Electricity System Operator RIIO-2 Stakeholder Group (ERSG)

Meeting 11 – 30 July 2020

Meeting held via WebEx with revised format, pre-read material circulated beforehand, presenters summarised only before opening for questions and feedback from the panel.

Minutes

Attendees

ERSG members	
Marzia Zafar	Kaluza
Ed Rees	Citizens Advice
Alan Kelly	Scottish Power Transmission
Eddie Proffitt	Major Energy Users Council
Simon Roberts	Centre for Sustainable Energy
Nina Skorupska	Renewable Energy Association
Nigel Turvey	Western Power Distribution
Chris Veal	Transmission Investment
Andy Manning	Centrica
Stuart Cotten	Drax
Matthew Wright	Consultant
Charlotte Morgan	Chair
Fintan Slye	ESO-Company rep
Angelita Bradney	ESO-Company rep
Kayte O'Neill	ESO-Company rep
Sophie Corbett	Technical Secretary

ESO Support	
Roop Phull	ESO-Observer
Paul Lowbridge	ESO-Presenter (RIIO-2 technology delivery)
Matthew Howson	ESO-Presenter (RIIO-2 technology delivery)
Nikki Jamieson	ESO-Presenter (Design Authority ToRs and recruitment)
Graham Dolamore	ESO-Presenter (Design Authority ToRs and recruitment)
David Bowman	ESO-Presenter (Design Authority ToRs and recruitment)

9:35-9:40

Conflict of interest review

No new conflicts of interest identified.

9:40 – 9:50

Introductions, minutes and actions

All actions from ERSG 10 have been closed.

9:50 – 10:20

Draft Determinations: ESO key messages and initial response (Angelita Bradney) (30 mins)

The presenter gave an overview of the circulated pre-read material and encouraged questions and discussion from the panel.

The presenter noted that the ESO was pleased to receive recognition from Ofgem on a number of items in the draft determinations (DDs), including agreement that the business plan is ambitious and challenging, and that there is a need for additional remuneration. The presenter summarised some of the key decisions in the DDs and noted that:

- The need for additional remuneration has been accepted, though the figure proposed in DDs of £1.9m is lower than the range proposed by the ESO of £13m - £39m.
- The evaluative incentive scheme is asymmetric, with a scorecard to be used to help set expectations.
- The efficient cost benchmark proposal suggests costs could be around 8% lower than what the ESO proposed, but Ofgem recognise the case for an increase in spending compared to today. £105.5m has not been assessed yet.
- Innovation funding will be set at £7.2 million over two years
- The ESO must review options for a separate IT delivery model.

The presenter noted that some key risks remain. The package overall doesn't drive the ambitious, proactive behaviours that stakeholders want. Components of this include:

- While there have been improvements to the incentive scheme it is still evaluative and ex post. Ofgem's proposal to make incentive decisions after two years further weakens the link between performance and reward.
- The financial package, with a proposed cost of equity is at the lower end of the ESO's expectations and the figure for additional remuneration is significantly lower than the lower end of their proposed range.
- Not of all the proposed costs have been deemed efficient and Ofgem has not provided guidance on how the ESO should demonstrate that costs are efficient.
- An increased reporting requirement could impact the ESO (and Ofgem) disproportionately to the network companies.
- It is difficult to fund innovation projects over two years, most partners will need certainty beyond that, for example, where universities are looking to fund phds. Network companies' regulatory period are five years which creates a barrier to joint working.

An ERSG member sought clarification on whether the figures of +£15m/-£6m, per annum would be levied for a 2 year period, making the incentive pot +£30m/-£12m range determined at the end of the two year period. The ESO confirmed this was the case, and encouraged feedback from the ERSG. A number of panel members shared their thoughts.

A panel member provided some additional context to the numbers, noting that a lot of the risk would be related to the disallowance, and describing that this is capped at 10% of RAV (starting RAV is around £220m) meaning the cap is roughly £22m, plus there is a £6m potential downside in relation to the incentive, summarising that the worst-case scenario for downside could be around

£28m in one year, but there would be return on equity. They continued to note that on the other hand, in a good year there could be a potential upside of ~£20m, and interpreting this to look like a range of +-£20m on a cash basis in each year. The panel member questioned whether a range of this size is suitable for a system operator (or any other entity responsible for such an important public service), and that perhaps the total package should be less risky and more stable to ensure sustainable and continued operation.

