Appendix 3: response to RIIO-2 Draft Determinations Electricity System Operator Annex questions

September 2020

Contents

1 Overview

As the Distribution Network Operator (DNO) for the North West of England, Electricity North West (ENWL) works closely with National Grid as the System Operator (ESO). As DNOs are actively evolving to the new role and responsibilities of a Distribution System Operator (DSO) this interaction with other parts of the energy system becomes ever more crucial.

Following the recent legal separation, and collaborative role the ESO will need to play in transforming the energy system, the time is right for the ESO to have its first standalone price control which is specifically designed to consider the unique nature of its business and the need for it to work more closely with others as the energy system decentralises.

We have been engaged in the RIIO-2 process to ensure that an appropriate price control is built which will enable the ESO to deliver its key functions in collaboration with others and is flexible enough to adapt to the rapidly changing energy system and its role within it. The DDs is a significant milestone in this journey and we share our views in this annex where appropriate.

We would like to draw out the increasing need for formal collaboration between DNOs, the ESO, and industry (including Ofgem). Whilst the ESO has some insights and experience in managing markets and network planning, it is unwise to try to develop wider plans in isolation or to consider the ESO is naturally positioned to take industry leadership. The industry has embarked on a long-term transition to DSO, collaborating through the Open Networks ENA project and elsewhere. It is critical that the ESO and DNOs work together collaboratively over the coming years to maximise benefits for consumers and take learning from each other. This is demonstrated through the aspects of role three which have proved hard to measure, and Ofgem's grading and comments on the delivery schedule. There are several references to integration and seamless interface/planning with distribution and this must be planned together rather than specified within one company's plans which effectively beholden the other party.

As well as collaborating to enable decarbonisation where there is much emphasis on future needs, the ESO still needs to focus on more every day matters such as carefully defining products and effectively operating markets including for example timely market information and managing code changes. These are areas the ESO must not lose sight of.

We appreciate the scale of complex work Ofgem has done on these ESO proposals. Though we've had limited time for detailed analysis of ESO DD content due to the amount of policy being shared simultaneously over the summer, plus a relatively time-compressed eight-week consultation, (rather than the standard 12 week we were originally anticipating for such a wide interest consultation and a new type of price control). Therefore, our comments are limited to regulatory principles and approach and we have not responded in detail within some areas.

We will continue to engage with Ofgem and the ESO throughout the price control process and will share our views on the updated delivery schedule as well as the forthcoming guidance document.

2 Incentives framework

We have not answered question 1 or 2 as we are not involved with the Electricity Market Reform (EMR) function, and therefore are not able to constructively comment on this area of operations.

ESOQ3. Do you agree we should regulate system restoration costs in a consistent manner to other external balancing costs?

The proposals appear to ensure that performance on Black Start is appropriately monitored which we support given it is important that the ESO and Ofgem do not lose any emphasis on what is a critical element of the ESO's role by moving away from the standalone Black Start assessment process.

We would add that it is important that costs do not escalate in this area following the removal of the disallowance mechanism. Therefore, scrutiny via the overall external balancing cost assessment should continue to ensure value for customers.

Whilst we acknowledge Ofgem's reference that the ESO has the ability to unlock substantial benefits for consumers, this does not mean that costs should be unchecked. Removing a disallowance mechanism, in an area where costs were noted as high in prior years, should not be undertaken without an appropriate and robust alternative in place.

We agree with the logic of having one overall incentive package in place for the ESO and therefore bringing in the Black Start performance and EMR elements simplify the framework.

ESOQ4. Do you agree with our approach to setting up-front performance expectations?

An evaluative approach to incentives is always challenging and therefore setting up-front performance expectations is key. It is critical that the ESO is clear on the expectations ahead of the period and also on how the assessment process will be undertaken, including the criteria and evidence required. Stakeholder input is also critical to ensure that the work programme and performance metrics are well supported and widely understood.

We note that the DDs show Ofgem's grading on the submitted Delivery Schedule, however given the requirement for an updated Delivery Schedule to be provided by the ESO by 9 October 2020 it is important that this final grading is completed and shared as soon as is practicable. This is to ensure that both the ESO and stakeholders have clarity on clear expectations and how delivery and incentive performance are linked.

ESOQ5. Do you agree that a financial reward or penalty should be determined every two-years, to align with the period over which we set expectations, costs and outputs?

