

## Resetting SO incentives – assimilating progress

The first phase of the review for this year’s reset of National Grid’s System Operator (SO) incentive schemes recently passed. Few in the market will have failed to notice the steady volume of documentation that has flowed through from the company over the summer. We thought it was time to take stock of developments in advance of the company producing its initial proposals. This next step should occur before the end of the month.

### Fine-tuning the process

In May the regulator set out the objectives, process and timetable for the development of SO incentives from April 2010 (*ES188, p11, 22/6/09*). It was aiming to build on the much wider engagement with stakeholders established since 2007 (see *figure below*). A number of key themes emerged from Ofgem. It wanted schemes longer than the current predominantly annual timeframes to be considered. And on the electricity side it said it also argued the benefits to be had from greater compatibility of the SO schemes with the transmission owner incentives in price controls.

National Grid subsequently issued four “mini consultations” for electricity through August and September, three examining aspects of SO incentives and the fourth looking at the incentives on the transmission owners and interactions with the SO. There have also been three themed consultations for gas. (*Key points are set out in the summary boxes*). All have been aimed at encouraging debate on the potential forms and structures of incentives, rather than presenting specific proposals. And to further debate National Grid has also presented to a number of industry meetings and has held bilateral discussions, including with our energy suppliers forum.

#### Box 1 - Electricity—bite size chunks

The first consultation examined reactive power, black start and transmission losses (*ES198, p12, 31/08/09*). National Grid considered a multi-year scheme for reactive power, an index to deal with cost drivers that it could not control, and unbundling reactive power from the main scheme. For transmission losses the company proposed two alternatives for unbundling: one to improve forecasting, and a procurement incentive in which it would source losses economically for the market. On black start, it invited views on how the current scheme could change as costs increase against a changing generation background.

The second consultation addressed the energy-related components of balancing services, that is, energy imbalance, margin, foot-room, response and fast reserve. Together they account for around 56% of balancing costs (*ES199, p13, 07/09/2009*). It considered improving the incentive scheme to counter external drivers outside National Grid’s direct control through a new adjustment methodology to update the cost target; further improvements to the Net Imbalance Adjustment calculation, which adjusts the scheme’s target to changes in power price and market length; the potential for a longer-term incentive scheme; and the potential to unbundle energy-related components under a separate incentive.

Transmission constraints (*ES203, 3/10/09*) are currently forecast at £234mn, and are not expected to diminish in the foreseeable future. The third consultation considered the separation of constraint costs. National Grid argued unbundling would limit opportunities for windfall gains and losses; but it would create complexity and could introduce perverse incentives. It examined options for updating the incentive forecast depending on key drivers of costs where it had little control (both price adjustments to adjust the forecast for changes in the bid/offer spread away from those used in the original forecast, and volume adjustments to take account of new generation or changes in the number of weeks outages on circuits across key boundaries). It also considered different durations for the scheme, both shorter (summer and winter) and a multi-year option was explored.

The final electricity consultation, transmission owner incentives (*ES205, p12, 19/10/09*) considered potential incentives on transmission owners (TOs) to achieve faster grid connection for generators and to help minimise constraint costs. It looked at how to address factors that can speed up connection dates,

such as processing of planning and consents, and a possible price control incentive on National Grid Electricity Transmission for connections to be delivered ahead of the current 48 months price control assumption. It suggested changes to the current process and incentives for the SO to request changes to the transmission owners' outage programmes. Also it examined the interaction of incentives on TOs and the SO and how different sharing factors potentially had a distorting effect and suggested alternative models. It also set out three options to incentivise TOs with the specific objective of managing constraint costs.

### Pausing for breath

There were a handful of responses to each consultation—typically around six but usually from the same participants. End customers and smaller gas and electricity suppliers may also have made their views known through bilateral meetings or at industry meetings. But consultation has been as requested by Ofgem and has been thorough.

A preliminary review suggests the logical approach of isolating the different elements of the schemes and raising specific questions for each has reaped a dividend as the responses are much more focussed and informative than in previous exercises. But a theme that quickly emerges is a resistance to change—not from National Grid. It has played all of the consultations with a straight bat, but rather from its main customers.

Overall the documentation represents a considerable improvement on previous annual rounds. The depth of the analysis provided alone may suggest the aim should be (as Ofgem and National Grid have suggested) to move to longer-term arrangements that would facilitate more periodic review. But recent experience tells us that there continues to be scope for shocks within the incentive arrangements as they stand, especially on the electricity side. What seems to be beginning to emerge from the analysis carried out this year and last is a much better understanding of the drivers of balancing costs and agreement on their implications.

#### Box 2 - Gas—similar issues, very different context

The first consultation concerned residual balancing, demand forecasting, maintenance, data publication, system flexibility a Calorific Value shrinkage (*ES198, p12, 31/08/2009*). National Grid said that as five of the seven incentives here had their own performance measures, there was no simple option to bundle them further. It also argued current arrangements resulted in schemes that were sufficiently transparent and targeted. Further refinements to the residual balancing scheme were considered including and whether it could become multi-year, with additional work on an inter-day line-pack product (line-pack is currently balanced within-day).

The second looked at extension of the environmental incentive (*ES201, p13, 21/09/2009*). This considered whether the incentive to minimise the release of gas into the atmosphere could be extended beyond the current coverage of gas released from compressors to other areas including pipelines, valves and other equipment. It also considered extending the scheme for up to three years.

