

## Future SO Regulatory Framework

Workshop 2: Incentives Design

11/10/17

ofgem

These slides are shared with stakeholders to facilitate working-level policy development. The content should not be considered as the views of the Authority.

## Workshop 2: Incentives design

13.00 – 13.30	Registration and tea/coffee
13.30 – 13.45	<b>1. Welcome and introduction</b>
13.45 – 14.45	<b>2. Options for incentives design</b>
14.45 – 15.15	Coffee break
15.15 – 16.15	<b>3. Evaluative Scorecard and performance panel design</b>
16.15 – 16.30	<b>4. Wrap up and close</b>

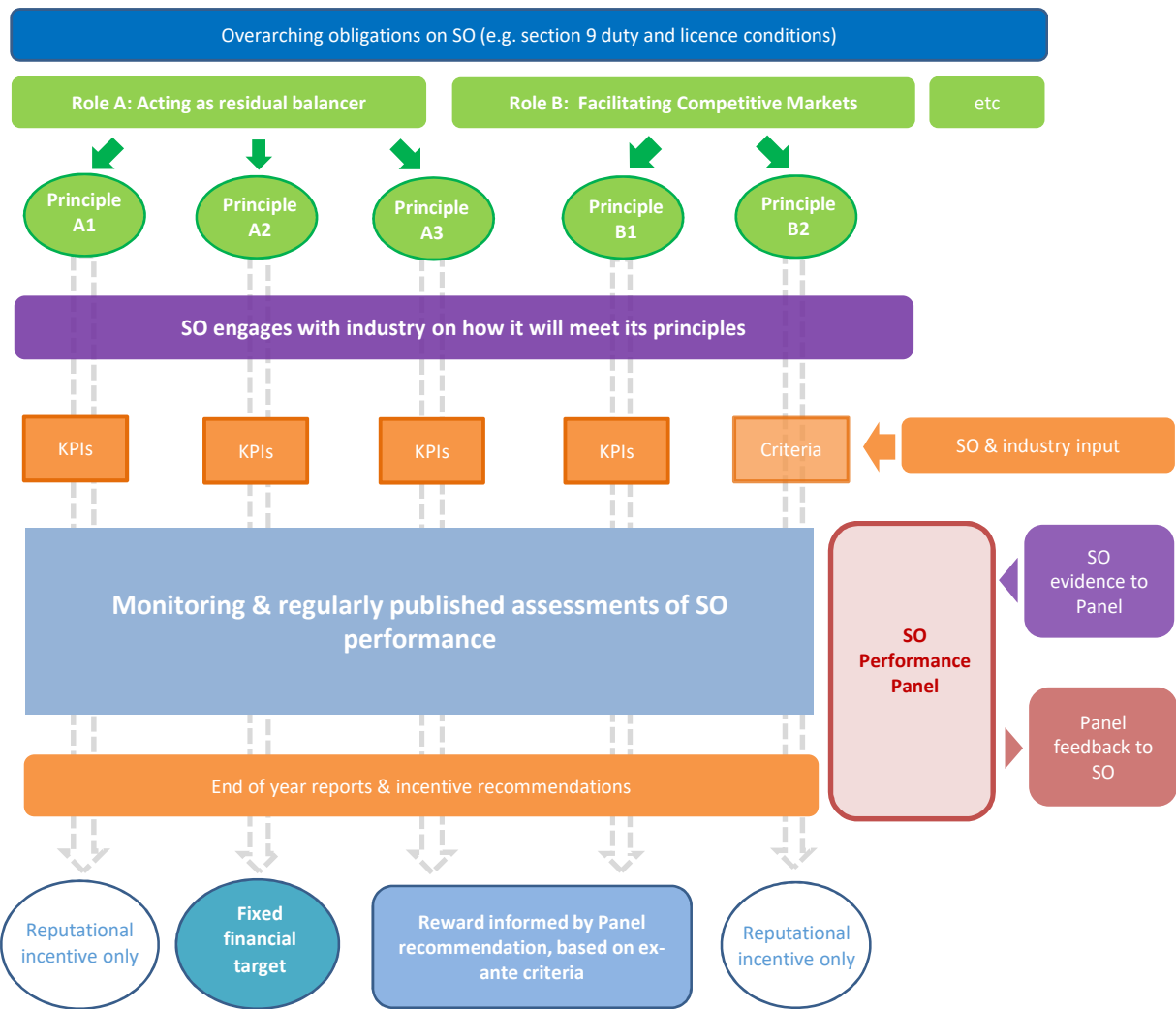
