



David Beaumont
System Balancing
Ofgem
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

polina.kharchenko@sse.com
01738 512072

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Dear David,

Future arrangements for the electricity System Operator: the regulatory and incentives framework from April 2018

Thank you for an opportunity to provide comments on Ofgem's initial thinking on the electricity System Operator regulatory and incentives framework from April 2018.

In our view, the regulatory framework for the Great Britain System Operator (GBSO) must be based on a combination of clear obligations and enforcement, incentives (both financial and non-financial), where appropriate, and robust governance. This approach, if properly designed, will deliver the maximum possible benefit to consumers and the system.

While it is clear that the role of the GBSO will need to evolve to respond to and facilitate the transformation of the electricity system, given that the roles of other parties in the future flexible market are still being defined, Ofgem should carefully consider the timescale for consulting on incremental changes to the GBSO regulatory framework.

In the attached annex we provide our responses to the consultation questions. This response should be read alongside our response to the consultation on the SO role and structure.

We would be happy to meet Ofgem to discuss our views in more detail.

Kind regards,
Polina Kharchenko
Regulation Manager

Consultation 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 that the principles Ofgem sets out in paragraph 1.13 of the consultation are valid. Clearly, the details behind these principles require a careful and thorough consideration so that the future GBSO¹ regulatory framework based on these principles delivers the maximum possible benefit to consumers and maximises the efficient operation of the electricity system.

We also note an increased focus on 'enhanced' GBSO roles which Ofgem envisages the GBSO will be playing going forward and we have provided our views on this in the response to the accompanying GBSO role and structure consultation.

Taking into account that the RIIO-T1 price control and the GBSO's incentives under Electricity Market Reform (EMR) are remaining in place until 2021, creating a more coherent and less fragmented regulatory framework for the GBSO with enhanced roles will require a number of interim steps over the next few years. While it is clear that the role of the GBSO will need to evolve to respond to and facilitate the transformation of the electricity system, given that the roles of other parties in the future flexible market are still being defined, Ofgem should carefully consider the time for consulting on incremental changes to the GBSO regulatory framework.

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

We are supportive of the proposal for legal and regulatory separation of National Grid's SO and Transmission Owner (TO) functions; and support the proposal for a separate transmission licence for the new 'NGSO' entity within the wider National Grid group. We note that this separation will not preclude the option to move to a fully independent SO at some point in the future if it becomes clear this would be in consumers' interests.

¹ DTI/Ofgem invited submissions for the role of System Operator for Great Britain (GBSO) in August 2002. In September 2002 it was announced that National Grid had applied to be the GBSO. On 17th December 2002, the Minister of State for Energy and Construction announced that the appointment panel had recommended the appointment of National Grid to the role of GBSO.

We also agree that the GBSO's regulatory framework must be based on a combination of clear obligations and enforcement, incentives (both financial and non-financial), where appropriate, and robust governance. This approach, if properly designed, will deliver the maximum possible benefit to consumers and the system.

We are looking forward to this summer's consultation on specific changes to the GBSO's incentive scheme from April 2018. In the interim, from April 2017, we expect that Ofgem will set out clearer expectations on the GBSO through modifying its relevant licence conditions and will produce additional guidance on what is expected from the GBSO's baseline balancing behaviour. We also expect that robust governance arrangements will be put in place prior to April 2019 ensuring adequate independence of the GBSO from the NGET Group TO function. We expect that a consistent package covering all elements of GBSO regulation will be finalised by April 2021. In this response we outline our initial thinking on the future design of the GBSO regulatory framework and possible timings for the changes to this framework.

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?

In our view regulation of the GBSO over the last few years has been lagging while both the system and the nature of balancing costs have been evolving.

In addition, the strength and reliability of the BSIS regulatory framework has been almost fully dependent on the GBSO's ability to develop and maintain the models, setting robust targets for itself to deliver on. While we appreciate the role Ofgem has been playing so far in performing the necessary model checks, GBSO's cumulative modelling errors of £500m resulting in overstated 2016/17 BSIS targets manifest a weakness of the current framework. We expect that the BSIS framework from April 2018 will be scrutinised by Ofgem accordingly.

Separately, we note Ofgem's decision of 24th February 2017 to increase the GBSO's allowances relating to the new enhanced GBSO role by £21.5m. Given the GBSO role and the impact GBSO's internal costs have on Balancing Service Use of System (BSUoS) charges, we expect that GBSO's internal costs will be scrutinised going forward.

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?

As Ofgem sets out in the consultation, the GBSO has an obligation to develop and maintain an efficient, coordinated and economical system of electricity transmission; and to facilitate competition in the supply and generation of electricity, as outlined in Section 9 of the Electricity Act 1989. In addition, similar obligations are also contained in Condition 16² of the GBSO's licence. Ofgem also notes that the GBSO is already obligated to focus on and deliver overall efficiency of system balancing, produce accurate system forecasts, release the transparency information required by market participants and continuously enhance the IT systems and modelling tools required to deliver on the aforementioned obligations. These existing obligations will be amended / updated with further obligations upon the GBSO arising from the application of the European Network Codes.

