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10 March 2017

Dear David,

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

We are pleased to respond to Ofgem's consultation on its review of the regulatory and incentives framework for the electricity SO. We are responding separately to the related consultation on the SO role and structure. Our network business is providing a separate response to this consultation on specific network issues relevant to its activities.

Our main points in response to the consultation are set out below, with answers to the specific consultation questions set out in Annex1.

We welcome Ofgem's reviews of the SO regulatory and incentives framework and recognise that the transition to the new structural and regulatory arrangements will depend on achievement of multiple milestones over an extended timeframe in order to meet the objectives.

We agree that there is no barrier to the SO implementing many of the changes immediately, without need for licence changes, in order to achieve early consumer benefits. However, we would caution against any changes to the RIIO framework prior to expiration of the current price control in 2021. If any such amendments in support of separation of the SO and TO activities need to be made, it will be important for investor confidence that the revisions are adequately financed and impose no additional burdens on National Grid.

We believe that the expiry of the interim 2017/18 BSIS incentive scheme in March 2018 will provide an opportunity to replace such schemes with more focused incentives within a framework of principles-based regulation, backed up if necessary with a robust enforcement approach. It has become clear that the BSIS incentive scheme is unnecessarily complex, consumes considerable administrative resource which would be better expended on improving the efficiency of SO activities, and results in windfall gains and losses in respect of activities which are not wholly or mainly in the control of the SO. Examples of such windfall gains/losses include:

- Congestion costs: lengthy unplanned generator outages in export constrained zones result in significant constraint cost savings, and consequential BSIS windfall gains, despite not resulting from SO actions.

- Transmission Losses: evolution of market price conditions in favour of northerly located coal plants over southerly located gas plants results in increased transmission loss costs, and consequential BSIS windfall losses, despite not resulting from SO actions.

We believe that principles-based regulation in this area would be a better way to incentivise efficient actions by the SO in activities within its control. The detailed expectations proposed by Ofgem in these consultations, and in the recent 2017/18 BSIS proposals, are a good starting point in providing guidance to facilitate such regulation.

I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,



**Rupert Steele**  
Director of Regulation

## **FUTURE ARRANGEMENTS FOR THE ELECTRICITY SYSTEM OPERATOR: THE REGULATORY AND INCENTIVES FRAMEWORK – SCOTTISHPOWER RESPONSE**

### **CHAPTER 1: 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 proposed objectives for the future SO regulatory framework and especially welcome the additional focus on innovation and the need to take a longer term approach to decision making where this is in the best interests of the system and markets.

We support the need for a better balance between short and long term actions, including the adoption of a more strategic approach to the procurement of vital services that require longer term investment decisions, such as black start, storage and flexibility.

The SO is likely to play a central role in the development, management and administration of the various industry codes and market arrangements, and consideration should be given to including an objective to ensure that these remain “fit for purpose” throughout the current and future transformation of the electricity system.

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

We recognise that the transition depends on achievement of multiple milestones over an extended timeframe in order to meet the objectives. For instance:

- RIIO price control: it would be inappropriate to revise the arrangements made in respect of the existing price control review period, so the earliest opportunity for such amendments is 2021.
- BSIS SO incentive scheme: the existing scheme is due to expire in March 2017 and proposals for a successor interim one year scheme, which we support, have been developed. We view April 2018 as being a suitable point to consider alternative arrangements in this area.
- C16 transmission licence conditions: as part of the package of interim 2017/18 BSIS SO incentive scheme proposals, we understand that Ofgem will seek to introduce amendments to the licence condition, which provide greater details of its expectations of the SO. We view April 2017 as being a suitable point for this change to be implemented.

We also agree that there is no barrier to the SO implementing many of the changes immediately without need for licence changes.

However, as an overarching observation, we would propose that while respecting these timeframes, implementation of the transition could be targeted for April 2018 wherever possible.

## **CHAPTER 3: 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?**

We believe there are many lessons that can be learned from previous approaches to regulating the SO including the need to strike a better balance between short term and long term incentives, improvements in clarity of obligations/expectations, better governance, and an increase in transparency. Some of the key lessons are expanded on below:

- Greater clarity is required from Ofgem in terms of its expectations of the SO: The absence of historic enforcement action but wide-ranging views on satisfaction with aspects of the SO's activities implies divergent stakeholder expectations of the role.
- Incentives which encourage innovation and promote outcomes beyond business-as-usual do work. Recent RIIO schemes have incentivised licensees to innovate and invest resource in activities which go beyond compliance with licence conditions. This has resulted in consumer benefits through activities which may otherwise not have been achieved.
- Incentives which cover activities which are not wholly or mainly in the SO's control or which incentivise business-as-usual outcomes are inappropriate. Recent BSIS schemes have provided financial incentives for management of activities which are not sufficiently within the SO's control and have resulted in windfall gains and losses.
- The recent BSIS schemes have been overly complex and have consumed excessive resources to administer. The complexity of the schemes, combined with the SO's failure to act in a sufficiently transparent manner, have resulted in an asymmetry of information between the SO and other stakeholders. SO management effort spent on negotiating the scheme, administering the models and providing evidence to secure the incentive payments could have been better employed in improving the efficiency with which the SO delivered on licence obligations.

## **CHAPTER 4: 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?**

Yes, we believe that Ofgem should introduce greater clarity about its expectations of the SO under its obligations. This can be achieved through a combination of: (i) more prescriptive licence conditions (as proposed by Ofgem for C16 in its recent BSIS consultation on interim arrangements for 2017/18); and (ii) greater reliance on principles-based regulation.

In principle, we favour increased reliance on principles-based regulation, bringing regulation of the SO's activities in line with those of Suppliers. In order to provide clarity on Ofgem's expectation, Ofgem could provide guidance materials including open letters and licence condition guidance documents, as it does in the regulation of other licensees.

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

We recognise the benefits and support the use of financial incentives to create an environment that encourages and supports innovation and improvement, but we believe that consideration needs to be given to striking the right balance between the use of financial incentives and the enforcement of licence obligations.

We support the use of financial incentives where clear targets, wholly or mainly within SO control, can be defined and where there is merit in placing incentives on the SO to develop innovative activities beyond licence obligations, which may otherwise not be achieved, eg improved stakeholder engagement, development of metering and forecasting of embedded generation (wind, solar, hydro, AD, etc), or development of innovative, accessible and transparent ancillary services.

We do not support placing financial incentives on the SO to deliver objectives which are not wholly or mainly in the control of the SO.

**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?**

We agree that there is merit in considering the introduction of non-financial incentives such as KPIs as these are likely to be adopted in the objectives of directors and employees, impacting cultural change. Potential KPIs could include metrics on:

- the accuracy of BSUoS forecasts provided to industry;
- achievement of milestones in support of migration from bilateral contracting to market-based approaches in the procurement of balancing services;
- administrative costs of delivering the SO function;
- customer satisfaction associated with stakeholder engagement seminars.

## **CHAPTER 5: 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?**

Presently, SO incentives are largely governed by Ofgem in an interaction with the SO, with a very limited role for licensees on whom the charges incurred by the SO are imposed. We would be supportive of an increased role for licensees in future, either directly or through appropriate industry association representation.

We think that this could be achieved through governance panels, with an appropriately diverse and qualified range of members being elected annually and serving for a finite duration, to scrutinise the SO's performance and propose developments which would better comply with Ofgem's expectations.