# 1. Welcome and introduction

# Two minute recap of workshop 1

Workshop 1

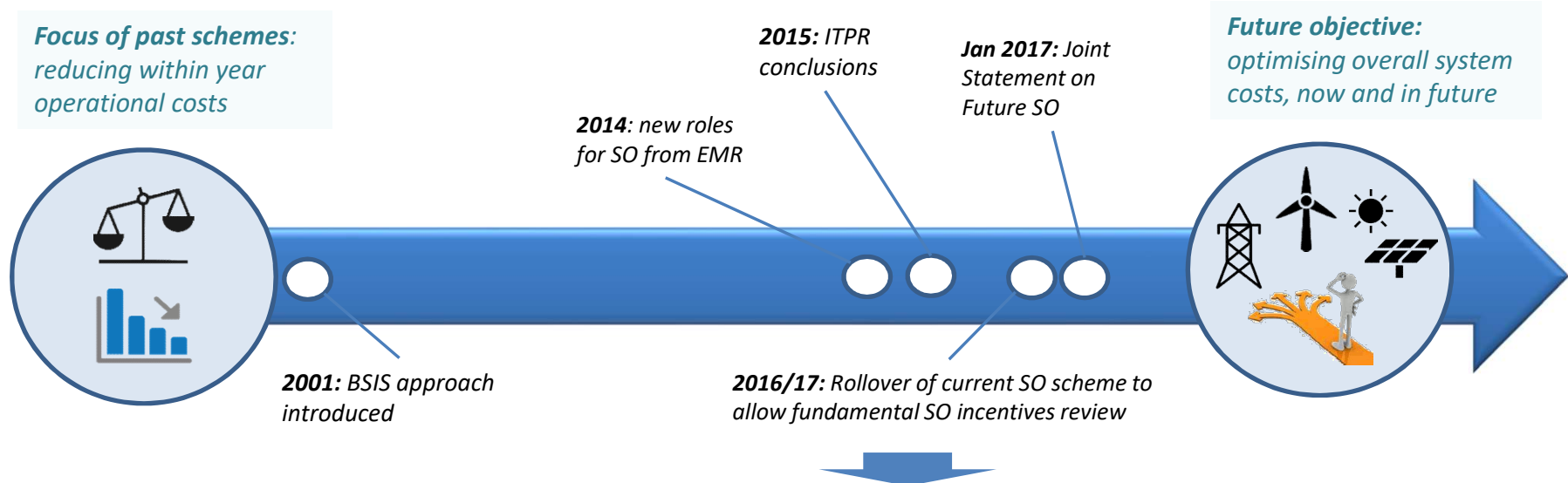
- A) SO roles and principles
- B) Setting Performance metrics
- C) Monitoring, reporting and external involvement
- D) Financial incentives

Focus of Today's workshop



## 2a. Options for incentive design

The SO's role has significantly grown in complexity since the current incentives approach was first introduced






### Key findings from incentives review:

1. Need for better balance between short & long term
2. Need to encourage more holistic & proactive SO thinking
3. Need for better governance, more transparency & more external involvement

