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ESB response to consultation on Future arrangements for the electricity system operator: its role and structure

Given the fundamental shift in the GB generation mix over recent years and the expanded role of National Grid group we believe that now is the right time to assess the future arrangements of the electricity System Operator (SO) to ensure that its roles and structures best serve its customers in an evolving energy system. We provide specific responses to the consultation questions below, but in summary:

- We are encouraged to see that the proposals put forward in the consultation stop short of full separation to an ISO model. We understand that this is the ultimate aim of SO reform but feel that the proposed approach best allows for the mitigation of potential unforeseen issues and provides a welcome level of market stability
- Changes to the generation mix and the increased penetration of flexible generation, storage and demand reduction at the distribution level mean the SO must take more of a whole system approach to ensure the most effective operational decisions are made. However, in order for the whole system approach to be effective much greater emphasis needs to be put on the role of Distribution Network Operators (DNOs)
- Improved forecasting, greater transparency and simplification of service procurement are all necessary to improve system operation in the short term and provide greater investor confidence in new technologies in the longer term. We see no reason such measures cannot be taken prior to the proposed separation of the SO and urge the SO to start implementing these proposals without delay
- There is much detailed work to be carried out regarding the licencing, governance and business processes associated with the separation but we are broadly satisfied with the measures being proposed

We are happy to engage further with Ofgem, BEIS and National Grid on this topic and would welcome any further communication.

Regards,
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ESB response to consultation questions:

Question 1: What are your views on our proposed objectives for the SO (set out in paragraph 2.1)?

In order to ensure the role of the SO keeps pace with the changing industry and that decisions are made in the most timely and cost effective manner a whole-system approach should be at the heart of any SO reforms and it is encouraging to see the objectives suggested by Ofgem are consistent with this aim. Although we appreciate that this consultation focuses on the future role of the SO we would suggest that any changes to SO objectives that encourage better whole system outcomes can only be carried out in conjunction with a review of the future arrangements for DNOs as the whole system objectives and incentives of the SO and DNOs must be aligned to ensure effective reform. It is important that the customer is seen as a vital part of this whole system approach. As technology improves and new business models are developed solutions to network issues will increasingly be driven by market participants and we would like to see more emphasis placed on the SO to engage with the market as part of a whole-system approach. We would also highlight that as the SO takes a more active role in the whole system it is important that the roles and responsibilities of all parties are clearly defined from the outset. SO interaction with the system should be on the basis of enhanced co-operation rather than encroaching on roles and responsibilities that are best managed by other industry parties.

We note the objective to drive efficiency across the system through the introduction of competition and the SO certainly has a role to play in this area. Without seeing further detail on any proposed new roles for the SO we are not able to comment further at this stage, but would highlight that any increased role for the SO, particularly in the NOA process, would likely increase the chances for conflicts of interest within the wider National Grid Group, further strengthening the need for effective separation (see response to Question 6).

As we set out in our response to the smart energy call for evidence storage, small-scale generation and demand flexibility are going to play a greater role in the electricity system creating challenges and opportunities for the operation of the future system. In order to meet these challenges and capitalise on the opportunities it is vital for the SO to adopt an open and innovative approach to system services. We therefore fully support the proposal to increase focus on innovation and flexibility.

Question 2: What are your views on our expectations for how the SO should seek to achieve these objectives?

Acting as a residual balancer

Transparency and accurate forecasting are vital to the proper functioning of the markets and although forecasting, particularly long-term forecasting through the FES document, has improved in recent years there is still much to do, particularly in relation to the long-term requirements for system services such as frequency response. Accurate long-term forecasts allow market participants to better understand the future needs of the system, supporting the investment case for technologies that are able to provide the products and services that best meet system requirements.



