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David Beaumont
Electricity System Operator Incentives
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Ofgem,
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Dear David,

We welcome the opportunity to respond to the consultation on the **Future arrangements for the electricity System Operator: the regulatory and incentives framework** published on 7 February.

Our shared commitment to create a legally-separate electricity system operator (SO) presents a unique and exciting opportunity to deliver new roles, underpinned by a fresh regulatory framework that will deliver significant benefits for consumers as we transition to the smart, flexible energy system of the future.

A well-designed incentives framework has the potential to drive significant savings for consumers. The SO currently manages just under £1bn of balancing costs per year and combined transmission and distribution networks costs are expected to equate to around £5.37bn per year over the RIIO T1 and ED1 periods. Financial incentivisation of efficient behaviour and encouraging innovation that drives effective, whole system solutions and better use of markets has the potential to realise significant savings as the smarter energy system evolves.

In keeping with the importance of cost to our customers and stakeholders, incentives should apply to any activity where the cost under management is significant. In our view, target-based incentives have a stronger impact in driving behavioural change than discretionary incentives. It will be important to maintain a consistent regulatory stance across the remaining RIIO T1 period – including continuing to use sharp financial incentives over a longer time period. This will support continued strong performance by the SO, focused on the areas where consumers will benefit most, and have a stronger impact on driving innovation and longer term thinking.

It is important to strike an appropriate balance between strong financial incentives and obligations. Alongside incentives, that give the SO freedom to act and drive value in the longer term, obligations managed through well designed key performance indicators (KPIs) allow the SO to demonstrate delivery of value, and increase the confidence of our customers and stakeholders through improved transparency. We welcome proportionate use of obligations and KPIs as an opportunity to streamline our reporting to customers and stakeholders and improve the demonstration of value for money.

The transformation of the electricity SO's role provides us with an opportunity to look at innovative new ways to regulate, incentivise and reward the SO, including good practice from other sectors. Where possible, in designing a scheme for 2018-21 we should take the opportunity to use some of this new thinking while maintaining consistency with the high-level approach used to regulate the SO to date.

The transition to a smart, flexible energy system requires leadership and co-creation between Ofgem and ourselves as SO. We are already stepping up to the challenge, for example investing in new products and IT infrastructure, facilitating the development of new technologies such as storage capacity through a new Enhanced Frequency Response tender, and leading the Power Responsive campaign to promote Demand-Side Response. These initiatives have already resulted in significant progress towards the transformation of the energy sector. In signing the joint statement of intent of 12 January 2017 we demonstrate our commitment to the new structure of the SO and have launched a programme of work to drive through the benefits to consumers in areas such as flexibility, whole system outcomes and network competition. More detail is given in our accompanying consultation response on the *Future arrangements for the electricity System Operator: its role and structure*.

We look forward to working with Ofgem to develop the regulatory and incentives framework for the electricity SO.

Our response to the specific questions raised in the consultation document is in the Appendix.

Yours sincerely,

Dr Charlotte Ramsay

Programme Director, Future Role of the System Operator

Appendix

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 the proposed objectives for the future SO regulatory framework, and would make the following additional points.

Firstly, the proposals for legal separation, agreed by the Gas and Electricity Markets Authority, will establish a regulated, for-profit SO within the National Grid group. To drive behaviour that delivers best value for consumers, future returns of the SO should be commensurate with the risk managed on behalf of consumers, and linked to SO performance. The impact assessment in the consultation shows that given the magnitude of system costs – just under £1bn annual balancing with annual network costs expected to be around £5.37bn over the RIIO T1 and ED1 period – even relatively small improvements in efficiency are able to yield significant savings for consumers. The scale of potential SO returns will remain small compared with the network and system costs borne by consumers. A small investment in a regulatory framework and incentive scheme that drives the SO to deliver efficiencies across the system has the potential to leverage significant benefits. We should look at examples from other sectors or countries which show how a for-profit organisation can deliver strong, positive outcomes for consumers in both the short and the long term.

