

David Beaumont
Electricity System Operator Incentives
Ofgem
9 Millbank
London
SW1P 3GE

19 January 2018

The Electricity System Operator Regulatory and Incentive Framework from April 2018

Dear David

We welcome the opportunity to respond to your consultation on *The Electricity System Operator Regulatory and Incentives Framework from April 2018*.

We agree with the case for a new incentives framework for the Electricity System Operator (ESO) that reflects the full range of its functions and the context of the changing energy system. It will also support the aims of legal separation of the ESO within the National Grid group. If designed appropriately, this new incentive framework has the potential to drive significant additional benefits for customers and consumers. To realise these benefits, as we have discussed and agreed, it is essential that a number of amendments are made to the proposed framework to create a clear, fair and effective evaluation process with proportionate risk and reward for the ESO.

The proposed arrangements bring a welcome increase in transparency and support our stronger focus on meeting the needs of customers and stakeholders. We look forward to ongoing, constructive engagement to help determine the ESO's priorities and drive us to continually improve our performance. This begins with the publication, for consultation, of our Forward Plan that sets out our strategy and actions we will take in 2018-19 across all the roles we play as ESO.

We support the continuation of financial incentives for the ESO as a robust way to promote actions that will deliver consumer value. They should mimic the rewards that a company in a competitive market would receive from successful innovations or improvements in customer service, and therefore promote efficiency, innovation and appropriate risk-taking.

An evaluative approach to performance management has the advantage of flexibility. However as we have discussed and agreed, to function effectively it requires the parameters and basis for assessing performance to be clearly set out. The framework as currently proposed does not do this and as such may not work as intended for the benefit of customers and consumers. Our main points are:

- Changes are needed in order for the framework to align with Ofgem's intent that 'on-track' delivery of an ambitious and challenging Forward Plan is rewarded with incentive payments. It is not reasonable for on-track delivery of an ambitious plan to result in a zero incentive payment

(and in effect a loss/penalty to the ESO as investments will have been made to ensure that on-track outcome).

- Ofgem's Formal Opinion on the ESO Forward Plan, and within-year reviews, should set out its assessment of the ESO's performance so far and the likely incentive payment or penalty at the end of the year.

As well as allowing us to take actions to rectify any areas of underperformance, these are critical to enabling us to justify, and make, those investments necessary to drive increased benefits for consumers.

Our answers to your specific consultation questions provide more information on the above and other areas where we think the scheme could be improved.

This scheme will be the first of its kind in the world. It has the potential to drive significant customer and consumer benefits and will allow openness and a shared understanding of the ESO's performance. It will, however, need continual review to ensure it works as an effective regulatory vehicle. This means learning lessons to improve the framework, particularly as we embark on RIIO 2 and a new price control for the ESO. Trialling new ideas during 2018-21, and learning from RIIO 1 and the previous incentive schemes, will help us create a robust RIIO 2 framework. We welcome the positive engagement so far and look forward to working with you to finalise the arrangements of the new scheme.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'CR', is positioned to the right of a vertical line.

Dr. Charlotte Ramsay

Programme Director, Future of the SO Programme

Response to consultation questions

1. Do you agree with our updated Roles and Principles for the ESO?

The Roles and Principles provide customers and stakeholders with visibility on what to expect from the ESO. As a result they must have the opportunity to understand them, engage with the Forward Plan and be consulted on any changes to the Roles and Principles.

We agree with the updated Roles for the ESO and welcome the inclusion of ‘operability’ in Role 1. Principle 2 should similarly be amended to include a reference to operability as well as balancing. Ensuring system balance (and increased use of market-based solutions) is only possible if the safe operability of the market is ensured.

The publication of the updated Roles and Principles document is welcome. We note the statement that the ESO’s licence conditions underpin the Roles and Principles and remain the legal obligations that the ESO must fulfil. Given that the Roles and Principles do not constitute licence obligations we would welcome further clarity over the legal status of the Roles and Principles and Ofgem’s views which are set out in the Roles and Principles document. We discuss this further in our response to question 10.

Operating successfully under the Principles will require a new way of working on the part of both Ofgem and the ESO, enhancing the existing relationship based on a shared understanding of ESO performance and the wider context. Publication of the Forward Plan, and regular updates on our performance, will give the ESO the opportunity to be more open and transparent about what we will deliver for consumers and how we make decisions.

