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

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Dear Stathis,

Thank you for the opportunity to respond to Ofgem's consultation on the future role and structure for the electricity System Operator (SO). 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 key points are:

- Once the new separate legal entity is established, it would be appropriate to give further consideration to the merits of a fully independent System Operator to promote and enhance an effective flexibility market.
- The separation must be managed to ensure an effective transition that minimises costs while nevertheless enabling a potential future move to an independent System Operator.
- The regulation function should not be shared.
- Even as part of NG Group, a physical relocation would be more appropriate to resolve perceived conflicts of interest and set the scene for a new NGSO, than a partitioning of National Grid House.

We support the separation of the electricity System Operator and Transmission Owner functions to address the conflict of interest that the current set-up has created, and establish a more appropriate structure for managing the evolving system. Major developments over the last few years, including the growth of intermittent and embedded generation, interconnection, and expansion of responsibilities of the SO following Electricity Market Reform (EMR) mean that it is time to separate these distinct



roles, and in so doing enable the potential establishment of a not-for-profit fully independent System Operator (ISO) in future.

The legal and physical establishment of the SO as a separate company under the National Grid Group in the first instance should be undertaken promptly, but with due regard to costs. We are concerned that some of the amounts suggested appear excessive and would appreciate further insight and scrutiny of these figures. Further clarity is also required regarding the Distribution interface.

Our answers to the consultation questions are set out below.

Chapter: Two

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

We broadly support the proposed objectives. Overseeing a safe, resilient and cost-effective electricity system is fundamental and we agree that taking a more holistic view of transmission and distribution systems should help to achieve more cost-effective operation of the whole system. Cost-effectiveness will also be maximised by improving transparency and minimising market distortions to enhance competition, enabling as many parties as possible to compete on a level playing-field.

Driving competition and efficiency across the system is critical; however, it seems inconsistent with this stated objective to go on to state in 2.1 that Ofgem expects “the SO to use competitive approaches in managing the system wherever this is in consumers’ interests”. Transparency is vital for good governance and taking an open, competitive approach to procuring and deploying services should always be in consumers’ best interests. As Ofgem have previously acknowledged, while bilateral contracting might occasionally seem a logical approach in the short-term, this can put concerned parties in a privileged position, potentially in possession of inside information. Longer-term, it risks hindering development of the market for the service in question and increasing costs due to an adverse impact on the competitive market.

Promoting innovation, flexibility and smart/demand-side solutions are worthy objectives, however these are only worth pursuing if they provide cost-effective solutions. It must also be remembered that such services cannot necessarily be relied upon to provide flexibility when needed. For instance, interconnection cannot be relied upon to provide flexibility services or ‘extra generation’, and it may be hard to verify accurate service provision from demand-side response and other small flexibility providers. All new products and services developed must be transparent, with associated terms and conditions developed across industry and not on a bilateral trial basis with individual parties, giving first mover advantage, before extending procurement to the rest of the market. All solutions developed should be offered to the market at the same time, to allow companies to compete for the opportunity on a fair basis.

Facilitating a whole-system view instead of considering only the transmission or distribution perspective is important to achieve the most efficient network planning, resilience and use of resources. We agree that there does need to be greater co-ordination between emerging DSOs, the SO, and TOs, both in terms of network planning and operation, given the challenges that the SO in particular has already faced as a result of changes in the patterns of use of the transmission system. However, while the SO could support competition in networks we are wary of the extent to which SO involvement behind closed doors is desirable before a tender is run. It is also not yet clear how the relationship between the SO and DSOs would work; it would be helpful to see this explored further.



Change will only be effective if implemented through the Regulator, SO and industry working openly together to identify solutions and implement them in a co-ordinated manner. Liaison with industry will be vital for the SO to achieve these objectives.

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

Ofgem should indeed be explicit regarding their expectations of the SO and we agree that the expectations of SO behaviour set out in this consultation are fair; we support Ofgem taking an ongoing monitoring and compliance role. As per our answer to question 1 and set out in 2.5, it is crucial that the SO does work closely with industry participants to achieve its objectives.

