

ESO RIIO-2 Sector Specific Decision Summary

May 2019

Key headlines

- Ofgem has published decisions and a further consultation on the ESO's funding model, which closes on 5 July.

Consultation

- Seeking views on two funding model proposals:
 - Remunerate the ESO with a RAV-based, slow money model for capex, and fund opex as fast money via pass-through.
 - Remunerate both capex and opex as fast money via pass-through, thus potentially removing the need for financing.
- The proposals start from the assumption that there will be no margins on opex nor a margin to capture the risk of the industry revenue management role.
- Ofgem is asking for stakeholder views on whether an additional return (either through a higher WACC or a margin on internal or external costs) is warranted, and whether there are benefits to retaining a two-sided incentive.

Decisions

- The ESO will have a two-year business planning cycle within a longer price control. This will be reassessed after four years.
- There will be no sharing factor, and cost disallowance will align to the other RIIO companies.
- The ESO will continue with an ex-post, evaluative incentive scheme, the design of which Ofgem will consult on in the summer.
- There will be continued innovation funding, which Ofgem will consult on in the summer.
- Ofgem is exploring the role the ESO could play in facilitating early competition in onshore transmission. The ESO is required to submit an early competition plan in December.
- Final business plans are to be submitted on 9 December 2019.

ESO consultation proposals

- Asking for stakeholder views on two potential funding models for the ESO:
 1. Remunerate the ESO with a RAV-based, slow money model for capex, and fund opex as fast money via pass-through. The approach for calculating the WACC would follow that of the other RIIO companies, but would reflect ESO-specific considerations in relation to gearing, cost of debt and cost of equity.
 2. Remunerate both capex and opex as fast money via pass-through, thus potentially removing the need for financing.
- The cost of a working capital facility would be passed through.
- Either model could include a margin to be applied to internal or external costs, if necessary. Ofgem is asking for views on whether an additional return is warranted, and its form.
- Under both models there could be benefits in moving towards a positively skewed incentive scheme, with a potential downside of zero. Ofgem is asking for views on whether there would be benefits to retaining a downside incentive penalty.

- Ofgem's intention is to honour the existing RAV, and apply a cost trigger mechanism to require the ESO to notify Ofgem when reaching a certain level of expenditure.
- Responses are requested by 5 July.
- A decision will be issued later in the summer, along with a consultation on ESO financial methodology and working assumptions.

ESO decisions

• Length of price control

- Ofgem has confirmed a two-year business planning cycle for the ESO. This will be reassessed after two cycles (i.e. four years) to decide whether to continue with the biennial approach, or to re-align with the other transmission price controls.
- At the beginning of RIIO-2, the ESO will need to set out:
 - A long-term vision out to 2030 or beyond
 - A medium-term strategy over the five-year RIIO-2 period
 - A two-year business plan that details costs, activities, deliverables and performance metrics
- The Performance Panel will be retained to scrutinise performance.
- Elements to be set for five years are: remuneration approach, activity categories for cost assessment, scope of any disallowance mechanism, incentives framework, regulatory depreciation and other financing arrangements.
- Elements that would change on a two-yearly basis are: costs, activities and deliverables, performance metrics and the forecast RAV.

• Funding model

- No totex incentive mechanism (sharing factor).
- Disallowance will align to the other RIIO companies, to allow efficiently-incurred costs
- Ofgem is consulting on new funding model proposals (in consultation section above).

• Cost assessment

- Business plans must be developed with stakeholders and must include:
 - Costs broken down by activities and sub-activities, with clear metrics
 - Historical costs for each activity, and sub-activity where possible
 - Separate reporting of business support costs
 - Comparable external benchmarks for activities and deliverables
 - Proportionate CBA and justification for proposed expenditure
 - Identification of uncertainties around deliverables, with cost ranges
 - Demonstration of consideration of longer-term vision
- Continuing to work closely with the ESO to develop business plan data templates.
- Third party audits and CBA should only be deployed when needed and should be proportionate to the investment.

• Incentives

- The ex post, evaluative incentive scheme will continue.
- Ofgem is consulting on an asymmetric scheme (in consultation section above).
- A further consultation on the future design of incentives is expected in the summer.
- The Black Start incentive will remain as a standalone cost disallowance up to 10%.
- Indicative position is that EMR incentives may be more effective if merged into the overall incentives framework, but this will be considered as part of the current five-year review of the Capacity Market.

- **ESO roles and competition**
 - The ESO will retain its current roles, including code admin, data admin, revenue collection and EMR. They will remain discrete functions to enable them to be opened up to competition in future.
 - Ofgem will maintain its current approach to roles and principles.
 - Ofgem will continue investigating and developing the ESO's ability and capacity to facilitate early network competition. The ESO is required to submit an early competition plan alongside its December business plan.
 - Depending on the outcome of the legislative process, Ofgem will consider the potential role of the ESO in facilitating some aspects of late competitions.

- **Innovation**
 - The ESO will continue to have access to separate innovation funding.
 - For all sectors, Ofgem has confirmed:
 - Measures to encourage companies to do more innovation as BAU
 - The removal of the Innovation Rollout Mechanism re-opener
 - A new strategic funding pot in place of the Network Innovation Competition
 - Opportunities for Network Innovation Allowance funding, subject to reforms.
 - There will be a separate RIIO-2 innovation consultation in the summer which will have a dedicated ESO section.

- **Whole system**
 - Ofgem is applying a broad definition of 'whole system' for the price control for projects that pass a consumer benefits test.
 - In addition to the standard CBA templates, whole system proposals may require a bespoke CBA approach proportionate to the value potentially arising from the project.

- **Cyber resilience**
 - The ESO is requested to develop and submit strategic investment plans for cyber resilience, setting out the steps it proposes to take during RIIO-2 and beyond to comply with the NIS Regulations. These would be in addition to improvements identified against the Cyber Assessment Framework ('CAF') undertaken during RIIO-T1.
 - Separate to these plans, the ESO is invited to submit business plans that include:
 - A Business IT Security Plan (which would be considered BAU expenditure) – focused primarily on IT security for business systems; and
 - A Cyber Resilience Plan – which is expenditure focused primarily on operational technology, in response to the NIS Regulations.
 - A reopener may be available for cyber investments.

- **Physical Security**
 - Ofgem will consider baseline allowances for physical security investment mandated by government.
 - There will be a re-opener at both the mid-period and end of the price control to adjust allowed revenues if government mandates changes to the scope of work required.