



Making a positive difference
for energy consumers

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Dear stakeholders,

Consultation on the evaluation process for the 2019-20 ESO regulatory and incentives framework

In October, we published our call for input on the 2019-20 ESO regulatory and incentives framework.¹ We proposed that we would not make any major changes to the framework we introduced in April 2018 but we would consider refinements based on feedback and lessons learned so far.

We have reviewed the stakeholder responses we received to our call for input and we intend to make some minor changes to the ESO roles and principles² and ESORI guidance document³ based on this. We will publish the updated documents as part of our final decision in March. We expect these changes to go live in April 2019.

In our call for input, we proposed that we would not make any fundamental changes to the evaluation process and financial incentive parameters. We are now considering some changes to streamline this process, based on our experiences so far and particularly the mid-year review process held last November. We have set out our proposals to the evaluation process and financial incentive parameters in this letter and we welcome your views by 14 March 2019. We would appreciate it if you could send your views to ESOperformance@ofgem.gov.uk.

Background

In April 2018 we introduced a new regulatory and incentives framework for the ESO.⁴ This applies a more 'principles-based' approach to ESO regulation and moves away from the use of targeted mechanistic incentives, towards a broader, evaluative incentives approach. It aims to create a much more proactive and outcome-focussed ESO, and encourages it to work flexibly with its stakeholders in order to maximise consumer benefits across the full spectrum of its activities.

¹ Call for input on 2019-20 ESO regulatory and incentives framework: <https://www.ofgem.gov.uk/publications-and-updates/call-input-2019-20-eso-regulatory-and-incentives-framework>

² ESO Roles and Principles guidance: https://www.ofgem.gov.uk/system/files/docs/2018/02/eso_roles_and_principles.pdf

³ ESORI guidance document: https://www.ofgem.gov.uk/system/files/docs/2018/03/esori_arrangements_guidance_document.pdf

⁴ 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>

The new approach is built around us being clear from the outset about the roles and behaviours we expect of the ESO; but it places the onus on the ESO to engage with stakeholders to identify how to best meet and exceed these expectations. It includes:

- A set of 'Roles and Principles' designed to set clear expectations about the baseline behaviours we expect from the ESO;
- A requirement on the ESO to engage with its stakeholders each year to produce a Forward Plan, which will include Performance Metrics to demonstrate how it will meet each of these Principles and add additional value for consumers;
- Regular performance reports published by the ESO;
- A new ESO Performance Panel, which will challenge the ESO on its plans, evaluate its performance and make recommendations to the Authority;
- A decision by the Authority at the end of each year to financially reward or penalise the ESO up to a maximum cap and floor of $\pm\text{£}30\text{m}$, informed by the Performance Panel's recommendation, as well as other evidence collected throughout the year.

Our intention is that this framework remains in place until March 2021. However, we have started reviewing the effectiveness of this scheme in light of practical experience and intend to make refinements where necessary for 2019-21. The lessons we learn from this new approach will also inform the development of a consolidated price control for the ESO under the RIIO-2 framework from April 2021 onwards.

Call for input on changes for the 2019-20 scheme

Summary of proposals

In our call for input, we proposed that we would not make any major changes to the framework we introduced in April 2018. However, we said that we would consider making some small refinements for the 2019-20 scheme based on the feedback we received and our experiences and lessons learnt administering the framework. The specific areas we considered as part of the call for input were:

- The ESO Roles and Principles – we proposed to keep the four roles and seven principles the same but asked stakeholders to consider whether we needed to add any clarifications to the supporting guidance to ensure they reflect the behaviour we expect from the ESO.
- The Forward Plan process – we proposed no fundamental changes to the Forward Plan process but we asked stakeholders to consider whether any additional requirements around stakeholder engagement, Forward Plan submission, internal cost reporting were appropriate.
- Within-year reporting requirements – we proposed no fundamental changes to these requirements but asked stakeholders to consider whether the current obligations strike the right balance between transparency and resource burden.
- The Mid-Year Review and Panel processes – we proposed no fundamental changes.
- The evaluation process and financial incentive parameters – we proposed no fundamental changes but we have set out our latest thinking and our updated policy position in the section below.

Stakeholder responses

We received ten responses to our earlier call for input. Overall stakeholders were broadly happy with our overarching policy positions. We will use this feedback (and any further feedback following this letter) to inform our final decision on these areas in March. We will update the roles and principles guidance and ESORI guidance document accordingly and we will publish these alongside our decision.