The risks the SO is managing on behalf of consumers are substantial and have increased since the RIIO T1 settlement – for example, the unprecedented increase in embedded renewable generation means the task of system balancing is significantly more complex. We have managed these risks throughout the T1 period to date, and consistency in the overall regulatory approach through to the end of the period – for example, the continued use of sharp financial incentives - will help us continue to manage this risk on behalf of consumers.

The regulatory framework also needs to take into account the fact that the proposals set out in Ofgem's consultation on *Future arrangements for the electricity SO: its role and structure* represent a step-change in the SO's role, for example in whole system thinking, and ask the SO to take on more risk on behalf of consumers. We need to accelerate innovation and change in system operation, and avoid stifling progress with overly prescriptive frameworks, or scrutiny that penalises learning from innovation.

We agree with the importance of maximising efficiency of the whole electricity system. In order to deliver this objective, incentives and associated obligations for other parties such as DNOs should be aligned with those of the SO. In the longer term, we may want to consider whether more consideration could be given to interactions and potential efficiencies across both gas and electricity system operation.

We agree with the importance of giving our stakeholders and customers the confidence that we are acting in the best interests of the system and consumers and would be keen to work with Ofgem to set up appropriate and proportionate schemes to ensure that our customers are satisfied and the SO is trusted. For example, through legal separation we will be creating a new SO Board and compliance sub-committee. We will be setting up new reporting structures that could be leveraged to improve the transparency of SO operations, which will build trust and support independent scrutiny of our work.

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

We note that the interim SO incentives will be in place until the end March 2018. We would be happy to work with you to develop new incentives for implementation from April 2018. In doing so we will need to take into account the changes to the role and structure of the SO going live in April 2019.

Changes in 2018 will need to be consistent with the longer-term direction of travel and sufficiently flexible to make the most of the opportunities presented by legal separation of the SO. These should also recognise that we are already stepping up our activity in 2018 ahead of legal separation in 2019.

The 2018-21 period is a stepping stone to a new price control under the RIIO mechanism, where more fundamental changes may be needed. This will be an unprecedented opportunity to put in place a new approach that helps enable the transformation of the energy system and drives the SO to deliver benefits to consumers throughout the transition. Where possible, we should look to capture some of this innovative thinking in our proposals for 2018-21, while maintaining consistency with the overall regulatory approach for the T1 period.

In order to set the foundations for an industry that can realise billions of pounds worth of consumer savings, we need to transform the SO. As set out in our response to Ofgem's consultation on *Future arrangements for the electricity SO: its role and structure* we have launched a programme of work to drive through these changes in areas such as flexibility, whole system thinking and network competition. Establishing new roles and activities in these areas requires early investment to successfully deliver the transformation. Alongside this early investment, new incentives will help drive the realisation of benefits for consumers and support the efficient delivery of this change from 2018.

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?

What we have learned

The first area where we have learned lessons relates to modelling against an increasingly uncertain backdrop. Because the future is increasingly uncertain, with rapid and dramatic change, modelling future outcomes and setting targets has become increasingly complex. We learned how this increased potential for information asymmetry, and decreased transparency in the model decision making. Modelling plays an important part in the current incentives scheme, and if models are to be used to support future schemes, these issues need to be resolved to avoid erosion of confidence in model outputs that undermine the incentive framework.

Secondly, we recognise that the design of the BSIS scheme has focused on cost control over a short timescale. Short-term incentives where the results must be realised within-year mean that we focus on efficiencies that will reap benefits in this timescale. We are committed to doing the right thing and have invested in activities such as new contracting structures beyond the incentive scheme term, because we consider it is the right thing to do for consumers. However, a short-term incentive scheme can make this kind of investment more difficult to justify and shows how shareholder and consumer benefits can become misaligned. The 2018-21 incentives scheme is an opportunity to design new incentives with longer term investment horizons in mind.

Thirdly, we have learned that well-designed financial incentives have driven the SO to control balancing costs – particularly the range of risk and reward and sharper sharing factors of recent schemes. We welcome Ofgem's recognition that during 2013-15 incentives drove the SO to reduce balancing costs by around £200m, equating to £150m of benefits to consumers. This is despite a significantly changed backdrop since the RIIO T1 settlement. We have also learned that there is a constant need to evolve and improve these incentives to reflect this changing backdrop.

