Rupert Steele OBE
Director of Regulation

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Dear David,

ELECTRICITY SYSTEM OPERATOR INCENTIVES FROM APRIL 2017

Thank you for the opportunity to provide views on behalf of ScottishPower on Ofgem's consultation on Electricity System Operator incentives from April 2017.

In the current absence of competition for the role of GB System Operator (SO), which is a monopoly buyer of balancing services, and given the overall cost of such services, we support the extension of an appropriate incentive scheme which helps to secure the system at least cost to consumers by encouraging efficient SO behaviours.

We broadly support maintaining the existing framework over the interim period, bridging expiration of the current two year scheme in March 2017 and implementation of the recommendations of Ofgem's wider review in spring/summer 2018. However, we believe that where quick wins exist which would benefit consumers if implemented early, these should be reflected in the interim scheme commencing April 2017.

Three such quick wins identified by ScottishPower include the introduction of incentives which would improve:

- the effectiveness and cost of black start services;
- the transparency of procurement processes and contracting activities which would improve competition in some key balancing services; and
- co-operation between the SO and TOs to reduce overall system management costs through the introduction of an appropriate SO-TO funding mechanism.

We have provided details of these proposals in our responses to the individual questions presented in the consultation.

However, given that the existing scheme expires in only 6 months' time and the interim scheme is expected to last for less than 18 months, we would caution against making more extensive changes at this time. Instead, we would prefer to see resources being employed to consider and implement an appropriate replacement scheme during 2018 which reflects the needs of a system which has substantially changed since the existing scheme was designed prior to 2015.

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In general, we consider that consumers would be best served by greater emphasis being placed by the SO on measures which enable competition to flourish. Such measures should primarily include ensuring that charging methodologies are cost reflective and that procurement processes and contracting activities for balancing services are fair and transparent. Furthermore, these activities should support accurate forecasting of BSUoS costs on a continuous basis by the suppliers and generators on whom they are imposed.

We believe that there are likely to be benefits from the introduction of an SO-TO funding mechanism which would reduce overall costs of managing the electricity transmission system. It is likely that there are already frequent instances where overall system costs to consumers can be reduced by the SO incentivising TOs to take action which, in the absence of such a mechanism, are not presently cost-efficient for the TO, working in isolation. We believe that it would be beneficial to introduce this proposal from April 2017 in order that early experience with the system can be incorporated into a longer term scheme.

I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Rupert Steele

Rupert Steele
Director of Regulation

Annex 1

ELECTRICITY SYSTEM OPERATOR INCENTIVES FROM APRIL 2017 – SCOTTISHPOWER RESPONSE

CHAPTER 2: WHETHER TO MAINTAIN THE EXISTING INCENTIVES FRAMEWORK

Question 1a: 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?

In the current absence of competition for the role of GB System Operator, which is a monopoly buyer of balancing services, and against the context of the magnitude of the overall cost of such services, we support the extension of an appropriate incentive scheme which helps to secure the system at least cost to consumers by encouraging efficient SO behaviours.

Question 1b: If we maintain financial incentives from April 2017 to spring/summer 2018, should we use the existing BSIS framework?

We broadly support maintaining the existing framework over the period bridging expiration of the current scheme and implementation of the recommendations of Ofgem's wider review in spring/summer 2018. However, we believe that where quick wins exist which would benefit consumers if implemented early, these should be reflected in the scheme commencing April 2017.

Question 1c: Do you agree that if we maintain the existing incentives framework during this period, we should seek improvements from the 2015-17 scheme? Please provide evidence to support your answers.

We agree that Ofgem should maintain the existing incentive framework during the period of the interim scheme and that a few "quick win" improvements should be sought. In particular, we propose improvements which would enhance the effectiveness of black start services and better stimulate competition in the SO's procurement of ancillary services. We would also like to see some trialling of the SO-TO funding concept. Details of these proposals are provided in our responses to questions 4, 7 and 9-19.

Beyond this, we would caution against seeking further change during the brief extension period. Instead, we would encourage Ofgem to focus its resource on developing an appropriate scheme for implementation during 2018 which would support efficient system operation over the period beyond this interim scheme.

CHAPTER 3: SCOPE OF POTENTIAL CHANGES FROM THE 2015-17 SCHEME

Question 3a: How could the BSIS target setting approach and modelling methodologies be improved in the short term?

