

Responses to our Thought Piece “Exploring how the ESO could be funded in RIIO-2”

1. Can a layered model meet the characteristics of a successful regulatory framework?

Citizens Advice

- Given the nature of the ESO, it is reasonable to assume that the layered model could meet the characteristics of a successful regulatory framework
- Each layer should be aligned appropriately to the specific business activities. The level of administration should not be burdensome to Ofgem, the ESO or stakeholders
- This approach provides the ability to tailor funding appropriately
- Do not think a five-year price control is appropriate for all the ESO’s activities. For some layers, where there is stability and predictability, longer term controls should be possible. In other areas, particularly around live performance targets that are subject to operational reward or penalty, setting targets over the next year that would still be relevant in the 2020s may be unwise.
- The ability to reassess and recalibrate targets on a regular basis should be retained for some of the ESO’s activities
- Consideration should be made for an approach that is layered, but also has different timelines for the layers

Ovo

- Support the principle of the layered model as it makes sense to ensure a baseline of service delivery whilst incentivising improved performance
- The benefit of a layered approach is that it can ensure the ESO has sufficient funding to function to deliver expected levels of services
- It can also be incentivised to improve its performance and help guide the energy system to one that delivers whole system benefits
- Given the ESO is a key actor in how the entire energy system develops, to be effective, the ESO needs to recognise its role as an agent of change, or lack of
- Having an agnostic approach to whole energy system outcomes will have a direct influence on how the energy system changes
- Would like to see the ESO set performance-based recommendations based on transparent criteria; these could relate to whole system, cost, practical feasibility, decarbonisation goals and alignment with Government policy

Orsted

- Believe the ESO will benefit from moving away from the traditional RAV-based approach
- In considering the layered model, the business model needs to achieve:
 - Delivery of the fit-for-purpose grid that meets the needs of decarbonisation and demand shifts. If a layer of the model can reflect this target, then we believe the ESO could make significant progress.
 - Value to consumers and network customers - the ESO has consistently mentioned this at events

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<ul style="list-style-type: none"> ○ Transparency to maintain the required scrutiny that a regulated monopoly operates under. A layered model if kept sufficiently high level may achieve this outcome; however, having too many layers could detract from this principle. ● Would like to see more detail in the layers that the ESO would propose to Ofgem
<p><i>Electricity North West</i></p> <ul style="list-style-type: none"> ● Support the principles that the ESO should have the ability to earn a fair return and be financeable as a separate licence holder ● Support the principle that the ESO should be incentivised to drive the best value and outcomes for customers, consumers and society as a whole ● Note the risks the ESO identifies that it is managing, but to some extent these risks might themselves be addressed by the regulatory regime itself so further work is needed to identify the risks borne by the ESO once the framework becomes clearer

<p>2. What are the pros and cons of the different funding approaches? Do you have additional funding approach suggestions?</p>
<p><i>Citizens Advice</i></p> <ul style="list-style-type: none"> ● Agree with ESO assessment of pros and cons
<p><i>Orsted</i></p> <ul style="list-style-type: none"> ● Largely agree with the pros and cons suggested by the ESO, further thoughts on each model are summarised below: <ul style="list-style-type: none"> ○ Margin approach - perhaps an overly simplified version of the layered approach that may obscure some ESO activities. A layered model that appropriately balances transparency with sufficiently targeted objectives has merit for further consideration. ○ Commitments approach - requires individual negotiations for each customer therefore non-beneficial to either party from a resource and fairness perspective. A larger, more well-resourced entity is likely to achieve a better perhaps preferential deal than others and the ESO is left with a complex set of obligations from multiple parties that the regulator is unable to scrutinise. ○ A performance-based model may have some merit for further consideration. As indicated in the June workshop most attendees supported this approach. Allowing the ESO to take more risk in its investments for a potential larger return may help it to seek better solutions that meet the challenges of an evolving energy system. In all other approaches where the revenue is set the ESO may be motivated to take a more conservative approach that does not match the pace of change.

