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Dear colleagues,

**Industry update following our Future Arrangements for the Electricity System Operator: Informal Consultation on Electricity System Operator Licence Drafting**

In January 2017, BEIS, Ofgem and National Grid issued a joint statement<sup>1</sup> which stated that a more independent Electricity System Operator (ESO) could realise benefits for consumers by enabling a more competitive and flexible system. The statement set out our joint views that the ESO should be underpinned by a governance structure that mitigates any actual or perceived conflicts of interest, and is ready to adapt further as system challenges continue to evolve. The statement recognised that a more independent ESO would need to be underpinned by impartial governance. The joint statement also recognised that greater ESO independence could increase consumer benefits through a greater focus on transparency, markets and competition.

In December 2017, we published a consultation document providing detail on how we expect to implement the legal separation of the ESO from NGET.<sup>2</sup> This set out our thinking on how we expect NGET's electricity transmission licence to be split into two separate electricity transmission licences – an NGET TO licence and an ESO licence. Our December 2017 consultation document should be read in conjunction with this update.

Our December 2017 consultation included our views on the appropriate licence changes required to facilitate an effective legal separation. We invited responses to the proposals we set out and asked specific questions to stakeholders where we had not reached a clear policy position. The purpose of this update is to share the stakeholder views we received and to explain how our policy positions have developed in light of these views and the additional policy analysis we have undertaken in early 2018. We have also included updated licence drafting to show how these policy positions have been translated into licence obligations.

We expect NGET to submit its formal application to transfer part of its existing transmission licence to the new ESO entity by the end of March. The preliminary window between now and the end of March provides an additional opportunity for industry to flag any urgent concerns with our updated policy and licence drafting set out in this update. Following National Grid's application we will also hold statutory consultations on the proposed

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<sup>1</sup> Statement on the future of Electricity System Operation  
[https://www.ofgem.gov.uk/system/files/docs/2017/01/statement\\_on\\_the\\_future\\_of\\_electricity\\_system\\_operation.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/01/statement_on_the_future_of_electricity_system_operation.pdf)

<sup>2</sup> Future Arrangements for the Electricity System Operator: Informal Consultation on ESO Licence Drafting  
<https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-informal-consultation-eso-licence-drafting>

modifications to the licences. These statutory consultation periods are expected to take place from early April to early July.

This rest of this update is structured around the following sections:

- (1) a summary of the stakeholder views received on our general approach to licence separation and ESO governance;
- (2) details of stakeholder views and the material changes that have been made to specific licence conditions since our previous consultation;
- (3) the next steps for the ESO separation programme; and
- (4) supporting appendices (including updated draft licence text).

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## **(1) General approach and ESO governance**

In our previous consultation, we provided an overview of the licence structure envisaged for the two organisations (NGET and the ESO) and invited stakeholder views on our proposals and in specific areas where we had not reached a clear policy position. The proposals we outlined aimed to achieve two key goals:

- i. to underpin the minimum requirements for separation; and
- ii. to identify and specify interfaces between NGET, the ESO, and the wider industry

Six respondents replied to our previous informal consultation on ESO licence drafting. This included Elexon, SSE, Scottish Power, Drax Group, National Grid and UKPN. These responses have been published on our website<sup>3</sup>. We have reviewed the stakeholder responses and have highlighted our updated policy positions below.

### ***General***

In undertaking the separation of the ESO from the rest of National Grid Group plc, we have been following several guiding principles:

- There will be no reopening of the RIIO-T1 price control (which applies to both TO and ESO activities).
- We are aiming only for the minimum change required to effect separation, and that where appropriate, NGET's transmission licence will align as far as is possible with the Scottish TO's transmission licences.
- As part of this exercise we do not propose to make licence modifications that we deem to be 'housekeeping', or policy changes that are not needed as a minimum requirement for separation.
- We will also remain consistent with our published regulatory stances.<sup>4</sup>

### **Stakeholder views:**

We asked stakeholders whether they agreed with the guiding principles that we set out and whether the licence changes we proposed were sufficient for ensuring effective separation between the ESO and all other National Grid Group transmission and competitive businesses (the details of the licence changes are covered below).

Most respondents agreed with the guiding principles that we set out. Drax argued that the principle of "minimal change for separation" should be replaced with a guiding principle that the ESO should "stand alone" as a business after the legal separation has taken place. National Grid agreed with the policy aims of the guiding principles but felt that there were

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<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/future-arrangements-electricity-system-operator-informal-consultation-eso-licence-drafting>

<sup>4</sup> <https://www.ofgem.gov.uk/publications-and-updates/ofgems-regulatory-stances>

some instances where the guiding principles of “minimal change for separation” and “alignment with Scottish TOs” had not been appropriately applied.

Most respondents also agreed that the licence changes we proposed were sufficient for ensuring effective separation between the ESO and other National Grid Group transmission and competitive businesses. National Grid argued that the proposed licence amendments impose unnecessary additional change. On the other hand, Drax argued that the licence changes did not go far enough to enable the ESO business to “stand alone” if a full separation is mandated in the future. They suggested additional licence conditions to alleviate real or perceived conflicts of interest. As a result, Drax did not support the sharing of staff and operating a ‘1SO’ model<sup>5</sup>.

