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Sent by email to: RIIO2@ofgem.gov.uk

Dear David,

Further consultation on the funding model and incentives framework for the Electricity System Operator

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

The funding model for the Electricity System Operator (ESO), as for any other licensee, should be calibrated so that it is appropriately remunerated for the risks it faces. Also, the ESO should be provided with adequate incentives to pursue consumer value because it has significant scope to influence wider energy industry costs and benefits. We believe the following are important:

- **The strength of the performance incentive should be independent of the assessment of the ESO's business plan.**
- **The benefits of allocating the risks associated with revenue collection activities to network operators should be reviewed ahead of RIIO-2.**

The strength of the performance incentive should be independent of the assessment of the ESO's business plan.

The ESO performs a crucial role within the energy system, and its actions and expenditure influence much greater sums of industry costs. We believe this means the ESO should be provided with adequate incentives to pursue initiatives that may realise consumer value. We agree the ESO should be encouraged to develop and submit stretching business plans. However, we believe it is a far greater risk that the price control framework for the ESO does not provide adequate incentives to pursue initiatives that may realise consumer value, compared to the ESO being overcompensated. This does not mean the incentive pot should be set at distortionary levels or asymmetry should not be considered; the pot should be appropriately calibrated.

The proposal to allow Ofgem to set ‘core’ metrics may mitigate the risk of an insufficiently-challenging business plan being progressed. Further, scrutiny by the Performance Panel should mitigate the risk of rewards or penalties not reflecting genuine performance.

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

We believe it is likely, from a consumer perspective, to be more efficient if transmission network owners (TOs) bear transmission use of system (TNUoS) revenue collection risk. It should be more efficient for multiple parties with lower operational gearing ratios to bear the risk instead of the ESO, which is an asset-light entity with a higher-operational gearing ratio and lower revenues. We recognise that this may not apply equally to all counterparties and, in particular, it may be appropriate to maintain current arrangements for smaller parties (e.g. offshore transmission operators).

As we have previously highlighted[1], most of the revenues the ESO collects is on behalf of National Grid Electricity Transmission (NGET) and other TOs. In its response to the May consultation, the ESO stated that £13.50m (or about 65% of what it may request as additional funding) is due to the risk associated with TNUoS revenue collection. It should be recognised this risk already exists and it can be assumed it is already implicitly remunerated in the current price control for NGET (as this was set before ESO separation). 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.

Answers to the consultation questions are attached. I hope you find these comments helpful. Please contact me if you would like to discuss any aspect of our response.

Yours sincerely,

Andy Manning
Head of Network Regulation, Industry Transformation, Investigations and Governance
Centrica Regulatory Affairs, UK & Ireland

[1] In our response to the May consultation.

Answers to the consultation questions:

Cost of Debt Questions

Q1. Do you agree that full indexation for the Cost of Debt allowance is appropriate for the ESO?

We agree full indexation for the Cost of Debt allowance is appropriate for the ESO.

Q2. Do you agree with the proposal for a bespoke debt indexation mechanism for the ESO?
Q3. Do you have a view on whether the options for a bespoke debt indexation mechanism are appropriate for the ESO?

A bespoke debt indexation mechanism for the ESO is appropriate given several factors, including the assumption of no embedded debt prior to legal separation, high levels of operational gearing relative to network operators and the relatively high levels of capital expenditure outlined in the ESO's draft business plan published in July 2019[2]. We agree Ofgem's principles guiding its approach to the cost of debt, reiterated in paragraph 3.5 of the consultation, should apply to a cost of debt methodology for the ESO.

The options for a bespoke debt indexation mechanism appear broadly appropriate. A 'trombone' mechanism extending from 2019 aligns with the assumption that the ESO did not raise debt prior to legal separation. A small-company-premium allowance should be allowed only if it is in consumers' interest to do so. If this option is considered, we recommend consumer benefits tests and cost efficiency tests like those adopted by Ofwat for the PR19 price control review[3].

Allowance for equity finance questions

Q4. Do you agree with our proposed approach to use the three-step methodology to assess baseline allowed returns to equity?

We agree the three-step methodology to assess baseline allowed returns to equity is appropriate.

Q6. Do you agree with our proposal to update the allowed returns on equity for changes in the risk-free rate, as described in the SSMD Finance Annex?

We agree the allowed returns on equity should be updated for changes in the risk-free rate.

[2] "RIIO-2 Business Plan Draft"; page 15: https://www.nationalgrideso.com/document/147026/download.
[3] See https://www.ofwat.gov.uk/wp-content/uploads/2019/02/Technical-Appendix-4-Company-Specific-Adjustments-to-the-Cost-of-Capita....pdf .

Methodology for considering additional returns questions

Q7. Do you believe that we should categorise ESO risks into seven categories (see our taxonomy at Appendix 2) for the purposes of assessing additional funding claims?

