

Akshay Kaul
10 South Colonnade
Canary Wharf
London
E14 4PU

Louise.schmitz@nationalgrideso.com
07583 012922
www.nationalgrideso.com

Cc: James Veaney
RIIO2@ofgem.gov.uk

14 October 2019

Open Letter Consultation on approach to setting the next electricity distribution price control (RIIO-ED2).

Dear Akshay,

We welcome the opportunity to respond to your Open Letter Consultation on approach to setting the next electricity distribution price control (RIIO-ED2). National Grid Electricity System Operator (NGESO) became a legally separate entity on 1 April 2019. As the Electricity System Operator (ESO) we use our unique perspective and independent position to facilitate market based solutions which deliver value for consumers. The way we generate and use electricity is changing, driven by a multitude of challenges including decarbonisation, digitalisation and decentralisation. In this changing landscape, many of the traditional distinctions between transmission and distribution become increasingly blurred. We have traditionally worked with the DNOs and larger distribution connected parties to deliver efficient outcomes for consumers; however, we believe these relationships need to deepen as the industry continues to evolve. The new RIIO-ED2 framework should appropriately fund and incentivise network companies to realise this vision.

As such, we recognise the importance of the RIIO-ED2 price control and the need for alignment between ED2 and the ESO RIIO2 price control. It is important that these price controls are aligned with the outcomes of Ofgem's Sector Specific Methodology Decision. This will ensure the industry is able to react to the changing landscape with innovative, whole system solutions, whilst maximising consumer benefit.

Key points in our response:

- We agree with Ofgem's proposed objective for RIIO-ED2 to ensure DNOs deliver value for money services for consumers of today and the future. As the industry undergoes major changes with topics such as decarbonisation at the forefront of debates, we support Ofgem's overall objectives for RIIO-ED2, and hope this will help ensure that DNOs are incentivised to adapt to and facilitate these changes in the energy system for the benefit of consumers.
- We support DNOs having price controls that support strategic investment but would encourage Ofgem to ensure that the resulting funding model provides sufficient remuneration to provide a fair return for the DNOs' exposure to risk.
- We agree with an approach that sees broader consideration of the new roles and responsibilities in the changing landscape. We agree with the need for an agile approach to Distribution System Operation (DSO). A coordinated approach that considers whole electricity system outcomes ensures that we can deliver least regrets solutions that create consumer value.

Our response, contained in the following appendix, aims to summarise our views on each topic rather than answer questions specifically. We have responded where we believe we can provide relevant insights and value.

We welcome the opportunity to further discuss the points raised within this response. Should you require any further information or would like clarity on any of the points outlined in this paper, then please contact Kelly Larkin in the first instance at kelly.larkin@nationalgrideso.com.

Yours sincerely,

Louise Schmitz
ESO Regulation Senior Manager
National Grid Electricity System Operator

Strategic approach to RIIO-ED2: responses to your questions

Setting price controls that support strategic investment

How do we ensure that network companies are best placed to undertake strategic investment and manage the associated risk?

The ESO Network Options Assessment (NOA) is an effective and valuable tool that we currently use to help balance the risk of over and under-investment in electricity transmission network assets. It is a central tool that supports the development of an economic and coordinated electricity system, informing the most efficient strategic investment for the National Electricity Transmission System (NETS). We believe that RIIO companies should demonstrate consideration for the whole system through their business plans. The NOA process could be further enhanced by the inclusion of DNO information, but we also acknowledge that with several companies potentially developing a similar NOA process, this requires a degree of coordination. Therefore, we believe network companies should be incentivised in a way which encourages the development of processes that complement existing activities, such as the NOA.

We welcome Ofgem's objective of creating an environment where more strategic investment is encouraged and ensuring the market is flexible to adapt to the changing market trends over future years. To ensure network companies are best placed to undertake strategic investment, network companies should have an appropriate funding model to allow for the exposure and risk undertaken with such investment decisions. It is also important to include flexibility within the price control to allow network companies to be responsive to changes in the energy landscape and to meet consumer and stakeholder needs.

Setting price controls that drive innovation and competition

Views on the proposed innovation stimulus and the types of projects that should be funded through either the NIA funding or a new funding pot?

NIA funding arrangements are necessary to drive innovation within the network and ensure network companies are taking sufficient risk to address mid to long-term challenges facing their networks and for the benefit of consumers. Having NIA funding accessible and managed by the networks allows projects to be done in a more agile manner and gives space to innovate in areas in which they best understand the challenges and can aim to solve these with support from academia, industry and other networks. It suits multiple shorter, higher risk, more disruptive projects, particularly at lower Technology Readiness Levels (TRL) e.g. research and early stage development.

