

Stathis Mokkas
System Balancing
OFGEM
9 Millbank
London
SW1P 3GE

10 March 2017

Dear Stathis,

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

Thank you for the opportunity to provide views on behalf of ScottishPower on Ofgem's review of the electricity SO role and structure. We are responding separately to the related consultation on the SO regulatory and incentives framework. Our network business is providing a separate response to this consultation on specific network issues relevant to its activities.

Our responses to the posed in your consultation questions on the future role are set out in Annex 1.

We welcome Ofgem's review of the arrangements for the SO, in terms of its role and structure, as the role of the SO and the activities of the wider National Grid group have evolved in recent years to the extent that perceived conflicts of interest have developed.

These conflicts of interest arise between the SO role (including the EMR delivery body role) and that of NG's other activities such as Transmission Owner for England & Wales and investor in interconnectors. Examples of such potential conflicts of interest include the ability of the SO to influence:

- aspects of network and BSUoS charging methodologies for generation (in which NG does not have an interest) and interconnectors (in which NG does have an interest), via the SO's code administrator roles;
- proposed de-rating factors for generation, and for interconnectors, for Capacity Market participants via its EMR delivery body role;
- ability to undertake TO network reinforcement works rather than market test competing ancillary service contracts which may represent a more cost efficient solution via its SO role;
- Ofgem's Cap & Floor assessment of interconnector projects (including those in which National Grid is an investor) through its analysis of system operability benefits in its role as SO;
- which transmission network projects are recommended for competitive tendering under the ECIT regime, through the Network Options Assessment (NOA) process.

In considering the degree of separation that should be required between the SO and other NG businesses, it is appropriate to assess both the depth and seriousness of any conflicts, and the cost of any separation measures that may be imposed, in order to

achieve a proportionate solution. In this case we consider that the potential conflicts are of sufficient seriousness to justify the full range of measures being proposed by Ofgem. We agree that it would be appropriate for the TO and SO businesses to have their own dedicated teams of regulatory, legal and other support functions. However, it may also be efficient for certain more specialist regulatory or legal affairs support to be provided at a corporate level, subject to appropriate safeguards.

We support the principle of Ofgem's proposals to strengthen the separation between its SO and TO roles, which build on similar existing arrangements between its SO role and that of its roles as EMR delivery body and investor in interconnector projects. We believe that the proposals represent a balanced approach which addresses the issue in a more proportionate manner than adoption of the alternative ISO model at this time.

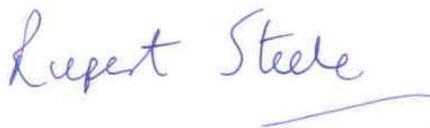
However, we would encourage Ofgem to consider carefully whether the estimates of upfront and ongoing costs provided by NG are all additional and necessary. We would also support measures to ensure the financial robustness of the SO, which might for example include parent company guarantees or other support from the TO business. Failure to maintain an appropriately robust SO could have negative implications for contracting counterparty licensees and ultimately for consumers.

We would encourage Ofgem to consider other relevant examples of how business separation has been adequately achieved between other licensees at least cost, for example between operators of regulated networks and de-regulated generation and supply businesses.

We welcome Ofgem's proposals regarding the need for increased transparency and provision of information around the SO's balancing actions and the recognition of the impact of these actions on operational and investment decisions for market participants. It is imperative that a market-based approach is consistently applied for the procurement of all balancing services. We have particular concerns that the current use of bi-lateral contracting for services is not proving cost effective (as evident in the excessive costs for black start contracts concluded in March 2016) and where there is not currently sufficient competition for particular services, longer term contracts should be designed and procured through competitive auction.

I hope you find these comments useful. Should you wish to discuss any of these points further, please do not hesitate to contact me.

Yours sincerely,



Rupert Steele
Director of Regulation

FUTURE ARRANGEMENTS FOR THE ELECTRICITY SYSTEM OPERATOR: ITS ROLE AND STRUCTURE – SCOTTISHPOWER RESPONSE

CHAPTER 2: THE ROLE OF THE SO

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 are appropriate for the electricity System Operator. We particularly welcome the proposals to move to a longer term approach to securing the new capacity and flexibility needed to deliver a safe, resilient and cost effective electricity system and the need to adapt the market for services and charging to deliver a level playing field.

In the context of system security, we agree that the SO's role should be focused on producing accurate recommendations on CM auction targets and de-rating factors, based on robust and transparent methodologies, but it is for the Government to set the reliability standard and for market participants to respond to signals in order to provide the necessary resources.

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

We support the proposed expectations for how the SO should seek to achieve these objectives and would encourage Ofgem to clarify their expectations through amendments to the existing SO licence obligations and interim incentive arrangements ahead of the implementation of any future governance and structure of the SO.

We welcome Ofgem's proposals regarding the need for increased transparency and provision of information around the SO's balancing actions and the recognition of the impact of these actions on operational and investment decisions for market participants. We believe that the role of the SO needs to include the co-ordinated development and design of services and a procurement process that is transparent and accessible. It is important that the services and procurement processes support both new technologies (such as batteries) and enhancements to existing technologies (such as pumped storage hydro and wind) to deliver the flexibility services needed under the new market arrangements. A transformational culture change will be required within the SO to adequately deliver this objective from the status quo position in which the approach is at best inconsistent.

It is important that the SO moves quickly to a market based approach for the procurement of all balancing services to include new, more flexible ancillary service products. We have particular concerns that the current use of bi-lateral contracting for services is not proving cost effective (as evident in the excessive costs for recent black start procurement); where there is not currently sufficient competition for particular services, longer term contracts should be designed and procured through competitive auction. We are increasingly concerned that the SO has set targets for the proportion of balancing services it procures solely from DSR technologies, as it should be contracting on a cost-effective, technology neutral basis in compliance with its licence obligations, where effective competition sets the balance between service providers.

