



Future of local energy institutions and governance

Northern Powergrid's response to Ofgem's Call for Input: Future of local energy institutions and governance

KEY POINTS

- Distribution Network Operators (DNOs) are the best parties to fulfil Distribution System Operation (DSO) functions because we have the local expertise, we have already been active in developing these capabilities for some time, and our stakeholders support us in doing so.
- Separation of system and network operation at distribution level is not in the interests of consumers.
- As a combined entity we are uniquely placed to leverage synergies between the system operation and network operation components of our business given particularly that, at the distribution level, the regulatory framework can (and does) mitigate any potential conflicts of interest between these two business components.
- DSO separation would result in a net cost to customers over the long term due to the costs of separation, which are compounded by the number of licensees compared to transmission, and reduction of the significant benefits that an integrated DSO model delivers.
- The theoretical concerns raised are all already extensively addressed by the design of the current regulatory framework and the package of measures envisaged for the ED2 period.
- Separation would negate the benefits of the distribution equalised incentives regulatory framework:
 - Perceived conflicts of interest in investment decisions at distribution are mitigated through equalised incentives, unlike the problematic regulatory framework that was present in transmission.
 - DSO functions taken on by others would negate the benefit of totex benchmarking across DNOs which enables Ofgem to set efficient price controls, driving up costs for consumers.
 - The potential for synergies across investment categories, notably between investment in asset maintenance and reinforcement, would be lost, raising costs and negatively impacting service quality and network resilience.
- Separation further risks impacting service for customers by removing clear accountability from one party for delivering, and maintaining quality of, an essential service at the local level.
 - The Call for Input does not give appropriate weight to the risk of diluting responsibility for safely maintaining reliability and quality of supply for customers.
- The proposed timing of a decision around DSO institutional arrangements risks delaying investment in DSO in the short term, and therefore progress towards the UK Government's Net Zero goals.
- Major change would bring delay, disruption and uncertainty. Given the enormous challenge of achieving net zero on time at a reasonable cost to customers we do not think it is appropriate for institutional change at this time.

Responses to specific Ofgem consultation questions

Q1. 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?

1. The functions outlined seem reasonable.
2. They are consistent with Ofgem's DSO roles for RIIO-ED2, which were mandated in the Business Plan Guidance, and therefore each Distribution Network Operator (DNO) have submitted a costed DSO Strategy in their business plan submissions.
3. The scope of the roles must clearly define accountability for network reliability and ensure there is no risk of removing clear responsibility for safely maintaining reliability and quality of supply for customers. When considering the roles for DSO that involve transition to a smarter and more flexible low carbon energy system it is vital that the fundamentals of providing a robust and resilient network platform is given high priority. Any proposals for changes to local energy institutions need to avoid and diffused accountability that includes reliability.

Q2. Do you agree with the criteria we have set out for assessing the effectiveness of institutional and governance arrangements?

4. Overall, the criteria are fine however there is not enough emphasis on safely maintaining reliability and quality of supply. Accountability in this area requires careful consideration to ensure clear boundaries aren't diluted.
5. Additional criteria to be considered includes value for money for customers, adaptability, and deliverability. On deliverability, there is a need to understand the risks associated with the time required to enact changes and the potential impact on decarbonisation pathways caused by any changes required.

Q3. 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?

6. No, the existing electricity distribution regulatory framework appropriately incentivises the right behaviours (i.e. minimising total costs) for DNOs whether they are delivering traditional network reinforcements or performing DSO functions. The main beneficiary of these arrangements is the customer – if business separation is pursued there is a risk that these benefits arising for joint DNO-DSO operation will be lost and create additional costs for consumers to bear.

7. DNOs have a strong track record of performing against incentives to deliver the desired outputs. Ofgem should value, and to the maximum extent possible seek to preserve, the existing regulatory framework that complements existing business structure.
8. Perceived conflicts of interest in investment decisions at distribution are mitigated through equalised incentives, unlike the problematic regulatory framework that was present in transmission.
9. Separating the DSO functions would also remove the comparative cost benchmarking benefit which drives efficiency for customers amongst DNOs. The existing comparative competition drives down overall costs, which enables Ofgem to avoid setting allowances too high – a significant difference between the distribution and transmission sector. Such comparative assessment would be lost if DSO functions were to be taken away from the DNO.
10. Furthermore, additional synergistic benefits are possible at distribution level which benefit consumers in terms of cost, quality of service and the possible rate at which decarbonisation can be facilitated. The opportunities for synergies in our network investment, notably between asset maintenance and reinforcement, are much greater under totex cost benchmarking when decisions are taken on a combined basis. The opportunity for synergistic investment across asset renewal and reinforcement would be lost if DSO were to be separated from DNOs.
11. Caution should be taken when comparing ESO and DSO markets. Perceived conflicts of interest in investment decisions at distribution are mitigated through equalised incentives, unlike the problematic regulatory framework issues that were present in transmission. The ESO market was well established with proven delivery for over a decade. For the DSO it is not appropriate to allocate parts of the regime to new ownership as the functions themselves are yet to be fully scoped and developed. There are no organisations fully doing what needs to be done for DSO currently.
12. In our DSO Strategy in our RIIO-ED2 Business Plan we outline how we will deliver against the prescribed three Ofgem DSO roles and how much it will cost. This includes additional DSO resources with new and more dynamic skillsets, we are bringing forward this investment and are continuing to expand our DSO functions in the current price control.

Q4. Overall, what do you consider the biggest blocker to the realisation of effective energy system planning and operation at sub-national level?