#### **Updated policy position:**

We have decided to continue using these guiding principles to shape our policy discussions going forwards. So far, the guiding principles have been a useful prioritisation framework when working through the licence and undertaking the separation of the ESO from the TO. We also support the ‘1SO’ model where the cross-SO activities are appropriately defined. As noted in our previous consultation, we think this model is in the interests of customers. Particularly when it provides a single combined system operator view of energy security and insights into the interactions between the gas and electricity sectors

#### **Governance**

##### **What we said:**

The ESO should have its own board, with three sufficiently independent directors. We proposed that no members of the ESO Board should sit on the National Grid Group plc board or the boards of other National Grid Group plc electricity subsidiary companies. We further proposed that we would modify Special Condition 20 (*Business separation requirements and compliance obligations, and conduct of the System Operator in performing its Relevant System Planning Activities*) for the ESO’s licence to detail the governance requirements for the ESO.

##### **Stakeholder views:**

We asked stakeholders whether our proposals for sufficiently independent directors would provide sufficient separation. All respondents agreed with our proposals regarding sufficiently independent directors. Elexon suggested that we should consider whether ESO stakeholders could have powers to request the removal of any ESO board director akin to the powers of BSC stakeholders in the BSC to remove ELEXON directors (implemented under BSC Modification P324).

##### **Updated policy position:**

We have reflected the requirement for three sufficiently independent directors on the ESO board in our updated licence drafting. Although an innovative suggestion, we do not believe Elexon’s proposal to remove directors is required at this point in time; however, it could be considered as a future development subject to a review of the effectiveness of the initial separation requirements. Further discussion of the modifications proposed to the ESO’s Special Condition 20 can be found in the next section.

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<sup>5</sup> The ‘1SO’ model is National Grid’s internal name for the joint organisation, under a single executive, that discharges the system operator accountabilities for the boards of both National Grid Gas and NGET (post-separation this will change to the board of the ESO).

## **(2) Material changes to licence conditions**

We have considered the existing special licence conditions within NGET's electricity transmission licence to determine whether they should apply to the TO, the ESO, or both in future. Below we have provided our updated policy positions in the areas where material changes have been proposed since our previous consultation, or where we previously asked for stakeholder feedback.

### **1A (Definitions and Interpretation)**

A number of the definitions used in the existing NGET transmission licence are relevant for only the ESO or TO. Only the relevant definitions will be transferred to the ESO licence and, similarly, only the relevant definitions will be kept in the NGET TO licence. The licence separation also necessitates the definition of 'Transmission Business Activities' to be modified to align with the Scottish transmission licences as the current distinction between NGET's transmission owner and system operator activities will no longer be required.

### **1C (Amended standard conditions)**

As with the definitions in Special Condition 1A, the current amended standard definitions must be allocated between the ESO and NGET TO licence. Of particular note, we proposed to amend the standard definition of 'Transmission Business' to exclude National Grid's TO business from the ESO definition and, likewise, to exclude the ESO from the NGET TO definition.

### **2A (Activities restrictions)**

#### **What we said:**

Special Condition 2A places restrictions on the activities that the licensee can undertake. In the current form of Special Condition 2A, the activities restrictions are linked to the transmission area which is a TO concept. As the ESO will not have a transmission area, we were minded to not include Special Condition 2A in the ESO licence and retain Special Condition 2A in its current form in the NGET licence.

#### **Stakeholder views:**

We asked stakeholders whether the ESO should have a licence condition that restricts the activities it can undertake (and if so, what activities should be restricted). All stakeholders, except for National Grid, supported a licence condition that restricted the activities the ESO could undertake. Drax argued that ESO activities should be limited to technical and commercial actions necessary to plan and operate electricity networks. Elexon argued for a restriction on National Grid developing a Balancing Market Reporting Service (BMRS) platform as this would confuse the market given that Elexon already provides this. Scottish Power suggested a restriction on ESO/OFTO activities. SSE suggested that any condition needed to be carefully drafted to ensure that customers are not prevented from potential savings due to the limitation of the ESO's remit.

National Grid did not think a licence condition that restricts the activities it can take was required in the ESO licence. They argued that the new ESO licence should relate to ESO activity only and as a result should prevent asset building. They also referenced a similar licence condition B6 (Restriction on Activity and Financial Ring Fencing).

#### **Updated policy position:**

We have proposed that Special Condition 2A will not apply to the ESO. Any new activity restrictions for the ESO would go beyond the principle of minimum change required to effect separation. Special Condition 2A will remain in the NGET licence unchanged. The restrictions on both the ESO and NGET TO related to holding an OFTO licence will be maintained, as it is currently, in Special Condition 2C.

**Special condition 2B (Restriction on the use of certain information) and Special condition 2H (Appointment of a Compliance Officer)**

**What we said:**

In its current form, Special Condition 2B applies when the licensee has received an application for connection to the National Electricity Transmission System in either England or Wales, or in an area which is outside the licensee's Transmission Area. Once separation has taken place, this condition should no longer apply to the TO in its current form, as the TO will not receive connections applications. We thought it was still necessary to place restrictions on the way in which the TO may use information. Therefore, we were minded to keep Special Condition 2B in NGET's TO licence, but change the wording to reflect the Special Condition 2B licence condition that is currently used in the Scottish TO licences (which refers to restriction on the use of information more broadly rather than specifically in relation to connection applications).

Special Condition 2H is closely linked to Special Condition 2B, as it details the requirements for the licence holder to appoint a Compliance Officer for the purpose of facilitating compliance with Special Condition 2B. As we were minded to keep Special Condition 2B in the NGET licence only, we were minded to keep Special Condition 2H in the NGET licence as well.

