



**Consumer
Focus**
Campaigning for a fair deal

Response to the initial proposals for the electricity system operator incentive scheme

December 2009

Summary

National Grid consulted on its initial proposals for a revised electricity system operator incentive scheme. We think the following principles should underlie any such scheme.

The system operator should be incentivised to reduce both the overall costs of the system and their volatility

System operator incentives are an important tool in controlling the costs paid by the industry – and ultimately by consumers – for managing the operation of the transmission system. Consumers therefore have an interest in ensuring that they are set within an appropriate structure and at an appropriate level, with the cost of risk management shared appropriately between them (through suppliers) and National Grid.

Consumers will benefit from any system operation incentive scheme that can deliver two key outcomes:

- A reduction in the overall costs of system operation
- An increase in the stability and predictability of these costs

Past electricity system operator incentive schemes have concentrated solely on the former. We think the latter is important too, because ultimately it is consumers that pay the risk premium when suppliers cannot accurately predict their costs.

Balancing Services Use of System (BSUoS) charges have been extremely volatile in recent years. We would like National Grid and Ofgem to give further thought to what measures could be taken to reduce this volatility.

Constraints should be separated from other costs

We welcome National Grid's proposal to separate out constraint costs into a separate incentive scheme. This is a major and increasing cost to consumers, and the drivers are different from those underlying the management of energy, reactive power, transmission losses and black start.

We note the analysis indicating that the range for constraint costs is expected to be considerably wider than for the remaining cost components. This makes it unsuitable to be bundled in with the remaining components.

But they are not currently a candidate for a multi-year regime

There are a number of potentially significant developments whose impacts on constraints costs could be significant but whose results are not yet known. These include pending decisions by:

- Ofgem, in relation to system to generator operational inter-tripping and the introduction of locational BSUoS
- The GB Parliament, which has proposed to introduce a market abuse licence condition for generation in the draft Energy Bill

- The Scottish Administration, which is considering whether planning permission will be granted for the Beaulay – Denny overhead line

There is also uncertainty around the costs arising from the interim ‘connect and manage’ policy and possible further changes to the transmission access regime.

Because of these uncertainties we agree with National Grid that an incentive scheme for constraints costs should be for one year only. We also agree that the cap and sharing factors should be lower than the bundled scheme.

As we move in to a period of ‘connect and manage’ a wider review is needed of generators’ ability to bid whatever prices they choose into the Balancing Mechanism. This has had a significant impact on constraint costs but is outside the scope of the system operator incentive scheme. It requires Ofgem’s urgent attention.

Incentives should be consistent

In setting the scheme parameters it is important to ensure that, as far as possible, incentives will continue to apply over its duration.

If caps or collars are reached too early then the incentive effect will be lost and, to the extent that this has occurred from windfall gains or losses, may represent a lost opportunity to exert downward pressure on costs. Unfortunately, this has happened on several occasions with previous electricity incentive schemes. That design flaw in the current arrangements suggests that the target should be profiled over the year.

Further unbundling should be considered

We think there could be merit in further unbundling of the scheme, in particular a split of energy and system costs into two parts (separately from transmission constraints).

We agree with National Grid that there are a number of benefits in unbundling the remaining cost components into separate incentive schemes. It would enable performance in each area to be addressed appropriately and then allow the differences in risk ranges across the components to be properly reflect in the incentive scheme.

National Grid has said that it is not proposing any additional unbundling of the scheme at this time because it would increase the scheme’s complexities. This is a legitimate concern but there is also clearly a balance to be struck between creating too much complexity and designing schemes which will best enable cost drivers for different elements to be identified and managed. We consider that further unbundling could be beneficial in terms of helping to exert downward pressure on these costs.

Were further unbundling to occur it would be essential to conduct an open review of how each scheme has been operated. This would help to provide assurance against double-counting and enable parties to better understand what contributes to the cost of each component and how volatile this is. A clear ex ante methodology for how costs will be apportioned, backed up by an independent ex post audit that this methodology has been correctly applied, would be necessary safeguards for an unbundled regime.

The conditions are not yet right for a two year scheme

National Grid has proposed a two year scheme for the remaining scheme costs. We are unconvinced that this is appropriate at this time. The analysis conducted by National Grid over the last two years has greatly improved the understanding of the drivers of cost and their implications. But we consider that there is still scope for unexpected shocks in the scheme as it stands and there is a danger that a two-year scheme could generate significant windfall gains or losses.

In our judgement there is not a sufficient level of certainty on costs over the course of the next two years to justify moving to a two-year scheme, and we consider that proceeding in this way risks jeopardising the downward pressure that could be maintained on costs through appropriately structured schemes of one year length. In addition we note that a two year scheme may not now coincide with the end of the current transmission price control under one of the options tabled by Ofgem for including the output from the RPI-X@20 review. We would therefore prefer that the remaining costs are managed under a one-year incentive scheme for the present.

In the longer term however we consider that multi-year schemes should be implemented but only in areas where there is a need for investment and the payback for this is longer than a year. Reactive power might provide a useful “test case”.

Transparency is improving, but there is still room for further improvement

We welcome the increased information that has been provided to the market through the consultation process and through the provision of information to industry operational forums. We believe that the information provided to stakeholders should be further enhanced to help their understanding and ensure that the costs of system operation are managed optimally. In particular we consider that further routine within-year reports on operations, and on progress against targets, would be valuable to market participants. The monthly balancing services report might represent a suitable vehicle for making this information publicly available.

In this context National Grid is under clear obligations to operate the transmission system efficiently. We believe considerably more information and forecasts could be made available to the market but do not see why specific incentive arrangements are needed, as National Grid suggests, to facilitate this outcome.