We would like to see improvements to the Black Start incentive, to the transparency of the SO's procurement activities and in the introduction of an appropriate SO-TO funding mechanism, and have provided detailed responses reflecting our views to questions 4, 7 and 9 to 19 respectively.

However, in the short term, against a context of the existing scheme expiring in only 6 months' time and the interim scheme being anticipated to last for less than 18 months, we would caution against making more extensive changes. We would prefer to see resources being employed to fundamentally review the scheme such that an appropriate scheme is implemented during 2018 which meets the needs of a system which has substantially changed since the existing scheme was designed prior to 2015.

Question 3b: Do you believe the existing BSIS sharing factor and cap and floor remain appropriate?

We support retention of the existing BSIS sharing factor and cap and floor metrics in an incentive scheme commencing April 2017.

Question 4: What is the best way to set an incentive on the SO to incur efficient costs when procuring Black Start from April 2017?

It is essential that the SO has a robust black start strategy in place, the fundamental objective of which is to ensure that adequate and swift re-energisation plans are in place throughout GB. Key enablers of this strategy will be to establish up to date Local Joint Restoration Plans (LJRPs) between the SO, TO, DNO and relevant black start service provider, and Commercial Service Agreements (CSAs) which facilitate their implementation in a black start event.

Once an appropriate strategy is established, it is necessary to ensure that costs to consumers are minimised via an efficient and transparent tender process which maximises the benefits of competition. We favour the establishment of annual competitive auctions, for say 1, 5 and 15 year durations, to purchase black start CSAs, in a manner similar to that in which capacity is procured in T-1 and T-4 CM auctions each year.

Incentives are required which reward the SO for establishing, or which penalise the SO for failing to establish, such a black start strategy and thereafter implementing it efficiently through procurement of appropriate CSAs. The black start cost target agreed in respect of the incentive scheme needs to be set at a level which facilitates delivery of the black start strategy in respect of each zone of the network. It is our view that the existing target was reflective of the short run marginal costs of providing the service from ageing plants which have since retired due to a lack of profitability, and that therefore the target needs to be significantly increased to attract new investment which will seek to recover its long run marginal costs.

In the event of unexpected events which were unforeseeable by the SO resulting in greater (though reasonably managed) costs being incurred than anticipated in the incentive scheme, it would remain appropriate for the SO to seek to recover those costs via an Income Adjusting Event.

Finally, we further propose that National Grid should be mandated to report to Ofgem annually on its assessment of its black start preparedness in each individual network zone, using a simple scale with a 1 to 5 scoring system. Publication of this report would facilitate preparations for a black start event, particularly by customers for whom swift black start restoration times are vital such as hospitals and prisons, and by the Energy Emergencies Executive and its Committee.

Question 5a: Do you agree that we shouldn't maintain the MDLC?

We agree that it would be inappropriate to maintain the MDLC requirement in light of the longer term review of the BSIS scheme which would be expected to no longer use these models.

Question 5b: Do you agree that we shouldn't maintain the SO IRM? Are there any alternative ways to encourage innovative behaviour from the SO in the short term?

We agree that it would be inappropriate to maintain the SO Innovation Rollout Mechanism (IRM) facility in light of the limited duration of the incentive scheme bridging the period between expiration of the existing scheme and the scheme resulting from Ofgem's wider review commencing in spring/summer 2018.

Question 6a: 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, hour-ahead, other?

We support maintaining the existing short term demand forecasting incentive for the transitional incentive scheme commencing in April 2017. However, in Ofgem's subsequent wider review for implementation in spring/summer 2018, we think that consideration should be given to extending the incentive such that the SO provides a fuller breakdown of its forecast between transmission demand and behind-the-meter generation and true Demand Side Response (DSR). The growth in embedded generation and in DSR responding to existing charging arrangements, particularly to Triad TNUoS arrangements, has distorted the picture of underlying customer demand.

We recognise the benefit of introducing new incentives which would improve demand forecasting over different timescales, including at the week-ahead stage, in that these could encourage the SO to take more cost efficient balancing actions on a forward basis rather than at delivery.

In the longer term, we would welcome proposals from the SO on its plans for use of Smart Meter data to better forecast both customer demand and behind-the-meter generation.

Question 6b: Do you think there needs to be any changes to the wind generation forecasting incentive or new incentives on any other system forecasts?

