

All interested parties

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Dear stakeholders,

### **Modification of the gas transporter and electricity transmission licences for our decision on the RIIO-T1 Stakeholder Satisfaction Incentive**

As proposed in our statutory consultation<sup>1</sup> published on 4 August 2016 we have decided to modify special condition 2C of the gas transporter licence held by National Grid Gas plc (NGG), and also special condition 3D of the electricity transmission licence held by National Grid Electricity Transmission plc (NGET), SP Transmission Limited (SPT) and Scottish Hydro Electric Transmission plc (SHE Transmission). The modification decision notices are published on our website alongside this letter. The changes will take effect from 18 January 2017.

The reason for these modifications is to implement the policy decision on the values that will apply in the stakeholder satisfaction incentive we took in August 2016<sup>2</sup>. The August 2016 decision letter explains how we considered responses to our April 2016<sup>3</sup> consultation proposals for setting the relevant values, and the basis for our decision.

### **Responses to the statutory consultation**

In total we received three non-confidential responses and one confidential response to our August 2016 statutory consultation. The non-confidential responses are published on our website. The responses focused on the policy decision rather than the proposed licence modification to implement the decision. We have carefully considered these representations in making our final modification decision.

Below we summarise our August 2016 policy decision, and stakeholders' views and set out our response to these.

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<sup>1</sup> <https://www.ofgem.gov.uk/publications-and-updates/notice-under-section-232-proposed-modification-national-grid-gas-transporter-licence>

<https://www.ofgem.gov.uk/publications-and-updates/notice-under-section-11a2-proposed-modification-she-transmission-s-and-sp-transmission-s-electricity-transmission-licence>

<https://www.ofgem.gov.uk/publications-and-updates/notice-under-section-11a2-proposed-modification-national-grid-s-electricity-transmission-licence>

<sup>2</sup> <https://www.ofgem.gov.uk/publications-and-updates/decision-values-within-stakeholder-satisfaction-output-arrangements>

<sup>3</sup> [https://www.ofgem.gov.uk/system/files/docs/2016/04/si\\_consultation\\_apr\\_16\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/04/si_consultation_apr_16_final.pdf)

### *Our August 2016 policy decision*

In our August 2016 decision, we adopted the baseline and associated values we consulted on in April 2016. We also adopted the option to switch off some components in the incentive during years 1 to 3, but with some changes to the weightings on the components that operate in the incentive during the first three years. We modified the weightings so that the relative impact of a good or poor score in those components has a consistent effect on revenues over the whole price control. The modified component weightings are as follows:

- NG's customer satisfaction survey component is 70% in years 1 to 3 (as it will be for years 4 to 8) instead of 100%. The stakeholder satisfaction survey component will be 0 at years 1 to 3; and
- SHE Transmission's and SPT's external assurance component is 10% in years 1 to 3 (as it will be for years 4 to 8) instead of 0. We noted the weighting on this component isn't related to the values we decided on in the August 2016 decision.

### **August 2016 decision on values for stakeholder satisfaction output arrangements**

<b>Component</b>	<b>NG</b>	<b>SP Transmission</b>	<b>SHE Transmission</b>
<b>Values apply for years 4-8 of the price control</b>			
<b>Baseline stakeholder satisfaction survey</b>	7.4	7.4	7.4
<b>Baseline KPI</b>	N/A	69	89
<b>Cap and collar stakeholder satisfaction survey</b>	+/-1.6	+/-1.6	+/-1.6
<b>Cap and collar KPI</b>	N/A	+/-16	+/-11
<b>Modified Component Weightings Years 1-3</b>			
<b>Customer satisfaction :</b>			
<b>Stakeholder satisfaction for NG</b>	70:0	0:0:10	0:0:10
<b>Stakeholder satisfaction : Key Performance Indicators : External Assurance for SP and SHE</b>			
<b>Weightings Years 4-8</b>	70:30	60:30:10	60:30:10

### *Stakeholders' view*

NG supports the August 2016 decision on the targets and weightings for years 4 to 8, as well as the targets for years 1 to 3. However, it disagrees with our decision on the weighting of the customer satisfaction component for years 1 to 3. NG argues that if we consider 70:30 (ie a total 100%) to be the appropriate weighting on the two components in years 4 to 8 of the price control then a 100% weighting should apply to the entire price control. It considers that our decision and the proposed licence modification should be changed.

NG argues that the policy decision in Final Proposals (FP) is to encourage the transmission owners and gas transporter to be more outwardly focused, and that this is to be implemented in NG's gas transporter and electricity transmission licences through a financial incentive in the stakeholder satisfaction licence condition which provides for a penalty or reward of up to +/- 1% of the licensee's annual revenue.

NG is concerned that our decision leaves it exposed to or with the ability to earn up to only +/-0.7%, instead of 1%. It considers that the August 2016 licence modification proposal

therefore fails to implement the intended purpose of the policy and that the latest decision changes the overriding principle of the FP policy decision. It also comments that our decision on changing the weighting and the limit of the incentive/reward is an unexpected movement and it found it difficult to reconcile with the options set out in the April 2016 consultation and the responses received on this.

