



9<sup>th</sup> March 2017

Electricity SO Reform Team  
Ofgem  
9 Millbank  
London  
SW1P 3GE

Dear Sirs,

**Future arrangements for the electricity System Operator: its role and structure (Con1); and, the regulatory incentives framework (Con2)**

Thank you for the opportunity to respond to the companion consultations, Con1 and Con2, on the future arrangements for the electricity System Operator. Enzen provides a range of consultancy and business transformation services to utilities in the UK and abroad, and we have drawn on this experience in the preparation of our response.

**Proposed roles of the SO**

We agree that the proposed roles set out in chapter 2 of Con1 will deliver benefits to consumers and that the SO is best placed to fulfil these roles. Although the SO is already carrying out these roles to a greater or lesser extent, it is clear that their comprehensive discharge, as envisaged in the consultation, will require the SO to undertake a transformation programme and to take on significantly increased ongoing activity.

**Principles-based approach**

We support a principles-based approach to regulation of the SO because it will provide the SO with degrees of freedom within which it can exercise its discretion and expert judgement, taking full account of contemporaneous factors such as context and prevailing assumptions. However, there are several factors that will need to be considered in scheme design and operation:

- **Design.** We recognise that the design of the principles framework is a topic for a future consultation. However, we thought it might be helpful to register a few thoughts at this stage. It is clear that the set of principles will need to provide coverage of the decision domain. It is also important that the principles are sufficiently focussed (i.e. not too broad) so that their scope and purpose is clear. There may also be a need to define hierarchical relationships between principles that may find themselves in conflict in certain complex situations. The design of the principles framework is hence by no means trivial and will require significant testing against a range of scenarios to ensure it is complete and effective.



- **Operation.** It is credible that, in certain complex situations, two independent and competent people would apply the framework of principles and arrive at different conclusions. The SO needs to have the confidence that, so long as it applies the principles competently, it won't find itself penalised in some way later. In particular, if a decision is revisited by Ofgem, or an expert panel, the test should not be whether the SO made the same decision as the regulator or expert panel would have made; it should be whether the SO made an objective and rational decision within its degrees of freedom. To the extent that the regulator believes an even better decision could have been made, this should be treated as a learning point for the SO.

### **Facilitating efficient whole system outcomes**

Most of the proposed roles for the SO, outlined in Con1, chapter 2, can be discharged by the SO largely through its own efforts. 'Facilitating efficient whole system outcomes' is different because it requires the alignment of several separately owned and licensed entities. Many of the activities under this umbrella relate to planning activities (e.g. network investments), where the SO will be required to provide expert and impartial advice, analysis and/ or recommendations to support the industry and relevant decision-takers. However, Con1 §2.5.7 discusses near-term operations, and the need for 'co-ordination' between the SO and DNOs, so that the system or network operational decisions taken by all parties combine to deliver the best outcome for the system. Under these circumstances, co-ordination between parties is necessary but it is not sufficient to achieve an optimal outcome. Parties can be expected to seek to optimise their own position within their framework of obligations and incentives. Hence, to achieve whole system alignment, it is unlikely that the application of incentives (and possibly obligations) can be limited to the SO alone. It is unclear from the consultation what Ofgem's thinking is here.

### **Incentives**

Con2 sets out quite clearly the high-level requirements of the incentive framework. The conversion of these requirements into carefully designed incentives and the development of models to simulate these incentives in action will be challenging; however, it is essential that, before implementation, Ofgem, the SO and industry are confident that the framework is sufficiently complete, coherent and predictable, and that it has been tested to an appropriate level to ensure it incentivises the right behaviours without generating unanticipated consequences. Given the complexity of this task, we believe the discretionary incentive approach would be more appropriate than the target-based approach (Con2, Box 3), at least until the new regime is implemented, stabilised and its operational characteristics understood. At that stage, a switch to target-based incentives could be appropriate.

### **Incentive scheme governance**

We agree that Ofgem's proposals for:

- Independent audits and QA;
- A greater role for industry;
- Panels and independent experts;





- Improved transparency and easily accessible data on performance; would collectively provide an appropriate package of governance measures for the incentive scheme. However, an important consideration is the intensity with which these measures will be used – particularly audits and panels/ experts - and this is not clear in the consultation document. In our view, governance should be as light as possible, consistent with giving Ofgem and the rest of the industry the confidence it needs. An overly burdensome regime, apart from being costly, is likely to lead to the SO being risk-averse rather than innovative, to the detriment of consumer benefits.

### SO Costs

We note Ofgem's position on costs – e.g. Con1 §2.72. Whilst we understand Ofgem's requirement to ensure costs are efficient, as transformation specialists we find the 'mind-set' behind the various statements in the consultations (e.g. tethering costs to RIIO with a stiff elastic band) gives us some cause for concern. In our view, costs need to be considered in the context of a significant transformation of the SO, impacting legal, regulatory, process, system, people, stakeholder and cultural dimensions. The primary focus should be on maximising the likelihood of delivering a successful transformation at an appropriate pace. This will require careful planning and part of this will be a structured process to identify the resources – people, time and funds – that are needed. An over-preoccupation with controlling costs risks the pace, quality and overall outcome of the programme. Given the ratio of benefits to costs, this would not be in the consumers' interest.

We trust the foregoing is helpful.

Yours faithfully,

A handwritten signature in blue ink, appearing to read "Dr Paul Banks".

Dr Paul Banks  
Client Director  
Enzen Global Limited