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Decision

RIIO-2 financial methodology and roles framework for the Electricity System Operator

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In May and August 2019, we made decisions on how we would apply the RIIO-2 framework to the Electricity System Operator (ESO). In August, we also consulted further on two aspects of the ESO's RIIO-2 price control. Firstly, on the methodology we will use for setting the financial aspects of the price control, and secondly, on potential changes to the ESO's roles framework and incentives scheme.

This document summarises the responses we received to our August consultation and outlines our decisions and next steps. This includes decisions on the financial methodology and roles framework for the ESO for RIIO-2.

We will set out detailed proposals for all aspects of the price control as part our Draft Determination in summer 2020. We also soon plan to consult on introducing some changes to the ESO's incentives early for the 2020/21 regulatory period.

Please note: this document sets out decisions with respect to the ESO's RIIO-2 price control, commencing April 2021. It is separate from the ongoing Ofgem investigation into the power cuts of 9 August 2019 announced on 20 August 2019. In the event there are issues arising from this investigation pertaining to this medium term framework, they will be addressed at the RIIO-2 determination stage in 2020.

Contents

Executive summary

The Electricity System Operator (ESO) has a central role in our energy system. The decarbonisation of the system presents both challenges and significant opportunities for the ESO to unlock substantial benefits for consumers. To make the most of these opportunities, and to ensure the ESO maintains a reliable, resilient and efficient system throughout this energy system transition, we need it to be flexible, collaborative and ambitious. Our regulatory framework for the ESO is key to achieving this. In April 2021, we will introduce the first standalone price control for the ESO under the RIIO-2 framework. This follows its legal separation from National Grid Electricity Transmission in April this year.

In May and August this year, we made key decisions on how we would apply the RIIO-2 price control framework to the ESO. As part of our August decision, we also ran an additional consultation covering two separate areas of the price control. Firstly, on the methodology used for setting the financial aspects of the price control, and secondly, on changes to the ESO's roles framework and incentives scheme. Following the consultation, we are now making several decisions and outlining our next steps.

ESO RIIO-2 Financial Methodology

We have decided to use a set of financial methodologies which are in line with our proposals in August. In particular, we will:

- Use a full indexation methodology for setting a cost of debt for the ESO.
- Use a three-step methodology for setting baseline allowed returns to equity for the ESO, in line with other sectors.
- Use a bespoke methodology for considering the need for additional remuneration, which will categorise ESO risks into seven categories, and apply three tests.
- Consider financeability using the metrics we proposed in August, as well as some additional equity ratio metrics.
- Adopt the same approach as the other networks for the inflation indexation of the weighted average cost of capital (WACC) allowance and regulatory asset value (RAV) adjustments.
- At this stage, approach other finance issues, including regulatory depreciation, notional gearing & tax allowances, in the same way as we have done for other networks.

We plan to investigate in further detail the allocation and management of risks associated with revenue collection. In particular, we plan to carry out further work with industry to consider where the cash flow risk associated with the collection of Transmission Network Use of System (TNUoS) charges would best be placed.

ESO Roles Framework and Incentive Scheme

We have decided to streamline our roles framework for the ESO, by moving from four to three roles as proposed in August. However, we will not introduce the proposed 'impacts and outcomes' as a new, formal component of the performance evaluation process, given feedback that suggests this could add complexity. Instead, we will update our existing framework guidance documents to ensure expectations we have previously set for the ESO are transparently accounted for. We will also ensure that these guidance documents describe more clearly how the ESO should demonstrate consumer benefits.

For other areas of the August consultation, we have summarised the stakeholder responses and provided an update on our next steps. This includes updates in relation to questions on the purpose and scope of the scheme; the process for agreeing plans and assessing performance; the evaluation approach; and the arrangements for stakeholder input and the performance panel. We thank stakeholders for these responses, which will help shape our detailed proposals on the design on the ESO's RIIO-2 incentive scheme.

Next Steps

We expect to receive the ESO's final RIIO-2 business plan on 9 December. Our detailed review of this plan will inform our Draft Determination on the price control in summer 2020. This will include detailed proposals for finance-related values and the detailed design of the ESO's incentives arrangements. We will make our Final Determination towards the end of 2020, prior to the start of the price control period in April 2021.

We aim to publish a consultation before the end of the year which will set out proposals for which parties should carry the cashflow risk associated with the collection TNUoS charges, including our proposed approach to implementing any changes to this. Any decisions made in this area will be factored into the RIIO-2 determinations process.

Before the end of 2019, we are also planning to launch a consultation on the detailed changes to the guidance documents supporting the ESO's current regulatory and incentives framework. These changes will aim to introduce the streamlined roles framework in time to apply for the 2020/21 ESO incentives scheme.

1. Introduction

Context

1.1. The Electricity System Operator (ESO) has a central role in our energy system. It performs a number of important functions from the reliable real time operation of the system, through to market development and longer term network planning.

1.2. The decarbonisation of the energy system presents both challenges and significant opportunities for the ESO to unlock substantial benefits for consumers. To make the most of these opportunities, and to ensure the ESO maintains a reliable, resilient and efficient system throughout this energy system transition, we need the ESO to be ambitious, forward-looking and proactive. We also need it to work closely with other industry parties and wider stakeholders to ensure there is a coordinated approach to solving system challenges. Finally, we need the ESO to be dynamic and flexible, so that it readily adapts to emerging issues and new developments.

1.3. On 1 April 2019, the ESO separated from National Grid Electricity Transmission (NGET), and became a legally distinct company within the National Grid group. This separation should further embolden the ESO to develop its own vision for its system operator role and to place wider system and consumer interests at the heart of its decision-making. Our regulatory framework for the ESO is a key enabler for this. In April 2021 we will introduce the first standalone price control for the ESO, under the RIIO-2 framework.

1.4. Our work in this area fits within our forward work programme for 2019-21 and is aligned with our strategic narrative from 2019-2023.[1] In particular, it is aligned with our priority to facilitate the decarbonisation of the energy system at lowest cost to consumers. Our work also follows our regulatory stance[2] on Driving Value in Monopoly Activities through Competition and Incentive Regulation. This includes our aim to design our price control mechanisms to ensure that the governance of monopoly companies, and the development and delivery of their strategies, are aligned with the interests of consumers.

[1] https://www.ofgem.gov.uk/system/files/docs/2019/07/our-strategic-narrative-2019-23.pdf
[2] https://www.ofgem.gov.uk/publications-and-updates/ofgems-regulatory-stances

1.5. We set out how we intend to apply the RIIO-2 framework to the ESO in our sector specific methodology decision in May 2019[3] and in our decision on its funding model in August[4]. As part of our August document, we also ran a further consultation on two aspects of the price control. Firstly, on the financial methodology we will use as part of the ESO's funding model; and secondly on the design of the ESO's incentives for RIIO-2, including its roles framework.

1.6. This consultation closed on 25 September (with an extension until 9 October for incentives responses). The non-confidential responses can be found on our website alongside this document.

Document Overview

1.7. This document summarises stakeholder responses to our August document and outlines our decisions. For areas where we are not making a decision at this stage, we provide an update on the next steps.

ESO RIIO-2 financial methodology

1.8. Chapter 2 sets out our decisions on the financial methodology for the ESO and outlines our rationale for these decisions. This includes decisions on:

- Our allowed returns methodology, including our approach for setting an allowance for the cost of debt; our approach for setting an allowance for the cost of equity; and our approach to assessing the need for additional funding.
- Our approach to considering the ESO's financeability.
- Our approach to the inflation indexation of the weighted average cost of capital (WACC) allowance and regulatory asset value (RAV) adjustments.
- Our approach to other finance issues (including regulatory depreciation, notional gearing & tax allowances).

[3] https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-decision
[4] https://www.ofgem.gov.uk/publications-and-updates/riio-2-methodology-electricity-system-operator-decision-and-further-consultation

1.9. We also provide an update on our thinking on risks associated with the ESO's revenue collection function, and describe our intended next steps in this area.

ESO roles framework and incentives scheme

1.10. In Chapter 3, we set out our decision on changes to streamline the ESO's roles framework for RIIO-2. This will inform the structure for the ESO's final RIIO-2 business plan.

1.11. For other areas of the August consultation, we summarise stakeholder responses and provide an update on the next steps. This includes updates in relation to questions of the purpose and scope of the scheme; the process for agreeing plans and assessing performance; the evaluation approach; and the arrangements for stakeholder input and the performance panel.

1.12. Finally, we provide an update on our proposal to introduce some changes early for the ESO's 2020/21 incentives scheme.

Timelines and Next Steps

1.13. We expect to receive the ESO's final RIIO-2 business plan on 9 December. Our detailed review of this plan will inform our Draft Determination on the ESO's price control in summer 2020. This will include detailed proposals for price control values and the design of incentives. We will make our Final Determination towards the end of 2020, prior to the start of the price control period in April 2021.

