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2 August 2023.

Sent by email to: FSO@ofgem.gov.uk

Dear David,

Funding the transition to a Future System Operator

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

We agree that National Grid (NG) and National Gas Transmission should be assured that efficient and economic costs incurred in establishing the standalone FSO should be fairly reimbursed. We welcome that, in these proposals, Ofgem aimed to strike an appropriate balance between facilitating the timely implementation of the Future System Operator (FSO) and protecting consumers. We think that the consumer protections can be improved and we discuss the improvements below.

The demonstrably wasteful and inefficient expenditure mechanism should also be applied to National Grid's costs:

We agree that the demonstrably wasteful and inefficient expenditure (DIWE) mechanism should be applied to the Electricity System Operator's (ESO's) FSO costs. In addition, we recommend that the DIWE mechanism should also be applied to NG's FSO costs.

We understand the rationale supporting the proposal to not apply the DIWE mechanism to NG's FSO costs, but we disagree. NG's costs are expected to account for about 50% of the FSO implementation costs to be incurred to 'Day 1', while the ESO's costs account for the remainder.[1] Decisions about FSO implementation costs to 'Day 1', whether the costs are incurred by NG or the ESO, will ultimately be made within the same ownership group.

Applying the DIWE mechanism to only about 50% of the FSO implementation costs creates the risk that cost allocation could be influenced by whether costs fall within the scope of the DIWE

[1] The latest view of costs is shown in tables 2-4 of the consultation. Costs expected to be incurred by National Gas Transmission account for less than 1% of the implementation costs to 'Day 1' and, so, are ignored for simplicity.

mechanism. This risk may arise in relation to both the allocation of costs across parties and across categories of costs attributable to NG (e.g. implementation and consequential costs). As a result, the protection (against consumers having to fund inefficient costs) offered by the DIWE mechanism may by weaker than intended.

We also disagree with the proposal because it is possible that relevant information could be identified during an ex-post assessment that could change Ofgem's initial view of cost efficiency. Not applying the DIWE mechanism to NG's FSO costs could prevent such relevant information being identified and, therefore, could prevent Ofgem acting to protect consumers' interests. We acknowledge concerns that an ex-post assessment of NG's costs could add material risk of FSO implementation delays.[2] However, the components of the ESO-NG contract (such as payment approval at milestones)[3] should significantly mitigate the risk of misaligned expectations. Furthermore, Ofgem has not explained why it considers that applying the DIWE mechanism to NG's costs could materially increase the risk of implementation delay while applying the same mechanism to the ESO's costs either will not increase the risk of delay or that risk is deemed acceptable.

The intent that the DIWE mechanism acts as an incentive and backstop protection[4] should apply to all costs regardless of the party that incurs costs. This becomes even more important given the scale of costs involved.

The disallowance cap should be reviewed:
The disallowance cap should be reviewed depending on how the ESO's FSO implementation costs are treated in the ESO's/FSO's price control.

Based on the ESO's 2021-23 (BP1) plan, the ESO's regulatory asset value (RAV) was forecast to increase by about 28% over the RIIO-2 period to £353m and annual expenditure was expected to peak at £266m or at 4% above expenditure in the first year. FSO implementation costs were not included in the BP1 plan. Since then, based on the 2023-25 period (BP2) plan, the ESO's RAV is now forecast to increase by about 84% over the RIIO-2 period to £497m, while annual expenditure is now expected to peak at £401m or at 65% above expenditure in the first year. FSO implementation costs were included in the ESO's BP2 plan.[5]

The ESO's RAV at the end of the RIIO-2 period is now forecast to be 41% higher than previously expected while the peak annual expenditure is now forecast to be 46% higher (as shown in the tables below). Some of the significant increase in the RAV appears to be due to the inclusion of FSO implementation costs in the expenditure from which the RAV is derived.[6]

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[2] Paragraph 4.42 of the consultation.
[3] Paragraph 4.39 of the consultation.
[4] Paragraph 4.65 of the consultation.
[5] See section 15.9 of https://www.nationalgrideso.com/document/266156/download.
[6] See page 3 of https://data.nationalgrideso.com/balancing/monthly-balancing-services-use-of-system-bsuos-forecast-reports/r/bsuos_forecast_august_2023.

Table 1: forecast RAVs

	2021-22	2022-23	2023-24	2024-25	2025-26
BP1[7]	275.6	302.2	329.3	348.9	353.1
BP2[8]	269.6	312.2	390.7	459.1	497.0
variance	-2.2%	3.3%	18.6%	31.6%	40.8%

Table 2: forecast expenditure

	2021-22	2022-23	2023-24	2024-25	2025-26
BP1	255.8	248.2	260.2	265.9	256.1
BP2	242.9	292.4	385.6	401.4	374.4
variance	-5.0%	17.8%	48.2%	51.0%	46.1%

The disallowance cap was set at 2.5% of the RAV for the entire RIIO-2 price control. The incentive 'strength' of the DIWE mechanism (or the financial value of the maximum disallowance) 'flexes' with expenditure within any given year. The manner in which the ESO's FSO implementation costs appear to be treated in the ESO's price control financial model (PCFM) – as part of allowed expenditure - maintains the incentive 'strength' of the DIWE mechanism agreed for the RIIO-2 price control. However, the way in which it appears that the ESO's FSO implementation costs are treated in its PCFM does not seem to align with Ofgem's previous decision: that the ESO's FSO implementation costs should not be classed as totex or added to its RAV.[9]

Treating the ESO's FSO implementation costs as pass-through costs (as per Ofgem's previous decision) effectively weakens the incentive 'strength' of the DIWE mechanism because those costs will not influence the size of the RAV. We consider that the effective weakening of the incentive 'strength' of the DIWE mechanism is not an intended consequence of treating the ESO's FSO implementation costs as pass-through costs. This is because Ofgem has not sought to explain or justify why the ESO should place different levels of focus on incurring efficient costs depending on the purpose for which those costs are incurred.

As a result, we recommend that Ofgem should consider how the incentive 'strength' of the DIWE mechanism that was agreed at the start of the RIIO-2 price control can be maintained whilst also treating the ESO's FSO implementation costs as pass-through costs. One way in which this can be done is by Ofgem making clear that the ESO's FSO implementation costs will contribute to the derivation of the ESO's RAV <u>solely</u> for the purposes of the calculating the disallowance cap.

The Cost Recovery Principles should be expanded:
As currently drafted, the Cost Recovery Principles do not explicitly place focus on cost efficiency. We recommend that the Principles are expanded to explicitly state that only costs that are demonstrated to be efficient can be recovered.

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[7] Values are taken from the PCFM that was published in February 2021. See https://www.ofgem.gov.uk/publications/eso-price-control-financial-model
[8] Values are taken from the PCFM that was published in December 2022.
[9] Paragraph 4.2 of the consultation.

We hope that you find this response useful. Please do not hesitate to contact me if you would like to discuss any aspect of this response.

Yours sincerely,

Gregory Edwards
Network Regulation Manager
Centrica Regulatory Affairs, UK & Ireland