**Stakeholder views:**

We asked stakeholders if a modified version of Special Conditions 2B and 2H were necessary for NGET.

Elxon supported modifying Special Conditions 2B and 2H but did not support the suggested appointment of a specific compliance officer within the ESO licence. Elxon saw this activity as being part of a wider role within National Grid. Scottish Power argued against modifying Special Conditions 2B and 2H as information ring-fencing will be covered under Special Condition 2O of the ESO licence.

National Grid did not support modifying Special Conditions 2B and 2H for the NGET TO licence because the current form of Special Condition 2B in the Scottish TOs licence exists to address the specific issue of vertical integration, which does not apply to NGET. Consequently, they argued that Special Condition 2B was not required in the NGET licence and therefore neither was the associate Special Condition 2H. National Grid also stated that inclusion of Special Condition 2B and associated Special Condition 2H in the NGET TO licence would introduce significant inefficiency without further policy aims and jeopardise the viability of their current TO operating arrangements.

**Updated policy position:**

We acknowledge National Grid's view that the original intention of Special Condition 2B was to ensure unbundling of the vertically integrated companies, and note that NGET is not, nor will be, vertically integrated. We also recognise stakeholders views that NGET should have some restrictions placed upon it in regard to the use of certain information. Therefore we are proposing to not use Special Condition 2B and Special Condition 2H in the NGET

licence. However, restrictions on the use of information and compliance will be included within Special Condition 2C and Special Condition 2O respectively in the NGET licence.

For completeness, we've proposed that Special Condition 2B (Restriction on Use of Information) will not apply to the ESO. Instead, we will incorporate restrictions on the use of information into our amended version of Special Condition 2O (further details below).

### **2C (Prohibited Activities and Conduct of the Transmission Business)**

#### **What we said:**

Special Condition 2C prohibits the licence holder from holding a transmission licence that has Section E (Offshore Transmission Owner Standard Conditions) in effect, and places requirements on the conduct of the transmission business. This condition was originally placed in NGET's licence, as a result of the TO and ESO operating under joint ownership.

We proposed to keep Special Condition 2C in both the TO and ESO licence to prevent NGET and the ESO from holding an OFTO licence.

#### **Stakeholder views:**

We asked stakeholders whether Special Condition 2C should apply to NGET in its current form and for views as to whether allowing NGET to acquire an OFTO licence would be beyond the scope of the separation project and therefore should not be considered at this stage.

Scottish Power noted that allowing NGET to acquire an OFTO business was beyond the scope of the separation project and therefore should not be considered at this stage. Elxon argued that any change would go against our guiding principles of minimal change and SSE stated this would constitute a substantial policy change and would therefore need to be consulted on separately. They recommended that such a decision should be considered during a wider review of the OFTO regime.

National Grid argued that there should be no restriction on NGET acquiring an OFTO licence as Scottish TOs are not prohibited in relation to holding an OFTO licence. They argued that the guiding principles of minimal change for separation and maintaining alignment between NGET and Scottish TO licenses would not be met if the activities prohibition in Special Condition 2C remained in force in NGET's licence.

#### **Updated policy position:**

We agree with the stakeholders who stated that removing this condition and allowing NGET to acquire OFTO business would constitute a substantial policy change and go beyond our core principle of undertaking the minimal changes required for separation. We think that it is necessary to see first how the separation arrangements are working as a whole, and then assess in future whether the OFTO activities prohibition in Special Condition 2C should be removed as an obligation on NGET. We consider that such a change (on whether NGET should be able to hold an OFTO licence) would require further policy analysis and targeted consultation which is outside the scope of this project.

We have also updated the Conduct of the Transmission Business section of Special Condition 2C to add a clear obligation on NGET TO's use of information. Whilst assessing the existing special conditions we identified a potential gap, post-separation, related to the TO's use of information mistakenly disclosed by the ESO. The additional obligation inserted into Special Condition 2C clarifies that the TO must not make use of any information received from the ESO, where this information has been disclosed through the ESO failing to abide by its own information disclosure obligations.

## **2I (Independence of and appointment of managing director of the Transmission Business)**

### **What we said:**

Special Condition 2I is not currently used in NGET's transmission licence. However, Special Condition 2I is used in the Scottish TO licences to ensure that the licensee establishes and maintains the full managerial and operational independence of the Transmission Business from any of the licensee's affiliates and related undertakings. This includes appointing a managing director to be responsible for the conduct of the transmission business and any external transmission activities. Whilst we stated that one of our guiding principles is to align NGET's TO licence with the Scottish TO licences, we said that we were minded to not include Special Condition 2I in NGET's licence, as the situation that it is looking to manage (in respect of a vertically integrated undertaking) is not applicable in respect of NGET.

However, we were considering whether to create a new Special Condition 2I for the ESO, with the wording made relevant for the ESO and its activities.

### **What stakeholders said:**

We asked stakeholders whether Special Condition 2I should apply to NGET and/or the ESO. Three respondents (Elexon, Scottish Power and Drax) thought that Special Condition 2I should apply to the ESO only. In particular, Elexon argued that there should be a requirement for the managing director of the ESO to be independent from NGET in order to maintain separation.

SSE argued Special Condition 2I should apply to NGET because it is important that NGET maintains full managerial and operational independence of its transmission business as National Grid Group has interests in other parts of the energy market.