1.14. We aim to publish a consultation before the end of the year which will set out proposals for which parties should hold the cashflow risk associated with the collection of Transmission Network Use of System (TNUoS) charges. This will include our proposed approach to implementing any changes in this area.

1.15. We are also planning to launch a consultation on detailed changes to the guidance documents supporting the ESO's current regulatory and incentives framework. This will aim to introduce our roles framework changes in practice so that they are applicable for the 2020/21 ESO incentives scheme.

2. ESO RIIO-2 Financial Methodology

<table>
<tr><th colspan="2">Summary of decisions</th></tr>
<tr><td>Decision</td><td>We have decided that full indexation is the methodology that will be used to determine the cost of debt allowance for the ESO.</td></tr>
<tr><td>Decision</td><td>We have decided:
that the three-step methodology is an appropriate framework for setting baseline allowed returns to equity for the ESO.
to implement equity indexation by updating the allowed return on equity to reflect changes in the risk-free rate only, using the same method as applied to RIIO-T2 and RIIO-GD2.</td></tr>
<tr><td>Decision</td><td>For additional funding claims, we have decided:
to categorise ESO risks into seven categories as proposed
to use the three tests as proposed
to retain a working assumption of zero</td></tr>
<tr><td>Decision</td><td>We have decided:
to use the metrics proposed at paragraph 3.39 of the consultation
to supplement this list of metrics with the following equity ratios:
Regulated equity / EBITDA
Regulated equity / PAT
EBITDA / RAV</td></tr>
<tr><td>Decision</td><td>We have decided to adopt the same approach as the other networks, i.e. an immediate switch from RPI to either CPIH or CPI from RIIO-2 onwards, for WACC allowance and RAV adjustments.</td></tr>
<tr><td>Decision</td><td>We have decided that the approach to other finance issues remains in line with the consultation proposal (paragraph 3.52) and hence in line with other RIIO-2 networks.</td></tr>
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Introduction to the Financial Methodology

2.1. In this chapter we make decisions and provide updates on the following aspects of the RIIO-2 financial methodology for the ESO:

- Allowed returns methodology, including:
  - a method for setting an allowance for the cost of debt finance;
  - a method for setting an allowance for the cost of equity finance;
  - a method for considering whether additional funding is required (in addition to allowances for debt & equity finance);
- Approach to financeability;
- Inflation index for WACC allowance and for RAV adjustments;

- Revenue collection, financial resources and the working capital facility;
- Other finance issues.

Allowed returns methodology: a method for setting an allowance for the cost of debt finance

Recap of consultation position

2.2. In August, we referred to the set of principles for the cost of debt that were proposed and decided at the RIIO-2 framework stage[5]. These are:

- Consumers should pay no more than an efficient cost of debt.
- The cost of debt allowance should be a fair and reasonable estimate of the actual cost of debt likely to be incurred by a notionally geared, efficient company.
- Companies should be incentivised to obtain lowest cost financing without incurring undue risk.
- The calculation of the allowance should be simple and transparent, while providing adequate protection for consumers.

2.3. We stated that we believed those principles apply to a cost of debt methodology for the ESO and that the consideration we gave in the Sector Specific Methodology Decision (SSMD) to the merits and challenges of different methodologies for debt allowances (debt sharing, debt pass-through and partial indexation) also apply to the ESO price control.

2.4. We proposed that full indexation be used for determining the cost of debt allowance for the ESO, in relation to term debt.[6]

2.5. However, we noted the different asset base, history and risk profile of the ESO relative to other networks and set out some potential options for a bespoke cost of debt index for the ESO. These included:

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[5] See page 52: https://www.ofgem.gov.uk/system/files/docs/2018/07/riio2_july_decision_document_final_300718.pdf#page=52
[6] We use the phrase 'term debt' to mean borrowings that are repaid over a set period, as distinct from other facilities that are drawn as needed e.g. a revolving credit facility or working capital facility.

- Using a shorter maturity benchmark (for example the iBoxx £ non financials 5-7yr or 7-10yr indices, rather than the 10yr+ indices used for the networks), recognising the likely shorter term debt to be raised by the ESO given its generally shorter asset lives.
- Calculating the index based on a shorter trailing average period, for example an extending trailing average starting on 1 April 2019, to reflect an assumption that the ESO had not raised debt prior to this date.
- Using the credit spread of the index and adding that to an interbank borrowing rate (LIBOR or its replacement) if we consider it likely the ESO would have a high proportion of floating rate debt.
- Weighting the index according to when ESO debt is raised (likely to be more relevant if we consider it likely the ESO would raise non floating rate debt).
- Providing a small company premium allowance

2.6. We also proposed using the same method for deflating nominal cost of debt indices to real CPIH figures for each date to be included in the allowance calculation as will be used for the networks (final method to be proposed at Draft Determination and decided at Final Determination).

2.7. We asked the following consultation questions:

- Q1: Do you agree that 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 set out in 3.10[7] for a bespoke debt indexation mechanism are appropriate for the ESO?

Stakeholder responses

2.8. We received four responses to the cost of debt related questions (SSEN, Centrica, the ESO and the RIIO-2 Challenge Group). All four agreed that full indexation for debt costs is appropriate for the ESO and that a bespoke mechanism is appropriate

[7] 3.10 paragraph reference refers to the paragraph in the August 2019 ESO consultation, paragraph 2.5 of this document sets out the same potential options.

given the different characteristics of the ESO. The respondents agreed that a shorter trailing average and shorter dated index than that used for the other networks seemed appropriate.

2.9. However, the ESO suggested that it would be more relevant to consider debt costs in the BBB rating category rather than a combination of BBB and A rated indices. It argues that this is because the ESO's current Moody's rating factors in a "high likelihood that National Grid would provide financial assistance should it become necessary to maintain the ESO's credit quality". The ESO argues that the regulatory framework should not assume reliance on National Grid Group and that an adjustment should be made to recognise the additional costs a notional company would be exposed to on a standalone basis. It estimates the value of this to be 25bps above the BBB Iboxx index.

2.10. The ESO also suggested that given its smaller size and likely funding strategy for RIIO-2, it is likely to rely on bank debt market for funding. The ESO proposed an alternative benchmark that it thought would be more appropriate for a floating rate bank debt funding strategy. The ESO proposed an index based on quarterly forward LIBOR/SONIA floating rates of interest added to the spread on the BBB 5-7 and 7-10yr BBB iBoxx indices. The ESO also proposed that a true up be included if the realised floating rate was higher or lower than the forward rate used in the ex-ante allowance.

2.11. The ESO thought a small company premium would be appropriate. However, one supplier response suggested that a small company premium should be allowed only if it is in consumer interests, recommending consumer benefits and cost efficiency tests like those adopted by Ofwat for the Price Review for 2019.

2.12. The RIIO-2 Challenge Group expressed concern that the working assumption provided did not directly reflect particular market index data and commented that as the ESO is rated Baa1, it could see no reason why "the cost of debt allowance should not be significantly lower and potentially below zero".

2.13. SSEN stated Ofgem should continue to keep its options open until the Final Determinations before concluding on the exact construct of an index.

Decision

2.14. We have decided that full indexation is the methodology that will be used to determine the cost of debt allowance for the ESO.

Rationale for decision

2.15. All respondents agreed that using a full indexation methodology, as we decided for the other networks, is appropriate for the ESO and we continue to believe indexation meets our design principles for determining the cost of debt allowance.

2.16. We do not yet have sufficient clarity on the risks inherent in the ESO to make an informed assessment of the likely rating or debt costs of a notional ESO. Therefore, we do not believe it is appropriate to calibrate the index to be used for the cost of debt allowance at this time, particularly in relation to which rating category indices should be used. Given the information we have available at this time, we do not propose to update the working assumption for business planning purposes.

2.17. We will propose specific calibrations for the cost of debt allowance for the ESO at Draft Determination.

Allowed returns methodology: a method for setting an allowance for the cost of equity finance

Recap of consultation position

2.18. In August, we decided to use a RAV*WACC methodology for the ESO's price control. We considered whether the methodology for determining the allowed returns on equity for other sectors could be applied to the ESO.

2.19. We provided background on our SSMD decision in May to apply a three-step methodology for estimating baseline allowed returns on equity capital. We stated that we believed this methodology would provide a useful framework for allowed returns on equity capital for the ESO.

