

# Early Competition Plan

ESO Role in Distribution Sector Early Competition  
April 2021



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## 1 Executive summary

While the primary focus of the Early Competition Plan ("ECP") is on transmission needs, Ofgem are in the process of making a decision on whether to include early competition in the electricity distribution sector as part of RIIO-ED2, due to start in 2023. For more detail on the ECP please refer to the ECP April 2021 document.

While developing the roles required to support early competition at a transmission level, Ofgem asked the Electricity System Operator ("ESO") to consider whether there is a role we could play in supporting early competition in the electricity distribution sector from 2023.

Following extensive engagement with stakeholders there is a consensus that there is not a role for the ESO in early competition in the distribution sector. Based on the outputs from workshops with industry stakeholders and the consultation responses received, the core reasons for this are:













- Future institutional arrangements for the delivery of Distribution System Operator ("DSO") functions are unclear at this point. Therefore, it is premature to propose whether there is a need for formal ESO involvement to support early competition
- The potential costs and complexity of introducing the ESO into the institutional structures is expected to be significant, given the ESO's starting position in terms of a low level of knowledge and expertise in distribution compared to transmission. The same is likely to be true of any new third party
- There is very little appetite from stakeholders across the board for ESO involvement, with a strong preference for existing distribution parties to be considered the better option.

Based on our engagement, the ESO agrees with the predominant stakeholder view that existing distribution parties and Ofgem are probably better positioned to take on roles to support early competition in distribution. Figure 1 indicates the options considered by stakeholders, with the preferred parties highlighted.

Given that arrangements relevant to early competition for both transmission and distribution will develop and become clearer later in 2021 and into 2022, we would recommend that Ofgem consider the following in more detail as ED2 develops:

- Whether potential conflict of interests have been created as the ED2 institutional arrangements develop
- What modifications are required to the proposed early competition model for transmission, to reflect differences between the transmission and distribution sectors
- Potential cost to consumers of multiple parties duplicating activity, such as the Procurement Body role.

Figure 1: Preferred parties

Role	Options
Procurement Body	ofgem  
Network Planning Body	 
Approver	ofgem  
Licence Counterparty	ofgem
Contract Counterparty	 
Payment Counterparty	 
Additional Roles	ofgem  

 3rd Party incl ESO

## 2 Approach and assumptions

This section sets out our approach and assumptions used to develop our thinking on the topic of whether there is a role for the ESO in distribution sector early competition.

Our approach to the request from Ofgem has been to collaborate with stakeholders to establish at a high level:

- Whether the process steps and activities developed for the transmission level model of early competition could be applied to distribution needs
- Whether the core roles required to support early competition are the same for both transmission and distribution early competition
- Whether there are potentially any additional process steps or roles that could be useful for distribution early competition
- What the key advantages and disadvantages are of each option for a party performing a role
- What stakeholder views are regarding which parties might be best placed to perform the roles.

To develop our thinking in this area we used the following key assumptions:

- The same model for early competition would apply for both transmission and distribution needs
- Where roles are common, the ESO could only be considered where this would be an extension of a transmission level role it was performing
- The ESO should only be considered as a possible third party option (a third party being an institution, new or existing, not traditionally directly involved in distribution)
- The exact nature of institutional structures for ED2 is not currently known, other than Distribution Network Owners ("DNOs") may take on additional DSO activities. These will be set up as separable and report separately. We have assumed that current business structures will remain in place during ED2
- The decision to implement early competition at distribution level is led by Ofgem as part of ED2, and Ofgem will decide how to conduct any deeper review of institutional arrangements.

Further details of the engagement activities conducted can be found in the "Developing the ECP" document.

### 3 Distribution early competition process

In the following section we set out our thoughts on whether the process developed for transmission level needs could be applied to distribution. Figure 2 sets out the process steps. For more detail on each, please refer to the Early Competition Plan document, Section 5 End-to-end process.

Figure 2: End to End Transmission Early Competition Process



#### 3.1 Application

Based on stakeholder input we currently think that the high-level process developed for transmission level needs could be transferable to distribution. The Project Identification ("PI") to Preferred Bidder ("PB") stage is a standard procurement process commonly used in utility sector procurement, followed by a recognised post award process. During our workshops with stakeholders to develop the process and activities for transmission level application, and considering consultation responses, no major incompatibility issues for distribution level application were identified.

