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Dear Stathis and David,

Re: Future arrangements for the electricity system operator

On behalf of Electricity North West Limited (ENWL), we appreciate the opportunity to respond to both of the consultations on the future arrangements for the electricity Transmission System Operator (TSO). Our detailed response to the questions posed in the consultation documents are provided in Appendices 1 and 2. In addition, we have summarised the areas that we believe merit greatest consideration below.

Interaction with DSOs

We strongly agree that it is essential to have a safe, resilient, and cost-effective electricity system. However, we do not believe the TSO can deliver this in isolation. In our view the TSO should maintain its focus on the transmission system, interacting with Distribution System Operators (DSOs) to understand the solutions that can be provided at lower voltages that will assist with the challenges faced by the TSO.

We do not believe it is economical or efficient for a single party to attempt to oversee all aspects and voltages of the entire electricity system. We therefore strongly support increased coordination of measures taken by the TSO and DSOs so that actions taken by the DSOs can assist the TSO in maintaining the macro system balance, whilst ensuring appropriate local focus, and providing a more efficient and effective approach to system management.

For further information on our view on the future role of DSOs and how we anticipate these interacting with the TSO, please refer to our response to the joint Call for Evidence on a Smart, Flexible Energy System (the 'CfE').

Alignment of obligations and incentives

In order for interaction with the DSOs to work effectively, we believe it is vital that the obligations and incentives for the TSO and DSOs are appropriately aligned. The current separation of price controls for transmission and distribution runs the risk of obligations mismatching, sitting with the wrong party or not being covered off for the period between T2 and ED2 commencing (2021 – 2023). We therefore believe it is vital that work is undertaken to consider how existing roles and responsibilities should be appropriately delivered by TSO or DSOs to deliver the most effective and efficient outcomes. Obligations on all parties should then be revisited in light of this. Depending on the outcome of this, it may be appropriate to consider the timing of the respective price controls to ensure that such alignment is achieved.

Transparency of information

The current arrangements have not always made it possible to distinguish between the actions of the Transmission Owner and the TSO. The proposed separation will assist with this and help customers and stakeholders throughout the industry to more effectively understand and appreciate the role of the TSO and what it is delivering for customers. In order for this to be effective, it is important that there is increased transparency surrounding the TSO's obligations and how it is delivering for customers. Introducing this during the remainder of the T1 period will also assist Ofgem and other stakeholders to be able to assess what the TSO's business plan should deliver for the T2 period.

We hope this response will assist you in this process. We appreciate the time taken by both Ofgem and NGET to engage on these developments and to discuss our initial thinking with them. We remain committed to ongoing engagement with both organisations as this process progresses and look forward to further dialogue on the points raised in this letter and the accompanying appendices.

In the meantime, if you have any comments or questions, please do not hesitate to contact either myself or Jen Carter (jen.carter@enwl.co.uk).

Yours sincerely

Steve Cox
Engineering and Technical Director

Appendix 1: ENWL response to the consultation questions on role and structure

Chapter 2

Q1: What are your views on our proposed objectives for the SO (set out in paragraph 2.1)?

Overseeing a safe, resilient, and cost-effective electricity system: Whilst we appreciate the driver behind the objectives set out, we are unsure if the current proposed wording correctly balances the roles and responsibilities between different parties in the development and operation of networks both now and also as we move towards DNOs being DSOs. We fully agree that there needs to be increased coordination of measures taken by the TSO and DSOs. However, we do not believe that this is necessarily the same as the TSO ‘overseeing’ or ‘managing’ these interactions.

As set out in our recent response to the CfE on a Smart and Flexible Energy System, increased exchange of information between TSO and DSOs will be essential to ensure that the actions taken by different parties do not have the effect of adding to customers’ costs but then cancelling each other. However, the level of granularity of information required to fully understand impacts on the distribution networks is likely to limit the extent to which the TSO can make fully informed recommendations on the long term needs of distribution systems and the impacts for customers without duplicating the work undertaken by DNOs/DSOs. As such, we recommend that this objective is revised to “Coordinating a safe, resilient and cost-effective electricity system”, with a greater focus on the TSO assessing the options proposed by DNOs/DSOs to meet the needs identified by the TSO at the transmission level. DNOs/DSOs should continue to proactively respond to the needs identified for their own networks.