13. There are a range of blockers in realising effective energy system planning and operation at sub-national level. Local accountability is required enabled by more clear policy direction, dynamic network charging and available open data.
14. Local authorities must have a clear understanding of roles and responsibilities, which is uniform across the board and is supplemented by funding and resources required to support effective energy system planning and operation. We are working with local authorities in our area to support the production of Local Area Energy Plans (LAEPs) and we are expecting to increase this

further in the 2023-28 period. However, they also need funding to upscale their activity and produce detailed place-based action plans to deliver on local commitments to decarbonise – where around 60% of our local authorities have declared an ambition to reach net zero emissions ahead of 2050.

Q5. Do you agree with the opportunities of change we outline and the potential benefits they may create?

15. We must note that DNOs are already delivering many of these functional synergies today and are striving to continue to maximise within the current institutional and governance framework. There are strong incentives and licence conditions in place today to drive these functional synergies.
16. To achieve Net Zero, we have to work together in a fast and highly organised manner, so maximising functional synergies, where they can speed up decision-making and reduce costs, is inherently sensible.

Q6. Are there additional opportunities for change and benefits that we have not set out?

17. No.

Q7. 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?

18. We believe there needs to be greater clarity on the discrete risks involved in what could be, depending on the chosen solution, a major change to the energy system. As such we think Ofgem needs to reframe its thinking along some very clear risk areas. We have identified the following risks:
 - a. major change would bring delay, disruption and uncertainty;
 - b. customers would bear unnecessary additional separation costs;
 - c. responsibility for safely maintaining reliability and quality of supply would become confused;
 - d. progress towards net zero would falter;
 - e. near-term investment in DSO would be disrupted;
 - f. lack of confidence in flexibility markets would reduce new entrants;
 - g. fragmentation of the sector would lead to inefficiency;

- h. a postcode lottery may develop around costs and reliability; and
- i. confused roles would create actual conflicts of interest and weaken checks and balances.

Q8. 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?

- 19. Both the models and the assumptions provided are high-level and lack detail, therefore it is difficult to assess the appropriateness of the key assumptions against the models.
- 20. Overall, what really matters is outcomes for our customers. The customer benefits for any model should be a pivotal piece of analysis and this is not clear in the CFI.
- 21. The current status quo is not outlined which makes it difficult to assess the following models. For example, we do not consider any of the key assumptions (section 4.8) in 'internal separation of DSO roles within DNOs' to be new in comparison to the here and now.
- 22. Substantial work is required to build out any model for consideration to include customer benefit, running cost to customers, deliverability challenges, risks and mitigations, responsibility split between DNO/DSO(s), legislation changes and one-off separation cost (total and apportionment).

Q9. 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.

- 23. Our ED2 business plan effectively contains a modified version of framework model 1. We advocate that:
 - a. Distribution Network Operators (DNOs) are the best parties to fulfil Distribution System Operation (DSO) functions because we have the local expertise, we have already been active in developing these capabilities for some time, and our stakeholders support us in doing so.
 - b. Separation of system and network operation at distribution level is not in the interests of consumers.
 - i) As a combined entity we are uniquely placed to leverage synergies between the system operation and network operation components of our business given particularly that, at the distribution level, the regulatory framework can (and does) mitigate any potential conflicts of interest between these two business components.
 - ii) DSO separation would result in a net cost to customers over the long term due to the costs of separation, which are compounded by the number of licensees compared to transmission, and reduction of the significant benefits that an integrated DSO model delivers.

24. We recognise that despite the positive aspects of the regulatory framework described in Q3, there remains the risk of a perceived conflict of interest, particularly in relation to the role we expect to play in the development of flexibility markets and in making investment planning decisions across network and non-network (including customer flexibility) solutions. It is also vital that we operate in a way that builds confidence in the potential participants in these new market arrangements – and transparency is key to that.
25. Our approach to mitigating those concerns is to combine operational effectiveness with openness and transparency. The deliverables and initiatives set out in our business plan and DSO strategy are designed to ensure we have the systems and processes in place to support efficient and technology-neutral decision making across planning, operation and market facilitation functions, and that this is clearly and transparently communicated to our stakeholders and customers.
26. The operational effectiveness and transparency of delivery by DNOs will provide the opportunity to demonstrate the value of the DSO functions continuing to be performed by these locally accountable institutions.
27. The proposals submitted by DNOs carried popular support from stakeholders and provide an executable plan for the 2023-28 period.

Q10. What do you consider to be the biggest implementation challenges we should focus on mitigating?

28. The proposed timing of a decision around DSO institutional arrangements risks delaying investment in DSO in the short term, and therefore progress towards the UK Government's Net Zero goals.
29. Also see response to Q7.

Q11. 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)?

30. As set out in our RIIO-ED2 Business Plan and described in Q9, and aligning to Ofgem's Business Plan Guidance, our internal processes, and organisational and governance structures will drive operational effectiveness and transparency, and ensure clear responsibility and accountability for the DSO transition, while preserving important synergies and incentives that are embedded in the regulatory framework.

Q12. Are there other key changes taking place in the energy sector which we have not identified and should take account of?

31. Given the enormous challenge of achieving net zero on time at a reasonable cost to customers we do not think it is appropriate for institutional change at this time. Major change will bring delay, disruption and uncertainty.

Q13. What do you consider to be the most important interactions which should drive our project timelines?

32. We would like clarity on how decisions on local governance will be factored into the RII0-ED2 timeline. In particular, we are seeking to avoid delay, disruption and uncertainty that is not in customers' interests.