Incentive payment / penalty reconciliation licence change

In our call for input, we explained the ESO's proposal for a licence change in this area. Under the proposal, any differences between the incentive value recovered by the ESO from market participants during Relevant Year t , and the final incentive value determined by the Authority after the year has ended, could be reconciled in Settlement Final bills for Relevant Year $t+1$. To achieve this, a new element would need to be added within the definition of the term 'TotAdj $_t$ ' in Special Condition 4C.2 of the ESO's licence.

Overall stakeholders were supportive of this approach. We will be publishing a separate licence change consultation on this later this year.

Changes to evaluation process

We received feedback bilaterally from our ESO Performance Panel following the mid-year review process. We have used this to propose some additional changes to the evaluation process and financial incentive parameters. We have set out our thinking below. For reference, the current arrangements include:

1) The performance evaluation criteria:

The performance panel uses five key inputs to evaluate the ESO's performance and determine a score for *each principle*:

- a) Evidence of delivered benefits
- b) Evidence of future benefits / progress against longer term initiatives
- c) Stakeholder views
- d) Plan delivery
- e) Outturn performance metrics and justifications

2) The maximum reward/penalty the ESO can achieve is \pm £30m split equally between the seven Principles (\pm £4.29m each).

Our previous position

In our call for input we proposed no fundamental changes to the evaluation criteria or the financial incentive value of \pm £30m but we asked stakeholders for views on where the evaluation criteria could benefit from additional clarity. We proposed that we would maintain the current equal weighting of the seven principles (\pm £4.29m each). We noted that there is a risk that seven different incentive pots could undermine our aim for the ESO to holistically consider where the most consumer value lies.

Stakeholder responses

Stakeholders agreed with retaining the evaluation criteria and the equal weighting of the principles. Stakeholders thought it was too early to draw any strong conclusions on this. A few stakeholders raised some concern that an equal weighting may not be appropriate for all the seven principles.

Updated policy position

Since the call for input was published in October, we held the Mid-Year Review⁵ in November and received feedback from the ESO and the ESO Performance Panel on how the evaluation process worked in practice and how it could evolve.

Under the current arrangements, the ESO provides evidence to demonstrate its performance for each principle in accordance with the evaluation criteria. In order to assess

⁵ Mid-Year Review 2018-19 Panel Report: <https://www.ofgem.gov.uk/publications-and-updates/mid-year-review-panel-report-2018-19>

the ESO’s performance and determine a score for each principle, the panel uses the evaluation criteria and carries out seven evaluation processes: one for each principle.

We realise that there are a lot of synergies across the principles and this can create difficulties placing certain deliverables under one principle for the purposes of evaluation. The panel and the ESO noted some difficulties in assessing and separating out this evidence. For example, we note that the deliverables and consumer benefits described for 2018-19 overlap between Principle 5, Principle 6 and Principle 7 in particular. This resulted in the ESO moving certain deliverables between the principles as the year progressed, which may have reduced its ability to present a clear and convincing case of performance against the evaluation criteria.

We think grouping some of the principles together for the purposes of evaluation will better take account of these synergies and create a more streamlined and robust process. We also consider that fewer evaluation processes should create a more robust and streamlined process with less reliance on incomplete evidence.

We therefore propose that the evaluation process should be carried out per ‘role area’⁶ instead of per principle. Specifically, we envision there being three evaluation processes: one for each role area that would be worth ±£10m. Table 1 specifies which principle will be considered under each role area. Figure 1 shows how the current arrangements map to our proposals for the evaluation process and financial parameters.

Table 1 – proposed changes to the evaluative process and financial incentive parameters for 2019-20

Role Area	Role 1		Role 2		Role 3 and 4		
Role Area incentive range	±£10m		±£10m		±£10m		
Principle	1	2	3	4	5	6	7

We consider that this will change the weighting and incentive range associated to different areas. The financial incentive value of ±£30m will remain the same and each role area will be equally weighted at ±£10m each. We want to maintain a signal for the ESO to deliver value for consumers across the full spectrum of its roles and principles. Based on our experience of what’s been reported by the ESO so far and our discussions with stakeholders, we think this re-weighting would be more reflective of consumer benefits.

