Consumer Focus
Campaigning for a fair deal

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Dear David, Giles,

Synergies and conflicts of interest arising from the Great Britain System Operator delivering Electricity Market Reform (response to 2nd consultation, January 2013)

Thank you for providing us with the opportunity to provide input into this area of policy development. This submission is entirely non-confidential and may be published on either (or both) of your websites.

Left to its own devices, National Grid should be systematically biased. This could result in synergies or conflicts depending on when its interests align with societies. The challenge for EMR policy is to facilitate the former while precluding the latter.

Consumers will pay for the total cost of the electricity system – generation, transmission, system operation, distribution, supply – but National Grid ("NG") only stands to financially benefit (or suffer) from anything that impacts on the cost of transmission or system operation. This could create a systematic bias – indeed, it *should* create a systematic bias if NG is acting in accordance with the interests of its stakeholders – for NG to favour solutions that increase its profitability rather than those that reduce societies costs (though the two are not mutually exclusive).

We agree with the broad thrust of the analysis contained within the consultation document, in particular that the main area of potential conflicts of interest is around the risk of abuse of influence, and the knock-on effect this could have on the prospects for its electricity transmission and system operation businesses.

We are asking MPs to amend the Energy Bill in two areas to try and mitigate these risks. One of these amendments also seeks to allow better delivery of synergies.

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Business separation must include unbundling remuneration

The first is around business separation and remuneration. You note in paragraph 209 that *'the de-linking of bonuses from overall group performance, can address to some extent the incentive to act on a conflict'*. We agree. Currently NG employees are subject to some areas of pooled remuneration where the financial wellbeing of an employee in one business unit can be affected by the performance of other business units. For example it operates two schemes, "Sharesave" and the "Share Incentive Plan", that allow opportunities for employees to become shareholders in the wider business[1].

The decisions made by the Secretary of State on which generation mix to promote through CFDs, and the volume and characteristics of generation purchased through the capacity mechanism, clearly have potential to impact on the future profitability of NG's transmission and system operation businesses. Advice coming out of NG's EMR functions therefore has the potential to impact on the value of its shares and any share options.

We would suggest altering Chapter 4 ("Conflicts of interest and contingency arrangements"), Paragraph 29 ("Modifications of transmission and other licences: business separation"), Sub-paragraph 6 of the draft Bill to add a requirement that remuneration policies applied to persons engaged in EMR functions are not contingent on the financial performance of other businesses in common ownership.

The intention would be to remove the potential that staff in EMR functions may be subject to bonus schemes, or other forms of remuneration such as share plans, that mean they could financially benefit (or suffer) from the knock-on effect that any decisions or advice emanating from its EMR functions have on other parts of its business. It is not intended that this should prevent National Grid from rewarding performance in the EMR function – it would remain open to National Grid to reward staff carrying out EMR functions provided this was linked to the performance of that specific business area, and not the wider group.

A more defined role for Ofgem in scrutinising the EMR functions' analysis and setting out the wider impacts of advice on consumer wellbeing.

In paragraph 189 you state that *'there may also be a role for Ofgem to scrutinise the SO's analysis and assess the impacts of the analysis on National Grid's businesses'*. We strongly agree.

In our response[2] to your initial consultation on synergies and conflicts we set out what forms this could take, and how this would fit into the context of the wider process for EMR advice being given and acted upon:

Risk	Measures to mitigate
NG incentivised to keep its own costs down – not total costs	NG advice to Government should articulate the impact of its recommendations (if acted on) on the revenues it will raise under its internal (price control) and external (SO) incentive schemes. Ofgem should provide commentary on this advice to the Government. Ofgem should design price control and SO schemes in a way that as far as possible strips out risk of windfall gains / losses arising for NG from the consequences of its advice. NG advice to Government should be subject to public consultation in order to ensure transparency and adequate stress testing. Government should set out the trade-offs it is making between network costs and generator costs when acting on NG advice.

[1] Source: National Grid website, http://tinyurl.com/b6aku7n
[2] Available here: http://tinyurl.com/a6fce2q

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We remain of the view that such measures are appropriate. In terms of Ofgem’s role within this process, we would like to see it advising the Expert Panel and/or Secretary of State of the likely consequences of his/her decisions on capacity adequacy and on generation mix on the costs of electricity transmission and system operation. The reasons for this are two-fold:

- Firstly because consumers do not simply pick up the generation cost consequences of these decisions, they also pick up the transmission and system operation costs. Any conflicts – or synergies – between generation and TO/SO costs should be taken into account in order to allow us to decarbonise at minimum cost. Ofgem is well placed to provide the Secretary of State with this advice given its expertise and independence.
- Secondly, because it would facilitate understanding of whether NG would be likely to financially benefit, or suffer, as a result of any aspect of its advice being acted on. Understanding the risk of bias is crucially important if the advice is to be adequately stress-tested and credible. In itself, we think the disclosure of likely financial gains/losses is likely to have the beneficial effect of acting as a significant incentive on NG to ensure its advice is above reasonable criticism.

We would therefore suggest altering Chapter 2 (“Contracts for difference”), Paragraph 10 (“Functions of the Authority”) of the Bill in order to provide that Regulations may also make provision for the Authority to advise the Expert Panel and/or the Secretary of State of any impacts that different generation mix choices may have on:

- The rewards or penalties that may be applied to the System Operator as a result of incentive schemes it has agreed with the Authority;
- The wider costs of building, maintaining and managing the transmission system in Great Britain.

Similar provisions would also need to be inserted into the Bill providing for the same advice to provided in relation to the Capacity Mechanism.

We hope that this submission is helpful. If you would like to discuss any of the issues raised in further depth then please do not hesitate to contact me.

Yours sincerely

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