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22 January 2018

The Electricity System Operator Regulatory and Incentives Framework from April 2018

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, storage, 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 support Ofgem's proposal for a revised regulatory and incentives framework for the Electricity System Operator (ESO). The ESO is operating in a much less predictable and stable environment meaning that a mechanistic approach is no longer appropriate and robust. We agree that there is a need to focus not just on short term performance but also on actions that deliver medium / longer term consumer benefits. The current framework does not do this.

We agree that a more principles based approach to the ESO performance framework may well be effective to drive benefits to consumers through assessment of longer-term benefits and considering whole-system issues. It will be important, though, to ensure that the performance metrics that are developed are robust and challenging.

We support the proposal to establish an ESO Performance Panel to support the evaluative process. A well-designed Panel should help reduce the information asymmetry between the ESO and Ofgem, strengthen incentives on the ESO to demonstrate its performance to a wider audience, and add greater transparency to the performance evaluation process. The Panel's role will be important to ensure the revised framework is a success. It is unclear without some form of independent analysis how the Panel will be able to challenge and scrutinise the ESO's proposed performance metrics and indeed their performance at end of year. In this regard, we look forward to Ofgem's proposal to develop some guidance in this area before the new regime is implemented and rapidly move forward to implementation of an expert panel. We would also suggest that Ofgem acts as the secretariat for the Performance Panel rather than the ESO to ensure conflict of interests, perceived or real, are avoided.

In principle, we support strong financial incentives to encourage the desired outcomes. The proposed +/-£30m may be a reasonable amount in the longer-term but we would suggest starting from a lower figure until confidence in these revised arrangement is established. Once the process has been tested and the ability of the Panel to really scrutinise and challenge the metrics proposed by the ESO have been observed, the

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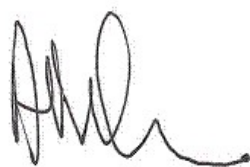
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incentives could be increased. We suspect processes will need to evolve and improve; the next three years should be spent wisely to learn and fine tune the framework without creating unnecessary risks to consumers.

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 Mari Toda on 07875 116520, 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 be "Mark Cox".

Mark Cox
Head of Transmission & Trading Arrangements

Attachment

The Electricity System Operator Regulatory and Incentives Framework from April 2018

EDF Energy's response to your questions

Q1. Do you agree with our updated roles and principles for the ESO?

Yes, we broadly agree with the new roles and principles identified by Ofgem.

Q2. Do you agree with our proposals for the ESO Forward Plan? Do you think our proposed process for reviewing the ESO's Forward Plan will create a sufficient incentive on the ESO to develop a plan and performance metrics that are appropriately challenging and comprehensive?

Yes, having a Forward Plan that would set out the ESO's longer-term vision for how it intends to drive consumer benefits under its different roles and principles will be useful. The draft work packages we have seen as part of the ESO's stakeholder engagement provided an overview of the ESO's current thinking. Although the SO provided some qualitative consumer benefits in its working document, to determine which work packages should be pursued or take priority, we would need to see more quantitative information specifying the anticipated consumer benefits.

We agree that a more principles based approach to the ESO performance framework may well be effective to drive benefits to consumers through whole-system consideration of issues and a greater focus on longer term benefits. In practice though, the performance metrics that are developed must be robust and challenging to ensure this works. We expect the requirement to develop the Forward Plan will encourage the ESO to develop a plan and performance metrics that are appropriately challenging and comprehensive. However, this has yet to be seen.

We are not completely persuaded that the development of the Forward Plan would encourage the ESO to invest in its internal costs (i.e. administrative and IT costs). Under the existing framework, the SO's internal costs are regulated through the RIIO-ET1 price control and this has arguably resulted in under investment in code administration and in the SO's website/IT systems. Under the new framework, investment in such fundamental building blocks of an ESO might not be recognised as ambitious enough by the Performance Panel and rewarded accordingly. The new framework must therefore be able to recognise the need to invest in internal costs as well as external costs and the benefits that this will bring.

Q3. Do you agree with our proposals for within-year reporting? Do they appropriately balance the need for transparency with resource burden for the ESO?