National Grid argued that Special Condition 2I should not apply to NGET or the ESO. They stated that the provisions in the Scottish licences are specifically seeking to manage a vertically integrated undertaking which is not applicable to NGET. Furthermore, National Grid noted that governance should be covered under Special Condition 20 for the ESO. They were also concerned that Special Condition 2I could frustrate their existing '1SO' model.

### **Updated policy position:**

Special Condition 2I is not required for the NGET TO licence nor the ESO licence. However, the business separation requirements on persons engaged in the management or operation of the ESO or NGET TO are necessary and these requirements are comprehensively set out in Special Condition 20 in both the ESO and NGET TO licences (further details below). We further note that Special Condition 20 does not exist in the Scottish TOs' licences and the provisions therein, we believe, go beyond the provisions of 2I in safeguarding the independence of the SO from the rest of the National Grid businesses.

## **2J (The Network Access Policy)**

The Network Access Policy (NAP) is predominantly a TO obligation. In our previous consultation, we did not ask a specific question to stakeholders on Special Condition 2J. Nevertheless, we included details of some minor modifications to the NGET TO licence to remove ESO obligations and to align the NGET Special Condition 2J with that used in the Scottish TO's licences.

We have now proposed to include a shortened version of Special Condition 2J in the ESO licence. This is to reflect the ESO's existing obligation to facilitate and contribute towards all TOs' development of NAP and to incorporate the outcome of NAP into ESO planning.

**20 [ESO] (Business separation requirements and compliance obligations, and conduct of the System Operator in performing its Relevant System Planning Activities)**

**What we said:**

Special Condition 20 currently sets out the business separation requirements between the licensee and the Relevant Other Competitive Businesses<sup>6</sup> (ROCB), the licensee's obligations as to its conduct in performing its Relevant System Planning Activities and the process the licensee must follow to comply with these obligations. While the focus of this condition is on separating NGET activities from other competitive businesses, we considered that going forward it could also provide the basis for the physical, legal and regulatory separation of the ESO from NGET's Transmission Ownership (TO) businesses.

We also considered that further changes to Special Condition 20 would be necessary to facilitate the retention of the '1SO' model. In particular, the provisions of Special Condition 20 should include details regarding the interface between the ESO and the gas system operator, to ensure that the sharing of information between the two entities takes place in specific circumstances and is subject to controls without losing the benefits of the synergies arising from close cooperation between the two system operator businesses.

We considered that the provisions the ESO and NGET TO would be required to make should be set out in Special Condition 20. However, the details of how those provisions are met could be set out in the accompanying compliance statement in order to ensure that stakeholders can be sufficiently comfortable with the separation of the ESO in practice.

**What stakeholders said:**

We asked stakeholders whether an amended version of Special Condition 20, as described above, would provide sufficient safeguards regarding the separation of the ESO from other National Grid Group plc companies. All respondents agreed with having an amended version of Special Condition 20 for the ESO.

Elexon stated that Special Condition 20 should cover the interface between the ESO and the gas system operator. They wanted to ensure that the sharing of information between the two entities takes place in certain circumstances and is subject to controls.

National Grid agreed at a high level with the proposal for Special Condition 20. National Grid agreed with the proposed measures regarding governance, financial ring-fencing, physical separation, employee incentivisation and transfer, shared services, culture and visual identity. However, they did not support the information ring-fencing obligation extending to all of the National Grid Group. National Grid argued the defined ring fence should be between the ESO and both NGET and ROCBs but not National Grid Gas (NGG). National Grid also argued that our proposal requires too much detail to be included in the licence. They proposed that these details should be included within the compliance requirements (Special Condition 20 Part D) rather than being expressed as licence

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<sup>6</sup> Relevant Other Competitive Businesses is defined in the NGET licence as meaning the business of: (a) participating in, or intending to participate in, a competitive tender exercise to determine a person to whom an offshore transmission licence is to be granted; (b) an Offshore Transmission Owner; (c) undertaking carbon capture and storage activities; or (d) owning and/or operating an entity participating in, or intending to participate in, activities which require a licence under section 6(1)(e) of the Electricity Act 1989.



obligations. For instance, greater clarity on the ESO/NGG interface should be captured in the compliance statement.

### **Updated policy position:**

We have proposed to include Special Condition 20 in the ESO licence and rename it to 'Business separation requirements and compliance obligations, and conduct of the System Operator in performing its System Operator Functions'. It provides the fundamental obligations for the physical, legal and regulatory separation of the ESO from National Grid's regulated businesses (NGET and National Grid Gas), as well as maintaining separation between the ESO and National Grid's other competitive businesses.

National Grid's 'ISO' model is permitted via the targeted provisions for Dual Fuel activities and roles. Dual Fuel Activities' are provisionally defined in the ESO licence as meaning: "*those activities which are conducted by the licensee in conjunction with National Grid Gas plc (company number 2006000) (and its successors in title) in its role as gas system operator in order to be delivered in a manner that provides a single combined view of energy security, insights and/or coordination into the interactions between the gas and electricity sectors, and where such activities add value for energy consumers.*"

In addition to the obligations on physical, legal and regulatory separation, Special Condition 20 includes obligations on the disclosure of system operator functions information<sup>7</sup> and the ESO's business separation compliance arrangements. It also includes provisions for the ESO board's new compliance sub-committee, which should be chaired by a sufficiently independent director and should be responsible for the ESO's compliance with the business separation duties as set out in the licence.