We believe there should be continuation of the NIA or a similar mechanism in RIIO-2. It is critical that there is a ring-fenced budget to allow for higher risk projects that would not pass internal investment criteria. It is important that there is certainty over NIA funding to ensure continuity of projects beyond the end of RIIO-1; otherwise, licensees will undertake only short-term, low risk projects where successful results are guaranteed.

We agree with Ofgem's changes to the innovation stimulus and agree with the proposal to replace the NIC with a new funding mechanism structured around solving the most significant strategic challenges for the energy system. The challenge with this approach will be in reaching agreement on the areas that these projects should focus on. We believe there should be a separate piece of work, which could potentially be owned by parties such as the Energy Networks Association (ENA), supported by industry, to propose these focus areas. If Ofgem were to take on the role of directly approving funding, it would need to possess a large department of experts who could evaluate the technical and commercial merit of individual proposals and would still need to pool from the experience and expertise of the various licensees in order to best judge the various proposals. Another possibility would be for the creation of a whole system innovation fund to be managed by a single licensee or cross-licensees programme. The ESO could potentially have a role in the management of such a fund because of its holistic view of system needs and concerns.

How can the benefits of the innovation stimulus be maximised by supporting schemes proposed by non-network parties?

We strongly support increasing engagement with third parties and believe this can be achieved through greater transparency, communication and collaboration across industry; for example, through our SO Innovation Strategy¹, at events such as Open Innovation Days and through participation in industry initiatives such as the Open Networks Project

¹ <https://www.nationalgrideso.com/innovation/strategy>

and other ENA programmes. We also see value in increased cross-sector collaboration for innovation projects to support whole system approaches.

However, we strongly disagree with direct innovation funding to third parties; funding should always be linked to, and directed by, the party that owns and operates the challenge. If third parties are funded in isolation, there is a high risk of developing solutions that do not match any real-world problem, or of developing expensive solutions to problems that have evolved or have been partially addressed through other means. The process to approve a project for funding should be a rigorous one, and it requires resources and a thorough understanding of the various issues affecting the network systems.

Views on the different competition models for ED2 and what, if any, criteria should be set out for the use of early or late stage competition models.

We fully support the introduction of competition in network development wherever possible. We believe Ofgem should adopt early models as they facilitate innovation and therefore can deliver greater consumer benefits. We believe the greatest consumer benefits can be realised by running competitions in the early stages of project design so that the full benefits from innovation in design and delivery can be realised. Late models could lead to further delays and therefore increased constraint costs, which should be considered in Ofgem's impact assessment.

Similar to the above, we would be cautious in opening competition funding directly to market participants and would encourage strong collaboration between the networks and third parties in the early and late stage competition models, throughout the process. Any collaboration should also be supported by all parties, rather than a forced arrangement, to ensure a better chance of success, and so that results are mutually beneficial.

How native competition obligations and best practices can be used to ensure the best outcomes for consumers and to drive changes in the role of the networks in a transforming energy system.

In exploring how network companies can use competition to find alternatives to network investment, Ofgem should ensure the approach it adopts complements the ESO's network development processes. The ESO is currently introducing competition to find the most economic solutions to transmission network needs. It is important to ensure the competitive processes of different companies don't conflict; Ofgem should consider how any incentives, funding arrangements or assigned roles and responsibilities can promote collaborative working and overall network benefits. Any incentives aimed at promoting collaboration should be objective and clear enough to reward different parties for their input.

Setting price controls for DSO functions:

Is there a need to separate out the revenues and outputs for 'traditional' DNO functions from DSO functions?

We welcome the publication of Ofgem's position paper on Distribution System Operation and the greater clarity it will provide to stakeholders. We recognise the impact of DSO on the RIIO-ED2 price control and agree with an approach that sees broader consideration of the new roles and responsibilities of DSO in the changing energy landscape.

We consider Distribution System Operation (DSO) to be a fundamental part of whole system development however it may be appropriate to ensure that RIIO-2 frameworks ensure that when necessitated, network organisations are appropriately incentivised to develop and undertake DSO activities.

We believe that transparency and clear separation in roles and outputs for DSO functions will help provide stakeholders with confidence that any potential conflicts of interest with DNO functions are appropriately managed. We therefore agree that revenues and outputs for 'traditional' DNO functions should be separate from DSO functions.