# Key messages from July working paper

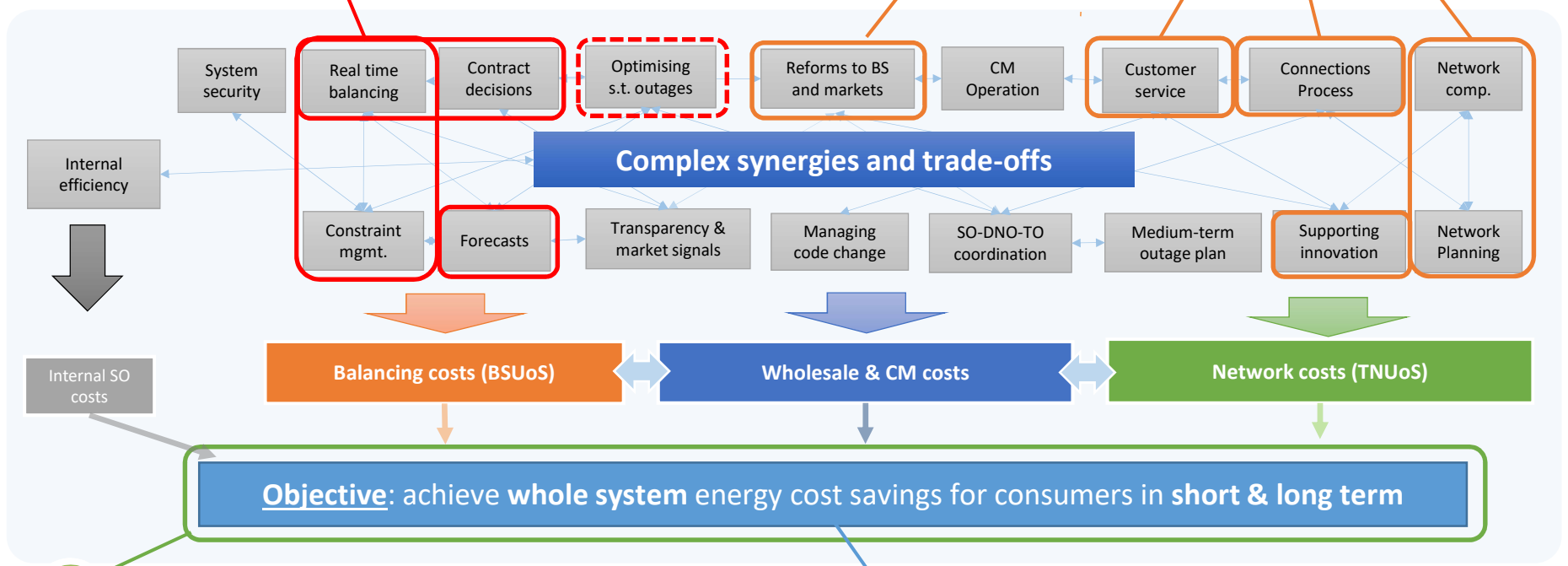
1. We see financial incentives as a key aspect of the future SO framework
  - Important there is an upside for the SO, to encourage it to innovate and unlock dynamic consumer savings
2. But the design needs to be right – and we face a number of key challenges:

 <b>More complex objective</b>	<ul style="list-style-type: none"><li>• How do we capture the complex interactions between different SO actions in a coherent incentives package?</li><li>• How can we reward longer term behaviors when it's difficult to define 'what good looks like' in advance?</li></ul>
 <b>Significant future uncertainty</b>	<ul style="list-style-type: none"><li>• Rapid system change → higher risk of unintended consequences with fixed incentives?</li><li>• Could rigid incentives undermine development of best solutions?</li></ul>
 <b>Driving a more proactive SO</b>	<ul style="list-style-type: none"><li>• How do we ensure SO proactively considers and prioritises the actions that drive the greatest, <i>overall</i> consumer benefits?</li></ul>

*There is no perfect solution to these challenges. But we think that April 2018 onwards presents a good opportunity to test out new approaches that could better align with our Future SO objectives, before the start of a consolidated SO regulatory scheme from 2021.*

**A** **Current incentives:** incentives review suggests these do not encourage SO focus on overarching objective

**B** **Broader package of mechanistic incentives:** high risk of unintended consequences, unlikely to drive more proactive SO behaviour and significant implementation challenges by 2018



**C** **1<sup>st</sup> best solution?:** one longer term target for whole system costs?

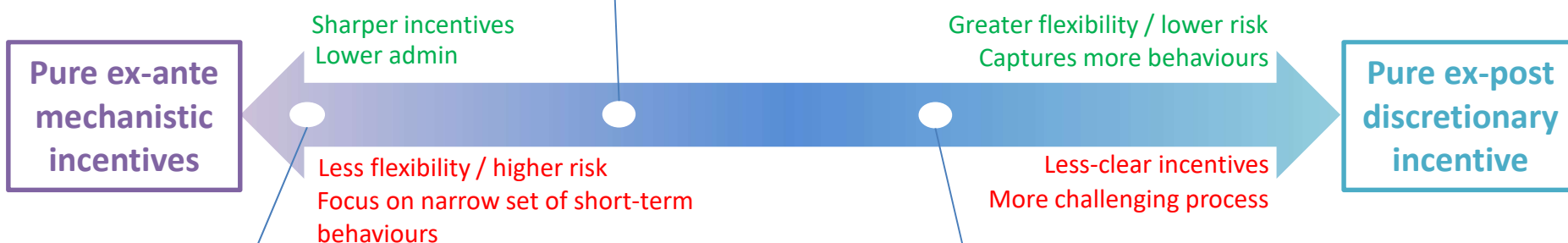
*In absence* →

**D** **2<sup>nd</sup> best solution?:** one holistic, more evaluative incentive focussed on this objective



## Mechanistic package + evaluative element?

- Mechanistic incentives for areas that can be more easily mechanised, an evaluative reward for all other. Sensible if:
  1. These behaviours are sufficiently separate and distinct
  2. This wouldn't create a disproportionate focus on certain outcomes
- *We don't believe either of these conditions are met*