We welcome the clarification that the SO should operate closely with industry and with improved levels of transparency. In balancing the system, Ofgem has identified in 2.17 that the SO should be releasing as much information as possible about the system and its actions in order to help market participants make decisions based on the best possible information. This should include location/identity, price, volume and utilisation from all market participants, both BM and non-BM, in order to end the present anticompetitive situation which puts non-BM parties in the privileged position of being able to see greater detail of BM activity whereas BM participants cannot see the same level of information on non-BM. To avoid distorting competition, equality in transparency of market information is also required across all technologies and between distribution and transmission connected providers. This should help to enhance efficient trading and dispatch, procurement and usage of ancillary services in fulfilling the SO's role of residual balancer. As Ofgem has identified, the European Electricity Balancing Guideline, due to go to a vote on the 15-16th March, will require market-based approaches to procurement of balancing services and the SO can certainly enhance this in relation to ancillary services such as black start. This should include transparent actions to widen the pool of potential providers where bilateral discussions have previously taken place due to the SO's perception of insufficient competition in that area. Maintenance of robust systems and seeking continuous improvements to modelling and forecasts will also help both stakeholders and NGSO.

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

Ofgem states that the right balance between licence conditions, financial and reputational incentives is to be considered as part of the fundamental review of the approach to SO incentives, and we agree that this should include consideration of the interactions between EMR and other SO incentives. We look forward to hearing Ofgem's initial thoughts from this review in summer.

We agree with making licence changes to supplement SO incentives and provide clearer expectations of the SO where required, but also, that the SO should endeavour to make progress as soon as it can. Expectations such as improved transparency and accessibility of balancing services should indeed be delivered under the SO's current licence obligations.

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

Where there is a singular objective then a specific target would be appropriate, but a move away from specific obligations to more principles-based ones is suitable for issues where it is hard to formulate an accurate target and may be more practical for licence conditions. This would also reflect Ofgem's desire to see an SO which



anticipates challenges and is proactive in responding, rather than an organisation whose actions are driven by adherence to prescriptive rules and regulations.

Chapter: Three

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

Yes. It is anti-competitive and consequently inappropriate for the same organisation to perform the role of System Operator, running the Capacity Market process while also being a Transmission Owner holding interests in cross-border interconnectors (or other flexibility services, such as storage) and bidding for capacity payments. As stated by the Cambridge University Energy Policy Research Group, 'Resolution of any perceived conflicts of interest is essential to opening the market to as many participants as possible'. The present situation is detrimental to investor and consumer confidence in the GB market. As the SO's roles and potential for conflicts of interest are increasing, this separation of NGSO and NGTO should be expedited.

It has also been recognised that longer-term, establishing an Independent System Operator/Distribution System Operators (DSOs) that no longer own network assets would potentially deliver significant benefits beyond the resolution of conflicts of interest. Indeed in their Smart Power report the National Infrastructure Commission affirmed that the SO should be more independent:

"It is important for the system operator to be more independent, and National Grid should work to achieve this. The strength of the case for an entirely independent system operator is likely to change over time, depending on how the electricity system evolves. Government should therefore keep this area under review."

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

We support the additional separation measures, although, while Ofgem does not intend to re-open RIIO-T1 settlement, if costs incurred in setting up an NGSO separate to the NGTO fall outside of this, industry must be consulted and given sufficient advance notice of any costs likely to be passed on to parties.

We agree that information ring-fencing provisions should be extended following the separation. To limit access to relevant information on a shared IT system such as the Industrial Energy Management software could be a practical, cost-effective solution for the moment. However when procuring any IT solutions in the future, the SO and TO should do so separately to make it easier if/when a move to an ISO took place.

Concerning governance, it is right that NGSO has a separate Board to NGTO, with different membership. We support the inclusion of a third Sufficiently Independent Director; independent directors should outnumber National Grid's own.

