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ESO response to the RIIO-2 draft determinations: Executive Summary

Energy is the lifeblood of our economy and society. As the Electricity System Operator (ESO) for Great Britain, we hold a unique position at the heart of the nation's energy system. Our actions influence investment decisions and markets worth billions of pounds. Our role is critical for the transformation of the energy sector.

Our ambitious, stakeholder-led Business Plan set out how we will facilitate the transition to a zero-carbon power system and help achieve the UK's commitment to net zero emissions. Climate change is the challenge of a generation, so we welcome Ofgem's recognition of the ambition in our plan and the criticality of the projects we have proposed, as well as the strong degree of stakeholder support.

For the ESO, the RIIO-2 price control represents a first-of-a-kind opportunity to design a regulatory framework that drives strong performance and supports us to deliver the necessary investment for a zero-carbon power system. By 2030 this system will be fundamentally different to today, with new generation and flexibility assets connected at both transmission and distribution level, and integrated onshore and offshore networks that will require complex data and engineering solutions to operate effectively. We are at a crucial stage in this transition, and to be successful the regulatory framework must encourage us to be proactive, agile and innovative, working across energy markets to develop solutions to the new technical challenges we face. Fundamentally, it must also enable our legally-separate business to be financeable. The ESO's internal costs are small compared to the value we can drive for consumers – around £2 billion of net benefits will be delivered by the ESO in RIIO-2 – and stakeholders have highlighted that an agile, flexible and innovative approach is required from the ESO to unlock these benefits and deliver our low carbon future.

Given this opportunity, it is disappointing that the draft determinations appear to have focused excessively on short-term cost reduction. They have also not taken into account all the available evidence. Ofgem's proposals undermine the ability of the ESO to deliver our stakeholder-endorsed Business Plan. Rather than encouraging us to be the proactive, agile, and innovative organisation that stakeholders want, the current proposals encourage risk aversion, undue caution and reactivity. This means that consumers will pay more for a transition to a low carbon economy that will happen more slowly and not at an efficient system-wide cost. In particular, the draft determinations present:

- A framework that drives the wrong behaviours through an unpredictable incentive scheme.
- A flawed cost assessment that means we will begin RIIO-2 in a risk-averse position with a presumption of inefficiency, undermining the aims of the pass-through model.
- A financially unsustainable model that fails to recognise the asset-light and service-based nature of the ESO business.
- A gross underestimation of the impact of asymmetric disallowance risk.

Taken as a package, the draft determinations, unfortunately, encourage a clear set of behaviours. The inadequate returns for taking risk and providing critical services, an unpredictable incentive scheme, and the very real risk of cost disallowance push the ESO to be overly cautious and risk-averse rather than proactive and forward-looking. Ofgem's proposals for micro-managing the ESO will require us to spend considerable time and resources justifying relatively minor costs on a continuous basis, rather than delivering value for consumers. They undermine and disempower our staff and leaders. Under Ofgem's proposals, the ESO will not have the financial headroom to be able to innovate, invest and take any risk. The proposed regulatory framework undermines the low carbon transition the UK must undertake and frustrates the ESO's ability to achieve the consumer savings that could arise through lower balancing costs, avoided network investment, and more efficient markets.

The financial risks, coupled with limited upside, make it impossible to construct a rational case for any investor to commit the additional £50+ million of additional equity the business needs to deliver the investments set out in our Business Plan and required over the next five years to deliver the changes stakeholders are calling for.

As such, this new price control represents a missed opportunity and could have serious consequences both for consumers and the UK's net zero ambition.

Incentivising the right behaviours

The current incentive scheme has been shown to be unpredictable with Ofgem recently overriding the view of its own Performance Panel, reducing the 2019/20 expected award by a factor of approximately four. This lack of clarity is set to continue into RIIO-2, with uncertain links between performance, efficiency and reward. The proposed two-yearly evaluative assessment undermines the ability of the scheme to drive strong performance from the ESO. The RIIO-2 scheme will not be effective if stakeholders and the ESO cannot have confidence that the outcome reflects a true, objective assessment.