#### 3.2 Modification for Distribution

However stakeholders have helped identify that that the application of the process cannot be a simple "lift and shift" to create a single identical process spanning both sectors. The Energy Network Association ("ENA") working group on competition have been particularly helpful on this topic. Some key areas already identified that could require modification to suit distribution are:

- Competition criteria would need adapting to reflect, amongst other things, shorter and more diverse timescales associated with multiple voltages, lower value of projects (both investment and constraint cost avoidance) and more direct consumer impact traditionally associated with distribution network needs
- The network planning processes used to support project identification for the transmission early competition process are different to those used for network planning in distribution. For transmission needs, early competition will integrate with the Network Options Assessment ("NOA"). For distribution, early competition would need to integrate with the Long-Term plan ("LTP") and Network Development Plan ("NDP") processes
- The requirement for a debt competition in the process may not be relevant for distribution early competition. The potentially different nature of events in areas such as cycle time, cost and design certainty may make alternative approaches to finance and debt more appropriate
- Associated incentives and uncertainty mechanisms would need adapting to ensure they remain applicable and align with other distribution initiatives.











Our thinking that the high-level process could be transferable with modifications has received near universal support from stakeholders. However, it should be noted by Ofgem that we have not consulted specifically on the nature of required modifications. Some stakeholder consultation responses have stated that they would expect a full Ofgem led consultation, should Ofgem wish to further investigate the application of the transmission designed process to distribution. One stakeholder, while agreeing that modification would be required, has gone further and stated that they would expect a separate distribution specific model to be developed and fully consulted upon by Ofgem.

## 4 Distribution early competition roles

Any formal role in distribution would represent a significant expansion of the ESO remit. We have engaged with the distribution community through the ENA, held a series of development workshops with the wider ECP stakeholder community, and consulted on this topic in the Phase 3 Consultation. All of the engagement has been instrumental in developing, testing and refining the thinking that is the basis of this thought piece.



The roles considered with stakeholders fall into 2 categories. There are the Core Roles that are required to support the transmission level process and the Additional Roles that could potentially be useful to distribution early competition. More detail on the proposed Core Roles can be found in the ECP Section 6: Roles, Responsibilities and Reward. Figures 3 and 4 below summarise the roles and options considered for distribution.

Figure 3: Core Roles

Role	Description	Options
Procurement Body	Responsible for the design of the procurement structure and process, supporting the development of tender and contractual documents as well as management of the procurement process	ofgem  
Network Planning Body	Responsible for identification of system needs through to the development of possible reinforcement options. This will also include identifying potential projects that meet early competition criteria and market engagement to understand options in Pre-tender stage	 
Approver	Makes the formal decision to conclude a stage of early competition	ofgem  
Licence Counterparty	Manages and monitors the obligations placed on a winning bidder that is issued, or has, a distribution licence	ofgem
Contract Counterparty	Manages and monitors any obligations placed on a winning bidder who will hold a contract for any solution not performing the function of electricity distribution (non-network)	 
Payment Counterparty	Manages financial transactions between the winning bidder and the other counterparties	 

 3rd Party incl ESO

Figure 4: Additional Roles

Role	Description	Options
Best practice coordinator	Set out, standardise and improve process used by all parties	ofgem  
Auditor	Monitor consistent application/compliance of process across all parties	
Project consolidation	Identify opportunities to bundle projects across networks	
Whole system review	A check to look at whether with minor changes to planned work on transmission or distribution network, a proposed competition is not required	

 3rd Party incl ESO

## 5 Core roles

Following stakeholder engagement and input we believe that the core roles required to support distribution early competition are broadly the same as those for transmission level, reflecting the similar nature of the process.

The options discussed with stakeholders for which parties could perform the roles reflect those considered at transmission level. However, there was a modification to the options to reflect the difference in system operator structure for distribution. For ED2 there is a developing picture of DNO's potentially taking on additional system operator functions, creating a number of integrated DNO/DSO's in ED2. We therefore replaced the ESO with the DNO/DSO as the system operator option, with the ESO becoming part of the third party option.

