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Future Arrangements for the electricity System Operator: the regulatory and incentives framework

March 10, 2017

Dear David,

Thank you for the opportunity to respond to Ofgem's consultation on the future regulatory and incentives framework for the electricity System Operator. This response is made on behalf of Uniper UK Ltd.

Uniper is an experienced international energy company focused on power generation, energy trading, transportation, and storage, as well as a provider of specialist power engineering services. In the UK we own seven power stations comprising over 6GW of flexible installed capacity, as well as a fast churn gas storage site. As such Uniper is the fifth largest generator in GB and is making a major contribution to ensuring security of supply and providing a bridge to the energy market of the future.

Our answers to the consultation questions are set out below.

CHAPTER ONE: Background and objectives
Question 1: Do you agree with our objectives for the future SO regulatory framework? Are there any missing?

Fundamentally we agree with these objectives. Transparency and efficiency, minimising excessive administration, are of course desirable and should be expected, not best practice; with no need for incentives. Recent developments in the challenges facing the system mean that there is merit in introducing a framework which aims to drive SO behaviour to maximise the efficiency of the whole electricity system now and in the future, facilitating greater competition and supporting efficient trade-offs between operational and investment costs. It follows that any risks and rewards should support balanced decision-making, and encourage the SO to seek actions which drive long term benefits. However, extending the Balancing Services Incentives Scheme (BSIS) would be challenging using the present model-based approach to setting targets, as confirmed by interim model results this year. Any longer incentive scheme would be likely to require a different approach. Additionally, the success of an investment in driving long-term efficiency cannot truly be measured for many years; if rewards are to be made on the perceived merit of the SO's actions based on the facts available to it at the time, for parties to have confidence that a reward is fair there must be no question of any conflict of interest and the SO's information and actions must be transparent. The SO should have sufficient flexibility to find the best approaches to driving positive system outcomes, including by working closely with network operators and market participants, but with the caveat that this is open activity, not potentially anticompetitive by engaging in discussions behind closed doors. Stakeholders should be able to have confidence that the SO is acting in the best interests of consumers and the system; and also, have a platform to hold it to account.

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

We agree that it is time to change the structure of the SO and introduce its own specific licence, and that April 2019 is an appropriate date to complete the legal separation of the NGTO and NGSO roles. Simplifying the regulatory framework to bring all elements together in one consistent package would be a positive move. While there is a desire to create regulatory certainty for the SO to help encourage behaviour that will be of long-term benefit to the whole system, transitioning via step-changes in 2018, 2019 and 2021 seems most realistic.

In 2018, we would also like to see mind-set and cultural changes taking place within the SO business before the licence changes. With final proposals issued for the SO incentives for NGET's external balancing costs from April 2017-March 2018, we would support further changes to incentives from the end of that scheme, potentially involving significant alterations to BSIS. A further one-year incentive scheme for 2018-2019 would allow refinements to be incorporated potentially into a two-year scheme for 2019-2021, after consideration of how best to manage a longer scheme in a rapidly changing environment. While Ofgem has long sought to establish longer incentive schemes, it must be mindful of the pros and cons of potential safeguards such as mid-year reviews and reopeners over such a timeframe. Were a two-year scheme to be established as for 2015-17, some precautionary measures would seem sensible, but should not discourage the long-term thinking that a longer incentive scheme and changing framework aim to encourage.

Beyond April 2021, when incentives under EMR and the RIIO T-1 transmission price control come to an end, Ofgem will have the opportunity to align changes to BSIS with incentives on the SO as the EMR Delivery Body and the next price control.

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?

We agree with Ofgem's analysis that changing requirements for system balancing mean that any future incentives must expand the focus from short-term transmission system costs to support longer-term planning and efficiency across both distribution and transmission networks. However, this makes target-setting challenging, particularly the continued use of model-based targets. These SO models have perhaps been relied upon too much in the past without their credibility being subjected to external review, rather, too much emphasis on NGET to identify errors without a strong incentive for them to do so. More than ever these models would require ongoing improvements to keep up with changes to the capacity mix and balancing solutions, to continue to be used to determine SO incentive revenue. A different approach to incentive-setting than a two-year BSIS scheme with a mid-term review may better reflect system uncertainty, but could also require more robust treatment of modelling and a move away from specific targets to higher-level obligations on the SO.

The success of actions taken for wider/longer benefit will be hard to judge and this assessment would also have to evolve from the current approach. We agree with Ofgem's conclusions that the future framework must involve greater transparency from the SO and facilitate the engagement of more stakeholders, enabling further oversight from external parties, in both setting incentives and determining performance.

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?

It is important that Ofgem be clear about the behaviour expected from the SO under its obligations, whether obligations are supplemented by incentives or not, but it could be advantageous if improved clarity of expectations could replace an incentive. In addition to clearer supporting licence conditions, or where existing licence obligations could be more transparent, setting out expectations in a guidance document, as Ofgem's final 2017-18 proposals plan to clarify the 'economic and efficient' obligation, is a practical approach. Producing official guidance also has the benefit that it could be updated at any time for additional content or clarity.