We believe this is a reasonable approach.

Q8. Do you believe that the three tests we propose are suitably comprehensive?

The three tests proposed appear appropriate. However, the second test could be expanded to include a consideration of potentially undesirable consequences of each mitigation mechanism and whether there would an impact on other elements of the financial framework.

Q9. What are your views on the ESO's additional funding assumptions, as summarised above (from its July 2019 submission)?

We believe further analysis needs to be presented to reach a conclusion on the ESO's additional funding assumptions. These assumptions are linked to the Competition and Market Authority (CMA's) findings and remedies relating System Operator for Northern Ireland's (SONI's) appeal of its 2015-20 price control settlement[4]. Apart from the findings and remedies, we conclude the following from the CMA's commentary:

- each individual risk should be quantified,
- the extent to which each risk is remunerated in element(s) of the financial framework should be assessed,
- any residual portion of each risk not remunerated in element(s) of the financial framework should be quantified,
- appropriate method(s) for remunerating each individual risk should be identified,
- 'double-counting' should be avoided.

The ESO's analysis of some of the risks it faces, e.g. risks associated with the revenue collection function, does not fully address the above factors (for example, it does demonstrate to what extent this risk is already remunerated). Additionally, the extent to which risks relating to connections activities should be remunerated via consumer funding is unclear since some of the risks associated with connections activities may be brought by a connecting party.

Inflation indexation questions

Q11. Do you agree that the ESO RAV indexation and WACC allowance should follow the approach decided for the networks, i.e. immediate switch to either CPIH or CPI from RIIO-2 onwards?

We agree the ESO RAV indexation and WACC allowance should follow the approach decided for the networks.

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[4] See https://assets.publishing.service.gov.uk/media/5a09a73ce5274a0ee5a1f189/soni-niaur-final-determination.pdf.

Revenue collection questions

Q12. Do you agree that it could be more efficient if Transmission Network owners bear TNUoS revenue collection risk, to reflect respective variances between allowed and actual revenue?

We believe it is likely, from a consumer perspective, to be more efficient if TOs bear TNUoS revenue collection risk. It should be more efficient for multiple parties with lower operational gearing ratios to bear the risk instead of the ESO, which is an asset-light entity with a higher-operational gearing ratio and lower revenues. We recognise that this may not apply equally to all counterparties and, in particular, it may be appropriate to maintain current arrangements for smaller parties (e.g. offshore transmission operators).

As we have previously highlighted, most of the revenues the ESO collects is on behalf of NGET and other TOs. In its response to the May consultation, the ESO stated that £13.50m (or about 65% of what it may request as additional funding) is due to the risk associated with TNUoS revenue collection. It should be recognised this risk already exists and it can be assumed it is already implicitly remunerated in the current price control for NGET (as this was set before ESO separation). 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.

We also recognise that, under a ‘pay as paid’ approach, counterparties may require some influence over how charges are calculated (to ensure their risk is managed adequately). This can be managed by allowing counterparties’ input into the demand forecasts used by the ESO to generate charges.

Q13. Do you agree that, to the extent not funded through other mechanisms, WCF costs could be passed-through? Could this arrangement be limited to arrangement fees, extension fees and commitment fees?

We agree that, to the extent not funded through other mechanisms, efficient working capital costs should be passed-through.

Question on other finance issues

Q14. Do you agree with adopting the same approach for the ESO to the other finance issues as was proposed in the SSMD Finance Annex for the networks?

We agree with adopting the same approach for the ESO to the other finance issues as was proposed in the SSMD Finance Annex for the networks.

Part 2: Regulatory and incentives consultation (chapter 4)

Roles framework questions

Q15. Do you have any views on our initial thinking for how the ESO roles framework should evolve?

The Roles framework has been a useful tool to encourage the ESO to pursue consumer benefits across the spectrum of its activities and to set out expectations of the ESO since the evaluative incentive approach was implemented. It is appropriate to refine the framework given the experience gained since the 2018/19 scheme year.

Redefining the Roles as proposed should reduce the degree of overlap compared to the existing definitions and should provide greater, common clarity around performance expectations for the ESO. Defining the broad outcomes and impacts the ESO is expected to achieve should help it better demonstrate the consumer value resulting from its actions.

Q16. Do you support the introduction of a defined set of ESO outcomes and impacts? If so, what should these outcomes and impacts be?

We support the introduction of a defined set of ESO outcomes and impacts. The proposed outcomes and impacts appear to be a reasonable starting point. However, these should be kept under review based on experience to be gained during the 2021-23 business planning period.

Q17. Do you think any changes are needed to ESO's licence conditions in order to further clarify its baseline obligations?

Licence conditions relating to whole electricity systems coordination should be reviewed, to ensure they complement parallel obligations on network operators.