We support maintaining the existing incentive. In common with demand forecasting, as stated in our response to question 6a above, we recognise that in the longer term there is likely to be a benefit from introducing new incentives which would improve wind forecasting over different timescales, including at the week ahead stage, in that these could encourage the SO to take more cost efficient balancing actions on a forward basis rather than at delivery.

We also believe that given the context of in excess of 10GW of solar PV capacity having been installed on the GB system, similar incentives should be in place for the forecasting of solar production.

Question 7: 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?

It should be a core assumption of the SO's balancing service activities that all procurement processes and contracting activities are transparent and facilitate competition, unless there is compelling evidence that there is a net benefit to consumers from not doing so.

We have longstanding concerns at the inconsistency of approach towards transparency across the various balancing services which the SO procures from industry. In recent years the SO, often with support from or at the request of industry, has largely migrated from bilateral negotiations towards the use of competitive tenders and has introduced a number of excellent pre and post tender reports which have facilitated competition. However, there remain a number of services where the procurement process is opaque and fails to adequately stimulate competition. We believe that pre- and post-tender reports should be published following each such procurement. Pre-tender reports should specify what the service requirement is and the assessment criteria against which competing offers will be judged. Post-tender reports should give details of all offers received, including the identity of the service provider and the parameters (price, volume, duration etc) against which offers were assessed by the SO. Good examples of such high quality reports are those published following monthly tenders for the Tendered Fast Reserve or Firm Frequency Response services.

Specific examples of services where transparency and therefore competition could be improved include:

- **Non-Tendered Fast Reserve**: Despite the SO spending £68.8m on this service in 2015/16 and BM instructions resulting from these agreements frequently setting cashout prices, no data is published on the prices charged or on the volumes awarded to individual service providers. Publication of such data (hourly prices, hours instructed) in respect of each of the sub-categories of the service would promote competition in this sector, by enabling service providers to dynamically adjust their prices in order to compete for greater market share, benefitting consumers. Sub-categories include: (i) Spin-Gen; (ii) Spin-Gen with Low Frequency relay; (iii) Spin-Pump; (iii) Spin-Pump with High Frequency relay; (iv) Pump-Deload; and (v) Fast Start.

- **Tendered Fast Reserve**: There is an excellent report published by the SO following each monthly tender which supports competition. However, we understand that the SO applies risk premia to offers received from service providers located north of the Cheviot export boundary, in order to reflect the probability of the value of the contracts being eroded due to the contracted service provider being inaccessible during periods of network congestion. However, there is no transparency of this important assessment criterion as the SO does not publish it in its pre-tender market reports.

- **Commercial Intertrip**: No data is published on the prices charged or on the volumes awarded to individual service providers. Publication of such data (arming prices, tripping prices, unit hours armed, unit trips) would promote competition in this sector between generators located within the same export congested network zone, by enabling service providers to dynamically adjust their prices in order to compete for greater market share, benefitting consumers.

- **Black Start**: See response to question 4.

- **Bespoke CSAs**: The SO periodically tenders for bespoke services such as reactive power or constraint management services at a particular location where only a subset of service providers can contest the service. Having published details of the invitation to tender which adequately promote competition from qualifying service providers, it has frequently been observed that the SO has subsequently failed to disclose details of the offers received and of the contracted services following agreements being awarded as a result of the tender process. Competition would be better facilitated over the longer term, and BSUoS costs would be better forecast by Suppliers and Generators across GB (thereby facilitating more efficient tariff pricing and dispatch decisions), were such details to be published on a consistent basis.

- **Supplemental Balancing Reserve**: We recognise that contracting for Contingency Balancing Reserve (CBR) was a transitional measure ahead of Capacity Market agreements being available. However, were it to be repeated, we would seek significant revisions to market reports published regarding the results of the tender. The report published by the SO dated 11 December 2015 in respect of the winter 2016/17 Supplemental Balancing Reserve (SBR) auction appeared to purposefully obfuscate the results by aggregating and anonymising the successful and unsuccessful offers. Competition would have been better served and BSUoS costs more efficiently forecasted by licensees had a simple list been published which clearly identified each of the offers.

We would support the introduction of incentives which encouraged the SO to take actions which resolved the failings described in respect of the procurement processes of these services. Incentives could include imposition of an appropriate financial penalty in each instance in which the SO fails to publish appropriately transparent pre and post tender reports in respect of total annual expenditure on the individual service exceeding £10k.

