



Making a positive difference
for energy consumers

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Dear Stakeholders,

Decision on modifications to the ESO regulatory and incentives framework for 2020-21

This letter sets out the Authority's decision to modify the Electricity System Operator's (ESO) regulatory and incentives framework for 2020-21. Alongside this letter, we have published updated guidance documents¹ to support and implement the changes to the ESO regulatory and incentives framework for 2020-21.

This letter explains our proposals and the changes we have made in response to the views stakeholders shared with us through our recent consultation. These changes will take effect from 1 April 2020 and will apply to the regulatory year 2020-21².

Background

The ESO regulatory and incentives framework was introduced in April 2018. It was designed to encourage the ESO to work flexibly with its stakeholders in order to maximise consumer benefits across the full spectrum of its activities. The framework is built around us being clear from the outset about the behaviours and outcomes 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;

¹ The Roles and Principles guidance document and the ESO Reporting and Incentives (ESORI) guidance document.
² For clarity, these changes will apply to the ESO's Forward Plan and Ofgem Formal Opinion for 2020-21, the ESO's mid-year review in 2020-21 and the ESO's end of year review in 2020-21.

- A requirement on the ESO to engage with its stakeholders each year to produce a Forward Plan, which will include performance metrics and should demonstrate how it will meet our expectations and add additional value for consumers;
- Regular performance reports published by the ESO;
- A 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 panel's recommendation, as well as other evidence collected throughout the year.

The ESO Roles and Principles guidance document supports the framework by describing the ESO's key activities and setting out our expectations for how these activities should be performed. It therefore should inform the ESO's forward plans and performance reports. The ESORI guidance document describes the key stages of the annual incentives process, including the evaluation criteria and guidance on how we will assess the ESO's performance.

Consultation on changes to the ESO regulatory and incentives framework scheme for 2020-21

In January, we published our call for input on the proposed changes to the ESO regulatory and incentives framework for 2020-21.³

We proposed to make three sets of changes that will take effect from 1 April 2020:

- Streamlining the ESO roles framework from four to three - the three streamlined roles are: Role 1: Control centre operations, Role 2: Market development and transactions and Role 3: System insight, planning and network development (see Annex 1). We believed this approach would reduce burden, minimise the scope for overlap in the ESO's reporting and align with the ESO's RIIO-2 framework. We also believed this could facilitate a more tailored approach to the performance evaluation.
- Streamlining how consumer benefits are considered as part of the evaluation criteria – we proposed to merge the criteria on delivered and future benefits as this would help to streamline the ESO's performance reports. The evaluation criteria would therefore become:

³ Call for input on 2020-21 ESO regulatory and incentives framework: <https://www.ofgem.gov.uk/publications-and-updates/call-input-2020-21-eso-regulatory-and-incentives-framework>

- a. Evidence of benefits (the ESO would be able to provide evidence of delivered benefits and/or future benefits)
 - b. Stakeholder views
 - c. Plan delivery
 - d. Outturn performance metrics and justifications
- Additional reporting requirements – we proposed to permit the ESO to structure its reports by the roles described above. We also proposed to introduce a new requirement in the ESORI guidance document for the ESO to report on its planned internal costs for each role at the forward plan stage and its outturn internal costs in the end of year performance report. This will add greater context to the ESO’s evidence reporting and help to support informed views on how the ESO is being ambitious and using its resources effectively to prioritise the right areas.

Stakeholder responses

We received four responses to our consultation. We have published these responses on our website alongside this letter. We considered all the stakeholder feedback we received to make our decision on the modifications to the ESO regulatory and incentives framework for 2020-21. Annex 2 lists the detailed feedback we received and any further amendments we’ve made to the guidance documents in response to this feedback.

Overall, stakeholders were broadly supportive of our proposals. The majority of respondents agreed with our proposals to streamline the number of roles from four to three, and in particular, that facilitating whole system outcomes should be an expected behaviour across all roles. All stakeholders supported the proposal to streamline the evaluation criteria.

There was some mixed feedback on the additional reporting requirements, particularly around the proposed reporting requirements related to the ESO’s forecasted and outturn costs for each role. Some stakeholders thought this would be beneficial as long as it doesn’t create additional burden on the ESO. One stakeholder would prefer the ESO to focus resources on delivering reforms instead of reporting. The ESO fed back that they would be able to provide forecasted internal costs for each role at the forward plan stage, but would not be able to provide robust outturn cost figures in the end of year performance report in May. The ESO noted that robust outturn cost information would only be available in July once it submits its annual Regulatory Reporting Pack to Ofgem.