### 5.1 Procurement Body

The majority of stakeholders from both the DNO and non-DNO groups have expressed a strong preference for the DSO functions to perform the Procurement Body role. This is largely driven by the view that an existing level of capability and resource is already established within the DNO/DSOs. Stakeholders have also stated that complexity and cost of introducing Ofgem or a third party to undertake the role would be significant, while not seeing an obvious corresponding benefit deriving from such a change. At this point we agree with the view that the ESO is not best placed to perform this role.

A common view from stakeholders is that any new third party is very likely to have limited experience and understanding of designing and running procurement events for distribution needs, and of the associated commercial environment. This would require significant investment (which has not yet been quantified) to acquire the knowledge, develop expertise in these areas and to resource to potentially cater for multiple events assuming all DNO/DSOs run early competitions.

The current DNO/DSOs generally have existing procurement teams which would likely have a narrower capability gap to resolve to be able to run early competitions. DNO/DSO stakeholders indicate they would need to maintain their existing capability, even if a third party was introduced, to deliver their existing procurement activities. This they felt would probably result in a duplication of capability, possibly creating a proportionally higher level of additional industry overheads being incurred by consumers. This would be in addition to the potentially high set up costs of a new third party.

Given the ESO having procurement experience at transmission level, and potentially taking on the Procurement Body role for transmission early competition, this role attracted a lot of stakeholder focus in terms of a potential ESO role. The majority of stakeholders indicate they feel that the capability gap for the ESO at distribution level to take on a the Procurement Body role is much greater than at transmission level, where they perceive the gap to be proportionally much smaller. Stakeholders state that the ESO has minimal involvement in distribution, with the characteristics and operations of distribution being very different to transmission. Ultimately, stakeholders have indicated that the ESO does not in their view have an obvious natural advantage over other third party options.

Stakeholders are also of the view that it is highly likely that introducing a third party will introduce greater complexity into the operational and strategic decision making of the multiple DNO/DSOs, potentially creating inefficiencies and complicating accountability. The regulatory regime would require significant review and change to accommodate a new third party and ensure that accountability is unambiguous.

In response to the disadvantages, most stakeholders from both the DNO and non-DNO sectors have expressed a strong preference for the DSO function to perform the Procurement Body role. This is due to the capability and resource already available within the DNO/DSOs and the perceived complexity and cost of introducing Ofgem or a third party to undertake the role.

Some stakeholders have raised concerns that as DSO arrangements develop in preparation for ED2, either real or perceived conflicts of interest could be created, jeopardising the independence required for a Procurement Body. However, there is general acknowledgement from the stakeholder community that this will depend largely on the final ED2 arrangements for DNO and DSO functions,

which are still being developed as part of the continuing ED2 framework development. The arrangements could become clearer later in 2021 or 2022, and we therefore feel it is currently premature to speculate on whether a conflict of interest will exist.

Ofgem may decide at a later date to consider the need for a third party as a potential mitigation option if such a conflict does arise. However, it should be noted that during our engagement there has been very little appetite from stakeholders for third party involvement, even if the level of separation between DNOs and DSOs is perceived to be minimal.

Only one stakeholder in response to the Phase 3 Consultation has suggested the ESO should be considered for this role to mitigate a potential conflict of interest. Other stakeholders have expressed a view that current licence conditions and existing legislation already create a strong legally enforceable framework preventing anti-competitive behaviour, and state that no further mitigation would be required. This view has also been expressed in relation to the transmission level process.

However, the most common view we heard from stakeholders (both DNO and non-DNO) is that if additional mitigation is deemed to be necessary based on ED2 developments, enhancement of the regulatory regime is preferable over the introduction of a third party. This is perceived as a more proportional and cost-effective mitigation compared to the introduction of a third party.

## 5.2 Network Planning Body

A significant majority of stakeholders have expressed very strong support for this role to be performed by the existing network planning parties. For reasons similar to the Procurement Body role, the majority of stakeholders do not see the ESO or another third party in this role for distribution early competition. Again we agree with this view at this point.

