and that this is likely to be a TO rather than SO function. We are not in support of a broader financial environmental incentive on the SO and believe that a reputational incentive should suffice.

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?
There is some evidence that incentives on NGG have delivered an improvement in the accuracy and timeliness of its demand forecasts and the availability of its website. There may be merit in a similar approach for NGET for forecasting wind generation given the potential impact of intermittent generation on the operation of both the gas and electricity systems. Any incentive on NGET in this area should not be in addition to existing funding.

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?
We have never been convinced about the benefits of the linepack incentive in the current energy balancing arrangements, not least as NGG appear to have only partial control over it. That said, the current balancing incentive arrangements are well understood by the market and we would need to better understand what the potential effects of a total cost incentive might be before providing a definitive view on its likely impact.

CHAPTER 4: 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.
The costs covered by incentives are broadly those that the SO has some control over, so they are appropriate from that perspective. Focusing on those costs that are controllable by the SO should only provide incentive returns where it can be demonstrated that, in performing its role, the SO has influenced the out turn costs.

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.
Generally, we have concerns about the target setting process (which has yet to be agreed) and question whether the methodology and any associated modelling will be robust over the eight year period. Breaking the period in shorter sections or including uncertainty or re-opener mechanisms may undermine the incentive properties that the schemes are seeking to engender. This is particularly true for electricity, as the current two year scheme has not yet ended and the results/outcome are not fully understood. We think it would be better to launch another two year scheme under the RIIO framework

and assess the progress of that alongside the results of the current one. For gas, we agree that there should be no further bundling. We note that, although bundled as a single scheme, the Shrinkage costs incentive contains a number of separate components that generate significant costs and that require separate forecasts and modelling.

Question 12: Do you agree with our proposals to introduce a payment mechanism to encourage efficient SO-TO interactions?
Where there is common ownership of the SO and TO, aligning the SO and TO regulatory frameworks should be sufficient for the SO to take account of SO-TO interactions. We agree that where there is separate ownership, there needs to be a payment mechanism to facilitate the interactions. Our overriding concern is ensuring transparency about how SO decisions are made and how trade-offs between operational solutions (SO) and investment solutions (TO) lead to long-term benefits for consumers.

CHAPTER 5: RISK AND UNCERTAINTY MECHANISMS

Question 13: Do you agree with the factors we propose to consider when deciding on the role of uncertainty mechanisms?
We note and agree with Ofgem's comment that the SO is a very different type of business from a network business. Ofgem has set out a description of the broad categories of risk faced by the SO that may impact upon its ability to deliver specific outputs over the life of the incentive scheme. Arguably, the need to mitigate specific and/or more general risks via uncertainty mechanism is a consequence of the proposed length of the incentive period and retaining one or two year duration schemes might remove the need for such mechanisms.

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?
We agree that there is a case for aligning incentives to minimise perverse outcomes. The design of the framework should put in place strong incentives to operate the electricity and gas systems as efficiently as possible, with an appropriate balance of risk and reward between the SOs and consumers. Until the detailed framework and incentive structures are put in place, it is difficult to give a definitive view.

Question 15: Are there any areas where you think specific uncertainty mechanisms should be introduced into the regulatory framework?
We need to understand better whether extending incentives for longer periods that require uncertainty mechanisms to change outputs in light of changes to the operating environment faced by the SOs would necessarily deliver stronger incentives to minimise SO costs than shorter periods.