RIIO-2 CHALLENGE GROUP

Akshay Kaul
Direct, Network Price Controls
Ofgem

(cc Eleanor Warburton, Charlotte Morgan)

26 September 2019

Dear Akshay,

Sub: RIIO-2 Challenge Group response to Ofgem's consultation on RIIO-2 methodology for the Electricity System Operator (ESO)

I am writing to provide the RIIO-2 Challenge Group's ("our") response to Ofgem's further consultation on RIIO-2 methodology for the ESO, which was published on 28 August 2019.

The Annex to this letter contains our response, which focusses on the issues in Ofgem's consultation which we consider to be of the greatest importance to consumers. We have no objection to this response being published.

Please do not hesitate to speak with me if you have any further questions.

Kind regards,

Roger Witcomb
(Chair, RIIO-2 Challenge Group)

Annex

This response focusses on those issues in Ofgem's consultation which the Group ("we") consider to be of the greatest importance to consumers. These are set out below in summary form but we are of course available to elaborate on any of the points raised.

- We are concerned that the allowance for both the cost of equity and the cost of debt should be set at a level which reflects the overall risk profile of the ESO. We understand that the numbers set out in the Consultation Document for the cost of equity allowance are Working Assumptions (WAs) only. However, given that the ESO's Cost of Equity allowance in RIIO-1 was in line with that of the National Grid (NG), the Group would have expected the Cost of Equity WA to be similar to that proposed for the transmission companies (which have a risk profile similar to that of the ESO). Indeed we think that, if anything, the Cost of Equity allowance in RIIO-2 for the ESO could be less than that for the transmission companies since, under the arrangements proposed for RIIO-2, the ESO will be expected to bear significantly less totex overspend risk than was the case under RIIO-1.
- Although we recognise that the cash flow risk for an independent ESO will be greater than they were when the ESO was part of NG, we note that these are only timing risks, and also that there are a number of possible mitigation measures, as set out in the consultation document. We do not consider, therefore that a higher WACC is warranted, or that there should be any additional mitigation, for the cash flow risk.
- There may be additional risks which it is appropriate to remunerate but we think it important that remuneration for specific risks should be separate and clearly over and above the base line return (compensated by the WACC/RAV methodology) rather than being compensated by a higher WACC, with resulting potential for 'double counting'. We note that the list of items for which the ESO is requesting a return in addition to the WACC is substantial and believe that it should be carefully reviewed.
- We also have concerns in relation to the WA for the cost of debt allowance, which has been set at 0.25% (rather than by reference to market rates). Moodys has maintained the ESO's BAA1 rating and we can see no reason why, against that background, the cost of debt allowance should not be significantly lower and potentially below zero. We support the indexation of the debt allowance for the ESO and agree that indexing against shorter maturity debt and with a shorter trailing average (both of which will serve to reduce the cost of debt allowance) is appropriate for a newly formed entity.
- Although we think it important that the WACC should be set at an appropriate level, our principal concern relates to the arrangements for totex pass through. The relatively low level of capitalisation of the ESO makes a pass through structure necessary but we are concerned that, as currently structured, there is a lack of clarity as to how a distinction will be made between costs which lie appropriately with the ESO (and should be part of the ESO's remuneration arrangements) and those which should rest with the NG. We note that currently the ESO is, to a significant extent, dependent on support services (HR, IT etc) from the NG and that this close dependence could give rise to perverse incentives in the allocation of costs between the two entities, given their different incentive arrangements. We believe that the pass through arrangements will need to be very carefully drawn and that the Separation Agreement between the ESOS and NG should give no scope for such perverse incentives.
- We also have concerns about ESO's IT expenditure, which is expected to constitute a very high proportion of the ESO's totex and where there is a risk of significant cost overruns. The dependence of the ESO on Group support services presents it with considerable challenges

of independence and control – it could be difficult for the ESO to avoid its priorities being compromised in the context of the 'greater good' of the NG group. This could be a particular issue in IT, where the ESO employees report directly to the NG IT department. We encourage Ofgem to seek to ensure that the ESO benchmarks NG charges to check that they are in line with industry practice and to explore ways in which the ESO can develop its own IT capability and in time operate independently of the NG.

- We recognise that the incentive regime for the ESO is still being developed and are keen that the new regime should drive real innovation and ambition. We believe that the ESO has the potential to have a substantial impact on the costs and effectiveness of the system as a whole, which is out of all proportion to the size of its own RAV. We consider that innovation should be remunerated separately from the base return on RAV (avoiding 'double counting'). Although not in any way advocating other than stringent control of the returns on capital, we would not wish a focus on the ESO's base returns to be at the expense of the appropriate incentivisation of innovation and the move to NetZero. In that context, we support the evaluation approach to incentivisation of whole system improvement: we consider that plus/minus £30 million should provide a significant incentive for an entity with a turnover of around £150 million (and a RAV of similar size).