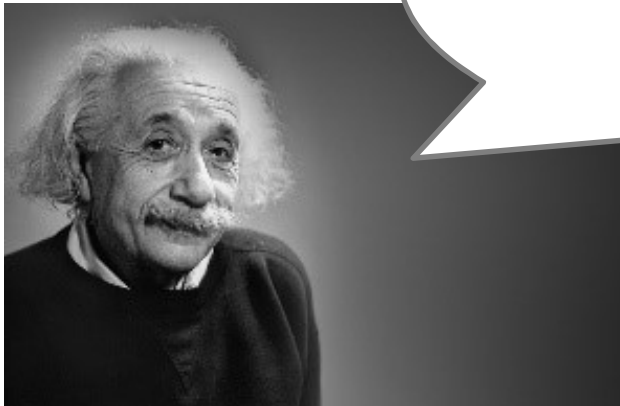


- Current incentives**  
Multiple mechanistic:
- BSIS
  - Forecasting
  - SO-TO



## Preferred option for April 2018

- A single *evaluative incentive*, backed up by a clear ex-ante methodology
- Broader assessment of SO performance against its principles
- Evaluation based on SO evidence, stakeholder views and performance against KPIs
- **KPI scorecard** defined ex-ante to increase certainty for SO



“Not everything that counts can be counted, and not everything that can be counted counts”

