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Dear Akshay Kaul,

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

I am writing on behalf of ESP Utilities Group (“ESPUG”) (comprising the licensed companies ES Pipelines Ltd, ESP Connections Ltd, ESP Networks Ltd, ESP Pipelines Ltd and ESP Electricity Ltd). We welcome the opportunity to respond to Ofgem’s “Open Letter Consultation on approach to setting the next electricity distribution price control (RIIO-ED2)” 6th August 2019).

ESPUG is supportive of the general direction of the price control. ED2 will need to meet some complex challenges not experienced in previous controls. The DNOs will have to potentially cooperate with other companies, make strategic investment ahead of time and fully utilise innovation incentives. This has two important implications:

- Allowances must reflect the significant changes in the risk the DNOs face which were not present in ED1.
- Ofgem will likely need to rely more on the assessment of individual projects in the business plans of the DNOs than it might have done in the past.

We think Ofgem should consider the following aspects not included in the consultation but which are important for IDNOs. We need to fully understand the DNOs’ charging models in order to set correct connection charges and to value future revenues from the networks. Furthermore, introducing early, late and native competition will require a similar amount of transparency for anyone bidding for services to the DNOs.

At present this is a very difficult task. We request that Ofgem consider creating an incentive mechanism for greater information release in this area. Furthermore we would ask for the publication of business plans during the control as its contents will have a direct impact on our business.

More detailed comments are contained in the annex of this response. If you wish to discuss any of the issues raised in our response or have any queries, please feel free to contact me on 01372 587500.

I confirm that this letter and its annex may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Seb Eyre', with a large, stylized 'S' at the beginning.

Sebastian Eyre
ESP Utilities Group

Annex

Proposed objectives for RIIO-ED2

1. Do you have any views on the proposed objective for RIIO-ED2?

We agree with the proposed objectives on page one of the consultation. We would note that the objectives may potentially clash, for example, the safety and reliability objective is matched against “bills as low as possible.” We trust that the RIIO2 process will provide further clarification on how Ofgem will make these trade-offs.

Strategic approach to RIIO-ED2

How to set price controls that support decarbonisation goals

2. To what extent should we take into account outcomes linked to decarbonisation targets, and what outcomes might this involve?

We fully support the decarbonisation agenda and believe there is scope to incentivise networks taking a wider role in reducing emissions as stated on page 6 of the consultation. We note that by taking this approach there is also more risk of stranding assets and thus a case for higher rates of return required for these activities.

3. Are there activities that DNOs are best placed to carry out in order to achieve these outcomes? What are the alternatives? Why would it be appropriate for energy consumers to fund these activities?

As a general principle, price control revenues must be earned from natural monopoly characteristics while any other activity should be contestable. Ofgem suggests that (through the link to Catherine Mitchell’s presentation) networks may need to solve some new tasks within the concept of “distribution service providers.”

4. How should we assess DNO funding requirements and measure DNO performance in these areas?

It could be very difficult to target both the funding and rewards for these activities within the current RIIO framework. In general, it may be prudent to let market mechanisms for the networks dictate the revenues they earn.

5. How should we incentivise DNO performance when the achievement of outcomes could be dependent on the actions of others?

To fairly allocate incentive revenue, Ofgem will need to determine the relative contribution of the DNOs compared with a third party. Given this can be problematic, the DNO should state in advance what outcomes it intends to achieve and provide evidence that it has facilitated outcomes matched against its original project plan.

How to set price controls that support strategic investment

6. How do we ensure that network companies are best placed to undertake strategic investment and manage the associated risk? How should the risks of these investments be managed?

Strategic investment will be critical for connecting different low carbon technologies on the system. We would encourage Ofgem to fund strategic capacity across the network including LV circuits. Furthermore, any future REPEX allowances should have extra capacity built in to accommodate future demand following the CCC recommendations (cited on page 7 footnote 8).

7. What, if any, changes to the framework are required to support strategic investment?

We do not think the price control framework itself needs to be changed. Instead the existing framework will require more robust and more bespoke business plans.