We agree with the incentive period covering the two-year business plan cycle, therefore removing the need for a separate forward plan. This reduces regulatory burden and provides stakeholders with earlier visibility of programme of work and outcomes. At present the forward work plan is published too close to the start of the year for stakeholder views to influence plans in any meaningful way. By using Business Plans and running Delivery Schedules as an alternative this will allow stakeholders to actively input at an earlier stage than seen in RIIO-1. This also better reflects the nature of many of the ESOs actions which do not always naturally lend themselves to neat one-year segments.

We agree with Ofgem that to "bank" incentive earnings or penalties in six monthly increments will not be reflective of the ESO's performance over the full two-year period. This will bring more complexity into the process and puts the ESO at risk of changes that will undo what was previously granted.

Based on observations to date we haven't seen particularly material rewards. This might simply be reflective of lack lustre performance, although we would expect that Ofgem would be in regular discussions with the ESO if this was the case. Instead this may represent the challenges of an evaluative regime and therefore clearer up-front expectations and explicit assessment criteria will help to manage this hence we want to see strong performance from the ESO in a regime which allows them to be able to earn and receive incentive rewards that will be sufficiently motivating.

ESOQ6. Do you agree with our proposed approach to within-scheme feedback, including the timings and approach to performance panel sessions?

We agree with Ofgem's proposals on in-period feedback, we consider this essential to ensure that the ESO has regular feedback from the performance panel. We also agree that the six-monthly intervals, with a full evaluation at the 12-month period and end of scheme point, strikes the right balance between administration burden and ensuring that the ESO is clear on expectations and the panels view on performance. It is important that there is timely and clear feedback that is transparently given and might be responded to by the ESO, again transparently if necessary.

We note that there are no proposals for a call for evidence or formal event at each six-month interval. However, it is not clear whether it is the intention that these are still held at the 12-month and two-year points. It is critical that stakeholder views are not lost in this new process as they are invaluable to support the panel in forming their views. we strongly suggest that these are maintained and held at the 12-month and two-year points.

ESOQ7. Do you agree with our proposed evaluation criteria for RIIO-2?

We agree in principle to the elements of assessment as laid out in the consultation position set out in table 9. We note that there is limited detail to be able to fully comment on the incentive regime and so intend to respond to the more detailed implementation and guidance document when it is consulted upon later this year as indicated in paragraph 2.56.

ESOQ8. Do you agree with our proposals on the incentive scheme value?

We have stated in previous consultation responses that the incentive strength for the ESO should be sufficient to drive the desired behaviours, however, at the same time not so great as it causes financeability issues for the new standalone ESO.

We agree with the preservation of a downside penalty, whilst maintaining an attractive enough upside value to drive performance. To some extent there needs to be strong performance from the ESO to benefit customers, therefore creating a virtuous circle; if the price control regime is clear on what good performance looks like that will earn an incentive, the incentive is paid and new clear and stretching targets are met. Experience to date of only modest incentive payments might be a reflection of the process in practice, as well as potentially ESO delivery capabilities. We also support equal emphasis on each of the three roles but recognise that there are limited performance metrics and measures on role three compared to the others which may need further consideration when coming to evaluate performance.

3 Outputs

ESOQ9. Do you think that our proposals will capture the full scope of minimum obligations/standards associated with the ESO's Business Plan activities?

We agree with the principle of ensuring that obligations on whole system outcomes should be consistent across DNOs, TOs and the ESO and welcome this clarification. We would caution that this work must be done mindful of the timing of and separate processes (e.g. ED2) for other consultations on any changes to the other sectors licence so that policy or licence conditions for one sector are not set as default by another sectors consultation process. This is particularly important for ED which is two years behind the ESO in terms of the RIIO-2 price control process and framework development.

It is also important that any new licence conditions referenced in paragraph 3.6 do not place new obligations on the ESO over and above their existing role and it is clear that the ESO should collaborate with DSO's as the energy system decentralises. It is key to enable DSO's who are closer to regional customers and operate more complex networks with millions of nodes and customers in increasingly dynamic and complex ways. The complexity of DSO is arguably much more complex than ESO and will require a different mix of capabilities to the ESO.

We are interested to better understand the intent behind the proposal to place obligations on the ESO to set strategic direction in code functions and welcome greater clarification on what this means in practice and how this fits with the BEIS and Ofgem significant code review of energy codes. Feedback on the ESO's performance in code management has been historically poor compared to other code managers.