Finally, it is worth noting that since T1, expectations on the SO have changed significantly. Our shared vision for legal separation and the future role of the SO set out the SO's increased role in enabling the transformation of the energy system and ensuring that benefits are delivered to consumers. This was not envisaged at the time of T1 and illustrates how regulatory frameworks may not keep pace with the fast-changing energy system. The RIIO T1 framework for NGET does not place a strong focus on SO activities nor on outcomes that can be driven by the SO's behaviour. Incentives for NGET under RIIO T1 have therefore not been as sharp on the SO as they have for the TO. More detail on this is given in the following paragraphs. We would welcome the opportunity to consider how elements of the current RIIO framework can be better tailored to SO outcomes over the remaining period in order to drive stronger benefits for consumers.

The RIIO T1 price control

The consultation outlines our forecast and actual regulatory performance over the RIIO-T1 period. We would like to clarify a couple of items within this section.

Firstly, the document quotes our forecast outperformance of the totex incentives to be £18m across the period. This figure is consistent with our 2015/16 regulatory reporting pack but includes assumed allowances for items subject to the 2018 security reopener and excludes any impact of costs resulting from legal separation. Forecasts for these costs total more than £120m across the period. We are confident these costs have been, and will be, incurred economically and efficiently so should attract additional regulatory allowances but at present this funding is not certain. This figure - more than one tenth of our totex forecast across the RIIO-T1 period – illustrates the level of financial uncertainty we are managing. We are progressing work which is in the best interests of customers without regulatory certainty around how or whether the costs will ultimately funded. This illustrates the importance of ensuring consistency of regulation applied to the SO, and how flexibility in the regulatory regime can balance this consistency with the ability to manage developments in the increasingly dynamic environment the SO is working in.

Secondly, the document refers to customer, stakeholder and environmental incentives as well as innovation funding that is in place for NGET through the RIIO T1 period. As currently scoped, the reward from the customer, stakeholder and environmental incentives are all a proportion of TO revenue only within NGET and the resulting revenue only accrues to the TO part of NGET. Similarly innovation funding is only calculated with reference to TO revenue. Whilst SO performance does influence the customer and stakeholder satisfaction incentives, there is no or minimal SO involvement in NGET stakeholder engagement or environmental incentives. We would therefore like to clarify that the SO does not currently benefit from these incentives, though it may be helpful to consider how the wider suite of NGET incentives could provide ideas for future SO regulation after legal separation. We welcome the opportunity to work together to ensure that the new regulatory framework drives the SO to deliver value to its customers and stakeholders.

What changes might be needed in future?

Given the uncertainty inherent in the fast-changing energy landscape, we know that we need to address issues in trust and transparency and for 2017-18 we have committed to improving governance of the BSIS scheme. In future it could be beneficial to maintain a modelled approach in some way, as target-setting is an important way of driving efficient behaviours, but we must ensure that issues relating to trust and transparency are addressed. Independent oversight of our simplified modelling activity is an option, as well as independent audit. We should also consider further ways to improve oversight and governance, and find new ways of working to support a shared understanding of the methodology across the SO and Ofgem teams.

We also need to ensure that the future framework should be transparent and flexible against the backdrop of a fast-changing landscape. We need to understand how to capture this in a baseline that is transparent and part of a wider approach of productive scrutiny and dialogue with the regulator and our stakeholders.

We need to incentivise and reward longer-term thinking. We recognise that we can do more to drive innovation and actions that will deliver benefits over the longer-term and would welcome discussing how changes to the incentive framework could encourage this – including drawing on examples from other countries or sectors to establish how consumer and shareholder needs can be realigned to realise value over a longer period. This improvement represents an opportunity to reduce whole system costs and hold the SO to account for its part in a cost-efficient transition to a smarter system.

Given the magnitude of balancing costs and the increasingly challenging environment, we need to ensure strict and ongoing management of these costs both in the short-term and over a multi-year period. We need to be better at communicating what we do to manage these costs, and how we are setting ourselves up in the longer-term to continue to do this.

