

# Call for Input – Future of local energy institutions and governance

## Overview:

The UK's commitment to reach net zero is driving largescale change on energy systems and networks at both a national and local level. A coordinated whole systems approach that spans multiple vectors, entities and geographies is clearly needed to support the most optimal delivery of the changes.

The time period to 2050 is shorter than the time elapsed since privatisation of the electricity and gas companies. Changes to the roles and responsibilities across energy system entities are planned at a national level and it is right that the institutional and governance arrangements at a local level are reviewed so they remain fit for the future.

WPD strongly believes a combined DNO-DSO within the same parent organisation will deliver the biggest benefits for consumers in the shortest period of time (RIIO-ED2). Urgency to deliver short term progress within the electricity system on net zero should focus on evolution of existing successful governance models and the opening of energy system data. This will be a key enabler in the strategic development of the whole energy system.

This should be supported by wider reforms where there is quantifiable evidence of additional benefits being achieved or where barriers remain evident. A key focus on coordination of activities between entities should avoid duplication and maximise more optimal whole system outcomes. There is also a need for missing activities to be identified and fulfilled by creation of new entities or orchestration of others.

FSO will be initialising and developing in its capability during this period. There will be strong FSO and DSO interactions amongst other actors to support delivery of net zero. The FSO will have an important role in coordinating the national top-down pathways across more local bottom-up progression driven by the DSOs, GDNs and other local actors. Successful FSO interactions could support the prioritisation of particular pathways and accelerate whole system decision making processes.

Distribution actions will be vastly different in scale, volume and timescales compared to transmission, which may necessitate a different approach. We would like to work with Ofgem and Government to fully consider the best approach for local governance of energy systems.

Competition across different DSO companies, driven by the structured KPI metric approach within RIIO2 will continue to accelerate the development of DSO functions. As this is reported on a licence area basis, granular data on regional performance will be evident.

The proposed ODI for DSO within RIIO2, if structured and rewarded appropriately, should incentivise outperformance of DSO activities and outputs for stakeholders/consumers. Incentive based regulation naturally drives this behaviour and reduces the regulatory burden on enforcing stretching and efficient delivery.

We are keen to work with Ofgem and Government to identify and then accelerate all actions needed to support net zero delivery on both a local and national basis. We are committed to do all that is needed alongside Ofgem and industry to strengthen the interactions that will achieve an optimal pathway to 2050 across the whole energy system.

## CFI Questions:

### 1. Are the three energy system functions we outline (energy system planning, market facilitation of flexible resources and real time operation of local energy networks) the ones we should be focusing on to address the energy system changes we outline?

The three energy system functions outlined in the call for input match the DSO functions identified within RIIO-ED2. Given the strong alignment with the RIIO-ED2 baseline requirements and WPD's RIIO-ED2 DSO Strategy, we agree that these functions are core to addressing energy system changes for electricity distribution. Energy system transition towards net zero is already happening at pace within distribution networks, so, from a DNO perspective, these functions can be clearly identified.

As decarbonisation begins to move at pace for other sectors and vectors, we would expect to see similar functions developed, but it is currently unclear how applicable all these functions would be to non-electricity local energy systems. The harnessing of those interactions will be key in achieving improved whole system outcomes. We agree with data and digitalisation being a cross-cutting enabler of decarbonisation and networks have all developed strategies to swiftly deliver further progress in digitalisation and benefits conferred. Openness of data to support this activity is a critical component and any local system governance must ensure that both system operator and market participant data is available and able to be ingested by network companies. Government and local authority data will also be a key input in supporting optimal delivery of net zero.

### 2. Do you agree with the criteria we have set out for assessing the effectiveness of institutional and governance arrangements?

The criteria set out for assessing the effectiveness of institutional and governance arrangements seem broadly acceptable in respect to assessing the performance of the entities. We would expect further consideration to be given to the regulatory impact of the institutional and governance arrangements, as this itself could have a high bearing on the suitability.

### 3. Do you agree with our assessment of how far the current institutional arrangements are, or are not, well suited to deliver the three key energy system functions?

Progress towards developing the energy system functions outlined in the call for input has been rapid within the DNOs during the current price control. Development of these functions has been quicker compared to other countries due to the agility and incentives within RIIO framework, principally, the totex approach and associated TIM, which has strongly supported the ability for DNOs to seek and utilise non-wire alternatives. To date, WPD has avoided £48.5m of conventional reinforcement by utilising competitively procured non-network solutions. Distribution flexibility markets have grown significantly quicker in the UK compared to the rest of the world and UK DNOs are benchmarked favourably in global smartgrid indexes such as [SP Group's](#).