The ESO confirmed that 10% of RAV is about £20m, which is also similar to 10% internal costs. The ESO noted that the proposed disallowance cap is not comparable to other network companies; if 10% of their RAV was disallowed this would be equivalent to almost all of their totex. The ESO also does not feel confident that the full amount of incentive upside will be available, particularly considering the evaluative nature with a review at the end of the two-year period.

A panel member commented that they had noted the review period, and agreed that the ESO would need some degree of predictability.

The ESO noted that a lot of work has been done to date to understand how they could try to make the scheme more predictable and to quantify the link between performance and reward. They continued to note that they had explored with Ofgem whether they could 'bank' performance over certain time periods, but noted that Ofgem were not comfortable with that approach and wanted to retain full discretion at the end of the two year period. The ESO noted that as a consequence of the current proposal, they would be deep into development of the plan for the next price control period ahead of understanding the outcome and having feedback on their performance for the previous one.

A number of panel members raised their hand to comment.

One panel member commented that they had reviewed the DDs and agreed that there were some positive elements and good recognition of ambition. They noted that Ofgem are looking for high levels of detail from the plan, so that they can assess delivery against it, however, because some of this is inherently uncertain, it is very difficult to give detail, which potentially leaves ESO very exposed. They noted that it is in the interests of the ESO to be as prescriptive as possible about exactly what they are going to deliver, and that granular outcomes to a high level of detail could minimise risk, otherwise they will be exposed to outcomes of a big range.

The ESO responded that they believe Ofgem are looking for them to be as detailed and prescriptive as possible for the two years, but that this will not include 'incoming' work, which historically has accounted for a lot of the benefits delivered to consumers, and while they recognise the need to be flexible to account for incoming activities, there isn't a clear way to account for this in the plan.

One panel member reiterated that perhaps it would be helpful to try to illustrate and bring life to these points, and to better explain to Ofgem how difficult it will be to plan with such precision that the framework requires.

One panel member, in response to the DDs noted that there are a lot of different risks that aren't unmanageable in themselves, but that the compound risk across the package needs to be considered, referencing that need for predictability and that at present there is no mechanism to lock in outcomes for the purpose of predictability. They reflected the need for focus on delivery and transparency, but that not having any 'lock-in' mechanism could be a real issue. They proposed a hybrid process, where for example, outcomes could be confirmed over the course of the period, but with the potential for an overall 'adjuster' mechanism at the end of the period.

It was discussed that hindsight alone cannot be used to gauge performance, and that the mechanism needs to considered whether the ESO did the best they could at the time using the information and tools available, and that it must also consider that ESO must be able to change course over the period where developments occur.

A panel member seconded this, and noted that although there had been notable moves forward with the incentive scheme, leaving the entire review process until the end of the two year period created more risk than is necessary and also risks Ofgem under or over-rewarding the ESO. They noted on the topic of shorter review periods that it is important to Ofgem whether the ESO can be precise enough in the business plan to outline what they will achieve in 6 months, and raised for discussion what would happen if the first review period did not go quite to plan, how would it be determined what is a good outcome for the second period? They raised for discussion, how the scorecard might get recalibrated and redefined over time, noting that agility and responsiveness of the scorecard to what is revealed meanwhile, ought to be part of that process.

The ESO agreed and noted in particular the point about responsiveness of the scorecard. The ESO are appreciative of the work so far that Ofgem have done to move the incentive scheme and scorecard forward, and are confident that Ofgem want to continue to find the right balance between holding ESO accountable for performance and delivery, but also to be able to take a holistic view at the end of the period to determine what is a good outcome. The ESO don't think there will be movement on Ofgem's view on locking in outcomes earlier in the period, and don't want to be in a position where there is no mechanism to acknowledge strong performance outside of pre-agreed deliverables in the plan. One approach that was discussed was defining the outcomes very well, but being less prescriptive about how these are delivered. It was agreed that on the whole, there has been positive progress, and that the ESO will continue to be positive and proactive about what they can achieve, and to continue to work with Ofgem to make the make the mechanism successful.