### **20 [NGET TO] (Business separation requirements and compliance obligations, and conduct of the System Operator in performing its Relevant System Planning Activities)**

#### **What we said:**

We were minded to keep Special Condition 20 in the TO licence (renamed to 'Business separation requirements and compliance obligations'), subject to applicable modifications, in order to maintain sufficient ring-fencing for NGET. However, as we were proposing to include Special Condition 2B in the TO licence, and as NGET would no longer be involved in Relevant System Planning Activities, the restriction on the use of certain information would not need to be included within Special Condition 20 for the TO.

#### **What stakeholders said:**

We asked stakeholders whether an amended version of Special Condition 20 for NGET was required for business separation requirements and compliance obligations.

All respondents except National Grid supported an amended version of Special Condition 20 for NGET. Scottish Power suggested that if Special Conditions 2B and 2H of NGET's TO licence were aligned with the Scottish TOs, the information ring-fencing requirements within Special Condition 20 for NGET TO could be removed or switched off.

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<sup>7</sup> System Operator Functions Information is provisionally defined in the ESO licence as meaning: *all information disclosed to or acquired in any way (and whether directly or indirectly) by the licensee's employees, agents, contractors and advisors solely by virtue of the performance of System Operator Functions by the licensee, but excluding all information that is in or has entered the public domain otherwise than as a direct or indirect consequence of any breach of this licence*

National Grid disagreed with an amended version of Special Condition 2O for NGET as they viewed this as inconsistent with the Scottish TO licences (which do not include this condition). They also argued that existing prohibitions in their licence and the Utilities Act<sup>8</sup> governed NGET information flowing to ESO, and it would not be appropriate to include any additional obligations in this respect in the NGET TO licence.

**Updated policy position:**

We agree that Special Condition 2O should be included in the NGET licence. This would be similar to Special Condition 2O for NGESO, but relate only to TO activities and obligations. Given that the ESO licence provides comprehensive obligations for separation between the ESO and NGET, the proposed NGET Special Condition 2O obligations focus on the requirement for NGET to maintain appropriate business separation between NGET and National Grid's competitive businesses.

As we have proposed not to use Special Condition 2H in the NGET licence, NGET's compliance obligations, including the need to appoint a compliance officer, should be controlled and maintained within Special Condition 2O (also see our updated views on Special Condition 2C related to the TO's use of information).

**3D (Stakeholder Satisfaction Output)**

**What we said:**

The purpose of this condition is to set out the mechanism for calculating the value of the licensee's Stakeholder Satisfaction Output (SSO). We said we were minded to keep Special Condition 3D in the NGET TO licence only. The existing amount of 0.5% for the stakeholder engagement reward, and +/-1% of TO revenue available for the stakeholder satisfaction survey would remain available and stay within the NGET TO licence. The change would be effective post separation (i.e. from 2019-20), whereby the TO survey base only will be used from this point.

**What stakeholders said:**

We asked stakeholders whether Special Condition 3D should be included in NGET TO's licence only. All respondents agreed that 3D should be included in NGET TO's licence only. National Grid agreed with the proposal to keep Special Condition 3D in the NGET TO licence only. National Grid also clarified that they expect National Grid 'customers' and 'stakeholders' will continue to be surveyed for the SSO.

**Updated policy position:**

We are minded to keep Special Condition 3D only in NGET's licence post-separation. We have asked National Grid to remove any links to ESO activities that currently exist in the TO's survey base for calculation of the incentive, thereby ensuring that the incentive is calculated on TO performance only. For the purpose of calculating the TO's Stakeholder Satisfaction Output, the existing stakeholder and customer surveys will be retained in a suitably modified form.

**3F (Adjustment in Respect of the Environmental Discretionary Reward Scheme)**

**What we said:**

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<sup>8</sup> National Grid did not specify the existing provisions in the licences and Utilities in its consultation response

This condition establishes the Environmental Discretionary Reward (EDR) scheme and includes provisions for arrangements relating to administration, governance and revision of the EDR scheme. We were minded to keep Special Condition 3F in NGET's licence only and remove any links to ESO activities as the reward primarily relates to TO activities. We considered that this would also align more closely with the Scottish TO EDR scheme.

**What stakeholders said:**

We asked stakeholders if they agreed with our proposal to keep Special Condition 3F in the NGET TO licence only. All respondents agreed that Special Condition 3F should be kept in NGET's licence only. National Grid said they supported this proposal as it is in line with the guiding principles to maintain alignment between the NGET and Scottish TO's EDR scheme and to not re-open RIIO-T1.

**Updated policy position:**

We are minded to include Special Condition 3F in the NGET licence only, as this would align with the Scottish TO stakeholder incentive. We will update the Environmental Discretionary Reward guidance to remove links to ESO activities so that the reward is calculated purely on TO activities. Please note, our proposal to keep Special Condition 3F in NGET's licence only will not change the RIIO-T1 settlement.

**3H (The Network Innovation Allowance)**

**What we said:**

The Network Innovation Allowance (NIA) is a set allowance that each of the RIIO network licensees receives to fund smaller scale innovative projects. The purpose of this condition is to calculate the value of the NIA term. Under the current arrangements, the NIA provides funding equivalent to 0.7% of NGET's base revenue. We considered that the NIA was still relevant for both NGET and the ESO, and we were therefore minded to include amended versions of Special Condition 3H in both licences.

