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# Statutory Consultation on proposed modifications to the RIIO-ET1 Price Control Financial Model to revise National Grid's allowances to account for the costs of implementing Electricity System Operator separation

## Consultation

**Publication date:** 23 August 2018

**Response deadline:** 20 September 2018

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**Overview:**

Changes are proposed to the ET1 Price Control Financial Model in respect of the notice we published on 10 August 2018, which confirmed our position on the appropriate level of funding for National Grid Electricity Transmission (NGET) related to the Electricity System Operator (ESO) separation.

As outlined in the notice, we assessed the ESO separation costs as £40.1 million for up front, one-off costs from 2016/17 to 2018/19 and £7.4 million for annual enduring costs in 2019/20 and 2020/21, for a total of £55.0 million over the current RIIO-ET1 price control period.

# Context

The RIIO Price Control Financial Models (PCFMs) determine adjustments to the annual revenue allowances for the companies that own and operate the transmission and distribution networks. As they are a part of the network licences, modifications to PCFMs are subject to normal processes for making licence revisions. This includes functional modifications of the PCFMs and modifications in previously agreed allowances, as is the case for this consultation. There are exceptions that allow for modifications to PCFMs that do not require consultation, these situations are included in the Special Conditions of the licences and can be broadly described as either being when modifications will not result in material modifications to licensee allowances and when conducting the RIIO Annual Iteration Processes. In both of these cases, notification of modifications are given with a 14-day window for representations to be made. On this occasion, the modifications proposed are material and therefore require this consultation to be issued.

# Associated documents

Future Arrangements for the Electricity System Operator: its role and structure
https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-its-role-and-structure

Future Arrangements for the Electricity System Operator: Response to Consultation on SO Separation
https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-response-consultation-so-separation

Notice on National Grid's allowances for the costs of implementing Electricity System Operator Separation
https://www.ofgem.gov.uk/publications-and-updates/notice-national-grid-s-allowances-costs-implementing-electricity-system-operator-separation

# Contents

# Executive Summary

We[1] are consulting on modifying the ET1 Price Control Financial Model (PCFM), in order to implement the appropriate level of funding for National Grid Electricity Transmission (NGET) related to the Electricity System Operator (ESO) separation, as set out in the notice issued on 10 August 2018. We assessed these costs as £40.1 million[2] for up front, one-off costs from 2016/17 to 2018/19 and £7.4 million for annual enduring costs in 2019/20 and 2020/21, for a total of £55.0 million over the current RIIO-ET1 price control period.

While we have not yet formally made a decision on the licence modifications required for ESO separation, NGET have already incurred significant implementation costs, hence we consider it appropriate for these costs to be recovered, from April 1st 2019 and in line with the expected go-live of ESO separation. This requires the PCFM to be modified in advance of this year's Annual Iteration Process, which is due to conclude on 30 November 2018.

If ESO separation does not proceed, we will revise and recoup NGET's allowances accordingly through further changes to the PCFM. This is consistent with our policy, set out in our 10th August 2018 Notice.

Details on responding to this consultation can be found in Appendix 1. If after having considered responses to this consultation we decide to proceed with the proposed modifications, then we will issue directions to this effect in September. In such circumstances we would intend for the related ET1 PCFM modifications to be reflected in the upcoming November 2018 Annual Iteration Process, setting allowed revenues for the year 2019/20.

We estimate that the proposed modifications would increase revenue for NGET SO[3] (the Electricity System Operator) by approximately £43 million during the RIIO-ET1 price control period.

[1] The terms "the Authority", "Ofgem" and "we" are used interchangeably. The Authority is the Gas and Electricity Markets Authority. Ofgem is the Office of the Gas and Electricity Markets Authority.

[2] All monetary values in this document are expressed in real 2009/10 prices.

[3] In the RIIO-ET1 price control we use the term "NGET SO" to account for the ESO function within NGET. From April 2019, as a result of the separation process, the ESO function will no longer be part of NGET and will be undertaken by National Grid Electricity System Operator Ltd.