As far as employees are concerned, as with IT systems it may be the most practical for the moment for the two companies to initially access some shared services, such as HR, on the same basis that they are provided to other NG Group entities. However, this should be limited to functions not of strategic importance. We agree with Ofgem that it would not be appropriate for the regulation function to be shared; this should be resourced separately by NGTO and NGSO. The same applies to Corporate Affairs, Finance and Legal; these areas can be party to confidential information and should be resourced separately.

Employee transfer between the two companies while both part of NG Group should only be allowed if Ofgem is satisfied that sufficient safeguards have been put in place



such as competition training and cooling-off periods where appropriate. All vacancies should also be open to external applicants from the outset, to ensure that the NGSO can select from the widest range of talent and external recruits can bring a genuinely independent mind-set to the new business. Staff incentives should be based solely on the performance of the SO business and not relate to that of the NG Group as a whole.

We would like to see a physical separation of the SO and the TO businesses, to go beyond separate entrances to the same building. We do not believe that dividing the current building would be sufficient to tackle a perceived conflict of interest. Ideally, NGSO as a new business with a new identity and branding would be in a different building, within a reasonable distance, to minimise disruption for staff who did transfer. This physical breakaway from the present building (even if sub-divided) would be psychologically beneficial, for developing a new culture and mind-set for the new business. Finding a suitable building within say 10 miles should be possible and would ensure adequate separation without excessive disruption. We would note that this approach was successful with the 2016 spin-off of Uniper from E.ON, with Uniper's UK headquarters moving to Birmingham Business Park instead of taking over part of one of E.ON's Coventry buildings. While the costs to partition a building were explored and would have been significantly lower, moving but keeping to within a reasonable distance meant that the number of staff negatively impacted and required to be compensated could be kept to a minimum, and the company has been better able to build its own identity away from its former parent.

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

We appreciate that partly owing to taking account of industry views there is some uncertainty around the timeline for these changes, other than for the separation for NGSO and NGTO to occur at the start of a financial year owing to the complexities that a mid-financial year implementation would cause under the Price Controls Financial Model. However, if this is not possible to achieve by April 2018 we would still urge NGET to make major strides towards it in 2018, including towards physical separation, for it to be completed by April 2019.

Chapter: Four

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

We support Ofgem's intention to undertake further work now to confirm which changes might be needed to enable the partial licence transfer from NGET to NGSO; we welcome the plan to conduct further consultation with industry on the potential licence changes later this year. As per our answer to question 3 we would urge that further, concrete steps be taken to progress different ways of working and the physical set-up of the new NGSO as soon as/if the decision is made to separate.

In advance of changes to the regulatory framework from April 2018 we support the introduction of a twelve-month SO incentive scheme for April 2017-March 2018, and look forward to the forthcoming consultation on Ofgem's initial thinking for the longer-term scheme. Possibly another subsequent twelve-month scheme could then be used to hone the incentives framework before establishing one for the new NGSO from April 2019, potentially a two-year scheme to take us up to the end of RIIO T-1 in March 2021.



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?

Other countries' experience might be helpful in assessing the options here. It would be useful also to further explore the additional measures and costs that would be involved in a potential subsequent move to a fully independent SO. For instance in such a move a change of physical location would seem inevitable, putting to waste the money spent on making changes to National Grid House in the next few years. It would be undesirable either for customers to have to fund a move shortly after funding the partitioning, but also, if such sunk costs in any way deterred a move to an ISO, should that otherwise be judged desirable in the longer-term. We note also that the suggested costs in Table 1 for making alterations to the building, not including IT systems, are essentially a good order of magnitude higher than we would have expected from our experience, and significantly higher than for Uniper's complete relocation (of ~200 people). The upfront business change cost estimate also seems very high. Financial, legal and administrative expenses for such necessities as obtaining a credit rating and maintaining pension arrangements may be harder to reduce but we believe that these initial estimates need further scrutiny before comparing with relocation costs.

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