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Dear Stathis,

Future arrangements for the electricity system operator: its role and structure

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group, excluding Centrica Storage.

We recognise the need to transform the electricity system and these proposals would better position the SO to meet these challenges. The focus on whole system management and overall long-term efficiency, together with an emphasis on the use of market-based approaches for procuring balancing services, and the promotion of innovation, flexibility and demand-side solutions should deliver benefits for consumers.

Greater separation of National Grid's electricity SO function:

Greater separation of National Grid's electricity SO function presents an opportunity to reinforce the obligation to be economic and efficient and to enable the SO to take a more active role in influencing the development of more market-led solutions.

We welcome the clarification by Ofgem in its *Final proposals for electricity System Operator incentives from April 2017*¹ that being economic and efficient entails:

- *“publishing the system operation information electricity market participants need in order to make efficient operational and investment decisions;*
- *producing and publishing reliable and unbiased forecasts of future margins, demand, wind generation and balancing costs;*
- *ensuring the procurement of balancing and ancillary services is as transparent as possible;*
- *ensuring that balancing and ancillary service product requirements do not inefficiently restrict new and existing providers from competing;*
- *anticipating future system requirements and using and developing competitive approaches to procuring balancing services wherever this is in consumers' best interests”*

We believe the SO should embed these expectations into their practices on an enduring basis, to ensure efficient outcomes for the market and consumers. We also support implementation of changes to increase separation, ahead of full legal separation, where the benefits can be realised earlier.

¹ <https://www.ofgem.gov.uk/publications-and-updates/final-proposals-electricity-system-operator-incentives-april-2017>

Price control arrangements need to be fit-for-purpose:

We agree the implementation of the proposed changes does not require the re-opening of the RIIO-T1 price control but will require revenues, outputs and incentives to be allocated across NGTO and NGSO. Also, we agree additional funding should be provided only if there is a material increase in costs due to activities that were not envisaged at the time of the RIIO-T1 price review. Similarly, funding for activities that were envisaged at that time but will no longer be required should be disallowed.

The proposed changes to the structure of the SO are meant to mitigate concerns about conflicts of interest within the National Grid group. However, any changes to the relationship between the electricity and gas SOs, if any, have not been discussed in the consultation. Clarity on the treatment of any expenditure and outputs straddling both sectors in the current electricity and gas price controls should be provided.

Developments on the Transmission – Distribution system interfaces:

Greater coordination across transmission and distribution systems can deliver whole system efficiencies. For example, generation and demand connected at the distribution level could provide solutions that more efficiently resolve constraints on the transmission system and vice versa. However, the current network price control arrangements cannot easily accommodate such 'cross-system' solutions. The RIIO regulatory framework has been designed to encourage each network licensee to undertake the most efficient actions in its licence area. Careful consideration should be given to how the regulatory framework can be adapted to facilitate the delivery of whole system solutions while maximising benefits for consumers.

Consideration of changes to the regulatory framework should include providing clarity on the difference between a DNO and a DSO. We are not aware of policy intent to require energy balancing at distribution network level and, as such, do not expect DNOs to assume responsibilities beyond developing and maintaining an efficient, co-ordinated, and economical electricity distribution system. Whilst we welcome the emergence of new and innovative ways of managing network constraints, such as procurement by the DNO of embedded generation or demand reduction to defer reinforcement expenditure on highly loaded circuits, this does not fundamentally change a DNO's core responsibilities.

We hope you find these comments helpful. Answers to the consultation questions are attached. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Fiona Navesey CEng MIMechE
Director, Wholesale Electricity Markets

Answers to the Consultation Questions

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

We agree that the proposed objectives should better position the SO to meet more effectively the challenges associated with the evolution of the electricity system. The focus on whole system management and overall long-term efficiency should encourage the SO to perform its roles in ways which maximise benefits for consumers, as well as ensuring a safe, resilient system. Similarly, the emphasis on the SO as a market facilitator, the use of market-based approaches for procuring balancing services and on the development of well-functioning markets should also deliver benefits for consumers.

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

We broadly support your expectations for how the SO should seek to achieve the high-level objectives. The focus on whole system management and overall long-term efficiency should encourage the SO to prioritise long-term efficiency over short-term cost reductions. Overall efficiency can also be achieved by encouraging the SO to undertake actions beforehand (such as making improvements the accuracy of forecasts) in order to minimise the volume of balancing actions required rather in addition to seeking to deliver those balancing actions as simply as possible.

We would like to see an SO that anticipates challenges and is proactive in responding and identifying market-led solutions with participants. We welcome, that to some extent, this is work in progress with the System Operability Framework initiative. We agree that SO proactive engagement with the industry, to understand the need for transparency and accessibility of the procurement of balancing services, is the most appropriate approach. We also support the SO taking on more responsibility for ensuring coordinated developments with distribution networks.

We acknowledge the SO has engaged with network operators to develop solutions to transmission-distribution issues. However, it is necessary for the SO to also proactively engage with the wider industry during solution development rather than consulting the wider industry once those solutions have been developed.