Stakeholders believe that the network modelling capability, knowledge of needs drivers, asset knowledge, network topology and behavioural characteristics of multi-voltage networks would make the transfer of this role to any third party extremely challenging and costly. The relative gap in capability for the ESO in this space at distribution level is significantly much greater than for transmission, as the ESO is not currently involved or experienced in distribution network planning. This means that the ESO is not a natural choice for this role.

Stakeholders are also concerned by the size of task of introducing a third party. This is viewed as a very large and disruptive exercise based on the assumption that the new organisation would need to service the 14 distribution networks. A further consideration would also be the complexity and difficulty to seamlessly integrate the third party with all the distribution networks, so that they could continue to discharge their other network planning obligations unhindered.

Similar to the Procurement Body role discussion, there has been some expression of concern that as institutional structures become clearer for ED2 later in 2021, real or perceived conflicts of interest could be created. Some stakeholders see a risk that without the DSO function being involved in this role, with a level of separation from the DNO, then there is no independent view of what needs could be competed, potentially leading to reduced opportunities for competition. However stakeholders have not identified any other strong need driver that would suggest existing parties are not best placed to perform this role.

If the level of separation becomes a live issue, most stakeholders' preferred mitigation is enhancement to the regulatory regime, rather than the transfer of network planning to a third party. This is perceived as a more proportional response considering the cost and complexity of transfer. DNO exclusion from participation has been suggested by a stakeholder, but this is not consistent with our view at transmission level to allow network operators to compete in early competitions.

## 5.3 Contract Counterparty

Current stakeholder preference indicates very strong support for the role to be performed by the DNO/DSO and this is a view we support. This thinking also reflects the proposal at transmission level, where the preference is for the ESO as system operator to perform this role.

As a contract will cover the provision of a service to address a system need, stakeholders agree that it is extremely important that there is a direct contractual relationship between the DNO/DSO as owner of the operational risk and the service provider. Introducing a third party would most likely create a



disconnect between the party responsible for provision of the service, and the party who is accountable to consumers and the regulator for issues created by a service failure.

Again, stakeholders view the introduction of a third party as likely to create more complexity for operational and strategic decision making for DNO/DSO's. It would also potentially incur high set up costs to acquire the relevant skills and knowledge. This in turn would probably result in ongoing duplicated costs as DNO/DSO's will still require capability to manage contractual relationships supporting their other regulated activities.

Ofgem may wish to keep this under review as preparations for RII0-ED2 develop. A concern expressed by a stakeholder was that there is the potential for perceived bias if the DSO is the contract counterparty and a dispute happened involving their corresponding DNO function and the service provider. We currently regarded this as a low risk as we would expect there to be a level of independent review available through dispute mediation and ultimately legal proceedings.

## 5.4 Payment Counterparty

There is strong stakeholder support for this role to be performed by the DNO/DSOs which we agree with. This would reflect the preferred option for the transmission level process where the existing party responsible for collecting network charges takes on this role. We do not think the ESO or another third party are best placed to perform this role, as there is a more natural fit with the DNOs who currently perform a similar role already.

The role requires an expert understanding of the relevant charging regimes which would require significant effort and cost to transfer to a third party. Such a transfer would also increase the distance between consumers and service providers in a key area, potentially weakening lines of communication. As it very probably represents an expansion of an existing charging role performed by DNOs, it is highly likely they could perform the role at lower cost to consumers.

Another consideration in our thinking raised by stakeholders, is that cashflow and credit rating requirements could be a significant challenge for a third party. Given that the business would probably be perceived as largely transactional, it could be difficult to find an interested third party, at least at an economically viable price.

Stakeholders have also stated that there does not appear to be much, if any opportunity, for a conflict of interest to arise in ED2 if the DNO/DSO's perform this role, so overall have questioned the need to consider other parties.

## 5.5 Licence Counterparty

The role of Licence Counterparty naturally sits with Ofgem as the only party with the power to issue a licence. This position has received universal support from stakeholders so far and reflects our thinking at transmission level.

## 5.6 Approver

There has been near universal support from stakeholders for Ofgem to perform this role as these activities are generally regarded as part of Ofgem's existing remit. Stakeholders expressed concern that ESO providing oversight of distribution sector decisions and representing the interest of end consumers would require a significant change to the regulatory environment. Aligning to our thinking at transmission level, we agree and believe this role naturally sits with Ofgem.

