



Bringing Energy
Together

ADE Response to RIIO-2 Sector Specific Methodology – ESO consultation | 14 March 2019

Context

The Association for Decentralised Energy welcomes the chance to respond Ofgem's **consultation on the RIIO-2 Sector Specific Methodology for the Electricity System Operator**. The ADE is the UK's leading decentralised energy advocate, focused on creating a more cost effective, efficient and user-orientated energy system. The ADE has over 160 members active across a range of technologies, and they include both the providers and the users of energy. Our members have particular expertise in demand side energy services, including demand response and storage, as well as combined heat and power, district heating networks and energy efficiency.

This consultation response is structured as follows. First, we highlight a number of issues with how the current incentive scheme and price control works, followed by a suggestion for how to structure the ESO's RIIO-2 plan to avoid these issues. Next, we provide a list of key asks that would help to deliver the flexible, low-carbon, resilient system of the future. In the final section, we respond directly to the questions raised in the consultation.

ADE vision for RIIO-2 ESO

There are a number of issues with how the ESO incentive scheme and price control framework currently work:

- ESO plans often provide a list of actions that are being undertaken, rather than a vision containing big goals and clear milestones towards these goals
- There is no clear definition of what success looks like
- Too many areas are listed as 'exceeding baseline'
- Delivery timelines are frequently delayed or unambitious, but are rarely penalised
- Some of the roles have targets that are unambitious or too vague
- Reforms in key areas, such as introduction of enabling technology and reform of balancing services, sometimes lack speed or ambition
- Rewards are split equally across the principles in the incentive scheme, despite the differing levels of consumer value delivered

The ESO's RIIO-2 framework should, therefore, be structured differently. The price control should be structured per role, with a number of big, audacious goals that Grid want to achieve by 2026, and clear milestones along the way for each goal. Under each role, the activities that would be expected of an efficient, modern System Operator would be set as 'baseline', with the milestones towards each goal set as 'exceeding baseline'. These categories would be allocated varying levels of risk, and therefore of margin, according to Ofgem's analysis.

The activities that are 'exceeding baseline' (i.e. the milestones towards the big goals) would be evaluated through the incentive scheme, with National Grid providing six-monthly updates to a Performance Panel and wider stakeholders to demonstrate how they are working towards the goals and if they are ahead or behind on the overall plan. This approach aligns the core Business Plan and the incentive scheme much more closely, rather than splitting the ESO's actions and goals into two categories. Moving to this approach would also make it much clearer which activities constitute 'baseline' and which are 'exceeding baseline', making success easier to demonstrate and evaluate.

Key asks for RIIO-2 ESO

Step change in transparency

- Publish planned technical upgrades (e.g. EBS), different options and parameters relating to them and plan to seek tenders from third parties in all relevant areas
- Publish details of all bilateral contracts (in aggregated form per service, to protect commercial confidentiality) and a timetable for phasing them out
- Publish timetable for introduction of close to real-time, pay-as-clear competitive auctions in all Balancing Services and details of each auction's structure
- Publish short and medium-term system need forecasts, with predicted volume requirements for each service and relationships and volume trade-offs between services
- Publish evolving strategy for system operability and ESO-DSO interaction
- Include all system actions taken by National Grid on portal, with clearly tagged rationales
- Provide a full breakdown of where volumes are procured from for all Balancing Services
- Publish all data (where necessary, anonymised or aggregated) held by National Grid, with explicit justification needed for any decision not to publish. All data should be published in accessible, standardised formats
- Create and publish a metric of how every MW of flexibility contributes to renewable penetration and reduces cost to the consumer through avoided reinforcement costs

Market structures

- Design markets around system need, not technical capability – rewrite technical requirements for existing products and introduce new products where needed
- 50% of the market to be comprised of non-traditional participants by 2026
- Introduce close to real-time, pay-as-clear competitive auctions in all Balancing Services by 2026. Any decision to procure a service in a different way would require explicit justification based on industry consultation and a published impact assessment
- Remove any artificial market separations, such as between Firm Frequency Response and Mandatory Frequency Response
- Demonstrate how the ESO's actions are contributing to annual reductions in the average carbon intensity of the grid
- Mandate National Grid to demonstrate that their current approach (algorithmic scheduling through EBS, followed by manual dispatch) is at least as efficient as algorithmic dispatch of plant (modelled by Ofgem). The size of any difference in efficiency should affect how much money NG receive through the incentive scheme.