Plans put forward for RIIO-ED2 by WPD build on the progress to date and seek allowances to take an enhanced role in co-ordinating energy system planning at a local level, supporting other vectors and actors to find optimum net zero pathways.

Energy system planning is working successfully between transmission and distribution, and existing licences require efficient and economic consideration across the whole electricity system. Whole system coordination has been piloted during the current price control and will broaden and deepen into RIIO-ED2. Both intra-vector and cross vector whole system coordination need improving to reach the desired competency to achieve optimal outcomes during the transition.

Value from DSOs into flexibility markets is increasing, but will always be considerably smaller than the value of wholesale or ancillary markets. DNOs have already facilitated network access to a significant amount of DER

participating in these markets, and further work has been committed in ensuring services remain stackable and coordinated between transmission and distribution, particularly with respect to primacy. Secondary trading across the electricity system will support competition across multiple value streams.

Enabling flexibility across networks must not come at the detriment of security of supply. Just as the national system employs the Capacity Market to ensure margins are secure, DSOs must utilise a combination of longer term, shorter term and real time markets to continue to operate a secure, economic and efficient distribution system. Learning is being taken from the ESO in supporting market development where appropriate, recognising the natural differences in participant types and volumes.

WPD's business plan for RIIO-ED2 also takes significant steps towards demonstrating strong governance in avoiding DNO and DSO conflict. Whilst there is the potential for conflict between asset owner and system operator, WPD's swift implementation of functional separation of the DSO and accompanying governance measures promoting transparency of decisions, independent audit and third party assurance will provide strong mitigations.

Additionally, incentives being developed for RIIO-ED2 will ensure high performing companies are rewarded regardless of the solutions employed to deliver the outputs, enabling asset backed and non-wires alternatives to be equitable.

#### **4. Overall, what do you consider the biggest blocker to the realisation of effective energy system planning and operation at sub-national level?**

There are some promising changes currently being delivered to better facilitate effective energy system planning and operation. Decisions made within Ofgem's Significant Code Review will enable distribution networks to take a more strategic view of required network developments, however it is still unclear how allowances might be provided to support this.

Clearer commitment is needed from the regulator to ensure network capacity can be delivered in line with the needs of customers. This must be twinned with an agile approach, enabling delivery of this investment to be efficiently paced but also able to respond to consumer-led requirements.

Consideration should be given to the balance of market-led versus strategic development of transport and heat networks, particularly against the lens of ensuring a fair transition.

A number of other key cross-sector actors also need to be willing and able to support net zero transition. The facilitation and incentivisation of their support may form recommendations for wider government policy. Domestic consumer flexibility will be particularly contingent upon smart meter uptake and retail supplier led developments.

#### **5. Do you agree with the opportunities of change we outline and the potential benefits they may create?**

The synergies identified seem realistic and many of the electricity network focussed activities are already incentivised through the existing RIIO mechanisms. Changes to governance arrangements that weaken those linkages or result in obscuring clarity of responsibilities should be avoided.

Consideration should be given to the extent any of the models demonstrate a low or no regrets state ahead of further transitional changes that may be required in the future.

#### **6. Are there additional opportunities for change and benefits that we have not set out?**

Many roles within the DSO baseline expectations will be funded under RIIO-ED2 and these can be further leveraged by network companies to target some of the synergies laid out in the call for input. Evolution of existing mechanisms, such as the Coordinated Adjustment Mechanism and NZ-UIOLI funded for ET/GDNs are aiming to maximise benefits realisations. Tracking of these interactions and reviewing the value added by successful deployments should see benefits being captured.

**7. We set out a number of risks associated with change. Do you agree with these risks and the potential costs they create? Are there additional risks of change and costs that have not been set out?**

We recognise the risks associated with the change as set out in the call for input. As expressed before, we feel the impact on regulatory oversight required should be a material consideration. We particularly note the urgent need to decarbonise and deliver the net zero transition and how any institutional change has the potential to adversely impact time and resources. The impact and cost of any changes needs to be carefully quantified ahead of making any decisions.

In best understanding these risks, we would expect plans to be put in place to capture information and supporting evidence on the current progress made through existing arrangements, allowing barriers and issues to be identified. At the outset, these plans should address how these risks will be quantified and what evidence is required to make a decision. It may also be suitable to set out an expected period for this evidence gathering phase.