## 2b. Incentives design table discussions

1. Do you agree we should financially incentivise the SO for the 2018/19 scheme?

2. Do you agree with our analysis and that we should move to a more evaluative incentive approach?

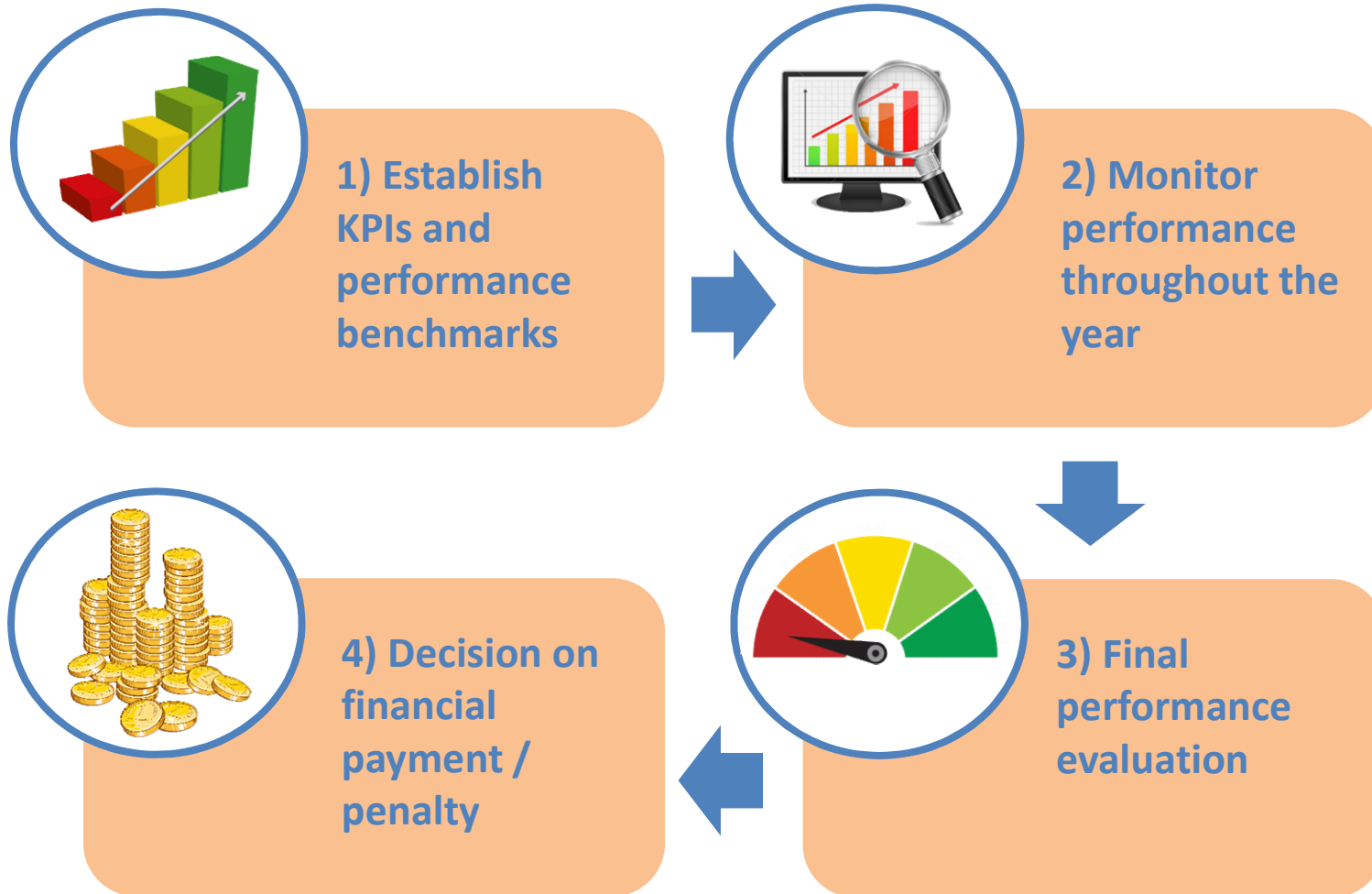


# Coffee break

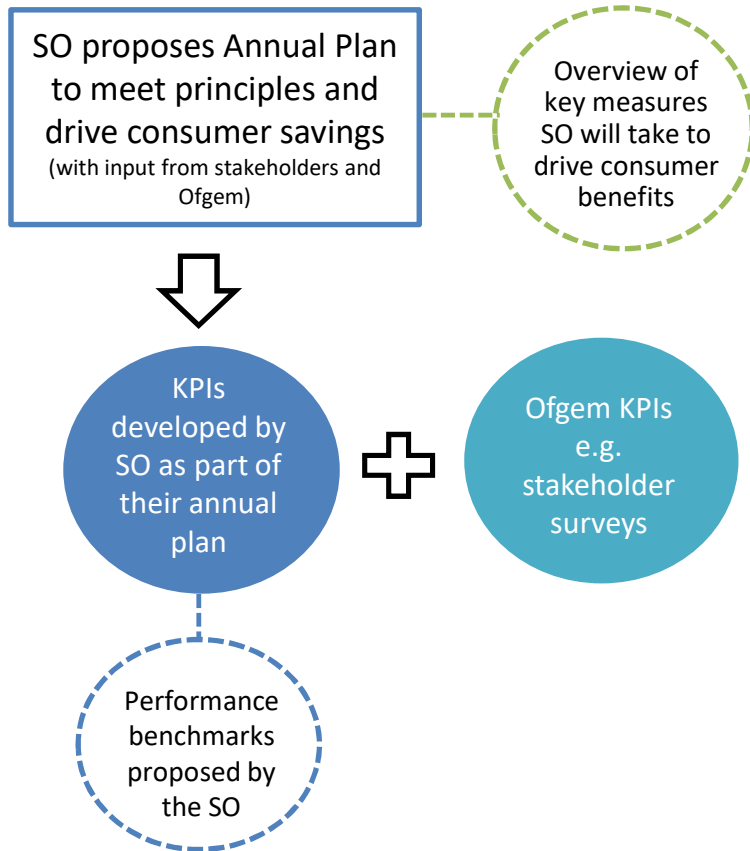


# 3. Evaluative scorecard approach

# Overview of the evaluative scorecard approach



# 1: Establish the KPIs and Performance Benchmarks



**Principle 1 - Support market participants to make informed decisions by providing user-friendly, comprehensive, and accurate information**

KPI	Performance benchmarks		
	below expectations	in line with expectations	above expectations
Wind forecast accuracy	<90%	90-98%	>98%
Demand forecast accuracy	<90%	90-98%	>98%
BSUoS forecasting accuracy	<90%	90-98%	>98%
Demand forecasting bias	>60%	40-60%	<40%
Stakeholder views on website user-friendliness	1-4	5-7	8-10

Baseline: No weighting between principles. All principles treated equally but perhaps some future flexibility for SO to focus on certain areas if they can demonstrate consumer benefits by doing so.



