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Dear David,

RIIO-2 methodology for the Electricity System Operator

Drax Group plc (Drax) owns and operates a portfolio of flexible, low carbon and renewable electricity generation assets – providing enough power for the equivalent of more than 8.3 million homes across the UK. Through our generation assets we are actively helping to contribute to the UK's security of supply, providing balancing and ancillary services which allow the UK's energy system to operate safely and securely. Drax also owns two retail businesses, Haven Power and Opus Energy, which together supply renewable electricity and gas to over 390,000 business premises.

From April 2019, the ESO is legally separate from all other parts of the National Grid Group. Ofgem's objective to enable an ambitious, proactive, flexible, and forward-looking ESO can only be achieved if the new regulatory and incentives framework reflects this change and ensures that the newly created organisation is appropriately incentivised. We consider this a key prerequisite for the ESO to deliver significant benefits to consumers and facilitate the transition to net zero emissions by 2050.

While our response focusses on the incentives-related questions, we recognise that the ESO's incentives cannot be assessed in isolation from the funding framework within which it will operate. In particular, we note that there will be no 'totex incentive mechanism' in RIIO-2 and therefore all of the ESO's efficiently incurred costs will be recoverable by the ESO. We understand that the objective of this change is to reduce risk for the ESO and enable it to move away from a regime that incentivises it to focus only on how to achieve short-term cost reductions. We support this objective and acknowledge that the ESO being less exposed to risk goes some way to encouraging it to be less risk-averse and more forward-looking and proactive. However, we believe that the cost-pass through approach alone is not sufficient to deliver the objective; as a privately-owned business, the ESO should also be appropriately incentivised to go above and beyond its baseline obligations and unlock additional long-term benefits for consumers.

To achieve this, we believe that:

- A longer-term, five-year business cycle would be more appropriate. Given that the business plan will be the main component of the regulatory framework binding the ESO to produce specific deliverables within set timetables, it should align with the length of the price control, providing industry with the necessary medium-term certainty required to support efficient investment decisions.

- During the five-year price control period, the ESO roles framework and expectations on how roles should be delivered should remain stable. Metrics for long-term roles and deliverables should be fixed throughout the price control period, although there could be some flexibility in setting metrics associated with short-term operations, so that they can be reviewed as needed.

- There should be a simple, clear and pragmatic link between performance and reward, recognising the different time-horizons (e.g. short, medium and long-term) involved in delivering the ESO roles.

- For the ESO to be proactive, forward-looking and able to accept an appropriate level of commercial risk, what constitutes “economic” and efficient” procurement needs to be clearer. In any review of ESO costs, Ofgem should take into account the uncertainties involved and the information available to the ESO at the time of procurement, as opposed to that available in an ex-post assessment with the full benefit of hindsight.

Our responses to the specific consultation questions are appended. We would be happy to discuss any aspect of our response with you further if it would be helpful.

Yours sincerely,

Marcelo Torres

Regulation Manager, Markets

Appendix - Consultation Questions

Q15. Do you have any views on our initial thinking for how the ESO roles framework should evolve?

We welcome the intention to streamline the ESO roles so that they are distinct and do not overlap. We support the three new roles (i.e. short-term operations, market development, and long-term network development & planning) and we agree with integrating 'whole system thinking' in each of the other roles, rather than it being its own distinct role.

Q16. Do you support the introduction of a defined set of ESO outcomes and impacts? If so, what should these outcomes and impacts be?

We see value in keeping the existing "seven ESO principles" and do not support their wholesale replacement with the proposed "outcomes and impacts". The ESO principles provide helpful clarity as to what is expected from the ESO to successfully deliver its roles. Indeed, we see the current principles framework being complementary to an outcomes and impacts framework. Obviously, the selection of those outcomes and the measurability of the impacts will be critical. For instance, we would note that outcomes such as "lower consumer bills" aren't wholly within the ESO's control and "environmental benefits" may conflict with the requirement for technology neutrality. If Ofgem considers that certain outcomes or impacts should be explicitly referenced in the existing principles framework, then relevant metrics should be introduced. Indeed, some specificity of necessary and desirable outcomes may provide helpful clarity to the ESO as well as aid the Performance Panel to judge the ESO's performance.

Q17. Do you think any changes are needed to ESO's licence conditions in order to further clarify its baseline obligations?

Standard Licence Condition C16 establishes the obligation for the ESO to co-ordinate and direct the flow of electricity onto and over the National Electricity Transmission System (NETS) in an efficient, economic and co-ordinated manner. It may prove beneficial to consider a more specific definition in the licence, or in a separate guidance document, as to what constitutes "economic" and "efficient" versus "uneconomic" or "inefficient". A clearer definition would reduce the risks that the cost disallowance mechanism creates, resulting in a more transparent procurement process and a less risk-averse ESO.

We would also support the inclusion of obligations around whole system outcomes. This includes but is not limited to the inclusion of an explicit requirement for the Network Options Assessment to consider wider system operability issues (e.g. inertia/RoCoF, dynamic voltage control, short-circuit, fault ride through capability, etc.), as part of Standard Condition C27: "The Network Options Assessment process and reporting requirements".

Q18. Do you agree the incentives scheme should be focussed on encouraging the ESO to provide an exceptional quality of service when delivering its price control funded activities? Do you agree with our initial views on what an exceptional quality of service would include?