We were minded to assign 0.5% of NGET RIIO-T1 revenue to the NGET licence in order to be consistent with the minimum level of funding available to any TO in the existing RIIO-T1 deal. Similarly, we were minded to assign the remaining 0.2% of NGET RIIO-T1 revenue to the ESO licence. This would allow the ESO to continue its current level of spending on NIA projects. For both the NGET TO and the ESO we proposed to maintain a split between 25% internal costs and 75% external costs.

**What stakeholders said:**

We asked stakeholders whether they agreed with our proposal for amending Special Condition 3H, to assign 0.5% of NGET revenue to the NGET licence and the remaining 0.2% of NGET revenue to the NGESO licence.

Most respondents (Elexon, SSE, Scottish Power and National Grid) supported amending Special Condition 3H. Elexon supported the proposed split between NGET and the ESO but suggested that it might be more appropriate to include the use of NIA in the ESO incentives scheme. National Grid supported assigning 0.5% of NGET revenue to the NGET licence and splitting this between internal (25%) and external (75%) costs. They also agreed with assigning 0.2% of the NGET revenue to the ESO licence but expressed that the current split between internal (25%) and external (75%) costs is not appropriate for the ESO. National Grid noted that they would be applying to the Authority for a consent (as provided for in Special Condition 3H) to change the internal and external cost percentage for the ESO licence and will work with Ofgem on the process and evidence required to achieve this.

Drax did not support the proposal for Special Condition 3H. Specifically, Drax expressed concern around cross-referencing revenues between the NGET licence and the ESO licence. They argued that this did not feel appropriate or sustainable.

#### **Updated policy position:**

We have considered whether the NIA should apply to NGET, NGESO, or both, as part of the separation. We think the NIA is still relevant for both NGET and NGESO, and have therefore included amended versions of Special Condition 3H in both licences.

We have proposed to not change the internal cost percentage as this is a separate policy discussion that would go beyond the scope of separation. Therefore, the 0.2% available to the ESO will continue to be split as before (25% internal costs and 75% external costs) until additional consent from the Authority is provided.

### **3I (The Network Innovation Competition)**

#### **What we said:**

The Network Innovation Competition (NIC) is a competition that can provide funding for larger development and demonstration projects. There are currently two versions of the NIC condition, one for NGET and one for the two Scottish TOs. NIC funding for all projects is currently recovered in NGET's licence and NGET transfers sums to other licensees as directed by the Authority.

We were minded to keep Special Condition 3I in in both NGET TO's and the ESO's licence, as both licensees will be able to participate in the NIC post-separation. However, we were considering what amendments needed to be made to the licence drafting to effect this:

- Option 1: leave the drafting for Special Condition 3I unchanged in the ESO licence, while NGET's licence drafting would be amended to reflect the drafting of Special Condition 3I used in the Scottish TO licences.
- Option 2: leave the drafting for Special Condition 3I unchanged in NGET's licence, while the ESO's licence drafting would be amended to reflect the drafting of Special Condition 3I used in the Scottish TO licences.

#### **What stakeholders said:**

We asked stakeholders whether both the NGESO and NGET should participate in the NIC going forward and how the licence drafting of Special Condition 3I should be amended to effect this.

Most respondents (SSE, Scottish Power, Drax and National Grid) said that the ESO and NGET should be able to participate in the NIC going forward. Elexon questioned whether it is appropriate to allow a non-TO to access NIC funding when organisations like themselves are excluded. Drax requested more clarification from Ofgem and said it might be more appropriate for ESO innovation to be covered under the enduring ESO incentive arrangements.

All the respondents supported Option 1, to amend Special Condition 3I in the NGET licence to reflect the Scottish TOs. Of the respondents that supported NGESO participating in the NIC going forward, all supported retaining Special Condition 3I, unchanged, in the ESO licence.

National Grid argued that the recovery and distribution of NIC funding (to other licensees as directed by Ofgem) is an ESO role, which should not change post-separation. They also

argued that Option 2 would require further changes to all applicable network licence conditions (because Scottish TO's Special Condition 8B and ES6, reference that payments are received from the ESO). They argued that this would go beyond the minimal change for separation principle.

### **Updated policy position:**

After reviewing stakeholder responses, we have proposed to amend Special Condition 3I in the NGET licence to reflect the Scottish TOs and have proposed drafting to effect this. Special Condition 3I will remain unchanged in the NGESO licence.

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### **(3) Next steps for the Separation Programme**

We expect National Grid to submit its formal application to transfer part of its existing transmission licence to the new ESO entity by the end of March. The brief window between now and the end of March provides an additional opportunity for industry to flag any urgent concerns with our updated policy and licence drafting set out in this update. Following National Grid's application we will also hold statutory consultations<sup>9</sup> as a consequence of the proposed modifications to the licences. These statutory consultation periods are expected to take place from early April to early July. After the statutory consultations, we expect make a final decision in July/August, which will have an implementation date of April 1<sup>st</sup> 2019.

