

Appendix 3: response to Electricity System operator questions

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1 Overview

As the Distribution Network Operator (DNO) for the North West of England, Electricity North West works closely with National Grid as the Transmission System Operator. As DNOs are actively evolving to the new role and responsibilities of a Distribution System Operator (DSO) this interaction with other parts of the energy system becomes ever more crucial.

With 2019 seeing the Transmission System Operator completing its legal separation from the Transmission Owner, it is appropriate for the Transmission System Operator to have it's first stand alone price control which is specifically designed to take into account the unique nature of it's business.

We will continue to develop our interfaces with the Transmission System Operator, particularly as the energy sector continues to change to facilitate our customer and stakeholders decarbonisation requirements. Already, during RIIO-ED1 we are working towards finding more efficient whole system outcomes. We are therefore fully engaged in the RIIO-2 process to ensure that an appropriate price control is built which enables the Transmission System Operator to deliver its key functions and is flexible enough to adapt to the rapidly changing energy system and its role within it.

We note that the consultation currently has, in some parts, fairly high level principles and approaches and therefore we cannot provide fully considered responses in some areas without further visibility as to how these approaches could be applied in more detail. We would expect that this new type of regulatory framework including the necessary detail will evolve over the coming months and may require further consultation as the options and details become clearer.

2 ESO roles and principles

ESOQ1. Do you agree with our proposal to maintain the current roles and principles framework for RIIO-2?

We agree that given the nature of the non-asset based Transmission System Operator, having clear roles and principles are an appropriate way of regulating a company of this nature. The roles and principles ensure there is a clear focus and also provide clarity to other stakeholders who need to interact with the Transmission System Operator.

We are not certain the existing four roles and seven principles will remain the most appropriate for consumers as we move towards and go through RIIO-2 which will be a period of change. Ofgem recently consulted on whether any changes should be made as part of the review of ESO performance in 2017-18. At that point Electricity North West felt that it was too early to constructively comment as we have not had chance to see how the current roles and principles are working in practice. Ofgem and the performance panel are likely well placed to consider if any revisions are required ahead of RIIO-2 with input from customers and stakeholders. There is a current consultation¹ (closing 14 March 2019) to merge roles 3 and 4 and change the weighting of the principles for the purposes of the incentives framework. Hence our view is that continuous review will be necessary over the coming years as parties gain further experience of working with the Transmission System Operator on the current basis and also while potentially changes to roles and principles become necessary.

The mechanisms for how any changes to roles and principles might be identified and implemented during the ESO RIIO-2 price control needs to be set out.

ESQ2. Do you agree with our proposals to keep the ESO's code administration, EMR delivery body, data administration, and revenue collection functions in place for RIIO-2? Do you believe that any of these functions (or any other functions) should be opened up to competition, either now or in future?

Taking each in turn:

Code Administration – we support the code administration function being separated from the current Transmission System Operator core responsibilities and subjecting this function to competition. This may result in a more efficient and better performing code function and it may additionally be conducive to code consolidation depending who would take the work on going forward. We do note that the recent Code Administrator Survey showed improvements, however ESO code activities have been historically and remain the poorer performing in the industry.

It would be prudent to make any changes once the outcome of the Energy Codes Review is sufficiently clear.

EMR delivery function – Electricity North West does not have involvement with this function, and therefore are not able to constructively comment on this area of operations.

Data Administration and information provision – It is unclear from the consultation what is meant by this element of service, and therefore we are not able to comment comprehensively, however we support the Transmission System Operator performing data administration and information provision which is relevant to their role. Any other areas of data administration and information provision which extend beyond their core role should be carefully considered including whether another party may be best placed to provide such a function including a developing DSO/DNO.

¹ <https://www.ofgem.gov.uk/publications-and-updates/consultation-evaluation-process-2019-20-eso-regulatory-and-incentives-framework>

Revenue collection and pass-through – we broadly agree with the proposed approach for the Transmission System Operator to retain responsibility for collecting and passing through TNUoS and BSUoS costs to market participants.

However, we have identified that some billing activities could be undertaken by DNOs, for example residual charges. We explained this in our 4 February 2019 response to the Targeted Charging Review consultation in terms of TNUoS. If the transmission residual is levied on suppliers directly by the Transmission System Operator then this will require duplication of existing processes and result in unnecessary industry change and cost. Levying the transmission residual through the DUoS tariff may be a more pragmatic alternative that should be fully evaluated.

ESQ3. Do you consider the ESO is best-placed to run early and late competitions?

We cannot see any specific information relating to the Transmission System Operator running early and late competitions within the consultation. We have addressed this point in terms of principles on our answer to questions CSQ60 - 64 within our cross sector response.

3 Price control process

ESQ4. Do you agree with our proposal to move to a two-year business planning cycled price control process for the ESO? If not, please outline your preferred alternative, noting any key features (eg uncertainty mechanisms or re-openers) that should be included.

We strongly support this move to a two year price control process and have proposed this approach in our previous framework responses. We believe there is a strong case for this approach, particularly as this will be the first of the Transmission System Operator stand-alone price control periods. It will give the flexibility to evolve the framework based on early learning without locking in to an extended period and also brings an element of alignment with the electricity distribution price control commencement in April 2023. This alignment will allow for any the Transmission System Operator and the developing DSOs to work together to greater unlock and explore whole system benefits from the use of capacity and flexibility markets.