A panel member raised to the group that Ofgem do recognise that this plan is ambitious, and that this was supported by the energy transition index, which compares the ESO to other countries. They suggested ESO should consider how to demonstrate to Ofgem that what they have promised to deliver is the right thing for the market, and how to evidence that activities with the ESO's control are under good control.

One panel member raised for discussion incentivisation of longer term activities, noting the industry demand for market signals and products and services that are investable over five to fifteen year timeframes. The panel member noted their uncertainty about whether two-year incentive schemes appropriately enable the ESO to provide those longer term initiatives for the market and investors, noting that the ESO's long-term impact on consumers/wider society must be evaluated, rather than (potentially) short-term negative impacts on the path to decarbonisation and high flexibility. The group continued to discuss how the ESO can move beyond the two/five year windows to provide for future consumers, and to appropriately recognise long term positive impacts even if there are short term negative impacts (for example, higher costs over the short term) under the incentive scheme.

The ESO noted that Ofgem use five lenses to assess performance, some of which focus on within the year, and some of which take a longer term view. They noted that longer term benefits are often harder to assess and harder to prove, and can lead to a cyclical discussion about delivering benefits that can be proven in the short term vs enabling changes that deliver benefits later. The ESO feel that Ofgem do agree in principle on acting now to deliver longer term benefits, but noted the complexity of getting the assessment of these right.

The group agreed there may be a need for the ESO to be able to take short term actions that may have short term negative impacts, but lead to greater long term benefits. They queried how to ensure that the ESO makes the right decisions for the long term, even if these appear to have short term negative impacts.

The Chair asked for any further comments on the risks noted.

One panel member commented on the order the risks had been presented in, noting their concerns about the equity model and cost of capital, but raising for discussion that other elements, such as the incentive model and disallowance cap could have a greater impact on the model and revenue.

The Chair agreed in relation to the order, noting the asset beta, and asking the ESO to elaborate on any particular vulnerabilities relating to the proposed additional remuneration figures. The ESO responded that in the business plan, a triangulation of different independent analyses had suggested an appropriate range of £13m to £39m additional remuneration, and the figure provided in the DDs was £1.9m, significantly below the bottom of the proposed range. They noted that the £1.9m figure includes a working capital allowance of around £500k, so in real terms, the figure is ~£1.4m. The ESO noted that they had presented a range of risks that would not be covered by RAV, and that only one of these was being considered in the proposed £1.9m figure. It was also discussed that the figure provided in the DDs was at the lower end of range proposed by the third party consultants, and that the ESO was not clear why that figure had been opted for. It was discussed as a result that any spending outside of the plan could therefore carry huge risk for the ESO, increasing the risk relating to innovation and ambition.

A panel member noted that Ofgem have set out disallowance principles, and asked the ESO whether these provided any comfort. The ESO responded that Ofgem have been trying to provide reassurance that the disallowance powers are a back stop, partly by citing that ESO had not had disallowances in the past. However, the ESO noted that RIIO-2 is different to RIIO-1 with greater emphasis on ex post cost assessment in the absence of a totex incentive mechanism, which makes it much more difficult to prove efficiency either way. It was noted that Ofgem have suggested reviewing staff remuneration and travel and expenses policies, a level of micromanagement that appears to increase disallowance risk. It was also noted that with the proposed pass through model there would be additional reporting requirements, but more information is needed about the level of detail that will be required for these. It could be difficult to explain costs where they span more than one role.

An ERSG member suggested that Ofgem are trying to move to a position that strikes the right balance but suggested the current proposal may not quite be there. They continued that in their opinion, ex post is the right approach, but that further thought is needed on the solution. The ESO responded that they must work with the ex post evaluative approach, but would aim to structure it in a way that provides enough certainty to enable ambitious behaviours and not to drive risk-averseness.

The Chair summarised the issues discussed by the group as follows:

The incentive scheme and level of volatility, and whether that will create proper stability for the ESO given the size of potential downside, particularly given the wide consensus on need for innovation.

Recognition that Ofgem has made some progress towards greater transparency around some of the disallowances but that perhaps there might be more that can be done to add comfort.