<p>3. How can incentives be used to drive performance and deliver outcomes that customers, stakeholders and consumers value?</p>
<p><i>Citizens Advice</i></p>

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- Incentives should only be in place to drive behaviours and deliver outcomes which are reasonably considered outside the BAU activities
- They should be aligned to customer, stakeholder and, importantly, consumer outcomes

Ovo

- Suggest that more emphasis be placed on the value of ancillary and flexibility services and the benefits these can bring to the system

Orsted

- Depends on the specific area that the incentive is being applied to e.g. a health and safety incentive should be downside-only
- However, a downside-only incentive in maintaining system operation could deter the ESO from making fundamental changes required to deliver a flexible grid system.
- In this instance a symmetrical incentive may be more appropriate to drive change at the right pace
- Would like to see more specific information on what areas of the ESO business it believes should be subject to an incentive

4. Could asymmetric incentives be appropriate for the ESO?

Citizens Advice

- Yes, a mix of upside-only, downside-only and symmetrical incentives may be appropriate but further detail is needed on potential incentive areas

Ovo

- Yes, the ESO should have the opportunity to hit greater upside-only incentives by hitting whole system output targets

Orsted

- A situation where there is less downside and more upside could be interpreted as a form of insulating the ESO against further downside when compared against a symmetrical incentive
- In this light an asymmetric incentive may not be helpful in keeping pace with the changes we are seeing in generations and demand profiles as the penalty for missing targets is not as deep
- The thought-piece suggests that the ESO business would not be able to obtain the same financing rates as it currently enjoys under NG Group, as a separate entity. The ESO suggests lending rates would be less favourable or not available.
- However, understand that in all models except the performance model, the ESO would continue to have an allowed revenue which it is allowed to recover from network users
- This protected revenue suggests that the ESO can continue to receive a more favourable lending rate than other energy industry participants
- The proportion and extent of incentives that the ESO is exposed to relative to this protected revenue is then a key consideration

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5. How can the funding model and incentives work together?
<p><i>Citizens Advice</i></p> <ul style="list-style-type: none"> • If incentives are necessary (to drive performance beyond BAU) and if the layered model is chosen, then these should complement the funding model and provide the ESO reward or penalty for exceptional or unacceptable performance
<p><i>Ovo</i></p> <ul style="list-style-type: none"> • The ESO could have a funding model that uses metrics like grid load factor and use of flexibility services to balance the system as measure for performance • The layered model will only work if the performance-based layers are meaningful • Non-performance based funding layers should be there to provide a minimum level of stability to enable it to raise debt finance and provide any positive return on investment • Like any private company, the ESO’s performance should determine whether it makes a profit or a loss • Performance should be related as closely as possible to established policy objectives from Ofgem and BEIS, e.g. Smart Systems and Flexibility Plan
<p><i>Orsted</i></p> <ul style="list-style-type: none"> • Interested to see the overall proportion of how much of the ESO’s revenue is subject to the base funding model and how much would be incentive-based • The proportion and areas where an incentive is applied is important as it then informs the risk appetite of the ESO to seek the necessary market reforms that improve system operation and flexibility • Legal separation presents an opportunity to better define the ESO business and play a stronger role in delivering a flexible grid as part of a whole energy system outcome • Under RIIO-2 we think the ESO should be better incentivised to make the right investments in how it operates the transmission networks and cooperates with the DNO networks

6. Do you have any further general comments?
<p><i>Solution InSight</i></p> <ul style="list-style-type: none"> • Agree with the rationale in the document covering boxes 2-5 • At a cost of £1 out of an average bill of £554, it is important to be proportionate. Whilst economic efficiency is important, it is much more important to deliver value to the industry, and if the fastest way to achieving this means a degree of inefficiency en-route, then so be it • A focus on efficiency may be more appropriate later when a BAU state is achieved • Benchmarking, although good in theory, is generally difficult to apply on a rigorous basis • If it is decided to go down this route, careful thought should be given to objectives, process and value/ confidence of derived outputs

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- In terms of risk, is it considered possible that the SO could (in extreme) go bust. If so, there needs to be consideration of an Operator of Last Resort, the arrangements for which would not be trivial.

Electricity North West

- The uncertainty facing the sector and need for collaboration across Tx and Dx has led to consideration of whether it is appropriate or achievable to establish a set of new regulatory arrangements to be in place for the start of T2 for the ESO, that can endure five years
- Have proposed to Ofgem that a two + five year price control review period is considered for the ESO to bring it in line with DNO timescales
- May also be appropriate for ESO incentives to be set for shorter periods than five years due to the dynamic environment the ESO operates in
- Agree in principle with the three high-level themes the ESO proposes in its thought piece, of driving performance, promoting transparency and ensuring financeability
- However, the characteristics the ESO proposes appear to be a means rather than ends, describing how the ESO should act rather than setting out what the ESO will do to respond to stakeholder priorities
- Some clearly defined outputs should be developed and a set of proposed associated measures