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Sent by email to: RIIO-ED1@ofgem.gov.uk

Dear Grendon,

ESO Financing for the RIIO-2 price control

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

The Electricity System Operator (ESO), as any other commercial organisation, should be paid for providing services and should be remunerated fairly for the risks it faces. Also, the ESO performs a crucial role within the energy system and its actions and expenditure influence much greater sums of industry costs. This means it is a far greater risk to consumers that the price control framework for the ESO does not provide adequate incentives to pursue initiatives that may realise value, compared to the ESO being overcompensated.

Model 1 (the 'Regulatory Asset Value' ('RAV') model) is preferable:

There are various ways in which the ESO can be provided with a baseline return for the risks it faces. Regardless of the way in which the ESO is remunerated for the risks to which it is exposed, the baseline return it receives should be the same. However, at this stage, we believe Model 1 (the 'Regulatory Asset Value' ('RAV') model) is preferable:

- it allows revenues to be 'smoothed', thereby having a positive effect on financeability and a downward effect of financing costs,
- the return on the RAV can be used to provide the ESO with a baseline return and a return on its 'internal' expenditure,
- the return on the RAV can also be used to provide the ESO with an additional return needed to reflect the potential risk of regulatory penalties, if this risk is not already captured in the baseline return.

In addition to this, we would also highlight:

- it is likely to be more efficient for much of revenue recovery risk to sit with the large transmission companies (i.e. ESO passes through only revenue collected),
- the overall costs to customers of revenue collection risks should not be increasing,

- any residual revenue recovery risk should be reflected in a margin on external costs,
- ESO returns/margins could be put at risk if minimum standards are not met, complementing an upside-only evaluative scheme.

The benefits of allocating the risks associated with revenue collection activities to network operators should be reviewed ahead of RIIO-2:

We acknowledge the risks associated with revenue collection activities to which the ESO is exposed, given the size of the revenues relative to the ESO's 'internal' costs. We do not assume allocating those risks entirely to the ESO is the most efficient approach. Most of the revenues the ESO collects is on behalf of National Grid Electricity Transmission and other transmission operators. It seems likely to be more efficient for this risk to be allocated to network operators instead of the ESO. This should be reviewed ahead of the RIIO-2 price controls so that mechanisms for managing these risks can be designed into the settlements for the relevant licensees.

Notwithstanding our view that it is likely to be more efficient for this risk to be allocated to network operators, we note the ESO has recognised a financial facility can provide coverage for reasonably foreseeable liquidity, though some residual risk may remain¹. As such, if the responsibility for revenue collection remains with the ESO, we support the proposal to require the ESO to procure a working capital facility, which will be fully funded by consumers. Any remaining residual risk could be remunerated by a margin on 'external' costs, which allows this element of the return to flex in line with the revenues.

Please contact me if you would like to discuss any aspect of our response. Answers to the consultation questions are included in the attached appendix.

Yours sincerely,

Andy Manning
Director - Network Regulation and Forecasting
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¹ The ESO's response to the RIIO-2 Sector Specific Methodology consultation, page 35. Available at: <https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-consultation>.
Page 2 of 7

APPENDIX – answers to consultation questions

ESQ1: 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?

We believe the ESO, as any other commercial organisation, should be paid for providing services and should be remunerated fairly for the risks it faces. In principle, the ESO can be remunerated via any of the mechanisms that have been considered – via margins, via the Weighted Average Cost of Capital (WACC) applied to the Regulatory Asset Value (RAV) or even a combination of both mechanisms. Regardless of the approach adopted, the overall baseline return the ESO receives should be the same.

Three models have been proposed:

- The ‘margins’ model, as proposed in the December consultation.
- Model 1 (‘RAV’ model), as proposed in the May Decision.
- Model 2 (‘all fast money’ model), as proposed in the May Decision.

At this stage, Model 1 is preferable. We assume the ESO will receive a baseline return for the range of risks it faces by applying the WACC to the RAV. This means separate margins on ‘internal’ expenditure are not needed since the return that the margins would provide will also be provided via the return on the RAV. We recognise there are risks associated with the revenue collection function. The majority of the associated risks would be mitigated by the working capital facility, which will be fully funded by consumers. Any associated residual risk that remains should be remunerated via a proportionate margin on ‘external’ costs. We assess the models below.