In terms of the increased costs and performance reporting, there is a concern that too much oversight might stifle innovation because people do want a flexible and agile ESO going forward, but also a concern expressed that when the ESO responds to the DDs, that it should not over-emphasise the concern about equity over the other concerns. The framework as a whole must ensure that the ESO is incentivised to perform in the innovative and agile way that its stakeholders expect.

One panel member wanted to reiterate the discussion point in relation to the process, noting that no one can be clear on exactly what will happen over the next two to two and half years, and that even if the ESO produced the best benchmarks and costings imaginable based on current information, the world will change. The panel member commented emphatically that it is critical that the process realises the course of action will change, and that it must recognise that ESO will do and will need to do things that aren't in the plan, and that planned items may need to be removed from the plan. The panel member felt strongly that the process should not only reflect what was stated in the plan versus what is complete at the end of the review period. The panel member suggested that Ofgem and third parties should have to endorse the plan changing course to minimise subjectivity. The panel agree that the scorecard must be changeable, but note that translating this into practice is a challenge.

The Chair asked, in reference to one of the slides, whether a process had been agreed for assessing the efficiency of the IT costs that had not be reviewed as yet. The ESO responded that while there is a process in place for ESO and Ofgem to discuss the costs, the ESO had not received details from Ofgem yet regarding how the assessment would be carried out. The group discussed that the concern here was not in relation to the ESO's ability to demonstrate how they believe the costs to be efficient as the ESO had a number of suggestions on this point, but rather that there was uncertainty over the rules or benchmark that Ofgem would use to determine the 'bar' for efficiency.

10:20-10:30
BREAK

10:30-11:00
RIIO-2 technology delivery options (Paul Lowbridge/Matt Howson/Nikki Jamieson) (30 mins)

The presenters introduced themselves and gave an overview of the pre-read, noting the importance of IT delivery on the delivery of the business plan as a whole. The presenters noted they have taken

feedback from this group and other stakeholders throughout the drafting of the business plan and since it was submitted.
The presenters explained that in the DDs, Ofgem have asked the ESO to outlines what an ESO central IT model in an agreed timeframe would look like, but have also asked the ESO to propose alternative suggestions outlining changes to the model and timeline that could also be appropriate. From June, the ESO have commenced a specific piece of work to look at what the alternatives could be, and continued to explain the design approach, which considers a four stage process: assessing the current baseline, assessing and defining the needs of the ESO, creating options with consideration of requirements for transformation, and finalising a model for submission in October for Ofgem to consider. This process creates a clear foundation from which alternatives can be developed and tested against assessment criteria. The presenter explained that the following the introduction to the approach in the session, they would like to invite ERSG members to provide input and test and challenge some of the alternatives on a one-to-one basis for targeted expertise before opening for questions.

One panel member questioned whether the ESO could do more to embrace the feedback about the IT delivery model in the DDs, and the ESO responded that they are embracing the need for the separate model, but want to make sure it is achieved in a way that works for delivery of the business plan, by being clear on the alternatives and the assessment criteria.

A panel member noted that there is a dependency with the TO systems, and requested early engagement where possible to understand any investment required in TO systems, noting that this engagement would be needed with sufficient time to respond to the DDs.

The Chair relayed some comments from a panel member who had had the opportunity to discuss the proposal with the ESO but had sent their apologies:

It was noted that the proposed micro-services architecture would require quite heavy systems architect resourcing to operate, and that this it was proposed that this function would be external, and the panel member had commented that it would be very complex to outsource. The panel member had also commented that failure to structure these projects around central architects and orchestrators does introduce significant delivery risk that isn't fixed just by changing reporting lines. They had suggested that a potentially more important fix is cultural, and moving this part of the technical team into the centre of an interactive design process (let them be the hub) as opposed to having product managers just feed requirements into them. They had noted that this is a problem widely faced and not a specific ESO failure, but evidence of an early cultural shift for ESO around a more technical delivery axis would help.

The ESO responded that there is a lot of work ongoing to try to develop the different models, and that although it has been too early to share more detail as yet, they wouldn't want anyone to be concerned that they are resisting the direction from Ofgem's plans. They emphasised that there has to be a credible plan by September and they are working on how they deliver that in a way that not only doesn't disrupt delivery of the business plan but also adds value.