We agree that it is important for Ofgem to take into account the views of customers and stakeholders before amending the Roles and Principles. This consultation should take into account timelines for the development of the ESO Forward Plan which will start in November each year. Changes to the Roles and Principles should be made infrequently, as these overarching requirements will set the direction of the ESO and change what stakeholders can expect from us. Any alteration to agreed Roles and Principles could also affect the evaluation of initiatives undertaken by the ESO in accordance with the Roles and Principles at the time.

2. Do you agree with our proposals for the ESO Forward Plan? Do you think our proposed process for reviewing the ESO’s forward plan will create a sufficient incentive on the ESO to develop a plan and performance metrics that are appropriately challenging and comprehensive?

We welcome the opportunity to publish a Forward Plan and engage widely with our customers and stakeholders on our priorities for the longer-term and the coming year. We have already engaged our customers and stakeholders over summer and autumn 2017, including through bilateral meetings, Ofgem-hosted events on ESO regulation and a dedicated workshop held by the ESO. It is right that the ESO takes the lead in developing the Forward Plan and we agree with the timescales proposed for consultation and publication.

In line with feedback from our customers and stakeholders, the Forward Plan will cover the full range of ESO activities. We will propose performance metrics to support the outputs that we will deliver under the Plan.

To drive the ESO to develop an ambitious and comprehensive plan, we need to consider the interaction between how the ESO's performance will be assessed at the end of the year, and the ambition of the plan at the start of the year. Ofgem's current proposal that 'on-track' performance should pivot around an incentive reward of zero makes it difficult to justify investment in risky, transformational activities that may yield substantial consumer benefits. This is because there is no guarantee of a return on investment in the case of successful delivery. If the plan is ambitious, it will be more difficult to 'exceed expectations' and therefore gain a positive share of the consumer benefit delivered. In our answer to question 4 we provide more details on how we think the performance evaluation methodology could be improved to avoid this 'double hurdle' and sharpen the incentive on the ESO to innovate and take risks on behalf of consumers.

Regulatory certainty is important for us, customers and consumers because it allows the ESO to focus on delivering value for consumers in the context of a stable, predictable framework that aligns consumer and shareholder value. Ofgem's 'Formal Opinion' on the Forward Plan is a valuable opportunity to set out expectations, ex-ante, on the ESO. We would like to understand which areas of our proposed activity fall above, in line with and below expectations, and how we might need to improve. The Formal Opinion should set out what portion of incentive rewards or penalties the ESO would be eligible for on the basis of the Forward Plan. It should be made clear under what circumstances the Formal Opinion could be revised during the year (e.g. if the complexities of the system reasonably change what 'ambitious' looks like) and how and when the revised opinion would be shared with the Performance Panel and stakeholders.

We note that the Formal Opinion may not be issued until 1 May of the relevant year with the Forward Plan being required to be published on or before 31 March. There is a proposed obligation for the ESO to consult with Ofgem and other parties ahead of publishing its Forward Plan. Given the importance of the Opinion in determining the range of incentive rewards or penalties on the ESO, Ofgem should share its emerging Opinion on the draft Plan ahead of its publication. This should be done in timescales that enable the Forward Plan to be amended on the basis of Ofgem's comments before publication of the draft and final version. We would like to start this dialogue with Ofgem from November when we will begin preparing the next year's Plan. At a minimum, we would like Ofgem to share its informal opinion with us at least four weeks before 31 January, the proposed deadline for publication of our consultation on the Forward Plan. Once published for consultation, we would like Ofgem's written feedback in line with the timescales for responses so that we can ensure the final version reflects views from all our stakeholders.

3. Do you agree with our proposals for in-year reporting? Do they appropriately balance the need for transparency with resource burden for the ESO?

We support regular reporting on our performance throughout the year as this can ensure greater transparency. Feedback from Ofgem, stakeholders and the Performance Panel should be sufficiently

detailed to allow us to make changes if our performance is below expectations, clearly setting out what actions we would need to take to demonstrate improved performance. We welcome your proposal to provide regular feedback as part of our ongoing monitoring and regulatory relationship.