We recognise the requirement to balance flexibility to reflect the changing energy system with the need for the Transmission System Operator to have certainty of funding for longer term activities or capital investment. Any risk the Transmission System Operator becomes short-termist in its plans can be addressed by allowing relevant funding streams to be agreed for longer than 2 years where Ofgem is satisfied this is in consumers interests. We expect some IT projects may fall into a category where a bespoke funding over multiple 2 year periods might be required.

We agree that business plans themselves should cover a longer time horizon than two years to demonstrate how the Transmission System Operator is planning for the future and indicate to stakeholders their potential funding needs. A business plan incentive could be designed to reward longer term strategies that work for consumers as well as rewarding delivery of outcomes at efficient costs.

We would therefore support rolling two year price controls with a longer five year planning time horizon.

We do not think specific uncertainty mechanisms or reopeners are necessary for a two year business planning cycle where the next business plan can capture and adapt as uncertainties arise.

ESQ5. What stakeholder engagement mechanisms should be put in place for the ESO's business planning and ongoing scrutiny of its performance? Do you agree with our proposal to maintain, and build upon, the role of the Performance Panel?

It is still early in our experience, though based on what we've seen to date we support the role of the Performance Panel. This is working well so we agree with the proposal to maintain and build upon its role. The role should continue to be developed in order to learn the early lessons from the performance review of 2018-19 and subsequent periods.

4 Output and incentives

ESQ6. Do you agree with our proposed approach of using evaluative, ex-ante incentives arrangements for the ESO?

It is appropriate to have performance based incentives for the Transmission System Operator. We found the call for evidence, followed by the open session ahead of the closed performance panel gave stakeholders a good opportunity for wider feedback and was well signalled.

Again it is very early days in the evolution of the Electricity System Operator Reporting and Incentive Arrangements (ESORI), therefore Ofgem should incorporate the lessons learned for 2018-19 and 2019-20 before setting the final arrangements for RIIO-2. The most recent draft forward work programme that the Transmission System Operator has proposed includes outcomes which are "meeting baseline" or "exceeding baseline" upon which evaluation is then possible. We do not agree with the classification of some of the outputs but expect the process will develop further. The development and shape of incentives should continue to be subject to stakeholder and Ofgem feedback to ensure that the targets are sufficiently stretching and relevant throughout the RIIO-2 period from 2021 onwards.

The roles are currently described in fairly high level so there are some aspects on which we are less clear what sits where within the Transmission Owner and the Transmission System Operator after separation. We expect the licence drafting or other Ofgem document will make this clear or that the separation boundaries have been very clearly defined as part of the separation process which isn't directly referred to in this consultation. Drafting licence conditions historically would be undertaken after the business plan is determined, though as this is a new price control we suggest this work is started earlier given the potential complexity of writing brand new licence conditions and potentially separating out any details from the Transmission Owner RIIO-T2 accountabilities/licence.

ESQ7. Do you agree that we should continue to apply a single 'pot' of incentives to the ESO, and that this should be a symmetrical positive/negative amount? If not, why not?

We agree that the incentive should remain symmetrical however it does need to be proportionate to the business scale and calibrated on the ability to deliver benefits or cause costs for consumers. The

incentive strength should be sufficient to drive the desired behaviours however at the same time not so great as it causes financeability issues.

The recently issued consultation on the 2019-20 incentive framework shares an updated proposed approach while retaining a single pot incentive where the evaluation process and incentive range is carried out per role rather than per principle. This feels like an appropriate build reflecting early learning. We continue to engage with Ofgem and the Transmission System Operator through consultations on this subject.

5 Cost assessment

ESQ8. Do you agree with our proposed approach to assessing the costs of the ESO under RII0-2? Do you think we should assess costs on an activity-by-activity basis? How would you go about defining the activity categories? Are there alternative approaches we should consider?

Please see response to ESQ9.

ESQ9. Do you consider the types of cost assessment activities we outline in this chapter are the right ones? Are there additional activities you think we should consider?

This is a combined response to ESQ8 and ESQ9.

We agree with the proposed approach to assess costs on an activity by activity basis. We also support separating out assessment of opex and capex with clear deliverables against activities. It is important for stakeholders to have transparency of the Transmission System Operator costs and this method provides for this.

Insufficient information has been provided in the consultation on current Transmission System Operator activities and associated costs for us to propose a way of defining the activity categories. We agree that using the principles is probably not appropriate and a functional separation is more workable.

Aspects of the eight categories proposed may have the potential to be opened up to competition, as per the considerations elsewhere in this consultation. The relatively limited activities where this might apply, such as code administration where another party might be able to provide a more appropriate level of service for an attractive cost to stakeholders, need to be separately costed.