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Increased transparency around SO actions in the short-term market will improve market participant's understanding of the actions the SO takes and the rationale behind them. A clearer understanding of the actions taken by the SO is likely to enable the market to better forecast SO requirements, making capacity and services available when they are most needed. Improved transparency will also lead to increased accountability for the SO. There are clearly some inefficiencies in the current SO operations, for example incorrect flagging of SO actions to the detriment of efficient dispatch. Increased transparency will help to increase accountability and should help drive improved SO performance, particularly if these metrics feed into the SO incentive scheme.

As the number of services increases it is becoming increasingly difficult for parties to understand the exact requirements of the SO and which services they may be able to provide. Bespoke tendering and contracting arrangements for each service puts an unnecessary administrative burden on potential service providers. Because of this we agree that there needs to be a rationalisation and where possible standardisation of procurement and contracting methodologies related to balancing services. We would however stress that such an approach may not be appropriate for the procurement of all services, particularly those that require potential providers to submit a significant amount of commercially sensitive information regarding the economics and capabilities of their equipment. Such sensitivities should be taken into account when re-designing procurement methodologies to ensure potential providers are not deterred from tendering their services. In addition, as forecasting improves and the longer-term requirements of the system become more apparent we would encourage the SO to procure system services over a longer period. Current contract durations average 1-2 years, which provides insufficient revenue certainty for investors looking to deploy new technologies capable of providing grid services. Longer term contracts would provide more certainty and encourage investment in technologies and services that will ultimately benefit the system. Clearly it is important that long-term services are not over-procured therefore an increased emphasis on accurate forecasting and conservative long-term procurement methodologies should be employed. This should be coupled with adjustments to the SO incentive scheme. The current incentive scheme is not sufficient to encourage the SO to enter into long-term contracts. By apportioning part of the SO revenue to long-term targets this should incentivise the SO to take a longer term view of system need.

As technology improves in both the new technology space and among existing technologies such as CCGT it is also important that Grid engage in much more active discussion with potential providers to allow market participants to help shape system services. Innovation thrives through collaboration and it may well be that more open engagement with market participants will lead to the development of cost-effective solutions that the SO had not previously considered.

Facilitating competitive markets

As set out above and in our response to the Smart Energy Call for Evidence it is important that where possible the services procured by the SO have standardised procurement and contracting arrangements to minimise administrative costs on providers.

As we move towards a whole system approach to network management it is vital that all industry codes work together to ensure efficient and timely execution of industry change. To this end we would fully support the SO taking a more active role in strategic planning of industry change and



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cross-code co-ordination. We are also of the view that when detailed analysis of complex industry change is required the SO should take a leading role in the co-ordination and provision of such analysis as too often it falls to industry participants. By obliging the SO to take a greater role in the provision of analysis it will lessen the burden on often limited industry resources and increase confidence in the impartiality of the analysis.

Facilitating efficient whole system outcomes

As outlined in our response to Question 1 and the Smart Energy Call for Evidence we strongly believe there is an increasing need for adopting a whole system approach and support the measures proposed to help achieve this.

Supporting competition in networks

Without seeing further detail on any proposed new roles for the SO we are not able to comment further at this stage.

Question 3: Do you agree with our proposals for what licence changes are needed to support these objectives?

Many of the proposals above, in particular improved forecasting, increased transparency and rationalisation of service procurement do not require changes to licences and we would urge the SO to act on these areas without delay.

Question 4: Do you agree that greater separation between NG's SO functions and the rest of the group is needed?

As the role of the SO changes there is a greater chance for conflicts of interest to arise. We are therefore supportive of greater separation of functions as this will act to minimise actual and perceived conflicts of interest.

Question 5: What are your views on the additional separation measures we are proposing?

Although we believe greater separation is necessary we are encouraged to see that the proposals stop short of full separation to an ISO model. We understand that an ISO may be the ultimate aim of SO reform but feel that a phased approach is most appropriate. As with any significant change there is the risk that it will create unforeseen issues and unintended consequences and incremental change is the best way to mitigate these risks. The proposed approach will allow both the SO and the parties that interact with them, including the TOs, time to adjust to the new arrangements and identify and resolve any issues before the move to a full ISO.

