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Dear RIIO-2 ESO team,

Further consultation on ESO RIIO-2 remuneration model

Thank you for the opportunity to respond to your further consultation on the potential remuneration models for a stand-alone price control in RIIO-2 for the Electricity System Operator (ESO).

As the Distribution Network Operator (DNO) for the North West of England, Electricity North West works closely with the Transmission System Operator. We are actively evolving to the new role and responsibilities of a Distribution System Operator (DSO) where our interaction with other parts of the energy system becomes ever more crucial.

Electricity North West has been actively involved in the stakeholder engagement activities with both Ofgem and the ESO as the RIIO-2 process continues and have shared our views both formally and informally at the appropriate points in the process.

This response is in addition to our previous response to the sector specific methodology response we provided in March 2019.

It is important that Ofgem takes the time to appropriately reflect on stakeholder feedback and considers all available options to setting a remuneration model for this unique type of business situation which differs from the RAV based companies that Ofgem traditionally regulates. However we also see the need for financial stability, regulatory certainty and effective incentivisation as the ESO builds their business plan and structures their business to ensure it is financeable and has the necessary funding to perform its role in a dynamic environment as society progresses the transition to a low carbon economy. It is therefore important that the remuneration component of any regulatory framework is settled in as timely way as possible, whilst recognising that key decisions need to be fully considered when setting a new style of regulatory framework and that the ESO must be financeable as a stand-alone entity including being able to be effectively incentivised.

We have supported and continue to prefer a hybrid approach, or what the ESO has called a layered model consisting of:

- continued treatment of existing RAV carried forward from RIIO-1;
- internal and external costs with an appropriate margin to reflect the activity and risk;
- strong incentivisation to drive positive behaviour and ensure the ESO is incentivised to deliver additional benefits for consumers.

We see this approach as providing a better overall outcome for consumers utilising innovation to avoid costs and seek alternative solutions and incentivisation to ultimately result in cost reduction for consumers.

Any stand-alone price control must be financeable for their specific company circumstances, and this is partly why we do not see a fully traditional RAV based model as appropriate.

We note that the consultation currently has, in some parts, fairly high level principles and approaches and therefore we cannot provide fully considered responses in some areas without further visibility as to how these approaches could be applied in more detail. We would expect that this new type of regulatory framework including the necessary detail will evolve over the coming months and may require further consultation as the options and details become clearer.

It would also be helpful for stakeholders to see worked models, particularly on any proposed treatment of RAV for the two options in order to better understand and be able to provide further comments on these proposals.

Of the decisions listed in paragraph 7.20 of the consultation document, there is no mention of the decision made on treatment of internal costs, nor is this the subject of further questions and therefore we are unclear as to Ofgem's intention in this area.

All of these points of detail could be addressed by Ofgem providing further information, or possibly via an industry workshop.

We would envisage that any customer bill impact resulting from the change from RIIO-T1 to RIIO-ESO2 would be relatively small, however it remains important to fully model the impact on customer bills as a result of this new price control regime.

Our detailed responses to each question are included within Annex 1 of this letter.

I trust our response is helpful to you, and should you wish to discuss any aspect of our response further, please do not hesitate to contact me.

Yours sincerely

P Auckland

Paul Auckland
Head of Economic Regulation

Annex 1 ENWL response

ESOQ1: Which funding model would most effectively remunerate the ESO and support its financeability? Would either model have any risks or unintended consequences that you can foresee? Are there other funding models you think would be more appropriate?

Of the two alternative models detailed in the consultation, we see Model 2 as being the most appropriate and flexible.

A price control for an asset light, service based business should consist of a funding model which provides cost pass-through plus an appropriate margin to provide a return based on risk and a clear incentive regime which is focused towards increasing customer value. On reflection we see benefit in having an asymmetric incentive regime, with greater upside and limited or no downside. If any downside is applied, we suggest that the maximum downside should be calibrated to value equivalent to a recovery at the maximum of margin recovery of the relevant activity which has under-performed, leaving "base costs" funded.

In order to justify a RAV based model there needs to be a steady and relatively predictable ratio of capital expenditure to operational expenditure, combined with assets which have a significant average life span. We state this on the assumption that the majority of any ESO owned assets are likely to be IT systems which have a much shorter asset life than say a Transmission network asset. As such, asset lives for the ESO are unlikely to lend themselves well to a RAV based approach or the RAV would need to have a high proportion of very fast money.

