

Giuseppina Squicciarini  
Head of Regulatory Economics  
Ofgem  
9 Millbank  
London  
SW1P 3GE

21 December 2012

Dear Giuseppina

**Electricity System Operator incentive schemes from 2013: disallowing costs and the efficiency in system operations reward scheme**

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

Our responses to the specific questions raised in the consultation are attached to this letter. We summarise below our key messages:

- We support incentive scheme rules that influence the System Operator (SO) to deliver cost effective actions.
- However, the cost of verifying the effectiveness of the SO's activities can be considerable, and the cost and effort expended on this should be proportionate to the cost of the actions themselves, the potential savings delivered through the scheme, and the incentive scheme penalties and rewards.
- The scheme should remain transparent and consistent and follow, where feasible, pre-determined guidance. Pre-determined rules and transparency allow industry participants to reduce their risk and uncertainty. Given that all competing participants face this risk, reductions will ultimately pass to consumers.
- It is surprising that a new approach is being considered so soon after the current approach was adopted. The current scheme sought to deliver transparency in monitoring the SO's effectiveness in a complex activity. It will be difficult to do this objectively without detailed models. Re-introduction of a simpler financial incentive mechanism should not be altogether dismissed if this is the better of the two proposals available.

**EDF Energy**  
40 Grosvenor Place, Victoria  
London SW1X 7EN  
Tel +44 (0) 20 7752 2200

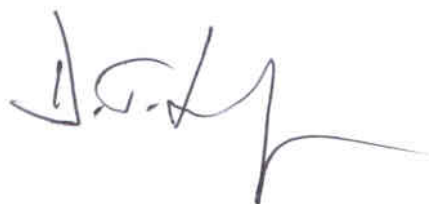
**edfenergy.com**  
*EDF Energy plc.  
Registered in England and Wales.  
Registered No. 2366852.  
Registered office: 40 Grosvenor Place,  
Victoria, London SW1X 7EN*

- A flexible outlook should be maintained in case the scheme becomes unduly arduous to manage in proportion to the benefits, or if the desired behaviour is not being met.
- Predictability in system operation charges continues to be a key issue for our businesses.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 01452 658415, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink, appearing to read "D. Linford".

**Denis Linford**  
**Corporate Policy and Regulation Director**

## Attachment

### Electricity System Operator incentive schemes from 2013: disallowing costs and the efficiency in system operations reward scheme

#### EDF Energy's response to your questions

##### SECTION: Two

**Q1. Do you agree with the way in which we propose to monitor the SO's costs?**

It is difficult for a third party to comment on whether the proposed process is appropriate because, as industry, we will have limited visibility of how the review will be prescribed in practice. We also have no understanding of whether NGET will have to implement new reporting mechanisms and/or other changes to existing business processes, or the associated costs.

**Q2. Do the various steps of the process we propose to follow to disallow costs seem appropriate?**

While we find the overview useful, more detail is necessary to determine whether the steps in the process are appropriate. For example, there is no mention of end-to-end timescale or potential for an appeal should NGET disagree with Ofgem's decision. In particular, we are interested in understanding how this might impact fluctuations in BSUoS charges.

**Q3. Is the proposed threshold level, and the way in which it will be applied, proportionate?**

We have no strong view regarding the 0.5% (currently equating to around £5m) threshold. If the 0.5% threshold is leading to several investigations, where inefficient costs are not confirmed, perhaps at this stage a higher threshold could be considered.

**Q4. Please provide your views on whether it would be appropriate to introduce a limit on the maximum level of costs that can be disallowed?**

In principle, it seems odd to place a limit on the maximum level of costs that can be disallowed if the costs were deemed inefficient. However, given that the rewards are capped, it would seem appropriate that both upsides and downsides need to be treated in the same way.

**Q5. Do you agree with our examples of uneconomic or inefficient costs? If not, why not?**

We note that the examples seem to illustrate what Ofgem would consider efficient behaviour rather than inefficient behaviour. It is not clear whether Ofgem is suggesting

that not acting in line with Ofgem's highlighted expectations would be deemed as uneconomic or inefficient.

**Q6. Should any disallowed costs be clawed back retrospectively or prospectively?**

From a practical perspective, the charges should be clawed back prospectively, with notice.

**SECTION: Three**

**Q7. Do you agree with the proposed process for granting rewards?**

We generally support the proposed process for granting rewards. Specifically the financial lag which will protect industry participants from a level of short-term uncertainty.

**Q8. Is it appropriate to include an "ex ante" option for granting rewards, when significant up-front costs for the SO are involved?**

Given the proposal, we appreciate that NGET might require reassurance that its capital expenditure costs would be recoverable (at to some extent). However, we do not believe that this needs to be in the form of an ex-ante option as described in the consultation. An agreement to funding should be sufficient.

**Q9. How should the net benefit to consumers be measured?**

We have no comments on a suitable measure.

**Q10. Have you any views on the composition of the independent Expert Panel?**

No.

**SECTION: Four**

**Q11. Do you agree with our proposal to introduce a financial incentive on the accuracy of the BSUoS cost forecasts produced by the SO?**

While the idea of a financial target for an accurate BSUoS forecast is welcomed, the reward or penalty for an inaccurate forecast is disproportional to the risks faced by suppliers and generators. We acknowledge that some of the costs are naturally unpredictable, but the SO has more information to provide good forecasts than any individual users.

If there is incentive payment for outturn being within +/-25% of the forecast, an outturn 25% higher than forecast would leave NG neutral with no profit or loss while participants have up to £200m unexpected BSUoS to fund. (This is based on £800m BSUoS spend per year).

If more importance is placed on an accurate forecast then a more challenging target needs to be created.

Separately, we are not certain how accurate year-ahead forecasting would be if the quality of the input data was the cause of the inaccuracies in the past. We understood that is why NG wanted to use ex-post data.

**Q12. To what forecasting time period should the incentive apply? (We have proposed the incentive should apply to a year-ahead forecast)**

We agree that a year ahead forecasting horizon seems reasonable given the uncertainty of regulatory and other pressures on forecasts further out.

If the accuracy of the forecast was significantly better for six months then this could be a better trade-off.

It could be that both an annual and six-monthly target are produced with an appropriate weighting given to these forecasts to create the target.

**Q13. Do you agree with the proposed parameters for the scheme?**

The parameters for the penalty and reward need to be proportional to the financial burden on users, otherwise the incentive will not have any benefit. Equally, a high risk or reward could mean that the scheme costs cause shorter-term (within current year) risk.

**Q14. Do you have a preference for the timing of the submission of the forecast to the Authority? (We have proposed 14 days before commencement of the scheme year).**

We would ideally like a forecast at least three months prior to the commencement date. April is generally a large contract round and therefore sufficient notice would be required to ensure the forecast for these customers are as accurate as possible. With relation to Question 12 a re-forecast prior to the October round would also be welcomed. It is always better to have a shorter-term forecast if the accuracy is better.

**Q15. Is it appropriate to require NGET to continue developing its models?**

Yes. Furthermore, there should be full transparency of the modelling methods, inputs and results.

**EDF Energy  
December 2012**