Infrastructure and flexibility

- Open the Strategic Wider Works process to market participation – describe the system need, see what viable solutions exist and let market participants tender to provide them. A genuinely open Strategic Wider Works process could include the following aspects (not comprehensive):
 - i) National Grid running a full engagement process for each new system need, with workshops with interested participants and clear signposting of opportunities to tender
 - ii) Release of a more detailed and collaborative NOA roadmap, with joint Transmission and Distribution planning and stakeholder involvement
 - iii) Cost-benefit analysis factoring in all avoided costs resulting from the use of non-network solutions
 - iv) Transparent decision-making, with publication of all criteria used to decide and reasoning for the choice made
- Target at least three pilot projects for market provision of Strategic Wider Works in the first business plan

Questions

ESQ1. Do you agree with our proposal to maintain the current roles and principles framework for RIIO-2?

The ADE agrees with the proposal to maintain the current framework. The framework has widespread stakeholder approval and has only been implemented recently, so wholesale reform appears unnecessary. We support the refinements discussed in Ofgem's **call for input for changes for the 2019-20 scheme**, particularly the proposal that the evaluation process be carried out per 'role area', rather than 'per principle'. This should make it easier for deliverables and consumer benefits to be evidenced by the ESO and assessed by the Performance Panel.

Ofgem should consider how the changes to weighting (with £10 million associated with the delivery of both Roles 3 and 4, and £10 million each for Role 1 and Role 2), affects the ESO's perception of the importance of each role. If Role 3 and 4 together provide the same consumer and system benefit as one of Role 1 and Role 2, the weighting is correct. If the two roles provide more benefit, the weighting will need to be adjusted. It is possible that Role 3 (Whole System Outcomes) would be better seen as a key prerequisite of the ESO's actions across the other three roles, rather than being a specific role in its own right.

ESQ2. Do you agree with our proposals to keep the ESO's code administration, EMR delivery body, data administration, and revenue collection functions in place for RIIO-2? Do you believe that any of these functions (or any other functions) should be opened up to competition, either now or in future?

The ADE agrees with the proposals to keep these functions in place for now but notes that the ongoing review of code governance and implementation of market-wide half-hourly settlement could open some of these functions up to competition in the future. The benefits of competition should be balanced against the risk of fragmentation, with any changes to these functions being considered as part of a wider package of reforms.

ESQ3. Do you consider the ESO is best-placed to run early and late competitions?

The ADE believes that the ESO can play an important role in promoting competition on networks. This process has already begun with the proposal to include non-traditional solutions in the NOA

but should be developed into providing a holistic view of network investment, with competition from third parties and implementation of non-network solutions when more economic and efficient. There is a strong case for the ESO running early and late competitions, which merits further consideration and analysis. The ESO is likely to be in a better position to run these competitions than network operators. There may also be merit in identifying which other bodies could potentially perform this role.

ESQ4. Do you agree with our proposal to move to a two-year business planning cycled price control process for the ESO? If not, please outline your preferred alternative, noting any key features (e.g. uncertainty mechanisms or re-openers) that should be included.

It is essential that the length of the price control strikes a balance between the ability for stakeholders and Ofgem to revise targets over relatively short time-frames (to reflect changing system needs) and the need to provide enough of an incentive to invest for the long-term. The two-year business planning cycle provides frequent opportunities for stakeholder input and for recalibration of the ESO's incentives, which is welcome. The evaluative framework introduced in April 2018, while not perfect, has driven increased stakeholder engagement and accountability. It is vital, however, that Ofgem provide more detail on how the two-year business planning cycle will interact with the longer price control.