In addition to the development of separate licences for the ESO and NGET TO, there are a number of other consequential activities that are currently being undertaken. These are:

- **Transfer of relevant assets:** We expect NGET to submit an asset transfer request in late March to request that relevant ESO assets are transferred to the ESO. Any relevant asset transfer is subject to our consent pursuant to Standard Condition B3 (Disposal of relevant assets and restrictions on charges over receivables).
- **TSO Certification:** The ESO will need to be certified by the Authority, in order to comply with the European Commission's ownership unbundling requirements. We do not expect that certification of the ESO will directly impact on NGET's existing certification. However, we will assess this once we have received all the relevant certification information. It should be noted that NGET would still be subject to its ongoing notification duties.
- **Changes to Industry Codes and other documentation:** All electricity industry codes may need to be modified to reflect the new arrangements. The allocation of TSO roles and responsibilities under the European network codes will also need to be reviewed. We expect modification proposals to be submitted to code panels in March and April and for these to be considered in the relevant fora and taken forward in the appropriate manner.
- **Reassignment of consents and derogations:** NGET has a number of directions, derogations and consents granted by the Authority in accordance with the existing NGET transmission licence. Many of these will need to be transferred to the ESO or, in the case of licence consents, duplicated in favour of the ESO. We expect to use a continuing effect clause to transfer the consents, directions and derogations from the existing transmission licence into the new ESO transmission licence. These are the conditions for the transfer referred to in our previous consultation.

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<sup>9</sup> We expect one statutory consultation related to the modifications to the NGET transmission licence's Special Conditions (known as a s7A modification) and another statutory consultation related to the modifications to the Standard Conditions of all transmission licensees (known as a s11A modification).

We would welcome industry's views on the revised licence drafting. It would be particularly helpful to receive quick responses so that any concerns can be addressed before National Grid submits its formal licence application. Comments and views may also be submitted at a later date as part of our forthcoming statutory consultations. Comments can be emailed to [electricityS0reform@ofgem.gov.uk](mailto:electricityS0reform@ofgem.gov.uk).

If you would like to discuss the content of this letter in more detail, please contact Grendon Thompson on 0207 901 1899.

Yours faithfully,

**Philippa Pickford**  
**Associate Partner**  
**Energy Systems Integration**

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#### **(4) Appendices**

- Appendix 1: Updated summary table of special conditions
- Appendix 2: Updated draft standard licence conditions (separate document)
- Appendix 3: Updated draft special conditions for NGET TO (separate document)
- Appendix 4: Updated draft special conditions for NG ESO (separate document)

Note: within Appendices 2, 3 and 4, any newly proposed modifications are **highlighted**. Track changes that are not highlighted were included in the appendices of our previous consultation.

## **Appendix 1: Updated summary table of special conditions**

Licence Condition	Ofgem's view on licence condition post-separation	
	NGET TO	ESO
<b>Chapter 1</b>		
Special 1A - Definitions and Interpretations	All definitions have been considered (and where necessary amended) for their relevance to the TO or ESO licence	All definitions have been considered (and where necessary amended) for their relevance to the TO or ESO licence
Special 1B - Transmission Area	Retain in NGET's licence unchanged	Not used
Special 1C - Amended Standard Conditions	Only the amended standard conditions relevant to the TO will be retained in NGET's licence	Only the amended standard conditions relevant to the ESO will be retained in the ESO's licence
<b>Chapter 2</b>		
Special 2A - Activities Restrictions	This condition will continue to be in effect in NGET's licence unchanged as this is clearly a TO obligation	This condition will not be in effect in NGESO's licence as this is a TO only obligation.
Special 2B - Restriction on the Use of Information	Not used	This condition will not be in effect in NGESO's licence. Instead, information ring-fencing provisions will be included in the modified Special Licence Condition 20 for NGESO.
Special 2C - Prohibited Activities and Conduct of Transmission Business	Retain in NGET's licence.	This condition will be duplicated and transferred across to NGESO's licence.
Special 2D	Not used	Not used
Special 2E	Not used	Not used
Special 2F - Role in Respect of the National Electricity Transmission System Operator Area located in Offshore Waters	Transferred from NGET's licence because this is an ESO obligation and is not included in Scottish TO licences.	Transferred to the NGESO's licence only as it is an SO obligation.
Special 2G - Prohibition on Engaging in Preferential or Discriminatory Behaviour	Transferred from NGET's licence as this condition does not appear in the Scottish TO licence	Transferred to NGESO's licence Paragraph 2 will be deleted as no longer relevant from a policy perspective.
Special 2H - Appointment of Compliance Officer	Not used	This condition will not be in effect in NGESO's licence. Instead, requirements for appointment of a compliance officer will be included in the modified Special Licence Condition 20 for NGESO.
Special 2I - Independence and Appointment of a Managing Director	Not used	This condition will not be in effect in NGESO's licence. Instead, requirements for the independence and