In principle, we support an incentives framework that encourages the ESO to be ambitious and delivers excellent quality of service across its roles. It is not clear how the criteria identified in the consultation document in relation to providing an "exceptional quality of service" interact with the rest of the regulatory framework. We wouldn't support an additional layer of criteria that may overlap with other parts of the framework (e.g. a requirement for an ambitious business plan or already stretching metrics). Simplicity and stability of the regulatory and incentives framework will be key factors for the Performance Panel and industry to engage effectively in the ESO performance assessment process. A simple, clear and pragmatic link between performance and reward is also important to provide the ESO with the necessary confidence over its ability to achieve "excellent quality of service" and be rewarded for doing so.

Q19. Do you agree with our proposal to align the length of the incentive scheme with the two-year business planning cycle?

We acknowledge the need for a more agile regulatory framework and the fact that the ESO as a separate legal entity is a relatively asset-light organisation. However, it needs to be recognised that the ESO sits at the heart of an industry that needs stability and predictability in order to make long-term, capital-intensive investments in the necessary infrastructure. We hold the view that a two-year business plan does not reflect properly the long-term nature of the sector. Given that the business plan will be the main component of the regulatory framework binding the ESO to produce specific deliverables within set timetables, we believe that the business plan should align with the length of the price control. This should provide market participants with the medium-term certainty required to enable efficient investment decisions.

We hold the view that during the five-year price control period, the ESO roles framework and any expectations on how roles should be delivered should remain stable. The business plan should include detailed ESO costs, activities and deliverables. Metrics for long-term roles and deliverables should be fixed throughout the price control period, while there could be some flexibility in setting metrics associated with short-term operations, so that they can be reviewed as needed.

As far as alignment of the incentives scheme with the business plan cycle is concerned, we believe that a yearly exercise is possible, provided that the performance assessment process is designed in a more efficient way than currently. In particular, more focus should be provided in the end-of-year review as opposed to the mid-year review, recognising that there is not enough time between the two reviews for a significant change in the ESO's performance and, therefore, in stakeholders' feedback.

We welcome the proposed breakdown of short, medium and long-term incentive areas and we believe that it goes some way in acknowledging the challenge involved in rewarding the ESO for pursuing long-term initiatives that deliver future benefits to consumers. However, we believe that this challenge would be better addressed by the combined effect of horizon-specific incentives (short, medium and long-term) and a longer business cycle, aligned with the length of the price control.

Q20. Do you agree we should introduce the possibility of 'core' metrics for the ESO? And, do you have views on which areas of ESO performance we should consider for any core metrics?

We agree with the proposed approach and the 'core' metrics identified. We also see merit in including a 'core' metric around transparency of system needs and one on effectively addressing long-term system operability challenges.

Q21. Should there be financial incentive implications for the ESO as a consequence of the business plan assessment process?

Ofgem should set out its expectations of what constitutes a high-quality plan. The ESO should then create a business plan, with meaningful stakeholder engagement, which meets these expectations. Given the importance of the ESO's role in the energy system, a low-quality plan has the potential to hinder the energy transition and impact GB consumers disproportionately, and, therefore, should not be an acceptable option.

If the reward is low due to the plan being of low-quality, there may be no incentive for the ESO to bring forward new deliverables or initiatives during the price control period. This could lead to a race to the bottom, eventually resulting in poor outcomes for GB consumers. Finally, linking the incentive pot to the quality of the business plan could lead to a potential change to the size of the reward every two years, which reduces certainty over rewards for longer-term initiatives.

Q22. What if any changes might be needed to the incentives evaluation criteria?

We believe that the current evaluation criteria are sufficiently wide-ranging, and stability of the framework is key for effective stakeholder engagement. We don't oppose the merger of "current" and "future" consumer benefit criteria, provided that there is a clear and effective mechanism in place to reward the ESO for long-term deliverables.

Q23. How should we best include internal cost efficiency in the evaluation framework – should it be a performance metric or explicit criteria?

The current efficiency check for Black Start could be improved to encourage the ESO to take a more forward-looking, strategic approach to addressing system restoration needs rather than a passive approach. Black Start contracting should be included within role 2 (market development & procurement), with a symmetrical incentive that rewards efficient contracting, rather than focussing on ex-post cost justification. Indeed ex-post justification increases the regulatory risk. This typically leads to more risk-averse ex-ante decision making and actions by the ESO which can be inefficient as a consequence.

Q24. Should we continue to evaluate the ESO's performance by role? If so, do you agree that we should we tailor the evaluation approach to each role?

We agree with evaluating the ESO's performance by role and with tailoring the evaluation approach to each role. We support the proposal to create a distinction between short-term activities where a higher focus on metrics is appropriate, and long-term activities, which are better suited to qualitative evaluation. We would like to stress that operating the system should not be regarded only as a short-term activity. The incentives framework should encourage the ESO to develop strategic, long-term solutions to addressing system needs, such as inertia levels or black start.

Q25. Do you think medium to longer term roles should have relatively more upside incentives focus than short term roles?

Yes, we agree that medium-term and long-term activities are more suited to incentives that are upside-only, as the existence of a penalty may drive risk-averse behaviour that does not benefit consumers.

Q26. Do these arrangements give stakeholders the right platform to shape ESO activity and hold it to account for its performance?

The current arrangements provide stakeholders with ample opportunity to provide feedback on ESO's business plans and performance. There may be scope for further stakeholder involvement in the process of designing the metrics against which ESO performance is measured.

Q27. Do you have any further suggestions for improving the existing ESO performance panel arrangements?

We agree that the Performance Panel should be responsible for scrutinising the ESO's business plans in place of the RIIO-2 Challenge Group.

We believe that the Panel's composition could benefit from a larger number of members, including subject matter experts from different parts of the industry.

Q28. What if any changes should be prioritised and introduced early for the 2020/21 incentives framework?

We support the move from four roles to three, as well as the distinction between short-term, medium-term and long-term ESO activities as soon as practicably possible.