If the two-year cycle is implemented, it is crucial that Ofgem provide the necessary comfort to mitigate the risk to the ESO of engaging in expenditure that goes beyond a two-year time horizon, such as IT upgrades or recruiting and training staff. If a project requires investment over more than two years and will drive significant system benefit or consumer value, the ESO should submit the forecast costs beyond the two-year window to Ofgem. If the costs are agreed to be reasonable and the project is delivered in line with them, the ESO should be able to have confidence that these costs will continue to be financed beyond the current two-year period. If the project runs far over predicted cost, there should be a mechanism for reassessment of whether its delivery is still the most economic and efficient outcome or whether the original intent can be achieved in a different way.

The mechanics of how to provide this comfort are a matter for Ofgem, but precedent exists in the Data Communications Company price control, where annual budgets are set but future costs are forecast and agreed. Clearly, this approach would have to be tailored in order to reflect the ESO's unique position in the system and needs.

ESQ5. What stakeholder engagement mechanisms should be put in place for the ESO's business planning and ongoing scrutiny of its performance? Do you agree with our proposal to maintain, and build upon, the role of the Performance Panel?

The ADE agrees with the proposal to maintain and build upon the role of the Performance Panel. The role of the Panel is crucial in giving stakeholders a strong voice in scrutiny of the ESO's performance.

It is essential that the ESO engages in regular stakeholder engagement throughout the development of its RIIO-2 business planning process, and that it demonstrates explicitly how the Plan has been shaped and altered in response to stakeholder feedback.

ESQ6. Do you agree with our proposed approach of using evaluative, ex-ante incentives arrangements for the ESO?

The ADE agrees with the proposed approach. As noted above, the arrangements have driven increased stakeholder engagement and accountability.

ESOQ7. Do you agree that we should continue to apply a single 'pot' of incentives to the ESO, and that this should be a symmetrical positive/negative amount? If not, why not?

The ADE believes that Ofgem should give further consideration to the use of several pots of incentives, each aligned with one role and the goals underneath this role. This would make it clearer to the ESO what evidence should be submitted for fulfilment of each role and easier for the Performance Panel to assess them. It also allows the potential for different weighting for different roles to be made more explicit, enabling stakeholders to provide feedback more easily. The use of several pots could also allow more flexibility to decide which incentives should be symmetrical and whether any should be asymmetrical.

ESOQ8. Do you agree with our proposed approach to assessing the costs of the ESO under RIIO-2? Do you think we should assess costs on an activity-by-activity basis? How would you go about defining the activity categories? Are there alternative approaches we should consider?

The ADE agrees that costs should be assessed on an activity-by-activity basis and split into capex and opex; this should allow a more transparent assessment process and for different risk margins to be allocated to different activities. We disagree, however, with the suggested activity categories, which fail to directly link the ESO's activities to the roles emphasised by the incentive scheme.

As Ofgem state in the consultation, principles-based cost categories would be likely to involve significant overlap. We believe, however, that there would be merit in using roles-based cost categories, which would then be broken down into activities with different levels of risk and margins. This approach aligns with Ofgem's suggestion that evaluation for the incentive scheme be carried out per role area in the [call for input for changes for the 2019-20 scheme](#).

Basing cost assessment activities on roles could allow closer integration between ESO cost assessment and the incentive scheme. It would allow all activities to be captured under the ESO activity framework, with those activities that are baseline to the running of an efficient system operator, such as facilitating and running markets to balance the system, alongside milestones to achieving each role's big audacious goals, such as implementing close to real-time competitive auctions for as many services as possible. The latter milestones would constitute 'exceeding baseline' activities and would be evaluated, and their delivery rewarded through the incentive scheme. It is vital that all activities are included in the ESO cost assessment in order to embed them within the core work of the ESO.

