Electricity System Operator RIIO-2 Stakeholder Group (ERSG)

Meeting 7 – 12th September 2019

Amba hotel, Charing Cross, London

Minutes

Attendees

ERSG members	
Angelita Bradney	ESO- Company Rep
Stuart Cotten	Drax
Peter Emery	Electricity Northwest
Sophie Hind	Technical Secretary
Jo-jo Hubbard	Electron
Alan Kelly	Scottish power Transmission
Andy Manning	Centrica
Nick Molho	Aldersgate Group
Charlotte Morgan	Chairperson
Kayte O'Neill	ESO – Company rep
Eddie Proffitt	Major Energy Users Council (MUEC)
Simon Roberts	Centre for Sustainable Energy
Nina Skorupska	Renewable Energy Association
Fintan Slye	ESO – Company rep
Jamie Stewart	Citizens Advice Scotland
Nigel Turvey	Western Power Distribution
Chris Veal	Transmission Investment

ESO Support

Kashia Anderson	ESO- Observer
Pirvinder Bansel	ESO- Presenter
Louise Clark	ESO- Presenter
Alice Etheridge	ESO- Presenter
Nikki Jamieson	ESO- Presenter

1. **Conflicts of Interest (all)**
   No new conflicts of interest were raised

2. **Introduction, Minutes and Actions (Sophie Hind)**

Open actions were reviewed and updates were given. For Action 5.5, NGESO confirmed that they will be extending an invite to all ERSG members for a webinar on the Digital Twin. For Action 6.1 *("ESO to confirm financing plan for ESO…")* the following response has been shared by the company:

We continue to assume that the ESO will be financed through a mixture of equity, term debt and working capital funding. Through the process to legally separate the ESO from NGET, we have put in *place fairly flexible debt arrangements to allow for future changes in our regulatory arrangements with a separate ESO price control.*

We anticipate that the ESO will use an external working capital facility to support liquidity volatility in light of our Industry Revenue Management role. Term debt is expected to be placed in the form of bank or intercompany term loans due to the expected size and tenor of its requirements; however, we continue to investigate the benefits of other sources of term debt. As a wholly owned subsidiary of National Grid Group, it is expected that equity investments will be made via our Parent Company.

3. Regulatory Framework– Louise Clark

The presenter confirmed that the company has not yet received a finance model from ofgem, and that the October business plan will be based on the ESO's internal model which has been based on feedback from Ofgem so far.

The deadline date for submission of the business plan of 9th December will still stand but there may ba an interim point where we revise financeability before June 2020 if needed (at this point there should be more information available from Ofgem).

In some areas, they have used SONI as a comparison starting point (for cost of equity etc). They have acknowledged that the ESO are different from other network companies which is a positive starting point. However, the ESO still has concerns with the RAV-WAAC model. The company will need to raise equity and the ability to do this will be limited.

Ofgem have confirmed that they will provide more clarity on incentives.

Ofgem are considering how the role of revenue collection could be performed by the TOs rather than the ESO. This idea has been raised in a consultation response but has not yet been fully considered. Ofgem have an understanding of the large risks involved with revenue collectyion and as a consequence they are giving some thought about how this risk is best dealt with. The idea raised in the consultation is that the ESO continue to perform the task of revenue collection, but rather than guaranteeing what is given to the TOs it would be a straight pass through to them, so the ESO would not bear the risk.

One member asked that more information on raising of debt and where this will come from be included in the business plan, and the ESO confirmed that this will be included in the next version.

The ESO were asked if they are still concerned about the cost disallowance aspect of Ofgem's proposal. The company are still concerned about this. Ofgem have added into the consultation material that there may be a possibility for a cap on disallowance risk, which would be welcome. However, the ESO are still very concerned about the downside only nature of this risk. In other models, there is still a sharing mechanism but in the ESO model this doesn't exist.

The chair provided a summary of a meeting with Ofgem to discuss concerns around the funding model. In terms of rationale for various elements, there has been a concern in ofgem that the RIIO-1 process meant that there was a lot of risk premium and higher incentives than envisaged. Because the ESO is a new standalone company there isn't much understanding of what the costs are, and Ofgem want a 2 year "bedding in period" to understand this.