2.20. We expressed the following views in relation to using the three-step methodology for the ESO:

Step 1: The Capital Asset Pricing Model (CAPM[8]) evidence

- The risk-free rate and Total Market Returns (TMR) are not company specific values and therefore the relevant analysis, and regulatory policy issues, as set out in the May 2019 Finance Annex, also apply to the ESO. We also saw benefit in applying equity indexation for the ESO, even though it will have a shorter business planning period than other networks. We stated that the third CAPM parameter, the equity beta, is, in contrast with the TMR and the risk-free rate, investment specific. We proposed therefore, when estimating an equity beta for the ESO, to consider a variety of listed companies, in addition to the five companies we presented in the SSMD (SSE, National Grid, Severn Trent, United Utilities and Pennon Group plc). We also proposed to consider the ESO specific risks, when conducting this assessment, outlining the risk factors that are included within this step, to provide clarity on whether residual risks remain for separate assessment.

Step 2: Cross-checking the CAPM-implied cost of equity

- We considered the four cross-checks from the SSMD Finance Annex in terms of inferring a cost of equity for the ESO. We proposed to utilise available evidence on all four cross-checks, being mindful of any inference, when estimating the cost of equity for the ESO.

Step 3: Expected versus allowed returns

- We stated that the principle of step 3, that investors can expect returns to equity capital (from financial incentives in the price control design) in addition to the baseline allowed return on equity, applies equally to the ESO price control. However, we stated that expected returns for the ESO, and information asymmetries, may differ relative to other network companies. For example, the absence of a totex incentive mechanism in the ESO's remuneration framework is a notable difference between the ESO and other network companies.

[8] The Capital Asset Pricing Model (CAPM) is a model used to estimate equity investor expectations. It is grounded in extensive financial theory and practice.

2.21. We asked the following questions relating to the allowance for equity finance:

- Q4: Do you agree with our proposed approach to use the three-step methodology to assess baseline allowed returns to equity?
- Q5: When estimating equity beta, which listed companies should we consider?
- 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?

Stakeholder responses

2.22. The ESO agreed with the use of CAPM, noting its view on risk-free and TMR is consistent with the views of the ENA members (step 1). In response to Q4, Centrica agreed our proposal was appropriate. The ESO agreed with the principle of cross-checks (step 2). The ESO considered that our working assumption for an asset beta of 0.6 was appropriate. The ESO and SSEN did not agree with the distinction between allowed and expected returns (step 3).

2.23. In response to Q5, the ESO referred to a consultancy report by Oxera[9] which identified seven companies that share ESO characteristics, such as lower asset intensity, limited competition risk, high reputational risk, liquidity risk and cash flow exposure.[10] SSEN stated that European comparators should be used.

2.24. In response to Q6, Centrica and the ESO agreed with the proposal to index the cost of equity allowance for changes in risk free rates. SSEN noted that equity indexation would be a new regulatory innovation and should follow the same high bar set for cost of debt indexation if implemented.

2.25. The RIIO-2 Challenge Group raised concerns on the working assumptions, stating that they thought they were too high, without commenting specifically on the methodology proposed. The RIIO-2 Challenge Group argue that the allowed return on equity should be lower, not higher, given that the ESO would bear significantly less totex overspend risk than was the case under RIIO-1.

[9] This report was submitted by the ESO as part of its response and is published alongside this document with the stakeholder responses.
[10] These companies are London Stock Exchange Group, TP ICAP PLC, Capita PLC, Balfour Beatty PLC, Experian PLC, UDG healthcare PLC, Sophos Group PLC

Decision

2.26. We have decided:

- that the three-step methodology is an appropriate framework for setting baseline allowed returns to equity for the ESO.
- to implement equity indexation by updating the allowed return on equity to reflect changes in the risk-free rate only, using the same method as applied to RIIO-T2 and RIIO-GD2.

Rationale for decision

2.27. Respondents supported alignment between the ESO and other network companies and we consider this to be an appropriate approach. Given the information we have available at this time, we do not propose to update our working assumption in this area for business planning purposes.

Allowed returns methodology: a method for considering additional funding

Recap of consultation position

2.28. In August, we set out a proposed method for considering additional funding for the ESO which would allow us to separate and assess different types of risk, allowing greater flexibility for implementation and incentive effects. We proposed this because some risks may be better remunerated by specific funding, rather than an increase in the WACC allowance. For example, it is possible that some risks may not be related to the size of the RAV (as implied by RAV*WACC).

2.29. We proposed to test each possible ESO risk as follows:

- <u>Test 1: CAPM and double-count test</u>
  Has remuneration been provided elsewhere in the price control?
  Is this risk already factored into the beta judgement?
  Is this risk symmetrical?

- <u>Test 2: Mitigation</u>
  Can the ESO/investors address this risk in whole or in part?
  To what degree does the regulatory framework mitigate this risk?

- Test 3: Scale
  How significant is this risk for the ESO?
  What drives the scale of the risk?

2.30. We set out concerns about possible perverse incentives from mechanically linking any additional funding to variables the ESO can influence. We stated that any additional funding, if required, might best be achieved through a fixed allowance.

2.31. We asked the following questions in relation to considering additional funding:

- 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?
- Q8: Do you believe that the three tests we propose are suitably comprehensive?
- Q9: What are your views on the ESO's additional funding assumptions, as summarised above (from its July 2019 submission)?

Stakeholder responses to Q7

2.32. Centrica agreed that the proposed approach was reasonable. The ESO agreed that the taxonomy provided by Ofgem provided a useful starting point for understanding risks that the ESO is exposed to. The ESO argued that Ofgem's taxonomy captured risk at a high level, and that a bottom-up approach to listing individual risks fails to capture or reflect all the ESO's risks. SSEN noted that the categories represent a step forward and that some risks could be mitigated by transfer to customers or Transmission Owners (TOs). SSEN noted that transferring revenue risk would need to be considered practically and that an impact assessment of risk transfer needs to be undertaken holistically.

Stakeholder responses to Q8

2.33. Centrica said the tests appeared appropriate but that the second test ("Mitigation") should be expanded to consider undesirable consequences.

2.34. The ESO agreed in principle that it should not be remunerated twice for the same risk. The ESO also agreed that each test has a role to play but that an important test was missing: the size of the risk in relation to the asset base. Related to this, the ESO argued that the proposed Test 3 (Scale) was not a test but a step in the process of determining how much additional remuneration is required and how it could be provided. The ESO suggested that it is important to cross check the results of the test to relevant benchmarks at both a role and organisational level. The ESO argued that this would ensure that difficult-to-quantify risks have been appropriately considered.

2.35. SSEN noted that an impact assessment and holistic review of risk transfer to TOs should be considered.

Stakeholder responses to Q9

2.36. Centrica suggested the ESO's analysis did not address fully the factors that should be considered in assessing additional remuneration, namely that:

- 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.

2.37. The ESO provided a report from KPMG to support its response, but asked that this report remained confidential, so we have not published it alongside this decision. KPMG's report suggested that the ESO could expect, based on assumed capital requirements, an overall return in the range £55m-61m, therefore suggesting a funding gap (after deducting RAV*WACC) in the range of £36m-£39m.

2.38. Referring to other benchmarks, including KPMG work published alongside the July consultation response, the ESO referred to margin benchmarking based on 72 comparator companies (EBIT margin of 11%) and using the London Stock Exchange (forecast operating margin of 13.9%). The ESO argued that these other benchmarks imply a similar funding gap compared to RAV*WACC funding model of £32m-£36m.

2.39. Therefore, by referencing KPMG's latest report and other margin benchmarks, the ESO's response implies an almost two-fold increase from its July assumptions of £20.75m.[11]

2.40. The ESO also suggested a cross-check against margin-based benchmarks, referring to the report from Oxera[12] that it submitted with its response. This shows:

- a margin on "external costs" in the range 0.20%-0.75%. Oxera select a point estimate of 0.35%, intentionally 'aiming down', explaining that "we [Oxera] consider that there should be no double counting of allowances for the handling of the revenue management function".
- EBIT benchmarks, as an overall remuneration cross-check, based on 'big six' energy companies (7-13%), comparable industries (13%) and regulatory precedent (5-12%). On this evidence, Oxera argue that a reasonable EBIT margin for the ESO would be in the range 7-12%.

2.41. The RIIO-2 Challenge Group noted it was important that any remuneration for specific risks should be separate from the RAV*WACC methodology. The RIIO-2 Challenge Group suggested that the revenue collection risk represents only timing risk, and that there are a number of possible mitigation measures as set out in the consultation document. Therefore, the RIIO-2 Challenge Group did not consider that either a higher WACC or any additional mitigation for the cash flow risk was justified.

Decision

2.42. For additional funding claims, we have decided:

- to categorise ESO risks into seven categories as proposed;
- to use the three tests as proposed;
- to retain a working assumption of zero.

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[11] As presented in the consultation, see Table 1 here: https://www.ofgem.gov.uk/system/files/docs/2019/08/riio-2_methodology_for_the_electricity_system_operator_-_decision_and_further_consultation.pdf#page=26
[12] Published alongside the ESO's response to this consultation.