Ofgem's proposal to grade our delivery schedule and highlight specific improvements that would lead to a final assessment of excellent performance, is welcome. However, Ofgem's proposal for a two-year assessment cycle will exacerbate the weaknesses of the current scheme through further decoupling performance from reward, particularly for outputs that are delivered in the early part of the two-year period.

To ensure the ESO is driven to be proactive, agile and innovative, a number of changes are needed. These include:

- An agreed scorecard setting out, at the start, what the ESO must do to be assessed as good or exceptional. Furthermore, Ofgem should address the factors that lead to the Performance Panel's assessment tending towards the middle of the range, regardless of performance.
- An independent chair of the Performance Panel who should provide input to, and be engaged in, Ofgem's process to determine the financial outcome.
- The year 1 outcome, for which the available pot should be at least 40 per cent of the two-year total, should be agreed at the end of year 1 and only altered at the end of the two-year period in exceptional circumstances.
- A dispute resolution process, whereby the financial outcome determined by Ofgem can be referred to an agreed independent arbitrator.

Driving the right outcomes through the pass-through model

The ESO's pass-through funding model is designed to focus the ESO on delivering the best overall outcomes for the energy system and consumers, rather than only minimising internal costs. With no totex incentive mechanism, the ESO will not automatically benefit if outturn costs are lower than forecast. The costs in our Business Plan were tested through historical and cross-sector benchmarking and found to be efficient. Despite this, Ofgem has proposed that our operating costs should be ten per cent lower than our proposal, based on the assumption that in some cases, RIIO-1 levels of spending are more appropriate. This fails to take into account the challenges of the energy transition and the investments we need to make today to continue the transformation of a system designed for large fossil-fuel plants to one that is decentralised, flexible, and open to huge numbers of small renewable generators and other participants.

It is concerning that further discussions with Ofgem have revealed that an inconsistent approach has been applied by Ofgem and its consultants when assessing our costs and proposing reductions. For example, some IT capital expenditure has been set aside for assessment at a later date but the operating costs related to these projects has been removed as an 'efficiency reduction'. Innovative, first-of-a-kind projects have been penalised due to the inherent increased level of uncertainty, despite the clear benefits they could bring. A more rational analysis would be that additional contingency should be applied to such projects due to this uncertainty.

Ofgem's proposals mean the ESO would start RIIO-2 in a risk-averse position, unable to fully deliver the activities in our plan and fearful that any investment that exceeds Ofgem's ex-ante view of appropriate costs may lead to an incentive penalty or disallowance (which the business would be unable to absorb due to the lack of financial headroom). This effectively places a cap on the ESO's spending, contrary to the aims of the pass-through model. We do not consider the proposed incentive scheme to be a suitable mechanism to offset this risk.

Further difficulties will arise as RIIO-2 progresses. The inconsistencies and uncertainties over how Ofgem's view of appropriate costs was derived will make it difficult for us to explain any deviations from this view in outturn costs. Again, this drives risk-averse behaviour. Ofgem should also provide more clarity on how deviations from its ex ante view of appropriate costs will be treated in the incentive scheme. Unfortunately, the information provided in the draft determinations document raises more concerns than it provides clarity. For example, the scale and frequency of reporting required appears disproportionate and indicates an unprecedented degree of micromanagement, such as Ofgem's proposal to review all staff travel and expenses policies with a value of less than one per cent of the ESO's internal costs.

To address these issues, our proposals include the following:

- On operating costs there needs to be agreement on a robust and well-justified ex-ante estimate, with a mechanism to give the ESO the flexibility and confidence to depart from this estimate and invest in innovative, new projects where appropriate. This mechanism should include a ten per cent materiality threshold or 'dead band' within which changes to cost will not be considered in the efficiency incentive.
- On capital expenditure, the process must recognise that some IT systems are new and innovative and their specifications are not fully set out (and in many cases are not fully in the ESO's control as rules or participant requirements evolve). Therefore, instead of reducing the view of efficient costs, there should be a contingency added to these projects. To support this, we would be happy to appoint an agreed external party to review our IT costs and provide assurance that they are efficient.
- The ongoing process to provide regulatory submissions on costs and performance must be proportionate and commensurate with the scale of our costs. It should not prevent the ESO being agile and proactive in responding quickly to changing market needs and going after consumer value.

