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Dear David,

**Future arrangements for the electricity System Operator: its role and structure**  
**Future arrangements for the electricity System Operator: the regulatory and incentives framework**

Drax Group is one of the UK's largest energy companies with businesses spanning generation, retail and heat. In recent years we have transformed Drax Power Station into the UK's single largest source of renewable power by upgrading its generation units to use wood pellets in place of coal. Our retail businesses, Haven Power and Opus Energy, are actively engaged in helping businesses with their energy needs, improving efficiency and switching to renewable products. Finally, our renewable heat business, Billington Bioenergy, supplies wood pellets to off-grid homes and businesses that would otherwise continue to use fossil fuels.

This is a single response in relation to both consultations listed above. In general, we welcome and support the proposal to create a more independent System Operator (SO) function. We continue to believe that full separation is the optimum solution for consumers over the longer term. However, the current proposal to increase the independence of the SO function from the wider National Grid group of companies provides an important step in the right direction.

To support the proposed competition and efficiency obligations, the new SO entity must have a separate licence to that of the transmission business. The licence should put competition at the heart of the SO's objectives, ensuring a level playing field for all market participants, obligating open tender processes and delivering transparency of decision making. This will allay concerns (perceived or otherwise) of conflicts of interest and/or bias in SO decision making.

We agree with Ofgem's proposal to place an emphasis on system management decisions being made on a "whole system" basis. However, to fully realise this approach, greater thought must be given to the principles of unbundling right across the GB electricity network. It is currently difficult to envisage decisions being made on a whole system basis when there is insufficient clarity on the potential future role of Distribution Network Owners/Distribution System Operators. A common framework must be developed, with clear objectives across network owner/operator businesses and appropriate delineation of responsibilities enshrined in licences.

Detailed answers to the questions raised in *the regulatory and incentives framework* consultation can be found in Appendix 1. Please feel free to contact me, should you wish to discuss any aspect of this response.

Yours sincerely,

*Submitted by email*

Paul Youngman  
Regulation Manager

**Appendix 1 – Answers to the specific questions on Future arrangements for the electricity System Operator: the regulatory and Incentives framework**

**CHAPTER ONE: Background and objectives**

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

We generally agree with the objectives identified by Ofgem, in particular the four key roles of acting as the residual balancer, facilitating competitive markets, facilitating a whole system view and supporting competition in networks.

With regards to acting as the residual balancer and facilitating a “whole system” approach, it is difficult to envisage how the arrangements will work without greater clarity of the future role of Distribution Network Owners/Distribution System Operators. A common framework must be developed, with clear objectives across network owner/operator businesses and appropriate delineation of responsibilities enshrined in licences. In our opinion there should be a single system operator across transmission and distribution networks.

We believe that competition should be at the heart of the SO’s objectives, promoting a level playing field for all market participants. This involves promoting the development of innovative solutions to meet the future needs of the system, without compromising system resilience or introducing undue discrimination in decision making.

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

There needs to be a clear roadmap for the transition. National Grid should lead the development of the detailed transition plan, but Ofgem should define the timescales for delivery and provide oversight of the process. Open engagement with stakeholders should be encouraged throughout.

There will be a number of areas that will prove difficult to clearly delineate and enforce. Ofgem have highlighted that finance and legal services will be especially problematic to share without conflicts of interest. We would widen this pool to data management and the movement of employees between National Grid companies. Each of these areas will require auditing to ensure adequate processes and compliance.

We agree with the current plan to achieve greater independence by autumn 2018 and code/licence changes by April 2019. However, these should be the backstop dates – where Ofgem find opportunities to transition at a faster pace, then they should mandate National Grid expedite their plans.

**CHAPTER THREE: Review of the current framework**

**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 changes to the structure and role of the SO provide an opportunity to revisit the operational scope and related incentive arrangements. We recognise Ofgem’s analysis of the evolution of the incentive scheme, and note previous concern and changes have been driven by ensuring payments were targeted to actions within the SO span of control. In our opinion there should be resolution of the SO role to a single system operator across transmission and distribution networks that can deliver the desired “whole system” approach.

The incentive framework should have at its heart the obligation to facilitate competition, and ensure a fair and level playing field. We agree with Ofgem that consideration needs to be given to the design of measures, including the relevant timescales, to ensure that there is sufficient balance between efficient short term operational activities and facilitating longer term developments. We are optimistic that the changes to the SO role will lead to the necessary cultural shift to improve openness and transparency. We trust that positive changes to transparency will be delivered with sufficient pace.

Going forward industry participants should maintain a greater role in the development, monitoring and governance of incentives. We would also encourage Ofgem to use external advisors, audit and compliance assurance to ensure that the objectives of separation and the specific outcomes encouraged by incentives are delivered. We believe that findings should be openly presented and any necessary actions to deliver the objectives of reform taken transparently.

## **CHAPTER FOUR: Future framework design**

### **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?**

Moving to principles-based requirements would pull the SO framework into line with Ofgem's wider approach to regulation. However, it is important to note that the European Network Codes are fairly prescriptive on the minimum requirements required from regional SOs, therefore the new framework must be mindful of those requirements. In addition, a principles-based approach only works effectively where the regulator is prepared to enter open dialogue and provide appropriate guidance – a call echoed in other areas of the wider regulatory framework.

It should also be recognised that the SO is a monopoly service provider. More prescriptive requirements would be highly appropriate to mandate competitive procurement processes, transparency of decision making and open dialogue with market participants. Functional areas should be subject to audits to ensure there are no conflicts of interest, perceived or otherwise.

### **Question 5: Should we place financial incentives on the SO? If so, in which areas? And what form should they take?**

Yes, financial incentives should be placed on the SO. However, it is important to strike the correct balance between incentivising effective decision making and ensuring sufficient flexibility to avoid decision paralysis due to post-event evaluation with perfect hindsight.

The high level framework should be set out in the SO's licence, with a separate detailed, multi-year incentive scheme. Key areas for incentives should include:

- Demand forecasting
- Wind generation forecasting
- Balancing requirements
- Transmission/balancing charges
- Requirements for ancillary services

### **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?**

Yes, there should be more non-financial incentives. These should include:

- Developing a longer term view on system requirements, including multi-year and multi-product contracts
- Monthly public reporting on commercial and physical operations
- KPIs on transparency of network requirements/condition and timeliness of publication
- Measurements on the equality of support provided to industry code processes
- Development of a separate SO culture that differs from the wider National Grid group of companies

## **CHAPTER FIVE: Incentive scheme governance**

### **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?**

There should be a single SO incentive framework that encompasses the full suite of requirements under the current schemes (including the current SO obligations, RII0, EMR incentives, etc.). This should be multi-year scheme that enables the SO to efficiently procure services to ensure system security and encourage innovation and investment.

There should be a greater role for stakeholders, with appropriate consultation from the SO and Ofgem (not only paper based, but also roundtable/workshop events). Transparency begins with a change in the culture of the SO – visible KPIs, appropriate audit processes, regular reporting on progress and greater interaction with stakeholders will provide a good starting point.