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Dear Giuseppina,

System Operator incentive schemes from 2013 initial proposals

We welcome the opportunity to comment on Ofgem's Initial Proposals for the System Operators' incentive schemes for the period commencing April 2013. This is an area that has undergone considerable change in the last few years and, as a significant market player, we are keen to input into its development / evolution.

The rationale for any SO incentive is to encourage the SO to behave in a way that best delivers the efficient market. It is important that these incentive schemes do not end up driving the SO and effectively encouraging the SO to do little in the absence of any financial reward. Moreover, Ofgem should be careful not to avoid introducing incentives for activities / behaviours that should be matter of course.

A specific example of this would be in relation to black start in the electricity market where NGET has recognised that there will be a shortfall in plants able to provide this service going forward. In terms of delivering an efficient market, we would not want to see the procurement of these services being contingent upon an incentive mechanism. The test for any incentive should be does it drive the efficient market? The incentives should not be the sole focus of the SO and they certainly should not compromise the delivery of the efficient market.

In terms of timescale, we believe it is difficult to put in place mechanisms that will still be appropriate in eight years. We are mindful of the number and significance of the recent changes raised by NGET to its current balancing services incentive scheme (BSIS), which is a two-year incentive regime. It is difficult to see how this (and indeed the other incentive mechanisms on the electricity-side) could ever be extended to an eight-year scheme, particularly given the level of industry change that is anticipated over this period, not least as a result of the Electricity Market Review, cash out significant code review and European Network Codes.

Nevertheless, we recognise the need for an appropriate risk-reward package for the SO and, as such, we are concerned that Ofgem's latest consultation falls short. We are less concerned about the structure and form of this incentive package, as long as it incentivises NGET to demonstrate the 'right' behaviours and to take the 'right' actions. For example, we want to see NGET being incentivised to enter into contracts rather than relying heavily on the balancing market. We do not believe it would be prudent or efficient for Ofgem to rely on monitoring NGET's costs with the backstop of enforcement action to ensure that these actions are taken. In any case, it is difficult to see what information Ofgem (or the market) will have for this approach to work in practice.

On gas, many of these same principled concerns apply. However, our specific concern relates to the distinct lack of information and modelling: this information asymmetry is considerably more pronounced in gas than it is in electricity. From a financial incentive perspective, this lack of information makes it impossible for customers to validate the appropriateness of caps, floors and sharing mechanisms. From a reputational incentive perspective, we are unable to have confidence in the effectiveness of these schemes. If reputational incentives are to feature to the extent proposed (and, for the avoidance of doubt, our preference is for a more financial-based approach), we believe much more information is needed about the detail, frequency and content of this reporting and monitoring and the process for assessing and validating NGG's performance.

I hope this provides you with a clear overview of our position and the sentiments that we believe need to be reflected in Final Proposals. In addition, we have responded to the specific questions set out in the Initial Proposals. These follow in the supporting annex.

Yours sincerely,

Gillian Hilton
Regulation

ANNEX

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?

The RIIO-T1 process identified the SO as best placed to take action to bring down system losses; it is therefore important that an effective incentive is retained in this area. It is not clear that a reputational incentive is suitably strong in the absence of competitors against which to benchmark / compare and where there is clear asymmetry of information.

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?

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

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?

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

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

We are not clear that this is an area that warrants an incentive. Given that accurate forecasting ensures that NGET's balancing costs (BSUoS) are kept to a minimum, it should already be in NGET's interests to ensure that its renewable forecasting is sufficiently accurate.

As an aside, we believe NGET's publication of its forecast BSUoS costs and the way in which these are updated to reflect actual BSUoS costs is more of an issue. This forecast is key to suppliers in calculating their tariffs. We are concerned that smaller suppliers in particular find it difficult to keep abreast of these forecasts and, as a result, are vulnerable to increasing BSUoS costs where these are not factored into their tariffs.

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

Whilst we don't support a financial incentive where there is insufficient confidence in the underlying modelling and where small changes in the data have a substantial financial impact, we are concerned that this has been stripped out of NGET's incentive framework and effectively left to the Network Availability Policy statements under RIIO-T1. We don't believe this in itself is enough to drive the 'right' behaviours.

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?

This seems at odds with the ex-ante approach of RIIO-T1. However, whilst we recognise that there may be some instances where this is still appropriate, our concerns would be in relation to the level of transparency and ability to review NGET's actions, particularly in the absence of any comparators in terms of costs and outputs.

