

David Beaumont and Stathis Mokkalas
Ofgem
9 Millbank
LONDON
SW1P 3GE

By email to: electricitySOreform@ofgem.gov.uk

10 March 2017

Dear David and Stathis

Future arrangements for the electricity System Operator consultations – “role and structure” and “the regulatory incentives framework”

Thank you for the opportunity to respond to the consultations on the future arrangements for the System Operator (SO), both in terms of the separation of the SO and National Grid Electricity Transmission networks businesses and the future regulatory framework and incentives. This response is on behalf of UK Power Networks’ three licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc.

We have replied to both consultations with the responses to your questions included separately in the appendices to this letter.

Separation of the SO and Electricity Transmission businesses

We agree that there should be separate workspaces for the SO and Electricity Transmission businesses, but do not consider that separation of shared access and facilities on the same site is entirely necessary. Ofgem should consider the cost benefit of the changes required.

Ensuring that good compliance processes and procedures are in place should be more important if the activities are to continue on a shared site.

Regulatory framework and incentives for the SO

We believe that Ofgem should build upon the RIIO process and require the SO to set its wider outputs in consultation with its stakeholders, including the electricity distribution companies as Distribution System Operators (DSO).

We have suggested that Ofgem consider rolling incentives where forecasting targets is problematic, as has been implemented for the planned interruptions element of the RIIO-ED1 Interruptions Incentive Scheme (IIS).

There is also scope for improved engagement incentives to promote SO/DSO engagement, where we would recommend the approach Ofgem has adopted for the Incentive on Customer Engagement (ICE) in RII0-ED1.

We look forward to continuing our engagement with Ofgem as the development of a smart, flexible energy system progresses to support the low carbon transition. If you have any questions regarding our response, please contact Robert Friel (robert.friel@ukpowernetworks.co.uk).

Yours sincerely

A handwritten signature in black ink, appearing to read 'James Hope', with a stylized flourish extending to the right.

James Hope
Head of Regulation and Regulatory Finance
UK Power Networks

Copy: Robert Friel, Regulatory Policy Manager, UK Power Networks
Sotiris Georgiopoulos, Head of Smart Grid Development, UK Power Networks
Paul Measday, Regulatory Returns and Compliance Manager, UK Power Networks

Appendix 1

Future arrangements for the electricity System Operator: its role and structure

Chapter Two

Question 1: What are your views on our proposed objectives for the SO (set out in paragraph 2.1)?

We generally agree with Ofgem's proposed objectives.

We would emphasise the SO's role in coordinating a safe, resilient and cost-effective electricity system. In order to promote the development of a smarter, more flexible energy system, the SO's objectives should include facilitating and supporting the development of the Distribution System Operators (DSOs) to help coordinate the use of distribution connected resources to develop a smarter system at the least cost to consumers.

Question 2: What are your views on our expectations for how the SO should seek to achieve these objectives?

The SO should have clear objectives to work with DSOs when identifying and procuring balancing services and obligations to promote and develop the DSO model. This should help to facilitate the coordinated and efficient development of the network and ensure that likely SO actions are understood by the DSO before they are put in place.

Question 3: Do you agree with our proposals for what licence changes are needed to support these objectives?

We would support changes to the licensing regime and industry codes to make it clear that the SO can share information for the purposes of the efficient development of the system. Our work with National Grid on the Kent Active System Management (KASM) project has highlighted that the generators connected to the transmission network own some of the data used by National Grid in analysing the system, and this has created uncertainty in the confidentiality and sharing of this data.

Question 4: What are your views on the extent to which we should set specific or general obligations for the SO?

In line with Ofgem's regulatory strategy, the licence should specify the principles under which the SO is expected to operate/ behave. Specific licence conditions should only be introduced where necessary.

Chapter Three

Question 1: Do you agree that greater separation between NG's SO functions and the rest of the group is needed?

We support separation aligned with that required in vertically integrated undertakings and agree that the SO can be effectively established within NG Group.

Question 2: What are your views on the additional separation measures we are proposing?

The requirements for separate access and offices require consideration as to their appropriateness. Whilst we recognise the need for separate access controls to office spaces and reasonable requirements on the SO in ensuring confidentiality, we believe the additional separation measures need to be proportionate and balanced against the risks they seek to mitigate.

The value to customers of rebuilding offices to provide separate entrances and facilities which could be shared, should be considered in the light of real risks to wider system benefits.

In terms of functional separation, we support Ofgem's approach and the proposal for a separate regulation function, as is widely implemented in vertically integrated companies. The SO's regulatory requirements may need independent specialisation and coordination, especially as SO and DSO frameworks develop and evolve.

Question 3: What are your views on our proposed approach for implementing these changes?

Certification: As NGET is already certified we would question whether there is the need for the additional burden and ultimately cost to customers on 'recertifying' the new SO entity.

Chapter Four

Question 1: What are your thoughts on our proposed approach for implementing the proposed changes set out in this consultation?

The proposed timescales and approach appear reasonable. If less onerous physical separation changes are acceptable then it may be possible to accelerate the timescales.

Ofgem should also consider whether the new SO is to develop and consult on a draft RIIO business plan ahead of the start of RIIO-T2, as part of developing its future incentives and price control plan. This could help drive the concept of separation of the SO from the NO.

Question 2: What further evidence should we consider in finalising our impact assessment of the proposals on the SO's roles and level of independence?

