

By e-mail to: [electricitySOreform@ofgem.gov.uk](mailto:electricitySOreform@ofgem.gov.uk)

10 March 2017

**Future arrangements for the electricity system operator: its role and structure and the regulatory and incentives framework – ELEXON Response**

We welcome the opportunity to comment on the two consultations relating to the future system operator arrangements.

As you are aware, ELEXON is the code administrator for the Balancing and Settlement Code (BSC). We are responsible for managing and delivering the end-to-end services set out in the BSC. This includes responsibility for the delivery of balancing and imbalance settlement.

In your consultation you have already highlighted that consequential changes are required to ensure the BSC and its Governance, including the relationships between ELEXON and NGET, align with the creation of the new licensed SO entity. We welcome further discussion with Ofgem and National Grid on the options for how this will work to allow our three organisations to ensure the changes are fully understood and progressed in a timely manner. There are other governance matters that may affect ELEXON during this timeframe (including potential assignment of activities under the European network codes and Ofgem's proposals for licensing).

We also believe there is a need to consider the right roles and responsibilities for future market design as there are some potential conflicts of interest even with a full ISO model and market design that extends across all market timeframes and parties. For example, decisions on priority for change and design need to be taken in view of the competing needs of existing and potential new users and services across the 'whole' system. Is the SO expected to lead and drive these changes or is this better driven by a group that includes but is not driven by the SO? These points are repeated in our more detailed response in Appendix 1.

The views expressed in this response are those of ELEXON Ltd, and do not seek to represent those of the BSC Panel or Parties to the BSC.

If you would like to discuss any areas of our response, please contact David Jones, Head of Strategy, on 020 7380 4213, or by e-mail at [david.jones@elxon.co.uk](mailto:david.jones@elxon.co.uk).

Yours sincerely,

Mark Bygraves  
CEO, ELEXON

List of enclosures

*Appendix 1 – Responses to specific consultation questions*

## Appendix 1 – Responses to consultation questions for Future SO ‘role and structure’

### Chapter Two

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

ELEXON agrees that the descriptions set out in 2.1 (and the suggested clarifications of the role of the SO in subsequent paragraphs) are, mostly, sensible descriptions for what an SO should do and what should be achieved through their actions. We would anticipate that the objectives would be further refined as there remains room for ambiguity over interpretation of what ‘facilitate’ means and the extent of the meaning of ‘market’ and ‘whole system’.

We would expect the objectives to align with (or in some respects to be cascaded through) the wider governance regime within which the industry (and SO) operates. This is important because the nature of potential changes or market developments that the SO will ‘facilitate’ will require wider collaboration across stakeholders and industry governance. For example the SO objectives should not conflict or give rise to any misinterpretation with the Applicable Objectives set out for the separate industry codes.

We would also expect the SO objectives to align fully with the obligations set out in European network codes (unless in future GB concludes that these should not apply).

*Point of clarification:* In section 2.28 you discuss the role of the SO in the BSC (and CUSC), noting that ‘The SO is able to...influence the final recommendations [on changes] which go to the Authority’. To be clear the Transmission Company representative on the BSC Panel does not vote on Modifications to the BSC, although as noted it does sit on the Panel (alongside Ofgem, BSC Party elected members, consumer groups and independent members).

#### *Roles and responsibilities for market design*

There is a separate question as to whether we have determined the right roles and responsibilities for future ‘market’ design. Decisions on priority for change and design need to be taken in view of the competing needs of existing and potential new users and services across the ‘whole’ system and all market timeframes. Is the SO expected to lead and drive these changes or is this better driven by a group that includes but is not driven by the SO? The SO remains a market participant in its own right and will participate in market arrangements, purchasing balancing services and executing other mechanisms. It is, for example, a market participant itself under the European Regulation on wholesale Market Integrity and Transparency (REMIT)

And as Residual Balancer, the SO may have a clear preference for certain aspects of market design that do not align with those of other stakeholders, and which could give rise to conflicts with the other proposed SO role of facilitating competitive markets. An example of this is where, in European debates, market participants and power exchanges have pushed for the balancing timeframe to be as short as possible, minimising the timeframe for the Residual Balancer role and SOs who have resisted, maintaining the need for longer Gate Closure in which to balance.

Another example could be a tendency to focus on Demand Side Response (DSR) needs of the Residual Balancer and DSOs, while the needs of customers, suppliers and aggregators and other market participants should be also be given weight in proposing the design of markets for DSR.

We are unclear on how the future SO role aligns with future industry governance and how policy and the regulatory Strategic Direction to be set will be managed through the industry institutions (consultative board, energy innovation board, code panels etc).

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

National Grid (SO) is undertaking work to transform its approach to delivering its SO functions in advance of any formal licence changes and separation. We agree with this approach which should deliver benefit in advance of the formal changes. During this period we would expect National Grid to collaborate with stakeholders on how it proposes to adapt its services as residual balancer, facilitator of competitive markets and whole system considerations for market design.

