The Association for Decentralised Energy

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Bringing Energy Together

RIIO-2 ESO Sector Specific Methodology Further Consultation - ADE Response | 5 July 2019

Context

The ADE welcomes the chance to respond to Ofgem's **further consultation on their updated thinking on finance issues** under the ESO's RIIO-2 framework. The ADE is the UK's leading decentralised energy advocate, focused on creating a more cost effective, low-carbon and user-led energy system. The ADE has more than 150 members active across a range of technologies, including both the providers and the users of energy equipment and services. Our members have particular expertise in demand side energy services including demand response and storage, combined heat and power, heat networks and energy efficiency.

Consultation Questions

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?

The ADE does not have a view on this question.

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 level of potential risk around cost disallowance and regulatory penalties can be reduced, as Ofgem have acknowledged, by giving sufficient notice of the possibility of penalty and by clearly specifying the circumstances under which disallowance or a penalty would be applied. The ADE would note that regulatory penalties should carry some level of risk to the ESO; no risk at all likely indicates that the penalties are not strong enough.

The ADE recognises, however, that if no additional return were granted, the ESO may be exposed to an unacceptable level of risk or become risk-averse in its approach, which would threaten delivery of key industry priorities. The decision about whether this return should be delivered via a higher WACC or an additional margin on costs should be taken by Ofgem on the basis of economic modelling. It is important for the modelling to demonstrate whether the WACC would need to be adjusted to an extent that would be distortionary in order to deliver the necessary return. If so, applying a small margin on costs would be a more sensible approach.

The ADE believes that any margin applied should be small and only apply to areas agreed within the ESO's business plans. A large margin could 'swamp' the incentive scheme, meaning that areas rewarded through the incentive scheme are deprioritised, while allowing margins to apply to areas outside of the business plans could create an incentive on the ESO to artificially inflate costs.

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 ADE does not have a view on this question.

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

The ADE does not have a view on this question.

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?

The ADE believes that the ability to apply a downside incentives penalty is important and should be retained. The penalty should be part of an overall design of the incentive scheme and funding model that incentivises excellent performance without having a negative impact upon the ESO's financeability. These goals are most likely to be achieved via an incentive scheme that is split across several pots, rather than being comprised of a single pot. This will allow Ofgem the flexibility to weight some pots more heavily than others and to apply asymmetrical incentives to some pots. It will also allow a downside incentives penalty to be applied in areas where it is likely to drive excellent performance, but for upside only incentives to be possible in areas where a penalty may be less necessary.

For the incentive scheme to effectively drive ESO performance, it is important that it is not swamped by any margin applied to ESO costs as part of the main funding model. This implies that the incentive scheme should be of significant relative size, with a generous incentive scheme and relatively small margins on ESO costs.

For further information please contact:
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