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## **Future arrangements for the electricity system operator: the regulatory and incentives framework**

Dear David,

RWE welcomes the opportunity to respond to the Ofgem consultation on the “Future arrangements for the electricity system operator: the regulatory and incentives framework” (the Consultation Document) published by Ofgem on 7<sup>th</sup> February 2017. We are responding on behalf of RWE Supply and Trading GmbH and RWE Generation plc. This is a non-confidential response.

The potential separation of the GBSO from the England and Wales Transmission Owner (E&WTO) is an historic opportunity to reconsider the nature of the GB SO incentive scheme. In particular, the creation of a new licenced activity enables the introduction of specific and well-designed obligations which will need to be discharged by the GBSO.

GBSO licence obligations could supersede the need for setting annual or multi-annual incentives. We have concerns that the current basis of GBSO incentives can in some circumstances result in windfall gains or unexpected losses. We note that historically the SO incentive scheme has been designed to drive the behaviour of the GBSO and to encourage innovation, risks and rewards and improve the economic and efficient operation of the GB transmission network. However, the SO incentive scheme has a high maintenance cost for Ofgem, requiring significant intervention and modification on an annual basis. This results in micro-management of SO activities and can result in unexpected or unpredictable outcomes, with consequent costs for consumers.

We believe that appropriate incentives could be introduced through the GBSO licence provisions, with a price control approach based on “allowed revenue” set for a specific time period (up to 8-years). The GBSO would be required to justify appropriate expenditure as part of this price control. Such an approach would provide greater certainty for the GBSO allowed revenue and for market participants, and facilitate the longer term approach towards the operation of the GB transmission system.

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Our response to the specific question in the consultation document is 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*

Bill Reed  
Market Development Manager.

## **Annex1: RWE Response to the specific questions**

### **CHAPTER ONE: Background and objectives**

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

We agree with objective that Ofgem has set for the design of the SO regulatory framework. Our preference is that these objectives are set out in the relevant GBSO licence rather than in a separate incentive scheme. Therefore in undertaking its role, the GBSO will be required to meet the overarching objectives for system operation. This will ensure that stakeholders have the confidence that in undertaking its role, the GBSO will be acting in the best interests of consumers and the system. We believe that the licence is the best way to hold the GBSO to account since failure to meet the licence objectives would result in a breach of the licence, with the potential for its revocation and allocation to a new entity that could provide GB system operation. Not only would this be a serious reputational issue for NG it could have significant financial implications (e.g. fines up to 10% of the GBSO turnover).

With regard to the specific objectives we believe that these should include a principal objective related to the economic and efficient operation of the GB transmission system. In addition to this, specific objectives and responsibilities should be set out in a licence conditions including:

- Maximising and facilitating competition in the GB electricity market; and
- Managing trade-offs between operational and investment costs; and
- Ensuring cost reflective transmission network use of system (TNUoS) charging arrangements to ensure that the TOs and OFTOs recover the allowed price control revenue; and
- Ensuring cost reflective balancing services use of system charges (BSUoS) that enable the GBSO to efficiently recover its costs; and
- Undertaking procurement processes for balancing services in line with relevant legislation and where applicable European Directives; and
- Ensuring open and transparent processes in delivering GB system operation
- Administering the GB Grid Code, the GB Connection and Use of System Code and, as the relevant designated GBTSO, any rules, codes, guidelines methodologies and terms and conditions related to the integrated European electricity market

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

The transition to a fully independent GBSO should be carefully planned and implemented as soon as practicable. The first stage is the creation of a separate GBSO role with the current electricity transmission licence and the establishment of an unbundled GBSO. This could include for example, the extension of the GB/SO Code to include the E&WTO.

The second stage in the transition, probably at the time of the next price control, is the designation of the independent GBSO fully separate from the E&WTO.

