



To all interested parties

*Promoting choice and value for
all gas and electricity customers*

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Dear stakeholder,

Decision on the concept for the implementation of the Environmental Discretionary Reward for the electricity transmission owners and system operator

The Environmental Discretionary Reward (EDR) is a key environmental incentive under the RIIO-T1 price control with a funding amount of £32 million over the period of the price control. Our stated purpose for the EDR is to sharpen transmission companies' focus on strategic environmental considerations and organisational and cultural change to facilitate growth in low carbon energy.

We released a consultation paper on our detailed concept for the implementation of the EDR in parallel with our publication of the initial proposals for fast tracked companies.¹ Our consultation strategy included seeking formal written responses on our consultation paper; conduct of a stakeholder workshop; consultation with our Sustainable Development Advisory Group (SDAG); and consultation with the Department of Energy and Climate Change (DECC).

This letter sets out:

- our decision in relation to the concept for the implementation of the EDR as part of the RIIO-T1 price control settlement for electricity transmission; and
- how we will address stakeholder views as we finalise the detail of the EDR scheme in the coming months through the RIIO-T1 process.

Decision on the form of the EDR as part of RIIO-T1

In our consultation, we outlined our concept for a targeted and discretionary mechanism to focus on aspects of the transmission operator's (TO) role which do not feature explicitly elsewhere in the RIIO framework. In particular, our concept for the EDR was a scheme which aimed to identify whether the TO has a systematic approach to facilitating a low carbon economy. Our design concept for the EDR was to complement and reinforce other environmental incentives included in the RIIO-T1 package.

Respondents to our February 2012 consultation welcomed the aim of the EDR as set out in the consultation document, and expressed views that the scheme as outlined had the potential to serve as a powerful incentive to the companies. The consultation responses

¹ The EDR consultation document is available on our website here:
www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=152&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes.

also indicated comprehensive support for our broad concept for the implementation of the EDR.

On that basis we now set out that the EDR scheme will be based upon:

- an environmental balanced scorecard comprising 6 key strategic and operational environmental objectives against which each of the companies will be measured and scored; and
- presentation of an executive level planning document which defines and explains in clear terms what the company has in place to meet the requirements for the transition to a low carbon energy system.

Importantly, the consultation comments also:

- noted that key area of performance in the scorecard involve the System Operator (SO), in particular, in relation to customer connections, system planning and demand side response (DSR); and
- provided very useful feedback on the elements of the EDR which will assist us in developing the details of the scheme.

Our responses to the issues arising from these two points are detailed below.

Each year the TOs and the SO will provide evidence to us of their performance against the EDR's requirements. We will complete an assessment of performance which will be considered by a panel of experts who will have discretion to determine the level of any reward made up to a cap. The EDR will have an annual funding of up to £4 million, up to a total of £32 million over the price control period, with up to half of the annual allocation being rolled over into the next year if the full amount is not awarded.

Decision to incorporate the system operator into the EDR

A majority of stakeholders emphasised the interrelationship between the TO and SO. Respondents suggested that we either make a clearer distinction between the roles of the TO and the SO in relation to the EDR, to enable a fair comparison of the performance of the three TOs², or expand the EDR to cover the role of the SO. This is because several categories of the scorecard have significant elements of SO involvement. Therefore, better performance and development of solutions may rely on what the SO and TO can do together.

We have therefore decided to incorporate the SO into the EDR scheme.

In our SO Incentives consultation document³ we committed to introducing a reputational output incentive scheme, complementing RIIO-T1 environmental outputs. We think that the EDR will provide appropriate incentives on the SO to play a full role in facilitating the transition to a low carbon economy. The EDR will continue to have a maximum reward of up to £4m per annum. The EDR will be designed to complement both the SO Incentives regime and the RIIO-T1 price control regime, by focusing on behaviours and operational practices that cannot easily be measured or incentivised through more mechanistic regimes.

Consultation respondents emphasised the SO's role in three of the scorecard categories:

² National Grid performs the role of SO for the whole of Great Britain, as well as being TO for England and Wales, whereas Scottish Hydro Electric Transmission Ltd and Scottish Power Transmission Ltd perform the role of TO in North and South Scotland respectively.