Ensuring financial sustainability

Ofgem's proposals do not provide the ESO with the financial headroom to invest in additional, modified, or enhanced services or solutions without first securing comfort from Ofgem that the costs will be deemed efficient. This puts at risk our ability to deliver our ambitious Business Plan, particularly the more innovative elements that are needed to deliver net zero emissions, and the consumer benefits that follow. The current proposals ignore a substantial portion of the ESO's risks and leave insufficient profit before tax to cover the incentive downside, let alone any cost disallowance or other unfunded costs or penalties that may arise.

Cost of equity

In setting the cost of equity Ofgem has relied on a report from CEPA that proposes a range for the asset beta that is too low. It relies on unsubstantiated judgements and fails to reflect the 2017 Competition and Markets Authority (CMA) appeal precedent for the ESO's closest comparator: the System Operator for Northern Ireland (SONI). It also fails to reflect the increase in systematic risk caused by the evaluative incentive scheme or the increased regulatory risk of a new and untested regime, despite such risk being recognised in the past by government departments and the CMA. Ofgem has then chosen to aim down within the range proposed by CEPA. This is despite its own consultants being of the view that risk is only "slightly lower" than the air traffic organisation NATS En Route Limited (NERL), another comparator. The poor investor proposition is at odds with the expectation implied by Ofgem's proposals that investors must inject additional equity of £58.6 million over the RIIO-2 period: more than 60 per cent over their opening stake. The range for the asset beta should be increased significantly, and rather than aiming down, Ofgem should aim up within that range.

Asymmetric disallowance risk

Ofgem's proposals misjudge both the materiality and likelihood of asymmetric disallowance risk. It is untenable to assert that capping disallowance at ten per cent of regulatory asset value (RAV) represents an equivalent risk to the asset-heavy networks. Totex as a proportion of RAV is approximately ten times greater for the ESO than the networks; disallowing ten per cent of RAV for the networks would be more than 100 per cent of their totex for a year, representing a non-credible risk. Disallowance will typically be at the margins of expenditure so ten per cent is not beyond the realms of credible risk for the ESO as we invest in innovative solutions and services to facilitate the transition to net zero emissions. If it is conceivable that a network could see ten per cent of its totex disallowed, then an equivalent and more proportionate cap on disallowance for the ESO would be one per cent of RAV.

The likelihood of disallowance is also far greater for the ESO. Ofgem has no need to use a backstop power for the networks as they are heavily and transparently incentivised with a totex incentive mechanism such that they know they suffer 30-50 per cent of every pound overspent, whether efficient or not. The opaque nature of the ESO incentive scheme means that the consequences of spending decisions on the ESO's incentive is unclear, hence the potential need for Ofgem to refer to the backstop power. Not only does the ESO face weaker totex incentives, but we are expected to invest in innovative new ideas and services and bespoke IT solutions, all of which are at risk of being deemed "inefficient" with the benefit of hindsight. Ofgem has sought to reassure with the publication of the 'ESO disallowance principles' but these actually confirm the increased likelihood of disallowance. These principles only apply to the ESO, leave the burden of proof of efficiency with the ESO, and indicate a very granular review and assessment of immaterial parts of the cost base.

While the materiality of this risk can be addressed by reducing the cap on disallowance, likelihood cannot. It therefore needs to be compensated through an increase in the additional funding, consistent with the precedent set by the CMA's review of the SONI price control.

Additional funding

While we welcome Ofgem's recognition of the principle that additional funding is required, the proposed value of £1.9 million is grossly inadequate. Of this sum, £0.6 million is badged as relating to the funding costs of the working capital facility and is based on a facility size that will not be adequate to cover the expected working capital requirements of the first two years, given the impact of COVID-19. The remaining £1.3 million is unexplained but assumed to reflect Ofgem's choice of the bottom of CEPA's proposed range of £1.3 million to £4.6 million. In taking the bottom of the range Ofgem fails to adequately reflect the risks and services undertaken by the ESO and provides no funding for asymmetric disallowance risk.