Rationale for decision

2.43. Respondents showed support for our taxonomy of risks. We believe our methodology will allow us to comprehensively assess risk and is flexible enough to consider a broad range of different factors. At this time therefore we have not modified the proposed methodology, although we remain open-minded to suggestions on this. Within its business plan, the ESO should submit in detail any relevant proposals.

2.44. In our view, the three tests we proposed, alongside the illustrative questions for each, are sufficiently flexible to consider undesirable consequences, as suggested by Centrica. Similarly, we are not persuaded that Test 3 (Scale) needs to be supplemented by an additional test for quantum, as suggested by the ESO, as the methodology is sufficiently flexible to allow quantum to be estimated in-the-round, in light of our overall assessment.

2.45. Together, the taxonomy of risks and the three tests, ensure that our assessment of additional funding claims is systematic, comprehensive and robust. We therefore suggest that the ESO use this methodology within its business plan submission in December.

2.46. In our view, additional funding of zero remains an appropriate working assumption for three reasons. Firstly, the ESO may not be exposed to the same level of revenue collection risks in RIIO-2. Secondly, long-term financing resources and facilities for the ESO remains unclear. Thirdly, the ESO's submissions, and work referenced in supporting consultancy reports, highlight a large degree of uncertainty with respect to the associated cost of any additional funding. Submissions by the ESO imply the cost could be; £7-8m pa (November 2018[13]), £20m (see July 2019), or £39m (see September 2019). Further, the ESO has not clearly identified capital requirements or the cost of those requirements. In this regard, benchmarking by Oxera implies a wide range of costs (a margin between 0.2% and 0.75%) but an unclear link between revenue collection risks and the associated costs. Similarly, we believe

[13] Based on submissions from ESO during separation from NGET, as reflected in ESO licence term FINt "the provision of financial facilities allocated from National Grid Electricity Transmission plc", and shown in the ESO's licence at page 66 and page 69 here: https://epr.ofgem.gov.uk//Content/Documents/NGESO%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf?utm_source=ofgem&utm_medium=&utm_term=&utm_content=licencecondition&utm_campaign=epr#page=66

KPMG's analysis lacks transparency on the overall capital required or the cost of that capital given the associated risks. We also question the suitability of the profitability benchmarks put forward, and note that the analysis relies on an unjustified assumption that capital is always fully drawn.

Approach to financeability

Recap of consultation position

2.47. In August, we proposed that the same approach to financeability should be adopted for the ESO as for the other sectors. This approach has a focus on the notional company in assessing financeability, but also states the importance of companies assessing the financeability of their RIIO-2 business plans on both a notional and actual basis.

2.48. We noted that the methodology and metrics used to assess financeability could be different for the ESO, and that it was not clear to us that there is a clear and consistent methodology for assessing the credit worthiness of an independent ESO. We also noted that as far as we were aware, no ratio guidance has been provided by ratings agencies for this type of business in the UK.

2.49. We proposed that the particular risks that the ESO faces, potential mitigations, and how and what level of remuneration is appropriate for each risk, be assessed as part of our proposed methodology for considering additional funding (as set out in paragraphs 3.20 to 3.29 of the August consultation).

2.50. We proposed a set of ratios for the ESO and set out the rationale for these in paragraph 3.39 of the August consultation. We also sought stakeholder and ESO input on how the ESO intends to satisfy its licence conditions with regards to financial resources, financial facilities[14] and maintaining an investment grade credit rating.[15]

2.51. We asked the following related question:

[14] See for example Standard Licence Condition B7 here: https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions
[15] Ibid, Standard Licence Condition B10

- Q10: Do you agree the above metrics are relevant for consideration of financeability of the ESO? Are there any other metrics that should be added?

Stakeholder responses

2.52. Only the ESO responded in detail on the question on financeability and appropriate metrics. SSEN noted that the policy position in relation to target ratings and alignment with rating agency methodologies should be clarified for all networks, not just the ESO.

2.53. The ESO suggested that RAV*WACC funding on its own would not ensure a financeable ESO. The ESO argued that although some credit metrics are acceptable the underlying profitability of the business does not provide an investable equity proposition.

2.54. The ESO noted that Ofgem did not provide a definition of how to interpret financeability and did not provide threshold levels for the metrics proposed. In the ESO's view, whether a company is financeable or not depends on the ability of that company to service the needs of its debt and equity investors. As a result, the ESO argued, any assessment of financeability needs to consider a suite of both debt and equity metrics. For equity financeability, the ESO suggested four additional metrics: Dividend/Regulated Equity; dividend cover; EBIT margin controllable revenue and EBIT margin total revenue.

2.55. The ESO also suggested that the Adjusted Interest Cover Ratio (AICR) is an important ratio to include.[16]

Decision

2.56. We have decided:

- to use the metrics proposed at paragraph 3.39 of the consultation
- to supplement this list of metrics with the following equity ratios:
  - Regulated equity / EBITDA
  - Regulated equity / PAT

[16] We note that AICR was included on the list of proposed metrics in paragraph 3.39 August and has been included in the ESO draft business plan financial model.

  - EBITDA / RAV

Rationale for decision

2.57. Our decision reflects: the possibility that the ESO is exposed to lower levels of revenue collection risks; the ESO's RAV being larger than water network companies and the metrics used in associated rating methodologies; and the equity metrics we use for other RIIO-2 companies.

2.58. At this time, we are not persuaded to use the ESO's suggested metrics. Thus far, the ESO has not clearly identified how risks could crystallise for debt or equity financiers. We therefore do not consider the ESO's proposal to use dividend and profitability ratios, for financeability purposes, has been adequately justified. This is particularly in the absence of a clear link to associated risks and how these risks compare to other companies in other sectors that use these metrics.

Inflation index for WACC allowance and for RAV adjustments

Recap of consultation position

2.59. Inflation assumptions are required to estimate a real-term WACC allowance and to update the value of the RAV.

2.60. The SSMD Finance Annex set out our decision, following consultation on both a framework and sector specific basis to:

- implement an immediate switch from RPI to either CPIH or CPI from RIIO-2 onwards (1st April 2021 for GT, ET and GD) for the purposes of calculating RAV indexation and allowed returns. In other words, not to phase the move away from RPI.
- consider again whether to use CPIH or CPI, in light of factors listed in the consultation and in terms of the most accurate reference point for estimating real returns. We will provide an updated position on this at the Draft Determination.

2.61. In August, we proposed to adopt the same approach for the ESO RAV and WACC allowance and asked the following related question:

- 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?

Stakeholder responses

2.62. Three parties responded to Q11 and all three agreed that the same approach should be adopted as the other networks. SSEN expressed reservations about the switch to CPIH and the impact on longer term metrics on financeability.

Decision

2.63. We have decided to adopt the same approach as the other networks, i.e. an immediate switch from RPI to either CPIH or CPI from RIIO-2 onwards, for WACC allowance and RAV adjustments.

Rationale for decision

2.64. Respondents supported aligning the ESO with other networks and we do not see any convincing reason for a unique approach.

Revenue collection, financial resources and the working capital facility

Recap of consultation position

2.65. In August, we considered whether the ESO would require additional funding or regulatory mechanisms to be able to procure a working capital facility (WCF) to manage its role in revenue collection activities (eg, in relation to collecting and redistributing TNUoS and Balancing Services Use of System (BSUoS) charges).

2.66. We proposed that the ESO should set out its plans to remain licence compliant, including its obligation to secure financial resources, financial facilities and to maintain an investment grade credit rating in its business plan for RIIO-2. This should explain the steps it has taken, and/or will take, under a range of plausible circumstances.

2.67. We noted a stakeholder's question on where the revenue collection risk associated TNUoS charges should sit, and their view that the TOs rather than the ESO should bear this risk given the TOs' larger asset base. However, we noted that not all TNUoS charges relate to onshore TOs.

2.68. We stated the ESO will, to some degree, remain exposed to revenue collection risk, and our view that an important element of its plans may be a WCF. We proposed that, should the ESO plan to meet its obligations through the use of a WCF, a pass-through arrangement can be used to cover efficient WCF fees and costs (including the arrangement fee, extension fee and annual commitment fee). We noted the ESO's argument that, even if these costs are covered fully, there may be some residual risk. We proposed that if this is the case, our view is that an allowance could also be provided to remunerate appropriately the residual risk.

2.69. We noted that the merit of a pass-through approach is that it would reduce the ESO's risk that the WCF is undersized. Further, it would reduce the risk that a pre-determined allowance for all revenue collection obligations would be too small (or too large), given the lack of available evidence and benchmarks.

2.70. We asked the following related 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?
- 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?