It is also important for cost efficiency and competition that industry codes and charging arrangements are regularly reviewed to ensure that they remain cost reflective and fit for purpose during the transformation of the electricity system. For instance, charging arrangements for network and BSUoS costs which fail to fairly reflect the changing profile of system users risk distorting competition between different users, resulting in inefficient outcomes for consumers over the long term. For this reason, we would propose that the expectations should also include specific references to the SO leading such regular reviews in its role as chair of relevant code governance panels.

Moreover, we believe that such detailed expectations could and should provide the basis for the adoption of principles-based regulation of the SO, providing guidance on the standard of performance which is expected and below which enforcement action could be considered.

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

We agree with the proposals regarding licence changes and recognise that there will be multiple timeframes in respect of each of the required changes, e.g. revised C16 licence condition, SO incentive scheme, RIIO review period, etc. However, we also agree that there is no barrier to the SO implementing many of the changes immediately without need for licence changes.

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

We believe that the obligations on the SO would be best governed through the adoption of principles-based regulation, supported by clear guidelines on expectations and backed up by an appropriate enforcement framework.

We recognise the benefits in the use of financial incentives to create an environment that encourages and supports the innovation and improvement which will be greatly needed to manage the challenges going forward. However, consideration needs to be given to striking the right balance between the use of financial incentives and the enforcement of licence obligations, with financial incentives being used only where clear targets (wholly or mainly within the SO's control) can be defined.

Where incentive schemes are used, we would favour more targeted schemes instead of the existing BSIS, which is overly complex, administratively burdensome and results in windfall gains and losses in respect of activities which are not wholly or mainly in the SO's control.

CHAPTER 3: A MORE INDEPENDENT SO

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

We agree that greater separation is required between the SO and National Grid's other activities in order to maintain investor confidence and address potential conflicts. In recent years the role of the SO has evolved, as have the activities of the wider National Grid group, to the extent that perceived conflicts of interest have developed between the SO role and that of other activities, e.g. NG's roles as Transmission Owner for England & Wales, as an investor in interconnectors and as EMR delivery body.

Examples of such potential conflicts of interest include the ability to influence: (i) some aspects of network and BSUoS charging methodologies for generation and interconnectors via SO code administrator roles; (ii) proposed de-rating factors for generation and interconnectors for Capacity Market participants via EMR delivery body role; (iii) ability to undertake TO network reinforcement works rather than market test competing ancillary service contracts which may represent a more cost efficient solution via SO role.

There is a spectrum of options for addressing this concern, balancing the need to address such conflicts of interest against the burden of increased financial costs and operational inefficiencies. We agree that the two options identified by Ofgem of separating the SO and TO functions within NG group or moving to a fully independent SO are more appropriate options than the third alternative of retaining the status quo position.

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

On balance, we agree that the proposed measures to boost separation of the SO and TO businesses are the best solution and that they provide a more proportionate solution than implementing a fully ISO model at this stage.

We believe that the greater costs associated with implementing an ISO model and the weakened financial strength of the SO with whom market participants would be contracting for in excess of £1bn of revenues each year, result in the ISO option representing a disproportionate solution at this time relative to greater separation. Indeed, we struggle to consider how the SO could maintain an investment grade credit rating standing in isolation.

We are however, concerned at the upfront and ongoing costs proposed by National Grid which appear excessive. We welcome the scrutiny which Ofgem will provide before coming to a decision.

In considering the degree of separation that should be required between the SO and other NG businesses, it is appropriate to assess both the depth and seriousness of any conflicts, and the cost of any separation measures that may be imposed, in order to achieve a proportionate solution. In this case we consider that the potential conflicts are of sufficient seriousness to justify the full range of measures being proposed by Ofgem. We agree that it would be appropriate for the TO and SO businesses to have their own dedicated teams of regulatory, legal, HR and other support functions. However, it may also be efficient for certain more specialist regulatory or legal affairs support to be provided at a corporate level, subject to appropriate safeguards.

We note that similar conflicts of interest have been successfully addressed through such separation measures without the need for fully independent ownership as demonstrated in the cases of companies with regulated and liberalised activities, eg ScottishPower's regulated networks and liberalised supply and generation companies. However, if following a suitable period for the revised arrangements to be given an opportunity to work, the measures have failed to achieve sufficient cultural change, or if the costs of greater separation cannot be considerably reduced relative to the ISO option, it may be necessary to re-consider this position.

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

We broadly welcome the proposals made by Ofgem for implementing these changes as they appear to achieve a sensible balance between addressing conflicts of interest and minimising cost and operational disruption.

In our view, in order to achieve the necessary cultural change, we believe that it would be desirable for the SO to use separate naming and branding to the remainder of the NG group as well as be subject to physical separation in terms of discrete office facilities, even if using the same location.

CHAPTER 4: NEXT STEPS

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

We support the proposals to implement the changes through a phased approach to April 2019 which allows the SO to make some changes immediately providing early benefits to consumers, and suggest that it would be useful to define some appropriate delivery milestones to maintain momentum, promote the necessary culture change over time and to provide assurance to stakeholders that activities are progressing as planned.

While we support the implementation of an interim BSIS incentive scheme between April 2017 and March 2018, we believe that it should be the last such scheme, being replaced by principles-based regulation and consideration of enforcement action beyond this date.

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?

There is no further evidence that we would wish to highlight at this stage.