The ‘margins’ model:

A benefit of the ‘margins’ model is the overall baseline return the ESO receives can be calibrated to more closely reflect the risks the ESO faces when delivering a specific mix of activities and undertaking capital investment. In theory, this means the overall baseline return can be more quickly ‘flexed’ in response to changes in activity and investment portfolios. The complexity of this approach could be justified if the required margins materially vary across the portfolio of activities and if ‘lumpy’ investment profiles are expected.

Honouring the legacy RAV carried over from the RIIO-T1 price control via margins on activities during the RIIO-2 price control could be unnecessarily complex and could introduce implementation risk. Additionally, honouring the legacy RAV while activity and investment portfolios vary could cause revenue volatility. The ‘margins’ model could be used in conjunction with bespoke arrangements for the legacy RAV. However, such an approach could still be unnecessarily complex and a degree of revenue volatility would remain.

We note a ratings agency states a desirable feature of the existing price control framework for the ESO is stable revenue flows². We expect this stability to have a positive effect on financeability

² See: https://www.moodys.com/research/Moodys-assigns-Baa1-rating-to-National-Grid-Electricity-System-Operator--PR_396553.

and, by extension, a downward impact on financing costs. Revenue stability is also desirable for market arrangements.

Model 2 ('all fast money' model):

We assume this model consists of the ESO receiving an overall baseline return for the risks its faces by applying the WACC to the legacy RAV and expenditure being recovered in-year. This approach is appropriate if the risks the ESO faces or the required margins are relatively homogenous.

It may eventually become impracticable to remunerate the ESO for the risks its faces by applying the WACC to the legacy RAV since the legacy RAV will be continually declining. This means another mechanism for remunerating the ESO for the risks its faces will eventually have to be adopted. Model 2 could approximate to the 'margins' model during the RIIO-2 price control, depending on how quickly the legacy RAV is wound down. We assume Model 2 will provide revenue stability only in the short term.

Model 1 ('RAV' model):

We assume this model consists of the ESO receiving an overall baseline return for the risks its faces by applying the WACC to the RAV and some expenditure would be recovered in-year. The size of the RAV will vary to reflect expenditure during the RIIO-2 price control. This reflects current arrangements and is appropriate if the risks the ESO faces or the required margins are relatively homogenous.

A benefit of this approach is revenue stability, which have a positive effect on financeability, a downward impact on financing costs and would be desirable for market arrangements. If this approach is adopted, it is essential a stylised capitalisation rate is retained rather than simply capitalising all capex. Otherwise, an incentive could be created for the ESO to pursue capital solutions when they are not the most efficient. Price control arrangements should always encourage licensees to pursue the most efficient solutions.

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?

The risk of a regulatory penalty is just one sub-type of regulatory risk that licensees are exposed to. The WACC remunerates investors for the risks they face, including regulatory risk. In the UKRN report, the authors explain how regulatory risk may be captured in the Capital Asset Pricing Model (CAPM), which is used to estimate the cost of equity³. If it can be demonstrated that regulatory risk faced by the ESO is not adequately captured by the CAPM, then an adjustment to the WACC would be needed.

³ "Estimating the cost of capital for implementation of price controls"; page F-127:
<https://www.ukrn.org.uk/wp-content/uploads/2018/11/2018-CoE-Study.pdf>.

We note the disallowance mechanism would be framed in line with existing mechanisms for other RIIO sectors. We support this approach. The clarity provided that the disallowance mechanism will be considered only in extreme circumstances should give the ESO certainty of revenues and the price control arrangements should allow the ESO to invest in initiatives to deliver additional consumer value. Similarly, this should mitigate investor concerns that the mechanism will be applied in an arbitrary manner. We would expect that risk of cost disallowance, being a common approach, to be captured within the CAPM. It is less clear that the ESO-specific Black Start arrangements would be, although we would note that the ESO can be rewarded for its approach to Black Start via the evaluative incentive.

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)?

The risks associated with the ESO acting as the revenue collection agent were implicitly expected to be managed by the National Grid Electricity Transmission licensee as the transmission operator and system operator functions were integrated when the RIIO-T1 settlement was agreed. National Grid Electricity Transmission has been implicitly remunerated for these risks. This arrangement may no longer be appropriate from 2021 when separate price controls will be set, following legal separation of the ESO within the National Grid group. How the risks associated with revenue collection activities can be most efficiently allocated should now be reviewed.

