Citizens Advice

Central Office
3rd Floor North
200 Aldersgate Street
London EC1A 4HD

Tel: 03000 231 231
Fax: 03000 231 053
www.citizensadvice.org.uk

Lewis Heather
Electricity System Operator Incentives
Ofgem
London SW1 3GE

11 July 2014

Electricity System Operator Incentives: Incentives

Dear Mr Heather

Thank you for the opportunity to comment on the development of the Electricity System Operator Incentive Scheme (incentive scheme) from 2015. This submission is entirely non-confidential and may be published on your website.

Summary

Citizens Advice has concerns with the effectiveness of the current incentive scheme and supports a comprehensive review of the kind foreshadowed by Ofgem in the consultation document. In our view, the escalation of balancing costs in recent years and the gaps we are seeing between National Grid Electricity Transmission's (NGET) forecasts and actuals provide a prima facie case for change.

In particular, we think there may now be a stronger case for the further unbundling of energy and constraint costs than has previously been the case. The view that was reached at the time was that the additional efficiencies that an unbundled incentive might deliver would be outweighed by the costs associated with the increased complexity that would accompany it. But as balancing costs have increased dramatically in recent years – from approximately £800 million in 2009-10 to more than £1 billion in 2013-14 – it follows that the concerns about complexity will have diminished relative to the potential efficiency gains. That is it largely constraint costs that have driven this increase also strengthens the case for the incentive to be split so that costs can be better targeted.[1]

That said given the flux in the current policy environment – particularly the introduction of sharper cash-out prices following the Electricity Balancing Significant Code Review, the establishment of the Capacity Mechanism and the adoption of European network codes – we agree that it is prudent to delay the review until 2016 with a view to introducing a wholly re-modelled incentive scheme from 2017.

---

[1] Electricity Balancing Services, National Audit Office, May 2014 p 25. http://www.nao.org.uk/report/electricity-balancing-services/

But a plan to conduct a comprehensive review in 2016 must not stop NGET and Ofgem moving now to get the best possible deal for consumers by firstly refining the design of the current incentive scheme and secondly, providing a better platform to make judgements about the design of a new incentive scheme from 2017. Foremost here is the need for NGET to improve the accuracy of, and confidence in, its forecasts of balancing costs: it is very difficult to provide a view on the appropriateness of the £25 million cap and collar or the Sharing Factor when the metrics are so volatile. This should include Ofgem reviewing the effectiveness of the Model Development Licence Condition and considering whether a targeted financial incentive could be introduced for forecasting accuracy. There may also be merit in commissioning a group like the EMR Panel of Technical Experts to conduct an independent review of the models.

And while we welcome the initiatives to improve transparency around the nature and location of network constraints – for example through the publication of the enhanced Monthly Balancing Services Summary Reports (MBSS) – it remains difficult for stakeholders to make informed judgements about whether NGET is optimising the network. Stakeholders would, for example, benefit from commentary being inserted into the MBSS on specific constraints and accounts of what NGET is doing to minimise their impact.

Ultimately, the key challenge for Ofgem is how to structure an incentive scheme that plays its part in a broader regulatory framework that's core objective must be to drive NGET to allocate resources between its SO and transmission operator (TO) roles in a way that optimises the efficiency of the system and delivers the best value for money for consumers. What consumers are interested in is the total cost of operating and maintaining the transmission system: the success of the incentive scheme will be judged on the extent to which it drives NGET (SO) to, for example, work with TOs to coordinate their maintenance and construction schedules to minimise whole-of-system costs.

Detailed Comments

The costs of balancing the GB electricity system have risen substantially in recent years, jumping from £642 million in 2005-06 to £1,002 in 2013-14. These costs are passed on to consumers through Balancing Services Use of System (BSUoS) charges that are levied on generators and suppliers by NGET. Although it is not one of the bigger factors, this escalation in balancing costs has coincided with, and contributed to, very significant increases in the size of consumers' electricity bills – increases that have outpaced inflation. Our analysis shows the average household electricity bill increased by 102 per cent between January 2005 (£275) and January 2014 (£556).[2]

There has also been significant volatility in BSUoS charges, with significant deviations between the costs NGET has forecast and what has eventuated. For example, whereas NGET had forecast balancing costs to total £1.296 billion in 2014-15, its latest update in May 2014 suggested that figure would be much lower at £802.7 million – a difference of almost £500 million.[3] This volatility is a concern for consumers because it means that suppliers, faced with balancing costs that are difficult to predict, will include a risk premium in their tariffs that only adds to the size of household electricity bills.

