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Electricity SO Incentives

Stakeholder workshop

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Agenda

1. Context for discussion and purpose of the day – Giuseppina Squicciarini, Ofgem
2. Considering our approach – Lewis Heather, Ofgem
3. Forecasting developments and the BSIS approach – NGET
4. Tea and coffee
5. Stakeholder discussion based on key questions – Ofgem to chair

Elec SO Incentives from 2013: History

January 2012
Principles and policy consultation published

July 2012
Initial proposals published – cost disallowance and discretionary reward based scheme

September 2012
Workshop held to discuss policy with stakeholders

October 2012
Further consultation published setting out additional detail around proposals

Today
Stakeholder workshop to discuss proposals before final decision on approach

Purpose of today

- Ofgem to present latest developments and reasons for final consideration of approach before proceeding
- Provide NGET with a platform to discuss:
  - developments to the forecasting models and methodologies
  - their views on why BSIS would better incentivise them to reduce costs in a 2013 scheme
- Give stakeholders an opportunity to share views on merits of the respective options

We consider this to be an important opportunity to discuss our approach before taking proposals forwards.
Our decision on the way forward is not yet final

Electricity SO Incentives

Considering our approach

Lewis Heather

What we are looking to achieve

- Placing optimum incentives on the SO to minimise costs of balancing the system
- Where possible encouraging the SO to forecast costs accurately
- 2013 scheme in place as interim approach
  - Ensuring these incentives are as strong as possible
- Step back to consider enduring approach to incentivising the SO
  - What behaviours are we looking for the SO to demonstrate
  - How do we encourage these behaviours most effectively?
  - Look to put enduring approach in place for 2015 scheme

Focus of today is on getting the most appropriate incentives in place for a 2013 scheme before developing an enduring approach.

BSIS principles

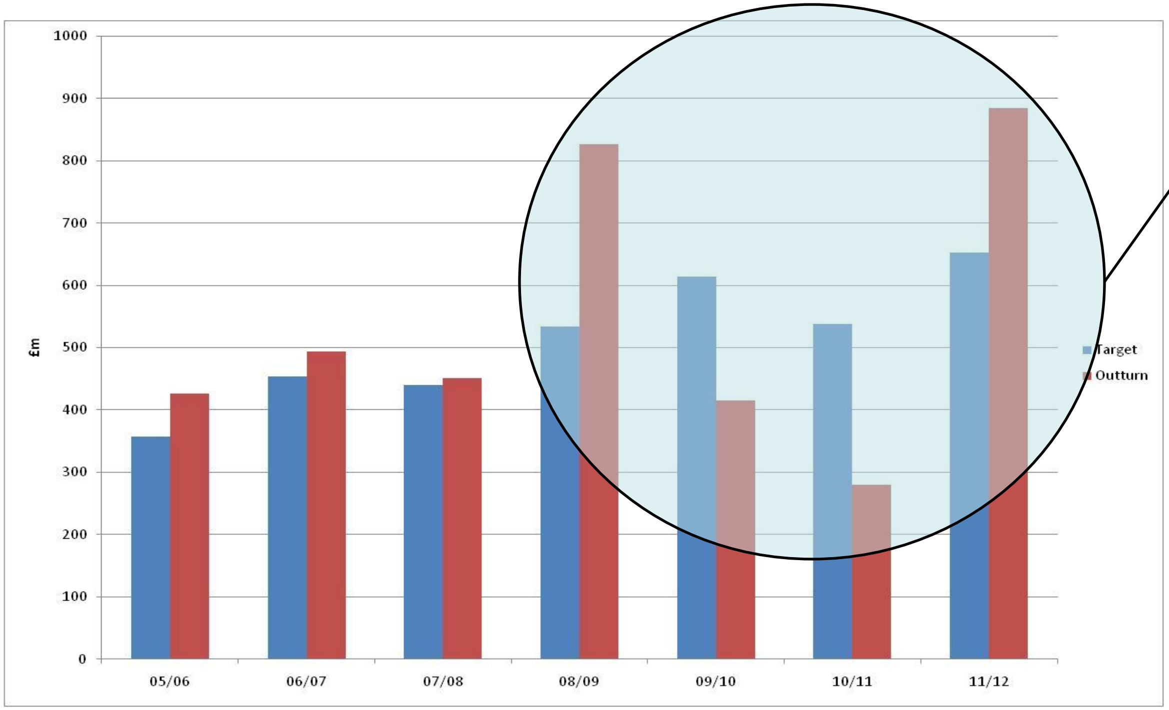
- Broadly consistent approach in place since 2001

<u>BSIS Principles</u>

- Ex ante – scheme rules defined at the outset
- Target based – models used to develop target
- Cap and floor and sharing factor in place
- Direct incentives on SO to minimise costs of actions within cap and floor and scheme timescales
- Look to build in longer term incentives: to date BSIS has been short term with 1 to 2 year schemes in place

BUT: Increasingly difficult to set targets

Since 2008 outturns have moved from the target due to significant changes in the market increasing challenges of target setting



Cap or floor hit in last four scheme periods

This led us to set out initial proposals for an alternative cost disallowance approach for a scheme commencing in 2013

Our Initial Proposals: Cost disallowance

- Aim to identify cost anomalies not justified by market fundamentals after the event
- Only consider information available at the time (avoid hindsight)
- Threshold for review: 0.5% of previous years balancing services costs (c. £5m)
- Limit on cost disallowance per year: 10% of previous years balancing costs (c.£90m)

An ex post cost disallowance approach would not be our preference under normal circumstances. Our proposals have resulted from concerns with target setting accuracy under current scheme

Summary of responses to Initial Proposals

SSE
'It is important that these incentives do not end up driving the SO and effectively encouraging it to do little in the absence of any financial reward'

E.ON
'If an ex ante approach is no longer feasible then an ex post incentive appears the only option. However, this will not be without its own challenges'

RWE
'We have long argued for the development of a performance based approach relating to specific areas of controllable costs'

NGET
'We regard the proposal to suspend BSIS as a backward step and detrimental to consumers.'