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

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

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

c. Is the size of the potential reward appropriate?

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

We support the sentiment of this mechanism; the challenges will come from identifying the qualifying behaviours taken by NGET and accurately calculating the benefit to ensure that the rewards are appropriate. That said, we recognise the work under RIIO-T1 to make discretionary rewards more objective. We believe a similar approach may increase industry and stakeholder understanding of and confidence in discretionary rewards.

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?

Going back to fundamentals, we question why there is a requirement for an incentive on NGET to procure black start as a service. On identifying a fall in the number of plants able to provide black start services, we believe NGET should naturally look to go out to the market and contract for additional black start. This should not be prompted by (or indeed stalled until) an appropriate financial incentive is in place.

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?

Whilst we are fully behind NGET being more proactive and would encourage NGET engaging in more forward contracts, we do not believe it is the role of the SO to incentivise the TOs.

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?

We agree with Ofgem's minded to position to implement Option 1, but agree that it would be wise to review the nature of this incentive once NGG has provided its more detailed information on emissions under its Scheme of Work.

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?

As we understand it, this is a continuation of the current incentive whereby NGG is incentivised to trade close to the market price when it enters the On the Day Commodity Market (OCM). We believe this mechanism is driving the 'right' behaviours and can and should be continued (with all of its associated parameters) for the eight year term.

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 do not believe this goes far enough. UAG places a significant cost on industry and we believe the incentive framework needs to reflect this. We support the proposed industry workgroup to assist NGG in its investigation of the drivers of UAG, but we are disappointed that this work has not been carried out earlier to enable a more robust proposition as part of Initial Proposals. We believe a symmetrical financial incentive (with appropriate caps and floors) is likely to be more effective in tackling UAG (rather than a reputational incentive).

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?
b. Do you agree with our proposal to amend the calculation of the error target, including increasing the weighting for days of higher demand?
c. Do you agree with our proposals for the D-5 to D-2 forecast incentive?
d. Do you agree that the improvement in the NDM forecast should be taken forward by the DNs?

We welcome the work that Ofgem has done in this area, in particular its proposal to weight the D-1 incentive according to daily demand. We consider this to be a positive step forward. We would, however, suggest that Ofgem should look to reduce the cap it has attributed to the proposed D-2 to D-5 demand forecast incentive. Whilst this forecasting incentive will bring some benefit to customers in terms of improved information, the benefit is much less than the D-1 incentive. As such, the potential upside should reflect this. We would suggest a cap closer to £2 m p.a. would be more commensurate.

In terms of the NDM forecast, we agree that this is an area to explore with the DNs rather than the SO.

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?

Having highlighted changes to NGG's maintenance schedule as an area of concern for us, we welcome the progress put forward as part of Initial Proposals. We are, however, concerned that the proposal in relation to changes to NGG's maintenance plan does not require NGG to take note of customer-instigated changes. In terms of helping to deliver the most efficient market solution, we believe NGG should be no less incentivised to take into account changes at the request of customers.

Given that any incentive in this area is new, we support the proposal to limit this to a two-year incentive. This will be particularly important in relation to assessing the appropriateness of the target days put forward as part of Ofgem's 'number of maintenance days' incentive.

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?

We believe NGG must be subject to a financial incentive in this area. A reputational incentive is not sufficient to ensure that the costs passed through to customers as a result of NGG's activity in procuring operating margins are kept to a minimum.

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?
b. Do you agree that the proposed changes to the reference prices are appropriate?
c. Do you agree with the proposed sharing factor? Do you agree with increasing the cap and floor of the incentive?

We continue to be of the view that Ofgem should look to unbundle the shrinkage incentive and put in place separate financial incentives. As a minimum, there should be a stand alone financial incentive for UAG (as per our response to Question 10).

Notwithstanding the above, in terms of the detail set out in Ofgem's appendix 5, we fundamentally disagree with the suggestion that any target for UAG would be based on the average volume in the previous quarter. This does not incentivise any improvements in the level of UAG.

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

We accept the need for uncertainty mechanisms in an eight year period and, in particular, where new incentives are being trialled. In particular, we want to avoid locking the SO into schemes that are ineffective or look to be driving perverse behaviours. We believe the *fallback of a reopener and the individual scheme parameters offer the SO sufficient safeguards to remove the need for any risk premium.*