

Executive Summary: ESO response to the BP2 Draft Determinations

Introduction

In August 2022 we published our second Business Plan (BP2), for years three and four of our RII0-2 price control (1 April 2023 to March 2025). Our BP2 submission, which was co-created with customers and stakeholders, will drive over £2.8bn of benefits for consumers, support a reduction in consumer bills and accelerate Great Britain's journey to net zero.

In our BP2 submission we have set clear priorities to deliver the outcomes our stakeholders need from us over the next two years – delivering excellence in system operation, building efficient and effective markets, driving clarity in our path to net zero and enabling our organisation to perform.

A big part of this will be our evolution into the Future System Operator (FSO) for GB. We will transition out of National Grid plc into an expert, independent organisation in the public sector. We will have responsibilities across both the electricity and gas systems and the ability to expand our remit to additional energy vectors when needed. Through this new organisation, we will be able to drive even greater progress towards net zero, deliver value for consumers, improve whole energy system decision-making and support energy security.

Ofgem assessed our BP2 submission and published their Draft Determinations on 30 November 2022 for consultation. Below we set out the main headlines of our response to the Draft Determinations. This is accompanied by a more comprehensive response to the individual questions posed.

Overall message

We broadly support Ofgem's Draft Determinations conclusions, namely that our plans for BP2 remain ambitious, are necessary for an effective ESO and have the potential to unlock significant consumer benefit. In particular, we welcome:

- Recognition that our BP2 plans continue to demonstrate strong ambition and have a strengthened focus on driving the transformation to a fully decarbonised electricity system, in line with the UK Government's 2035 target.
- Ofgem's draft decision to allow recovery of the full amount of expenditure requested to fund our activities, which equates to £671m of total expenditure ("totex") over the two-year BP2 period. This gives us the certainty needed to continue to invest in the systems, processes, and people capabilities necessary to enable the energy transition and deliver substantial benefits for consumers.
- Agreement that all the activities we outlined in our BP2 submission are necessary for us to carry out our roles and functions effectively and to support the wider energy transition.

Cost regulation

We support Ofgem's proposed changes to cost regulation. We recognise that, due to the bespoke nature and level of maturity of some of our technology investments, it is challenging for Ofgem to provide an appropriate cost-efficient benchmark for programme delivery. We therefore welcome the pragmatic decisions taken by Ofgem for the BP2 period. Specifically, we support the proposal to move away from setting an ex-ante cost benchmark and to replace it with clear approval for BP2 totex recovery combined with an upfront value for money score. This strikes the right balance between the need for investment certainty whilst providing a clear signal on delivery expectations.

We also support the introduction of a cost monitoring framework which, in combination with the ex-ante insight provided by Ofgem in its Draft Determinations, will help drive cost-effective delivery. We look forward to collaborating with Ofgem to fully define how this framework will work in practice. To aid this, we have included a proposal for how the cost monitoring framework could operate in our detailed response.

Flexibility within RIIO-2

We recognise that the flexibility inherent within our RIIO-2 regulatory framework has been invaluable during the BP1 period, allowing us to be responsive to changes in the external environment. It has enabled us to make new investments and take on new or expanded responsibilities, such as our work on Offshore Coordination and Early Competition, even between formal business planning cycles. With the pace and scale of change ever increasing within our sector, we expect the flexibility within our framework will continue to be utilised during the BP2 period.

Technology investment plans

We agree that technology and data are fundamental to our role and will have greater importance as the energy system becomes increasingly complex. In particular, we believe that successful digitalisation of products, services and processes will further unlock innovation, flexibility, and transparency and deliver cost savings for the benefit of consumers. Given that our technology investments play a central role in enabling substantial consumer benefits, Ofgem applied a higher level of scrutiny to this area of our plans. Accordingly, through the BP2 submission process, we have provided a large quantity of information in support of our technology investment plans. This included a cost data model describing our enterprise IT and a Digital, Data and Technology annex containing full details of each of our investment programmes. We have also engaged extensively with Ofgem and their independent consultant via meetings and through detailed responses to Supplementary Questions. We will, of course, continue to collaborate with Ofgem as we deliver our technology investments throughout the remainder of the RIIO-2 period and, within our detailed response, we set out a roadmap to engage with Ofgem to address residual areas of concern.