## 2: Monitoring performance throughout year

SO outturn performance is then measured against performance benchmarks

SO submits evidence to explain/justify performance



Wider context

**Principle 1 - Support market participants to make informed decisions by providing user-friendly, comprehensive, and accurate information**

KPI	Performance benchmarks			Outturn	Performance vs. expectations
	below expectations	in line with expectations	above expectations		
Wind forecast accuracy	<90%	90-98%	>98%	93%	In line
Demand forecast accuracy	<90%	90-98%	>98%	98%	Above
BSUoS forecasting accuracy	<90%	90-98%	>98%	93%	In line
Demand forecasting bias	>60%	40-60%	<40%	70%	Below
Stakeholder views on website user-friendliness	1-4	5-7	8-10	6.3	In line



Stakeholder views through surveys / workshops / challenge panel

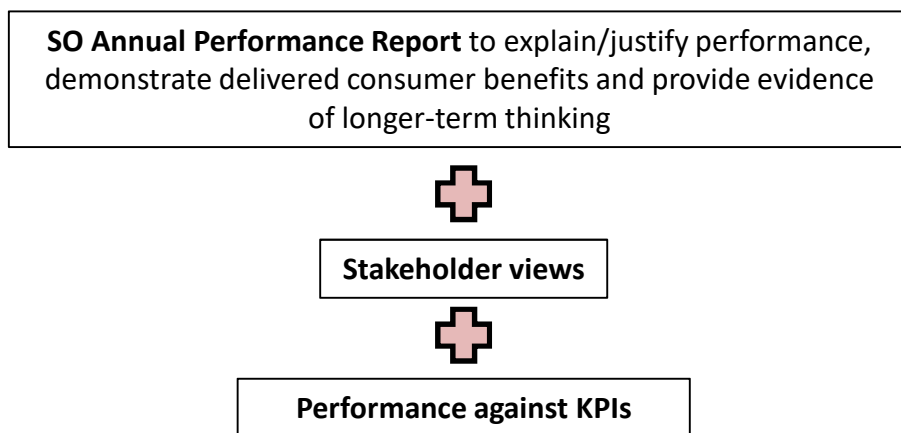


Builds narrative for SO performance throughout the year



### 3: Final performance evaluation

The Panel uses all of the information below following established criteria to evaluate SO performance for each principle.



**Principle 1 - Support market participants to make informed decisions by providing user-friendly, comprehensive, and accurate information**

KPI	Performance benchmarks			Outturn	Performance vs. expectations
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**Panel decision criteria**

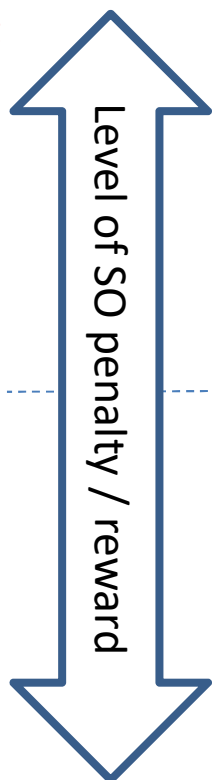
Evidence gathered from the SO Annual Performance report, from stakeholders and the performance of KPIs will determine a score for each principle.

In particular, in assigning a score, the Panel should consider:

- The extent to which the SO has demonstrated and evidenced the achievement of consumer benefits
- The extent to which the SO has provided evidence of actions/activities that may lead to longer-term consumer benefits
- The level of ambition in the SO’s annual plan and performance benchmarks
- Stakeholder views and evidence on the SO’s over/under performance
- Outturn performance against KPIs, for example:
  - Mostly exceeding KPI expectations => higher score
  - Mostly in line with expectations => average score
  - Mostly below KPIs expectations => low score
- The SO’s justification regarding KPI over/under performance – eg, innovative SO activity, external factors (eg weather)
- Whether significant over/under performance for a particular KPI should result in that KPI having a greater relative influence on the final score

