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Dear Leonardo,

This response was prepared by Citizens Advice. Citizens Advice has statutory responsibilities to represent the interests of energy consumers in Great Britain and welcomes the opportunity to respond to the consultation on Ofgem's initial proposals for electricity system operator incentives from April 2017.

The need for credible targets, backed by a trustworthy methodology

We warmly welcome the package of reforms proposed by Ofgem and think it provides an appropriate balance of incentives and targets for the SO.

We recognise that there are considerable difficulties in setting targets for such a scheme given the volatility in some areas, particularly Black Start at the present time. Those forecasting difficulties have manifested in the cap or collar of the incentive scheme being hit within year on a number of past occasions, and for there to be significant divergence between forecast and outturn costs. These forecasting problems may create some risk of the SO incurring windfall gains or losses that result from modelling issues or external market conditions rather than from its adoption of efficient or inefficient behaviour. Notwithstanding that risk, we share Ofgem's view that it is preferable to have an SO incentive scheme in place rather than none at all, as there being potential cash to gain/at risk for the SO is more likely to drive efficient behaviour than simply relying on licence conditions would.

We strongly welcome your move to reduce the BSIS target for 2016/17 by £491m as a result of correcting errors in National Grid Electricity Transmission (NGET)'s modelling. This is an appropriate step, as NGET should not be rewarded for poor modelling - that would be a perverse outcome. We note that even with this correction, this may be the fourth year in a row where outturn costs fall below those forecast. This may be the manifestation of consistent good practice - of consistent outperformance - by the SO. But it may also suggest that its modelling tends to systematically overestimate likely costs. Of course, those two possibilities are not mutually exclusive.

Because of these issues, we think your proposals to require an ex ante independent third party audit of the methodology used by NGET to set BSIS targets before it is used, and for the Authority to retain the right to direct NGET to again seek third party validation in the event of subsequent problems, both seem prudent. We also think your proposals to reduce the sharing factors and caps and collars, and to provide a mechanism to disapply incentive payments in any month where performance falls more than two standard deviations from historical costs, should also reduce the risk that the SO makes significant windfall gains (or losses) that are driven more by modelling issues than by genuinely good (or bad) performance.

Black start

We agree with you that the risk of modelling errors appears particularly acute for Black Start services, where costs appear to have septupled from £19.2m to ~£147m between 2015/16 and 2016/17. With that degree of year on year volatility, the setting of a ex ante target appears to come with excessive risks of windfall gains and losses. Adopting a combination of requiring the SO to produce an ex ante strategy and procurement methodology on how it will source these services, and an ex post, audited, Ofgem assessment of how efficiently it delivered them, seems like an appropriate approach.

We remain anxious that the extent to which Black Start costs have recently ballooned may suggest problems with both the liquidity of the market and with NGET's procurement processes insufficiently testing the market to see if new sources of these services can be found. We note that the perceived opacity of NGET's procurement processes has been criticised by other potential providers of ancillary services as causing market distortion.[1]

As you move towards putting in place the successor SO incentive regime covering the years 2018/19 to 2020/21 inclusive, we would like to see you bring forward proposals to improve the transparency of NGET procurement processes and to provide an assessment of the liquidity in the Black Start service provision market. In the event that the latter suggests a problem, we would look to you to bring forward proposals on how this could be tackled, in order to avoid the risk that consumers see a continuation of the material hike in costs that has been witnessed in 2016/17.

Wind forecasting incentive

We agree with you that revision is needed to the wind forecasting incentive given the evidence you present that the accuracy of its short term forecasts is asymmetric, with a tendency to over forecast output.

We also agree with you that there is value in an incentive design that rewards both the accuracy of forecasting and the removal of any tendency towards asymmetry in the direction of any errors. Though this is the case, we suggest there may be value in setting a tighter target on the asymmetry incentive than the one you put forward.

You are proposing that NGET would not receive any reward if it over or under forecasts [≥]60% of the time. You note that it had a 63% over-forecast record between 2013 and 2015, which has deteriorated to 72% in recent months. We recognise 60% would be tighter than both recent and historic performance, and would therefore appear to incentivise performance improvements compared to the status quo. But we consider that it would still allow the SO to be rewarded for providing forecasts with a fairly significant systematic bias in one direction or the other. While intermittent generation poses natural forecasting problems for an SO, these problems are not particularly new and it has had a number of years to get used to the

[1] 'Tempus Energy calls for investigation into black start contracts,' Utility Week, 5 April 2016. http://tinyurl.com/hrxykg6

output profiles of scale wind. We would expect to have seen it get progressively better, not progressively worse, at these forecasts through experience. We also think the value of these forecasts to market participants is likely to be heavily contingent on their trustworthiness, and a tendency toward asymmetric errors will likely reduce their trustworthiness.

We would therefore suggest you consider tightening the 'unbiased forecast' trigger from 60% to 55%.

Demand forecasting incentive

You suggest that there is evidence that the SO is consistently over forecasting day ahead demand, that traders are aware of this trend and that it is driving up day ahead prices.

We agree that this suggests more effective incentives are needed to encourage better demand forecasting.

We would find it useful if you could give a sense of the consumer materiality of the detriment caused by this in any follow up work as without this it is hard to judge the proportionality of any incentive applied here. Because of this, we offer no views on the level of the incentive/penalty payments proposed here.

SO-TO mechanism

We agree with your proposal to introduce a mechanism for the SO to exchange funds with a Scottish TO if there are opportunities for it to carry out works that lead to overall system cost savings.

We note that you do not plan to apply this scheme to England and Wales because the SO and TO are integrated for those nations. Because of this, you argue that these trade offs should happen internally, and would be difficult to monitor. Because SO and TO incentive schemes are set separately, and will contain their own individual parameters, it is not self evident to us that these trade-offs will necessarily take place in an optimal manner. For example, if a cap or collar has been hit under one price control but not the other, or one rewards or penalises an over or under spend more strongly than the other, we can see potential for those trade-offs to be sub-optimal.

While we are comfortable for the geographic restriction on this incentive to be in place for 2017/18 given that it is a pilot scheme, we encourage you to more explicitly demonstrate how NGET makes internal trade-offs between SO and TO spend when you bring forward proposals for the SO incentive for subsequent years. We would find this extremely useful, and it may help wider understanding of the efficacy of interactions between the schemes.

This submission is entirely non-confidential and may be published on your website. We trust this submission is clear but please do not hesitate to get in contact if you would like to discuss any issue it raises in further detail.

Yours sincerely,

Richard Hall
Director of Strategic Infrastructure, Consumer Futures