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Friday 19<sup>th</sup> January 2018

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## The Electricity System Operator Regulatory and Incentives Framework from April 2018 - RWE Response

Dear David,

RWE welcomes the opportunity to respond to the Ofgem consultation on “The Electricity System Operator Regulatory and Incentives Framework from April 2018” published on 15<sup>th</sup> December 2017 (the Consultation Document). We are responding on behalf of RWE Supply and Trading GmbH and RWE Generation plc. This is a non-confidential response.

We support the proposal to separate the ESO from TO activities and the introduction of an interim incentive scheme. However, we have reservations about the proposed incentive scheme, particularly in relation to the subjective assessment of ESO performance. The incentive regime should be based on

- A set of specific deliverables that enhance consumer welfare in the ESO Forward Looking Plan;
- A quantitative set of performance measures;
- An independent Performance Panel monitoring progress and making recommendations on incentive payments in relation to completion of the deliverables; and
- Final determination of incentive payments by Ofgem in relation to deliverables.

Our detailed comments on the questions in the Consultation Document are included in Annex 1. If you have any comments or wish to discuss the issues raised in this letter then please do not hesitate to contact me.

Yours faithfully

*By email*

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## **Annex 1: RWE Response to the consultation questions**

### **Chapter 3**

#### **Q1: Do you agree with our updated roles and principles for the ESO?**

We agree with the updated roles and principles for the ESO. We expect the ESO to consult widely on way that it will interpret the proposals and develop a framework for the delivery of the ESO Forward Looking Plan.

#### **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?**

We agree with Ofgem's proposals for the ESO Forward Looking Plan. The process for reviewing and developing the Forward Looking Plan must include meaningful consultation with wider market participants. We support the development of metrics in terms of ESO performance, but we also believe that this should be linked to a set of deliverables from the plan such as, for example, introducing new balancing markets, delivery of IT solutions, and initiatives to improve balancing performance.

#### **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 agree with the proposals for within year reporting. However, we note that one of the key issues for market participants is the ability to forecast the potential monthly costs associated with system operation. We think it would be helpful if the ESO could publish regular updated estimates of anticipated spend throughout the year and for each year in which the incentive scheme is in place. This will enable market participants to check on ESO performance and produce more cost reflective billing arrangements for pass through costs.

The role of "income adjusting events" needs to be considered in the context of regular reporting of ESO performance and updated forecasting of expected outcomes. We expect that the risk of "shocks" in terms of unexpected costs in system operation should be minimised through the new arrangements.

#### **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 are concerned about the design of the evaluative scorecard incentive, the Panel scoring criteria and the penalty payment methodology. The ESO should be able to recover efficiently incurred costs associated with its licenced activities from the relevant charging base. Incentives should be linked to clearly defined initiatives and related to deliverables where these enhance the performance of the ESO in the discharge of its licences activities in accordance with the ESO's forward plan.

The use of a subjective scorecard approach that involves judgement by a Panel in relation to incentive payments is a novel approach and has a number of risks. These include information asymmetry between the ESO and the Panel, the possibility of regulatory capture by the ESO or a lack of available expertise in determining outcomes. The key process is the justification of expenditure defined in the Forward Looking Plan by the ESO in Step 3. The key element of this process should be the customer welfare benefits from the related initiatives. This should be objectively justified by the ESO and subject to rigorous evaluation by the Panel. Essentially the

process could be seen as an assessment of plan delivery. This should be absolute and not subjectively scored: i.e. has the ESO done what it has said it was going to do? If the answer to this is affirmative then the Panel should recommend the appropriate incentive payments.

**Q5: Do you agree with our proposed scheme cap and floor of  $\pm$ £30m?**

The doubling of incentive payments from  $\pm$ £15m to  $\pm$ £30m has not been justified in the consultation document. It is not appropriate to provide the potential for increased financial benefits on the basis of an increased confidence in the scheme or the changes in the regime.

Rather the incentive scheme should be justified in relation to the potential benefits that could arise in terms of increased customer welfare as a result of the actions of the SO. In other words there should be an agreed set of deliverables in the Forward Looking Plan. If these are completed to the satisfaction of the Panel then incentive payments can be authorised. As part of planning process the scale and level of the incentive performance payments should be established (noting that these could be positive or negative in relation to the specific deliverables).

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

We support the introduction of an ESO performance Panel. However, the role and responsibilities of the Panel should relate to monitoring the performance of the ESO in relation to specific deliverables in the Forward Looking Plan and the recommendation of the performance payments in relation to the completed initiatives (subject to Ofgem final determination).

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

The Performance Panel should have sufficient expertise to determine the nature of the efficient deliverables in the Forward Looking Plan, to monitor ESO performance and to make recommendations to Ofgem in relation to incentive payments. The Panel Members should be independent of the ESO and wider industry participants. Nevertheless there needs to be confidence that the Panel has sufficient knowledge of the industry to be able to understand the role and responsibilities of the ESO.

**Q8: Who should chair the ESO Performance Panel?**

We support an independent chair of the ESO performance Panel.

**Chapter 4**

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

We agree with the proposed approach to implementing the new framework.

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

We do not have any comments on the draft licence changes.