RIIO-ED2 Framework

Length of price control

The length of the price control should balance flexibility with appropriate certainty to enable longer-term strategic investments for the benefit of consumer. As the ESO price control will have a two-year business planning cycle within the longer RIIO-2 price control, we believe that any differences in length of cycle between DNOs and the ESO are managed so that we can continue to work together to deliver outcomes across the whole electricity system.

Enabling whole system solutions:

How can RIIO-ED2 best capture the benefit of whole system solutions? How could these benefits be measured?

We fully support the attention that is being given to whole system solutions in RIIO-2 and strongly believe that there is benefit in taking a whole system approach to transforming our energy landscape. We welcome the proposal that RIIO-ED2 could support in capturing this benefit. For RIIO-ED2, we would advocate a set of price controls that ensure companies have obligations and incentives to play their part in whole system thinking, and that consumers only have to pay for services once.

Through our work with others in the ENA Open Networks Project we are already identifying barriers and areas to focus on to improve whole system outcomes. We are taking a 'design by doing' approach with initiatives such as our Regional Development programmes and our Pathfinder Projects which look across the whole system landscape to identify key areas of development to unlock additional network capacity, reduce constraints, and open new revenue streams for market participants. We would hope that this collaborative ethos is reflected in the ED2 Price Controls and would encourage Ofgem consider how future whole system solutions are funded

We would note that further mechanisms may be required to allow a wider range of options to be considered as possible solutions to issues on the transmission network, such as investment in DNO-owned network assets to meet transmission network needs. Roles and responsibilities in relation to whole system solutions should be clear. Alignment between the RIIO-T2 and RIIO ED-2 price controls is key to ensuring parties are sufficiently remunerated for their respective contribution to whole system solutions, without the possibility for 'double counting' where multiple parties are potentially remunerated for the same outcome. Whether an ESO solution or a solution developed by network companies is deemed the most economically efficient, the associated licences and price controls should ensure this solution can be delivered.

Within our RIIO-2 price control submission we have listed several areas that facilitate whole system thinking on the transition to DSO. We believe that these activities will need to be coordinated with the future activities of DNOs in RIIO-ED2 and will actively work with stakeholders in this development.

Whilst our role as Electricity System Operator is different to the new system operator responsibilities that DNOs may develop, there may be merit in considering the suitability of the metrics we are developing in both the ESO Forward Plan and RIIO-2 Business Plan for DSO activities.

Whilst the pathway to whole electricity system outcomes is relatively clear, opportunities for whole system thinking across energy vectors are still in a nascent stage. Given the timescales for ED2, provision needs to be made to facilitate these opportunities whilst recognising the inherent uncertainty at this time.

Forecasting and scenarios, flexible energy systems and data environments:

To what degree should DNOs modernise their handling practices to adhere to data best practice and therefore (among other things) provide available, transparent, and interoperable data about their networks?

Digitalisation of the energy system is key to capturing the benefits of the low carbon energy transition for consumers. With this in mind, we strongly believe that a principle of 'open data' is the lifeblood of efficient markets, playing a crucial role in innovation and flexible energy systems. The industry must transform the way its data is managed, moving from a world where access to data is limited to one where it is seemed shareable by default.

We have committed to transforming the data we make available as the ESO and believe that DNOs should be sufficiently incentivised to support this open data ambition. We believe this will require a large degree of modernisation of data handling practices for DNOs and would encourage Ofgem to develop price controls for DNOs that ensure a joined-up approach to data best practice across the industry.

We believe that network companies should maximise the availability of data in line with a presumed open data policy, where such datasets do not pose commercial or sensitivity risks.

We believe that enhanced data availability and insights are essential for effective investment and operational decision making. Understanding current and future trends in both the technical characteristics of system operation and market dynamics can attract new sources of flexibility to the market.

How to set price controls for a smart flexible energy system

Access to usable data sets will inherently drive the development of flexible markets, enabling better investment decisions and help market participants to identify innovative solutions to managing operability issues – at the least cost to

consumers. Price controls within RIIO-2 should incentivise the sharing of data, driving the development of a flexible energy system.

Forecasting and scenarios:

The future energy landscape will be significantly different from the present. Our ESO Future Energy Scenarios (FES) have proved to be invaluable for informing longer-term debates within the energy system guiding future investment decisions. We are already working with network companies to improve data provisions and flows between companies for the purposes of scenario development. We have also collaborated across the industry (transmission and distribution) based on FES outputs to ensure RIIO business plans are consistent and comparable, enabling value for consumers.