[2] Citizens Advice Analysis http://tinyurl.com/khdh22r
[3] Monthly Balancing Services Summary 2014-15, May 2014, National Grid http://www2.nationalgrid.com/UK/Industry-information/Electricity-transmission-operational-data/Report-explorer/Services-Reports/

Volatility in balancing costs makes it difficult to calibrate the incentive scheme and increases the risk of windfall profits or losses by NGET. Although the current incentive scheme attempts to manage this by imposing a £25 million cap and collar on NGET's profit or loss, consumers will nevertheless bear 100 per cent of the costs in situations where NGET overspends beyond its collar. Conversely, if NGET routinely hits its cap, it suggests that the target is set at a level that is insufficiently challenging. Although NGET remained within its caps and collars for the period 2011-13, it hit the collar in 2008-09, and the caps in 2009-10 and 2010-11. The latest forecasts in the May 2014 MBSS suggest that NGET will again hit the cap.

The question is whether the gap between forecast and actual balancing costs can be explained by factors that were not reasonably foreseeable by NGET at the time the initial forecasts were made. While we accept that there are a range of factors that influence balancing costs that are outside NGET's control, it does not follow that this means they cannot be forecast. But the difficulty for stakeholders, particularly those who are not industry participants, is that NGET and Ofgem do not report the reasoning behind adjustments to the forecasts. We expand on this issue in response to Question 2 below.

We have similar concerns about transparency in relation to NGET's approach to optimising the operation of the electricity network: finding the balance of capital and operational costs that delivers the best value for consumers. As it stands, stakeholders largely have to rely on statements from Ofgem that are not supported by a comparison to a counterfactual or a detailed description of the initiatives.[4] We understand that there are legitimate issues of commercial confidentiality that mean that NGET should not disclose aspects of its procurement strategy for balancing services. But we believe that the presumption must be for NGET to release the information unless a compelling case not to can be made on confidentiality grounds – not the other way around.

We provide further comments against the questions in the consultation document at Attachment-A. Thank you for the opportunity to make this submission and please do not hesitate to contact me if you would like to discuss it further.

Yours sincerely

Chris Alexander
Policy Manager

Direct dial: 03000 231 153
Email: chris.alexander@citizensadvice.org.uk

---

[4] See p 3 of Electricity System Operator Incentives: Incentives from 2015, where Ofgem states that it 'considers that the current framework has delivered real efficiency improvements and savings for consumers'.

Attachment A
Citizens Advice Responses to consultation questions

1. Do you agree with the proposed scope of changes to the incentive in 2015-17?

We support the 'no-regrets' work Ofgem foreshadows in the consultation document to refine the Plexos and Energy models. Given the variation we are seeing between forecast and actual balancing costs, there is clearly scope for improvement to either or both the design of the models themselves or the quality of the date being fed into them.

What is either lacking (or hidden) in the current arrangements are clear performance criteria for model development. As it stands, stakeholders are largely reliant on qualitative statements by Ofgem about NGET's performance against its model development licence condition. If a reputational incentive like this is to work (and we generally have doubts about their effectiveness for monopolies like NGET), stakeholders need to be able to make an informed decision about performance and pose challenges where appropriate. Although it may be crude, a metric based on the gap between actual and forecast costs, measured over successive incentive periods and linked to a stand-alone financial incentive, should be considered.

We also support a review of the governance arrangements for the models, but we do have reservations about opening up the range of circumstances where NGET can adjust the methodology and the forecasts within incentive periods. While we understand the logic here – that this flexibility allows the models to be adjusted for factors that might be outside NGET's control – we have seen in other settings how this can introduce asymmetries into the methodologies for calculating rewards, with the regulated entity able to shift the probability distribution curve for penalties and rewards unreasonably towards the latter. It can also water-down the incentive for NGET to get the forecast right the first time and provide electricity retailers with more lead time to make pricing decisions.

Given one of the major limitations in NGET's ability to forecast balancing are information asymmetries between it and other industry participants – for example on generator reliability – there is logic in opening-up the model to further scrutiny by stakeholders who may have a clearer view of the drivers for the key variables. There is also a need for a robust auditing regime to complement the work by Ofgem to validate the models. Given the materiality of balancing costs, we think there is also a case for Ofgem to commission a group such as the EMR Panel of Technical Experts to review the models.

We note that Ofgem is minded to maintain the cap and collar and sharing factors that are in place for the current scheme. As we have previously outlined, the regularity at which NGET is hitting its caps and collars suggests that the incentive scheme could be better calibrated. However, given the current volatility in overall costs and forecasts, and the information we have available to us, it is difficult to suggest alternatives arrangements for 2015-17 with a degree of confidence. Our expectation is that the settings for the caps and collars, and the sharing factor, will be key issues for the comprehensive review in 2016. We will be keen to see this review approach the design of the incentive scheme from a whole-of-system perspective: in particular how it can be calibrated to influence NGET (TO) to make efficient decisions about asset reinforcement.

2. Do you consider NGET's modelling to be sufficiently transparent? How could this transparency be improved?

We are not in a position to comment on the detailed design of the models. It is also unclear to us whether industry participants, who do have the technical capability to engage at this level, consider the models to be sufficiently transparent. We do hear anecdotal complaints from industry participants about the transparency of the modelling but we do not have a sense how representative this view is.