Stakeholder responses to Q12

2.71. There were five responses to Q12. Centrica agreed with our proposals but SSEN & SPT raised concerns. NGET agreed there is benefit in considering where the TNUoS revenue collection risk should best lie. It felt our approach should follow the RIIO principle of risk lying with the party or parties best able to manage the risk, but that wherever the risk is managed, there is adequate recompense for the party.

2.72. NGET argued that the ESO is best placed to manage forecasting and tariff calculation errors. Given this, NGET suggested it is important that accurate forecasting and tariff calculations remain a priority for the ESO, for example by implementing suitable performance incentives.

2.73. NGET suggested that any transfer of the revenue risk to TOs should be consistent across all TOs (or reflect that one owner is taking risk on behalf of others). The simplest approach, NGET suggested, would be allocation pro-rata by proportion of total revenue (whether from onshore TOs, OFTOs, future CATOs or interconnectors).

2.74. The ESO agreed that there are potentially other ways to manage the cash collection risk and welcomed further discussion to ensure the risk is held by the most appropriate party. The ESO estimated K collection risk as representing £140m covering the two-year period between forecast and collection, explaining that "in the RIIO-1 period we have experienced demand driven under-collections of up to £70m p.a."

2.75. The ESO noted that cashflow collection risk was not limited to TNUoS and that it extended to other charges. The ESO argued that other cashflow risks are not covered by the K term, as follows:

- a "negative cashflow impact of around £250m" because "the ESO is reliant on customers forecasting their own annual charges", where £250m is based on reduced mitigation following CUSC modifications and on the basis of a 10% underpayment.
- up to £25m relating to "an unexpected delay in a supplier becoming liable to TNUoS charging…sized as the impact of one major generator in a high tariff zone being delayed."
- up to £75m, "in the case of a customer terminating a connection agreement" because "the ESO has an obligation to recover termination sums from the customer and to cover any costs incurred by the relevant TO. Any mismatch between these amounts is subject to a time lag of one year being recovered via TNUoS charges."
- up to £100m "for a major supplier default" covering TNUoS and BSUoS responsibilities, plus "cash requirement of managing smaller supplier defaults to be up to £20m".
- other short term cashflow requirements:
    - For balancing services, a "risk range up to £63m" based on the ESO's "historic cash position… in part driven by an event in 2016, when additional Black Start contracts were entered into for the period April 2016 to March 2017 amounting to £113m. Since this gave rise to an increase in BSUoS costs to customers of around 10%, a decision was made to defer billing of the first six months of contracted costs until the final settlement billing, which deferred the recovery of cash for 14 months."
    - With respect to Assistance for Areas with High Electricity Distribution Costs (AAHEDC), any short-term mismatch between the ex-ante forecast and ex-

post realised costs is funded through ESO working capital. A recent BEIS consultation on AAHEDC shows that costs could increase from £61m to £90m per annum, from April 2020 onwards.[17] The ESO note that in the event of supplier failure it must pay the relevant costs, and hence is exposed to the associated cashflow risk.

- Any revenue related pass-through costs in excess of forecast (e.g. Ofgem Licence Fees, Inter-TSO compensation recovery) are funded through the ESO until recovered through future TNUoS charges two years later.
- Income Adjusting Events as determined by Ofgem, drive a timing difference between costs incurred and revenues collected.
- Calculation and timing of site-specific connection charges from customers and obligations to make payments to the TOs.

2.76. There was general consensus that any consideration around moving this risk should recognise that it affects multiple industry participants and consumers so any changes should be fully consulted on before any final decisions are made.

Stakeholder responses to Q13

2.77. There were three responses to Q13. Centrica and SSEN agreed that WCF costs could be passed through, but SSEN noted that a check should be performed to ensure costs are efficient.

2.78. The ESO suggested that it didn't believe funding could be limited to arrangement, extension and commitment fees because this wouldn't provide full compensation for interest charged on drawn amounts, utilisation fees, contingent capital or interest rate risk. The ESO argued that while there is an existing funding arrangement for recovery of interest on under-collection of allowed revenues ('K' term), there are no arrangements in place for the interest cost of funding other cash outflows, which the ESO argues constitute the majority of its working capital provision.

[17] See here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/815822/HBRS-CTO-consultation.pdf#page=14

2.79. The ESO noted that if additional remuneration is included as set out in its response to Q9, there is no need to pass through the cost of a WCF, which instead would be paid for out of this additional remuneration.

2.80. The ESO also acknowledged "a WCF mitigates the majority of our liquidity risk" adding however "it does not address other risks that are directly linked to the revenue management role."

Update

2.81. We will investigate in further detail the allocation of revenue collection risks. We aim to publish a consultation before the end of the year which will consider where the cash flow risk associated with the collection of TNUoS charges is best placed, and how any changes to this would be implemented.

2.82. We expect the ESO to consider the implications this may have on its business plan proposals. Following submission of the 9th December plan, we will work with the ESO to undertake financeability analysis for both the situation where it does hold TNUoS cashflow risk and the situation where it does not. We will work closely with the ESO and TOs to consider any implications this could have for our price control determinations next year. In particular, any decisions made to change the allocation of the TNUoS cashflow risk in time for the start of RIIO-2 would be factored into our three test methodology for considering additional remuneration for the ESO.

2.83. We agree with the ESO that not all costs associated with the revenue collection role could be covered via a WCF pass-through – because some costs are unobservable, such as interest rate risk costs. At the Draft Determination we will confirm whether any additional funding is provided in part by a pass-through mechanism, and make clear the scope of any such pass-through arrangement.

Other Finance Issues

Recap of consultation position

2.84. We proposed to adopt, at this stage of the review, the same approach to other finance issues for the ESO set out in the SSMD Finance Annex (such as regulatory depreciation, fast/slow money split, notional gearing, equity issuance transaction cost allowance, tax allowances, pension scheme established deficits, directly remunerated services and disposal of assets).

2.85. We asked the following 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?

Stakeholder responses

2.86. There were three responses to this question and all broadly agreed with this proposal.

2.87. The ESO suggested that a notional gearing assumption of 50-55% is reasonable but agreed that it is too early in the process to decide the notional gearing level.

Decision

2.88. We have decided that the approach to other finance issues remains in line with the consultation proposal (paragraph 3.52 of the consultation) and hence in line with other RIIO-2 networks.

Rationale for decision

2.89. Respondents supported the proposed alignment with other networks and we do not at this time see any reason for a unique approach.

3. ESO roles framework and incentives scheme

Summary of decisions	
Decision	We will streamline the existing roles framework by moving from four to three roles.
Decision	The existing ESO principles will not be used as part the performance evaluation process for RIIO-2. We have also decided against introducing the 'impacts and outcomes' as a new, formal component of the performance evaluation process.

Background

3.1. In April 2018, we introduced a new evaluative approach to regulating and incentivising the ESO. This approach is built around us being clear up front about our expectations for the ESO. However, it puts the onus on the ESO to engage with stakeholders to develop the details of how it can best deliver against these expectations.

3.2. The framework is centred around a forward plan that the ESO creates with its stakeholders at the start of the year. The ESO then reports on its progress against this plan throughout the year and receives feedback from stakeholders, ourselves and an external performance panel. At the end of the year, the panel then performs an evaluation using predefined evaluation criteria. This end of year evaluation forms a recommendation to us, who then make a final decision on the incentive payments or penalties for that year. This broader incentives approach replaced the package of discrete, target-based financial incentives that existed previously.[18]

3.3. In May 2019, we set out our decision to maintain the evaluative, ex post approach to incentives for the ESO for RIIO-2. We believe this approach is better aligned with driving the proactive, flexible and collaborative behaviours we need from the ESO in the rapidly changing energy system. At the same time, we also recognised that the framework was still relatively new. We noted our intention to review the first year of the scheme and consult on potential changes.

[18] For more information please see: https://www.ofgem.gov.uk/publications-and-updates/policy-decision-electricity-system-operator-regulatory-and-incentives-framework-april-2018

3.4. In August, we set out lessons learned from the first year of the incentives scheme. We explained our initial thinking on how it should evolve for RIIO-2 and asked consultation questions in the following areas:

- the roles framework;
- the incentive scheme purpose and scope;
- the process for agreeing plans and assessing performance;
- the evaluation approach; and
- the arrangements for stakeholder input and the performance panel.

3.5. We also noted our intention to consider introducing some changes early for the 2020/21 ESO incentives scheme, and we asked stakeholders which changes should be prioritised.

3.6. In this chapter we are making decisions on changes to the roles framework for the ESO. We also provide updates on the next steps in relation to the other areas of the August consultation.