8. How should we hold the companies to account for the delivery of strategic investment, and the outcomes that they are expected to deliver?

This will be difficult as it will only become apparent that strategic investment has been insufficient when it is too late. We would suggest that the scrutiny of the business plans is the primary way of holding companies to account, similar to the standard in which Ofwat scrutinised water company plans in PR19.

How to set price controls for DSO functions

9. Is there a need to separate out the revenues and outputs for 'traditional' DNO functions from DSO functions? How could this be achieved?

At this point in time we do not see any point in separating out DSO revenues.

10. In the event of the DSO function being delivered by a separate party, how might we determine the revenues for DSO activities? What type of funding model would be appropriate to set DSO revenues? In this event, would changes also be required to DNO revenues and outputs?

If this were to happen we would suggest using the blue print developed for transmission.

11. Where a DNO is undertaking a DSO function, what type of outputs or outcomes are necessary to measure how efficiently they are performing this function? Over what time period could these be measured?

As stated above, we would suggest using the blue print developed for transmission as a default using a RAV based approach if the objective is to provide incentives to efficiently invest. We note that

- the DSO cannot (as yet) dispatch generation;
- nor is there a cash out price that could be used as a reference for incentive design or the determination of balancing efficiency.

How to set price controls that drive innovation and competition

12. In what ways could the existing arrangements drive more innovation and competition?

As a general position, we suggest that Ofgem's price controls facilitate competition elsewhere in supply and generation. The price control is based on totex and the incentive framework should apply to these specific activities. In principle, any other activity should be contestable.

RIO is designed both to encourage efficiency and incentivise defined outcomes. We believe it is possible for Ofgem to do this within the existing price control framework.

How to set price controls for a smart, flexible energy system

13. To what extent should we set (and incentivise performance against) baseline totex allowances for activities where flexible solutions could be provided?

If electricity demand fundamentally increases, investment in physical assets will be inevitable even if it is deferred. This implies that the existing model of upfront totex funding is an efficient mechanism.

14. Should we instead set allowances based on the costs revealed through the flexibility tendering process? How might this work?

We agree. It may be preferable to avoid many of the issues associated with the flexibility market by using the competitive tender approach for activities over and above traditional network activity.

How to set price controls in a big data environment

15. 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? What measures will be needed to ensure data remains secure?

Existing data practices reflect the current use of information required by industry. Any modernisation will simply reflect new requirements as a result of decarbonisation which we agree needs to be transparent and interoperable. Networks should therefore be funded for system upgrades but we note that we do not know for certain what the delivery and type of data will ultimately be needed. This will present a potential funding problem due to risking stranding assets.

Finally, data is not just related to consumption but also about costs if new entrants are going to understand the savings which could be made from their product.

16. How should we structure RIIO-ED2 to encourage metadata to be made available, and for data to be presumed open? How should we measure DNO performance in this area, and on what basis should funding be set to deliver relevant outcomes?

We agree metadata should be made available and presumed open. We urge Ofgem to think about data related to facilitating connections and network planning. This information has an important role in the connections market and can be used to understand network constrained areas or incentivise investment.

17. Do you agree with the themes we plan to include in our guidance on data best practice?

We agree.

RIIO-ED2 Framework Consultation

Length of the price control

18. We welcome views on our proposed position of a five-year price control for RIIO-ED2.

We support a five year control. Given the rate of change in the energy system, the consultation is anticipating it does not seem feasible to think much further ahead.

19. Are there any elements of RIIO-ED2 price control that we should consider setting over a longer or shorter period? Please give reasons.

None.

Giving consumers a stronger voice

20. We welcome views on whether these enhanced engagement arrangements are appropriate for RIIO-ED2.

We support enhanced engagement arrangements but argue that there is a legitimate need for industry to view the business plans they are commenting on.

Meeting the needs of consumers and network users

21. We welcome views on whether the proposed output categories and incentive arrangements are appropriate for RIIO-ED2.

We broadly agree with the proposed output characteristics presented on page 15.