# 1. Allowances for the costs of implementing ESO separation

**Chapter Summary**

Modifications are proposed to the ET1 PCFM to give effect to the appropriate level of costs related to ESO separation, as set out in the notice dated 10 August 2018. We assessed these costs as £40.1 million for up front, one-off costs from 2016/17 to 2018/19 and £7.4 million per annum for enduring costs in 2019/20 and 2020/21, for a total of £55.0 million over the current control period. This chapter describes how we propose to implement the corresponding revised allowances in the RIIO-ET1 PCFM.

**Question 1: Do you agree that the proposed PCFM modifications correctly implement the allowances to NGET SO, as set out in the notice dated 10th August 2018, for the recovery of costs related to ESO separation?**

## Background

1.1. In January 2017, we consulted on the future arrangements for the ESO's role and structure[4]. In August 2017, we published a response to this consultation[5]. This response included our view of the appropriate level of costs to implement the ESO separation, which is £40.1 million for one-off costs from 2016/17 to 2018/19 and £7.4 million for annual enduring costs in 2019/20 and 2020/21, for a total of £55.0 million additional costs over the current control period.

1.2. On 10 August 2018 we published a notice that followed up on the detailed cost adjustments part of our August 2017 response document and confirmed our previous view on the costs of ESO separation[6].

[4] Future Arrangements for the Electricity System Operator: its role and structure https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-its-role-and-structure

[5] Future Arrangements for the Electricity System Operator: Response to Consultation on SO Separation https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-response-consultation-so-separation

[6] Notice on National Grid's allowances for the costs of implementing Electricity System Operator Separation https://www.ofgem.gov.uk/publications-and-updates/notice-national-grid-s-allowances-costs-implementing-electricity-system-operator-separation

## Proposed modifications to the RIIO-ET1 PCFM

1.3. We propose to modify the "Non-variant allowed non-operational capex" and "Non-variant allowed controllable opex" allowances in the PCFM for NGET SO, as a means of incorporating into our allowance calculations the ESO separation costs, as set out in the 10 August 2018 notice. We propose a £55.0 million increase in non-variant allowances over the years 2016/17 to 2020/21. We detail the distribution of the allowances over the RIIO-ET1 control period and between non-operational capex and opex in Appendix 2.

## Allowed revenue impact of the proposed expenditure allowance modification

1.4. The increase in cost allowances resulting from the ESO separation funding will feed into the Totex Incentive Mechanism (TIM), which shares the difference between actual and allowed expenditure between the licensee and consumers, thereby determining total allowed expenditure.

1.5. In turn, total expenditure translates into allowed revenue in two ways known as "Fast Money" and "Slow Money". Fast Money contributes directly to allowed revenue in the year in which it is allowed, Slow Money is capitalised on to the company Regulatory Asset Value (RAV) and contributes to revenue over decades through the depreciation of assets and return on the remaining RAV.

1.6. In this instance, the additional revenues resulting from ESO separation are predominantly received through Fast Money, due to NGET SO's lower capitalisation rate of 28%. This means that the greater proportion of these costs is recovered in the short term, via a corresponding increase of allowed revenues; the remainder, in turn, is recovered at a slower pace over the years, via increased depreciation and return on the (higher) RAV.

1.7. Due to the operation of the TIM, we estimate that the additional £55.0 million cost allowances will increase revenue allowances only by approximately £43 million in the current control period. Nonetheless, the ESO will recover additional revenues in future price controls, via increased depreciation and return on RAV.

1.8. Allowed revenue increases will first be delivered via the MOD term for 2019/20 and this will reflect all cost allowance adjustments for the years 2016/17 to 2019/20.

## Next Steps

1.9. While we have not yet formally made a decision on the licence modifications required for ESO separation, NGET have already incurred significant implementation costs, hence we consider it appropriate for these costs to be recovered, from April 1st 2019 and in line with the expected go-live of ESO separation. This requires the PCFM to be modified in advance of this year's Annual Iteration Process, which is due to conclude on 30 November 2018.

If ESO separation does not proceed, we will revise and recoup NGET's allowances accordingly through further changes to the PCFM. This is consistent with our policy, set out in our 10th August 2018 Notice.

1.10. Details on responding to this consultation can be found in Appendix 1. If after having considered responses to this consultation we decide to proceed with the proposed modifications, then we will issue directions to this effect in September. In such circumstances we would intend for the related ET1 PCFM modifications to be reflected in the upcoming November 2018 Annual Iteration Process, setting allowed revenues for the year 2019/20.