The ADE believes that the key asks outlined at the beginning of this consultation response should form the basis of some of the 'exceeding baseline' cost assessment activities and prioritised through the incentive scheme.

ESOQ9. Do you consider the types of cost assessment activities we outline in this chapter are the right ones? Are there additional activities you think we should consider?

Please see our response to Q8.

ESOQ10. Do you agree with our proposed remuneration model for the ESO under RIIO-2? Do you think it provides the right incentives for the ESO to deliver value for money for consumers and the energy system? Are there other models you think are better suited?

The ADE agrees that a layered funding model is suitable for the ESO and that a 'cost pass-through plus margin' approach could provide the right incentives for the ESO, as long as it is designed carefully.

The move away from a cost sharing factor, while creating risks (please see below), provides a strong incentive for the ESO to focus on strategic investments for wider system and consumer benefit, rather than a narrow focus on reducing internal costs. For a service-oriented, facilitative organisation with relatively small internal costs and a crucial strategic role in the energy system, this incentivisation is important. The remuneration model should help to increase the relative power of the incentive scheme, giving stakeholder priorities more weight.

Ofgem should ensure that the interaction between the margin, incentive scheme and any ESO-specific innovation funding provides strong enough incentives to engage in strategic investment.

ESOQ11. Are there any risks associated with our proposed remuneration model that you do not think have been effectively captured and addressed? Do you think that we should put in place any of the mechanisms intended to provide additional security to the ESO outlined in this chapter – e.g. parent company guarantee, insurance premium, industry escrow or capital facility?

There are two risks associated with the model which, though discussed in the consultation, merit further consideration.

First, there is a risk that the combination of implementing a cost pass through model and removing the cost sharing factor could, without appropriate checks, remove incentives for the ESO to focus on efficient and economic delivery of projects. Ofgem should ensure that they provide a sufficiently clear definition of what constitutes 'demonstrably inefficient' spending that would be subject to the cost disallowance mechanism. If this is not clearly defined, it is likely that the mechanism will be ineffective. Likewise, it is important that the ESO's requirements under the cost trigger mechanism are clearly defined, specifying the percentage over budget that a project would have to reach in order for the ESO to be required to inform Ofgem and the Performance Panel.

Second, and conversely, the measures that Ofgem have suggested to address these risks could, if implemented incorrectly, inadvertently incentivise risk-averse behaviour by the ESO. If the cost disallowance mechanism is incorrectly designed, it could lead to the ESO focusing on minimising costs due to a worry that large amounts of costs could be disallowed. This risk can be mitigated by ensuring that the ESO provides clear projections of future costs for all projects, with sufficient opportunity for Ofgem and industry stakeholders to provide challenge, together with a cap of cost disallowance at a certain percentage of ESO revenues, as occurs under the price control for the System Operator of Northern Ireland.

Of the mechanisms mentioned to provide additional security to the ESO, an insurance premium or financial facility could be the most preferable, depending on the level of operating cost that would be added. A parent company guarantee would have to be carefully structured to avoid creating an indirect incentive to reduce costs in order to reduce National Grid plc's overall liabilities. Industry escrow is likely to be inappropriate.

ESOQ12. Do you agree with our proposal relating to remove the cost sharing factor? Can you foresee any unintended consequences in doing so, and how could these be mitigated?

Please see our answer to Q11.

ESOQ13. Do you agree with our proposal to introduce a cost disallowance mechanism for demonstrably inefficient costs? What criteria should we apply in considering what constitutes 'demonstrably inefficient'?

Please see our answer to Q11.

ESOQ14. Do you agree with our proposals to retain an innovation stimulus for the ESO, but tailor aspects of this innovation stimulus to take account of the nature of the ESO business?

The ADE agrees with the proposals.

ESOQ15. What ESO-specific issues should we consider in the design of the ESO innovation stimulus package?

As mentioned in the consultation, Ofgem should consider where ESO innovation funds would be recovered from and how to alter the NIA to make it appropriate for the ESO if it is retained.

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