EDF
'The proposal to remove BSIS from April is challenging. To develop an effective alternative will take some time'

SPT
'We believe Ofgem's proposal to remove short-term financial incentives in favour of a broader incentive approach will help ensure that longer term benefit takes precedence…'

Renewable UK
'Use of the existing balancing services modelling should be retained if possible…'

Some concern with merit and practicalities of approach

Key developments

NGET model and methodology developments

- NGET to talk us through developments in this area today

Responses to October Consultation

- Number of concerns with cost disallowance remain – in particular with NGET and EDF
- Focus of other respondents on BSUoS charges and accuracy of forecasts

Internal analysis

- Further consideration of pros and cons of options available

Key question for today: Do these developments justify moving to a BSIS approach?

Summary of responses to October Consultation

NPower
Broadly agree with proposals but believe more detail is needed

E.ON
'Seems appropriate to take this approach at current time rather than relying on more mechanistic approach...'

EDF
'It is surprising that a new approach is being considered so soon after the current approach was adopted.'

Haven
Agree with BSUoS forecasting proposals but have concerns with timing

Scottish Power
'Broadly support Ofgem's approach'

NGET
'We consider that this approach to regulation is not in the best interests of consumers and represents a step in the wrong direction.'

SSE
'Proposals are a welcome development but importantly do not ignore the longer term aspiration of developing a robust financial incentive...'

SP Networks
'Welcome proposals as current arrangements do not provide best platform to encourage required level of investment...'

Responses generally more positive than at initial proposals however a number of important concerns remain. BSUoS charges are the key concern of the majority of stakeholders

Pros and cons of BSIS approach

Pros	Cons
Transparent and ex ante target based incentive	Risk of windfall gains or losses
Low resource and information requirement	Risk of ex post adjustments
Tried and tested processes	Additional delay before a scheme is in place (at least 1 month)
Build on previous learning	

Pros and cons of Cost Disallowance approach

Pros	Cons
Little dependence on accuracy of ex ante targets	Ex post approach
No risk of windfall gains or losses	Lack of direct incentives for day-to-day actions
Ex post adjustments only to decrease industry costs	Significant resource and information requirements
Reduces risk of lack of incentives as a result of hitting cap or floor	Reduce benefit from previous learning. Applying new scheme may raise new challenges

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Elec SO 2013 – Timeline: Best case

Feb	March	April	May	June	July	Aug

Internal decision: Decision on whether to proceed with cost disallowance or BSIS

Cost disallowance Scheme

Final Proposals Published. Late March: 4 Week consultation launched

Decision to modify licence published. Late April: 56 day notice period

Licence Conditions in place. Late June: At least 3 months without elec scheme

BSIS Scheme

Initial Proposals published. Early March: 4 Week consultation launched

Consultation closes. Early April: Initial Proposals consultation closes

Final Proposals Published. Mid May: 4 Week consultation launched

Decision to modify licence published. Mid June: 56 day notice period

Licence Conditions in place. Early August: At least 4 months without elec scheme

KEY: Ofgem External Stakeholders Outcome

Further issues: Other measures

- Discretionary reward
  - Some ex ante funding available with ex post share of benefits of actions 'beyond business as usual'
  - Reward of 25% of net benefit capped at £25m per year

- Other incentive schemes
  - BSUoS forecasting incentive scheme (financial)
  - Renewables forecast accuracy incentive (financial)
  - Black Start (financial)
  - Model development licence obligation
  - Transmission losses (reputational)

Important to note that many of these could work alongside either scheme and would be included in any further consultation

Further issues: Scheme length

- Any scheme which is put into place in 2013 could last 1 or 2 years
- We see the following benefits in having a 2 year scheme in place:
  - Provide additional certainty to NGET and stakeholders
  - Allow move towards longer term thinking with a view to building on this
  - Allow development of an enduring approach from 2015
    - Time to consider and consult on approach
    - Continued model developments
    - Better understanding of market developments

Views are welcome today. Scheme length would be part of any future consultation

Further issues: ‘Gap’ between scheme periods

- Whichever approach is pursued we would expect a period of at least 3 months without any formal incentive scheme in place
  - However we note that the details of a scheme would be finalised at the 56 day licence notification stage

- Within this period the following options would be available:
  1. Monitoring NGET under Licence Condition C16 only
  2. Retrospective application of the new scheme: 2 sub-options exist
     a) Retrospective charging
     b) Prospective charging

Comment on stakeholder preference in the ‘gap’ period is welcomed at the workshop

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Key questions for discussion

1. Given discussion today what are your views on the relative merits of a BSIS and cost disallowance scheme in 2013? Which do you consider more able to minimise SO costs?

2. Do you have sufficient comfort that modelling and methodology changes allow BSIS to be a viable option?

3. What duration should a scheme apply for?

4. What are your views on the options to cover the period when no formal scheme would be in place?

Key questions (continued)

5. Alongside our proposals for cost disallowance we have included proposals for a number of other incentive schemes. Which of the following incentives could/should be implemented alongside a BSIS approach if taken forwards?
   - Discretionary reward
   - BSUoS forecasting incentive scheme (financial)
   - Renewables forecast accuracy incentive (financial)
   - Black Start (financial)
   - Model development licence obligation
   - Transmission losses (reputational)