The third consultation addressed operating margin (*ES202, p12, 28/09/2009*). National Grid gave an update on measures to increase contestability in operating margin (OM) provision following the licence obligation introduced in the 2007 transmission price control for it to use reasonable endeavours to promote competition for OM services. It also considered reintroducing the availability element and the potential for a longer-term scheme.

These observations have a number of implications from our perspective going into the concluding phase:

- Ofgem should adopt again as a guiding principle a **one-year approach** rather than multi-year, at least for the time-being. This should not necessarily preclude longer durations for discrete costs with known drivers. But in the current context longer means two years given the imminence of the commencement of the next transmission price review. Although

generally respondents did not support change, there is no reason why, for instance, the residual balancing scheme or the environmental incentive in gas cannot be dealt with on a two-year basis at least as a test case. Both are well-established with relatively predictable costs. We would support a similar trial in electricity with reactive costs probably representing the best guinea pig. More generally the principle should be from 2012 that once costs are better understood and possible shocks dealt with through appropriate indexation or logging, areas with investment needs but payback of longer than a year should be based on multi-year schemes;

- we continue to support **unbundling** of electricity arrangements and believe National Grid itself is open to the need to isolate at least constraint costs and deal with them differently. In this context there seems to be wide-spread agreement that individual targeted schemes in gas seem to work well. But Ofgem should go further and split energy and system costs into two separate electricity schemes separately from transmission constraints. In the case of constraints it would be prudent to start with seasonal rather than annual schemes. As for losses given National Grid's wider energy purchasing role, we see no reason why it should not be tasked with purchasing (and minimising) losses;
- **indexation** should be used where external variables can materially impact on the operation of a scheme, and to deal with truly uncontrollable and unpredictable costs. It is disappointing that this way forward was dismissed by Ofgem last time round, but it should be embraced now. National Grid has also flagged a number of other technical adjustment mechanisms (e.g. to the NIA) that appear sensible;
- although this has not yet been the subject of consultation, established arrangements based on **caps, collars and sharing factors** levels of incentive with a £10mn ceiling for electricity and proportionately less for gas "feels about incentives on particular sub-sets of costs. In the event of unbundling, the total reward pot should be split between the different schemes. It is a minor point, but risk/reward under each scheme should be symmetrical;
- **constraints** should clearly be dealt with outside the incentive mechanism and probably passed through. As we will explain in a later comment, the key here is to try to get the costs under control at source. The "constrain and manage" world that we appear to be heading towards means there needs to be a more fundamental shake-up of generators' ability to bid into the Balancing Mechanism at any numbers they see fit. Ofgem also needs to develop its thinking on the TO/SO interactions and address the institutional impediments to smoother interaction with the Scottish TOs. We also support the implementation of a formal obligation on TOs to minimise constraint costs;
- it is clear that some large users and smaller supply-side participants value the enhanced **transparency and information** introduced over recent years through extensions to the gas incentive scheme, and we would like to see firm proposals for electricity especially with regard to likely market length; and
- with appropriate use of indexation and carve outs, **income adjusting events** should be unnecessary. But, if they are permitted, there should also be scope too for claw-back of "income adjusting" or windfall gains to the company.

So in large measure the various consultations suggest the continuing pursuit of a largely evolutionary path. This narrower focus is reinforced by the immense challenge of the next price control reviews for transmission. On the basis that the new controls for both electricity and gas are scheduled to start in April 2012, initial preparatory work can be expected to commence sometime in 2010, but after the arrangements for 2010-11 have been set in place.

It is already probable that some change in wider sectoral governance is likely going forward in the run up to TPCR5, with Ofgem looking to build on the increased customer engagement that its multi-lateral process introduced over the past three years. National Grid will probably be disappointed with the number of responses received to date. But if a coherent and more comprehensive stakeholder engagement is to be realised, more formal structures and processes are likely to be needed.

But there are other important changes that are needed with regard to governance. Despite increases in information—not least through the current consultation processes—more routine reporting on system operations could be introduced certainly in electricity. National Grid has already taken positive steps through its Operational Forum on the status of incentivised balancing costs. But further improvements could be easily introduced. In particular, there should be far more routine reporting within-year based around a monthly report to complement that published since 2004 on balancing services. Enhanced reporting is required with regard to among other things routine publication of year-to-date position against target/s; regular full-year IBC and BSUoS forecast updates; and a monthly operating report.

More generally operational performance and decisions reached by National Grid within year should also be much better explained, perhaps drawing on the opportunity offered by the annual BM audit and the procurement guidelines report (which incidentally has a habit of appearing rather randomly and significantly after the end of the relevant year). While periodic reporting to the Operations Forum has improved and with the introduction of the useful monthly balancing services report, there is still a long way to go before market reporting is fit for purpose. Above all, National Grid should begin to address the development of wider performance measures and indicators pertinent to its SO roles. As we have said before the logical end-point of this enhanced framework would be the establishment of some kind of service level agreement between Ofgem on behalf of grid users (if they cannot do it themselves) incorporating explicit targets.

These kinds of arrangements do have precedents in other electricity markets with independent SO structures. In order for National Grid to have a fair and informed negotiation with market participants as Ofgem envisages, a framework of this nature is very desirable irrespective of what falls out of innovations to the TPCR5 on customer engagement. The longer any elements of the incentive mechanisms are, the more crucial ongoing reporting and compliance will be.