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Ørsted response to RIIO-2 ESO methodology further consultation

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Our ref. ANDMH/RIIO2

The Ørsted vision is a world that runs entirely on green energy. In the UK, we develop, construct and operate offshore wind farms as well as battery storage and innovative waste-to-energy solutions. We also offer flexibility solutions to our industrial and commercial customers as well as supplying them with electricity and gas. Headquartered in Denmark, Ørsted employs 6,000 people, including nearly 1,000 in the UK. Ørsted is the largest offshore wind farm developer, generator and owner in the UK

We welcome the opportunity to responds to the methodology decision and further consultation on the RIIO-2 methodology for the Electricity System Operator (ESO). We believe that the sector methodology decision and two proposed remuneration models for the ESO represents a mismatch between the risk that it will be taking on under the proposals, and the incentives required for it to meet its objectives.

Risking ambition when it is most needed

Ørsted has welcomed the ESO's RIIO-2 ambition plan[1] which has an overall ambition to allow it to run a carbon-free grid by 2025. Whilst challenging, we believe it is right for the ESO to adopt a thought leadership position to drive transformative change in an agile fashion in order to meet shared decarbonisation objectives. However, the conclusions of the RIIO-2 sector methodology risks delivery of this ambition at a time when the UK Government has recently legislated to enhance our position on climate change, and aim for net-zero, 100% decarbonisation[2].

Whilst we welcome the intent from the regulator to create a more agile System Operator, the proposals to commit the ESO to a two-year only remuneration period under RIIO-2 coupled with the proposed remuneration models risks the delivery of this ambition through creation of a high level of risk to the ESO's revenue that will not encourage transformative and longer-term investments to be made. As stated in our original response to the RIIO-2 sector methodology for the ESO[3], a two-year model that contains five-year elements would allow the ESO to take on more transformative initiatives and blends out risks presented in a two-year only model by creating exposure to a longer term revenue profile.

[1] National Grid ESO, RIIO-2 Ambition published 3 April 2019
[2] Via the Climate Change Act 2008 (2050 Target Amendment) Order 2019, passed on 26 June 2019
[3] Please see our response, submitted to Ofgem 16 March 2019

A risk heavy approach

Addressing the areas under this further consultation, we are concerned about the two models being proposed. Adopting either the total expenditure (totex) or purely fast-money based funding model presents risks or inefficiencies, and we would have liked to have seen further detail from Ofgem about how each model would be applied to specific areas of the ESO business, or why other models were discarded. Coupled with the risk of disallowance and unavailability of a sharing factor, we believe the calibration of the ESO price control results in a risk heavy price control that does not incentivise change at the pace required to meet decarbonisation objectives.

For example, we do not believe a totex-led approach to remuneration (Model 1 in the consultation) as presented is appropriate for the ESO. By applying a capital-led, RAV*WACC approach to funding an asset-light entity, it may distort the outcomes of the ESO as the model may downplay the significant role in the day-to-day running of the grid and the operational role of a system operator. For a Model 1 style approach, a layered model which introduces a return margin for each of the ESO’s activities presents the best case for transparency and may help offset risks of disallowance being presented.

Adopting a pure fast-money to both capital and operating expenditures (Model 2 in the consultation) also raises concerns. This will produce an extremely volatile revenue profile to the ESO that will make it difficult to asses value from a network customer perspective if capex is remunerated as fast money. Capex remuneration as fast money also suggests that network customers will face more volatile network charges, which represent a significant cost area for generators and demand users alike. The ability to have a predictable and stable outlook on these costs should not be overlooked.

Furthermore, applying the ex-post, evaluative methodology for assessing incurred expenditure may mean that high portions of expenditure potentially becomes disallowed and exposes the ESO to significant losses under Model 2. We believe the overall increased exposure to volatile revenues and the risk of disallowance will result in an extremely risk-averse ESO that favours conservative options that may result in a failure to accomplish its ambitions in the required timeframe. This will not facilitate the swift transition to a decarbonised power sector under the increased ambition of net-zero policy.

Framing the business with the right incentives to succeed and be progressive

We appreciate the ways in which Ofgem have attempted to mitigate some of the risks presented to ESO that a new price control will bring. By avoiding symmetrical upside and downside incentives, it may allow the ESO to make significant progress to bring new systems and practices to market which would be needed to operate a smart, flexible and carbon-free grid. For example, the Future of Balancing Services activity should allow for greater access for new service providers and allow for closer to real time procurement of services such as frequency response by the control room. This would bring greater value to consumers as more competition is introduced into these areas but requires the ESO to make significant changes from today's practices.

However, in order to fully build a forward-looking and robust business for the ESO, there may be additional mechanisms that could be considered. A model that separates legacy costs and new costs could compliment a layered model which remunerates the ESO on the basis of each activity it undertakes. For example, it makes sense to promote behaviour that lead to core business areas or legacy costs to be made efficient over time. This would be the same approach that other businesses take when searching for efficiencies in current processes as part of ongoing optimisation via increasing sophistication and experience building in core business areas. We would like to understand how this kind of behaviour is being promoted within the ESO organisation if a sharing factor is no longer available.

Lastly, we expect an ESO that aims to operate a carbon-free grid to pursue transformative changes. There is a risk that disallowance on inefficiently-incurred costs on new expenditure may in fact lead to inefficient procurement. The ex-post, qualitative nature of evaluating these costs means that the definition of what is efficient or inefficient remains unclear at this stage. A risk averse ESO may want to pass risk through to suppliers to provide additional guarantees and warranties to deliver projects to schedule. Suppliers will in return raise their costs in order to comply and avoid potential disallowances on behalf of ESO. It therefore becomes vitally important to ensure that definitions on how the ESO is to be assessed are clear, well-defined and understood by all parties to ensure that differences in interpretation do not lead to increased costs.

Please do not hesitate to contact me (andmh@orsted.co.uk, 07827 283123) should you have questions about our response.

Yours sincerely

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