**Consultation on Electricity System Operator Financial Incentives from April 2017**

**Consultation by Ofgem**

**Response by E.ON**

**<u>Consultation questions</u>**

**Q1a. Should we place financial incentives on the SO in the period between 1 April 2017 and when we are in a position to implement longer term SO incentives?**

1. We agree with the approach of setting financial incentives on the SO from the period between 1 April 2017 and the conclusion of the comprehensive review being conducted in tandem.
2. We agree with Ofgem's observation that there is an inherent information asymmetry between Ofgem and the SO; there are opportunities to address this in the more comprehensive review but this is not a justification for removing incentives in the meantime.
3. We would highlight that the process of implementing interim financial incentives should not divert resources away from the comprehensive review. Ad hoc solutions are limited in their efficacy and we believe that an overall vision of where SO incentives fit into the energy landscape is needed.

**Q1b. If we maintain financial incentives from April 2017 to spring/summer 2018, should we use the existing BSIS framework?**

4. On the assumption that an enduring regime is introduced from spring/summer 2018 we agree that using the existing BSIS framework would be the most appropriate course of action while the fundamental review is being carried out.

**Q1c. Do you agree that if we maintain the existing incentives framework during this period, we should seek improvements from the 2015-17 scheme?**

5. Given that any change implemented as a result of this consultation will be replaced by the enduring regime in spring/summer 2018, there is a balance to be struck between seeking improvements and minimising costs. However, we believe there are opportunities for simple changes that can deliver benefits in this limited period. Notwithstanding our response to Question 1b, we highlight in response to Q3a & b several aspects ought to be considered if the existing incentives framework is used.

**Q3a. How could the BSIS target setting approach and modelling methodologies be improved in the short term?**

**Q3b. Do you believe the existing BSIS sharing factor cap and floor remain appropriate?**

6. We believe there could be benefits associated with lowering the sharing factor. The SO has only exceeded the target on two occasions in the period between 2009 and 2015 (2012/2013 being a minor increase in outturn compared to the target), and the SO has hit the reward cap on three occasions. This lends credence to Ofgem's argument against financial incentives: the asymmetry of information between the SO and Ofgem. Lowering the sharing factor may mitigate the effect of any defects in the target setting methodology, which, if they exist, at the moment appear to be operating in the SO's favour.
7. To further address any potential downsides from this asymmetry of information, there may be benefits associated with lowering the BSIS cap whilst keeping the collar unchanged. However, we recognise that all of these changes rest on the assumption that accurate targets can be produced. Even a scheme consisting only of financial penalties would involve working toward a target, and without evidence to suggest that the SO's models for producing forecasting targets are accurate, it is difficult to know whether such changes would act as an incentive.

**Q4. What is the best way to set an incentive on the SO to incur efficient costs when procuring Black Start from April 2017?**

8. We believe that transparency for the procurement of Black Start services is a key point of concern. Therefore we would advocate an incentive that promotes a higher degree of transparency in this area.
9. Likewise, we believe the procurement of Black Start needs to be opened up to other market entrants by moving away from bilateral procurement to a tendering process. Whilst this may not be possible in such a short amount of time, an incentive scheme that facilitates diversity in relation to Black Start provision could promote greater efficiency in the short term.
10. One problem with the approach of financial incentives in this arena is that certain transparency requirements are imposed via licence conditions, which raises the question of whether it is appropriate to incentivise something that the SO should be doing anyway.
11. We would highlight that the recent procurement of Black Start has caused significant issues for suppliers and has significant implications for energy consumers. Additional Black Start contracts were agreed in April 2016, the market was informed the following month, but as of September 2016 the process for recovering the costs of these contracts is still unclear. Our view is that a process already exists to recover these costs and should be followed. Leaving the methodology unclear for such a long period of time and for such a substantial cost has caused significant issues.

**Q5a. Do you agree that we shouldn't maintain the MDLC?**

12. We are concerned that removing the MDLC could result in simple and cost effective improvements not being pursued. Therefore, whilst we understand that substantial changes to the BSIS may not be sensible given the ongoing review, maintaining some form of incentive under the MDLC is important.