We welcome the improved transparency that the enhanced MBSS Reports have delivered. But what is missing are explanations of what is driving adjustments to the forecasts. We understand that NGET provides this sort of information to industry at the three-monthly Operational Forums – for example, identifying specific constraints that have impacted balancing costs in that period. We think there is real value in building on this commentary and incorporating it in the MBSS Reports.

We find the Statement of the Ex-Ante or Ex-Post Treatment of Modelling Inputs Methodology (Modelling Inputs Methodology) provides a useful insight into the modelling by clearly identifying the variables and indicating whether NGET considers them to be in or out of its control.

3. How do you think the additional incentives that sit alongside the BSIS could be improved?
    a. Do you have any views on areas of functionality of the models that should be improved or introduced? How would you like to be engaged in the model development process?

Please see response to Question 2.

    b. What value do you place on NGET's wind generation forecasting? To what extent do you use this and how? Do you see benefit in extending the incentive to other areas of forecasting?

While we understand the rationale for this incentive, Ofgem is right to foreshadow a review of this incentive to determine if it is being utilised by industry and is delivering savings for consumers at a whole-of-system level. If it is found to represent value for money, then we would expect that NGET to demonstrate continuous improvement in the accuracy of its forecasts via error bands that incrementally tighten over time.

    c. Do you believe that the SO Innovation Roll-out Mechanism (IRM) should be retained? To what extent do you consider that it encourages the SO to take an innovative approach? How could the processes for application and approval be improved?

Given the IRM is in its infancy, it is difficult to provide a view on its effectiveness. We understand that NGET submitted three applications under the IRM for 2013-14 and that all three were rejected for funding by Ofgem. Ofgem identified three main reasons in its decision published on 27 June 2014 for rejecting the applications: firstly, that they failed to demonstrate long-term consumer benefits; secondly that they were not properly evidenced; and thirdly that they were not supported by a robust process of stakeholder engagement.[5]

---

[5] Electricity System Operator Incentives 2013-14: System Operator Innovation Roll-Out Mechanism Determination, https://www.ofgem.gov.uk/ofgem-publications/88464/electricitysystemoperatorincentives2013-14-systemoperatorinnovationroll-outmechanismdetermination.pdf

Although the applications were not publicly available and Citizens Advice cannot independently assess their merits, this result certainly raises serious questions about NGET's commitment to innovation and the design of the IRM so we will closely following the outcomes of the lessons learned exercise Ofgem is undertaking.

We have broader concerns about the role that incentive and innovation play in networks significantly outperforming base revenue allowances under price control settlements in a way that raises serious questions of transparency and value-for-money. In-principle, we therefore support Ofgem's decision to reject NGET's IRM applications if they did not meet the IRM criteria.

d. To what extent do you find the information that NGET publishes on transmission losses in its monthly balancing services statement and ten year statement useful?

Citizens Advice supports greater transparency around transmission (and distribution) losses given the very substantial associated costs for consumers. In general, we are not convinced that reputational incentives drive real improvements in monopoly contexts, but if they are to have a chance of working, the target of the incentive needs to be reported in a prominent and accessible way. But as it stands, the losses reporting in the MBSS Report consists of a single line in the table 'Volume of BM Actions by Category'[6] that is not supported by any commentary about the relevant trends or what is driving losses. It does not appear that the Ten Year Electricity Statement goes much further in addressing the issue of losses. At the very least we would expect to see a dedicated section on losses that sets out the relevant facts and figures and outlines a management strategy.

4. Is there a need for an additional SO-TO financial mechanism to facilitate whole system consideration for outage planning (i.e. taking account of the impact on constraint costs)?

There is clearly scope for NGET in both its SO and TO roles to coordinate whole-of-system planning to minimise disruption and constraint costs – something that the Network Access Plan (NAP) is designed to address. As we have mentioned earlier in this submission, in many cases the root cause of a constraint can be attributed to information asymmetries or agency problems. So while NGET (SO) can access NGET's (TO) outage plan, and understand how contractor availability might impact transmission availability, it does not have a similar view of the Scottish Power Transmission Limited or Scottish Hydro Electric Transmission TO networks.[7]

But we do not understand why these parties are not already sharing this information under the existing incentive arrangements or the NAP, and therefore, why a new incentive may be required. If it is that there are regulatory or legal barriers to engagement between the various actors then they should be addressed before a new incentive is created that might simply increase costs without delivering a net benefit in terms of system efficiency.

5. Is there sufficient transparency of the SO's action? If not, where are improvements needed?

See responses to Question 2.

---

[6] Monthly Balancing Services Summary 2014-15, p 38 May 2014, National Grid http://www2.nationalgrid.com/UK/Industry-information/Electricity-transmission-operational-data/Report-explorer/Services-Reports/

[7] Statement of the Ex-Ante or Ex-Post Treatment of Modelling Inputs Methodology, p 40, National Grid, http://www2.nationalgrid.com/UK/iNDUSTRY-information/eLectricity-transmission-operational-data/TRansmission-License-Condition-C16-Statements/