Ofgem are also concerned about the level of change in the industry and the ESO's ability to respond to this change, which is why they have decided on the RAV-WAAV model. They feel that in recent years companies have not put as much money into carrying out works as they should, becausr they can benefit from over-performance. Because there is so much that the ESO needs to achieve, they believe that a cost pass-through model is in the interests of the insutry and the ESO.

Ofgem believe that cost disallowance risk is something that can be managed through greater transparency of the business plan. If you have maximum transparency then the risks should be manageable. They recognise that cost disallowance may have a restraining effect on the ESO. A cap was mentioned, which they believe would also help the risk to be more manageable and understood. They will need to look at the structure of this. Because of the 2 year time period, as long as the near term plans are really clear and costed up then the risk of disallowance is low and therefore this is the best way to manage it.

On incentives, Ofgem have taken on board the concerns arising from if these are completely subject to review by a performance panel. In the near term incentives should be clearer. If clearer then it would be easier to set a regime around clear deliverables and clear costs. Risks should be manageable and there should be incentives on out-performance.

Overall Ofgem feel that they have listened and responded to concerns, and they have included a risk matrix based on what they have heard from the company in the consultation materials. They are interested in ERSG's view of these risks and whether they are real and evident. In terms of additional costs associated with this, they are looking at giving company specific adjustments to the ESO. They are very keen that both sides are given time in the 2 year period to understand what costs look like and hence have the flexibility in the regulatory regime.

The ESO were asked if this aligns with what they have heard from Ofgem. Perspectives of how the risk will impact on behaviours differ from that of Ofgem's the ESO are concerned that these arrangements will drive risk aversion.

The chair confirmed that Ofgem hope to get a greater understanding of the risks from their consultation, particularly from wider industry.

One member suggested that it seems there is an assumption that funding will come through incentives as well as the funing model rather than just the funding model. It is important that ESO are accountable and equipped to handle some risk on behalf of the industry, and we don't want them to be afraid of risk. They need to drive the market forward and be ambitious. The chair raised this with ofgem who said that there are two funding pools; BAU and pay as you go. They are still allowing innovation funding so that the ESO aren't frightened of taking the next steps. The ESO countered that the innovation part doesn't deal with the IT investments that we need to deliver by 2025 as these are all in the BAU pot, where there is a real risk of cost disallowance. There is a clear disconnect between the fact that everyone wants an ambitious ESO and the funding model that is proposed by ofgem.

Another member asked if the incentive performance panel would still exist and would it still be comprised of the same members. The ESO confirmed that it would still exist with the same members.

The ERSG asked the ESO if they think they can use this two year probationary period to change Ofgem's view for the next 10 years. If not then an environment is not going to be created where you can take risks. Could the ESO perhaps carve out some projects acknowledging that they are more risky and have some additional flexibility on these?

If Ofgem don't make any changes to the proposed funding mode, how will this impact the business plan? What changes would need to be made? The ESO confirmed that they are proceeding with the business plan based on decisions that have been made, but there is still a great deal of uncertainty. They are proceeding on the assumption / basis that is financeable. There won't be any further clarity until November and even then there won't be sufficient clarity on everything. It won't be possible to turn the business plan around in these timescales so the ESO will continue with the current level of ambition for the December submission.

The chair asked when the ESO will have clarity on detail that is needed from ofgem. The draft determination consultation will take place in June next year. The ESO are expecting some further information on the funding model next week. This won[t be in time for the October draft but may be incorporated into the December version. However, this information will still not fully resolve whether there is additional remuneration.

The chair asked if the ESO will be able to identify what would be removed from the plan because of lack of certainty, or whether the plan will be delivered regardless and adjustments will be made to financial metrics instead. The ESO confirmed that both financeability and scope discussions will need to take place. If the financial model doesn't support the investment plans (and at the moment it doesn't), then investment will have to be removed from the plan.