Roles framework

Recap of consultation position

3.7. The ESO Roles and Principles framework describes and groups the ESO's key activities and sets out our expectations for how these activities should be performed. Its purpose is to encourage the ESO to focus on delivering benefits for consumers across all of its activities and it is designed to align expectations between the ESO, Ofgem and stakeholders. The roles framework is also the foundation of our current incentives approach. It defines the groupings of activities against which the evaluation process relates to, and therefore presents a structure for the ESO's plans and performance reports.

3.8. In August, we proposed streamlining the roles framework by moving from four to three roles.[19] In particular, we considered that 'Facilitating whole systems outcomes'

[19] See page 40 of our consultation document: https://www.ofgem.gov.uk/system/files/docs/2019/08/riio-2_methodology_for_the_electricity_system_operator_-_decision_and_further_consultation.pdf

and 'Facilitating competitive markets' were more suited to describing expectations we had for the ESO across all of its roles, rather than setting groupings of activities. Our three proposed roles were: short term operations; market development and procurement; and network development and planning. We believed this approach would minimise the scope for overlap in the ESO's reporting and the evaluation process. We also believed this could facilitate a more tailored approach to the performance evaluation. This is because the proposed roles could be seen to deliver benefits over broadly different time horizons.

3.9. We also proposed replacing the ESO principles with a defined set of 'impacts and outcomes' for the ESO. We felt this could align further expectations about what the ESO should be trying to achieve through its activities, and how it can demonstrate the delivery of consumer benefits.

3.10. Finally, we stated in August that we believed it would be worthwhile reviewing the ESO's existing licence requirements to see if they need to be improved, expanded or adapted in any way. In particular, we wanted to consider whether Standard Licence Condition (SLC) C16 is the right vehicle for providing clarity on baseline obligations across a diverse set of roles. We also noted that we will consider whether any further clarifications are necessary in the ESO's licence to ensure consistency with whole system obligations on other network operators.

3.11. We asked stakeholders for the following questions:

- Q15: Do you have any views on our initial thinking for how the ESO roles framework should evolve?
- Q16: Do you support the introduction of a defined set of ESO outcomes and impacts? If so, what should these outcomes and impacts be?
- Q17: Do you think any changes are needed to ESO's licence conditions in order to further clarify its baseline obligations?

Stakeholder responses

3.12. The majority of respondents agreed with our proposals to streamline the number of roles from four to three, and in particular, that facilitating whole system outcomes should be an expected behaviour across all roles. They felt this should help to provide clarity on expectations and help ensure the roles do not overlap. However, one stakeholder believed that the roles should be fully split by short, medium and long term time horizons, as they believed this approach was more in line with economic theory and regulatory practice.

3.13. There were mixed responses on the impacts and outcomes proposal. Whilst some felt they could add value, others believed they could be too high level and non-specific to be useful in practice. One stakeholder felt measuring the ESO against impacts and outcomes would need to be supported by clear metrics. The ESO felt the proposed outcomes and impacts broadly represented a logical direction of travel for the ESO. However, it did not consider them to be specific enough to be used to evaluate ESO performance, and it was unclear how they would replace the existing principles in practice. The ESO also felt it was too late to engage stakeholders on the role of impacts and outcomes in its 2021-23 business plan.

3.14. Several respondents felt that the ESO's licence should contain obligations on whole systems outcomes consistent with those proposed for the Distribution Network Operators (DNOs) and TOs. The ESO also supported embedding whole system obligations within in the licence, and believed more generally that SLC C16 does not underpin the entire roles framework. The ESO argued that the contents of associated licence documents should be embedded into the licence as far as possible. One stakeholder suggested new licence conditions relating to the ESO running the lowest possible carbon system and procuring balancing services through the most open, competitive route possible. Another stated that more specific definitions should be considered within SLC 16.

Decisions

<u>Roles</u>

3.15. We have decided to streamline the ESO roles from four to three. These three roles are broadly the same as those proposed in August, but with small differences to their names to improve clarity.

3.16. The three streamlined roles are:

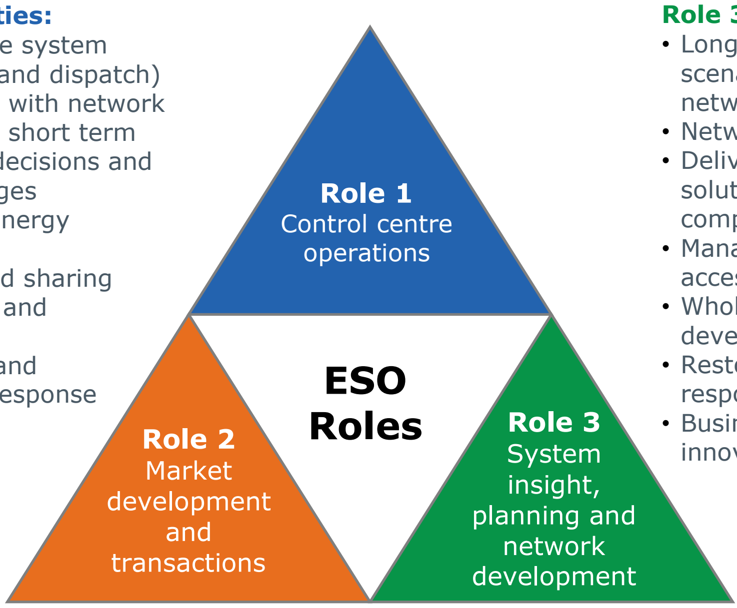
- **Role 1**: Control centre operations;
- **Role 2**: Market development and transactions; and
- **Role 3**: System insight, planning and network development.

3.17. We currently expect the ESO's key activities to be split between the roles as displayed in Figure 1.

3.18. For the avoidance of doubt, no activities or expectations included against each of the previous roles are being removed. They will instead be re-categorised to the most appropriate of the three streamlined roles.

Figure 1 – ESO roles framework for RIIO-2

Role 1 activities:
- Operating the system (monitoring and dispatch)
- Coordinating with network operators on short term operational decisions and outage changes
- Short term energy forecasting
- Managing and sharing system data and information
- Restoration and emergency response



Role 3 activities:
- Long term forecasting, energy scenarios and identification of network needs
- Network Options Assessment
- Delivering competitive system solutions and early network competition
- Managing connections and access to the network
- Whole system process development
- Restoration and emergency response planning
- Business change strategy & innovation

Role 2 activities:
- Balancing and ancillary service market design
- Service procurement and settlement
- Revenue collection
- Policy advice and delivery of market framework changes
- Code administrator
- EMR Delivery Body

3.19. The ESO should structure its final business plan in December in line with these three roles. In addition, we intend to launch a detailed consultation on specific changes to the ESO roles framework guidance document before the end of 2019, in order to introduce these changes for the 2020/21 ESO incentives scheme.

Principles, impacts and outcomes

3.20. The existing ESO principles will not be used as formal part the performance evaluation process for RIIO-2. We have also decided against introducing the proposed 'impacts and outcomes' as a new, formal component of the performance evaluation process.

3.21. Instead, we will edit our framework guidance documents to ensure the expectations we have previously set for ESO are transparently accounted for. This includes expectations previously communicated through the four previous ESO roles, the seven ESO Principles, and through existing documents and decisions.

3.22. We will also ensure that our ESORI Arrangements guidance document provides sufficient clarity on how the ESO should demonstrate the delivery of consumer benefits. We envision that the high level impacts proposed in August will be incorporated as additional, explanatory guidance to support our existing evaluation criteria (as opposed to being a new, separate part of the framework).

Rationale for decisions

<u>Roles</u>

3.23. The streamlined three roles were supported by the responses to the consultation. We believe this structure will minimise the scope for overlap in the ESO's performance reports and the evaluation process, and aid stakeholders' understanding of the ESO's activities and deliverables. Grouping activities which deliver benefits over more similar time horizons, could also enable us to tailor the evaluation process to each role. This could help target and sharpen the overall incentive.

3.24. We have considered the stakeholder suggestion to structure entirely the roles by short, medium and long term activities. However, we note that the purpose of our roles framework is not just for structuring the performance evaluation. It also sets a structure for the ESO's business plans and reports and provides transparency for stakeholders about the ESO's activities and deliverables. The roles structure therefore must strike a balance between grouping the ESO's activities by those that are closely related in terms of their content and those that deliver benefits over similar time horizons.

Principles, impacts and outcomes

3.25. We acknowledge the feedback from respondents that it is important to maintain simplicity in the framework. We also note that respondents appeared to have differing interpretations of the purpose of the proposed impacts and outcomes. We do not want to introduce confusion or complexity. As a result, we think it would be better to clarify expectations through existing aspects of the framework, rather than introducing new aspects.

3.26. For the avoidance of doubt, these decisions do lessen our expectations for the ESO. We do not see the outcomes described in our August publication as new objectives. Instead, we believe the outcomes are aligned with existing expectations and therefore we can articulate these within the existing guidance, rather than being introduced as separate, standalone elements.