Driving competition and efficiency across all aspects of the system: We continue to support the introduction of competition where it can be shown to be in the interests of customers and similarly support increased efficiency to drive down costs for our customers. We support the use of competitive approaches in operating the system and think there is opportunity for further development of balancing services to increase the scope for new and emerging solutions to meet the challenges seen and anticipated to be seen by the TSO. We also see merit in an increased role for the TSO in identifying suitable options for competition in transmission. However, we firmly believe that the final decision as to whether or not it is in customers’ interests to tender transmission projects must reside with either Government or the Regulator.

Promoting innovation, flexibility and smart / demand-side solutions: We fully agree with the importance of widening up the market for who is able to provide solutions to system operators, at both transmission and distribution. We also agree with the importance of adapting how the TSO procures services to reflect the changing needs and the alternative solutions that new and emerging technologies can offer. We see the promotion of innovation, flexibility and smart / demand-side solutions as a shared responsibility, in conjunction with DSOs who have an equally important need to access these solutions.

As set out in our response to the CfE, we believe some significant changes are required to the charging regime to better reflect how customers use the systems, which we believe will, in turn, provide clearer messages to customers about the impact of their use of the system. Such changes would also address concerns expressed by some stakeholders in relation to how emerging technologies, such as storage, should be factored into the charging regime.

Q2: What are your views on our expectations for how the SO should seek to achieve these objectives?

We agree that the TSO has a unique role within the industry and see a real opportunity for the TSO to deliver value to its customers and stakeholders by sharing its knowledge, understanding and experience. In order for it to deliver this and achieve the proposed objectives, increased transparency and openness with all parties in the sector, including Government and the Regulator will be essential. However, such openness needs to be delivered in a measured way that makes information accessible, without swamping parties with detail that they are unable to process.

It is also important that the TSO sees itself as a facilitator of change within the sector, rather than being 'in control' or forcing a particular agenda on parties. This is particularly important in relation to the TSO : DSO interface where the TSO can act in a manner that will assist and support the DSOs to achieve their objectives, to the benefit of all customers, or can seek to hinder these developments to the detriment of customers. Whilst this is applicable in relation to the objective of facilitating efficient whole system outcomes, it is also potentially applicable in the relation to facilitating competitive markets and supporting competition in networks.

Across all of the objectives, the litmus test of whether or not the TSO is achieving its objectives should be the extent to which the industry is able to respond and deliver change to meet customers' and society's needs and expectations.

Q3: Do you agree with our proposals for what licence changes are needed to support these objectives?

We are unclear as to what Ofgem is proposing in terms of licence changes to support these objectives due to the lack of detailed proposals within the consultation document. However, we do expect that there will be a requirement to introduce new conditions for the TSO that set out the obligations it is expected to deliver. Some of these may evolve from conditions within NGET's current licence, while some may need to be drafted from scratch.

At this point, we expect that the licence for the National Grid TO will then be largely in line with the licence held by the Scottish TOs as we are unaware of any justification for there to be a difference between the TOs at this time. Indeed, the greater the similarities and treatment, the increased confidence for the sector that the proposed independence matches that between equivalent parties outside the National Grid group.

Q4: What are your views on the extent to which we should set specific or general obligations for the SO?

We believe that there will need to be a mix of specific and general obligations for the SO. Many of the SO's obligations are the enactment of EU legislation and hence must be more directive in respect of obligations. Others may be more general, expanding on the statutory obligation on transmission licensees, with a clearer focus on how the TSO is anticipated to contribute to this.

Chapter Three

Q1: Do you agree that greater separation between NG's SO functions and the rest of the group is needed?

Yes, we do. Whilst we have no reason to believe that NGET has or would act in a way that is inappropriate, the increased responsibilities proposed will mean that it becomes even more important that the TSO is seen to act in a manner that is demonstrably both impartial and unconflicted. For that reason, we do believe it is important to establish 'clear water' between the TSO function and other business activities within the National Grid group that may have an interest in the outcome of the TSO's decisions.

We do not believe it is appropriate at this time to establish the TSO as a completely standalone entity due to the financing and cashflow risk that such an organisation is likely to experience. We believe that to do so is likely to significantly increase costs to customers and create uncertainty within the sector.

Q2: What are your views on the additional separation measures we are proposing?

We generally agree with the proposed separation measures and believe they generally constitute an appropriate and reasonable approach to deliver the desired outcomes. There are, however, a few areas where we believe further consideration is required.

Industry codes: As set out in your consultation, we believe it should be relatively straightforward to identify the necessary changes to the majority of codes. However, ensuring the allocation of responsibilities lies with the correct party may be more challenging for the more technical codes (such as the Grid Code) and the European network codes. It is essential that appropriate consideration is given to this.