The group raised the concern that theme 1 is all about investment, and you can't put forward a comprehensive business plan without having all of the financial information. There also seems to be an issue with Ofgem's capability to make it work in terms of resource (performance panels etc); making sure it works consistently and neutrally etc.

The first stages of delivery of the business plan will be about scoping and R&D. In the first two year period are we really saying that these kinds of activities couldn't be delivered on this pay as you go type mechanism? The Business plan needs more information on interdependencies in the first two years. If this detail is right then the ESO should be able to lock in what they need.

The ESO explained that the problem is that Ofgem have said that if costs are inefficient then they will be disallowed. The smallest disallowance could potentially bankrupt the company.

The group asked that, if the cost disallowance is the key problem, can we take this part back to Ofgem to negotiate on?

The IT annex is still relatively light. If that’s where the main spend is going to be then more information is needed. Ofgem understand that IT projects are challenging and there is a such a history of these projects going wrong. Perhaps the best way to deal with it is to increase the specificity on what will be spent and what the deliverables are which will minimise risk, because Ofgem will need to sign off on this. If everyone can see what would be spent it will be much harder to disallow.

The ESO have asked Ofgem to give more clarity on disallowance and their response is that it’s in the license. However, the license is very vague and the ESO need more detail to understand the risks.

The group made the point that incentives are there to drive behaviour, and if the ESO are doing something wrong then it should be picked up here rather than in the funding model. Initial steps of the business plan are very important and hard to separate out, because it involves building a platform to facilitate the future modular system. It’s the foundation of the rest of the plans. The rest of the business plan rests on this. So it’s the incentives that should reward of penalise for performance.

The chair summarised that ofgem see the cost pass through mechanism as beneficial because it allows the company to do what they need to do. The rest of the group were asked for their views.

One member argued that everyone knows that IT projects always require more money and more time than expected. There should be a third party arbiter. Agreement that the ESO need to protect themselves because the disallowance could put the company out of business. The chair asked if this could be dealt with through the cap. The group were unsure about this.

The group discussed that innovation projects are often inefficient. On cost disallowance, if Ofgem are just saying that its in the license, are there any past examples of this? Have any precedents been set? The ESO have looked into this and found that typical disallowance on major IT projects has been 15-20% which would equate to 6% of the ESO RAV.

The impact of cost disallowance is completely dependent on how Ofgem enforce it.

The ESO’s main issue are the elements added to the funding model which restrict the flexibility that is intended by the cost pass through itself. If there is a cost pass through and the company must prove that costs are efficient, a lot of money will be spent proving that its efficient. The company will be in a position where moving and committing to projects is such a risky thing that behaviours will not make the most of the cost pass through. When the package proposed by Ofgem is considered as a whole, it will not drive the behaviours that have been agreed are needed.

The group suggested that someone from Ofgem could be dedicated to look at costs as the projects are in progress. This is done in other industries such as rail and water. From a consumer perspective increased scrutiny on large projects is not necessarily a bad thing.

The group speculated on what might be driving Ofgem to lock this kind of arrangement in. There is increased scrutiny from the NAO. Although it might be more that they are concerned about the company's ability to deal with big IT projects and therefore cost pass through is a good way to handle this.

The ESo clarified that they see the benefits of implementing a cost pass-through, but the accompanying details of the package don't drive the right behaviours. The ESO are not suggesting that they should have free reign to spend money. Ofgem should and will always set an efficiency bar at some level. But at the moment its an uncapped, unspecified disallowance risk which is downside only. The ESO believe this will encourage risk averse behaviour.

An ERSG member pointed out that from the bar chart on page 28 of the business plan, it looks as though the risk is only on 20% of total costs, as the rest is BAU. This might mean that the risk is manageable. The question is how you carve out IT risks as a special case. The ERSG could help Ofgem to understand where the risk really lies as it isn't on the whole portfolio.