ESOQ10. Do you agree with our proposed changes to the ESO Roles Framework guidance?

As we explain in our answer to question 4, we understand the challenges that exist with an evaluative incentive regime and therefore are supportive of the intent to update the roles framework guidance to provide greater clarity on the expectations as well as what "exceeding baseline" looks like.

We are less certain on the Ofgem guidance prescribing expectations from the ESO's second business plan period (2023-2025) as this should come from the ESO and its stakeholders building on the progress towards the longer-term vision, rather than specified by an economic regulator.

We note the reference that there is the possibility that the guidance may be updated within the two-year business plan period and we would suggest that this should remain static in order to ensure the ESO has clear and unchanged guidance in terms of expectations to ensure regulatory certainty. Ofgem might find it useful to give clear forward signals of what is intended for the next regulatory period in plenty of time to allow all to consider and prepare for the next phase.

Delivery Schedule and Performance Metrics

We have not responded to questions 11-15 on the detail within the Delivery Schedule, Performance Metrics or Ofgem's grading due to the time-compressed nature of the consultation, however, we would draw your attention to those elements of the Delivery Schedule which require DNO action.

Given the timing difference between the start of RIIO-2 for DNOs compared to other sectors, BP1 for the ESO takes place during the remaining two years of RIIO-ED1 for DNOs. As a result, the deliverables which require action from DNOs will need to be considered alongside their existing ED1 commitments and allowances. One example may be category '(c)' whereby Ofgem's expectations are stated as an ESO-DNO data exchange into the data platform. Depending on how this is designed this could impose significant costs on DNOs whereby ESO has funding within its price control but DNOs do not. Decisions on how this is progressed needs to be jointly taken by the affected parties.

We will of course continue to engage with both Ofgem and the ESO as the updated Delivery Schedule is generated for the October deadline.

ESOQ16. Do you agree with our proposals for measuring stakeholder satisfaction?

We are supportive of the proposal for a stakeholder satisfaction survey and agree with the proposal for independent provision and benchmarks. We do not see any proposals for eligibility criteria which would be helpful to see to be able to fully comment on whether the proposals will adequately measure stakeholder satisfaction. The ESO has a large number of stakeholders and it is important to ensure that there is sufficient reach for the survey to fairly reflect the full range of stakeholder views. Particularly DNO's are a key community to feedback on ESO performance and vice versa the ESO should provide views on working with DNO's as they transition to DSO.

We are unsure whether this is intended to replace the existing stakeholder input into the incentive performance as it currently works for RIIO-1 and it would be helpful for Ofgem to clarify this before Final Determinations (FDs).

ESOQ17. Do you agree with proposed approach to tracking plan benefits?

We agree it is appropriate for the ESO to report regularly on the achievement of benefits, and that six-monthly reporting is a reasonable frequency. Because of the scale of activities and changes the ESO is involved in we would not expect continuous updates of all aspects.

ESOQ18. Do you agree with our suggested areas for regularly reported evidence?

We have no comments on the regularly reported evidence for roles one and two, however, as we mention in our response to question 8 given that role three has limited metrics and deliverables associated with it, it is important that regulatory reported evidence is clear on the ESOs performance on role three to support assessment of performance.

4 Internal costs

The assessment for the ESO is unique to the ESO and as such we offer no comment on the process undertaken and the questions posed by questions 19-23.

ESOQ24. Do our proposed changes to the reporting of changes to the ESO's shared services costs offer a sufficient level of consumer protection?

Where there are shared service costs we believe it is appropriate for methodologies to be scrutinised with any changes made in a clear and transparent manner.

5 Finance

We have provided our detailed comments on finance arrangements within our response to the Finance annex contained in this document and therefore have not provided further comment within this section specific to the ESO.

6 Innovation

ESOQ30. Do you agree with the level of proposed NIA funding for ESO? If not please outline why.

We have no comments on the level of funding proposed but do note Ofgem comment in paragraph 6.8 that the ESO RIIO-2 request is relatively larger as a percentage of totex than other network companies.

We recognise the ESO ability to impact balancing services costs using innovation funding and consider this to be strongly in the interests of customers.

We will follow with interest the NIA projects undertaken and their outcomes in line with our standard business processes.

ESOQ31. Do you agree that ESO's NIA funding should be subject to the condition that all projects must involve partnership with other network companies, third party innovators and/or academics?