Board: We support and welcome the proposal to separate the Board for the TSO from other parts of the Group and welcome the proposal to have three SIDs on the Board to increase the scrutiny applied to the TSO's decision-making.

Financing: As described above, we believe that a truly independent TSO would be exposed to potentially quite volatile cashflows, as a consequence of its balancing activity and increased reliance on incentive revenue, rather than a return on assets (RAV). As such, we support the proposal that the TSO be able to access parent guarantees or equivalent from the wider National Grid group, on arms' length terms, to ensure its financial stability. This enables the TSO to be exposed to powerful incentives which will drive efficient decision making and positive outcomes for all customers.

Employee separation: We generally agree with the approach described. However, we are less convinced whether it is appropriate for some of the more strategic functions to be shared. Based on our experience, we see regulation and some aspects of both finance and legal as key strategic functions which play a significant role in shaping business direction and policy. (We do recognise that some aspects of finance and legal are much more transactional in nature and therefore do not think this applies to all aspects of these functions). As such, we believe there should be separation of these strategic functions. In relation to corporate affairs, it will be important that the TSO is perceived to have its own 'voice' within the industry and more widely. We therefore think it may be more appropriate for this function to also be separated.

Q3: What are your views on our proposed approach for implementing these changes?

We welcome the proposed approach being set out by both Ofgem and NGET in implementing these changes. In particular, the proposal to have a 'run-in' period to test the

arrangements and ensure that industry continues to be able to work effectively with both the TSO and the TO arms before the formal implementation date seems sensible.

Chapter Four

Q1: What are your thoughts on our proposed approach for implementing the proposed changes set out in this consultation?

Please see our response to question 3 in chapter 3.

Question 2: What further evidence should we consider in finalising our impact assessment of the proposals on the SO's roles and level of independence?

The Impact Assessment has not sought to quantify the benefits associated with the proposals for the changes to the TSO role. Whilst we agree with the process, we think there is merit in attempting to quantify these, especially given the level of cost forecast to facilitate these changes. We also recommend that, in assessing the proposed costs for the TSO, it is important to give further consideration to where the appropriate delineation is between the TSO and DSOs in delivering some of the desired outcomes.

Appendix 2: ENWL response to the consultation questions on the regulatory and incentives framework

Chapter One

Q1: Do you agree with our objectives for the future SO regulatory framework? Are there any missing?

At a high level, we do agree with the objectives set out in paragraph 1.13 of the consultation document. However, we suspect that the detail of how these are interpreted and implemented will be significant and therefore they need to be considered in light of our response to our views on the proposed objectives for the TSO (as set out in relation to Chapter 2, Question 1 in Annex 1).

At this stage, we think these are likely to be sufficient.

Q2: How can we best transition to a SO regulatory framework which meets these objectives? When should changes be made?

We support the proposals to begin to introduce changes to the regulatory framework for the TSO from 2018 onwards as a prolonged period of uncertainty is unlikely to be beneficial for any party in the industry. However, we recognise and appreciate the desire to minimise the disruption to an established price control. In our view, changes can be made to the SO incentives package potentially as early as April 2018, as the current proposals are due to expire then.

As set out in our covering letter, we believe it is essential that the obligations and incentives between the TSO and DSO are aligned. Whilst it may be possible to achieve this with the current two-year lag in timeframes, there is an increasing risk of obligations mis-matching, sitting with the wrong party or not being covered off for the period of 2021 – 2023. We are concerned that this is will have undesired consequences for customers.

It therefore may be more appropriate to consider aligning the next price control for the TSO (and possibly the transmission owners) with the commencement of ED2 in April 2023. This could be achieved by 'rolling-over' T1 (in a similar manner to that applied to TPCR4) or a using a mini price control for the intervening period so the TSO's RIIO-2 price control commences from April 2023.

Chapter Three

Q3: What lessons can be learned from our previous approaches to regulating the SO? What are the key areas where changes might be needed in future?

The TSO has historically been regulated in line with other network companies and, whilst the proposals will see the TSO move away from traditional focus of network companies in terms of the ownership and management of physical assets, it will remain a monopoly provider. As DNOs transition to increasingly become DSOs, there will be an increased need for the incentives and obligations for the TSO and DSOs to be aligned and to interact effectively together. For these reasons, we believe that the RIIO framework provides a strong foundation for regulating the TSO.

We see merit in bringing together all of the strands of the TSO's current regulatory structure into a single price control, under the RIIO framework, that clearly sets out what the TSO is expected to deliver for all of its customers. Much can be learnt from the regulation of these separate aspects to date. However, the evolution into a number of separate frameworks is complex and makes it difficult to assess the TSO's performance in the round.