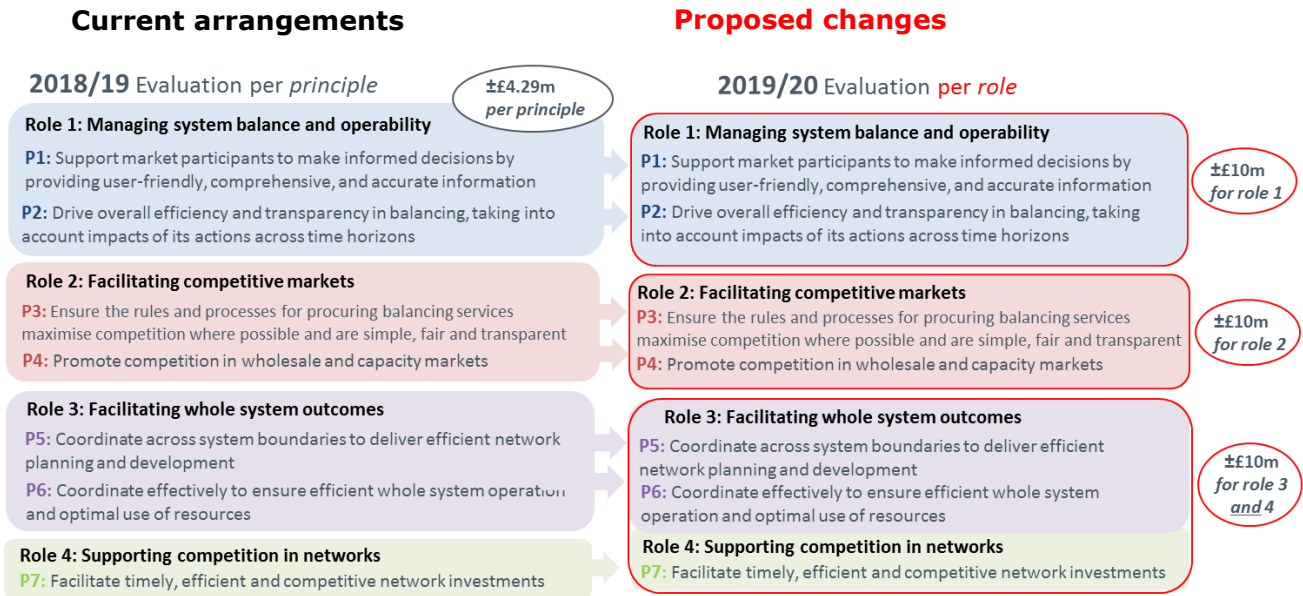
The principles will continue to be a key part of the framework and will continue to provide the ESO with clear guidance on the behaviours and standards we expect of it when performing its roles. However, the principles will no longer have an explicit weighting and incentive range associated with them. They will continue to feed into and will be considered as part of the relevant role area evaluation. For the ESO to demonstrate good performance for each role area, the ESO will still be expected to demonstrate how it is meeting our expectations for each principle (as defined in the ESO roles and principles guidance document).

In the long-term it may be possible to further analyse where the ESO can deliver most consumer value and this could allow us to apply more granular weightings for its different roles or explicitly weight the principles within each role area. We expect to begin this work later in 2019 and this could inform any changes to the incentives scheme from 2020-21 onwards.

⁶ ‘Role area’ refers to the three groups of principles, each with a separate evaluation process:

- Role 1 evaluation considers principles 1 and 2
- Role 2 evaluation considers principles 3 and 4
- Role 3 and 4 evaluation considers principles 5, 6 and 7

Figure 1 – current vs proposed changes to the evaluation process



We consider this change would require amendments to the ESORI guidance document and some minor changes to the overall process. We have listed these changes below:

1. The current arrangements state that the ESO should structure its Forward plan (and all subsequent reporting documents including monthly, quarterly, mid-year and end-year reports) by principle. Under this proposal, the ESO would be able to structure these documents per role area in order to align with the evaluation process. The ESO will still be expected to demonstrate how it is meeting its expectations for each principle (as defined in the ESO roles and principles guidance document), but will be able to structure this narrative according to each role area. The ESO will be able to set its long-term vision, deliverables and performance metrics for each role area instead of each principle.
2. The ESO Performance Panel will be asked to apply the evaluation criteria to each role area to assess the ESO’s performance. The Panel will use this to provide a scoring for each role area instead of each principle.

Next steps

We welcome stakeholder views on the changes to the evaluation process and financial incentive parameters outlined in this letter by 14 March. Please submit your responses to ESOperformance@ofgem.gov.uk.

We are aiming to make a final decision on any changes before the end of March. We expect that amendments to the scheme for 2019-20 would be taken forward through changes to the ‘ESO Roles and Principles’ and ‘ESORI Arrangements’ guidance documents. The amended versions will be published alongside our final decision.

If you have any questions on the contents of this letter, please contact us at the email address above.

Yours sincerely,

Grendon Thompson
Head of ESO regulation