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Email: ESOperformance@ofgem.gov.uk

Date: 28 March 2018

Dear Colleagues

Decision to modify the special conditions of National Grid Electricity Transmission plc's licence in order to introduce new reporting and incentive arrangements for the Electricity System Operator

This letter sets out the Authority's decision to modify the special conditions of National Grid Electricity Transmission plc's (NGET's) electricity transmission licence. We are amending special conditions 4B, 4C and 4J; removing special conditions 4D, 4E, 4F and 4H; and inserting new special condition 4M. These changes will introduce a new set of reporting and incentive requirements for the Electricity System Operator (ESO) and enable the 'SO-TO funding mechanism' to continue from 2018/19 onwards.

The letter also notifies stakeholders that we have today published our Guidance Document for the new ESO Reporting and Incentives Arrangements and explains the changes we have made in response to stakeholders' views.

Background to the licence modification

The ESO sits at the centre of our energy system. It has a number of different roles, from the day-to-day operation of the system, through to managing new network connections and longer-term network planning. The ESO role is currently carried out by NGET.

We believe our rapidly evolving energy sector needs an ESO that proactively responds to longer-term system challenges and maximises consumer benefits across the full spectrum of its roles. We want the ESO to work more closely with its stakeholders and other energy sector parties to ensure there is a coordinated approach to system operation and planning. We also want a more dynamic ESO that readily responds to new developments.

From April 2019, the ESO is due to become a legally separate company within the National Grid plc group. We believe this will ensure the ESO is well-positioned to take on a more proactive role in shaping the energy system transition. To support our aims for the new ESO, we are also making changes to its regulatory and incentives framework.

On 23 February 2018, we published our policy decision on a new regulatory and incentives framework for the ESO to apply from April 2018. Under our new approach, we will set our clearer expectations for the behaviours and outcomes required from the ESO. The ESO is then required to engage with stakeholders to identify how it can best meet these expectations and maximise benefits for consumers. In particular, we have decided to introduce a new set of reporting requirements on the ESO, including an obligation to work with stakeholders to develop an annual Forward Plan. We also decided to replace the

previous ESO incentive scheme with a broader, more 'evaluative' financial incentive. For more information, please see our policy decision document.¹ Alongside this policy decision, we published our statutory consultation on the licence changes needed to implement the new framework. This consultation closed on 23 March 2018.

Summary of responses and our changes

We received four responses to our statutory consultation. These are published on our website alongside this letter. The points raised by respondents included some suggested additions to the processes and procedures under the new arrangements, as well as wording clarifications and the correction of typographical errors. Other key points included:

- Transmission losses reports: a Scottish Transmission Owner (TO) respondent raised a concern about our proposal to remove special condition 4I (which requires the ESO to produce reports relating to transmission losses). This respondent noted that TOs are reliant on the information produced by the ESO under this condition to fulfil their own licence obligation to report annually on transmission losses.
- Incentive payment/penalty recovery: the ESO provided its revised thinking on how best to recover incentive payments/penalties under the new arrangements and suggested that changes to special condition 4C would be needed to enable this.
- SO-TO funding mechanism: three respondents wanted clarity on whether our changes to special condition 4J (SO-TO mechanism) would allow funding to be recovered in relevant years other than the year in which TO works are carried out.

Based on the stakeholder responses, we have made a number of changes from the consultation version of the modification. These are mainly to correct typographical errors and address minor issues raised in the consultation responses. We have also made changes based on issues we identified. These changes are firstly to ensure consistent references to the new arrangements throughout the licence, and secondly to ensure there is robust process for changing the incentive cap/floor in future.

In response to the three key points raised above:

- Transmission losses reports: We have decided not to make the proposed modification to remove special condition 4I. Our future aim is to move to a more 'principles-based' approach to reporting requirements, where the onus is on the ESO to identify the best ways of reporting on the information needed by its different stakeholders. However, in this instance, because the specific information reported under this condition is needed by the TOs to fulfil a licence requirement, we believe that it is important to keep this requirement in place (at least until we have had the opportunity to consider this requirement fully).
- Incentive payment/penalty recovery: We have considered the ESO's views that it may be appropriate to make changes to the incentive payment / penalty recovery period. However, we consider a change to special condition 4C of this nature would be a material change from the position we consulted on and that it would not be appropriate to make such a change at this stage in the process. Nevertheless, we welcome the ESO's updated thinking in this area. We encourage the ESO to work with its customers and stakeholders to consider options for cost recovery under the new arrangements. We will work with the ESO and stakeholders to consider whether further changes to the licence are required as a result of this engagement.
- SO-TO funding mechanism: We do not believe additional changes are needed to special condition 4J based on the responses. However, we have responded to the requests for clarification on how the funding allowance can be used by providing further guidance in our response in Annex 1.