The chair asked the ESO to explain which risks cannot be mitigated in their opinion. The key risk outlined by the ESO is the revenue management role, where they handle funds much larger than the size of the ESO. There is a need for additional remuneration for this, and there is no compensation available in what Ofgem have set out. Other risks include cost disallowance 9which could be mitigated to a certain extend but will always be there), incentives downside and reputational/ political/ regulatory risks (for example the introduction of new roles such as EMR). It is much more difficult to quantify these latter risks.

The chair asked whether, on the revenue management model, have Ofgem agreed to fund a working capital facility? The ESO confirmed that they have not. Although, there is one currently in place which came from legal separation. Do the ESO want to continue to have this role, or do they believe that it should change? The ESO made the point that by moving the role elsewhere the risk would not disappear, it would just be moved / spread around. It could go the the TOs who are larger and may be able to manage it better, but they have no leverage to manage the risk because they are not a counterparty. The question is what this would do to capital on their balance sheet. It isn't out of the question but the ESO want to be clear that the risk does not dissipate if you put it on the TO balance sheet, which seems to be the assumption in some cases.

The chair asked what the most essificnet way to manage this risk would be. The ESO replied that it depends on how the TO would view it as a risk on their balance sheet. TO representatives in the room confirmed that more thought would have to be given to this. There could be benefits through the TOs ability to secure the capital.

The chair asked the group if everyone was in agreement that there is additional risk from the revenue role which should be remunerated. The group were unsure on whether it is a risk or a cost. The ESO explained that even considering a working capital facility, handling £4bn of someone elses money still involves risk which needs to be remunerated.

Some in the group felt that this role should be taken wherever the risk is lowest. Others argued that the ESO is in the middle and this means that you only pay for the risk once rather than spreading it and having it in different places.

The chair asked about the other risks that were mentioned. How does one quantify them and think through how you'd remunerate what is a reputational risk? The ESO replied that it is very difficult to quantify this, and any approach would be imperfect. There is no direct comparator. Ofgem have published three tests on how you would measure risk. The best comparators are SONi and Eirgris as they are the only two SOs that have a similar model. They typically have have a layered approach with an upside only incentives layer.

There is upside potential to things like reputational risk as well, but its about how you put the overall package together. The ESO aren't trying to put a pound sign against everything. But how the overall package is put together depends on how we want to treat these.

The ESO needs to be financeable as a standalone business. The business plan and funding model need to lead to a proposition which remnunerates both equity and debt. The ESo should not rely on the rest of the NG group. It needs to be a standalone business which a rational investor would put money into.

The ERSG thought that Ofgem should recognise that there is a different effect of ESO reputation as opposed to group reputation. Is there some quantification on what impacts are on the group as opposed to the ESO. Are ESO looking at share price of group etc? ESO confirmed that Ofgem aren't comfortable with this approach so it will kept purely to ESo risk.

The fact that the labour party is pushing for normalisation hasn't been mentioned. The process of this agreement will be scrutinised from the outside. So reputational risk is really high. What the ESo has been doing to gather feedback has been a good way to manage this but people are to be looking at the reaction to what ofgem says. The media are putting a lot of pressure on Ofgem at the moment. The ESO confirmed that they are consciously trying to manage this.

4. Business Plan – Changes since July, Ofgem RIIO-2 Challenge group written feedback and Q&A- Angelita Bradney

The presenter talked through the changes since the last version of the business plan, which had been grouped into 7 categories.

- *ESO role achieving net zero emissions by 2050*

The group felt that the changes made to this section were very good. They asked whether there is a broader role of ensuring that other infrastructure industries (i.e. transport) are able to respond to power outages given recent events. The ESO replied that joining the dots between CNI networks is something that the government need to do. ESO need to play their part in helping others to understand what needs to be responded to.

As the ESO are currently technology neutral, will any recommendations to government be made on this point? The ESO feel that this is a policy decision for government. General perspective is that we have not yet moved from converting a legislative targert into a policy and regulatory framework and this needs to be done.

When asked if the policy outstanding policy issues required are sufficiently articulated in the business plan, the ESO confirmed that there isn't much detail in there at the moment, but a new section is in development which will be part of FES 19. This will be more specific on what is required from policy makers and regulators. There are also plans to update the CBA and highlight more clearly where benefits are dependent on policy decisions.