Reporting should not be an administrative burden and we agree that monthly reporting will not be appropriate for all performance metrics. We agree with the proposals for the quarterly 'hot-spot' reporting and the mid-year evaluation. These should allocate a provisional score to the ESO against the performance scorecard and give an indication of the forecast incentive reward or penalty. For the consistency of financial reporting we would like to continue with the current process of reporting the within year incentive performance as part of the financial results. A reasonable estimate of the outturn is required to do this. We have an obligation to provide shareholders and potential future investors with a true and fair view of the expected financial performance. In addition, forecast outturn is valuable to our customers as it influences the forecasts of Balancing Services Use of System (BSUoS) charges that our customers pay. It is also important for the ESO as it helps us to make investment decisions and take appropriate risks on behalf of customers and consumers that can drive longer term value.

4. Do you agree with the design of the evaluative scorecard incentive? Do you have views on the panel scoring criteria or payment-penalty methodology?

Financial incentives have a strong role to play in incentivising a for-profit ESO because they align consumer and shareholder interests. In previous consultations, stakeholders have largely supported their use.

We appreciate the flexibility that an evaluative scheme allows. We think that where clear targets and outcomes can be set, mechanistic incentives are the sharpest tool for driving behaviour and aligning ESO and consumer interests. We have shared views on where these could be used in the framework, for example our proposed performance metric on controlling balancing costs.

Further improvements are needed to the methodology for determining incentive rewards or penalties, focused on the following points:

- Providing regulatory certainty
- The payment/penalty methodology
- The range of roles the ESO will undertake

Providing regulatory certainty

To ensure a scheme that drives consumer value, the process for evaluating the ESO's performance needs to achieve a balance between clear, unambiguous criteria that give the ESO certainty on what good looks like and the flexibility to take new information or changing circumstances into account. As set out in our answer to question 2, Ofgem's Formal Opinion on the Forward Plan and the quarterly and mid-yearly performance reviews must provide clarity on how the ESO's performance is rated, the likely implications for incentive payments or penalties and what needs to be done to improve. The less clear the link between activities that deliver consumer benefits and any incentive payments, the more difficult it will be for the ESO to change and to justify investment in innovation or transformational activities. The framework needs to allow a reasonable forecast to be made of returns on investment to meet the needs of BSUoS payers and ultimately to ensure the ESO business makes the right decisions on behalf of consumers.

The criteria suggested for use by the Performance Panel should be clearer and less ambiguous. For example, the definition of 'mostly,' and how 'expectations' are defined need further clarity. Similarly

the criteria should provide clarity on what inadequate, adequate and good 'evidence of long-term thinking and future consumer benefits' looks like.

We do not understand the process that Ofgem would use to determine the final decision on the ESO's incentive reward or penalty within the (very broad) bands of the score/reward relationship. Subjective assessments tend to avoid extremes of reward or penalty, therefore the framework needs to set out clearly how the maximum payment or penalty could be awarded to, or imposed on, the ESO. This would mean the full incentive opportunity is harnessed to drive behaviour. We provide further thoughts on the proposed score-reward methodology in the next section.

Consideration of context will be important when assessing ESO performance and the ability to do this is one of the advantages of the proposed scheme. It would be good to have more clarity on how the changing context could influence the evaluation of the ESO's performance and for this to be reflected in the criteria. The use of hindsight to retrospectively assess the ESO's performance should be avoided; the ESO's performance should be assessed on the basis of the information available to it at the time. Clarity on how the regular monthly and quarterly reporting will support appropriate evaluation of the ESO's performance will help here, as would learning lessons from the 2017/18 Balancing Services Incentive Scheme (BSIS) that is also following a similar approach with a more qualitative explanation of actions taken being provided each month.

The payment/penalty methodology

We do not agree that 'on-track' performance should lead to an average score of zero, particularly against an ambitious Forward Plan which, due to the transformational activity proposed, already carries an inherent risk and has an up-front cost. As proposed, the ESO would need to overcome a 'double hurdle' for the possibility of recovering any investment and potentially receiving an incentive payment: firstly, that Ofgem's Formal Opinion should confirm the Forward Plan is ambitious, and secondly that the delivery of the already-ambitious plan is judged at the end of the year to have exceeded expectations.