### **CHAPTER TWO: The current SO regulatory framework**

n/a

## **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 SO incentive scheme has something of a chequered history. In most years the GBSO has significantly outperformed its incentive scheme parameters. In other years the GBSO has declined to participate in the incentive scheme. It is fair to say that there have been significant difficulties in forecasting scheme performance and out turns have been somewhat volatile (or random). While Ofgem has endeavoured to refine the forecasting process and introduce new incentives to enhance performance, these have not always been successful, resulting in mid-term revisions to scheme parameters.

Ofgem has aspired to introduce a long term incentive scheme design and always failed to deliver on this aspiration. Reasons for this include short term volatility and the uncertainty associated with potential outcomes. With such a history it is difficult to see how any new scheme can address the shortcomings of the incentive scheme approach to managing system operation.

As far as market participants are concerned, the incentive scheme parameters have always been something of an enigma. There is a significant information asymmetry, with the SO in possession of considerably more information than individual market participants. On this basis it is always difficult to comment on the forecasts related to the provision of specific services (e.g. STOR, frequency response etc.).

Future incentive arrangements should focus on the specific interventions by the SO which have resulted in more efficient outcomes than would otherwise be the case. These interventions should be aligned with the SO objectives set out in its licence. The onus should be on the SO to demonstrate enhanced performance, at least to Ofgem and more widely to the market as a whole. The GBSO should be rewarded for enhanced (or exceptional) performance based on a fixed ex ante schedule of benefits that could be allocated ex post. These rewards should be related to the specific intervention undertaken by the GBSO. The total extent of the benefits available to the GBSO should be limited and subject to review from time to time.

We believe that the roles and responsibility of the SO under the European Network Codes including the Electricity Balancing Guidelines (EBGL) should form an important aspect of any incentive arrangements. The EBGL includes specific requirements on the SO to perform certain duties and responsibilities and to report to the relevant competent regulator. The move towards standard products procured on central platforms suggests that the SO role will be more prescribed in future while the reporting and transparency requirements will be significantly enhanced.

## **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?**

We believe that more clarity should be set out in relation to the SO obligations and that this should be in the form of specific objectives in the GBSO licence provisions. This should include an over-arching principal objective related to efficient and economic system operation. Such specific objectives and associated responsibilities would facilitate principles based regulation.

It is essential that the GBSO operates in an open and transparent manner to enable Ofgem and the wider market to determine that the relevant objectives have been met in undertaking its role. The scope for interpretation of the objectives by the GBSO should be limited and subject to relevant Ofgem guidance and industry consultation.

We do not support the approach adopted in relation to the current C16 statements including the Procurement Guidelines and Balancing Principles. These documents are somewhat ambiguous and allow significant scope for interpretation by the SO. It is not apparent how the SO delivers economic efficient outcomes in relation to these statements or indeed how the SO is held to account in relation to performing its role under these statements.

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

It may be appropriate to provide financial incentives on the GBSO. However, these benefits must relate to demonstrable enhanced performance and better meet the relevant GBSO licence objectives.

The GBSO should provide a specific schedule of proposed interventions ex ante that indicate the areas that it considers should be subject to potential incentive benefits. This schedule should not include business as usual activities.

The GBSO should be required to demonstrate in the incentive schedule where it can deliver added value to GB consumers and the wider system. The GBSO should consult on the schedule and seek regulatory approval for the potential interventions. The GBSO should then be rewarded through specific benefits if it delivers the relevant schedule. The schedule should indicate interventions that could take place over more than one year.

**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?**

As noted above the GBSO should provide specific schedule of proposed interventions ex ante that indicate the areas that it considers should be subject to potential incentive benefits. This schedule could include financial or non-financial interventions and include KPIs. It is up to the GBSO to identify the schedule of interventions and the relevant KPIs subject to approval by Ofgem following industry consultation. It is up to the GBSO to deliver the incentive schedule. This schedule should not include business as usual activities.

**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?**

The SO incentive scheme requires oversight by both Ofgem and the wider electricity market including customers. It should be up to the GBSO to demonstrate how incentive activities deliver enhanced benefits to customers and for the GBSO to deliver on its promises. On this basis, the GBSO may be rewarded for enhanced performance.