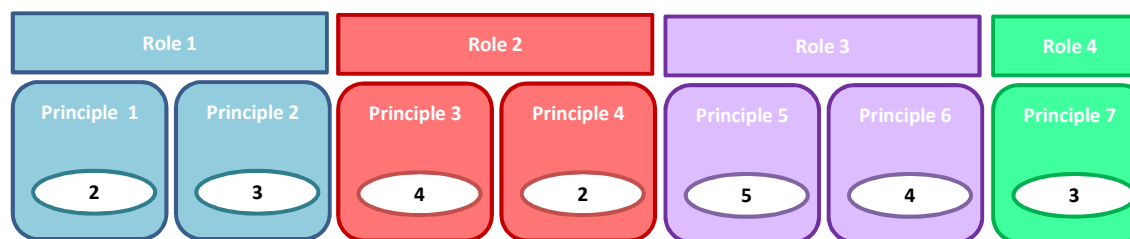
### 3: Final performance evaluation - scoring

**EXAMPLE**  
scoring  
criteria



Score	Criteria for each principle
Weak (1)	<ul style="list-style-type: none"> <li>✗ Below expectations for all KPIs</li> <li>✗ Very weak/no demonstration of delivered consumer benefits</li> <li>✗ Neutral or supportive external factors</li> <li>✗ No evidence of long-term thinking or future consumer benefits</li> </ul>
Poor (2)	<ul style="list-style-type: none"> <li>✗ Below expectations for most KPIs</li> <li>✗ Weak demonstration of delivered consumer benefits</li> <li>✗ Neutral external factors</li> <li>✗ Little evidence of long-term thinking or future consumer benefits</li> </ul>
Average (3)	<ul style="list-style-type: none"> <li>✓ Performance of all/most KPIs in line with expectations</li> <li>✓ Neutral external factors</li> </ul>
Good (4)	<ul style="list-style-type: none"> <li>✓ Mostly exceeding expectations for all KPIs</li> <li>✓ Some evidence of delivering consumer benefits</li> <li>✓ Neutral / negative external factors</li> <li>✓ Some evidence of long-term thinking and some evidence for future consumer benefits</li> </ul>
Excellent (5)	<ul style="list-style-type: none"> <li>✓ Exceeding expectations for all KPIs</li> <li>✓ Strong demonstration of delivered consumer benefits</li> <li>✓ Negative external factors</li> <li>✓ Evidence of long-term thinking and demonstrating/evidence of future consumer benefits</li> </ul>

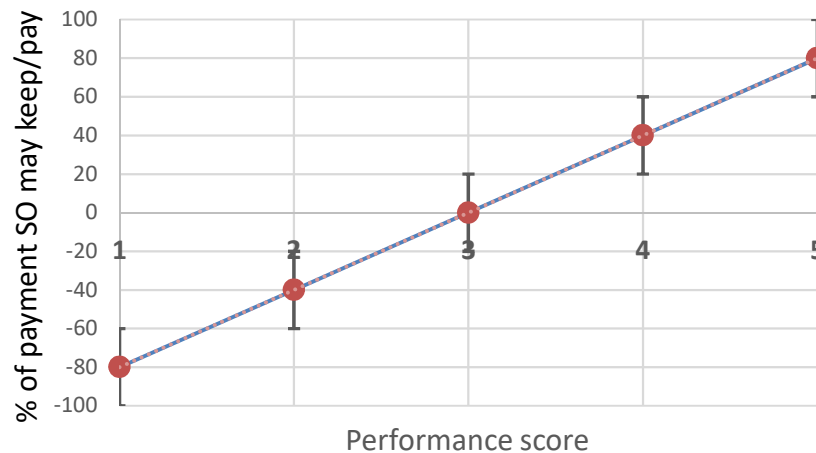
Assessment by principle



## 4. Incentive payment

How do you determine a payment from scores?

### Option 1) Clear relationship between performance score and financial outcome



- Risks becoming too mechanistic
- Gives SO more certainty
- More transparent especially with industry