Updates

Licence changes

3.27. Whilst we do not have specific proposals at this stage, we will consider further the need to update the ESO's licence to clarify its baseline obligations, and in particular whether SLC C16 is the appropriate location for this. We anticipate that any proposals in this area will be developed as part of the wider, ongoing RIIO-2 licence modification process. We expect to consult informally on RIIO-2 licence modifications next year.

3.28. We are currently clarifying the licence conditions for DNOs and TOs to reflect our expectations for whole electricity systems coordination.[20] As these are finalised, we will consider whether any further clarifications are necessary in the ESO's existing licence requirements to ensure consistency.

[20] https://www.ofgem.gov.uk/publications-and-updates/consultation-licence-conditions-and-guidance-network-operators-support-efficient-coordinated-and-economical-whole-system

Incentive scheme purpose and scope

Recap of consultation position

3.29. A key aim we have for the ESO's RIIO-2 price control is coherence between all different types of incentives and the new business planning process.

3.30. We believe that the move to a pass-through funding approach will better encourage the ESO to take on new deliverables and activities within a business planning period and to deliver these to a high standard. In addition, a two-year planning cycle will help ensure that plans can be refined more easily and adapted when beneficial new projects or responsibilities are identified. On top of this, the ESO will have access to RIIO-2 innovation funding, which will enable it to fund additional, innovative projects which focus on solving problems relating to the longer term energy system transition. We think this means that as a baseline expectation, the ESO has significant scope to fund activities that deliver in industry and consumers' interests.

3.31. In August, we set out our initial view that the incentives scheme should be focussed on encouraging the ESO to provide an exceptional quality of service when developing and delivering its funded activities. An exceptional quality ESO service could include:

- the development of clear, comprehensive and ambitious future strategies, backed by robustly-defined and tangible short-term plans;
- strong progress and timely delivery against these clear, tangible and ambitious strategies and plans;
- robust stakeholder engagement and a high level of industry trust and respect;
- the maximisation of benefits in the way funded activities are performed, (including outperforming past performance levels and maximising short and long-term efficiency in system costs, such as balancing costs); and
- the delivery of innovative and future looking internal business models and processes, in order to maximise short and long run internal cost efficiency.

3.32. We asked stakeholders the following question:

- 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?

Stakeholder responses

3.33. The majority of respondents agreed with our initial thinking on the purpose and scope of the scheme. Some suggested additional objectives for the scheme, including ensuring it encourages an exceptional level of transparency in procurement, as well as the complete removal of barriers to entry to balancing markets. Another suggestion was that the scheme should cover the successful rolling out of innovation projects into business as usual, as well as the identification of whole system projects that can deliver benefits to society. One stakeholder questioned how these aims would interact with the rest of the framework in practice. They felt there should not be overlapping layers of performance criteria and that simplicity was important.

3.34. The ESO considered that 'exceptional' was too high of a bar for performance measurement, and that exceptional service may come at a high cost (that may not be in consumer's interests). It also believed that quality of service alone is too subjective and needs to be supported by clear performance measures.

Update

3.35. We will feed responses received in this area into the precise design our incentive scheme, which we will consult on at the Draft Determination stage next summer. We agree that simplicity and transparency in the design of incentives is important. For the avoidance of doubt, the points covered in paragraph 3.31 above would not be separate performance measures for the ESO. They are to seek views on the overarching purpose and scope of the scheme to inform its precise design. The ESO's performance would be measured solely using the evaluation criteria.

3.36. We agree on the need to ensure a degree of predictability in the scheme and note the ESO's request for greater ex-ante certainty. Predictability is supported by unambiguous and justified metrics and deliverables, which have been agreed with stakeholders and Ofgem. The ESO has a fundamental role to play in ensuring predictable incentives through the development of its business plan. We strongly encourage the ESO to ensure its December business plan meets the expectations we set out in May.[21]

Process for agreeing plans and assessing performance

Recap of consultation position

3.37. The incentives scheme currently runs for one year. As part of the ESO's annual forward plan, it is required set out key deliverables and performance metrics for each of its roles and consult on these with stakeholders. Once the final plan is published we produce a 'formal opinion'. This formal opinion sets out our views on the level of ambition in the plan and is designed to create clarity over the extent to which the ESO can expect to score highly from successfully meeting its deliverables and outperforming its performance metric benchmarks. The formal opinion is therefore intended to be a tool to support predictability and incentivise the ESO to develop strong forward plans and metrics in the first place.

3.38. In August we set out our view on the need to strike the right balance between predictability and flexibility in the performance evaluation. We also set out our view that during the first two years of the scheme, the ESO has not consistently developed sufficiently justified, well-specified or stretching performance metrics. As a result, the panel and Ofgem placed less weight on these metrics in the performance evaluation. This ultimately increases the ex-post elements and reduces the ex-ante elements of the scheme, and can also create additional reporting burden for all parties.

3.39. We set our thinking in three areas:

- On the scheme length: we proposed aligning the length of the incentive scheme with the two-year business planning cycle.
- On the governance of metrics: we set out our view that, in the event that the ESO does meet our requirements to develop well specified and stretching

[21] See page 32: https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodoloy_decision_-_eso.pdf

metrics, we would set metrics in key areas during the price control determination stage.

- On the plan assessment process: we set out our view that our review of the ESO's business plan would influence the overall size of incentives for the two-year period, which we would consult on during the determinations process.

3.40. We asked stakeholders the following questions:

- Q19: Do you agree with our proposal to align the length of the incentive scheme 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?
- Q21: Should there be financial incentive implications for the ESO as a consequence of the business plan assessment process?

Stakeholder responses

Scheme length

3.41. The majority of respondents were supportive of moving to a two-year incentive process in order to align with the business planning cycle. The ESO suggested that six-monthly panel meetings should be retained to ensure it is provided with regular feedback on its performance, whilst another stakeholder felt that performance was unlikely to change significantly in a six-month period.

Governance of metrics

3.42. The majority of respondents supported Ofgem setting performance metrics in key areas. There were a range of views on whether this should be a last resort, or whether this should be the default for all metrics. Some stakeholders suggested additional areas where they believed metrics were particularly important. This included metrics on developing competitive and accessible balancing markets, the transparency of balancing and procurement, progress in addressing long term system operability challenges, and the transition to a zero carbon system.

Plan assessment

3.43. Several respondents, including the ESO, were against the concept of changing the total incentive value according the quality of the business plan. They were concerned that this could weaken the incentive scheme, create uncertainty and discourage the ESO from looking for additional ways to unlock benefits for consumers during the price control period. Some respondents considered the proposal was akin to the Business Plan Incentive (BPI) on other RIIO network companies, and suggested the processes and approaches are fully aligned. The ESO believe the proposal was a BPI and believed that it was too late in the process to introduce this for the 2021-23 ESO business plan.

Update

Scheme length

3.44. We anticipate moving to a two-year scheme for RIIO-2, but we will make a final decision during the determinations. This will allow us to further consider the impact of a two-year scheme on revenue recovery. We will take on board comments on the timing of specific scheme process (such as panel sessions) as part of this decision.

Governance of performance metrics

3.45. We reiterate our expectation that the ESO needs to meet our requirements and submit relevant, specified and stretching performance metrics in December. Once we have reviewed the December business plan, we will determine whether or not there is a need for Ofgem to edit or intervene in the design of the final performance metrics through the price control determinations process.

Plan assessment

3.46. We agree with stakeholder feedback that we need the ESO to be ambitious and that the calibration and value of incentives is important to this. We acknowledge the strong stakeholder feedback that reducing the incentive value could dampen incentives on the ESO to be ambitious. This could lead to missed opportunities during the price control period. We are therefore not proposing to take this proposal forward.

3.47. At the same time, our intention is that the incentives scheme directly relates to the ESO's performance in delivering the business plan. If the business plan deliverables and metrics are unambitious, then we should not be rewarding the ESO for delivering an unambitious plan. This could also have the perverse consequence of encouraging the ESO to develop plans that are easy to outperform, which in turn could undermine the energy system transformation at a crucial time.

3.48. We strongly expect the ESO to ensure its plans meets our May business plan expectations.[22] However, in the event that this does not happen, our current thinking on the implications for the ESO is as follows. We would not reduce the maximum incentive available for exceptional performance. However, as above, we may choose to set certain metrics ourselves, which would likely be set at more challenging levels than the ESO's. We may also indicate during the determinations process that the performance evaluation should place relatively less emphasis on plan delivery, and more emphasis on the other evaluation criteria and/or additional evidence provided outside of the plan (e.g. if deliverables and their timelines are poorly justified and do not factor in industry feedback).