We recognise that there can sometimes appear to be overlap between the various services procured by the SO and that there may be a case for bundling some of the services together. However, we would like to see specific detailed proposals brought forward before any action is taken, in order to fully consider the impact of such actions and prevent any unintended consequences. Many Response (Firm Frequency Response, Mandatory Frequency Response) and Reserve services (Fast Reserve, STOR, Contingency Balancing Reserve) may appear to overlap but we believe that they differ substantially in terms of the timeframes and the different obligations they impose on service providers, and therefore the value which they provide to the SO and ultimately to customers. For example, successful Fast Reserve service providers contract to respond many times each day, within one minutes' notice, for short minimum run times, contrasting with say the Supplementary Balancing Reserve service, which is subject to much longer notice and minimum run periods.

Question 8: Do you agree with our proposed scope of changes? Is there anything else you believe should be changed, added or removed from the existing scheme?

We agree with the proposed scope of changes.

APPENDIX 1 – CONSULTATION ON SO-TO MECHANISM

Question 9: Do you agree that there is a need for a mechanism that allows the SO to exchange funds with the TOs? Are there any additional pros and cons that we should consider in our analysis? Do you agree it should be introduced from April 2017?

We agree that there may be benefits from the introduction of an SO-TO funding mechanism in reducing overall costs of managing the electricity transmission system. We also agree that it would be beneficial to introduce this from April 2017 in order that early experience with the system can be incorporated into a longer term scheme.

We think Ofgem should also consider whether additional efficiency gains could be achieved by extending the funding mechanism to include generator involvement. This could cater for situations where the cost of accelerating engineering work was less than the cost of lost renewables production, and generators were willing to provide funding in exchange for reduced outage durations.

Question 10: Do you agree with the codified-approach?

We agree that it would be appropriate to codify any mechanism into the STC as this would give Users of the transmission system and BSUoS payers visibility of the mechanism and the decision process behind actions which may affect them both operationally and financially.

Question 11: What do you consider to be the most appropriate cost recovery levy methodology?

There appear to be issues with each of the cost recovery methods identified in paragraphs 43 to 45. While targeting the costs into the periods in which the savings are realised would be most cost-reflective, there may be some subjectivity involved in determining those periods affected. This could potentially increase the existing volatility and unpredictability of BSUoS costs and, on balance, we would prefer a flat recovery overall settlement periods in the year.

Question 12: Do you agree with the proposed approach with regard to the financial aspects of the mechanism outlined above?

We agree that once the costs of carrying out a cost-mitigation activity have been agreed with the TO that the TO should be paid for completing the works whether or not the anticipated cost savings are realised as this is outside the TO’s control.

Question 13: Do you agree with our proposed investment threshold for Ofgem approval?

Potential outage cost savings may be identified at relatively short notice through agreement between Users and the TO and therefore a flexible mechanism is required to allow these opportunities to be realised without an overly administrative approval process. The threshold of £100,000 for such schemes would appear to be appropriate.

Question 14: Do you think the costs incurred through a mechanism should be incentivised as part of an overarching financial target on balancing costs, or as part of a separate financial incentive?

The potential costs savings identified are likely to be contained within cost elements which are already subject to the SO Incentive Scheme and therefore we believe that a separate financial incentive may result in “double-counting” of any savings.

Question 15: What, if any, impact will limiting the mechanism to the end of RIIO-T1 period have on the efficiency of potential projects that cover both RIIO-T1 and RIIO-T2 periods?

We would expect that the potential schemes envisaged are likely to be of relatively short duration and complexity given the suggested threshold of £100,000. This aside, any project which bridged the two price control periods should be able to benefit from the appropriate incentives under each scheme. Early agreement of the SO Incentive scheme would help prevent and potential hiatus in projects.

Question 16: Are there any other criteria we should consider for such projects?

No.

Question 17: What level of transparency would you want regarding this mechanism?

We would expect the System Operator to report on the operation of the mechanism through the monthly BSIS report and at the Operational Forum meetings.

Question 18: Do you consider that we have identified the changes required correctly? Are there any other changes required to the existing framework in order to implement the mechanism?

Yes.

Question 19: Are there any other factors that you think we need to consider in the design of the mechanism?

No.

ScottishPower
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