³See System Operator incentive schemes from 2013: principles and policy, available on our website: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=277&refer=Markets/WhlMkts/EffSystemOps/SystOpIncent

- Category 2: involvement in whole electricity system planning for low carbon future, including integration with DNOs and involvement in development of demand side interactions
- Category 3: approach taken to connections for low carbon generators
- Category 5: development of approaches to demand side response and 'smarter' networks, including storage and best use of existing network

We will develop the scorecard to incorporate the role of the SO under these categories and to provide more clarity on the respective roles of the SO and TOs in the activities covered by the EDR scorecard, and consult further on this as set out below. This approach will highlight where the SO is the key interface with users of the transmission system under these categories and recognise the importance of TO/SO co-operation in many of the activities. We will develop the scorecard to reflect the regulatory roles of the SO and TOs, and the expectations set out by the System Operator - Transmission Owner Code (STC). This holistic approach should help ensure that earning a reward under the scheme would be within the reach of all TOs, and National Grid Electricity Transmission would not be unduly advantaged by its dual SO/TO role.

Consultation responses in relation to elements of the EDR

We received seven written responses to the consultation, in addition to evidence gathered through events we held during the consultation⁴. Some consultation responses suggested amendments to the scorecard categories. For example, workshop attendees thought that the *demand-side response* category should focus on *making the best use of the existing network*, whether through using demand-side response or other options.

Others emphasised the need for the EDR to be outputs-based and to demonstrate implementation, and expressed the view that our proposals for the annual report were too prescriptive. Another common theme was the view that the EDR should be adaptable so that we can review the scorecard and the broader process according to developments and learning as we implement the scheme.

We will consider these views as we develop the detail of the EDR scheme in the coming months.

Next steps

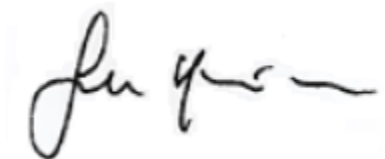
We are currently developing the details of the EDR scheme incorporating our decision to include the SO in the scheme and taking into consideration the views on detailed elements of the scheme expressed by respondents to the consultation.

We will finalise the detail of the EDR in the autumn, including licence drafting and scheme guidance, in line with the RIIO-T1 timescales. Our next steps are to publish an outline of the EDR scheme guidance in late July as part of the RIIO-T1 informal licence consultation, and to hold a second workshop on 5 September to consult on the EDR scheme guidance with the industry and other stakeholders. We will then publish the draft EDR scheme guidance document as part of the second informal licence consultation in October. The EDR will come into force on 1 April 2013 as part of the RIIO-T1 package, with the first EDR submissions due to be submitted to Ofgem in spring 2013.

⁴ Please see Annex 1 for a summary of responses and our response to the key issues raised. The consultation document and all written responses are available on our website here: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=152&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes, and the minutes to the March meeting of the Sustainable Development Advisory Group which discussed the EDR, are available here: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=28&refer=Sustainability/sdag

If you have any questions or comments about the EDR, please contact Tom Handysides at tom.handysides@ofgem.gov.uk.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Sarah Harrison', with a horizontal line extending to the right.

Sarah Harrison
Senior Partner, Sustainable Development

Annex – summary of responses

1. Background

1.1. We issued a consultation regarding our proposals for an Environmental Discretionary Reward (EDR) under the RIIO-T1 price control in February 2012. The consultation was open for 8 weeks⁵.

1.2. We received seven written responses. These were from National Grid, Scottish Hydro Electric Transmission Ltd, Scottish Power Energy Networks, RenewableUK, the Renewable Energy Association, the Scottish Environmental Protection Agency and Electricity North West.

1.3. We also received feedback in a workshop (involving the transmission owners (TOs), Northern Powergrid and RenewableUK), from our Sustainable Development Advisory Group and from DECC.

2. Summary

2.1. There was broad support from respondents for both the aims and the structure of the proposed EDR, and we received feedback that rewards of this type usually serve as powerful incentives. Some amendments were suggested to the scorecard measurements, whilst there were concerns that our proposals for the annual report were too prescriptive.

2.2. There was emphasis on the need for the EDR to be outputs-based and to demonstrate implementation.

2.3. The TOs raised the need for a clearer distinction between the roles of the TO and the system operator (SO), and to ensure that the EDR does not conflict with the TOs' duty to not discriminate between parties.

