

ESO RIIO-2 price control stakeholder workshop – summary of discussions

From: Maryam Khan, Sarah Barry

Date: 06/08/2018

Time: 0900-1330

Location: 10 South Colonnade, Canary Wharf, London, E14 4PU

1. Overview

- 1.1. As part of our recent RIIO-2 framework decision¹, we decided to introduce a separate price control for the Electricity System Operator (ESO) following its separation from National Grid Electricity Transmission (NGET) in April 2019. The ESO will become an asset-light, service-focused entity and the new price control would come into effect at the end of the current RIIO-1 period in 2021.
- 1.2. We have started thinking about what a separate ESO price control could look like. To inform our policy development, we recently commissioned and published a consultancy report on the future regulation and remuneration of the ESO².
- 1.3. On the 6 August 2018, we held a stakeholder workshop on the future remuneration and regulation of the ESO. The workshop was an opportunity to discuss key parts of the report and to hear stakeholders' views on the key considerations for the future framework for the ESO.
- 1.4. We have published the slides used at the workshop and have summarised the feedback below. The views expressed in this document do not represent the views of Ofgem.

2. Agenda

- 2.1. We split the half-day workshop into two parts. The first session was focused on our ESO RIIO-2 strategy (our high level vision for the ESO and early views on the framework design). We discussed what the ESO currently does and key activities it should perform in future, and the different regulatory approaches we could take to designing a price control for the ESO. The second part of the day focused on specific parts of the design of the ESO's future remuneration and regulation framework. As part of each section we held breakout discussions on certain key questions for the design of the price control. We summarise the feedback to these questions below.

¹ RIIO-2 Framework decision: <https://www.ofgem.gov.uk/publications-and-updates/riio-2-framework-decision>

² Consultancy report on the future regulation and remuneration of the electricity system operator: <https://www.ofgem.gov.uk/publications-and-updates/consultancy-report-future-regulation-and-remuneration-electricity-system-operator>

2.2. ESO RIIO-2 stakeholder workshop 6 August – agenda:

Time	Title	Speaker
0900-0930	Welcome (registration, tea and coffee)	
0930-0945	Introduction and overview presentation	Jonathan Brearley, Louise van Rensburg
1030-1045	Presentation 1 <ul style="list-style-type: none"> • Our ESO RIIO2 Strategy • What does the ESO currently do? Is this right for 2021-26? • Four regulatory approaches we could take 	Maryam Khan, Grendon Thompson
1015-1000	Breakout session / workshop	All
1100-1115	Coffee break	
1115-1140	Presentation 2 Key considerations for ESO RIIO2 framework design: <ul style="list-style-type: none"> • Separating price controls and incentives? • Single allowance vs. separate allowances for each service? • Remuneration of the ESO? • How to incorporate comparative assessment and the role of stakeholders? 	Barry Coughlan
1145-1230	Breakout session / workshop	All
1230-1245	Closing remarks	Grendon Thompson
1245-1330	Networking lunch	

3. Attendees

- 3.1. We had approximately 40 stakeholders from across industry at our workshop. We have listed the organisations that were in attendance below:

Organisation	
BEAMA	Reckon
Cambridge Economic Policy Associates	Renewable Energy Association
Centrica	RenewableUK
Citizens Advice	RWE
Department for International Trade	S&C Electric Company
Electricity North West	SIMEC
Elxon	SPEN
Energy Capital	SSE
Ernst & Young LLP	Storelectric Ltd
Morgan Stanley	Sustainability First
National Grid Electricity Transmission	UK Power Networks
Navigant	UK Power Reserve
Northern Powergrid	Waters Wye
Npower	Western Power Distribution
Orsted	

4. Workshop 1

Do you think anything important is lacking from our vision and framework design points?

4.1. Stakeholders generally supported our vision for the ESO. The following suggestions were noted:

- Stakeholders commented that the extent to which the ESO will play a leading, proactive and/or coordinating role will depend on the activity in question. We should be clear about where, for example, we would expect the ESO's *leading* role to stop, and where they should play more of a *collaborative* role – especially in light of the Open Networks Project Future Worlds consultation³.
- Stakeholders also asked for more clarity on the role we expect the ESO to play in supporting whole energy system outcomes – for instance stakeholders questioned whether this is in relation to electricity transmission, distribution, heat networks and/or transport. Furthermore, they said the vision should reflect a forward-looking element to take into account that definitions will change over the RIIO-2 period.
- Some stakeholders wanted the vision statement to be more specific to the ESO, while others suggested that the overarching vision could be supplemented with more specific principles outlining in more detail what we expect of the ESO.