We agree with the range of requirements proposed to allow assessment of the Transmission System Operator plan, such as CBA's, qualitative and where possible quantitative expenditure justifications, historical costs, comparators and further detailed assessments as per your section 6.26. In some cases we see Ofgem as best placed to consider efficient costs by virtue of the reporting and data they have held historically. Some of the Transmission System Operator activities might be similar enough to those Ofgem undertakes (administering government schemes for example) so there might be some ability to benchmark against Ofgem's own costs in certain areas.

Monopoly service providers like ourselves and the Transmission System Operator need to add value for customers while simultaneously being as efficient as possible to help manage consumer bills. An activity led view of costs should support being able to measure increased efficiency in established activities being delivered over time. It will also give clarity if and where any new activities are added

to show the extra cost of these and also show where any activities are stopped and enable the removal of the relevant costs.

6 Finance

ESQ10. Do you agree with our proposed remuneration model for the ESO under RIIO-2? Do you think it provides the right incentives for the ESO to deliver value for money for consumers and the energy system? Are there other models you think are better suited?

Please see response to ESQ13.

ESQ11. Are there any risks associated with our proposed remuneration model that you do not think have been effectively captured and addressed? Do you think that we should put in place any of the mechanisms intended to provide additional security to the ESO outlined in this chapter – eg parent company guarantee, insurance premium, industry escrow or capital facility?

Please see response to ESQ13

ESQ12. Do you agree with our proposal relating to remove the cost sharing factor? Can you foresee any unintended consequences in doing so, and how could these be mitigated?

Please see response to ESQ13

ESQ13. Do you agree with our proposal to introduce a cost disallowance mechanism for demonstrably inefficient costs? What criteria should we apply in considering what constitutes ‘demonstrably inefficient’?

This is a combined response to questions ESQ10 to ESQ13.

We agree that a RAV approach is not appropriate for the business model of the Transmission System Operator, and therefore other remuneration models should be considered.

There are merits to the annual budget with a margin and sharing factor approach which would incentivise the Transmission System Operator to strive for efficiency in their operations. A mechanism on how inter-year effects would be managed needs working through.

We also see merit at a principle level in the cost pass-through with margin which is Ofgem’s proposed approach. Ofgem’s illustrative example on how allowed returns would be calculated appears sensible; however it is critical that resulting returns are set a level sufficient to compensate investors adequately for this risk. Returns must be set at an appropriate premium to the risk free rate. This will help attract long-term investors and ensure appropriate capital structures are adopted. Any potential risk that a cost pass-through approach may hold, i.e. due to poor cost management/excessive costs incurred which are within the control of the Transmission System Operator can be appropriately managed via evaluation of performance and ex-post tests.

The risks with the proposed model have been covered within the consultation, and it is appropriate that mechanisms are put into place to manage these risks and ensure there is sufficient scrutiny and transparency of costs.

We would highlight that the Transmission System Operator internal costs are generally small relative to the significant benefit that they may be able to generate for consumers and therefore there is higher risk for consumers should the focus be disproportionately placed on budget and cost management. It is important to ensure an adequate business model that provides appropriate funding for the Transmission System Operator activities in order to allow them to focus on those areas that can generate greatest consumer and system benefits.

The risk that the ESO could not cover its costs should be managed in the most cost efficient manner. In our view, this would typically follow practices adopted in competitive market environments. All options should be considered in more detail, but our initial view is that a financial/capital facility is likely to be the most appropriate. Any Escrow arrangement would need to ensure that the industry is appropriately compensated for locked-up capital.

Moving from a RAV based model that is currently in place for the Transmission System Operator (by virtue of them currently being part of the existing T-1 price control regime) will result in an impact to customer bills. The movement from a RAV based slow/fast money funding route to a likely substantially “fast money” approach will need to be carefully considered. Information on customer bill impacts of the new regulatory approach to the ESO needs to be provided.

Care is needed to ensure that any selected mechanisms work in a complimentary way, not using multiple tools for the same issue, or risking having a regulatory package where elements work against each other. Ex post evaluation and cost disallowance appear to work effectively in the DCC price control, and can be mirrored for the Transmission System Operator, however it is important for the Transmission System Operator to have clear guidance and clarity on any cost disallowance mechanism in order to ensure that they do not take an overly cautious approach to the detriment of customers.

The price control needs to allow for a sufficient level of return in order to attract the patient capital required for a company of this type. It will also be important to ensure the company returns are sufficient to support an investment grade rating.

7 Innovation

ESOQ14. Do you agree with our proposals to retain an innovation stimulus for the ESO, but tailor aspects of this innovation stimulus to take account of the nature of the ESO business?

It is appropriate that an innovation stimulus package continues for RIIO-2 and the Transmission System Operator has an opportunity like other networks to take part in this. The package should allow for joint initiatives with third parties and other sector companies. Particularly as we progress embedding whole system thinking we do not consider there is a requirement for a bespoke innovation mechanism for the Transmission System Operator business.

Should there be evidence presented to build a case for something specifically tailored to the Transmission System Operator then the flexibility of two year business plan cycles is well placed to review such requirement as part of the cyclical process.

ESOQ15. What ESO-specific issues should we consider in the design of the ESO innovation stimulus package?

In line with our response to ESOQ14 we do not believe there needs to be anything specific for the Transmission System Operator in the innovation stimulus package.