For more details on the key points raised and our responses, please see Annex 1.

¹ Policy Decision on the Electricity System Operator regulatory and incentives framework from April 2018: <https://www.ofgem.gov.uk/publications-and-updates/policy-decision-electricity-system-operator-regulatory-and-incentives-framework-april-2018>

Our decision

Having carefully considered the responses to our statutory consultation, we have decided to proceed with modifications to the special conditions of NGET's electricity transmission licence. We are amending special conditions 4B, 4C and 4J; removing special conditions 4D, 4E, 4F and 4H; and inserting new special condition 4M. A statutory decision notice modifying NGET's licence has today been issued to NGET. This has also been published on our website alongside this letter.

These modifications to the licence will take effect on 24 May 2018, and will apply to the period from 1 April 2018, when the new incentive year begins.

Publication of our Guidance Document for ESO Reporting and Incentives Arrangements

Today we have also published our Guidance Document for the new ESO Reporting and Incentive Arrangements. This provides guidance on the new incentive scheme processes, the new reporting requirements placed on the ESO, and the approach the Authority will take to determining an incentive payment or penalty each year. The Guidance Document will apply from 1 April 2018.

We published a draft version of this Guidance Document for comments on 23 February 2018. We received comments from three respondents covering a range of topics. In particular, there were a number of comments seeking further details on the operational details and timings of the new ESO Performance Panel. Stakeholders also asked for more clarity in the wording in a number of places.

Following our review of the stakeholder comments, we have made a number of revisions to the guidance. Our revisions have mainly been to improve readability and clarify wording, as well as to respond to specific points raised by respondents. We have not added significant additional detail in relation to the Performance Panel at this stage, as we intend to develop this detail over the course of the coming months to enable us to seek views of the Performance Panel (once established). The responses we have received to this consultation will help inform our work in this area.

For more details on the stakeholder comments and our responses, please see the Annex 2.

Next steps

The new arrangements will commence from 1 April 2018. The ESO published its final Forward Plan for 2018-19 on 27 March 2018.² We will now review the final plan and the stakeholder responses to this in order to produce our Formal Opinion. Where there is sufficient information available, our Formal Opinion will aim to provide a steer on the ambition of the Deliverables and Performance Metrics contained in the plan. This should help provide the ESO with additional clarity on how it needs to perform in 2018/19 in order to unlock incentive payments and/or avoid incentive penalties.

We are currently in the process of forming and implementing the new ESO Performance Panel. We intend to engage with industry over the final details and are aiming to have this in place by the first Mid-Year Review process in October/November 2018 at the latest.

Stakeholder feedback is a key aspect of our new regulatory arrangements for the ESO. We have been encouraged by the contribution stakeholders have made to the ESO's Forward Plan process. We strongly encourage stakeholders to continue engaging with the ESO to

² Electricity System Operator Forward Plan 2018-19: <https://www.nationalgrid.com/uk/about-grid/our-role-industry/future-electricity-system-operator>

shape its plans and activities over the course of next year and beyond. If you have any feedback on the ESO's performance throughout the course of 2018/19, including both positive examples and areas of concern, you can provide details of these to us by sending an email to our new mailing list: ESOperformance@ofgem.gov.uk.

Ongoing review of the new arrangements

Our decision represents a fundamental change to the way we incentivise the ESO. We therefore expect there will be lessons we can learn as the year progresses. We intend to review the effectiveness of this new framework over the course of 2018/19. Whilst our intention is that this overarching approach would remain broadly the same for the three-year period between 2018 and 2021, we will consider the need to make changes to the scheme processes and parameters from 1 April 2019, alongside the legal separation of the ESO.

The findings from this review will also inform the design of the RIIO-2 framework for the ESO, which is due to commence in April 2021. We recently published a consultation on the overall RIIO-2 framework. In this consultation we proposed that the ESO should have its own separate price control. We also set out the high-level options for its remuneration model.³ Over the course of this year, we intend to engage with stakeholders to further develop the policy for the ESO's RIIO-2 price control arrangements.

If you have any questions regarding the contents of this letter, please contact David Beaumont using the email address above.

Yours faithfully

Philippa Pickford
Associate Partner, Energy Systems

³ <https://www.ofgem.gov.uk/publications-and-updates/riio-2-framework-consultation>

Annex 1: stakeholder comments on proposed licence modification

This annex summarises the key stakeholder points made during our statutory consultation on licence changes for the new reporting and incentive arrangements. The full responses have been published on our website alongside this decision letter.