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

We agree with the suggested areas identified in Chapter 2 relating to proposed licence changes.

*Relationship between ELEXON (BSCCo), the BSC and National Grid.*

In your consultation you highlight that consequential changes are required to ensure the BSC and its Governance, including the relationships between ELEXON and NGET, align with the creation of the new licensed SO entity. We welcome further discussion with Ofgem and National Grid on the options for how this will work to allow our three organisations to ensure the changes are fully understood and progressed in a timely manner. There are other governance matters that may affect ELEXON during this timeframe (including potential assignment of activities under European network codes and Ofgem's proposals for licensing).

**Chapter Three**

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

We note that the separation activity comes at a significant cost (£46m) and effort for National Grid. Ofgem appear to believe there is an overall cost benefit to consumers of spending this. However Ofgem indicates it will keep further change under review. It is unclear what criteria or trigger Ofgem would use in deciding whether to move towards even greater separation or a full ISO (if ever), or when such a decision will be revisited. It is therefore difficult to justify the costs against this uncertainty if further change is planned in the next 3+ years.

We recognise that making changes to the governance and objectives of the SO function provides a clear distinction for National Grid and eliminates any potential for confusion. Arguably however National Grid could adapt its approach to how it delivers its services by increasing transparency, engagement and facilitating whole system market review and design under its existing arrangements (the document appears to acknowledge National Grid is doing this)?

If Ofgem believes that separation is essential to achieve the outcomes described in chapter two of the consultation then a not for profit model may better address the risk of there being any incentive for the SO to operate in the interests of the parent company?

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

We agree with the proposals for how separation will be achieved through the separate licences, obligations and novation of contracts. We agree that the composition of the Board should provide for an effective balance of NG and Sufficiently Independent Director (SID) members; however the most efficient way to ensure the Board acts in an independent manner would be to place clear

responsibilities on the Board (and powers to address any breach of Director responsibility proportionate to the breach). Ofgem may wish to consider whether SO stakeholders could have powers to request removal of Board members akin to the powers of BSC stakeholders in the BSC (implemented under BSC Modification P324).

We do not believe that separate sites are necessary and that National Grid can implement measures to ensure effective separation. Even shared infrastructure can be managed to allow for separation to be effective. In the event that there is a risk of 'perceived conflicts' it would be prudent to assess the option of introducing additional independent assurance or audits versus forcing costs of complete physical separation.

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

We agree that April 2019 appears a reasonable timeframe for the official separation to take place, noting that National Grid will be taking steps to implement any changes it can in advance of this date.

## Chapter Four

**Question 1: What are your thoughts on our proposed approach for implementing the proposed changes set out in this consultation?**

We agree that April 2019 appears a reasonable timeframe for the official separation to take place, noting that National Grid will be taking steps to implement any changes it can in advance of 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?**

We note that Ofgem has indicated that it will keep consideration of whether further separation is necessary under review (e.g. a move to a full ISO). It is not apparent what would be the criteria or trigger for any move to ISO, however if the timeframe for potentially moving to a full ISO is in the next 5 years (e.g. from 2021 at the end of the current price control regimes) then this may challenge the benefit of spending £46m on any 'interim' SO changes.

*Roles and responsibilities for market design*

There is a separate question as to whether we have determined the right roles and responsibilities for future 'market' design. Decisions on priority for change and design need to be taken in view of the competing needs of existing and potential new users and services across the 'whole' system. Is the SO expected to lead and drive these changes or is this better driven by a group that includes but is not driven by Grid? The SO remains a market participant in its own right and will participate in market arrangements, purchasing balancing services and executing other mechanisms. An SO may have a clear preference for certain aspects of market design that do not align with users (e.g. debates about Gate Closure).

## Appendix 2 – Responses to consultation questions for Future SO 'regulatory and incentives framework'

### Chapter One

**Question 1: Do you agree with our objectives for the future SO regulatory framework? Are there any missing?**

ELEXON agrees that the regulatory framework objectives are, mostly, sensible for the future SO. We would anticipate that the objectives would be further refined as there remains room for ambiguity

over interpretation of what ‘facilitate’ means and the extent of the meaning of ‘market’ and ‘whole system’.

We would expect the objectives to align with (or in some respects to be cascaded through) the wider governance regime within which the industry (and SO) operates. This is important because the nature of potential changes or market developments that the SO will ‘facilitate’ will require wider collaboration across stakeholders and industry governance. For example the SO objectives should not conflict or give rise to any misinterpretation with the Applicable Objectives set out for the separate industry codes.

We would also expect the SO objectives to align fully with the obligations set out in European codes (unless in future GB concludes that these should not apply).