**8. For each model, we have set out the key assumptions which need to be true for the model to offer the right solution. Which of these assumptions do you agree with?**

The key assumptions set out in the call for input are high level and leaving much scope open for interpretation. Currently, we would see the DSO roles are closely linked and require agile support from network owner and system operator to reach optimal, timely and coordination decision. This is especially evident in energy system planning and system operation, but as standardisation of these functions occurs during maturity of these roles, then there will be the potential to separate and codify relationships. Market facilitation requires some elements to be performed by system operators (selection of flexibility bids across multiple platforms, risk spread across long, short and real-time markets, definition of technical products) but other elements (market visibility, auction capability, settlement) are already being undertaken by other entities where economic. Data and digitalisation across standardised industry flows will be a key enabler of this.

The strong governance arrangements in place and developed further in WPD's RIIO-ED2 plans will demonstrate there are consistent processes in place when making decisions and these outcomes will be made transparent to stakeholders as well as independently assured. Following these changes, we expect further evidence and quantification to be gathered to support any proposals for additional measures which may better capture the improvement of synergies.

Whilst the proposed models have a strong electricity focus, it will be important to ensure the models also consider the benefits, risks and synergies that might be appropriate for other significant actors in the energy system.

**9. Out of the framework models we have developed which, if any, offer the most advantages compared to the status quo? If you believe there is another, better model please propose it.**

WPD has already implemented functional separation and so would currently align most closely to the "internal separation" model. RIIO-ED2 business plans for the DNOs mostly identify the "internal separation" model as being adopted within the period. We see this as a necessary transitional step whilst the risks, costs and opportunities for other governance arrangements, regulatory mechanisms and required role interactions are considered for future implementation.

Competition between DSOs, innovation across multiple entities and performance management through RIIO controls will all support increased benefits delivery at speed. The agility and effectiveness of incentive based regulation to make quick progress has already been demonstrated and should be a key tenet of any future model.

Openness of data will support transparency, which will complement all potential framework models and should be seen as low regret.

# **10. What do you consider to be the biggest implementation challenges we should focus on mitigating?**

Implementing institutional changes will clearly come with a degree of risk, cost and impact based on the level of departure from the current status quo. The evolution of existing models is already happening at speed to respond to stakeholder feedback but it is right for questions to be asked around the pace, ambition and effectiveness planned changes.

In considering future models of governance, it is essential to understand the speed, ease and cost of implementation as mitigating these will support the earliest delivery of net zero.

The complexity within the energy system is also a challenge and with many major changes recently decided and due for implementation, there is a risk that the rapid short-term change might lead to non-optimal outcomes.

# **11. Taking into account the varying degrees of separation of DSO roles from DNOs under framework model 1, do you consider there are additional measures we should consider implementing, in particular in the short term (e.g. changes in accountability etc)?**

Across the DNO business plans for RIIO-ED2 there are a number of mitigations for minimising the level of conflict between DNO and DSO.

- Independent DSO Scrutiny Panel for each DSO
- Separate DSO directorate
- Ring-fenced functional separation
- Separate/separable IT systems
- Commitment to codify DSO-DNO relationship
- Openness of energy system data
- Regulatory incentives for successful DSO activities
- Equitable regulatory treatment of asset based and non-network alternatives

The regulator should set forward a minimum position of compliance for mitigation options for the next regulatory period consider a number of the above options. Consideration should also be given to how these may integrate or complement with other energy system actors.

# **12. Are there other key changes taking place in the energy sector which we have not identified and should take account of?**

It is expected that the outcome decision from the network access Significant Code Review will result in significant short-term growth, maintaining a net zero compliant pathway and flexibility will be a strong tool for DSOs to manage DNO asset risk. The changes proposed within RIIO-ED2 business plans and various incentives across the RIIO framework may need time to bed in to understand effectiveness. There are further considerations around the viability of an iDSO in underwriting the risk of the asset/reduction in service.

# **13. What do you consider to be the most important interactions which should drive our project timelines?**

The speed of progress and future capability of change will be particularly important.

The electricity industry has demonstrated a significant ability to decarbonise, with the existing arrangements facilitating a faster pace of change compared to other similarly placed countries. With some pressing timescales for achieving milestone targets set by the government, focus should be on understanding what can be immediately delivered by driving forward institutional improvements and what elements can only be supported by wider reaching reforms over a longer timescale. This analysis should help direct the current finite resources.

Changes at a national level will clearly have a material impact and early understanding of the interactions between FSO, GDNs, DNOs and other local actors will be paramount.

ED2 draft determinations and final determinations will be completed by the time the reforms are proposed, so consideration should be given to the risk of significant cost in undermining the price control if implementation is within the ED2 period.

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