By definition, transformational investment covers spending on new activities and/or enhancing existing capabilities with the expectation of delivering consumer benefits. Due to the novelty of these new roles and the dependence on other parties in the energy system, for example distribution network operators (DNOs), there will be uncertainty over the exact outcomes that will be achieved and uncertainty around what is wanted by stakeholders. Nevertheless the ESO is investing in these areas because it is the right thing to do for consumers. The proposed framework risks inadvertently penalising this investment. This is because it brings additional downside risk on top of the inherent risk (i.e. no return on invested cost and time) the ESO is already taking by investing in these activities. If, for reasons outside the ESO's control, the benefits from these activities are smaller or delivered later than forecast, the ESO will have already faced a financial penalty through the up-front costs it has borne. The framework risks imposing an additional incentive penalty on the ESO for performance below expectations.

The result of these aspects of the proposed framework is a blunting of the incentive on the ESO to take risks and invest in additional discretionary activities because:

- Publication of an ambitious plan could lead to the ESO being penalised at the end of the year if delivery is 'merely' on track, leading to a zero reward.
- If the plan is not judged as ambitious, even if the ESO exceeds expectations through investing additional discretionary funds over the year, the potential rewards are likely to be low or zero.

- Investment in potentially beneficial transformational or innovative activities carries the risk of an incentive penalty on top of investment already foregone on these activities.

This goes against the purpose of the incentive to mimic the pressure of a competitive market for a company to innovate and deliver consumer benefits 'above and beyond' its basic duties, through providing clear and achievable financial rewards linked to the delivery of consumer benefits.

To address this point and to improve regulatory certainty, we propose that Ofgem's Formal Opinion on the Forward Plan should set out, at the start of the reporting year, the range of rewards or penalties that (on- track) delivery of the plan would render the ESO eligible for. The outturn reward or penalty within that range should then be based on what the ESO has delivered against the plan, any outputs that go beyond the plan, together with stakeholder feedback. The decision on outturn should not consider the ambition of the plan a second time, as this would have already been used to set the range of potential rewards and penalties based on the ambition of the Plan.

The range of roles the ESO will undertake

Our core roles are funded through the RIIO 1 framework, with associated licence obligations and efficiency incentives. Failure to deliver these core roles could lead to enforcement action by the Authority. It is not clear how this approach interacts with the proposal for the 2018-21 framework to consider performance against the full range of the ESO's roles in determining incentive rewards or penalties. There is a potential risk that, in relation to our core roles, we are faced with the 'double jeopardy' of potential enforcement action and incentive penalty for non-delivery. Given the RIIO 1 framework is not being re-opened, the new 2018-21 regulatory framework must not be seen as a rebasing of our core commitments.

As currently proposed, the incentive opportunity is split equally across all seven principles. This is unlikely to reflect the consumer value associated with each Principle. We therefore agree with the aspiration to review this weighting. To sharpen the scheme in its first year, it would be worthwhile applying a high-level weighting across the Principles, based on an estimate of consumer value. This would provide a sharper incentive than the proposed ex post evaluation of where consumer benefits have been delivered.

5. Do you agree with our proposed scheme cap and floor of $\pm£30m$?

We have reservations about the proposed scheme cap and floor of $\pm£30m$, though we recognise that Ofgem may not feel it is appropriate to exceed this amount in the first year of the new scheme. In previous years the BSIS alone has had a cap and floor of $\pm£30m$, recognising the scale of consumer value the ESO manages in this area. The proposed new cap and floor would apply to all areas of ESO activity. We therefore think there is a case for a higher cap and floor given the increased scope of the scheme and the potential benefits to consumers. In future years there may be a case for increasing the cap and floor so that it reflects the risks held by the ESO, the transformation we are delivering through our Future of the System Operator roles, and the value delivered to consumers.

We have argued above that transformational activities already have an inherent 'downside' for the ESO and that the delivery of outcomes from these activities should not be subject to additional penalties. There is therefore a case for an asymmetric cap and floor with a smaller downside. We would be happy to work further with you to determine what appropriate parameters would be.

