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Initial Proposals for electricity SO incentives from April 2017

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We welcome the opportunity to respond to your initial proposals for the SO Incentives scheme for the one year period, commencing 1 April 2017. In anticipation of the comprehensive review to the SO incentive scheme from April 2018 it seems prudent to limit any fundamental changes to the current scheme and so in general we support Ofgem's proposal. Our key points are:

- We support the narrowing of the cap and collar to a maximum of £10m and lower sharing factor, particularly considering the deficiencies identified in some of the modelling seen in 2016/17;
- For the avoidance of doubt, we expect Ofgem to address the identified 'model errors' to ensure there is no windfall gain for National Grid;
- We support the removal of Black Start funding from BSIS, given cost volatility and scale, and support Ofgem's drive for increased transparency. However, we still have a number of concerns regarding black start procurement, namely:
 - The black start procurement methodology is not proposed to be transparent - we are concerned that given its ex-post assessment, National Grid will be incentivised to follow the methodology precisely rather than ensure best value;
 - With the need to encourage new black start providers it is not clear that an ex-post one year incentive will create the right incentives to National Grid to reach out to the market and deliver a more competitive market in the medium term;
 - Ofgem need to look wider than SO incentives to ensure effective black start procurement: we continue to believe that generators also need to be held to account as part of a more stable and enduring solution to black start provision. We note Ofgem have not taken forward this suggestion within their initial proposals; we consider this an important aspect of the arrangements to ensure efficient black start procurement and should be assessed in future;

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- Ofgem should also recognise that Suppliers still face significant risk of surprise costs arising from black start provision which will impact our ability to compete and offer customers fixed price deals. Ofgem in parallel need to address this growing uncertainty, e.g. through changes to BSUoS charges (CMP250).
- Finally, we would encourage Ofgem to engage with industry as early as possible on the enduring SO incentive scheme to ensure that sufficient time is made available so that any new incentive framework is fair and fully transparent to industry participants and holds the SO accountable for their actions.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 01452 658415, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Angela Hepworth".

Angela Hepworth
Corporate Policy and Regulation Director

Attachment

Initial Proposals for electricity SO incentives from April 2017

EDF Energy's response to your questions

CHAPTER: Two

Q1. Do you agree with our proposals to introduce new licence requirements / guidance around SO balancing behaviour? Please explain your answer.

Yes. It is very useful to be able to hold the SO accountable to more specific conditions and drive the right behaviours to lower costs for market participants and consumers. The evidence of the scale of model errors reinforces the need to have clearer expectations set of SO balancing behaviour.

Q2. Do you agree with the clarifications we propose to introduce to NGET's licence? Is there anything missing or that should be removed? Please explain your answer.

The more detailed explanation proposed to be introduced to NGET's licence removes some of the ambiguity within the previous condition. Without the necessary framework to fully assess these more detailed conditions in the market, the industry is more reliant on the regulator to challenge the SO on its actions.

It would be helpful if the SO was incentivised to provide an update on their expected annualised forecast more frequently with any new information that will impact future costs.

Q3. Do you agree with our Initial Proposal of maintaining a model-based target from April 2017 until March 2018? Please explain your answer.

We agree that keeping the existing form of model-based targets is appropriate, especially given the narrower cap and collar proposed. While a lower cap and floor range will reduce incentives on the SO to manage costs, it strikes the right balance of retaining a financial incentive but mitigating modelling deficiencies that can produce inaccurate targets.

Q4. Do you agree with our proposed changes to the governance and incentive parameters? Is there anything missing or that should be removed? Please explain your answer.

The appointment of an independent party to oversee the accuracy and appropriateness of assumptions provides a welcome additional layer to ensure that targets are fit for purpose.

We also welcome the process the SO will be required to follow to identify and correct modelling errors within the incentive scheme and the direct suspension to the incentive scheme under certain circumstances until the Authority is fully satisfied.

We request that any mechanism adopted which caps or suspends incentive funds is communicated effectively to industry participants to allow them to reflect these in their commercial operations.

CHAPTER: Three

Q1. Do you agree with our proposal to remove Black Start from BSIS? Please explain your answer.

Yes. It is becoming more apparent that the procurement strategy for Black Start is changing and applying an out-dated incentive target serves no benefit.

If the incentive remained it could promote the SO to achieve a sub-optimal solution when the focus should be on a longer-term more enduring procurement strategy.

Q2. Do you agree with the principles of our Black Start regulation? Should we add or remove any principle? Please explain your answer.

On the whole it is useful for the Authority to expand on its principles and these are in line with what we would expect. The transparency objective which aims to make this process more competitive amongst market participants is very much welcomed and, while we understand the requirement for a level of security, it is important to increase transparency where possible to engage the market effectively.

Q3. Do you agree with our proposed regulatory framework for 2017/18? Please explain your answer.

