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Dear Stathis,

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 proposals for the future role and structure of the electricity system operator ('SO').

Responding to emerging challenges

We are open minded on the case for the SO to be more independent than it is today. Your consultation identifies a wide range of areas in which the SO role could be improved and refined. Some of these are in areas where actual or perceived conflicts of interest could hamper the SO from making optimal decisions, for example in procurement of assets through onshore competition where National Grid may itself be a possible provider. Others are in areas where improvements to processes do not appear to be contingent on greater independence. For example, we think that greater transparency and competition in the procurement of balancing and ancillary services is a necessary step that could and should be pursued regardless of whether the SO became more structurally independent.

The initial cost benefit analysis consists of a quantified cost (~£167m NPV) and a range of uncosted qualitative benefits. Those qualitative benefits are broadly credible, and could plausibly outweigh the costs - as you point out, system balancing costs are running at a level of £850m/year, so even fractional improvements could rapidly add up to significant consumer

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benefits. But £167m is not a trivial sum, so we will look to you to provide greater confidence that those benefits will materialise as you develop your separation plans. As you acknowledge, the proposals are a transitional step that results in the SO being more independent than it is now, but not fully independent, and it may still be desirable to move towards a fully Independent System Operator (ISO) at a later date. Because of this potential that these arrangements may only be in place for a few years, we think it is crucial that you can be confident that any costs incurred now would also support a future full ISO role as well as this transitional model. If they would need to be written off in a handful of years as the next step towards ISO is taken, the case for introducing these transitional arrangements will be weaker.

Our biggest area of concern on these reforms is that the full functional separation of Transmission Owner ('TO') and SO roles may impede rather than facilitate the optimisation of trade offs between what is built and how it is utilised. Because consumers face these net aggregate costs, it is important that those trade offs are efficiently made. Theoretically, this could be achieved through the integration, or very close alignment of SO and TO incentive schemes. Historically, this has not happened because the volatility in SO costs, and difficulty in forecasting them, has meant that establishing long term incentives in that area to sit alongside NGET's long term TO incentives has not been possible. But it has seemed as though Ofgem has recently started to make very real progress in tackling those impediments to allow for longer term SO incentives to be set. As you further develop your proposals, we would find it very useful if you could further draw out your thinking on how separate TO and SO entities could be incentivised such that they collectively reach the lowest cost solution to consumers where both build (TO) and operate (SO) options are available to tackle a problem.

If those are areas of concern, we do recognise that there are very logical, and well evidenced, reasons to suggest that the nature of balancing assets and solutions is rapidly changing in a way that the current framework appears badly suited to handle. While the NETA arrangements were set up in a manner that theoretically gave both generation and demand equal weight in balancing the system, it still appears to us that the SO has a greater focus on

the use of transmission connected assets than distribution connected ones, and of production assets than of demand response.

In part, this no doubt quite reasonably reflects the current availability of assets but we think it is also possibly indicative of cultural comfort in using conventional transmission connected assets, which in turn may stop it from seeing a role for itself in promoting new markets. That it is less likely to call on demand and/or distribution connected assets because they are less available and untested, but that those assets are in turn less likely to be available and untested because they are unlikely to be called on. We note that some demand side response providers have complained that they have little opportunity to find out when NGET is tendering for ancillary services and that it may be that they can offer the SO services that it is unaware of.¹ We also note that, anecdotally, some demand side response providers complain that while they cannot provide the exact services that the SO procures, they could provide different products that could provide cost effective solutions to balancing problems. For balance, it should be highlighted that we think the SO's 'Power Responsive' campaign is a good example of outreach that is seeking to both deepen the demand side market available to the SO, and to deepen its understanding of demand side participants.

It appears to us that tomorrow's power sector faces not so much a capacity problem, as a flexibility problem, as the balance of production assets tilts from conventional thermal towards more intermittent or inflexible low carbon generation. The capacity mechanism does not really address this problem, and in some regards may even exacerbate it by dampening wholesale price signals that would otherwise provide scarcity rents. In some areas, the market for balancing services may be becoming more illiquid - we note the ballooning cost of procuring Black Start. So the SO will need to become more innovative to balance the system cost effectively, and may need to intervene more in the market to keep the lights on. You allude to the need for the SO to be more active in industry code processes to reform those instruments, governed by Ofgem, but we think it will also need to consider

¹ Tempus Energy calls for investigation into black start contracts,' Utility Week, 5 April 2016. <http://tinyurl.com/hogj54g>

reforms to government (BEIS) instruments too. This will require a degree of organisational self confidence as it brings risks of conflict between SO, regulator and government as the first of these three may be perceived as making, or trying to initiate, public policy decisions - something that is not traditionally the role of a private sector organisation. In managing that potential friction, it is highly useful that there appears to be initial tripartite buy-in that its role needs to evolve, but it may be useful to try and develop a mechanism for ensuring that tripartite buy-in remains in place on an ongoing basis. This could perhaps take the form of annually revised public workplan, agreed with BEIS and Ofgem and developed following public consultation, setting out its core priorities for the coming period and views on areas where reforms and/or new products are needed. This may also assist in improving the overall transparency of its operations, noting your comments that suggest many market participants would welcome greater SO transparency.

The four areas where you see a need for the SO role to evolve all seem sensible to us, though again, we note that the scope for improvements in these areas often does not appear to be contingent on whether it becomes more independent of TO activity. Many seem to us to be wins that could be achieved with or without greater SO independence. The area where this evolution appears most ambitious is in the third area, facilitating a whole system view and approach. This will require the SO to have much greater understanding of distribution connected assets, and distribution network activity than it currently has. It may be the case that DNOs can widen the range of balancing and ancillary services available to the SO, and in any event it will need an understanding of the ever deepening pool of production and demand response assets connected to those networks. Your review should consider whether the framework for sharing of information, and procurement of products, between SO and DNOs will adequately support this. You should also consider whether some system balancing can be done more cost effectively by a Distribution System Operator, than by the (Transmission) SO. The role of residual balancer has traditionally been held by National Grid because most flexible assets were transmission connected. But as more distribution flexibility becomes available, the question of who is best placed to carry out that role is becoming less self evident.

Functional separation

Currently the SO's internal costs are funded through the RIIO-T1 price control, while its external costs in balancing the network are incentivised through a separate SO incentive scheme. We suggest that a planning assumption for RIIO-T2 is that the SO's internal costs should be separated out and captured under the SO incentive scheme from the commencement of that control period. This would reinforce the greater independence of SO activities and is also a necessary functional step towards a future ISO. In addition, it would help with the transparency and accountability of the SO role by making it easier for stakeholders to understand its total operational costs. It would be useful if you could set out any emerging thinking of how RIIO-T2 may be applied to SO costs early in this transition process.

The only further consideration we would note at this time is that while you identify a need for SO staff bonuses to be decoupled from the performance of the wider National Grid business (eg in paragraph 3.62), the consultation is silent on the question of employee share ownership schemes. It is our understanding that National Grid operates several different schemes that allow employees to acquire an equity stake in the company.² If SO employees continue to participate in those schemes, their remuneration would still remain contingent on the performance of the larger TO business. To avoid this becoming a real or perceived conflict of interest, we think you should consider whether SO staff should be provided with an alternative remuneration device that removes this link between the company's non SO activity and their income.

Yours sincerely,

Richard Hall

Director of Strategic Infrastructure

² "Share schemes. Enjoy the chance to become a National Grid shareholder through our share schemes - Sharesave and Share Incentive Plan (SIP)," National Grid website. <http://careers.nationalgrid.com/working-here/>