3.49. The consequence therefore for the ESO of not delivering a well specified, well justified and stretching plan is that it may have created relatively less ex-ante certainty. This would be similar to the approach taken with the formal opinion process now. We will explore how to ensure our conclusions during the determinations stage provide a focussed steer on the relative quality of the different parts of the business plan, to reinforce predictability around incentives for the ESO.

Evaluation approach

Recap of consultation position

3.50. The ESO's performance is currently evaluated in three 'role areas' using predefined evaluation criteria. For more information on the approach, please see Chapter 3 of

[22] See page 32 of our May 2019 sector methodology decision: https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodoloy_decision_-_eso.pdf

our Electricity System Operator Reporting and Incentives (ESORI) arrangements guidance document.[23]

3.51. A key lesson learned from the first year of the scheme is the importance of ensuring there is the right balance between predictability and flexibility in the evaluation process for the ESO.

3.52. Our experience in practice is that the ESO's roles vary in nature. This means that the focus of the evaluation for each role has also been different in practice. Whilst our current evaluation criteria are designed to allow for these differences, this flexibility could also mean the incentive effect is less sharp than it could be. It could also result in the ESO disproportionately reporting against criteria which might be viewed as less relevant for a role.

3.53. In August, we set out our initial thinking on potential adjustments to the evaluation criteria in order to target and streamline the evaluation process and ensure it worked effectively with the new funding model.

3.54. We asked stakeholders the following questions:

- Q22: What if any changes might be needed to the incentives evaluation criteria?
- Q23: How should we best include internal cost efficiency in the evaluation framework – should it be a performance metric or explicit criteria?
- 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?
- Q25: Do you think medium to longer term roles should have relatively more upside incentives focus than short term roles?

Stakeholder responses

3.55. Respondents were broadly supportive of our initial thinking on the evaluation approach and criteria. Most supported continuing to evaluate by role, the tailoring of

[23] ESORI Arrangements Guidance document:
https://www.ofgem.gov.uk/system/files/docs/2019/03/esori_guidance_document_2019-20.pdf

criteria to each role, as well as the potential to have relatively more upside for longer term focussed roles. One stakeholder suggested this could be countered with a relatively sharp downside incentive on balancing costs, building on the approach taken in Ireland. A number of stakeholders also supported the suggestion to merge criteria on current and future benefits.

3.56. Respondents generally felt plan delivery should be a key evaluation criterion, so long as the initial plan's timescales and budgets are clearly ambitious (and there is sufficient expertise available to understand this). One respondent noted that many of the ESO's deliverables need close collaboration with other parties, so incentivising ambitious timescales may risk the coordinated delivery of initiatives.

3.57. A few respondents commented on the inclusion of internal costs within the incentives framework. Most of those respondents felt this could be better achieved through a performance metric than a discrete evaluation criterion. One respondent suggested that any expenditure on new initiatives that are brought forward within a business plan cycle should be reported separately. The ESO did not believe internal costs should be included in the incentive framework. The ESO believes it will already be operating at the efficiency frontier through its business plan proposals, and that including internal costs in the framework (in combination with the potential to disallow inefficient costs) would lead to risk aversion and a disproportionate focus on internal costs.

Update

3.58. We will feed the responses received into our detailed proposals on the evaluation approach during the determinations process.

3.59. A key aim for our price control is that there is the correct balance between incentives on internal cost efficiency and incentives on the ESO to deliver wider outcomes. This is the key driver for removing the TOTEX incentive mechanism for the ESO. As part our determinations process, we will take into account evidence provided by the ESO in its business plan on the efficiency of its cost proposals.

3.60. At present, we still believe internal costs should be factored into the incentives in some way, as we should ensure the ESO has an appropriate incentive to run its business efficiently and to introduce innovative new internal processes. We also note the ESO's concern in response to Q18 that targeting incentives at exceptional performance could lead to levels of spending that would not be in consumer's overall interests. We believe that including both internal costs and external outcomes in the wider incentives framework could encourage the ESO to view striking the right balance between internal expenditure and delivering wider benefits as a key part of delivering an exceptional quality of service.

Stakeholder input and performance panel

Recap of consultation position

3.61. Stakeholder feedback is a key aspect of our ESO regulatory framework. In many areas, industry is better placed to help shape ESO priorities and judge its performance than we are. Stakeholders and external parties are also crucial for helping us to address the inherent information asymmetry in monopoly regulation. We therefore want to continue providing stakeholders with the right platforms to shape ESO activity and hold it to account for its performance.

3.62. The ESO performance panel is a vital part of our effort to factor in more stakeholder and external perspectives into ESO regulation. The panel plays a key role in our current incentives framework. It helps to define the ESO's priorities at the start of the year, challenges its performance throughout the year, and makes recommendations which guide our incentive decisions.

3.63. In August, we set out our view that the role of the panel would stay broadly the same for RIIO-2, although it would also be asked to consider the ESO's internal costs. We proposed it would meet to comment on the ambition and cost efficiency of the business plan; provide feedback at the mid-period stage; and perform a performance evaluation at the end of the two-year business plan period.

3.64. We considered that there are likely to be synergies from the panel considering both inputs and outputs when evaluating overall performance. We set out our view that that strong business plan and metric governance, streamlined reporting and targeted evaluation criteria should make the inclusion of this task manageable. This is because it should lead to less focus on the ex post assessment of new, additional evidence provided by the ESO throughout the year, and more focus on assessing how the ESO's performance is tracking against elements defined ex ante in the plan.

3.65. We did not propose any major changes to the structure or make-up of the panel, and proposed maintaining an Ofgem chair in the short term. We noted that we would continue to review whether we have the right mix of skills and expertise on the panel prior to the start of RIIO-2.

3.66. We asked stakeholder the following questions:

- Q26: Do these arrangements give stakeholders the right platform to shape ESO activity and hold it to account for its performance?
- Q27: Do you have any further suggestions for improving the existing ESO performance panel arrangements?

Stakeholder responses

3.67. Most stakeholders agreed the current arrangements give them the right platform to shape ESO activity and comment on performance. However, some noted that moving to a two-year scheme could reduce opportunities to input and shape ESO activity. They would like the ability to input at the mid-period point and propose deviations from the original business plan. One respondent felt there may be scope for further stakeholder involvement in the process of designing performance metrics.

3.68. Most respondents agreed the performance panel should have a role in assessing the business plan and considering internal cost expenditure, although they noted we should carefully consider whether this would markedly increase administrative burden for the panel.

3.69. The ESO noted the arrangements have helped create a culture of the ESO seeking feedback on its performance. However, the ESO stated that feedback will be negatively skewed and that this needs to be accounted for the in the evaluation. The ESO noted that actions taken to benefit consumers may not please all industry stakeholders. The ESO also suggested that Ofgem should not chair the panel as this risks de-valuing the independent scrutiny provided in the performance evaluation.

Update

3.70. We will factor in the feedback provided to shape detailed proposals on the arrangements for stakeholder involvement and the panel at the Draft Determination.

Priority areas for 2020/21 incentives

3.71. In August we noted that we may consult on bringing in some changes to the incentives framework early for the 2020/21 scheme. We asked stakeholders which areas should be prioritised.

Stakeholder responses

3.72. Most stakeholders that responded to this question noted that changes to the roles framework could be brought in early. A couple of stakeholders also commented that changes to licence conditions relating to whole electricity systems coordination should be prioritised. Some suggested that changes to target the evaluation criteria could also be introduced early.

3.73. The ESO suggested that changes could be introduced to the incentives framework to account for its belief that there is inherent negative bias in industry feedback. The ESO also note that there was scope for it to improve its performance metrics before the next scheme and that it would be seeking views on this in the coming months.

Next steps

3.74. We will soon launch a consultation on specific changes to our two guidance documents: the ESO Roles and Principles[24] and the ESORI Arrangements Guidance.[25]

3.75. This will introduce our decision to streamline the roles framework, for the 2020/21 incentives year. Whilst it will be challenging to introduce any significant additional changes to the evaluation process at this point, we are considering smaller changes, such as merging the criteria on delivered and future benefits to help streamline the ESO's performance reports. We will also further consider whether there is clarity on how stakeholder feedback should be accounted for as part of the evaluation approach.

[24] https://www.ofgem.gov.uk/system/files/docs/2019/03/eso_roles_and_principles_guidance_2019-20.pdf
[25] https://www.ofgem.gov.uk/system/files/docs/2019/03/esori_guidance_document_2019-20.pdf

3.76. We are not proposing to introduce changes to the ESO's licence conditions before April 2020 given the need to prioritise the review of the ESO's RIIO-2 business plans. However, we will factor in the feedback received on changes to the ESO's licence as part of the licence change consultation process for RIIO-2, which will begin next spring.