ACTION: The ESO will share more detail on the proposed alternative models imminently after the ERSG 11 meeting closes, and will set up a webinar for ERSG members to discuss further.

The Chair noted the scale of the task to develop these models by September, and encouraged the panel members to support over August where possible.

A panel member asked if it would be helpful to take the opportunity in the meeting to further discuss the proposed assessment criteria. The ESO responded that they had been in discussion with Ofgem even before the DDs about articulating the problem statement, and that summed up into the assessment criteria are the four problems the new solution needs to resolve, along with the other aspects that need to be considered as they work to resolve those four items, summarising that there had been a breadth of discussion behind the broad summary given in the pre-read.

One member commented that more detail would be helpful covering the weighting of the assessment criteria, the scoring framework and how things will be prioritised. They noted that they thought control and independence were most important.

The Chair commented that there has been a push from ERSG, the challenge group and Ofgem, that as the ESO designs new IT systems, that the infrastructure is there to do it, and that a managed migration sounds sensible.

11:00 – 11:15

Design Authority ToRs and recruitment plans (Nikki Jamieson/Graham Dolamore/David Bowman) (15 mins)

The presenter gave an overview of the circulated pre read material, noting that they see an important role for the Design Authority before RIIO-2, and as such the ESO is working to recruit a Chair and members to achieve this. The presenter also noted that Ofgem are really keen to see more detail on the plans, and that the ESO are working with Ofgem to see how they can provide confidence without disrupting their proposed agile delivery method. The presented noted that the terms of reference were circulated in the pre-read before opening for questions.

While members ruminated, the ESO asked whether the panel were aware of changes to the ESO Board, and proceeded to summarise that they considered the structure of the Board in the context of RIIO-2, and identified the need to build capability in the non-executive directorship in engineering and IT, in response to the scale of the challenge in approaching net zero and transitioning to a data-driven organisation. As a consequence, two new non-executive directors had been appointed to build this capability, resulting in the Board composition now being majority non-executive. The Chair was pleased that the suggestions from the group had been taken on board, and commented positively on the level of experience of the candidates.

In relation to the Design Authority, the Chair asked whether there was a process in place for recruitment, and the ESO responded that this process had been started. The ESO continued that had been working to identify what types of experience and industry they would seek representation from, and that they had sought guidance from the non-executive directors on the composition and numbers for the group. The ESO are aiming for ~10 members, covering technological and engineering companies, academia and networks, and may leverage existing relationships where possible.

A panel member queried whether the intent was for the Design Authority to act as counsel for guidance, consultation and challenge, or to have a more formal role in decision making, to which the ESO responded that the intent for the Design Authority is consultative and advisory, with decision making sitting within the ESO. It was noted that the terminology 'Design Authority' can present legal and statutory obligations regarding decision making, outside of the intent for it, and the group discussed perhaps renaming the group to 'Design Council', or 'Design Consultative Body'.

In response, a panel member suggested that the perspective of the Design Authority ought to have some influence on outcomes and decisions that are taken in order for it to be meaningful.

A panel member agreed on reconsidering the name of the Design Authority, and added for discussion the need to differentiate it from the cross-industry PMO body that is being discussed with Ofgem to avoid confusion.

A panel member asked the ESO whether the Design Authority would be focussed getting the right input and expertise, or whether outputs would be within its remit too, the panel member suggested as that the group could be valuable in providing recommendations to industry on wider collaboration for cross-industry data processes, for example, where code modifications require changes to Elexon systems. The ESO responded that they see the group as having an output role as well, and that this is included in the terms of reference.

Note: an update was provided after the meeting to confirm that the new name for the group will be the Technology Advisory Council.

11:15-11:30
AOB and close

The Chair had been contacted by Ofgem regarding the possibility of presenting to the group at the next meeting about the draft determinations.

ACTION: ESO/Tech sec to arrange for Ofgem to attend next session considering the timings of DDs.

The Chair had been contacted by the challenge group, and asked that any ERSG members who would like to join the next meeting w/c 10th Aug contact either herself or the Tech Sec to arrange, otherwise the Chair will report back at the next meeting.

No further AOB.