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Dear David,

Electricity System Operator Incentives from April 2017

Thank you for the opportunity to respond to the above consultation. This response is made on behalf of Uniper UK Ltd.

We believe that given the major developments in the electricity system over the last few years, including the growth of intermittent and embedded generation, interconnection, and the SO's role, there is a pressing need for a fundamental review of SO incentives. Ideally such a review would have been undertaken in time to set incentives from April 2017. As this is not the case we support the development of a System Operator Incentive Scheme to cover the period April 2017-March 2018, based on, but seeking improvements upon, the 2015-17 Scheme.

Our answers to some of the specific consultation questions are as follows:

<u>Whether to maintain the existing SO incentives framework:</u>
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?
Uniper believes that an incentive scheme should be continued in order to maintain pressure on the System Operator to seek to reduce balancing costs to customers. However, we are wary of setting up a scheme to cover more than twelve months, beyond which it becomes more difficult to set accurate targets. We would suggest that a scheme covering April 2017 to March 2018 is preferable, with incentives from April 2018 dependent on the findings of the fundamental review.

Question 1b: If we maintain financial incentives from April 2017 to spring/summer 2018, should we use the existing BSIS framework?
This would be a practical approach given the expectation that a fundamental review of the effectiveness of the current scheme may result in significant revisions to the framework of future incentive schemes, perhaps within a year or so. It is also desirable to prioritise resources for the more fundamental review. As per our answer to question 1a however, we would prefer this interim scheme to cover no more than twelve months.

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?
Yes, we agree with Ofgem's preference for pursuing this option. Various concerns have been identified with the existing SO incentive scheme and this opportunity should be taken to address them, without diverting too much resource from the more fundamental review.

Scope of changes from the 2015-17 scheme
Question 3a: How could the BSIS target setting approach and modelling methodologies be improved in the short term?
As a general observation we would suggest that ex-post inputs should be kept to a minimum. We agree that the SO should perform a full review of the methodologies and assumptions underpinning the BSIS models to improve accuracy in BSIS target-setting, but National Grid is best placed to perform such a review; parties have a limited ability to critique SO modelling and provide input into the target setting process. Parties are most interested in understanding the scheme and what it can tell them about expected levels of balancing costs and therefore Balancing Services Use of System charges, so they can better manage the risks associated with these costs to the benefit of customers. Greater transparency of modelling is desirable to assist this, for instance, we would appreciate greater clarity of National Grid's BSUoS forecasting methodology. Uniper also supports Ofgem's suggestion of external scrutiny or audit of the SO's models.

Question 3b: Do you believe the existing BSIS sharing factor and cap and floor remain appropriate?
We see no strong arguments for changing the sharing factor from 30%, capped at plus or minus £30m for each year of the scheme.

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?
The agreement of two Black Start contracts costing £113m for 2016-17 seems to be partly as a result of National Grid having left itself a distressed buyer and we hope that this situation will not occur again. The SO should be striving for best practice and maximum efficiency in procurement of Black Start from April 2017. This would include tendering at the earliest opportunity. We believe that Ofgem are best placed to determine how to set a Black Start incentive. (With regard to the contracts agreed with Drax and SSE, while Ofgem has been informed, other parties are not privy to the SO's reasoning behind the agreement of these contracts).

Question 5a: Do you agree that we shouldn't maintain the Model Development Licence Condition?
Yes.

Question 5b: Do you agree that we shouldn't maintain the SO Innovation Rollout Mechanism? Are there any alternative ways to encourage innovative behaviour from the SO in the short term?
Yes, from the information provided we agree that this Rollout Mechanism should not be extended.

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?
Yes, we believe that an incentive on short-term demand forecasts would be useful, and that this should go down to settlement period granularity. We do not see a need for a week-ahead incentive, but day-ahead and hour-ahead would be appropriate. This should help to drive improvements in forecasting accuracy.
Concerning the forecasts themselves, for clarity, we would also like to see gross demand, with wind separated from the short-term forecast, and the embedded forecast split by Wind, PV, and Other embedded. Potentially, separate incentives could be put in place for the individual elements. If not now, this could be considered as part of the wider review of incentives.

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 do not believe that changes to the wind generation forecasting incentive are necessary as such. However as per our answer to question 6a, we would like to see a gross demand forecast and the embedded generation split by Wind, PV, and Other embedded.
We would also suggest that an incentive on BSUoS forecasting would be appropriate, particularly given the considerable increase in both the size and volatility of BSUoS charges in recent years. Accurate BSUoS forecasting is very important for generators to incorporate in prices, and improvements in understanding and accuracy of National Grid's forecast would be very helpful.

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?
Yes, the SO should be required to follow a transparent procurement process. Transparency of NGET's actions and decisions is of vital importance for the efficient functioning of the wholesale electricity market, providing certainty and sending clear signals to the market, driving innovation, competition and efficiency. The procurement process should be open from the start, market-based with limited undertaking of bilateral discussions. National Grid's procurement guidelines affirm that currently 'where sufficient competition exists, we will seek to contract for Balancing Services via some form of market mechanism'. However even when there may be few providers able to provide a certain service, to provide transparency for all market parties it would still be preferable to undertake an open process. It is important that procurement of balancing services also ensures equal treatment and transparency of contracting with both BM and NBM service providers.

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?
As per our answer to question 6, we would like to see an additional incentive on the SO to improve the accuracy of BSUoS forecasts.

<u>Consultation on SO-TO mechanism</u>
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?
It seems that market developments could justify a SO-TO mechanism. However, the details warrant careful consideration. Not least, passing costs from the TO business, which are normally recovered over a longer timeframe, to the SO business, with cost recovery typically over a year or less, could result in significant volatility in balancing costs year on year. We believe that there are arguments for a two-way mechanism: it may be that the SO incurs costs owing to TO actions, and there should also be arrangements in place for monies to flow from the TO to SO in such circumstances. Thorough consideration must be undertaken to ensure that a robust mechanism is developed before any such mechanism is introduced.

Question 10: Do you agree with the codified-approach?
Yes, we agree that a codified approach is desirable to provide a robust structure to process any future changes.

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?
We believe that an overarching target is sufficient. Ultimately it is the total costs that matter to the customer.

Question 17: What level of transparency would you want regarding this mechanism?
We would expect complete transparency. Any transactions undertaken through this mechanism should be made visible; we see no reason for exceptions. This could also assist parties with BSUoS forecasting.

I hope the above comments prove helpful. Please contact me in the first instance if you have any further questions.

Yours sincerely,

Esther Sutton
Uniper UK Limited