Against this backdrop of substantial information provision and review, our high-level response to Ofgem's findings in the technology area can be summarised as follows:

- We have confidence in our technology plans – We reaffirm our confidence in the robustness of our technology plans. All our investments are strongly cost beneficial, delivering substantial consumer benefits. We believe our chosen technology solutions best meet the challenges of a complex and changing external environment. We will continue to use the agility offered in our regulatory framework to ensure our plans, and associated costs, evolve with industry needs.

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We are pleased that our technology investments are recognised as being vital to the delivery of priority activities across our three Roles and are essential to delivering the majority of benefits in our business plan. At the same time, we acknowledge that there are some areas where we need to provide additional information to justify our strategic decisions and respond to the questions that have been raised. In this regard, we agree that the proposed cost monitoring framework can be suitable for this purpose.

- In our more detailed response, we challenge some of the Draft Determinations' technology assessment conclusions. We feel that the assessment of our technology investments was subjective and incorrect in some areas and not aligned to either energy industry best practice or how technology of this type is typically delivered. Our more detailed response highlights where we feel an incorrect assessment of our investments has taken place.

Additional revenue

Regarding the ex-ante fixing of BSUoS tariffs, we see merit in extending the methodology (a return on capital employed approach aligned to the CMA's energy market investigation approach) used by Ofgem in its Final Determinations for BP1. We request Ofgem to continue to use this approach for the remainder of the RIIO-2 period. This would provide consistency and certainty of how capital employed will be remunerated. It also scales with the level of capital committed to the revenue management role and can flex if the level of capital to support BSUoS fixed tariffs increases or decreases. Furthermore, it would be independent of the scale of revenues invoiced which has increased significantly since we have published our RIIO-2 plan.

Future System Operator

Regarding the creation of the FSO, we welcome the proposal that efficient FSO transition costs, which include one-off costs to achieve the FSO and enduring costs for building capability for new FSO roles, will be funded through the ESO licence, with ex-ante comfort provided by Ofgem on what activities it considers to be efficient. In assessing expenditure, we believe that any cost protection measures (i.e., those relating to demonstrably inefficient and wasteful expenditure or DIWE) should be the same as the established principles set out for RIIO-2.

We also welcome the proposal that the FSO monitoring framework is to be entirely separate and decoupled from the BP2 determination and incentive process. It is correct to apply this approach to the one-off costs to achieve the FSO, which are discrete from our BP2 commitments and will unlock significant value across the energy industry and for consumers. We broadly agree with the principles set out on the scheme's design and value. In our detailed response we set out why the scheme should remain in place until "Day 2" of the FSO and the importance of proportionate reporting, recognising the current level of governance oversight already in place for FSO delivery.

We note that Ofgem has signaled that it may consult, in early 2023, on the plans to deliver the FSO, based in part on our December 2022 FSO submission to BEIS and Ofgem. We welcome further engagement on our indicative plan. Given the nature of the programme, along with several factors which are outside of our control, such as the progression of legislation and deliverables owned by other parties, we believe the consultation should focus on the plan and which activities Ofgem will consider funding, rather than specific costs (which, per the above, will in any event be subject to separate regulatory scrutiny).

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In terms of funding, we believe that the proposed pass-through mechanism is only appropriate for the one-off costs to achieve the creation of the FSO - as it does not provide the ESO with any return. Enduring costs for running the business, such as additional employees to fulfil the new advisory role, should be subject to recovery and incentivization in line with the current ESO regulatory model.

Conclusion

Overall, we welcome Ofgem's Draft Determinations on our BP2 submission. We are pleased that Ofgem's proposals contain a strong endorsement of our level of ambition and allow us to implement all the elements of our BP2 plan, delivering around £2.8 billion in benefits for consumers over the five-year RIIO-2 period. We will continue to work collaboratively with Ofgem to provide any additional information needed and to understand how the cost-monitoring framework and changes to some of our performance metrics will work in practice. We also look forward to working closely with our customers and stakeholders to deliver our BP2 commitments and accelerate the UK towards a fully decarbonised electricity system which is reliable, affordable, and fair for all.