



## OVO Response

### RIIO2 sector specific methodology response

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#### **Introduction**

OVO is the UK's largest independent energy technology company and supplier. Across the group, OVO serves 1.5 million customers with intelligent energy services. Founded in 2009 by Stephen Fitzpatrick, OVO redesigned the energy experience to be fairer, greener and simpler for all. Today OVO is no longer simply an energy retail business: it is a group of innovative, dynamic companies, all striving to harness technological advances with great consumer propositions to create more abundant clean energy for everyone.

Kaluza is part of OVO Group and was launched to accelerate the transition to a zero carbon energy grid. Kaluza provides tech-enabled solutions to support the integration of electric vehicles, battery storage and renewable energy onto the grid. Kaluza's intelligent platform unlocks the value of connected devices, harnessing flexibility to help balance the system and create returns for businesses and their customers.

OVO firmly believes in the opportunities that emerging energy technologies present for addressing the complex challenge of providing reliable, affordable, balanced, and renewable energy at scale. The Kaluza platform is the first to deliver ancillary services and energy arbitrage. Innovations like these will be critical in changing demand flows, balancing the system and preventing under-utilisation and over reinforcement of the grid.

#### **Executive Summary**

OVO supports the focus that Ofgem has placed in this sector specific methodology on unlocking the whole system benefits that networks can offer. The RIIO-2 price control and the network charging reforms have potential to realise a framework that enables consumers and the energy system to truly benefit from the value energy flexibility holds. However, what is proposed in this sector methodology will not realise the full value of what flexibility can offer. We call on the RIIO-ED2 proposals and the network charging reforms to create sufficient pricing dynamics to achieve a mature, competitive flexibility market.

Specifically, the competitions for specific projects referenced in Chapter 8, although aimed at flexibility will result in uncoordinated change. It would be better for the system and consumers, for flexibility to be considered at all decision points, not just when making a reinforcement decision.



## **Cross-sector questions**

### **Output categories questions**

**CSQ5. Do you agree with our proposals to introduce dynamic and relative incentives, where appropriate? Are there any additional considerations not captured in our proposed framework which you think we should take into account?**

Yes, incentives need to be more dynamic, particularly at ESO level to allow National Grid and other network operators to make decisions about how to use the network more efficiently. Dynamic incentives need to go further than outlined and regarding the structure presented, some discrete funding decisions have been accounted for while others have not.

Networks should be rewarded for increasing overall network utilisation. Using a dynamic “improvement factor” risks setting the pace of change for the next five years. It would be better to create a performance-based incentive design which would encourage companies to increase their pace of change.

The proposed framework may leave Ofgem unable to accurately measure customer value and congestion of the system - given the lack of infrastructure that is in place to properly meter customers. This is a particular problem given the lack of Half-Hourly Settled (HHS), Smart Meter Points.

**CSQ6. Do you agree with our proposals to introduce dynamic and relative incentives, where appropriate? Are there any additional considerations not captured in our proposed framework which you think we should take into account?**

Ofgem should ensure that its over-arching framework allows for flexibility and agility throughout the price control period. As such, the need for bespoke outputs should be minimal. Where it may be required, Ofgem should ensure that the whole-system benefit has not been reduced by the more individual approach. There is a risk that this drives localised decisions at the expense of a more efficient system.

### **Enabling whole system solutions**

**CSQ8. Do you feel we have defined the problem correctly?**

In order to answer this question, the following definition of the problem has been used: *“The problem to be solved is how to enable greater levels of co-ordination*



*between different parts of the energy system in investment planning, and operational delivery, so that the sum of costs across the system is minimised”.*

Added to the above problem should be the recognition of beneficial whole system outcomes including decarbonisation, value for money for customers and resilience of the grid.

It is welcome that this question recognises the problem of a lack of co-ordination across different parts of the energy system. This problem extends to the different regulatory reforms that are underway and is particularly problematic for creating a pricing framework that realises the full value of what flexibility can offer to the customer and to the system.

The RIIO team should ensure that the sector methodologies, RIIO-ED2 proposals, the ENA's Open Network's Programme and the network charging reforms under SCRs create the pricing structures needed for a flexible energy system. This should be underpinned by an obligation for DSOs and TSOs to increase average utilisation rates across all infrastructure assets. This type of outcome driven approach would deliver material benefits to consumers and place an implied obligation on the industry to improve productivity levels.

It is particularly concerning that the RIIO-ED2 price control is not being consulted on as part of this sector specific methodology package. The lack of its inclusion here undermines attempts to consider whole system outcomes. Ofgem should consider what structures will be in place across reform to ensure ED2 is aligned with the desired outcomes of charging and pricing reform.

Overcoming lack of co-ordination is the right approach to take to reform the problems identified, including incorrect incentives, insufficient information and the ways these influence behaviours and processes are correct. However, of the six ways identified to address this problem, we do not believe these will create the right incentives to create the behaviour change/outcomes desired.