A well justified business plan that can be appropriately scrutinised and challenged by customers and stakeholders, that demonstrates how the different activities of the TSO interact and that sets out how the TSO expects to discharge its obligations efficiently and effectively is an important part of this.

One of the key elements of the RIIO framework is the focus on Outputs. Identifying the outputs (or outcomes) that the TSO is uniquely placed to deliver and structuring its regulatory arrangements in order to deliver these would seem to us to be the most effective and appropriate model for regulating the TSO.

To assist in preparing for such an assessment, it may be beneficial for the TSO to begin during the T1 period to separate its own performance out from the TO's. This will allow Ofgem, customers and stakeholders and the TSO itself to understand its baseline performance prior to the need to begin to develop or refine incentives and similar mechanisms for the next price control.

We recognise that there are specific and particular challenges associated with incentivising the TSO's balancing activity and are cognisant of the fact that it has so far not been possible to develop an incentive package for balancing services that is longer than two years in duration. However, we do believe it is important that appropriate and effective incentivisation is put in place around all aspects of the TSO's activities to drive appropriate behaviours and outcomes. It may be appropriate to focus the remainder of the T1 period on developing a longer-term approach to incentivising these activities, rather than the short-term schemes that have been used in recent years. This could lead to clearer understanding of all of the mechanisms and lead to more effective outcomes for customers.

Chapter Four

Q4: Do you believe we need to introduce more clarity about what we expect from the SO under its obligations? How should this clarity be provided? To what extent should we set prescriptive or principles-based requirements?

We do think there needs to be more clarity in relation to the TSO's obligations and the proposed separation will assist this. Requiring the TSO to set out its plans and how it intends to discharge these, followed by full consultation with its customers and stakeholders, as described above, will greatly assist in clarifying understanding of the roles and responsibilities of the TSO.

We see opportunity for principles-based regulation to be used for the TSO (and other network companies subject to the RIIO framework). However, the balance between prescriptive and principles-based needs to be carefully struck to ensure other parties within the sector feel able to be clear about what can be expected from the TSO and avoid unnecessary ambiguity.

Q5: Should we place financial incentives on the SO? If so, in which areas? And what form should they take?

Yes, we do believe financial incentives can be and should be placed on the TSO. In our view, financial incentives should be used where there are clear and objective targets that can be appropriately defined in advance and can then be effectively measured. Wherever possible, incentive measures should be based on outcomes for customers rather than inputs delivered. In this way the mechanism provides incentive to develop innovative alternative solutions to deliver the outcome and also is able to deal with changes in required technical inputs.

Q6: Should we introduce more non-financial incentives on the SO? What approaches should be taken? Do you support the introduction of a set of KPIs, and if so, what should these KPIs be?

We also support the use of non-financial incentives in certain limited circumstances, particularly where it is more difficult to effectively set targets or identify how strongly an incentive should be set. KPIs can, if appropriately set, provide a useful insight into how effectively a party is performing and are therefore an important tool for incentivising performance. However, it is important that the legal status of these KPIs is clear and that the consequences of not delivering against any targets are understood. Equally, the KPIs set must be meaningful and reflect an objective and realistic level of performance and, ideally, allow others to understand what minimum, good and exceptional performance looks like so parties can objectively assess how well a party is delivering. Assuming that minimum performance is that required to meet the TSO's obligations, then it would be appropriate for measures to be taken to reflect that the TSO has not delivered for customers. However, in the event that more stretching measures are not achieved, we do not believe that such penal consequences would be appropriate.

Further, in the event that clear and quantifiable KPIs can be set, we believe these may sit more appropriately within a financial incentive. In our view, financial incentives are the most effective for delivering change. Non-financial and reputational incentives tend to be less effective and introduce a greater risk of regulatory uncertainty.

Chapter Five

Q7: How should SO incentives be governed in the future? Would you support a greater role for stakeholders in this process? How can we introduce more transparency around incentives?

In our view, it is essential that the TSO is ultimately regulated across all of its activities by the Regulator, whilst being able to be held to account by its customers and stakeholders. We do believe that the RIIO framework can provide this and requiring the TSO to set out its intentions and to then publically report on its performance against these, with appropriate scrutiny and challenge provides a strong framework.

There may be some elements of this where it is appropriate to use audits, panels or independent experts to scrutinise aspects that may otherwise be difficult to assess. However, such arrangements do introduce additional costs into the regulatory framework and we therefore believe should only be used in limited circumstances.