Reform of heat was highlighted as an interesting part of the proposals., and the ESO were asked how they would facilitate policy on something like this. The ESo will be doing this through FES. They will be setting out what is needed in order to achieve the scenarios articulated in FES> Hopefully it is clear that the leadership of these aspects have been dialled up in the business plan. The objective is to lead and shape but not to dominate with an ESO answer.

The group feel it is important that the ESO are clear about policy decision dependencies and timelines because otherwise they will get kicked into the long grass. The ESO is a key advisor in this regard. Government will be distracted with other priorities and so the more you proactively inform and advise the better. There will be some good opportunity over the next two years for the ESO to advise.

- *Challenge of cost proposals*

With regard to IT cost proposals, the ESO have removed £53 million from the plan. The plan now looks at where platforms can be merged and leveraged across more than one investment. 84% of the plan has been benchmarked. 33 investment cases will be include in the next version of the plan.

The group feel that theme 1 is much improved. Efficiencies from RIIO 1 were better explained, a better breakdown year on year has been included. The investment tables are useful and there is good cost justification. A lot of narrative is focussed on the increased FTE. The evolution of capex is less well explained. It would be useful to have the same level of explanation for the capex evolution as for the FTE increase. Where does the evolution of capex come from, which items?

A summary sheet of investment cases that will be provided would be useful. This area needs to be as clear as possible on cost because of the high risks associated with it.

Other members echoed the positive comments on this chapter. Clearer and more organised, and governance, people and capabilities were all included. There is a much better understanding demonstrated of the nature and type of people that need to be brought in.

It is still not clear how the ESO will work with contractors vs permanent staff, and ensure that there is complete control. How will you eventually bring the work in house? How are you building and retaining your own capability?

The chair echoed the positive comments and found the timetables of what will be done where helpful. There are still some questions around how the shared services model will work. It is now clear that there will be an ESO dedicated team as part of shared services, but there will be pushback on why that team can't just be part of the ESO. The sharing of costs for shared services needs to be understood to ensure that it isn't being subsidised in any way. How has this cost been calculated and why it's the right proportion. This applies to all shared services, not just IT. The ESO confirmed that there is an Ofgem approved methodology for this so it will be made very clear in the next business plan.

It was emphasised that for the 33 investment cases the interdependencies need to be really clear. This could be shown by a critical path and how investments will be sequences.

A webinar will be scheduled to go into more detail on these proposals.

ESO to propose some dates for the webinar on IT aspects of the business plan.

- *Deliverability*

The updated plan has a smoother cost profile and a more gradual ramp up of investment. This also applies to people. The cost has reduced since the July version as more work has been done on deliverability.

The group agreed that these are good updates. The smoothing is much better and the FTE info was really useful. They asked if it's possible to have a more collated view of what will be delivered when, particularly over the next 2 years. A milestone chart would be really helpful and should assist with the incentive discussion.

As there will be so much change, it would also be useful to have further information on change management / transformation plan. This may help to give confidence in the deliverability of the plan.

- *Deliverability risk and mitigation*

The overarching risks have been identified and there is more detail in the people culture and capability chapter. The group feel that the people, culture and capabilities section is a much stronger chapter. However, it still needs something additional around transition and the confidence in achieving the change. Rate and nature of change is described well but more is needed on why we should have confidence in this. E.g. The example of women in engineering is used, how has that changed and what has been done recently to get there?

More information is also required on where the DNOs sit in the process, particularly for connections. Also, more information on the NOA expansion and how this fits with DNO plans and direction. Reading the connections chapter (p. 109-113) as a DNO, it doesn't really suggest that the industry will work together to come up with the best cost solution.

The ESO confirmed that the stakeholder annex will include detail of feedback received from DNOs and how this feedback has been incorporated.