**Q5b. Do you agree that we shouldn't maintain the IRM? Are there any alternative ways to encourage innovative behaviour from the SO in the short term?**

13. We disagree with this proposal. The argument that it is difficult to know what innovative schemes to fund before the results of the comprehensive review in 2018 has merit. However, removing the IRM is likely to stifle innovation.
14. We propose that, instead of discontinuing the IRM, applications for funding should be required to include a justification of why the particular project would likely be valuable regardless of the outcome of the comprehensive review. This would avoid inhibiting potentially beneficial innovation whilst address the issues raised by Ofgem.
15. This would also encourage applications to be made in good time, improving predictability for suppliers who will be forecasting the costs, ultimately resulting in lower prices for customers.

**Q6a. Do you believe there is a need for a new incentive on short term demand forecasts from April 2017? How could this be designed? What timescales should it be based on: week ahead, day-ahead, or hour-ahead?**

16. We agree that a financial incentive on short term demand forecasts would improve efficiency. However, we would also emphasise the need to build such a scheme robustly, and this may not be practicable in the short period time before implementation in April 2017. Therefore we believe it may be more sensible to deliver this new incentive through the comprehensive review.

**Q6b. Do you think there needs to be any changes to the wind generation forecasting incentive or new incentives on any other system forecasts?**

17. It is our belief that accurate wind generation forecasts provide significant benefits for the SO without the need for further incentives, and that these benefits would influence the behaviour of the SO regardless of whether an additional financial incentive existed.
18. We would highlight that more transparency in wind forecasts, for example through publication of the SO's 4 hour ahead wind forecast could help other parties to balance and reduce balancing costs overall.
19. Whilst visibility of individual forecasts is important, the net forecast, after accounting for demand, embedded wind generation, solar generation and so on is also crucial. The accuracy of this net position should not be ignored when constructing a new framework of incentives for the longer term.

**Q7. Do you think the SO's procurement of balancing services needs to be more transparent and open? If so, what steps should be taken? Should the SO pursue more market-based approaches? Should we introduce any incentives or requirements on the SO in this area from April 2017?**

20. We think the SO's procurement of balancing services needs to be more transparent (see Q4). The recent Enhanced Frequency Response tender is a good example of the levels of

transparency that are likely to reduce the cost of that service in future. This would be a corollary to moving away from bilateral agreements, as mentioned in connection to the procurement of Black Start.

21. A move to more market-based procurement is crucial in reducing SO costs overall and ultimately in reducing costs for customers. We believe there are numerous opportunities to realise some of the benefits of markets and competition through auctions, increased frequency of tenders, increased transparency and so on. It is crucial that incentives to encourage such schemes are reflected in the enduring scheme.
22. We believe that future flexibility markets should not be based around long term contracts. Long term contracts carry a risk for the SO (and therefore the end consumer) of locking in expensive solutions for the long term. This is especially true in terms of flexibility, with large price decreases expected for lithium-ion storage over the next 5 to 10 years.
23. We recognise that investors seek certainty when making long-term investments. However, we believe well-designed market structures will give stability over the long term; markets can provide sufficient stability for those seeking to invest in flexibility. Flexibility is a service that is needed by the SO and becoming increasingly important, clear and reliable price signals are key.

**<u>Appendix 1 – Consultation on SO-TO mechanism</u>**

24. We highlight below some general thoughts to be considered.
25. We agree with Ofgem that the relationship between the SO and TOs is becoming increasingly important and that opportunities to reduce costs should be explored. However, we are concerned that financial incentives that encourage greater collaboration between the SO and TO risk a conflict of interest; this needs to be thoroughly explored, understood and mitigated before any mechanism was introduced.
26. We also highlight that there are likely to be benefits to the SO working more closely with Distribution Network Operators (DNOs), perhaps with those DNOs taking a much more active role in managing their networks and their impact on the SO overall (i.e. moving to Distribution System Operators).
27. Given the complexity of these issues we believe any mechanism should be introduced as part of the wider changes to SO incentives, giving time for robust analysis and review.

E.ON

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