Views on consultation questions

The consultation posed 49 separate questions. We have chosen to only answer those where we have strong views.

1. Do you agree with the benefits outlined for the unbundling of constraint costs and the remaining balancing cost components into separate incentive schemes? What additional issues need to be considered?

Yes, we agree with the benefits of unbundling constraint costs. But as outlined above we consider that a wider review is needed of generators' ability to bid whatever prices they choose into the Balancing Mechanism within the context of a connect and manage framework.

2. Do you agree that there is a misalignment in the internal and external SO incentives caused by different scheme durations?

Yes, but we consider that lengthening elements of the schemes beyond one year should be considered at the next transmission price control review once costs are better understood and providing that mechanisms, such as appropriate indexation or logging up of costs, are put in place to cater for potential shocks.

3. What option could or should National Grid use to develop a two year constraint forecast?

We do not consider that a two year incentive for constraint costs is appropriate because of the level of uncertainty. Of the options proposed we consider that the fifth option of the development of a two year incentive with four seasonal constraint targets is preferable. This seems most likely to limit the windfall gains and losses for each season and provide an opportunity for adjusting targets as more up-to-date information becomes available.

4. Do you agree with the benefits outlined for the implementation of a two year incentive? What do you believe are the additional benefits and/or drawbacks of a multi-year scheme?

Were costs stable and well understood – and they are not – we agree that a two year incentive could help focus resources and investment in improving the management of costs for BSIS, excluding constraints. But we believe that the appropriate time to consider a longer term scheme is at the transmission price control review. At this stage we consider that the uncertainties are too great for a multi-year scheme for the remainder of BSIS costs.

5. Do you agree with the introduction of a Reactive Index Adjustment based on actual default reactive power prices? Do you agree with the form of the adjustment as presented here?

We support the introduction of a Reactive Index Adjustment in the form proposed.

6. Do you feel at this stage that there is a case for any additional adjustment terms to be introduced at this stage?

No, we agree with the majority of respondents and National Grid's view that this would not be appropriate at this stage.

7. Do you believe that National Grid should include an allowance for fault outage costs within the constraint forecast? Do you agree with the level set?

Yes, we agree that an allowance for fault outage costs should be included within constraint forecasts and that the average cost since BETTA go-live of £12mn seems a reasonable approach.

8. Do you agree that transmission losses should remain bundled with the other components of BSIS excluding constraints?

We consider that a transmission losses procurement incentive should be further investigated whereby National Grid would procure all transmission losses volumes on behalf of the industry and then have an incentive to decrease costs below an agreed target.

9. Do you agree that the Transmission Losses Reference Price should remain a fixed value for the duration of the scheme?

Yes.

10. Do you agree with the criteria used to develop the incentive scheme design? If not, what additional points should be considered?

Yes. Additionally the ease of unbundling elements of the scheme and how far they may be polluted by other elements should be considered.

11. For the unbundled constraints scheme, do you agree with the parameters used? If not, what parameters should be implemented? Please explain your rationale for any changes.

The parameters reflect the wider forecast range of costs and the increased uncertainty, but we believe that the sharing factors should be symmetrical on both sides.

12. Do you agree with the implementation of two single year incentive schemes for all balancing costs except constraints? Do you agree with the parameters used? If not, what parameters should be implemented? Please explain your rationale for any changes.

No, we do not agree with the implementation of two single year incentive schemes for all balancing costs except constraints. We consider that the uncertainty of events over two years outweighs the advantages of fixing the target and other parameters in advance and we would prefer to see a one year scheme at this stage. We consider that the parameters for the first one year scheme, in particular the 50 per cent sharing factor, place a strong incentive on National to reduce costs.

13. Do you agree with the parameters used for the one year fully bundled scheme? If not, what parameters should be implemented? Please explain your rationale for any changes.

We support the unbundling of constraint costs and therefore do not support the parameters for the one year fully bundled scheme; the lower sharing factor provides a weaker incentive to reduce costs as it reflects the uncertainties over the costs of constraints.

14. Do you agree with the development of a two year bundled incentive? How should the constraint cost forecast for year two be included in the incentive target eg agreed post scheme or some form of constraint forecast developed pre-implementation?

We do not support the development of a two year bundled incentive as we consider that constraint costs should be unbundled as a minimum and that there are major issues with developing a credible and reliable constraints forecast for the second year.

15. Do you agree with the scheme options presented here for implementation from April 2010 and what is your preferred option? If not, please provide an explanation as to why and any alternatives that you would like to see developed.

Our preferred option is a one year scheme with constraints unbundled into a separate scheme. We consider that at this stage it takes one important step towards a desirable unbundling of the incentive scheme, but does not create hostages to fortune by extending the scheme length at this stage. Our view is that longer term schemes should be considered with the next transmission control price control review.

16. Do you have any comments regarding the information provided within this consultation?

We believe that National Grid has provided full and detailed information to the market through the combination of this consultation and the previous mini consultations. This is welcome as it is vital to a proper understanding of the costs and their drivers and needed as a basis to make judgements on the level and structure of appropriate incentive schemes.

17. Do you have any comments regarding this consultation process? What improvements would you like to see in future years?

We consider that the consultation process has been well run and that the series of mini consultations and workshops has enabled market participants to consider aspects of the scheme in detail. As indicated in our summary we would like to see further information made available to the market as a background to the consultation process. This should include monthly operational reports, reporting of the year-to-date position against targets and regular full year forecasts for Incentivised Balancing Costs and BSUoS.

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