- *Efficiency work from RIIO-1 through to RIIO-2*

All costs included in the plan have been tested for efficiency. The chair asked the group whether they are comfortable with the level of increase in the costs, given what has been proposed. Some felt that it is still not completely clear what is driving the cost increase for BAU. The company are working on better demonstrating this for the next version o0f the plan. Generally, they are facing a more challenging operational environment which is driving cost. It was suggested by the group that this additional cost due to increased challenges is neither BAU nor transformational but somewhere in between and could be represented differently on the graph on slide 19.

The chair summarised that the increase in the BAU costs on this graph does jump out, and it would be helpful to have an explanation of why this is.

ERSG discussed that the proposed £50m in the first two years will be challenging to achieve. The ESO have worked through this and are comfortable that it is deliverable, and can provide more information on the transition. More information on the control around this will give more confidence in what the ESO are proposing.

The group asked whether the benchmarking used has a forward-looking element, assuming that it would go down over time. The ESO are going to check if this is the case or whether it just looks at comparators.

ESO to confirm whether the benchmarking used in the business plan has a forward-looking element.

The CBA contains better information on what default counterfactuals are being used. Counterfactuals tend to be current BAU, but is this always an appropriate counterfactual to use? Within the CBA narrative for each theme it would be useful if the ESO could add information about testing against alternative options as well as the existing solution. This would help to strengthen the proposed cost for investments.

It could be clearer in the executive summary that the cost increases that you will see will achieve benefit elsewhere in the industry. The impact of net reduction in the bills should be brought out more. This is an important part of justifying the additional costs.

- *Revising proposals based on stakeholder feedback*

The ESO explained that they are yet to test the business plan in its entirety with stakeholders, but an event is planned for the 2nd of October to do this.

The chair thanked the ESO for the way that they have clearly shown the feedback that has been received and how it has been acted on. The way that the company has responded has been impressive. The Challenge group have also been impressed with this. The level of detail included is high compared to other companies, and the way that feedback has been reflected throughout the report has been good. Section on consumer views is limited but better.

- *Revision of theme narrative and ongoing vs transformational costs*

The group thought that this was greatly improved in the business plan, and there were no additional suggestions. The delivery roadmaps are particularly useful.

- *Metrics*

In Aigust Ofgem confirmed that metrics need to be included in the business plan. The ESO have proposed some in the October draft, and these will be consulted on during the October events, followed by more detailed discussion at the ERSG meeting scheduled for November.

The group asked about a metric included in theme 1; around dispatch in merit order. Why is this a good or bad thing? It is a good track that the ESO are correctly dispatching smaller units along with larger players in an appropriate cost order. This is something that has been included as a result of feedback from market participants.

The group suggested that a metric is included for measuring carbon. Difficult to know exactly what this metric should look like. A metric like this will tell us whether clean energy is most economic and will give transparency to the issue.

There was some confusion around the metrics for theme 3 and what they mean.

Metrics around data wuality and availability can be included in theme 1 and 2 in terms of why certain decisions were taken.

- People, culture and capability

The group agreed that this chapter of the business plan has much improved. It was noted that the Change management aspects should be highlighted more in the slides for future as this is such an important topic.

The chair asked whether the growth of headcount over time will reduce reliance on Shared Services. The ESO explained that there will be dedicated ESO teams within Shared Services, and that in some cases the growth of capabilities will be within shared services itself, rather than through a separate IT team. The majority of these people will be dedicated to the ESO. Shared services numbers are included in the overall FTE increases and costs in the business plan.

A slide showing the ESO leadership organisation was presented. The group felt that it was getting harder to justify the shared services model and why HR and IT aren't directly part of the ESO. More clarity needs to be given on where the buck stops with making decisions. What is the control mechanism for guaranteeing that the ESO get what it needs? The ESO explained that there are different types of IT delivered to the ESO and there are different levels of oversight required for each.

At the time of legal separation, agreements were made with Ofgem on how the Shared Services model should work. Some aspects were taken out of shared services (e.g. regulation) and others were left in. This approach was approved by Ofgem.

The group agreed that this model needs to be fully transparent, and assurance needs to be given that there are no “leakage points”. It was also asked whether the lead ESO IT business partner and CIO should sit directly within the ESO.