We have mixed views on the proposal of mandatory partnerships on all NIA funded projects. On the one hand collaboration can bring benefits and can provide Ofgem and stakeholders with comfort that the ESO work is aligned with the wider industry challenges, however, on the other hand it does bring an added level of complexity and also will incur time to develop and research appropriate partnerships for the specific issues identified together with stakeholder calls for input and suggested work areas. This additional burden may have the unintended consequence of slowing down innovation and reducing the ESO ability to be agile and respond to emerging needs. So, in general we think ESO projects should involve one or more other partners but it's important that the number of partners doesn't become an aim in itself.

We also hold the view that time-bounding NIA projects to the two-year BP periods may limit what can be achieved, particularly in BP1, given the time needed to mobilise and develop partnership proposals in the period between FDs and the start of the price control period. We suggest Ofgem consider extending the period in which NIA projects are able to run so that it does not have the result of limiting projects to those which can be delivered within the two-year parameter or alternatively provides a clear signal that NIA funding won't be turned off for in-flight projects mid-way through up to a certain value. We think the ESO could likely plan for multi-year projects beyond the two years as it would not seem to be in consumers interests for Ofgem to not fund multi-year projects, especially those part way through. However, in a low risk regime, Ofgem should consider greater clarity for the ESO and the stakeholders they work with that projects with benefits with customers would continue to be funded by NIA.

The ESO is an active participant in the innovation effort across industry and anything which places this at risk would be retrograde to the overall Net Zero ambition.

7 Uncertainty

ESOQ32. Do you believe our price control design is sufficiently flexible to account for uncertainty? Are there any relevant foreseeable future uncertainties which we have not identified here?

We do not think specific uncertainty mechanisms or re-openers are necessary for a two-year business planning cycle where the next business plan can capture and adapt as uncertainties arise.

ESOQ33. Do you have any views on whether we should introduce a different funding approach or uncertainty mechanism to account for the risk of material changes to the ESO's revenue collection role? Do you have any views on how this should be designed?

We provide no response to this question.

8 Other cross-cutting issues

Governance of ESO IT

ESOQ34. Do you agree with our assessment that the current approach, with the ESO's IT provided by National Grid Group is not appropriate for the future? Have we identified the correct concerns with the current model?

We agree that if the ESO is to be held to account for delivery and performance against its business plan, then it is essential that it has control of the key dependencies within the plan, of which many of the IT projects are considered integral. A strong enough regime will ensure that the ESO is able to secure the IT services it needs when it needs them. A shared services model might give benefits such as lower costs and rapid access to a very broad range of capabilities. The ESO business management itself is best placed to determine what IT support model to follow and it should be clear that this decision is taken by the ESO.

ESOQ35. Do you agree that the ESO needs full control of its IT provision? Are there other options that you think are preferable?

We do agree that the aim should be for the ESO to have full accountability and control of its IT provision, particularly given the level of expenditure stated within the plan and the reliance on IT projects to deliver the outcomes and customer benefits stated.

ESOQ36. Do you have a view on the proposed timing of implementing IT autonomy?

We agree that having a desired aim of autonomy which aligns to the start of a business plan cycle is attractive in its simplicity, however, setting an arbitrary target linked to the timing of price controls may not be the best solution.

The separation of IT systems and full autonomy will be a significant programme, in terms of resource, time and cost. A cost benefit assessment of options including other mechanisms than separation should be considered. Also, when considering work of such complexity an enforced delivery within two years could lead to inefficiencies or sub-optimal delivery, certainly in the short term. We would therefore suggest that the ESO is given the opportunity within its IT separation plan to propose a date which is deliverable and affordable whilst being no longer than necessary.

Cost Recovery

We do not have any views on the ESO's cost recovery and therefore have not answered question 37 or 38.

Regulatory Reporting

We do not have any views on ESO reporting requirements and therefore have not answered question 39.

Timings for the future Business Plans

ESOQ40. Do the proposed timings for the BP2 process provide sufficient time for the ESO to develop and refine a robust plan, stakeholders to contribute to this and Ofgem to undertake the necessary assessment and decision making?

We agree that there does not need to be such a prolonged process for BP2 in terms of the submissions to determinations due to the framework parameters being established for BP1.

We would however suggest that the gap between DD in November 2022 and FD in March 2023 gives stakeholders limited time to respond to DDs and influence changes ahead of FDs. Consideration should also be given to the timeline for ED2 to ensure that stakeholders are given appropriate time to consider and input into both processes.