A reliance of Business Plans to overcome some of these co-ordination challenges is unsatisfactory because they are based on existing “Business As Usual” (BAU) incentives. There's also a lack of clarity on DSO activities and responsibilities, and the relationship with the ESO. For instance, it is unclear how DNOs will be funded to develop DSO capability and what the drivers of their performance will be and how these will be applied.

**CSQ9. What views do you have on our proposed approach to adopt a narrow focus for whole systems in the RIIO-2 price control, as set out above?**

Not included in this approach is the fact that facilitating the greater electrification of the energy system will also support the electrification of the transport and heat sectors in a cost efficient way.



Given the increased need to supply energy for electric vehicles and electric heating, the cost of the electricity sector could increase by up to 40%. However, modelling by Imperial College London<sup>1</sup> shows that this cost is more than offset by the displacement of the cost of fuel for transport and heat and their associated carbon emission if the transition is facilitated in an efficient way (e.g. by maximising the use of networks and renewables through flexibility).

**CSQ10. Where might there be benefits through adopting a broader scope for some mechanisms? Please provide evidence.**

Ofgem should ensure that the networks are properly incentivised towards increased decarbonisation in the most efficient way in order to achieve the outcome of a low carbon, low cost system for consumers. This should be facilitated by pricing mechanisms that reward the network operators for improved network utilisation.

Ofgem risks under-valuing the role flexibility has to play in keeping the cost of the system down by not recognising the impact a low cost, decarbonised energy system will have on the transport and heat sectors.

CSQ11. Do you have reasons and evidence to support or reject any of the possible mechanisms outlined in this chapter? Do you have views on how they should be designed to protect the interests of consumers?

Flexibility should be considered at the point the constraint on the network is identified as an ongoing management activity. A price signal should be ongoing to ensure the industry continues to invest.

1. Business Plans
  - a. We have concerns about reliance on Network Companies Business Plans because creating the right framework would be completely reliant on how flexibility service providers were able to engage with network companies. It would not create an underlying flexibility market that providers could compete in.
  - b. There are no tools of measurement outlined in the Business Plan proposal to assess how network companies have worked with companies offering whole system benefits.
  - c. We do support the financial rewards and penalties suggested in the proposal.

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<sup>1</sup> Imperial College London, Blueprint for a post-carbon society report:  
<https://www.ovoenergy.com/binaries/content/assets/documents/pdfs/newsroom/blueprint-for-a-post-carbon-society-how-residential-flexibility-is-key-to-decarbonising-power-heat-and-transport/blueprintforapostcarbonsocietypdf-compressed.pdf>



- d. It is noted that companies that could demonstrate how they are “stretching” their ambition could be financial rewarded, however no detail is provided on how this will be measured.
2. Ensuring network innovation has a whole system focus
  - a. We agree that innovation is absolutely vital to ensuring network companies facilitate and contribute to a sustainable and cost-effective energy sector.
  - b. Innovation stimulus is not sufficient. Innovation should be part and parcel of BAU. As with normal businesses, companies should adopt innovation because it makes them more efficient and produces better outcomes. By silo-ing innovation into separate, non-BAU funding and projects.
  - c. Using innovation funding for one-off projects to try solving problems that are fundamental to the changing nature of energy is not a successful outcome.
3. Coordination and information sharing incentive
  - a. Options analysis to identify whole-system solutions should be an expected requirement from network companies, rather than an “additional” activity. In a competitive environment, continuing with “BAU” without identifying more valuable options would be detrimental to the business and this dynamic should be a consideration for network companies.
  - b. As currently drafted, the proposals, even penalisation of non-delivery, could encourage piecemeal project-by-project analysis. It would be more efficient to provide an underlying whole-system benefits framework, where performance is judged by whole system outcomes.
  - c. Ofgem shouldn't introduce onerous administrative behaviours (and cost) without clear benefits identified. However, we agree there are a range of clear benefits that could come from better coordination and information sharing. Additionally, any industry body should be able to identify a need for additional data sharing and there should be a process to require this sharing from the companies.
4. Balancing financial incentives between traditional and whole systems behaviour.
  - a. If conflicting price controls between licensees is not in scope, Ofgem should publish clear guidance on the overlaps and distinctions between RIIO and SCR activities.
  - b. Ofgem should consider that “BAU” activities may be changing on a more fundamental level, and therefore appropriate performance

incentives should account for this. Flexibility should be considered at all decision points, not just when making a reinforcement decision, and should rapidly be considered a “BAU” activity.

