

Charlotte Morgan
In capacity of Chair, and on behalf of the
ESO RIIO-2 Stakeholder Group

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FAO: RIIO-2 Consultation - ESO Draft Determinations

Ofgem

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Dear Colleagues,

Response of the ESO RIIO-2 Stakeholder Group (ERSG) to the RIIO-2 Draft Determination regarding the ESO business plan.

On behalf of the ERSG, I refer to the RIIO-2 Draft Determinations for Electricity System Operator (ESO) and the related consultation requesting responses by September 4 2020. Thank you for the very helpful meeting on September 1 2020 between ERSG, Grendon Thompson, David Beaumont and Eleanor Warburton of Ofgem, where we discussed the issues which the ERSG has raised in more detail. This letter sets out our formal response to the RIIO-2 Draft Determinations.

Incentive proposals: We appreciate that Ofgem and the company have been developing the incentive proposals since the initial proposals, but the ERSG is concerned that there remains a level of uncertainty for the ESO which may have a perverse incentive on the ESO to be more cautious and less ambitious than the ERSG (made up of industry participants and consumer groups) would like. We very much welcome Ofgem's support of the ESO's ambition, which we believe to be a very positive and forward looking contribution to the country's net zero targets.

The ERSG is aware of a significant gap in alignment in respect of each of Ofgem's and the ESO's perception of the incentive package. Ofgem are clear that you want to encourage ambition. You have removed any TOTEX incentive and provided a pass-through mechanism to encourage investment all of which are positive steps and are conceived by Ofgem as supportive of the ESO's ambition. However, conversely the ESO are concerned that the disallowance mechanism and the uncertainty and subjectivity of the incentives mechanism present a significant downside risk, with no reliable opportunity to mitigate this with a corresponding upside opportunity. The ERSG is concerned that the ESO's concern, notwithstanding Ofgem's intentions, could prevent the ESO from taking the proactive, innovative and ambitious approach needed in RIIO-2 to deliver key changes and benefits to the whole system and to achieve key public policy goals relating to the decarbonisation of the power sector.

In some aspects, Ofgem seem to have applied established incentives and not the ones which may be required for the transformation. The ESO is a one-of-a-kind and therefore we would encourage Ofgem to apply a different toolkit from that used for other companies, in a different way. The focus on cost assessment, and the efficiency of the business plan is similar in nature to the other RIIO Draft Determinations. This is less appropriate for the ESO, and less relevant with pass-through arrangements, and brings a risk that the ESO will focus on expenditure levels at the expense of the ambition and innovation that are needed for it to fulfil its objectives in the years ahead.

Although the Ofgem guidance is welcome, there remains a need for more ex-ante clarity to provide more transparency and certainty for the ESO to encourage ambition that will achieve rewards for the whole system and support delivery of key legislative targets and public policy goals. A clearer linkage

between the ESO's journey towards achieving their aim of £2bn of net benefits for consumers over the RII0-T2 period and their incentives reward may be worth considering and the ERSG would be supportive of this, given as stakeholders we believe the ESO has a unique position in the industry from which it can drive real change for the benefit of consumers and stakeholders.

Banking good progress: To encourage a proactive and innovative business model and timely investments, we believe it could be beneficial for the ESO to be able to bank good early progress through continuous assessment, rather than have to wait until the end of the assessment period, which potentially creates a significant degree of uncertainty and therefore risk. By having early assessment and determination of incentives the concerns which the ESO has can be more allayed freeing it up to be more innovative and industry facing, delivering consumer benefits with more confidence.