In its *Review of the RIIO framework and RIIO-1 performance*, CEPA identified two key principles to inform how risks are treated within the regulatory framework. One of those principles is that risks should be allocated to the parties best placed to manage them in order to maximise the efficiency of risk allocation⁴. A significant portion of the revenues the ESO collects is on behalf of National Grid Electricity Transmission and other transmission operators and these, generally much larger, companies should be better placed to manage the revenue collection risk. The ESO could provide revenue to the network operators on the basis of the revenue it collects (rather than paying the same amount regardless of revenue collected). The network companies' allowed revenues would adjust in a future year for any under or over recovery of allowed revenue. This would bring the transmission companies in line with the treatment of distribution companies. We recognise that this may not be suitable for all counterparties that the ESO passes revenue to. This should be reviewed ahead of the RIIO-2 price controls so that mechanisms for managing these risks can be designed into the settlements for the relevant licensees.

Notwithstanding our view that it is likely to be more efficient for this risk to be allocated to network operators, according to the ESO's commentary⁵, there are two main risks it is exposed to in fulfilling its revenue collection activities:

⁴ "Review of the RIIO framework and RIIO-1 performance"; page 55:
https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa_review_of_the_riio_framework_and_riio-1_performance.pdf.

⁵ The ESO's response to the RIIO-2 Sector Specific Methodology consultation, page 34.

Cashflow risk: The ESO states an industry escrow and/or a financial facility can provide coverage for reasonably foreseeable liquidity risks⁶. Additionally, the ESO states either would significantly change its risk profile⁷. The proposal to require the ESO to procure a working capital facility so that is always has sufficient financial liquidity, which would be fully funded by consumers, aligns with the ESO's views of how cashflow risk can be mitigated. As such, a working capital facility should mitigate the cashflow risk to which the ESO is exposed if it continues to fulfil the revenue collection role.

Customer non-payment risk: the ESO explains that bad debt risk is additional to the cashflow risk. The ESO states it may be possible for an insurance policy to be used to mitigate these risks but would require careful consideration. The ESO also mentions guidance relating to credit cover requirements should be formalised. This suggests there may be regulatory mechanisms that could be explored to mitigate the risk of bad debt.

The ESO has recognised a financial facility can provide coverage for reasonably foreseeable liquidity, though some residual risk may remain. We would assume that a working capital facility that removes all risk would not be efficient for consumers and so agree some residual risk will remain. The size of the above risks are proportional to the size of the revenue flows, so we suggest the residual risk could be remunerated by a margin on 'external' costs. This allows this element of the return to flex in line with the revenues. Whilst we accept this means the ESO will make more return as external costs increase, we do not believe this creates a perverse incentive as the risks also increase along with external costs.

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

Requiring the ESO to procure a working capital facility so that is always has sufficient financial liquidity, which would be fully funded by consumers, is an appropriate way of managing the majority of the risk the ESO would be exposed to if it continues to fulfil the role of revenue collection agent. The ESO would require additional funding beyond that required to deliver its outputs.

At this stage, we do not think consumers fully funding the working capital facility should result in an overall increase in consumer funding provided to licensees. The revenue collection function and the associated risks already exist. As discussed above, National Grid Electricity Transmission has been implicitly remunerated for the risks associated with the ESO acting as the revenue collection agent. Placing an obligation on the ESO to procure a working capital facility should not be treated as the creation of an additional cost which consumers should bear. Instead, it should involve a redirection or redistribution of funding to remunerate the relevant party or parties for those risks.

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?

⁶ The ESO's response to the RIIO-2 Sector Specific Methodology consultation, page 35.

⁷ The ESO's response to the RIIO-2 Sector Specific Methodology consultation, page 35.

The downside element of the incentive was included in the evaluative approach to encourage the ESO to deliver levels of service that do not fall below the baseline expectations of a competent and efficient system operator. For this reason, we support the use of a mechanism that aims to prevent levels of service falling below baseline expectations.

Under the Data Communications Company price control arrangements, margin is put at risk depending on performance. A similar arrangement could apply to the ESO, where the return/margin the ESO earns for providing services is put at risk if it fails to meet minimum standards. The evaluative incentive could then run as a separate, upside only, scheme. The impact on notional financeability should be assessed for a range of performance scenarios, but it would be expected that the ESO will always meet minimum standards and so, in practice, should retain any return/margin.