We agree that there is a role for the SO to coordinate with DNOs. However, we are not sure of the relevance of Ofgem's notes in parenthesis "DNOs will transition to DSO roles" in Para 2.21. Currently there is a lack of clarity on the difference between a DNO and a DSO. We are not aware of policy intent to require energy balancing at distribution network level and, as such, do not expect DNOs to assume responsibilities beyond developing and maintaining an efficient, co-ordinated, and economical electricity distribution system. Whilst we welcome the emergence of

new and innovative ways of managing network constraints, such as procurement by the DNO of embedded generation or demand reduction to defer reinforcement expenditure on highly loaded circuits, this does not fundamentally change a DNO's core responsibilities. However, if the responsibility for system-wide efficiency develops to include a local SO (in addition to the national TSO) then this entity should be independent of the DNO.

Finally, we also agree that the SO's knowledge of system balancing and operation means it is well placed to understand the interactions between different market arrangements and in particular how a future market(s) for flexibility / system management services will interact with the wholesale markets. In particular, the potential to impact liquidity in the wholesale markets needs to be given further consideration in the overall design going forward.

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

The proposed combination of the modification of existing licence conditions and the introduction of new conditions is broadly appropriate. Though not discussed in this consultation, the proposed changes to Standard Condition C16 (presented in *Final proposals for electricity System Operator incentives from April 2017*) represent a reasonable starting point as obligations on the SO to improve transparency of its actions, to pursue market-based approaches for procuring system management services and to develop such markets where appropriate. Standard Condition C16 can be further bolstered to embed other requirements we believe are necessary for the development and operation of well-functioning and effective markets such as cost-reflectivity and non-discrimination.

Further modifications may be required once the policy decision has been made on the specific nature of the role of the SO relating to coordination of the whole system and its relationships with transmission and distribution network operators. We also note there will be a suite of standard and special licence condition modifications relating to the legal separation of the SO and the rationalisation of roles, responsibilities, revenues, outputs and incentives across NGTO and NGSO. We look forward to these proposed modifications in future consultations.

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

Whilst it is accepted that the electricity system needs to transform and become a smarter, more flexible system longer term, how this will be achieved most economically and effectively is not yet clear because of the range of interdependencies with other aspects of the whole energy approach. This means that all parties will need to adapt and the electricity system design be allowed to evolve to meet the future needs.

Generally, principles-based rules should allow the SO to be more flexible in a changing environment and to facilitate the evolution of the electricity system. Principles-based rules can mitigate a drawback of prescriptive rules and regulations: an organisation may seek to

maximise its financial performance within the framework set by those rules and regulations, even if this has a negative impact on longer-term considerations. However, there may be instances in which some obligations should be prescriptive, even in a changing environment, to encourage the SO to deliver solutions that are optimised for consumers and market participants. For example, if an output required may be very specific in nature and the obligation to be placed on the SO can be tightly defined, then a prescriptive regulation may be suitable. As such, a hybrid approach comprising principles-based rules and prescriptive obligations will be needed.

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

The legal separation of the SO from the rest of the National Grid group goes some way towards mitigating concerns about perceived conflicts of interest in the electricity sector, subject to appropriate undertakings being implemented. Changes to the relationship between the electricity and gas SOs, if any, have not been discussed in the consultation. Clarity should be provided on how interactions between the legally separate SO for the electricity sector and the SO for the gas sector (which may or may not remain integrated within the National Grid group) can be appropriately managed and funded.

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

The proposed additional separation measures relating to information ring-fencing, physical separation governance of the SO are appropriate. Given the concerns about perceived conflicts of interest, the regulation, legal and finance functions (which are 'leading' functions) should be separately resourced by NGTO and NGSO businesses instead of being classified and delivered as shared services. Undertakings relating to all aspects of the separation should be drafted so as to deliver the expected levels of separation. Consideration should also be given to cultural changes and how best to eliminate any "unconscious bias" towards solutions that favour the TO.

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

The proposed approach is appropriate. We also support retaining the option to evolve further to a full ISO model, but only if this would serve better customer interests.

Chapter Four Question1: What are your thoughts on our proposed approach for implementing the proposed changes set out in this consultation?

The timetable and sequence of events to implement the proposed changes appear sensible. We agree that progress can be made by the SO on some of the issues discussed in the consultation, such as improvement of transparency and accessibility of its balancing services, ahead of licence changes. We acknowledge some such improvements have already been made and will continue to support industry efforts to develop and deliver improvements.

Chapter Four 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?

Along with the costs to be incurred by National Grid group and the Authority arising from the restructuring of the SO, the following should be included in next iteration of the impact assessment:

- Costs to be incurred by industry parties to facilitate the restructuring.
- Implementation and ongoing costs to industry parties because of the changes to the SO's roles.
- The costs of any negative exogenous effects such as, for example, any negative effect of the impact of the proposed changes on the wholesale electricity market.

The expected benefits of the proposed changes should also be quantified so that industry stakeholders may comment meaningfully on the merits of the proposed changes. Quantification of the expected benefits will support the tracking of benefits realisation and this this could also be used to inform any future decisions on a full ISO model.