## 6 Additional roles

To fully explore the question of whether the ESO may have a role in supporting early competition in the distribution sector, we have also worked with stakeholders to generate and consider ideas for additional roles. The result of this work is that stakeholders generally feel that there is no direct role for the ESO to perform. There does not appear to be enough obvious value to stakeholders in the potential roles to warrant the creation of new defined and funded roles, based purely on early competition. Stakeholders have in some cases suggested there could be some limited value. However they also generally state that either existing distribution parties are probably better placed to accommodate activities, or that the regulatory landscape is already providing appropriate direction.

### 6.1 Best Practice Co-ordinator

Stakeholders generally feel the potential value proposition for a specific role in this space appears very limited, especially given the continuing development of industry cooperation. There is also a view that primary and secondary legislation for early competition should provide a clear framework for organisations to work within, which will create a level of standardisation and best practice.

A key message from stakeholders is that it is highly unlikely that a third party would be able to influence the distribution community to the same degree as Ofgem, or a distribution sector appointed working group. So consideration should be given to these options by Ofgem rather than the creation of a specific role. A common view stated is that with Ofgem in the Approver role, Ofgem would be in a good place to promote better ways of working.

Ultimately sharing and adoption of best practice is driven by organisational culture. We agree with stakeholders that there is not a formal role for the ESO to coordinate the adoption of best practice across distribution early competition parties. Our view is that where the ESO is involved in transmission early competition in the future, there will be the opportunity for the ESO to share our learning at transmission level with distribution parties, and vice versa.

### 6.2 Project consolidation

Stakeholders have expressed that they see very little value to be achievable through cross network consolidation of procurement events. DNO stakeholders in particular have highlighted that they are already required to demonstrate efficient planning of their project portfolio as part of their interaction with Ofgem. A number of stakeholders suggested that the concept itself introduces major challenges such as the ownership of the early competition event, and the resulting Competitively Appointed Distribution Owner ("CADO") or non-network solution impacting multiple networks. One stakeholder thought there might be some opportunity to support procurement of common requirements such as IT systems to support DSO activity. However, we would point out that joint procurement of goods and services is already an option available to organisations under the Utility Contract Regulations. Overall this does not seem to be a role that requires further consideration, or where there is a role for the ESO.

### 6.3 Whole System Review

The concept of the role is to check whether minor changes to existing projects at distribution or transmission could remove the need for running an early competition event in the other sector. There has been very little support from stakeholders for the creation of this role. Most stakeholders have stated that Ofgem through RIIO-2 are already creating strong direction and focus in whole system approaches to need, for example the Coordinated Adjustment Mechanism. We think that this is another area where influencing the behaviour of existing parties through the regulatory regime is more appropriate than creating a new a role to be performed by a third party. We also anticipate that the forthcoming System Operator review from government will continue to develop the approach to greater coordination between transmission and distribution networks.

### 6.4 Auditor

Many stakeholders have strongly questioned the value of a new audit role citing that existing internal audit and compliance functions in the DNO/DSOs already fulfil this role. Others have added that with Ofgem in the Approver role this should provide a level of assurance that the processes are being well

run. Where there was a view for a third party, the National Audit Office was suggested as an existing expert in this area that could audit the process. Given stakeholder input and that the ESO does not have specific capability or experience in auditing distribution, we do not see a role for the ESO to perform in this space.

## 7 Next Steps

The current views we have set out in this paper have been developed with significant stakeholder input and are based on the known institutional arrangements and emerging transmission early competition model. As both the preparations for RIIO-ED2 and the transmission model for early competition continue to develop, Ofgem may wish to consider how to continue distribution sector engagement. As well as promoting process consistency where possible, it could also inform further thinking on which parties may be best placed to perform roles at distribution level.

Through 2021 and into 2022 the picture at both transmission and distribution will continue to evolve. The outcomes of Ofgem's decision on early competition at both transmission and distribution level, the final RIIO-ED2 arrangements and the outcome of the System Operator review will all continue to shape and alter the landscape. It seems premature to completely rule out consideration of ESO involvement to support early competition in distribution at this point, and we look forward to continuing to take an active role in defining how we can best service consumer interests.



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