Whilst this framework looks reasonable and the longer-term approach seems sensible there still must be more transparency for industry participants. In particular, we expect the black start strategy to be a public document and consulted on. As noted above and recognised by Ofgem, we are concerned that the ex post regulatory approach proposed will encourage National Grid to focus on following the agreed process rather than finding the best solution for industry and consumers in the medium and long term.

CHAPTER: Four

Q1. Do you agree with our amended wind generation forecast incentive proposal? Are there any elements you feel should be changed or that are more relevant to you? Please explain your answer.

We would expect that the SO does not implicitly require a financial incentive to a component that in itself provides a benefit to them as well. It should be in their baseline behaviour.

We are pleased to note that the incentive has been spread more equitably over the year which means there is a clear incentive to continue accurate forecasting throughout the scheme year.

Q2. Do you agree with our proposal to introduce demand forecasting incentives in this interim scheme? Are there any elements you feel should be changed or that is more relevant to you? Please explain your answer.

Similar to incentivising wind generation there is already an incentive for NGET to ensure accurate demand forecasts. However, as the targets proposed to be set to measure accuracy appear to be very challenging (using the historical lower quartile), it may challenge the SO to explore improved techniques.

Q3. Do you have any additional criteria that you would propose for the Quarterly Forecast Report? Please explain your answer.

We welcome the additional reporting for the SO. It would be good to engage industry on the key areas that would improve transparency and add value from such a report going forward. Reports need to be not only informative but able to clearly explain variations to forecasts which appears to be what this report aims to do.

Q4. Do you agree with how the parameters for the incentives are calculated? Should we consider anything else when setting the target?

We are reliant on the regulator to ensure that targets are fit for purpose and the introduction of an independent party should ensure that industry participants are more confident that they are fair and value for money for the consumer.

Q5. Do you believe we should introduce an additional mechanism to counter the incentive to under or over-forecast in any given month to maximise incentive value? Please explain your answer.

The SO incentive should be designed so that the ability to “game” is removed. We look to the regulator to ensure that the appropriate behaviours are targeted by the creation of an incentive. Clearly the ability for the SO to deliberately alter a forecast to compensate for a previous poor forecast is a breach of their licence of providing an unbiased forecast so will look to the regulator to monitor and take any necessary actions.

CHAPTER: Five

Q1. Do you agree with our proposal to introduce a mechanism for the SO-TO to exchange funds? Please explain your answer.

We agree that a framework is required if it optimises the network and lower costs for consumers.

Q2. Do you agree with our proposal to introduce a pilot SO-TO incentive? Do you agree with the structure proposed? Is there anything missing or that should be removed? Please explain your answer.

Yes. In order to be able to start formulating a wider framework to include SO-DNO transactions in future incentive mechanisms it would be beneficial to trial it at a small scale between SO-TO. The learning from this process can be used in future incentive scheme designs to help optimise the whole network.

We are reliant on the regulator to ensure that sufficient evidence is provided which justifies that paying the TO has reduced costs.

Q3. Do you agree with our proposal to introduce a requirement for a quarterly report? Is there anything missing or that should be removed? Please explain your answer.

Yes. We expect that the report contains sufficient detail to enable the industry to understand the benefits that have arisen from any SO-TO transactions.

CHAPTER: Six

Q1. Do you agree that the proposed changes describe in Chapter 2 will enhance transparency? Please explain your answer.

We are hopeful that the increase of detailed explanations from actions taken by the SO is a positive step to enhance transparency.

The current SO Incentive framework is very reactive. Information contained within the MBSS reports do not go far enough to explain actions taken, challenges faced, procurement strategies and leaves some industry participants placing less value on its content. The Industry forums held by the SO does bridge that gap slightly but the infrequency of them, generally several months after the reports have been published it out of date. It is however at these forums that a least some insight is given on future direction, challenges and priorities which could be updated in the MBSS report.

Q2. Do you agree with our proposal to not introduce a financial incentive on transparency? Please explain your answer.

Yes. There needs to be no financial incentive to allow more transparency and engagement with industry.

Q3. Do you agree with our proposal to retain the MDLC? If not, please explain your answer.

On the understanding that modelling deficiencies are addressed and does not provide windfall gains or losses, we do not have any strong reason for its removal for the SO Incentive scheme for April 2017.

Q4. Do you agree that we should amend the MDLC to require NGET to get third party scrutiny on areas where the model could be improved? Please explain your answer.

As we look to move towards a more enduring incentive solution and decide upon the significance of the models within this framework we cannot see any downside in asking a third party to see if improvements to the model can yield better targets.

Q5. Do you agree with our proposal to discontinue the System Operator Innovation Roll-Out Mechanism? Please explain your answer.

Yes. Given that NGET has not applied for any funding in 2015-17, it seems sensible to discontinue this and perhaps re-look at the objectives in preparation for 2018.

**EDF Energy
January 2017**