As we have already highlighted, we welcome the intent to mitigate uncertainty by providing performance feedback throughout the year. We have received clear feedback from BSUoS

customers that uncertainty of outturn position of BSUoS charges has a very real impact on their business. As mentioned in our answer to question 4, we are concerned that the more evaluative approach to incentives will negatively impact the certainty of BSUoS charges. This highlights the importance of specific in-year feedback to provide the ESO with clarity on likely outturn. Customers have asked that we provide clarity on the approach to recovery of incentives for 2018-19 before the end of March 2018. We are keen to work with Ofgem to establish an agreed approach that will enable us to meet the needs of BSUoS payers and our shareholders.

6. Do you agree with our proposal to introduce a new ESO Performance Panel?

We are content with the introduction of a new ESO Performance Panel as part of a strengthened approach to stakeholder engagement. We agree that the Performance Panel brings opportunities to reduce information asymmetry, provide a greater role for industry in governance and increase the transparency of the performance evaluation process. As already highlighted, we are concerned that an overly subjective performance evaluation process makes it harder for the ESO to justify investments that can lead to consumer benefits because the clarity over potential returns on that investment is greatly diminished.

There are important considerations around relevant expertise, neutrality and administrative burden that need to be considered. We have previously provided our views on lessons learned from other performance panels that may help to ensure an effective ESO Performance Panel is established. Some further thoughts are provided in our response to question 7.

We agree with the process outlined in the consultation document for the Performance Panel to provide feedback on the ESO's Forward Plan and conduct the mid- and end-of-year performance evaluations. The Panel's feedback should be advisory only with Ofgem as the final decision-maker on ESO penalties and rewards in accordance with its duties. We note that the Performance Panel will not be in place in time to conduct the review of the Forward Plan for 2018-19 and would welcome clarity on what might happen instead.

The published incentive methodology should make clear what rights of representation, dispute or challenge the ESO has in relation to evidence considered by, and the recommendation of, the Performance Panel and Ofgem prior to the final decision on incentive reward/penalty being taken by the Authority.

7. Who should sit on the ESO Performance Panel? What is its appropriate size?

The Performance Panel needs to act in an expert capacity with neutral panellists. It is important that the Performance Panel has industry representation to ensure an adequate level of knowledge of electricity system operation. The possibility of vested interests exists, including perverse incentives for Performance Panel members if they are ultimately the parties who are required to fund any reward we receive, or if panellists are unable to take a wider view on whether the ESO has acted in the best interests of consumers. For this reason the Performance Panel should include independent experts with no affiliation of existing industry parties and it should be clear to industry representatives that they are acting in their capacity as an expert rather than as a representative of their organisation.

To this end we are broadly content with the proposed Performance Panel make-up that is suggested.

8. Who should chair the ESO Performance Panel?

We agree an Ofgem chair for 2018-19 is sensible. This should be reviewed for subsequent years.

9. Do you agree with our proposed approach to implementing our new framework?

It should be noted that (in less than a year) licence condition C16 (Procurement and use of balancing services) has changed from an overarching obligation to *co-ordinate and direct the flow of electricity onto and over the NETS in an efficient, economic and co-ordinated manner* to an expanded version of that condition reinforced by a non-exhaustive list of the minimum requirements necessary to satisfy the obligation. Furthermore, this expanded obligation is also now subject to the requirement that it should be read in conjunction with the Roles and Principles document which sets out Ofgem's views on the behaviours or outputs that it expects to see when the SO fulfils its roles.

We understand that Ofgem is to have regard to the Roles and Principles document when considering compliance with condition C16 and possible investigation and enforcement action. This means that the ESO could be subject to a suite of expectations in the Roles and Principles document that are essentially to be treated as licence condition obligations. This is the case notwithstanding the fact that we have been afforded no rights to appeal against their introduction. The legal status of the Roles and Principles document is unclear, as is the ESO's ability to influence this document and Ofgem's vires to have regard to the document when assessing compliance with condition C16. We would welcome further clarification from Ofgem on this position.

To better satisfy the principles of good regulation the licence should clearly set out the legal basis of the additional expectations on the ESO. Furthermore, the ESO should have the opportunity to inform the form and content of any document subsidiary to the licence which set out the expectations with which the licensee must comply.

10. Do you have any comments on our draft licence changes?

We have specific comments on the drafting of *Special Condition 4M: Electricity System Operator Reporting and Incentive Arrangements*. For clarity we have included these comments in a marked up version.