4.2. In relation to the framework design points proposed on slide 3, stakeholders made the following comments:

- Generally stakeholders agreed with using principles rather than prescriptive rules to guide the design. However, they noted that for this approach to be successful it would be important for the principles to be clearly drafted, and for stakeholders to have a shared understanding of what they might mean in practice.
- A few stakeholders pointed out that given the wider system impacts the ESO has, it is difficult to isolate and quantify the incremental costs and benefits of the ESO. In particular, they felt it would be very difficult to quantify consumer benefit, and suggested that sometimes the best consumer outcome is not always delivered by the cheapest option. Stakeholders questioned how the framework design would reflect this.
- Stakeholders emphasised that incentives and penalties need to be designed so they drive performance in the right areas, without compromising other activities. Some stakeholders pointed out that if incentives are poorly-designed, there is a risk that the ESO is encouraged to focus on certain narrow areas of activity while ignoring others.

Are the ESO's 4 roles and 7 principles still accurate? Do you think anything is missing? Do you expect these to still be accurate in 2021-26?

4.3. Stakeholders supported the ESO roles and principles as set out in the slides. They felt these represented a good starting point, and there is an opportunity to understand

³ Open Networks Project Future Worlds consultation: <http://www.energynetworks.org/electricity/futures/open-networks-project/future-worlds/future-worlds-consultation.html>

how they are working in practice through the new incentives framework before deciding whether they are right for the future framework in 2021.

- 4.4. Generally, stakeholders highlighted the large number of industry and political developments that make it hard to predict where we might want the ESO to focus its efforts in future. Therefore, the principles should be kept under review, and the price control process should have appropriate mechanisms in place to allow the roles and principles to evolve over time.
- 4.5. Other specific feedback included:
- Stakeholders commented that the vision should feed through to the principles. Specifically, the principles do not mention anything around affordability and low carbon, whilst the vision does.
 - Stakeholders felt there should be more explicit reference to the day-to-day system stability, security of supply and 'keeping the lights on' role of the ESO.
 - One DNO pointed out that the need for coordination with DSOs should be reflected in all the ESO's roles, particularly in light of the recent Open Networks Future Worlds Consultation.

Are there any additional services that you think the ESO should provide in the 2021-26 period?

- 4.6. Stakeholders suggested a few additional services that the ESO could provide in 2021-26, including:
- Data administration services, particularly ESO-DSO data flows.
 - Non-specific 'innovation' services, to identify and exploit opportunities for efficiencies and new services.
 - Automatic dispatch of services.
- 4.7. Stakeholders suggested that shorter (eg, annual, biennial) control periods, as opposed to a single 5-year framework, could be used to ensure industry change can be effectively managed. However, they also noted that longer-term certainty may be required for certain investments – in this case the controls could run to different time periods depending on the ESO activity area in question.

Are there any services that the ESO currently provides that could be open to competition or undertaken by another entity?

- 4.8. Overall, stakeholders agreed that some of the ESO's current roles could be opened up to competitive pressures, and that this could benefit consumers in certain cases. However, some felt that the fragmentation of services could lead to too much complexity. These stakeholders felt that we should ensure accountability rests with one organisation.
- 4.9. Out of the ESO's current activities, stakeholders suggested code administration, data administration, EMR delivery and revenue management functions (collecting and passing through revenue) as possible services that could be opened up to competitive pressures. Although, some questioned whether assigning the code administration role to another body might slow the pace of change.

5. Workshop 2

Should the ESO be remunerated under one holistic scheme (covering internal and external costs and incentives) or should we treat the price control and SO/EMR incentives as completely separate?

- 5.1. Stakeholders generally had a preference for a single holistic scheme. Stakeholders argued that the current mix of ex-ante and ex-post funding and incentives mechanisms, and the fact that they are set out at different times (every 8 years versus annually) is slightly odd. They suggested that they could be brought together, focusing on balancing cost performance and delivering quality outcomes.
- 5.2. Some stakeholders suggested that with one holistic scheme it could be easier to spot double remuneration risks or conflicting incentives. However, others were less concerned about whether there was one or separate schemes as long as the overall design delivered good outcomes for consumers.

Should we have a single allowance covering all ESO activities or separate allowances for different ESO activities?

- 5.3. There was some difference of opinion on whether there should be a single or separate allowance for different ESO activities. Overall, stakeholders stressed that the allowance, or allowances, need to be manageable and simple to govern in order to enable effective scrutiny.
- 5.4. Some stakeholders felt a single allowance would be more transparent and reduce complexity. Other stakeholders felt that the benefits of adopting an activity-specific approach are likely to greatly outweigh any additional complexity that may arise. They felt that separate allowances would enable us to utilise different regulatory approaches, including customer or competitive pressures, to maximise the benefits for consumers on an activity-by-activity basis. Separate allowances would also open up the possibility of providing funding over different timeframes for certain activities.