Condition	Summary of key points	Our response
Existing special conditions		
4C	The ESO suggested a change to this condition to allow incentive payments/penalties to be recovered in Relevant Year t+1 if needed. This is to minimise the impact that an incentive decision made in Year t+1 may have on BSUoS charge volatility in Relevant Year t (e.g. where the final payment/penalty significantly differs from forecasts).	We have not made this change at this point, as we believe it is a material change from the modification notice, which we did not have enough time to consider fully or follow due process to implement prior to the Modification. However, we welcome the ESO's updated thinking in this area and are keen to work with the ESO and industry to identify the best approach to recovering incentive payment/penalties under the new arrangements. This could include consulting on changes to the incentive recovery period via a separate licence change process.
4I	Information published by the ESO under this requirement is needed by Transmission Owners (TOs) to fulfil a legal reporting requirement.	Having considered this response we have decided not to make the amendment to remove this condition. Our aim with the new arrangements is to move to a more principles-based approach to reporting requirements, where the onus is on the ESO to identify the best ways of reporting on the information stakeholders need. However, because the specific information reported under this condition is needed by the TO's to fulfil a licence requirement, we think it is important to keep this condition in place.
4J.2	Three respondents (the ESO, SP Energy Networks and SSE) asked for clarification on the proposed changes to the COS _t term in condition 4J.2. They wanted to clarify whether the ESO could fund or commit to funding TO works in years outside of the year in which the relevant works take place.	The licence modification removes the previous sunset clause for the COS _t term. There will therefore be an allowance of £1,146,800 available in each regulatory year from 2018/19 onwards (assuming no further changes to the licence). We have not identified any restrictions in the licence which prevent the ESO from agreeing works with the TO in years outside of the year in which payments are recovered. We note that any further changes to this licence condition would need to go through the licence change process. At this point in time, we are not considering any changes to the allowance. However, it is likely that this condition will be reviewed before the start of 2021/22 (when the RIIO-2 framework is due to commence).
4J.2	Errors in references to 'SOTOc _t ' and 'SP Transmission plc'.	We have corrected these errors.
New special condition 4M		
4M.1 (b)	Potential error in wording.	We have corrected this error by removing 'and'.
4M.3 (a)	Clarity needed to explain how the ESO should be seeking to maximise consumer benefits. Current wording could imply that the ESO should be seeking to maximise the length in time of consumer benefits.	The intention behind this condition is for the ESO to consider actions that would deliver the greatest overall benefits for consumers across time horizons. We have clarified this in the final licence text.

4M.4	There should be minimum 4-week consultation period for the draft ESO Forward Plan.	We believe this is adequately covered by the ESORI Arrangements Guidance Document, which the ESO is required to comply with.
4M.5	Clarity may be needed to ensure that 'FP consultees' refers to all the persons in 4M.5 rather than just those in 4M.5 (d).	'FP consultees' refers to all persons in 4M.5. We have made a formatting change to clarify this.
4M.6 (b) and (c)	The ESO should be required to report on and explain why it may have rejected part of a stakeholder's consultation response.	We agree with this, but believe it is already captured under the wording of the consultation licence text. We have added a line to the ESORI Arrangements Guidance Document to further clarify this point.
4M.13	Suggestion by the ESO to add a line specifying that any changes to the ESORI Guidance Document that change the way the ESO is assessed should only apply from Year t+1.	We are not making this change, as we believe this issue is adequately addressed in the ESORI Arrangements Guidance Document. Whilst we agree with the principle, we believe there would be benefits in enabling certain changes to the guidance document within a regulatory year (for example, when all parties agree a process change is needed). This is particularly important in this first year of the new arrangements.
4M.18	Request for a materiality threshold in relation to the requirement to notify and republish inaccurate or erroneous information.	We believe the ESO should notify the Authority of all inaccuracies and errors to the information it publishes under the new arrangements. Whilst we recognise it may not be practical to correct and republish every identified inaccuracy or error, we believe we should make this judgement. We have therefore added 'unless otherwise agreed by the Authority' to address this point.
4M.19	Request for Authority to direct incentive payments by 31 July at the latest.	We cannot oblige the Authority to meet deadlines in NGET's licence. The date in the licence is indicative of when the Authority will aim to make a decision by, but the Authority can use its discretion to make a decision at a later date if necessary.
4M.20	Request by the ESO to specify that the incentive cap/floor of £30m only applies to 2018/19, and that the Authority should consult on the value for future years.	We do not believe we should reference 2018/19 only as this would potentially force the need for a licence change process for future years. However, we do consider that any changes to this important parameter should be made via a robust process. We have therefore removed the ability for the Authority to direct a different cap/floor, so that a change would have to be made via a licence change consultation process.
Part G	Add definitions for Mid-Year Report and End of Year Report	We have added these definitions.