Question 6: What are your views on our proposed approach for implementing these changes?

Separating licence, transferring assets and contract novation

We would need to see the detailed proposals on this before we could comment fully, but the principals of the approach set out are consistent with our understanding of the process. Through any



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splitting the allocation of RIIO – T1 will require careful consideration, but we agree that it is unnecessary to re-open RIO – T1 at this stage.

The novation of existing contracts between NGET and industry parties is likely to put a significant legal and administrative burden on industry participants. It is therefore vital that NG engage at the earliest stage possible so that parties are prepared for the changes and can allocate resources appropriately. It will also be important for parties to understand the financial standing of the new SO, therefore questions around financial separation will need to be addressed at the earliest opportunity (see 'Financial Separation' below for more).

Governance of the SO

We agree that the new SO should be governed by a completely separate board and agree with the proposal that SO board members should not sit on any other National Grid boards. We are also supportive of the inclusion of three, rather than two, Sufficiently Independent Directors (SIDs) but would need to see more detailed proposals on how these SIDs would be appointed. One option would be to allow industry parties to nominate and appoint the SIDs. We would also note that as the SO will still sit under the same ultimate parent group as other National Grid businesses no matter how carefully considered the governance structures are there is always potential for conflicts. This makes compliance and monitoring of all relevant National Grid boards vital for industry confidence and we would encourage Ofgem to review their powers in this regard, ensuring that the penalties for non-compliance are sufficiently stringent.

Financial separation

Separate statutory and regulatory accounts are necessary for the new SO to be considered an independent company. We also agree that the new SO should maintain an appropriate credit rating but with the majority of regulated assets within NGET associated with the TO we are unsure how the new SO will maintain such a rating. As the cost of maintaining an appropriate credit rating (e.g. holding significant cash reserves) will ultimately fall on the consumer the best way to ensure the new SO maintains its financial standing will need to be carefully considered through the separation process.

Employee, information and physical separation

We agree that there should be separation of staff with personnel working solely within the business by which they are employed, as is the case with the EMR Delivery Body. For the majority of staff transfer between businesses should not pose too great a risk, but the transfer of senior management and directors should be avoided where possible and if such transfers are necessary there should be a period of gardening leave before such staff are able to join the new business.

With regards to shared services we agree that finance, legal and corporate affairs could be considered shared but regulatory functions should be separated as there is a much greater chance for divergent positions in this area. The cost implications of such a move are likely to be insignificant when compared to the potential conflicts of interest that could arise from a shared regulatory function.



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With regards to information it is vital that the new SO only provides the same information to NGTO as it does to the other TOs. We understand there are issues and cost implication of separating out ITS, but these should be resolved as quickly and efficiently as possible with temporary measures put in place to restrict NGTO access to information where necessary.

We agree that modifications and access restrictions should be applied to the office space. If all other separation measures are effective there should be no need to incur the expense of physical relocation of either business.

Question 7: What are your thoughts on our proposed approach for implementing the proposed changes set out in this consultation?

The implementation approach appears appropriate. There is now a significant amount of detailed work to be done and we would encourage Ofgem to engage in open dialogue with industry as the proposals are being developed. Balancing the amount of work required with the need to put a solution in place in a timely fashion we believe that the April 2019 timescale for implementation is appropriate.

In addition to these proposals we would encourage Ofgem and BEIS to publish more detailed thinking on the longer-term transition to an ISO and how they are ensuring that the measures to be taken now are being 'future-proofed' i.e. they will not cause issues for the transition to an ISO at a later date. By providing such a view, even if only indicative, it may shape views on the changes being proposed through this consultation and provide clarity on the future for industry.

Question 8: What further evidence should we consider in finalising our impact assessment of these proposals on the SO's roles and level of independence?

We have no comment at this time.