#### *Roles and responsibilities for market design*

There is a separate question as to whether we have determined the right roles and responsibilities for future ‘market’ design. Decisions on priority for change and design need to be taken in view of the competing needs of existing and potential new users and services across the ‘whole’ system. Is the SO expected to lead and drive these changes or is this better driven by a group that includes but is not driven by Grid? The SO remains a market participant in its own right and will participate in market arrangements, purchasing balancing services and executing other mechanisms. An SO may have a clear preference for certain aspects of market design that do not align with users (e.g. debates about Gate Closure).

#### **Question 2: How can we best transition to a SO regulatory framework which meets these objectives? When should changes be made?**

We agree with the transitional approach Ofgem sets out in section 1.15 of the consultation.

### **Chapter Three**

#### **Question 1: What lessons can be learned from our previous approaches to regulating the SO? What are the key areas where changes might be needed in future?**

We wonder whether Ofgem considered a not for profit model when developing its regime for the new SO function? The consultation document discusses the incentives and regulatory regime and highlights the financial and non-financial incentives. Does Ofgem perceive that there may be benefits in allowing the SO a mechanism to recover costs and introduce a not for profit (or not for dividend) entity. The consultation is creating greater separation in an attempt to demonstrate independence but leave the SO with a funding and profit arrangement as part of the wider National Grid group. We believe there are examples of where not for profit organisations (e.g. ELEXON and the BSC and EMR settlement bodies) can deliver on their obligations and objectives and that this does not have to be driven by a profit motive. By removing the profit incentive you remove the potential for conflict (perceived or actual).

We understand that National Grid desires that the future SO function should contribute to the National Grid group, through the ability to make a profit.

### **Chapter Four**

#### **Question 1: Do you believe we need to introduce more clarity about what we expect from the SO under its obligations? How should this clarity be provided? To what extent should we set prescriptive or principles-based requirements?**

Ofgem has indicated that it wishes to move to principles based regulation and we would agree that the approach applies to all regulated entities. Whilst the regulatory regime should not need to be wholly prescriptive, it would be sensible to set some objectives that are clear and unambiguous

particularly where Ofgem wants to use these as a measure for reward. This reduces the scope for misinterpretation and unnecessary debate.

Ofgem could either directly, or through the SO, engage stakeholders on a regular basis to help form its assessment of what is being achieved and whether this meets the expectations of Ofgem, users and National Grid's interpretation of what it should deliver.

In particular Ofgem and National Grid need to be clear on what terms like 'facilitate' mean in practice and be reasonable about what the SO can achieve as it will operate within a wider industry framework of (potentially shifting) policy ambition, Ofgem direction setting and wider industry governance.

**Question 2: Should we place financial incentives on the SO? If so, in which areas? And what form should they take?**

The application of financial incentives very much depends on what behaviours you are trying to generate. There are for profit and not for profit (like ELEXON) models of central service provision. We suggest Ofgem considers the existing models of organisations providing central services and compares the behaviours, performance and user views of those different models, as we believe this would help determine a model/design that works best for consumers.

We wonder whether Ofgem considered a not for profit model when developing its regime for the new SO function? The consultation document discusses the incentives and regulatory and highlights the financial and non-financial incentives. Does Ofgem perceive that there may be benefits in allowing the SO a mechanism to recover costs and introduce a not for profit (or not for dividend) entity. The consultation is creating greater separation in an attempt to demonstrate independence but leave the SO with a funding and profit arrangement as part of the wider National Grid group. We believe there are examples of where not for profit organisations (e.g. ELEXON and the BSC and EMR settlement bodies) can deliver on their obligations and objectives and that this does not have to be driven by a profit motive. By removing the profit incentive you remove the potential for conflict (perceived or actual).

We understand that National Grid desires that the future SO function should contribute to the National Grid group, through the ability to make a profit.

**Question 3: Should we introduce more non-financial incentives on the SO? What approaches should be taken? Do you support the introduction of a set of KPIs, and if so, what should these KPIs be?**

We believe that non financial incentives are a valid approach to the new SO regime. In particular if there is the potential that the interpretation of the SO objectives could/should develop over time (as both the SO and Ofgem ease into the new regime) then non financial incentives may be more suitable to developing a collaborative regime and effecting change.

**Chapter Five**

**Question 1: How should SO incentives be governed in the future? Would you support a greater role for stakeholders in this process? How can we introduce more transparency around incentives?**

Yes, transparency and openness should be a measure of how SO delivers its service (and should apply to all central service providers). Examples of transparency include issuing a budget to users for comment, describing activities expected in the year ahead. The BSC approach could be a useful precedent here.

Stakeholders should be clear on the role and incentives of the SO and feedback should be sought on how the SO will deliver its service and its priorities and future work. However stakeholder input should not constrain innovation or initiatives but allow for greater collaboration and understanding.

