SCOTTISHPOWER

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Ofgem
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Dear Giuseppina,

Electricity System Operator incentives schemes from 2013: disallowing costs and the efficiency in systems operations reward scheme

Thank you for the opportunity to provide views on this consultation on behalf of ScottishPower and ScottishPower Renewables.

ScottishPower considers that past Electricity System Operator Incentive Schemes have resulted in the adoption of a short-term approach to meeting Scheme targets and in windfall gains and losses to the System Operator. We broadly support Ofgem's approach of ensuring that System Operation costs are incurred economically and efficiently while providing specific targeted incentives on BSUoS forecasting and for clearly identifiable cost-reduction projects which deliver measurable benefits.

Our responses to the specific questions in the Overview document are attached below.

Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

James Anderson
Commercial and Trading Arrangements Manager

Question 1: Do you agree with the way in which we propose to monitor the SO's costs?

ScottishPower agrees with the way in which Ofgem proposes to monitor the System Operator (SO)'s costs. It would be helpful if as much of the supporting information on SO costs which will be made available to Ofgem in support of costs incurred is also made available to industry participants. Greater transparency of cost information, subject to appropriate commercial confidentiality where appropriate, should lead to improved competition in the provision of services to the System Operator.

Question 2: Do the various steps of the process we propose to follow to disallow costs seem appropriate?

The steps outlined in Figure 1 of Chapter 2 provide a methodical approach to monitoring costs, investigating areas of concern and taking appropriate action. We support the opportunity for stakeholders to be able to respond and provide evidence during the Formal Notice procedure.

Question 3: Is the proposed threshold level, and the way in which it will be applied, proportionate?

We broadly support a threshold of 0.5% of the previous year's balancing costs (i.e. approximately £5m) before the balancing costs in any particular month would be subject to the investigation process. However, we note that over 12 months this threshold could result in costs of up to £60m potentially being unchallenged. We note that this figure is greater than the £50m incentive available to National Grid under the previous two year scheme.

We would expect Ofgem to query any transaction or series of transactions entered into by the SO where costs would appear to be over the threshold of 0.5% and not restricted to costs over a two month period as suggested in 2.15.

Question 4: Please provide your views on whether it would be appropriate to introduce a limit on the maximum level of costs that can be disallowed?

Setting a limit on the maximum level of SO costs that can be disallowed would limit its exposure and the exposure to National Grid shareholders. However, there is always the danger, as existed under previous cap and collar incentive mechanisms, that there is no further incentive on the SO to limit costs once a particular limit has been breached. The only recourse to Ofgem in this circumstance would be to treat such costs as a breach of Standard Licence Condition C16. Again, we note that the proposed 10% (£90m) annual cap on disallowed costs is considerably in excess of the £50m cap under the previous two year incentive scheme.

Question 5: Do you agree with our examples of uneconomic or inefficient costs? If not, why not?

The 5 Examples provided appear to demonstrate instances where the SO would have failed to act economically and efficiently if it failed to take appropriate action when presented with these circumstances.

Question 6: Should any disallowed costs be clawed back retrospectively or prospectively?

ScottishPower believes that any disallowed costs should be clawed back retrospectively. This ensures that any reconciliation amounts are allocated in the same time periods and to the same parties who suffered the original uneconomic and inefficient costs. While prospective clawback would increase predictability it would do so at the cost of reduced cost-reflectivity and could result in windfall gains to users.

Question 7: Do you agree with the proposed process for granting rewards?

ScottishPower believes that all applications by the SO under the Discretionary Reward scheme should be prior-approved and we do not support a process whereby the SO can present an ex-post report in support of a reward payment. We believe that there is a danger that where cost-savings are identified, the SO may seek to find an explanation that would justify an ex-post reward payment where this may have arisen without specific effort beyond “business as usual”.

Question 8: Is it appropriate to include an “ex-ante” option for granting rewards, when significant upfront costs for the SO are involved?

We believe that payments under the scheme should be on the basis of savings actually delivered and that “ex-ante” payments for granting rewards should only be made in exceptional circumstances for projects which involve significant upfront operating or capital expenditure. Ex-ante payment of rewards should not be the norm.

Question 9: How should the net benefit to consumers be measured?

It is important that Ofgem and National Grid agree an accurate counterfactual representing “business as usual” when determining the net benefit to consumers. Given the problems identified with the existing SO cost forecasting systems, we are not sure that these could be relied upon to provide such a measure. We also accept that as time progresses, the counterfactual becomes harder to define due to ongoing industry changes. However we do have concerns that basing the total reward payment upon a multiple of savings identified within the first year could result in payments for savings not actually realised in future years.

A compromise could be to identify the savings demonstrated over the initial two or three years of the project, when the counterfactual should change least, and use these as the basis of the reward payment.

Question 10: have you any views on the composition of the independent Expert Panel?

The independent Expert Panel will need to consist of individuals who have the relevant economic analysis skills and an understanding of the key areas of System Operation while being independent of both the SO and users who are subject to the SO costs (and could bear the cost of any reward payment).

This could be achieved through the use of independent economic consultants but could entail significant additional costs.

Question 11: Do you agree with our proposal to introduce a financial incentive on the accuracy of the SO’s forecasts of BSUoS charges produced by the SO?

ScottishPower agrees with the introduction of a financial incentive on the accuracy of BSUoS forecasting. This is an important issue for industry users as indicated by the recent CUSC Modification CMP208 requiring National Grid to provide more regular detailed BSUoS forecasts.

Question 12: 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 forecast is the most appropriate timescale for the incentive.

Question 13: Do you agree with the proposed parameters of the scheme?

ScottishPower has concerns that the incentive scheme parameters suggested are not sufficiently tight. While the potential incentive payments/receipts (+/- £5m) are relatively small in terms of overall BSUoS costs (2011/12 £900m), the scope for an incentive payment to be received by NGET if it can forecast within an accuracy of 50% (+/- 25% of £900m) of this target does not seem particularly onerous. Indeed, total BSUoS costs would need to exceed the target by 50% (£450m in 2011/12) before NGET had to pay the maximum incentive penalty of £5m. While we accept that some of this “overspend” may be disallowed if deemed inefficiently or uneconomically incurred, we would expect a higher level of forecast accuracy to be incentivised.

We would suggest that a graduated incentive payment should be available if forecast error is less than +/-15% with a maximum penalty for errors in excess of +/- 30%.

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

We believe that the incentive should be measured against a BSUoS forecast delivered in the December preceding the charging year to provide sufficient time for users to incorporate the forecast in their contract terms. Although a submission 14 days before would allow NGET more time to refine their forecast it would not provide sufficient predictability to allow users to make use of their forecast in pricing/tariff decisions.

Question 15: Is it appropriate to require NGET to continue developing its models?

ScottishPower considers that it would be appropriate to require NGET to continue to develop its SO cost models. Considerable effort has already been expended on the development of the models to date and while the accuracy of the results has been disappointing it should be possible to refine the model using further iterations of forecast and actual results until accuracy is improved.

Development of such a model should assist the SO in achieving the level of accuracy required under the BSUoS forecast incentive mechanism.

Provided a consistently reliable forecast model can be developed, ScottishPower would consider that it may be appropriate, at a future date, to return to the type of SO incentive scheme used previously.