# Appendices

**Index**

# Appendix 1 – Consultation Response

We would like to hear from interested parties about whether they agree that the proposed licence modifications correctly implement the policy position.

**Please include any reasoning and evidence in your answers.**

Unless you mark your response confidential, we will publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

We prefer to receive responses in electronic form so we can more easily place them on our website.

**Responses should be received by 5pm on 20 September 2018**.
Responses should be sent to:

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**General feedback**

We believe that consultation is at the heart of good policy development. We are keen to hear your comments about how we've conducted this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send your comments to stakeholders@ofgem.gov.uk.

# Appendix 2 – RIIO-ET1 PCFM proposed modifications

The proposed modifications to the PCFM are shown in Table 1 and Table 2 below, and correspond to the Revised Allowances as set out in the 10 August notice (see Appendix 1 of that notice). The sheet and rows that the modifications are applied to are detailed in the table captions. The proposed revised PCFM is as per Appendix 4.

*Table 1: Proposed modification to NGET SO "Non-variant allowed non-operational capex". This modification affects sheet "NGET SO", Row 25.*

| £m 09/10 prices | Year ending | 31 Mar 2014 | 31 Mar 2015 | 31 Mar 2016 | 31 Mar 2017 | 31 Mar 2018 | 31 Mar 2019 | 31 Mar 2020 | 31 Mar 2021 | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Previous | | 39.4 | 36.0 | 29.9 | 28.8 | 29.6 | 20.4 | 25.5 | 25.4 | 235.0 |
| Increase | | - | - | - | - | 1.2 | 10.2 | - | - | 11.4 |
| Revised | | 39.4 | 36.0 | 29.9 | 28.8 | 30.9 | 30.6 | 25.5 | 25.4 | 246.4 |

*Table 2: Proposed modification to NGET SO "Non-variant allowed controllable opex". This modification affects sheet "NGET SO", Row 26.*

| £m 09/10 prices | Year ending | 31 Mar 2014 | 31 Mar 2015 | 31 Mar 2016 | 31 Mar 2017 | 31 Mar 2018 | 31 Mar 2019 | 31 Mar 2020 | 31 Mar 2021 | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Previous | | 74.1 | 75.7 | 79.1 | 82.2 | 82.5 | 82.9 | 84.0 | 85.8 | 646.3 |
| Increase | | - | - | - | 2.5 | 5.9 | 20.3 | 7.4 | 7.4 | 43.6 |
| Revised | | 74.1 | 75.7 | 79.1 | 84.7 | 88.4 | 103.2 | 91.5 | 93.2 | 689.9 |

# Appendix 3 – Glossary

### Allowed Revenue

The amount of money that a network company can earn on its regulated business.

### Annual Iteration Process

The annual iteration process is the process of annually updating the variable (blue box) values in the Price Control Financial Model (PCFM) and running its calculation functions in order to provide updated MOD and SOMOD values.

### MOD Term ($MOD_t$)

The term of that name included in the formula for Base Transmission Revenue (System Operation Revenue) set out in Special Condition 3A (or Special Condition 4A for SO) of the Electricity Transmission licence. It represents the incremental change to be applied to the licensee's Opening Base Revenue Allowance for the Relevant Year concerned. The value of the MOD term is calculated through the Annual Iteration Process for the ET1 Price Control Financial Model (see Chapter 1 of the Price Control Financial Handbook) and is specified in a direction given by the Authority by 30 November in each Relevant Year.

### Opening Base Revenue

The best estimate at the start of a price control on the amount of money that a network company can earn on its regulated business.

### Regulatory Asset Value (RAV)

A financial balance representing expenditure by the licensee which has been capitalised under regulatory rules. The licensee receives a return and depreciation on its RAV in its price control allowed revenues.

### Total expenditure (Totex)

Totex consists of all the expenditure relating to a licensee's regulated activities with some specified exceptions. See the Regulatory Instructions and Guidance[7] for a list of these exceptions.

[7] Latest version for RIIO-ET1: https://www.ofgem.gov.uk/publications-and-updates/direction-modify-regulatory-instructions-and-guidance-rigs-riio-et1-version-53