- c. Incentives that can be shared or transferred across ESO and DNOs to enable better whole-system solutions are strongly supported. Successful sharing of financial incentives could engender a competitive environment between network companies to deliver the most benefit to the whole system. Networks could “bid” to access funding, evidencing the outcomes achieved to receive an additional “bonus” payment (or avoid disallowed spending).
5. Ensuring the framework is able to flex to meet whole system needs
- a. Introducing the facility to re-open the price control for projects which operate across multiple networks and deliver a whole-system benefit would be beneficial. However, a suitably flexible framework for incentives would limit the requirement for this to happen
6. Whole system discretionary funding mechanism
- a. OVO supports the inclusion of a discretionary mechanism that could provide additional funding for previously unknown projects that would deliver a whole-system benefit.
  - b. However, could this not be better achieved by a more robust funding framework rather than piecemeal projects.

**CSQ12. Which of the possible mechanisms we have outlined above could pose regulatory risk, such as additionality payments or incentivising the wrong Behaviour?**

Rather than the above options, it would be better to provide an underlying framework that better considers whole-system outcomes.

**CSQ15. Are there other mechanisms that we have not identified that we should consider (please give details)?**

Networks should be incentivised to support the wider activities that result in whole-system benefits (delivering these may be out of scope of this review, but incentivising National Grid appropriately to achieve this aims should be included in the scope).

There may be instances where another party identifies or can deliver a better solution than the network companies themselves. Ofgem could consider a mechanism to redirect funding from the network to a third party (or support the networks to do this). This could work in the same way as sharing incentives between network companies.



Ofgem should look to define a framework of “consumer benefit” and index network incentives to the whole system benefits customer would receive. This would allow much more flexibility within the price control period with less intervention required from Ofgem.

### **Managing the risk of asset stranding**

**CSQ39. Do you think there is a need for a utilisation incentive at the sectoral level? If so, how do you think the incentive would operate coherently with the proposed RII0-2 price control framework for that sector?**

OVO advocate the use of network utilisation incentives, across network activities. This includes when considering the risk of asset stranding. We do not recognise Ofgem’s assertion that low-demand scenarios are a low probability; we would suggest that successful deployment of flexibility and smarter grids may result in a flatter consumption profile and therefore while total demand may increase, expected peak demand may actually reduce. If this is not considered appropriately, networks will continue to be biased towards traditional reinforcement decisions at the expense of flexibility that delivers whole-system benefits and ultimately a cheaper system for the consumer.

### **Innovation and competition**

It is recognised that specific consideration has been made in Chapter 8 towards competition incentives aimed at procuring flexibility. However, we would say that this model - funding for a project, or a single event - would not lead to a dynamic competitive process through the price control period, and would result in uncoordinated change.

The lead time between competition and delivery should be considered in order to appropriately incentivise resolving constraints ahead of reinforcing for them. Additionally, the capital cost of participating in any competitions should be considered in order to not perpetuate or create new barriers to entry.

We would advocate instead, introducing a robust overall framework, something along the lines of a “flexibility market” that could take place every day, not every year.

These competitions and model - funding for a project, or a single event - will not lead to a dynamic competitive process throughout the price control period, and will result in uncoordinated change that do not deliver the most beneficial whole system outcomes.

We would advocate instead, introducing a robust overall framework, something along the lines of a “flexibility market” that could take place every day, not every year.





## **Business Plan and totex incentives**

Ofgem should recognise that the systematic over-forecasting of companies for RIIO1 suggests that the mechanism for challenge of business plans was not strong enough.

Ofgem should therefore adjust its' confidence in its' assessment ability appropriately, especially in the context of its proposals for the ESO. This may result in a greater preference for benchmarking or more stringent evidencing from companies required.

## **Ensuring fair returns**

"Failsafe" mechanisms should not be used to allow companies to recover the costs of poor decisions from consumers. Material deviations from expected returns should be critically assessed, including by industry, before being permitted so that there is not a perverse incentive for companies to use the mechanism for protecting extreme downside risk while retaining upside. This could incentivise companies to take undue risks or poor decisions at the cost of the consumer.

## **ESO consultation questions**

### **ESO roles and principles questions**

**ESO Q1-3. Do you agree with our proposal to maintain the current roles and principles framework for RIIO-2? Do you consider the ESO best placed to run early and late competitions? Do you agree with proposals to keep the ESO's function in place for RIIO-2, should any of these functions be opened up for competition?**

The ESOs flexible principles are supported. Provided the ESO is appropriately incentivised to facilitate innovation and seek whole system outcomes there are no clear opportunities in opening up the ESO's roles to competition that could not otherwise be secured.

Provided it is properly incentivised, the ESO should play a key role in facilitating a competitive flexibility market given its position to co-ordinate activity. However, the prioritisation of this function should be made clear in its roles and will be central to the ESO delivering against each of its 7 principles.

The relationship between the DSO and ESO should be clearly defined ahead of the control period.





