

RIIO-2 Sector Specific Methodology Annex: Electricity System Operator

ESO roles and principles

ESOQ1. Do you agree with our proposal to maintain the current roles and principles framework for RIIO-2?

Yes, the roles and principles are currently appropriate and remain a good basis for RIIO-T2 but should evolve in line with stakeholder feedback through the rest of the RIIO-T1 period.

ESOQ2. 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?

It is appropriate that the range of ESO activities which are a mixture of administration and management are managed as a package on behalf of the Government and the regulator for the benefit of consumers by the ESO. It is important for the ESO to continue to demonstrate they are not unduly commercially influenced by the outcomes in any way. The development of an appropriate regulatory and incentive regime is therefore critical.

ESOQ3. Do you consider the ESO is best-placed to run early and late competitions?

For the reasons set out in more detail, in response to the competition chapter of the main Sector Specific consultation, we support the ESO's role in continuing to make recommendations as to how we, as network companies, might best discharge our duties to deliver effective transmission and distribution networks.

A key issue of concern is the avoidance of actual or perceived conflict of interests. For this reason, the ESO may be seen as conflicted where choices between commercial alternatives, asset provision and hybrid options are required. The ESO interest in the outcomes of some solutions will offer scope for their own trading or other commercial interests must be recognised. Ultimately, the Regulator or government must be responsible for defining the suitability of providers who must become licensees for the period of operational service.

Depending on whether it is a competition for the market or competition in the market, ultimate responsibility for deciding the correct balance should be with the Regulator who has statutory duties to protect the interests of present and future consumers. The process should not be run by a body without enduring accountability, or in a way which is inconsistent with the statutory framework.

Price control process

ESOQ4. 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 unclear how a two-year business planning cycle differs from a two year price control. The proposals appear confusing and add complexity and uncertainty, undermining the fact that Ofgem are maintaining a five year price control.

The benefits of a two year business plan that Ofgem highlight are reasonable but these can be achieved through an appropriate funding model, such as the 'layered' approach.

It is crucial that the ESO has confidence and certainty of funding in certain areas and the bulk of their operational costs are not necessarily subject to the broader developments in the industry.

A longer price control will support decision making in early years that can bring benefits to consumer in future years. For example, TOs can offer constraint cost mitigation through alternative design and approach to infrastructure projects. For years this opportunity has been blocked by the incentive regime the GB SO operated under to reduce annual constraints against a forecast baseline.

It is imperative this opportunity is unlocked in the new regulatory framework and incentive package the ESO operates under.

ESOQ5. 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?

Yes, the concept of "principled" regulation that accompanied the introduction of the new ESO incentive package that is in place until 2021 is positive. It is still unclear of the benefits this will achieve but learning lessons and implementing improvements from experience and stakeholder feedback will help deliver the aspirations of this regulatory approach. We believe the Performance Panel is a useful addition to the regulatory oversight of the ESO and should, over time, be expanded to include a wider range of expertise and representation.

Outputs and incentives

ESOQ6. Do you agree with our proposed approach of using evaluative, ex-ante incentives arrangements for the ESO?

Yes the current framework is in the early stages of development and may or may not prove to be an appropriate regulatory approach for the ESO. It has potential to unlock benefits for consumer and should be continued to establish its merits or otherwise.

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 single pot approach is appropriate to retain at this stage but as the maturity of the assessment process develops a more targeted segmented incentive pot could be an improvement.

A means to develop an appropriate split of the incentive pot could be by introducing a balanced scorecard approach with high level metrics against the five key areas of consumer benefit the ESO laid out in their Forward Plan as fundamental to fulfilling their Mission:

1. Improved safety and reliability
2. Improved quality of service
3. Lower bills than would otherwise be the case
4. Reduced environmental damage
5. Benefits for society as a whole

The ESO should baseline its performance now to provide a benchmark position to demonstrate the effectiveness of the improvement activities being undertaken. The metrics should be able to demonstrate the current level of system safety and reliability, level of service overall, costs to consumers, environmental impact and levels of benefit for society and the economy.

These measures could be a basis for segmenting the incentive pot.

Cost Assessment

ESOQ8. Do you agree with our proposed approach to assessing the costs of the ESO under RII0-2? 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 approach appears quite complex for the relatively small value of operational costs the ESO incurs annually compared for example, to the value of balancing services costs they can influence. This could give rise to an excess in reporting and analysis that is not in consumer interests.

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?

To the extent that these activities are ring-fenced then there is merit if Ofgem decide to adopt this granular approach. Where there is overlap in shared services and responsibilities across the organisation, the effort to isolate these could be an unnecessary overhead and would not seem to be adding value for consumers. Ofgem should focus on higher level metrics.

Finance

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 proposed cost pass through plus margin approach relies on the ability to effectively isolate costs against each activity area. The ability to achieve this could be burdensome as highlighted in the previous answer. To the extent that this is an issue the cost plus approach has decreasing level of merit.

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?

The approach seems light touch in terms of protecting customers and incentivising efficient delivery. The cost disallowance mechanism could potentially be difficult to justify and could create a level of risk that undermines the ESO's confidence to incur expenditure in any area it consider may be disallowed. An upfront approval of expenditure would seem more appropriate with a recovery of inefficient costs above a certain agreed level.

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?

It is not clear this approach is of benefit to consumers with a risk that efficient expenditure is no longer incentivised or presents a risk to the ESO.

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 response to ESOQ11 above.

Innovation

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?

We agree with this approach.