Incentive scheme aims and scope questions

Q18. Do you agree the incentives scheme should be focussed on encouraging the ESO to provide an exceptional quality of service when delivering its price control funded activities? Do you agree with our initial views on what an exceptional quality of service would include?

We agree the pass-through funding approach and access to innovation funding means, that as a baseline expectation, the ESO has significant scope to fund activities that could lead to consumer value being realised. These arrangements reinforce that the incentive scheme is not meant to fund initiatives. As such, the incentives scheme should be focussed on encouraging the ESO to provide an exceptional quality of service when developing and delivering its funded activities. This is consistent with our general principle that performance should be both good and improving to be considered for a reward. With fewer obvious comparators available to assess what good performance looks like than for network companies then the initial views on what an exceptional quality of service would include appear to be a reasonable starting point.

Scheme process questions

Q19. Do you agree with our proposal to align the length of the incentive scheme with the two-year business planning cycle?

We agree the length of the incentive scheme should be aligned with the two-year business planning cycle.

Q20. Do you agree we should introduce the possibility of 'core' metrics for the ESO? And, do you have views on which areas of ESO performance we should consider for any core metrics?

We agree the possibility of 'core' metrics should be introduced. This should reduce the risk of an insufficiently-challenging business plan being progressed in some areas. Metrics relating to the development of competitive markets for system management services should be included.

Q21. Should there be financial incentive implications for the ESO as a consequence of the business plan assessment process?

We agree the ESO should be encouraged to develop and submit stretching business plans. However, we believe it is a far greater risk that the price control framework for the ESO does not provide adequate incentives to pursue initiatives that may realise consumer value, compared to the ESO being overcompensated. This does not mean the incentive pot should be set at distortionary levels or asymmetry should not be considered; the pot should be appropriately calibrated.

The proposal to allow Ofgem to set 'core' metrics may mitigate the risk of an insufficiently-challenging business plan being progressed. Further, scrutiny by the Performance Panel should mitigate the risk of rewards or penalties not reflecting genuine performance.

Q23. How should we best include internal cost efficiency in the evaluation framework – should it be a performance metric or explicit criteria?

We recognise the ESO's internal expenditure is still a significant cost, and it should be encouraged to continue to seek efficiencies. However, at this stage, we do not think cost efficiency should be a specific criterion that the Performance Panel considers, to reduce the risk of ESO seeking to reduce costs at the expense of creating wider benefits for consumers during the price control. Instead, cost efficiency should form a performance metric for each role. This will allow cost efficiency to be included in the Performance Panel's consideration of each role - essentially cost efficiency will act as an aggravating or mitigating factor in the assessment.

For each role, the ESO should report on cost expenditure versus agreed allowances for the portfolio of activities in its business plan. the ESO should report separately on expenditure for initiatives identified during the price control period. This transparency should enable efficiencies to be taken into account for subsequent business plan periods.

Q24. Should we continue to evaluate the ESO's performance by role? If so, do you agree that we should we tailor the evaluation approach to each role?

The ESO's performance should be evaluated by role. We agree it would be appropriate to tailor the evaluation approach to each role.

Q25. Do you think medium to longer term roles should have relatively more upside incentives focus than short term roles?

For the reasons set out in the consultation, we agree the medium- to longer-term roles should have relatively more upside incentives focus than short term roles.

Q26. Do these arrangements give stakeholders the right platform to shape ESO activity and hold it to account for its performance?

Our interpretation of the proposed arrangements is that stakeholders can formally influence and shape the ESO's business plan only ahead of the two-year planning cycle, compared to current arrangements which allow stakeholder input annually via the Forward Plan process. We think additional opportunities to allow stakeholders to input should be included in the arrangements.

We note the shorter business planning cycle of two years was developed to provide the ESO with the flexibility to adapt activities in response to changes in the energy system, and the ability to adjust its priorities where appropriate. We support this approach. By removing the annual Forward Plan process, stakeholders will be limited to contributing to the development of the 2021-23 plan during 2019 (with reduced opportunities in 2020) for activities to be undertaken to three years ahead. Given the uncertainty arising from the energy system transition, we do not think the reduced opportunities for influencing the ESO's activities is in consumers' interests.

The administration of the ESO's arrangements should not be unduly burdensome for the industry. We suggest that, as a part of the mid-period review, the ESO should be required to consult the industry on proposed deviations from its original business plan it thinks is necessary during the second year of the business planning period. Similarly, stakeholders should be allowed to propose deviations.

The Performance Panel should have a role in the assessment of the ESO's business plan.

Priority areas question

Q28. What if any changes should be prioritised and introduced early for the 2020/21 incentives framework?

Any changes to licence conditions relating to whole electricity systems coordination, to ensure they complement parallel obligations on network operators, should be prioritised and introduced early. Changes to the Roles framework and the evaluation approach could also be introduced ahead of 2021.