There needs to be an acknowledgement that the SO should be paid for what it does, and a transparent and appropriate approach to providing this revenue that is commensurate with the SO's increasing role and the risk being managed on behalf of consumers. We should take the opportunity presented by legal separation and the new roles of the SO to consider how new incentives can drive the SO to deliver benefits in the areas most valued by its customers, stakeholders and consumers. A regulatory approach that is consistent with the continued use of strong financial incentives will provide a platform for the SO to continue to improve outcomes while maintaining an appropriate balance of risk and reward.

We are committed to improving the way we work and communicate with our stakeholders and fostering a transparent and open dialogue with Ofgem. A joint commitment on both sides to work together in a spirit of co-creation will help the SO play its full part in delivering the benefits of the energy transition, in keeping with its future role and legally-separate structure.

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 are working with our customers to better understand their expectations of the SO and how we can best serve them. Doing the right thing for our customers, who are themselves subject to competitive pressure, translates into consumer value. We drive this positive effect through promoting effective competition – one of our key obligations. Given this, we welcome increased clarification of expectations on the SO, as do our customers.

In terms of setting requirements for the SO, we believe that an appropriate balance between principles-based requirements (delivered through financial incentives) and obligations (delivered through KPIs) is the best approach to maximise the value delivery to consumers.

With this balanced approach, financial incentives give freedom to act and drive longer term value for consumers by leveraging the structure of the for-profit SO, aligning shareholder and consumer interests while encouraging innovation and leadership. Well-designed KPIs promote transparency in delivery and provide simple metrics of success that demonstrate consumer value.

The balance between incentives and obligations is also important to ensure that there is sufficient flexibility for the regulated party to choose different approaches and innovate in an uncertain world.

In developing more clarity on obligations, we look forward to moving to a more collaborative approach with Ofgem, in line with the SO's legally separate status and the important role we have to play in enabling the transition of the energy system. It is important that our expectations are aligned, now and as the landscape evolves. Tools such as guidance documents and open letters should be considered to deliver these clarifications, as licence conditions are not necessarily sufficiently agile to incorporate changes in expectations of the SO.

We note that Ofgem is consulting on proposed changes to licence condition C16 to provide clarification of current expectations of the SO under this condition. These changes to the licence and any accompanying supporting guidance document should not be assumed, at the stage that they are introduced into the licence, to extend in scope to capture future (perhaps yet undefined) expectations of the new, future roles of the SO. This could have the unintended consequence of reducing the flexibility of the SO to find appropriate and innovative solutions and drive benefits for consumers, given the fast pace of change. More detail on this is given in our response to Ofgem's consultation on *Future arrangements for the electricity System Operator: its role and structure.*

Any clarification of SO obligations must be sufficiently broad to avoid stifling innovation and falling out of date with the progress of the market. We do not think an overly prescriptive approach is appropriate given the fast pace of change in the energy system. Use of principles can also be stifling if the oversight and scrutiny leads to penalising mistakes or "failed" innovation rather than learning from it. Any change like this needs to be delivered alongside a culture shift for both the SO and the regulator, where we work together to build trust and work side by side in the interests of consumers and facilitating effective transitions that align with public interest and government policy. The proposals for greater independence of the SO facilitate this and we should work with Ofgem to ensure that we both attain this culture shift.

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

Consumers have already benefited from financial incentives on the SO. As highlighted in our response to question 3, over the last incentive period the financial incentives on the SO drove a reduction of balancing costs by around £200m against what they would otherwise have been, equating to £150m of benefits to consumers.

Consumers will continue to benefit from a legally-separate, for-profit SO that is empowered through financial incentives, to take risk and drive positive outcomes. We can co-create a regulatory model where innovation and long-term thinking can thrive and deliver value to consumers. The 2018 incentive scheme is an important foundation for the next price control period that can leverage the unique characteristics of the future SO model.