Disallowance: In our meeting on September 1 2020, you confirmed that the level of disallowance is aligned with the Transmission Owner (TO) companies and that, to date, these mechanisms have not been used in the transmission space to disallow any spending. Risk can be considered as comprising probability and impact. We note that Ofgem has sought to align the limits of the impact of the cost disallowance risk (in terms of proportion of RAV potentially disallowable) between the TOs and the ESO. However, we have not seen evidence that Ofgem has also sought to align the probability of cost disallowance risk occurring, nor the level of impact before reaching the limit. The spend and risk profile of the ESO is quite different to that of the TOs and could be construed as having a significantly higher probability of disallowance than a TO, given the nature of the projects being undertaken in the IT arena on ground breaking first of a kind technology development as opposed to more business as usual work in the transmission owner space. Furthermore, given the size of the ESO key projects compared to their RAV, just a few significant cost disallowances could lead to very significant impacts for the ESO. Whereas for a TO, who might have a larger number of lower risk projects, the impact of the same number of cost disallowances would be lower. Has Ofgem taken into consideration the probability of the ESO having spending disallowed compared to the TOs? In the Offshore Transmission regime, the offshore wind farm developer usually has a proportion of its expenditure on the offshore transmission assets it constructs disallowed as part of the cost assessment process Ofgem carries out in determining the transfer value of the offshore transmission assets. Whilst this is not a directly comparable exercise (as the offshore wind developer will to some extent recover disallowed expenditure through lower TNUoS charges), it does provide a data point which appears to cause concern to the ESO. Perhaps setting out why this is not relevant could be helpful. We would welcome the cap on the disallowance and recognise that Ofgem needs to have the power to disallow costs, but perhaps some lower calibration of the cap or some additional comfort around disallowance would be helpful to ensure we don't have an ESO who worries about the risk to its viability caused by potential disallowance, however remote.

Potential disruption with a new IT delivery model: We are concerned that, if not carefully planned and managed, changes to IT delivery model (although welcome) will disrupt innovation/development in the short-term (next 2 years). The ERSG has been vocal in its concern that dependency on a shared Corporate IT model could undermine the very ambitious IT programme that is required to move the industry forward. Ofgem's proposal is to mandate a fully independent model by 2023. The ERSG supports this and we will be working the ESO during delivery. We recognise, however, that this change is a difficult transition and we are also aware that the ESO considers that this timescale it is challenging. ERSG would recommend that Ofgem may want to consider a more gradual move to an independent model to ensure that the speed of transition does not impact the ESO's ability to deliver its ambitious programmes. We have been updated on the ESO's plans and continue to work with them on delivery of this transition and welcome the approach and openness with which the ESO is already engaging on this task.

Whole system approach: Ofgem support the ESO's overall vision (operating the system carbon-free by 2025) and even talk of it taking a shaping role when working with other parties to ensure a whole system approach, but we have raised in our discussions with both Ofgem and the challenge panel that it is still unclear that Ofgem and BEIS have given the ESO the necessary powers they would need to have to ultimately secure this. Is this to be achieved solely through seeking to influence other parties or will the ESO have more formal powers to facilitate a unified direction of travel? We understand that there is an ongoing consultation on the role of the ESO and we would encourage Ofgem and BEIS to consider closely the pivotal role we all hope the ESO will take in the energy

transition and ensuring it is given the requisite ability to play its full part in driving forward to net zero for the benefit of all of its consumers and stakeholders.

In summary, we welcome the draft determination recognition of the role of the ESO, its ambitions and the projects which it will be permitted to take forward. These are all huge positives in the draft determination. The ERSG does retain a concern that the incentive mechanisms may encourage the ESO to be more cautious than we would hope them to be, thereby reducing the ambition and how innovative the company is. The ESO should be enabled to deliver the benefits of their plan. We would request that before the final determination Ofgem review whether, overall, there is enough incentive for the ESO to be ambitious, make the organisational transformation required, take risks and deliver the very substantial benefits identified for the entire system and for the UK's broader policy goals.

The ESO is central to achieving decarbonisation across the whole energy system so we encourage Ofgem to ensure it puts significant weight on incentivisation in making its final determinations. If the ESO succeeds, consumers and stakeholders will benefit and the UK will be on course to meet its legal commitments to achieve net zero greenhouse gas emissions by no later than 2050.

Kind regards,

Charlotte Morgan, on behalf of the ESO RIIO-2 Stakeholder Group.