Annex 2: stakeholder comments on the draft ESO Reporting and Incentive Arrangements Guidance Document

This annex summarises the key stakeholder comments we received on our draft ESO Reporting and Incentives (ESORI) Arrangements Guidance Document.

Summary of key points	Our response
Chapter 2	
Performance Panel processes, timings and details	
The 31 January deadline for the draft Forward Plan may be too late, especially if the Panel meeting is held in February. The panel meeting should be after the consultation period to enable it to take on stakeholder views.	<p>We are currently working on the detailed design of the Performance Panel, including the potential transitional arrangements in place during the first year. We expect to update industry on the arrangements over the coming months.</p> <p>For 2019/20, we currently believe that the Performance Panel would provide a review of the plan, but that the responsibility for producing the Formal Opinion will remain with Ofgem.</p> <p>However, we recognise that the panel may need a good understanding of the ESO's stakeholder views in order to effectively comment. In practice, we expect the ESO to engage with stakeholders well before 31 January 2019, and clearly state in its draft Forward Plan how it has built on these views.</p>
The Panel review report should be published before the end of the Forward Plan consultation to allow the ESO time to incorporate its comments.	
A 2-week review period for Mid-Year Report could be too short for the Panel to take account of stakeholder views.	
More clarity is needed on how the Performance Panel engages with the ESO's customers; whether there needs to be closed sessions; which reports and briefings will be public and whether the Panel should see confidential information.	
Question about whether Ofgem would be able to influence the Panel's recommendation before it is made.	
Question around whether the ability for stakeholders to submit further evidence could undermine the effectiveness of the panel. Clarity needed on what the timings for this would be and how that would impact upon Authority decisions.	We believe it is appropriate for Ofgem to have a more active role in the Panel for year one of the new arrangements; particularly as the Panel will not be in place from the start of the year to review the Forward Plan. However, we recognise the potential benefits of a more autonomous panel, and we will review Ofgem's role in future years. In any case, the Authority would always need to be the final decision maker on incentive payments/penalties.
Chapter 3	
Establishing a baseline	
It may be difficult for the Panel to understand 'baseline expectations', particularly if Ofgem's view significantly differs from the ESO's. The Panel may also find it difficult to gauge weightings for metrics. It may be wise to enable further iterations to the Forward Plan or for Ofgem to 'rebase' the metrics this first year.	We recognise the challenges of identifying a baseline under a more evaluative scheme. Our intention is that the ESO's principles and our Formal Opinion will help provide clarity in this area. However, we believe the alternative of placing too much focus on data-driven metrics would not lead to the more proactive and flexible behaviours we want the ESO to display. This is why the incentive decision will be based on a number of criteria rather than metrics alone. We expect the ESO to be flexible and deviate from its plan where necessary. However, we think a process for revising the plan document would add undue complexity to the new framework.
Chapter 4	
Evaluating the ESO's role in supporting competition in networks	
There could be limited opportunity for activity in this area, making an incentive evaluation difficult. The ESO should instead be measured on its role in facilitating timely and efficient network investments and establishing a more effective framework for sharing information.	Our expectations for the ESO in this area are set out in our Roles and Principles Guidance document. We consider that the ESO can deliver additional consumer benefits in this area through its role in the Network Options Assessment, as well as through industry engagement and information provision. Our policy decision was to have equal pots available for each Principle. However, we will keep this under review for next year.

Chapter 5	
Reporting requirements	
Reporting requirements should be reviewed over course of 2018/19 – it is not immediately clear monthly frequency is necessary.	We still believe monthly reporting of metrics (where practicable) is appropriate. We will review this over the course of 2018/19.
There should be a materiality threshold for republishing inaccurate data.	We have clarified paragraph 5.4 of the Guidance Document in line with our changes to licence condition 4M.8.
The Forward Plan should specify the detailed questions that will be asked in the stakeholder surveys.	We agree. We have added a section to Chapter 5 to make it clear that the ESO should ensure this is the case from 2019/20 onwards.
Other points	
Clarity of wording	
More clarity is needed in a number of places. This includes in paragraphs 2.25, 2.3, 2.29, 3.15, 3.22, 4.8 and Box 3.	We have provided more clarity in a number of areas and made changes throughout to assist readability.