We have previously provided initial thoughts on the other proposed licence changes. In particular:

- **4C:** The need to further change 4C to delete "LBS" from BSCC and 4C.3 and to amend 4C.6(b) to remove reference to methodologies

Whether the IncAdj error adjustment term in TotAdj in 4C needed to be restricted to years prior to 18/19 as this did not seem relevant to the regime from 18/19 onwards.

- **4G:** We do not agree with special licence condition 4G: Black Start Allowed Revenue remaining unchanged.

The new regulatory framework has been designed to provide a holistic package of incentives and having a cost disallowance incentive sitting outside this package detracts from the value of the new scorecard approach. This cost disallowance results in an asymmetric reward package, as we are exposed to an additional downside risk of 10% of total Black Start costs for each year. As with all other priority areas managed by the System Operator, appropriate Black Start procurement should be included as a Performance Metric within the ESORI scheme.

- **4J:** The SO-TO mechanism limits us to spend money only with SP Transmission and Scottish Hydro Electricity Transmission in order to generate consumer savings.

We would like the framework of the mechanism to be extended to any opportunity which the SO identifies to save the consumer money, and not just limit the interaction to ESO-to-Scottish TOs. This extension would allow the ESO to work with the distribution networks to implement changes within their networks which are currently driving increasing balancing costs. This would better enable us to “coordinate effectively to ensure efficient whole system operation and optimal use of resources.”

Irrespective of expanding this mechanism to include other parties, for this mechanism to be a success it should be extended to the end of RIIO 1. This will enable us to work with these parties, currently Scottish TOs exclusively, to plan further than one year in advance. There has been limited opportunity to use this mechanism to deliver consumer savings as the timescales required to plan and deliver changes within a TO construction program have fallen outside the requirements of the licence. The dates in the licence condition 4J.2 should be updated to reflect this.

Annex 1: Proposed Amendments and Commentary on Special Condition 4M (to be read in conjunction with the marked-up version)

Comment Number	Paragraph	Comment
1	4M2	We propose that there should be mention here of benefit to users of the NETS / market participants as well as consumers. This would appear to be supported by 4M.5(a).
2	4M8(a)	We propose removing the words ‘at all times’ as they are redundant. We suggest: “keep the Forward Plan under review during a Relevant Year t, including taking into account any representations made by FP Consultees in that year”
3	4M.9	We propose including a condition for the Authority to provide an informal opinion on the Forward Plan prior to publication at the end of March. It would be unreasonable for the Authority to provide an opinion that could detrimentally impact on incentive performance when there is no ability to revisit the Forward Plan until the following year.
4	4M.11	We propose removal of the words ‘without limitation’ as their inclusion suggests that changes could be proposed to the ESORI guidance document during relevant year t. This introduces additional uncertainty for the ESO.
5	4M.11(f)	We propose that this condition includes the rights of representation and dispute that the licensee has in respect of the Formal Opinion, the recommendation of the panel and the determination in respect of IncPayExt.
6	4M.12	We have significant concerns about the inclusion of this condition particularly in conjunction with 4M.11. This combination introduces new licence conditions, which require the compliance of the licensee, which the Authority can update ‘without

		<i>limitation’.</i>
7	4M.13	We propose that this condition includes provision for the licensee’s right to appeal against the proposed changes.
8	4M.14	We request clarity on when the “requirements in the ESORI Guidance Document” will be finalised to understand the impact of this condition.
9	4M.15	We wish to highlight that due to the reporting deadline of 7 October that the “Mid-Year Report” will primarily report on the achievements within the first 5 months of the scheme. We would propose a deadline of the 15 th working day in October to ensure that half of the performance year is captured and reported, and to allow the ESO to continue cost reporting on the same basis as has been undertaken for many years for balancing costs
10	4M.17	We wish to highlight that the submission date of the “End of Year Report” may require the use of initial data. This data will be to the “best of our knowledge and belief” “accurate and correct” at that point in time, but may be subject to change once the fully reconciled data is available.
11	4M.19	We request that the Authority directs the value of IncPayExt_t by 31 July at the latest. Delay to the reconciliation of payment recovered throughout relevant year t introduces unnecessary financial uncertainty to the ESO and industry.