Any model which is taken forward can be adaptable to become a RAV based model in future years with a greater established business model, steady and predictable expenditure levels and types and in time could also incorporate a totex incentive mechanism. We think a totex incentive mechanism merits further thought and should be introduced as soon as possible once robust cost benchmarks are established as this would be in consumers interest to incentivise cost reductions.

Adopting a RAV based model with a relatively modest level of capital expenditure as a ratio to operational expenditure, combined with shorter asset lives would result in a greater mismatch of cash-flow timing, in turn resulting in the need for a greater value of capital facility.

A smaller and more variable RAV is unlikely to support high gearing, capital market debt or inflation linked debt. If the RAV model is to be adopted, Ofgem should consider setting notional gearing levels below that of DNOs and adopting a nominal return model, in order to ensure financeability of the ESO.

We are unclear as to what level/value of existing RAV from RIIO-1 is to be carried forward by the ESO and at what depreciation rate. If this is known, we will be able to provide a more informed response on this particular aspect.

ESOQ2: Is an additional return needed to reflect the potential risk of cost disallowance or other regulatory penalty? How would this additional return be best delivered – via a higher WACC or a margin on internal or external costs?

It is reasonable that companies should receive an appropriate return to reflect the risk that is held by them.

Where there is a risk of cost disallowance, then clearly the company bears further risk than if such a mechanism were not in place. We note in the consultation that the cost disallowance would only apply if spend were "demonstrably inefficient". We support this clarification of circumstances. We suggest that any cost disallowance, where it is applied, is only applied to the scale to either remove upto all the margin and any relevant incentive rewards allocated to relevant activities or to reduce costs down to Ofgem's view of an efficient cost if lower than removing all the relevant margin/incentive reward, rather than the full value of the demonstrably inefficient expenditure. Whilst unlikely that demonstrably inefficient spends happen, if there is a risk these could be in excess of the ESO's business to absorb these (through margin and incentive payments) then the business might be caused financial distress and face higher financing costs than otherwise the case.

This measure combined with a move to an asymmetrical incentive reduces the risk carried by the ESO company.

With regard to the aspect of the question which looks at risk of regulatory penalty we have interpreted this as two separate points;

1) If it relates to risk of downside penalty through an incentive mechanism etc, then yes, this risk should be covered via the margin which is applied to activity costs;
2) If it relates to risk of regulatory penalty through licence or breach of legal obligations, then this is a company risk which should be appropriately managed through good corporate governance and not be covered by a risk premium for owners.

In summary, it is reasonable to expect that shareholders should receive an appropriate return for the risks they are exposed to and the regulatory framework should allow for this.

ESOQ3: Would a working capital facility adequately cover the full range of risks the ESO is exposed to in fulfilling its revenue collection activities (in relation to collecting TNUoS and BSUoS charges)?

We agree it is sensible for the ESO to hold a working capital facility and the costs of providing such a facility should be adequately covered through a regulatory mechanism, with the requirement that such facility should be acquired efficiently.

The actual level of capital facility should be determined after a full review of the commercial arrangements between the ESO and TOs in particular. It also depends on the charging reviews, in particularly the targeted charging review, which is likely to improve revenue certainty for the ESO as are the proposals to move BSUoS charges to a cost recovery basis. The TOs should also be required to provide a minimum of 15 months' notice of their charges to align with the current arrangements in distribution and this should also improve cash-flow forecasting and minimise the level of working capital facility needed by the ESO. It would also be appropriate to profile payments to TOs based on forecast revenue recovery from TNUoS.

ESOQ4: Would the ESO require additional funding or regulatory mechanisms to be able to procure a working capital facility? Please explain your answer.

It is possible that additional funding or regulatory mechanisms would be needed to ensure that the cash flows of the ESO are sufficiently generative, predictable and stable to meet lender credit assessments. The structure and size of additional funding and regulatory mechanisms would be dependent on ESO model adopted and resultant credit metrics.

With the ESO model in its infancy, solvency will be a consideration for lenders. The model should be appropriately stress tested for scenarios that could lead to cash flow shortfalls.

For the avoidance of doubt, any costs explicitly incurred in procuring and maintaining a working capital facility should be funded through regulatory allowances. This will be an important element of maintaining the company's financeability in order to perform its role, of which one aspect is the collection of revenue for TNUoS and BSUoS. If this requirement for revenue collection were to change, then these measures should also be reviewed.

ESOQ5: Do the benefits of retaining the ability to apply a downside incentives penalty outweigh the potential costs in terms of the impact on ESO financeability?

As we explain in our answer to question one, any downside, if applied, should be limited to loss of margin earned, with a greater upside to appropriately incentivise the ESO to focus on developing opportunities that can create the greatest customer value.