What is the priority – cost minimisation or service provision?

- 5.5. Overall stakeholders preferred an ESO that prioritised value for money. This means that rather than focusing solely on cost minimisation or service provision, they should take forward those options and services that will deliver greatest benefit for consumers and the energy system.
- 5.6. Stakeholders emphasised the risk that cost minimisation could drive short-term thinking, at the expense of future investment. They pointed to the relatively small size of the ESO's internal costs, and suggested that cost minimisation would not lead to significant consumer benefits, especially given the potential for the ESO to influence a much larger amount of overall industry spend. However, they also did not want to see the spend increase substantially over time. They suggested the best way to prevent this is to ensure robust scrutiny of individual costs, possibly by monitoring the ESO's spend against each activity area. There was a broad agreement that transparency of the ESO's costs is important.

- 5.7. Stakeholders suggested that the ESO could expand on its current forward plan approach to transparently set out its intended spend, and allow stakeholders to challenge this. Stakeholders also argued that the priority – cost minimisation or service provision – would differ depending on the activity in question. For example, networks may require cost minimisation while Principles 3 and 4⁴ may require the ESO to deliver service provision, but these may change over time.

Is the traditional RAV*WACC appropriate for the ESO?

- 5.8. Stakeholders were of the view that it would not be appropriate to adopt a traditional RAV-based approach for the price control as a whole. However, they noted that although the ESO will be asset-light, the RAV could still play a limited role in future as a baseline for costs. Stakeholders recommended that we look to other service-based organisations to determine what approaches have been taken elsewhere.

Are there any benchmarks that exist that we can use for comparison? If there are areas where we don't have benchmarks how do we overcome information asymmetry and what does this mean for the design of the price control?

- 5.9. Stakeholders felt that international comparators (looking at System Operators and Independent System Operators internationally) might be helpful, but only as part of a broader benchmarking exercise. They felt that there are limitations to international cost comparisons, as there are often too many variables for useful financial comparison.
- 5.10. Stakeholders also suggested tracking the ESO's costs over time. They recommended we adopt a granular approach, which would enable us to benchmark specific areas of their cost, for instance code administration, IT systems investment and maintenance.
- 5.11. Stakeholders agreed that costs shouldn't be passed through if you can't guarantee that they are economic and efficient. Transparency around costs is important and any challenge panel would need to leverage industry expertise in order to sufficiently challenge the ESO.
- 5.12. Stakeholders also emphasised that Ofgem need to ensure we have the right skills, either internally or by seeking expert input, to effectively challenge the ESO across all of its activities.

How can we best use customers and stakeholders to expose the ESO to performance/efficiency pressures?

- 5.13. Stakeholders felt much of the onus is on Ofgem to scrutinise and challenge the ESO to ensure they are acting economically and efficiently. Peer review from network companies and international comparisons can help with this. Generally, stakeholders want the opportunity to feedback on things important to them, via the right forums / challenge groups. To maximise the value of their input, they suggested that Ofgem

⁴ Principle 3: Ensure the rules and process for procuring balancing services maximise competition where possible and are simple, fair and transparent. Principle 4: Promote competition in wholesale and capacity markets.

may have an information provision role to play to help stakeholders better understand the issues and therefore challenge the ESO.

Should we adopt an outcomes- or outputs-based approach to our assessment of the ESO's performance?

- 5.14. Stakeholders did not have a strong preference for whether we should adopt an outcomes- or outputs-based approach for the price control. They felt that a mixture of the two was probably most appropriate, e.g., using an outputs-based approach where activities are firmly within the control of the ESO, and adopting an outcomes-based approach where they are not.
- 5.15. Additionally, in monitoring the ESO's costs and performance, stakeholders felt it would be important to assess costs and benefits on different timescales. They felt that short-term bias may be an issue, both for the ESO and for those scrutinising its performance, which could lead the ESO to prioritise near term projects at the expense of others.

6. Next steps

- 6.1. We will use this feedback, as well as our ongoing engagement, to assist us with our policy development.
- 6.2. We will be consulting on the future remuneration and regulation framework for the ESO at the end of this year. At this stage, we do not intend to convene any ESO-specific working groups.
- 6.3. If you have any questions or further feedback, please contact electricitysoreform@ofgem.gov.uk.