We support transparency so having within-year reporting is welcome. Whether the ESO needs to publish monthly, quarterly and bi-annual reports may need to be reviewed after

a year or two. In practice, the benefits of such reports will depend on the meaningfulness of the reports and if stakeholders are not finding them useful, then the contents and frequency of the reports may need to be changed. This may be an issue where the ESO's Forward Plan includes projects that span over a few/several years – e.g. monthly reporting might not produce anything insightful.

Q4. Do you agree with the design of our evaluative scorecard incentive? Do you have views on the Panel scoring criteria or payment-penalty methodology?

We support the proposal to move towards a more evaluative approach from a purely discrete, mechanistic, financial incentives. We believe this approach will be more able to capture the broader, more proactive and more customer focussed set of behaviours that is expected from the ESO in future. This approach would also be more flexible, helping to support a more responsive and dynamic ESO that responds to changes and new developments.

A key principle for the ESO being able to achieve an above average score is that it has gone beyond baseline expectations. This means taking new steps within that year to deliver better practices, business models and technologies that lead to material improvements in the ESO's performance (and which are not currently expected as part of its outputs and obligations). The consultation states that the Performance Panel should only take account of evidence of consumer benefits if it relates to 'new' actions by the ESO with that year. We suspect that in practice, the definition of 'new' could be contentious at times owing to differences in interpretations. While we are supportive of the panel scoring criteria / payment penalty methodology proposed in the consultation, we believe the Panel would benefit from further guidance from Ofgem.

Q5. Do you agree with our proposed scheme cap and floor of ±£30m?

In principle, we support strong financial incentives to encourage the desired outcomes. +/- £30m may be a reasonable amount in the long term but we would suggest starting from a lower figure until confidence in these revised arrangements is established. Once the process has been tested and the ability of the Panel to really scrutinise and challenge the metrics proposed by the ESO have been observed, the financial incentives could be increased. We suspect processes will need to evolve and improve; the next three years should be spent wisely to learn and fine tune the framework without creating unnecessary risks to consumers.

Q6. Do you agree with our proposal to introduce a new ESO Performance Panel?

Yes, a well-designed panel could help reduce the information asymmetry between the ESO and Ofgem, strengthen incentives on the ESO to demonstrate its performance to a wider audience and add greater transparency to the performance evaluation process.

Since the new scheme is expected to come into effect from April 2018, we understand Ofgem's desire to have the Panel in place by mid-2018. However, we believe this might be on the ambitious side. As recognised in the Impact Assessment under Risks & Uncertainties, panels involve a lot of resource to be set up effectively. In addition,

recommendations from the panel are only as good as its expertise; getting members of the right calibre is imperative. While we are encouraged to see that Ofgem intends to retain its existing 2.5 full time employees in the team and increase headcount by one in the first year, we would urge Ofgem not to underestimate the amount of support, including analytical support, the Panel is likely to need. We would also suggest that Ofgem acts as the secretariat for the Performance Panel rather than the ESO to ensure conflict of interests, perceived or real, are avoided.

Q7. Who should sit on the ESO Performance Panel? What is its appropriate size?

The Performance Panel should contain members who can challenge and evaluate performance across the full spectrum of ESO activities. We believe that a mixture of industry parties and independent experts would be the most appropriate (Option 3) and believe around five or six members (odd number of panels may help to alleviate disagreements on scoring) is a manageable and productive size. We would also welcome a senior representative from Ofgem with working knowledge of the ESO and its role.

Q8. Who should chair the ESO Performance Panel?

We believe the chairperson should be an independent person, who has a strong working knowledge of the ESO's role. To avoid any conflict of interest, real or perceived, the chair should not have been employed by National Grid in the last five years.

Q9. Do you agree with our proposed approach to implementing our new framework?

Yes. Specifically, we agree that the continual change in the energy system might mean that the identified principles may need to change in future. It makes sense to keep them under review and where changes are needed, impacted parties should be consulted.

We also think that the development of guidance documents to support the new licence conditions will be important and useful. In particular, we would welcome clear guidance on the criteria against which the ESO's performance is assessed; the information and evidence included in the performance assessment; and how the Performance Panel's recommendation will be used by the Authority to determine an incentive payment or penalty.

Q10. Do you have any comments on our draft licence changes?

No.

EDF Energy
January 2018