3. Question 1: Do you agree it is appropriate to have an EDR?

3.1. All bar one respondent agreed that the EDR is an appropriate incentive and agreed with its aims. They noted that there are areas covered by the proposed scheme which may not otherwise be financially incentivised by the RIIO-T1 package.

3.2. One respondent noted that the proposed discretionary scheme avoided the potential to duplicate rewards elsewhere in RIIO-T1 and ensured that only activities under the TOs' control would be rewarded. However, another response raised concerns that a discretionary reward would not be effective in enabling TOs to build investment cases.

4. Question 2: Do you support the proposed environmental balanced scorecard?

4.1. Five of the written responses specifically supported the proposed environmental balanced scorecard, with accompanying comments that it has the potential to provide clarity on what is being assessed and takes an analytical approach.

4.2. Four of the written responses and four of the workshop participants noted that the proposal does not take sufficient account of the different roles of the TOs and the SO, so the TOs which do not have a dual TO/SO role may struggle to demonstrate performance against some of the measurements. One company raised particular concerns about measure 3 in this respect, whilst another group flagged measures 2, 3 and 5. One

⁵ The consultation is available here: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/EDR_consult.pdf

response suggested that some of the measurements may be better covered under the SO incentives.

4.3. Four of the written responses requested further consideration of the weightings. One respondent noted that the weighting associated with the approach to low carbon generation connection appears low, whilst two other respondents said the same of the demand side response measurement. One workshop participant emphasised that the ease of measurement should not be a consideration in the weighting, and suggested that we should list the factors that influence the weighting we give to each category, in line with the approach set out in early RIIO documents.

4.4. One response requested further clarity on how scores will be calculated and how they will feed into the recommendation to the Panel.

5. Question 3: Are we asking the right questions in the balanced scorecard reporting template we are asking Transmission Owners (TOs) to complete?

5.1. Five respondents had suggestions regarding how to refine or amend the measurements. General comments were that the template should be flexible to allow for changes over the price control period, or that we should allow for a change to the questions if necessary.

5.2. Three written responses emphasised the need for the measurements to be outputs-rather than inputs-based, in order to emphasise the desired outcomes rather than the methods for achieving them. One respondent suggested a further question for most of the measurement, to follow through into practical implementation.

5.3. Two respondents suggested an additional category to record any activities which are not captured by the six defined performance areas.

5.4. One response suggested the inclusion of more non-carbon factors such as wider environmental impact and environmental stakeholder engagement.

5.5. A workshop participant suggested renaming the fifth measurement from "demand side response" to "best use of networks", and reconsidering the contents accordingly.

5.6. One response suggested removing the sixth measurement on the grounds that the activities listed are already covered by the RIIO-T1 environmental outputs.

6. Question 4: Do you support the proposed requirement for TOs to publish an annual report on what they have in place to meet the requirements for the transition to a low carbon system?

6.1. Four of the written responses specifically supported the principle of an annual high-level report.

6.2. Two of the responses stated that the proposal was too prescriptive, as the information could be included in other documents or presented online to make it more accessible to stakeholders, and a presentation by the Chief Executive may not be appropriate for every company.

7. Question 5: Do you believe the proposal would be effective in driving TOs towards facilitating low carbon energy?

7.1. Five of the written responses specifically agreed that the proposed EDR, working alongside the other incentives, has the potential to drive TOs towards facilitating low carbon energy.

7.2. One response emphasised the significance of a sufficient financial incentive to ensure the EDR's effectiveness.

8. Question 6: What is your view on the standards to be met to receive the reward and do you believe the level of the reward is appropriate?

8.1. Three of the written responses several suggested that £4m across all three TOs would be too modest to be effective in driving behaviour.

8.2. There was also disagreement regarding the proposal to carry over half of the annual allocation if the full amount is not awarded, with one respondent objecting to any carry over and another suggesting removing the cap.

8.3. One response suggested that more emphasis could be placed on the reputational benefits that a successful company could reap.

9. Question 7: Do you believe the outlined timetable for making the reward is appropriate?

9.1. Four of the written responses specifically supported the proposed timetable.

9.2. One respondent suggested an adjustment to the timing requirements to avoid a clash with other RIIO reporting deadlines.

9.3. Another response emphasised the need for the EDR submissions to align with the rest of the RIIO-T1 business plan work, to ensure the reward is integrated into their work.