Given the above, we encourage Ofgem to set clearer expectations on the GBSO through modifying its **licence conditions**, in line with the recently proposed modifications to licence condition C16. We also welcome additional guidance by Ofgem on what is expected from the GBSO's baseline balancing behaviour. Additionally, it is our view that transparency and accessibility of balancing and ancillary services procurement are the prerequisites to effectively deliver on the GBSO's obligations and, therefore, these principles must be followed by the GBSO as the basis for its baseline behaviour. We expect that Ofgem will set clearer guidelines for the GBSO prior to April 2018. In that respect it is regrettable that it appears³ that much of the compliance by the GBSO of its obligations under the Transmission System Operation Guideline will be undemonstrated to stakeholders, as this will remain in their internal Business Procedures which are, we note, not subject to any external oversight or approval.

Separately, we recognise that **principles-based regulation**, if applied appropriately, has its merits in order to provide the required flexibility for the GBSO to achieve its objectives. However, in our view the future SO objectives do need to be embedded in its new licence as part of its obligations and it is difficult to see how the GBSO's objectives could be achieved through principle-based regulation, particularly when planning and connection codes place

² Condition 16: Procurement and use of balancing services: The licensee shall co-ordinate and direct the flow of electricity onto and over the natural electricity transmission system in an efficient, economic and coordinated manner.

³ From the discussions at the GC0095 Workgroup meetings, most recently on 1st March 2017

specific obligations on licenced parties. Where flexibility is provided to the GBSO to fulfil its functions, Ofgem must ensure that additional governance arrangements apply in these areas and the outcomes of such a flexible approach are thoroughly assessed.

Finally, we agree that the residual NGET TO licence should be similar to that of the Scottish TOs. Separately, we note that Ofgem does not intend to re-open the RIIO-T1 settlement and we are supportive of this. However, it is clear that licence changes will be required to ensure these new GBSO obligations are embedded within the industry framework. We are looking forward to Ofgem's consultation on any licence change proposals which might be required in the future.

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

In our view, once clearer expectations are set out on how economic and efficient balancing behaviour must be exhibited by the GBSO, a requirement for specific financial incentives can be examined.

It is our view that the **financial incentives** on the GBSO's external costs from April 2018 to encourage the GBSO to fulfil its role, as prescribed by its Transmission Licence and the European Network Codes, must be carefully considered. We recognise that the characteristics of supply and demand have evolved significantly, and are likely to continue to evolve, creating new challenges to system development, network operation and network resilience, as discussed in the recent BEIS/Ofgem Call for Evidence on Flexibility to which we responded in detail. Hence, while a target-based approach under the current BSIS has delivered relative short-term improvements in balancing efficiency in the past, it is questionable whether the current BSIS is fitting to deliver stable, longer term incentives on the GBSO from April 2018 onwards. We, therefore, question whether it is appropriate for the BSIS, as we know it today, to remain in place as a holding framework between April 2018 and April 2021.

We recognise the challenge of assessing the GBSO's performance against an overall balancing efficiency objective based on robust and tangible targets. Therefore, if the current BSIS remains in place from April 2018, we encourage Ofgem to review the existing scheme parameters and to thoroughly scrutinise the models used to set the cost targets.

In addition, we would suggest setting a cap on the total value of the GBSO's financial incentives equal to a mark-up on its internal costs. This would ensure that overall return the GBSO business is able to achieve is capped at an appropriate level. Furthermore, any additional incentives on the GBSO in light of its future enhanced roles should only be

introduced when the roles of other parties in the market are defined and agreed. We do not believe that any additional financial incentives should be put in place as soon as April 2018.

Prior to April 2021 we encourage Ofgem to carefully review how financial incentives, including discretionary incentives, available to the GBSO under its price control interact with the wider incentive scheme and whether these incentives remain appropriate.

Separately, we see merit in Ofgem using its discretion to allow or disallow specific externally-driven costs based on a careful assessment of the factors contributing to these costs and trade-offs and versatile tools available to the GBSO to achieve its cost targets. Ofgem's discretionary assessment can be supported by industry and/or expert panels.

In addition, the GBSO's **internal costs** must be scrutinised and audited when the time is appropriate. Given the impact the GBSO's totex of c. £140m (2015/16) has on BSUoS charges and, ultimately, on consumers, the GBSO's internal costs must be transparent and auditable.

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 Ofgem notes, the importance of mind-set and cultural changes within the GBSO business cannot be underestimated and, therefore, we encourage Ofgem to consider **non-financial incentives** which will drive the GBSO to maximise the efficiency of its actions. We support Ofgem's proposal to introduce a set of formal Key Performance Indicators (KPIs) to incentivise the right behaviours by the GBSO.

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?

We welcome Ofgem's increased focus on GBSO **governance**. We fully support Ofgem's initial proposals around governance of the GBSO interim incentive scheme from April 2017 and believe that these proposals should be taken forward from April 2018. Independent third party audits and quality assurance and additional regular reporting, analysis and commentary by the GBSO explaining how it performs against its objectives will ensure accountability and more transparency around GBSO incentives.

We agree that consideration should be given to the role of the industry parties in the GBSO governance process going forward.