Despite RIIO-2 being the first price control framework to separately consider the risks and financing needs of a separate ESO, Ofgem has so far not engaged with and considered relevant data points, including both the SONI CMA appeal precedent and evidence on earnings before interest and tax (EBIT) margins that demonstrate the level of returns investors would normally expect for managing similar risks and services. We acknowledge that the risks associated with our revenue collection role have been reduced since our Business Plan was submitted. However, the draft determinations fail to adequately compensate for the remaining risks. Based on the published licence model, additional funding of £15 million per year is required to achieve a threshold EBIT margin of ten per cent, the lower end of the 10-15 per cent benchmark outlined in our Business Plan.

In summary, the financial package should be revised so it delivers:

- Increased remuneration and equity returns commensurate with EBIT margins of 10-15 per cent, in line with reasonable comparators.
- A proper calibration of disallowance risk, with a maximum disallowance set at no more than 1 per cent of ESO's annual totex. This must be coupled with the other changes to the pass-through model set out above.

IT delivery model

We recognise the importance of our IT strategy and delivery to ensure success in RIIO-2, and the feedback received from stakeholders on this point. In the draft determinations Ofgem set out that the ESO should have full autonomy and control over our IT by April 2023. This would mean that we would manage and deliver our own end-to-end IT provision with accountability, control, and capability residing 'in house' rather than via National Grid group's shared IT service.

As a result, we have undertaken an independent and robust assessment of the alternatives to our current IT delivery model. We consider this to be an important opportunity to take an independent view of what the most effective ESO IT delivery model for RIIO-2 would be. Our analysis has focused on three potential models:

- Full separation by April 2023, as required by Ofgem.
- Full separation by 2026.
- An alternative model that addresses Ofgem's concerns at lower cost and risk.

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Through examining the pathway to full separation by April 2023, our review has found that this would present an unnecessary and potentially unacceptable level of risk, undue cost to consumers, and disruption to the ambitious transformation programme set out in our RIIO-2 Business Plan. We have therefore set out an alternative and pragmatic set of timescales in which the end-state of full autonomy over ESO IT could be reached by 2026. Extending the timescales for such a transition would reduce risk to an acceptable level, lower costs to consumers and ensure less disruption to the delivery of our Business Plan.

We have also identified an alternative option that addresses the key concerns raised by Ofgem on the ESO's accountability, control and capability whilst also minimising the cost to consumers and the disruptive impact on our RIIO-2 transformation. This 'alternative model' would see a number a material changes from the current shared services model for IT, for example:

- New 'intelligent buyer' capability within the ESO including strategy and planning, enterprise architecture, demand and portfolio management and performance, vendor and value management.
- Full ownership and control of ESO delivery services – from user requirements through to support and maintenance of ESO applications and services.
- The ability to contract with partners outside National Grid IT frameworks.

Where we propose that links remain with National Grid group IT for infrastructure and security services, we have set out appropriate governance and service level agreements to ensure that Ofgem's concerns around accountability, control, and capability are addressed. This model is a better solution over the RIIO-2 period.

We will continue to work with Ofgem on these three options before submitting a final report by 9 October.

Conclusion

RIIO-2 is a unique opportunity for the ESO to step up and be the proactive, agile, innovative, consumer-focused ESO that stakeholders want. Our funding model, incentive scheme, and IT delivery model must work together to support this ambition. We are at a crucial point in the transformation of the energy industry to a low carbon, decentralised and flexible system that will be essential to achieve the UK's commitment to net zero emissions. The investments and activities in our Business Plan will deliver net consumer benefits of £2 billion and enable us to operate a zero-carbon electricity system by 2025. Unfortunately, Ofgem's proposals for the ESO's funding model and regulatory framework undermine our ability to deliver these benefits for consumers. As a financially-constrained organisation with an uncertain incentive scheme, the ESO will be encouraged to be unduly risk-averse and reactive. Beneficial investments may not be made, or will be made too late. It is crucial to address the failings in Ofgem's draft determinations though improving the incentive scheme, fixing the flaws in the pass-through model, and ensuring an appropriate level of remuneration that reflects the risks we hold and the services we provide. We look forward to working with Ofgem to make these changes, so that the ESO is driven to innovate and deliver benefits for consumers as we transition to the zero-carbon energy system of the future.