### **Price control process**

ESO Q4-5 Proposal to move to a two-year business planning cycled price control process. What stakeholder engagement mechanisms should be put in place for scrutiny of performance?

OVO/Kaluza support a shorter business planning cycle. However, we note that a shorter planning cycle itself does not entirely resolve issues of agility and flexibility throughout the price control period.

It is concerning that there are not robust incentives for the ESO to consider the long-term framework and outcomes of price controls. It is possible that activities in one period will not materialise system benefits until subsequent periods, so Ofgem should ensure the ESO is incentivised away from short-term decision making and towards ensuring long-term business plans, feasible beyond 2 years.

One way of balancing long termism with agility could be flexible funding that is able to respond to developments in the system without the requirement for a 2-year structural review. This would allow funding to adapt and make the most of opportunities that arise, rather than losing the value of two years worth of benefits by not having the flexibility to respond to change.

If using an evaluative activity-based incentives framework, and given the reasons for systematic outperformance throughout RII01, there is an absolute need for industry to be able to robustly challenge and scrutinise the performance of the ESO.

Given the changing nature of the energy system, Ofgem should ensure that new players are effectively represented in the challenge function in order to avoid continuous lag in identifying new innovation opportunities. The ESO should be proactively identifying whole system benefit opportunities and encouraging companies who can deliver these benefits to be part of the engagement process. In addition, there should be the opportunity for stakeholders, as well as the ESO and Ofgem, to make the case for a change within the control period.

We urge Ofgem to ensure that engagement with this process is not so resource intensive that it increases costs, across both the ESO and industry. We believe this is achievable.

### **ESO Outputs and Incentives**



ESO Q6-7 Do you agree with our proposed approach of using evaluative, ex-ante incentives arrangements for the ESO? Do you agree we should continue to apply a single ‘pot’ of incentives to the ESO?

Provided Ofgem/ESO are transparent in their criteria for evaluation and that these are genuinely open to challenge, an evaluative approach to incentives would be supported.

There is a risk that the pace of market change and available data could mean Ofgem are unable to operate as an effective proxy to market forces. To mitigate this, Ofgem should use market-based information and industry engagement wherever possible to inform its’ thinking.

Market and industry engagement is particularly valuable when thinking about flexibility markets - as the DSO capabilities are developed, the ESO’s balancing role should be benchmarked appropriately. Balancing should (and will be) a competitive activity.

### **ESO Cost Assessment**

**ESO 8-9 Do you agree with our proposed approach to assessing the costs of the ESO under RIIO-2? Do you consider the types of cost assessment activities we outline in this chapter are the right ones?**

OVO agrees that the departmental level of assessing costs would be overly resource intensive and difficult to manage in practice owing to the overlap in responsibilities and potential for boundary effects.

Ofgem should define the time periods it is considering under its’ assessment, for instance, aims to “balance the system” should be defined over a certain term period.

This would also be a good place to make explicit that the ESO’s role is to engender an appropriate flexibility market and support the delivery of BEIS/Ofgem’s smart system’s and flexibility plan.

The ESOs activities should also include delivering an appropriate route to market and price signals for domestic flexibility and distributed generation. This should be a considered a core goal and not an “innovation project”.

Proposals to require the ESO to provide external benchmarking evidence and evidence of market testing risks under-valuing or ignoring novel technologies or nascent markets. Consumer engagement may need to go beyond the Performance Panel if the full scope of potential innovations in the market are really going to be considered.



Historical costs will grow increasingly irrelevant as previously considered innovative activities become business as usual. Ofgem should not put undue focus on historical evidence in its assessment, even when it is available. Appropriate market testing should be evidenced and whole-system benefit should be the core criteria upon which assessment is made.

### **ESO finance**

**ESO Q10-13 Do you agree with our proposed remuneration model for the ESO under RIIO-2? Are there any risks associated with our proposed remuneration model that you do not think have been effectively captured and addressed? Do you agree with our proposal relating to remove the cost sharing factor? Do you agree with our proposal to introduce a cost disallowance mechanism for demonstrably inefficient costs?**

Care should be made to ensure the ESO is not incentivised to over-spend or inflate its' cost base in order to increase allowed margin. The ESO should be required to robustly demonstrate that spending delivers genuine consumer value, and Ofgem should use a clearly defined ex ante cost/benefit analysis framework to support this.

### **ESO innovation**

**ESO Q14-15. 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? What ESO-specific issues should we consider in the design of the ESO innovation stimulus package**

The ESO should be incentivised to identify innovative opportunities to deliver whole system benefits. This can be achieved by an incentives framework that requires strong cost/benefit analysis over a longer-term timescale and not necessarily through specific innovation funding.

The structure of cost-passthrough and cost-disallowance should remove the disincentive against risk and therefore the use of specific innovation funding should have less of a role. Ofgem should be careful to avoid double-funding the ESO's required activities.