To maximise the benefits to consumers, strong financial incentives must be a key part of the regulatory framework to ensure that consumer and shareholder value is aligned. They should drive similar behaviour in the SO to that which would exist in a competitive market. The SO is willing to take risk on behalf of consumers, therefore financial incentives should reflect this and provide a means of balancing this risk with reward.

Our thoughts on high-level areas for financial incentives, together with potential forms, are as follows. Firstly, the value of financial incentives should correspond to the value of the relevant outcomes for the consumer. Engagement with our customers and stakeholders indicate that their priorities are value for money/low costs, a high standard of customer service, reliability and security of supply. In delivering for consumers now and in the future, sustainability considerations are also important. Incentives should promote positive outcomes in all of these areas. In keeping with our customers' focus on cost, incentives should apply to any activity where the cost under management is significant. The incentive period should be long enough to support whole system and long-term thinking. As we have already mentioned in our answer to question 1, for optimal whole system outcomes, the incentives of other parties such as DNOs need to be aligned with those of the SO.

In our view, target-based incentives have a stronger impact in driving behavioural change than discretionary incentives. If the criteria for achieving a discretionary reward is less than certain this can lead to excessive focus on regulatory reporting and justification of activities to the regulator, rather than delivering outcomes for the benefit of consumers. We understand the challenges in establishing a baseline or target, and would be happy to work with Ofgem to consider what an appropriate, and transparent, methodology could be. Other sectors may provide examples of where financial incentives drive positive outcomes for their customers and value to consumers. They can also provide examples of other ways of providing an appropriate return for the risk being taken on behalf of consumers, such as the concept of a baseline margin on an appropriate and efficient definition of assets or costs. We would be happy to work with Ofgem to consider what outcomes are most important to deliver for the consumer and how these can be incentivised.

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 recognise the importance of transparency and information provision, and are responding to stakeholder requirements for information, for example in our new, forthcoming, System Needs and Product Strategy publication. We support the appropriate use of key performance indicators (KPIs) and would be happy to work with Ofgem to consider what an appropriate set of KPIs could be. We welcome KPIs as an opportunity to streamline our reporting to customers and stakeholders and improve value for money. In developing KPIs, it will be vital that we consult customers and stakeholders on what information they would value, and incorporate these requirements into the design.

The consultation refers to giving stakeholders a platform to hold the SO to account. Giving our stakeholders and customers the confidence that we are operating fairly and efficiently is important to us, and we would be keen to work with Ofgem and stakeholders to establish appropriate and proportionate schemes to ensure that stakeholders are assured in this area and have confidence in the SO.

Noting that the examples in Ofgem's consultation relate to not-for-profit independent system operators, it would be beneficial to consider whether reputational incentives could be sharpened by incorporating a financial impact – for example a reward on the basis of performance against a defined outcome. These could further drive positive behaviours and outcomes by leveraging the for-profit structure of the SO. The stakeholder engagement incentive on NGET under RIIO has shown how this can drive actions that go above and beyond business-as-usual engagement to deliver positive outcomes.

<u>CHAPTER FIVE: Incentive scheme governance</u>

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 would welcome an increased role for stakeholders in the governance of SO incentives. We agree that greater transparency of what the incentives are and how the SO is performing could be achieved through clear reporting, streamlining of reports, and stakeholder panel sessions. New governance arrangements should focus on the information that is most beneficial to stakeholders to facilitate a reduction in overall cost to the consumer.

As we move to legal separation of the SO from the TO, the way we define our customers and stakeholders will become more important. It would be beneficial to ensure that we and Ofgem have a joint understanding of these definitions, and that common definitions are used to set up any new approaches to improve transparency and give stakeholders a greater involvement in our governance.

In addition to the measures proposed in the consultation, it would be beneficial to also consider how the new SO Board and governance arrangements can be leveraged in order to deliver the additional transparency and confidence that is sought. As set out in our response to Ofgem's consultation on *Future arrangements for the electricity system operator: its role and structure*, we propose to appoint at least three sufficiently independent directors to the NGSO Board. We also plan to establish a compliance sub-committee chaired by a sufficiently independent director. We hope that this obligation, when combined with other measures, will further provide confidence to our stakeholders.