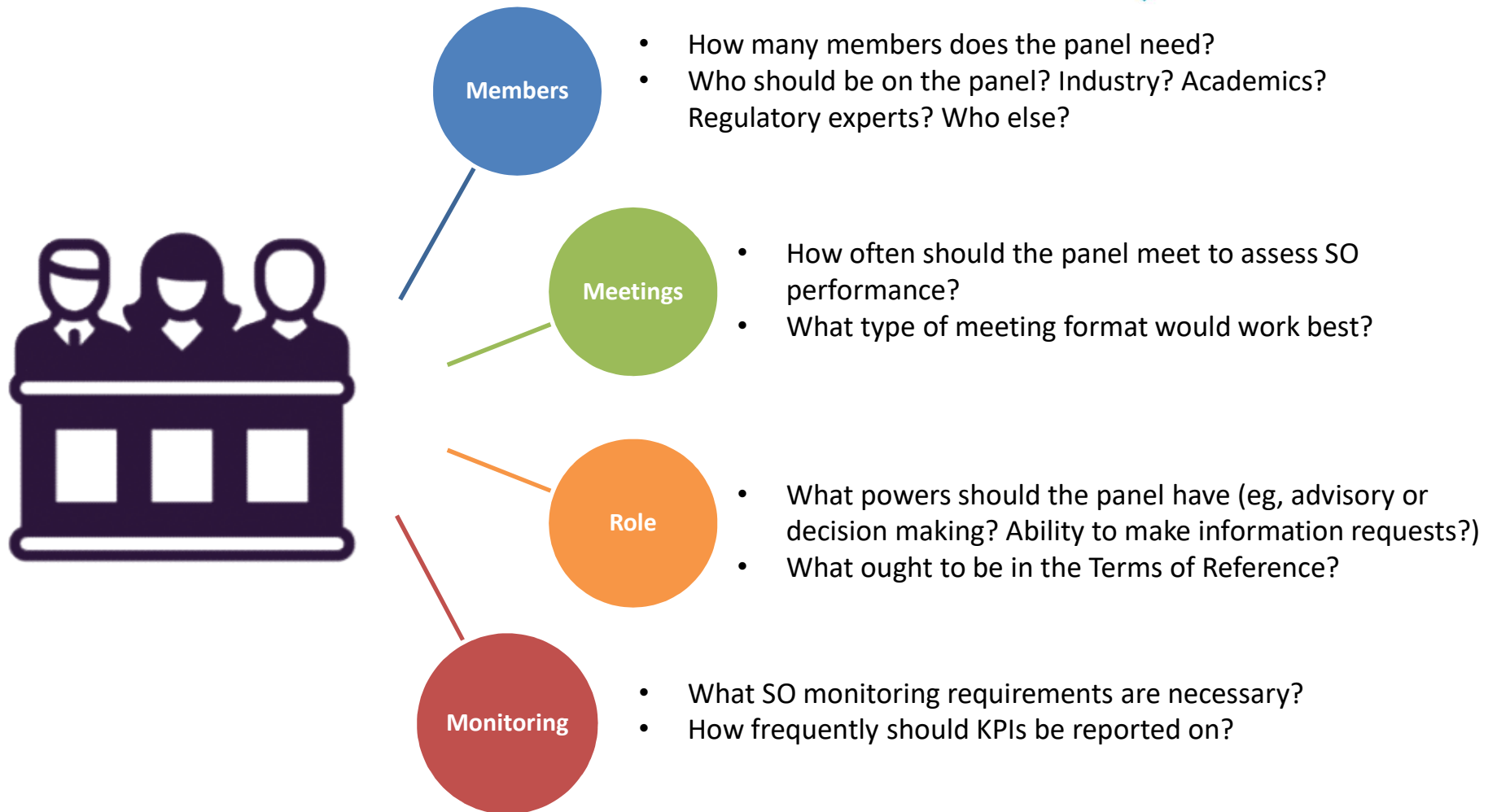
vs.

### Option 2) Determine payment using our discretion (holistically consider scoring for principles)

- Less revenue certainty for the SO
- Feasible for 2018
- More flexibility for decision making
- Risks becoming too subjective if no clear decision framework

– Either option will require a cap / floor

# Design of the SO Performance Panel



**2018/19 Arrangements:** we will likely need some temporary arrangements while we set the panel up. What interim arrangements should be in place for April 2018?

## 3b. Scorecard and panel table discussions

1. Should we weight some principles over others or begin with balance throughout the framework?

2. Does the decision criteria look comprehensive? Should other criteria be included? How can the decision criteria best foster SO certainty?

3. How should the panel be designed? (Views on questions from panel slide)



## 4. Final wrap-up and close

**Additional half day condensed workshop:** Friday 27<sup>th</sup> October, in **Glasgow** covering both London-based workshops.

Please email [Christopher.Haworth@ofgem.gov.uk](mailto:Christopher.Haworth@ofgem.gov.uk) to attend

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