22. We are interested to hear if there are new elements of the services DNOs will need to deliver that should be included in the current output categories. Alternatively, we welcome views on whether these should be captured by a new output category. For these new elements, we are interested to hear how delivery of these services should be valued and measured.

It should be possible to incorporate new activities into the categories suggested on page 15. In any event “meet the needs of consumer and network users” seems to be a catch-all objective.

23. We welcome thoughts on how to ensure that we continue to protect the interests of vulnerable consumers, particularly in light of the energy system transition.

Vulnerable consumers may potentially have compounding effects as a result of market developments during this control. They may be cross subsidising other consumers who have invested in renewable

technologies though they may not have access to a smart phone or the internet to take advantage of any of the new products available. Furthermore, they may have inelastic demand, for example, as a result of a medical condition. Whilst this is not directly linked to the RIIO process, we urge Ofgem to think about the issues identified above.

Maintaining a safe and resilient network

24. We welcome views on how DNOs should continue to ensure their networks are resilient, particularly in the context of the new or changing way assets are used.

The nature of reliance will fundamentally change during ED2. If smart technology is widely deployed as predicted in the consultation, new risks will emerge while shifting towards virtual risks. We need to be assured that the NARMS framework will take account of this.

25. We are interested to hear stakeholder views on how DNOs should ensure their networks are resilient to physical and/or virtual threats, as well as being able to withstand the effects of adverse weather and the impacts of climate change.

As we have suggested, the focus should be on new risks entering the energy system that have not been encountered before.

26. We would also like to hear how stakeholders believe climate change mitigation and adaptation may affect network maintenance and development in the short, medium, and long term.

We would suggest that the DNOs are well placed to design their schedules that should be included in the business plans that will be scrutinised by Ofgem.

27. We would like to hear views on how we ensure DNOs remain resilient to the challenges presented by an ageing and changing workforce.

We have not experienced problems in this area.

Delivering an environmentally sustainable network

28. We welcome views on how DNOs should work to minimise the impact of what they do on the environment and facilitate the transition to a low carbon energy system. We are particularly interested in the implications of the government's updated target of net-zero emissions by 2050.

We have no specific information on this issue but agree that the control should facilitate the transition to smarter networks.

29. We also welcome views on what this may mean for the type of activities networks undertake, how these may be funded, as well as the outputs and/or incentives they should be exposed to.

We would suggest that the DNOs are well placed to determine their activities. Therefore, there is no reason to think a specific incentive could not be developed during the course of the control. Funding of the projects requires calculation of the marginal cost of abatement to assess the effectiveness of the DNOs' proposals.

30. Finally, we are keen to understand how DNOs' performance should be measured, and how we should assess the value that consumers place on the provision of these services and activities.

The default position should be that performance assessment must not differ from established metrics of carbon saving for other businesses. However, an interesting trade off may occur as some network activity itself will lead to greater harmful emissions savings. This may require a reassessment of a DNOs emissions performance if renewables are brought onto the system.

Value to customers could easily be measured during the course of the customer engagement phase of the control.

Enabling whole system solutions

31. We welcome views on how RIIO-ED2 can best capture the benefit of whole systems solutions. We are also interested in views on how these benefits should be measured.

We support the use of the Totex Incentive Mechanism (TIM) to fund whole systems solutions.

In terms of measurement, an ex post project based assessment would seem the fairest way. Within the project plan, we expect to see a transparent investment cases linked to specific outcomes. Since whole system benefits may be difficult to quantify in a standardised way, we think the DNOs should be allowed to argue for a particular measurement.

32. We further welcome stakeholders' opinions on whether the electricity distribution sector's approach to whole systems should be different from the other sectors and, if so, why.

Precisely because the networks activity can act as a platform to facilitate technologies that reduce emissions, special care should be taken to encourage investment.

Managing uncertainty

33. We welcome views on how we should manage the uncertainty associated with forecasting allowances, and whether there are any mechanisms we could or should consider in helping to manage this uncertainty.