		appointment of a Chief Executive Officer will be included in the modified Special Licence Condition 20 for NGESO.
Special 2J - Network Access Policy	Retain in NGET's licence with minor modifications to reflect TO only obligations	A modified version of Special Condition 2J will be included in NGESO's licence to reflect the SO's role in coordinating with the TOs over the development of Network Access Plans.
Special 2K - Transmission Losses	Retain in NGET's licence unchanged	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 2L - Methodology for Network Output Measures	Retain in NGET's licence unchanged	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 2M - Specification of Network Replacement Outputs	Retain in NGET's licence unchanged	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 2N (SO) - EMR	N/A	Transferred to NGESO's licence with minor changes as this is an SO obligation
Special 2N (TO) - Provision of Information to System Operator	Retain in NGET's licence with wording amended to reflect Scottish TO licence wording	N/A
Special 2O - Business separation requirement and compliance obligations and conduct of the System Operator in performing its Relevant System Planning Activities.	Retain in NGET's licence to place business separation requirements on NGET.	Will be modified to capture the fundamental business separation requirements for NGESO.
<b>Chapter 3</b>		
Special 3A - Restriction of Transmission Network Revenue	Retain in NGET's licence with amendments to terms/formulas	Duplicated and transferred to NGESO's licence with amendments to terms/formulas
Special 3B Calculation of allowed Pass-Through Items	Retain in NGET's licence with amendments to terms/formulas	Duplicated and transferred to NGESO's licence with amendments to terms/formulas
Special 3C - Reliability Incentive Adjustment in Respect of Energy Not Supplied	Retain in NGET's licence unchanged as this is clearly a TO only obligation	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 3D - Stakeholder Satisfaction Output	Retain in NGET's licence. Remove the Customer Satisfaction Survey term and amend the Stakeholder Satisfaction Survey Term to ensure all SO questions are removed.	Will not be in effect in NGESO's licence as this is a TO only obligation



Special 3E - Incentive in Respect of Sulphur Hexafluoride Gas Emissions	Retain in NGET's licence unchanged as this is clearly a TO only obligation	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 3F - Adjustment in Respect of the Environmental Discretionary Reward Scheme	Retain in NGET's licence. Remove links to SO activities in EDR Guidance Document.	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 3G - Financial Incentive for Timely Connections Output	Not used	Not used
Special 3H - The Network Innovation Allowance	Retain in NGET's licence. We are considering whether further modifications are required.	Duplicated and transferred to NGESO's licence with minor modifications
Special 3I - The Network Innovation Competition	Retain in NGET's licence. Considering whether further modifications are required.	Duplicated and transferred to NGESO's licence
Special 3J - Transmission Investment for Renewable Generation	Retain in NGET's licence as TO only obligation	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 3K - Allowances in Respect of a Security Period	Retain in NGET's licence as TO only obligation, and modified wording to match Scottish TOs licence	Duplicated and transferred to NGESO's licence
Special 3L - Pre-construction Engineering Outputs for prospective Strategic Wider Works	Retain in NGET's licence as TO only obligation	Will not be in effect in NGESO's licence as this is a TO only obligation
<b>Chapter 4</b>		
All Specials in Chapter 4	Do not include in NGET's licence as SO only obligation	Include all in NGESO's licence as SO only obligation. Some minor changes to references to NGET in some Appendices will need to be updated to refer to NGESO.
<b>Chapter 5</b>		
Special 5A - Governance of ET1 Price Control Financial Instruments	Retain in NGET's licence, with removal of references to SOMOD.	Duplicated and transferred to NGESO's licence, with removal of references to MOD.
Special 5B - Annual Iteration Process for the ET1 Price Control Financial Model	Retain in NGET's licence with minor amendments to update terms.	Duplicated and transferred to NGESO's licence with minor amendments to update terms.
<b>Chapter 6</b>		
Special 6A - Legacy Price Control Adjustments (Transmission Owner)	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6B - Supplementary provisions in relation to transmission asset owner incentives scheme	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation

activity in the legacy period		
Special 6C - Determination of PCFM Variable Values for Totext Incentive Mechanism Adjustments - Transmission Owner	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6D - Specified financial adjustments - Transmission Owner	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6E - The Innovation Roll-Out Mechanism	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6F - Baseline Generation Connections Outputs and Generation Connections volume driver	Retain in NGET's licence only with minor amendments	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6G - Mitigating the impact of Pre-existing Transmission Infrastructure on the visual amenity of Designated Areas	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6H - Arrangements for the recovery of uncertain costs	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6I - Specification of Baseline Wider Works Outputs and Strategic Wider Works Outputs and Assessment of Allowed Expenditure	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6J - Allowed Expenditure for Incremental Wider Works	Retain in NGET's licence only with minor amendments	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6K - Allowed Expenditure for meeting planning requirements and volume driver	Retain in NGET's licence only	Will not be in effect in NGESO's licence as this is a TO only obligation
Special 6L - Baseline Demand Related Infrastructure Outputs and Allowed Expenditure volume driver	Retain in NGET's licence only with minor amendments	Will not be in effect in NGESO's licence as this is a TO only obligation
<b>Chapter 7</b>		
All Specials in Chapter 7	Will not be in effect in NGET's licence as SO only obligation	Include all in NGESO's licence as SO only obligation. This chapter should not require adjustment as a consequence of the TO/SO split (as it relates solely to the System Operator) except that

		references to NGET in Appendices need to change to NGESO.
<b>Chapter 8</b>		
Special 8A - Disapplication of Relevant Special Conditions	Retain in NGET's licence with minor amendment to remove references to SO Special Conditions (as this will be put in SO licence)	Duplicated and transferred to NGESO's licence with minor amendment to remove references to TO Special Conditions (as this will be put in TO licence)
Special 8B - Services treated as Excluded Services	Retain in NGET's licence  Remove 8B.8(b)(c) as these relate to SO activities  Add Outage Changes and NIC payments made by the SO	Duplicated and transferred to NGESO's licence
Special 8C - Basis of transmission owner charges	Include in NGET's licence with drafting to align with the Scottish TO licences	Will not be in effect in NGESO's licence as this is a TO only obligation