SPT agrees with our decision for years 4 to 8. However, it reiterates its position at the April 2016 consultation that switching off the incentive for years 1 to 3 is not consistent with the policy intent. It states that we have never previously suggested that the baseline values it proposed in 2013 were inappropriate or were likely to change retrospectively.

SPT also notes that the current licence (for the Scottish TOs) does not allow for different weighting values, so our decision to specify more than one weighting value was inconsistent with our rationale for revoking the November 2015 decision.

Similar to what NG has said, SP states that setting the incentive to zero for the first three years reduces the overall value of the potential reward or penalty during the price control period, from +/-1% of base revenue to +/-0.625%.

SHE Transmission welcomed the decision to operate the external assurance component in its incentive for the whole price control, but says it is disappointed with both the process and the final decision. It said that the decision penalises companies who had undertaken stakeholder activity based on the expectation of reward for good performance, creating regulatory uncertainty.

#### *Our response*

- The value of the incentive in years 1 to 3

The original FP policy decision and licence drafting envisaged the stakeholder satisfaction incentive would be worth up to +/- 1% of annual base revenue. The formula in NG's licence condition presently requires the sum of the two weightings on the customer and stakeholder components in its incentive to equal 1 (by having a value calculated as 'x' and '1-x'). This was on the basis that all the components of its incentive are operating and counting towards the value of the reward or penalty.<sup>4</sup>

In August 2016 we decided it is in consumer interests not to apply, in the first three years, the stakeholder satisfaction incentive component, as well as the key performance indicators component that only operate in SPT and SHE Transmission's incentive. This is because the target values for these components had been determined in the fourth year of the price control due to unanticipated difficulties and delay. Consequently we considered it would be unfair to operate these components in the incentive because the companies are not able to change past performance in response to the newly determined target values.

In our April 2016 consultation, we sought views from stakeholders on the proposed weightings to be applied to the components of the incentive. British Gas took the view that under the option in which the stakeholder satisfaction survey component is switched off in years 1 to 3, the part of the incentive attributed to that component should be foregone.

Having considered consultation responses we decided to modify the weighting on the customer satisfaction survey component in years 1 to 3 to the level of 70% (as it will be in years 4 to 8). We think it is appropriate to do this so that the relative impact of a good or poor score in the customer survey will have a consistent effect on NG's revenues over the whole price control. While we recognise there was an initial policy intention for the incentive as a whole to be worth up to +/- 1%, this was on the basis that both the customer and

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<sup>4</sup> The formula in the current licence condition is drafted differently for the two Scottish companies.

stakeholder surveys would be taken into account. Now that assumption has changed, we think it is reasonable the overall level of the incentive is reduced so that the relative impact a single survey can have on revenue is the same as if the other survey component is operating. Otherwise this would result in an over-amplification of reward or penalty for NG's performance in relation to the customer component of the incentive. The clear policy intention for the incentive is that it motivates improved performance in customer satisfaction as well as wider stakeholder satisfaction. In our August 2016 decision and the proposed modification we adjusted the weightings to reflect this policy intention.

We also have decided that the same principle should apply in the case of the SPT's and SHE Transmission's stakeholder satisfaction incentive. Therefore we decided to operate the external assurance component with a weighting of 10% in years 1 to 3 (as it will in years 4 to 8) instead of 0.

Our August 2016 decision and the proposed licence modification resets the incentive up to +/-1% of annual base revenue for the remaining five years of the price control, when all the components of the incentive will be operating.

- Process and regulatory uncertainty

We acknowledge that it is not ideal that the values for this incentive are being set during the fourth year of the price control. The reasons for this are explained in our August 2016 decision. However, we note that annual financial incentives for the Stakeholder Satisfaction Output have not been calculated yet and therefore no sums have been determined. To this extent, our decision is forward-looking.

Although the relevant values for the incentive are being set during the price control period, our decision limits the extent to which there will be any backward-looking element to the calculation. The need to avoid potential adverse impact on consumers' interests from any retrospective application of targets underpins our decision to switch off the stakeholder satisfaction survey and key performance indicators components for the first three years.

- Licence modification

SPT said that the proposed licence modification to specify more than one weighting value appears to be, in their view, at odds with our rationale for revoking the November 2015 decision. However, the November 2015 decision was revoked because we didn't have the power to set different values for different years. In addition, we identified policy reasons in our August 2016 decision for not having different baseline values for the first three years of RIIO-T1. At the same time we proposed changing the licence for introducing time varying weightings on the components, and above we've expanded on our policy rationale for this decision.

A final copy of the amended licence condition is contained in the schedules to the modification decision notices.

If you have any questions regarding the content of this letter, please contact Anna Kulhavy [anna.kulhavy@ofgem.gov.uk](mailto:anna.kulhavy@ofgem.gov.uk).

Yours faithfully

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Partner, Networks (RIIO)