Of the proposed costs of separation, approximately half the cost (£24 million) is associated with internal and external change management costs. It would be helpful to have a further breakdown of these anticipated costs, i.e. the direct programme management costs, the directly related separation costs (e.g. licence drafting) and the proportion of this cost estimate that relates to third party costs associated with code changes.

Appendix 2

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 set out in paragraph 1.13 of the consultation document. However, we note that they are focused on the efficient operation and development of the system and transparency and confidence in the SO's actions and do not consider the service the SO provides to other actors with a role in ensuring the efficient development of the system. The SO regulatory framework should also incentivise the SO to provide a good service to its stakeholders; for example, by using a model such as the RIIO-ED1 Incentive on Customer Engagement (ICE) for major connections customers, whereby the SO would have to set out a programme of improvements and would then be judged on their delivery by its stakeholders.

As a key stakeholder of the SO, we would like to see the service it provides to us reflected as a key element of its regulatory framework.

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

We would support the development of the framework to inform RIIO-2 and ensure alignment of any incentives across the transmission and distribution boundary.

Our experience of introducing the Broad Measure of Customer Satisfaction (BMoCS) in DPCR5 encourages us to support the introduction of the framework (with limited impact on the agreed RIIO-T1 settlement) ahead of this time, to ensure that the framework is understood and effective. Aiming to introduce 'parallel running' of measures from April 2018 would seem appropriate where these can be developed (e.g. our proposal above for a service measure based on the RIIO-ED1 ICE incentive, such that these mechanisms can be fully calibrated and incorporated formally into the RIIO-2 settlement).

Chapter Two: The current SO regulatory framework

The questions in this chapter are not relevant to our activities as an electricity distribution company.

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?

Incentives need to be significantly controllable in order to be highly effective, and combined with targets that are predictable so that investments can be made to perform well against them. In electricity distribution, the Interruptions Incentive scheme (IIS) is a good example of this.

The challenge for the SO incentives is setting targets in an uncertain world, especially where forecasts are an inherent part of these targets. One option would be rolling targets, as have been implemented for the planned interruptions component of IIS, where Ofgem has moved to a rolling incentive to avoid the issues associated with promoting higher forecasts at the time of setting the price control. This is appropriate for this element of the incentive as it allows planned levels to rise during a price control but creates a lag that incentivises the network operator to limit rises and to try to reverse them.

We support Ofgem reviewing wider successful incentive mechanisms to identify the principles and approaches that may be successfully applied to SO incentives.

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?

Clear expectations are valuable to all parties. Ofgem should seek to set clear principles within the SO licence for how it expects the SO to discharge its objectives, what those objectives are and how the SO will demonstrate compliance with them.

We agree that prescriptive requirements are necessary, and helpful, in some circumstances – for instance, setting transparency and reporting requirements, or data handling and sharing obligations with other market participants.

Ofgem should build on the principles used in RIIO-1 of asking companies to define the output measures they will use to measure performance across a number of broad categories. For example, the categories of reliability (energy lost), environment (CO₂), customer (stakeholders) and connections (ability of system to connect LCTs) could be used for the SO.

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

Financial incentives should be developed to promote the reduction in whole system costs, balancing short and longer term pressures. The SO incentives should form part of this framework, but the framework needs to cover both costs of the capacity markets, ancillary and balancing services and network investment (transmission and distribution), balancing drivers for efficiency and investment.

Target based incentives that act over time (e.g. IIS and BMoCS) are better for allowing companies to implement change and invest to deliver improved performance and as such may be best for driving the efficient development of the system (e.g. forecasting, balancing and cost reduction incentives).

The key areas where financial incentives make sense are:

- Balancing Services
- Capacity Market size
- Forecasting incentives
- Stakeholder incentives (though these may be discretionary)

The SO should be incentivised to reduce whole system costs, but it should do this through encouraging efficient investments to reduce the balancing and capacity market costs and by actively improving coordination with DSOs.

We suggest that Ofgem consider an incentive on engagement with DSOs – much like ICE, which requires DNOs to commit to a plan of work and then judges them on their delivery against that plan. Ofgem could consider an upside element to any such incentive in order to positively encourage investment by the SO in developing the DSO framework. This should also promote effective engagement and support by the SO in the development of RIIO-ED2 business plans.

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?

Discretionary incentives can be effective in promoting secondary outputs such as stakeholder engagement and service improvement plans and environmental outputs.

For RIIO-ED1, Ofgem took the step of allowing companies to set their own outputs and targets in their business plans, and should consider doing the same as part of the SO control, particularly where this relates to reporting and reputational incentives. In our answer to question 4, we set out some of the possible categories of SO outputs.

The environmental impact of the generation mix may not be directly within the SO's control. SO environmental outputs could therefore be focused more specifically on the mix of resources used to balance the system and may be reporting only incentives.

Measures of the amount of capacity contracted for balancing services or performance against a wider range of forecasts may be appropriate.

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 support the RIIO framework approach, where the SO should be encouraged to consult with stakeholders in defining and setting its incentives and targets as part of a business planning approach. Such an approach would allow the SO to set out and obtain feedback on how it will achieve its objectives, how it proposes to be measured on them and the targets it proposes.

Ofgem should also consider whether the new SO is to develop and consult on a draft RIIO business plan ahead of the start of RIIO-T2, as part of developing its future incentives and price control plan. This could help drive the concept of separation of the SO from the NO.