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Dear David,

Future arrangements for the electricity System Operator: the regulatory and incentives framework

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group, excluding Centrica Storage.

Incentive Mechanisms:
We support the review of the overall regulatory framework and the assessment of how incentives can be used to supplement obligations on the electricity system operator (SO). Incentives, when properly calibrated, can encourage behaviours that deliver benefits for consumers. The calibration of some of the incentives on the SO has dampened the incentive properties and so may not have always led to the best consumer outcomes.

A key aspect of the development of the enduring arrangements will be consideration of the interaction of incentives on the SO with those on the transmission and distribution network operators. Scenarios where the SO's actions, potentially relating to an incentive, can distort network operators' incentive performance need to be avoided. This is essential since the SO is likely to be obligated to promote the long-term efficiency of the whole electricity system and coordinate network operators' actions. The timing of the introduction of the relevant incentives must also be carefully considered. The enduring SO incentives regime is likely to be introduced from 2018 while the current electricity transmission and distribution price controls expire in 2021 and 2023 respectively. Issues relating to revenues, outputs, accountability and end-of-period performance assessments will have to be resolved. The phasing-in of the relevant incentives to coincide with the next round of price controls might be a pragmatic way of avoiding any distortions.

Governance:
We agree industry parties should play a greater role in the governance of the SO incentives and wider scrutiny of SO performance should encourage the SO to adopt behaviours that maximise consumer outcomes. Currently, panels for mechanisms such as the Stakeholder Engagement Incentive assess submissions by the companies being assessed as evidence of performance. There is no formal mechanism by which industry parties can comment on the companies' submissions or make additional submissions. We believe that the governance of SO incentives (and the governance of other mechanisms involving panel assessments) can be enhanced by providing industry parties with formal opportunities to comment on companies' submissions and make additional submissions. Further, panels should be required to take account of industry views when recommendations are made. This

would encourage the SO to be even more responsive to the needs of its stakeholders. We also support third party audits and quality assurance of the models used to set incentive targets and of the analysis of performance.

We hope you find these comments helpful. Answers to the consultation questions are below. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements

Answers to consultation questions

CHAPTER ONE: Question 1: Do you agree with our objectives for the future SO regulatory framework? Are there any missing?

Yes. The proposed objectives for the future SO regulatory framework are aligned with the objectives for the SO, outlined in the *Future arrangements for the electricity system operator: its role and structure* consultation[1].

CHAPTER ONE: Question 2: How can we best transition to a SO regulatory framework which meets these objectives? When should changes be made?

Ahead of the electricity SO becoming a legally separate entity, an assessment should be carried out to determine whether 'shared' incentives such as the Stakeholder Engagement Incentive (which apply to NGET as a whole) remain relevant to the SO and can drive the right behaviours. If so, it will be necessary to consider how those incentives can be applied to the TO and SO functions while still maintaining to the overall parameters that were agreed during the RII-T1 price review.

The timing of the introduction of the incentives which can interact with incentives on the TOs and DNOs must also be carefully considered. The enduring SO incentives regime is likely to be introduced from 2018 while the current electricity transmission and distribution price controls expire in 2021 and 2023 respectively. Issues relating to revenues, outputs, accountability, risk and end-of-period performance assessments will have to be resolved. The phasing-in of the relevant incentives to coincide with the next round of price controls might be a pragmatic way of avoiding any distortions. The mid-period review for the RIIO-ED1 price control may be an opportunity to revise relevant elements of that price control.

CHAPTER THREE: Question 3: What lessons can be learned from our previous approaches to regulating the SO? What are the key areas where changes might be needed in future?

The key areas in which change is needed relate to calibration of models used to set target and measure performance. The wide variation of performance of the SO against the Balancing Services Incentives Scheme, discussed in the consultation, has undermined confidence across the industry that robust targets have been derived from the underlying models. Further, the frequency with which scheme caps and floors have been hit indicates incentive properties have been weakened. The reduction is sharing factors addressing this to some extent. We suggest the ongoing model validation exercise continues. Alternative incentive mechanisms for achieving more efficient balancing costs should be investigated if confidence cannot be restored.

[1] https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-its-role-and-structure

CHAPTER FOUR: Question 4: Do you believe we need to introduce more clarity about what we expect from the SO under its obligations? How should this clarity be provided? To what extent should we set prescriptive or principles-based requirements?

We broadly agree with the areas identified in the *Future arrangements for the electricity system operator: its role and structure* consultation[2] in which clarity about expectations of the SO is required. Clarity can be provided through a combination of the modification of existing licence conditions, introduction of new licence conditions and guidance.

Principles-based requirements of the SO should allow it to be more flexible in a changing environment and to facilitate the evolution of the electricity system. They should provide greater flexibility for the SO to innovate and places greater responsibility on the SO to ensure the appropriate consumer outcomes are delivered. Principles-based requirements can mitigate a drawback of prescriptive rules and regulations: an organisation may seek to maximise its financial performance within the framework set by those rules and regulations, even if this has a negative impact on longer-term considerations. However, there may be instances in which some obligations should be prescriptive, even in a changing environment, to encourage the SO to deliver solutions that are optimised for consumers and market participants. For example, if an output required is very specific in nature and the obligation to be placed on the SO can be tightly defined, then a prescriptive regulation may be suitable. As such, a hybrid approach comprising principles-based rules and prescriptive obligations should be considered.

CHAPTER FOUR: Question 5: Should we place financial incentives on the SO? If so, in which areas? And what form should they take?
CHAPTER FOUR: Question 6: Should we introduce more non-financial incentives on the SO? What approaches should be taken? Do you support the introduction of a set of KPIs, and if so, what should these KPIs be?

In principle, financial and non-financial incentives should be placed on the SO if they promote the right consumer outcomes. We support the use of non-financial incentives in instances in which the use of financial incentives is not appropriate.

We believe the properties financial incentives schemes should exhibit are:

- Schemes must promote long-term efficiency and drive continuous improvement.
- Targets must be properly calibrated.
- Rewards and penalties should be proportionate.
- Upside and downside risks should be genuinely symmetric where appropriate.
- Scheme performance must be robustly measurable.

[2] https://www.ofgem.gov.uk/publications-and-updates/final-proposals-electricity-system-operator-incentives-april-2017

The pilot of the SO-TO Mechanism should be carefully monitored to ensure it does not cause any distortions. The development of appropriate performance metrics and the improvement performance reporting will increase transparency of the SO actions and allow industry parties to participate in the incentive process.

CHAPTER FIVE: Question 7: How should SO incentives be governed in the future? Would you support a greater role for stakeholders in this process? How can we introduce more transparency around incentives?

We agree industry parties should play a greater role in the governance of the SO incentives. The wider scrutiny of SO performance should encourage the SO to adopt behaviours that give the best consumer outcomes. Currently, panels for mechanisms such as the Stakeholder Engagement Incentive assess submissions by the companies being assessed as evidence of performance. There is no formal mechanism by which industry parties can comment on the companies' submissions or make additional submissions. We believe that the governance of SO incentives (and the governance of other mechanisms involving panel assessments) can be enhanced by providing industry parties with formal opportunities to comment on companies' submissions and make additional submissions. Further, panels should be required to take account of industry views when recommendations are made. This would encourage the SO to be even more responsive to the needs of its stakeholders. We also support third party audits and quality assurance of the models used to set incentive targets and of the analysis of performance

One of the main ways in which transparency around incentives can be increased is by requiring the SO to explain why actions taken are meant to represent consumers' best interests. The reporting requirements on the SO relating to the proposed SO-TO mechanism are a good example of requirements on the SO to explain its actions and the benefits of those actions.