We consider the development of RIIO in its existing form is already able to cope with errors in forecasting. Though if Ofgem think we are entering a period of increased risk, this should be supported by using an ex post cost assessment.

34. We seek views on the use of indexation, particularly on any adjustments for labour and construction cost inflation.

Labour and construction inflation are the primary cost drivers for DNOs so they should be weighted to reflect their true significance in Ofgem's cost assessment.

35. We welcome views on our approach to highly anticipatory investment projects. We are interested to hear whether stakeholders would suggest additional processes or regimes for facilitating such investments that support the energy system transition whilst protecting consumers from potentially inefficient investments.

Highly anticipatory investment projects, by their nature, require a higher standard of detail in the investment case than normal. It follows that the existing framework of working up investment proposals in a business plan simply needs to be more carefully scrutinised for higher risk projects.

36. We welcome views on the type of issues that should be considered through an inter-institutional group.

We welcome any mechanism that is able to share risk of anticipatory investment and place the projects in further scrutiny.

37. We invite stakeholders to advise what type of expenditure they believe should be subject to alternative arrangements for sharing risk, and what these arrangements may look like.

We would not want to be too prescriptive regarding how such arrangements should be constructed but rather leave that to the industry participants. It should be obvious what projects are anticipatory.

Driving efficiency through innovation and competition

38. We welcome views on the proposed innovation stimulus. We are interested to hear views on the types of projects that should be funded through either the NIA funding or a new funding pot.

Identifying projects based on non-traditional network activity such as the development of smart networks would be obvious candidates for this type of funding. We see no reason for a separate funding pot.

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

We have no comment.

40. We also welcome views on our proposals for the different competition models in RIIO-ED2, and what, if any, criteria should be set out for the use of early or late stage competition models.

Ofgem will need to ensure the timing and symmetry of information between the DNO and the service providers are level. We do not think there should necessarily be any specific criteria for early or late stage competition models.

41. We also seek input from stakeholders on 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.

As above, the timing and symmetry of information between the DNO and the service providers should be level.

Forecasting and scenarios

42. We welcome views on our approach to planning, forecasting and scenarios for RIIO-ED2. In particular, do stakeholders have other suggestions as to how we can best manage forecasting risk for consumers?

The pace of decarbonisation is a significant source of risk over and above what has been experienced in previous controls. There is no clear way to predict the uptake of technology. A further source of uncertainty linked to the development of gas networks is the speed they move towards hydrogen.

Business plan and totex incentives

43. We welcome views on our proposal to remove the early settlement process for RIIO-ED2, instead focusing on alternative mechanisms to receive high-quality and ambitious business plans.

We agree with the removal of the early settlement process. We would argue that the consumer challenge panels should have an enhanced role in facilitating the approval of business plans.

44. We also welcome views on our proposals to use the Business Plan Incentive and the confidence-dependent incentive rate arrangements for RIIO-ED2. In line with this, we are interested to hear stakeholder views on the range that should be used for both of these.

We agree the “consistent view of the future” is a sensible approach to deal with uncertainty within the business plans.

Fair returns and financeability

45. We welcome stakeholder views on our proposals to introduce measures to enable network companies to finance their activities whilst ensuring they receive a fair return.

We are content that Ofgem propose to retain debt indexation for ED2.

46. We are interested to hear from stakeholders on how they believe we should set allowances for the cost of debt, particularly around the method of recalibrating the index.

We believe the process should require setting the cost of debt to match similar industries and risk profiles. We would therefore expect Ofgem to follow Ofwat’s allowed rate of return methodology.

47. We also welcome views on our proposed approach to setting allowances for the cost of equity, as well as our proposal to move away from RPI.

RPI will no longer be used as a measure of inflation by Government for technical reasons. It follows that Ofgem should use its replacement, CPIH, as the index of inflation.

48. Finally, we would like to hear stakeholders’ views on our proposed introduction of a ‘sculpted sharing factor’ in instances of high out- or under-performance, or whether an alternative mechanism could be more effective.

We are content with the introduction of sculpted sharing factors.