We do not want requirements to be so prescriptive that they risk stifling innovation in the actions or approaches that the SO might explore. However conversely it would be undesirable to set overly subjective requirements that were open to interpretation. Ultimately a mixed approach may well be necessary, but we would support principles-based regulation where appropriate to allow the SO some flexibility in how to deliver its objectives. The introduction of such an approach might help to foster the change to a more proactive mind-set desirable for the new NGSO.

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

Fundamentally it can be questioned whether there is a need or justification for an SO incentive scheme at all. Complex schemes must be carefully designed else risk unintended consequences and conflicts between incentives. Behaviours such as transparency should be an expected way of working, not something for which the SO should be rewarded or consumers should have to pay extra for. The same could potentially be said for actions such as striving to reduce balancing costs. Although, it does not follow that for instance a lack of transparency is not deserving of penalty. For certain issues, it is more appropriate for no reward, only a penalty mechanism to apply.

In matters such as forecasting, improved forecasts are beneficial to the SO as well as market parties so in theory no incentive should be needed to improve performance. Nevertheless as the incentives applying to forecasts have recently been extended to attempt to address concerns such as persistent overforecasting of wind, it will be seen whether this helps to drive improvements. Consequently we would support continuation of some incentives on forecasting, though would also like to see more focus on prompt timeframes (for example, hour-ahead demand).

Overall, we would support a scheme with fewer financial incentives and the introduction of more non-financial incentives on the SO, such as reputational risk. Financial incentives might be more appropriate for specific tasks such as forecasting (although forecasting accuracy could also be a metric reported under a reputational incentive), than for behaviours such as transparency (which should be an obligation, or at the very least confirmed in Ofgem's formal guidance document setting out the behaviours expected in accordance with licence obligations). In setting any financial incentives for less specific tasks we would be interested to see a move from target-based to more discretionary financial incentives considered. The latter would seem more flexible with the expanding SO's role in an evolving market, and more supportive of a holistic long-term approach to, and assessment of, actions taken. However as Ofgem have identified, there must be clear up-front criteria and a transparent decision-making process for their assessment.

Improving performance as measured under NGET's Stakeholder Engagement Incentive and customer and stakeholder surveys suggest that these non-financial measures may have helped to encourage improvements in those areas, supporting the case for extending reputational incentives. Setting reputational not financial incentives would also align with the desire for the SO to take a more holistic, long-term view of system planning through minimising the risk of expenditure on a longer-term investment being deferred in order to hit a current cost target. We agree that further exploration of the international application of reputational incentives on ISOs in the USA would be useful to assess whether some of the same incentives or metrics might be appropriate here.

To help determine performance, publication of regular reports would be welcome, and if some qualitative assessments of the SO's actions are to be made these should include formal communications of actions both taken and intended, to promote competition and network co-ordination, with an explanation of the SO's reasoning. The introduction of a scorecard or set of KPIs could also be useful to help assess performance; these could include performance in congestion management, code administration targets, stakeholder satisfaction, etc. Rather than purely internal assessment, stakeholders could be engaged in this process potentially through an independent review panel. This could include a variety of industry representatives, to assemble a wide spread of knowledge and avoid any risk of bias in members' views of actions taken by the SO.

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 Ofgem's suggestions around improving transparency and accessibility, and in the first instance building confidence in incentive targets through independent scrutiny or potentially ownership of modelling where target-based financial incentives are intended. In such a rapidly changing environment it would be challenging to continue with a scheme based strongly on modelled targets as now, and robust oversight will be needed of the BSIS models particularly if/where a target-based approach continues to be used. (However, it seems unlikely that an independent/industry panel would have the resources to go beyond quality assuring to potentially having ownership of models used in the incentives process, a possibility suggested in 5.10).

As the SO's role grows, along with more focus on the whole system following the growth in embedded generation and flexibility options, it will become increasingly important but also more difficult to avoid a situation where the SO claims that a course of actions taken (for short and/or long-term benefit) was the best option at the time, and an asymmetry of information means that it is hard for anyone, including the Regulator, to challenge this, leading to the SO almost inevitably meeting or exceeding its targets. This is another reason to move away from financial to reputational incentives, and to establish more timely and widespread scrutiny of the SO's undertakings.

As stated above, more open and detailed communication will be required from the SO to explain, not just report, plans and actions on a regular basis; this could be via an expert/industry panel, which we would support. We would expect all related documents to be made available for wider scrutiny. Some improvements to existing reporting would also be welcome. (For instance, while the market is evolving and the Monthly Balancing Services Summary already quite detailed, it would not add much bulk but would be informative if more historical data were provided for services procured, e.g. a comparison with the previous year or at least a rolling twelve months, not just the figures for preceding months in the current financial/incentives year, in the charts in sections 2 and 3. Black Start expenditure, listed separately for the month in the Summary of Balancing Services costs bar chart, the Information Summary Page and Table 10.4, is not listed separately in the Year to Date Summary or Projection Tables 10.1 and 10.2 – without a description of 'Minor components' here a reader must assume that it is included; a footnote confirming these components would be useful. For consistency and accessibility however, particularly as balancing services evolve, it would be more transparent if each service was listed separately). We appreciate Ofgem's intention to seek more joined-up reporting with greater narrative in future; it would be helpful if parties and/or perhaps a new panel were able to comment on drafts of any new reporting formats.

We hope that you find our response to be of help and we would be happy to discuss any aspect with you further.

Yours sincerely,

Esther Sutton

Uniper UK Limited