Our decision

After considering the stakeholder feedback we received to our consultation, we have decided to proceed with the proposed changes to the ESO's regulatory and incentives framework to move to three roles and to merge the evaluation criteria on consumer benefits to streamline reporting. In regards to the ESO's reporting of costs we have decided that:

- the 2020-21 Forward Plan should include limited cost information (for each role) on planned cost for 2020-21, forecast outturn cost for 2019-20, and outturn cost for 2018-19; and
- the 2020-21 End of Year Performance Report should include (for each role) a forecast of the annual 2020-21 outturn cost.

Next steps

The new arrangements will commence from 1 April 2020. The ESO is due to publish its final Forward Plan for 2020-21 by 31 March 2020. We will review this Forward Plan and the stakeholder responses to this in order to produce our Formal Opinion for 2020-21. Where there is sufficient information available, our Formal Opinion will aim to provide a clear steer on the ambition of the deliverables and performance metrics contained in the plan. This should provide the ESO with clarity on how it needs to perform in 2020-21 in order to unlock incentive payments and/or avoid incentive penalties.

We appreciate the contribution stakeholders have made so far to scrutinise the ESO's plans and feedback on its activities over the course of the incentives process.

We will be publishing a call for evidence in due course to gather evidence from stakeholders of the ESO's performance over the course of 2019-20 which will feed into the end of year review that will take place between June and July 2020. If you have any feedback on the ESO's performance, including both positive examples and areas of concern, you can provide details of these to us by sending an email to ESOperformance@ofgem.gov.uk.

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

Yours sincerely,

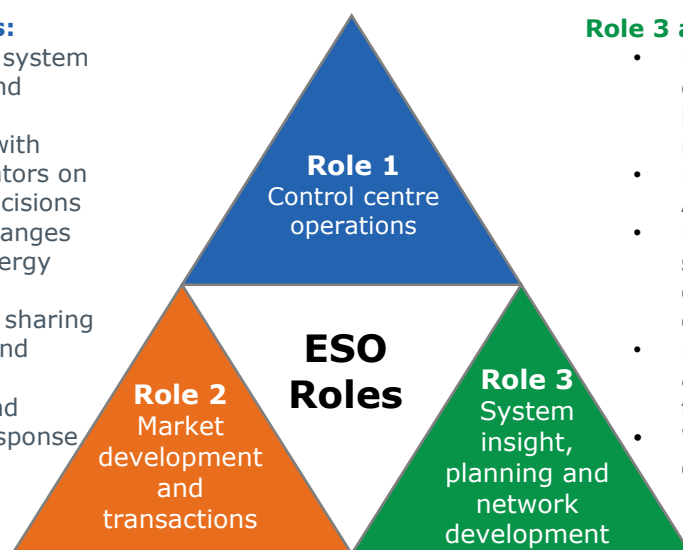
Maryam Khan

Senior Manager, ESO regulation

Annex 1 - Summary of the ESO roles and activities for 2020-21

Role 1 activities:

- Operating the system (monitoring and dispatch)
- Coordinating with network operators on operational decisions and outage changes
- Short term energy forecasting
- Managing and sharing system data and information
- Restoration and emergency response



Role 3 activities:

- Long term forecasting, energy scenarios and identification of network needs
- Network Options Assessment
- Delivering competitive system solutions and early network competition
- Managing connections and generator access to the network
- Whole system process development

Role 2 activities:

- Balancing and ancillary service market design
- Service procurement and settlement
- Revenue collection
- Policy advice and delivery of market framework changes
- Code administrator

Annex 2 - summary of responses received and our decision

We have summarised the feedback we received and the changes we have made in response to this feedback below.

Stakeholder feedback	Our response
Clarification on when these changes will apply.	We have clarified that these changes will take effect from 1 April 2020 and will apply to the regulatory year 2020-21. For clarity, these changes will apply to the ESO's Forward Plan and Ofgem Formal Opinion for 2020-21, the ESO's mid-year review in 2020-21 and the ESO's end of year review in 2020-21.
General feedback on the ESO's incentives framework: The evaluation of the ESO is too subjective and would benefit from a more deterministic approach. This evaluation could be based on the performance metrics proposed by Ofgem in para 5.14. These metrics are intended to be reflective of performance against each role but could be supplemented by additional metrics at the level of the four key criteria listed in para 3.8. Baseline levels of performance can then be determined and use to calculate a score. Evaluation by the performance panel on softer elements of their performance could then be used to supplement this deterministic score and achieve an overall result.	For the 2020-21 incentive year, we have decided to continue with the overall approach introduced in 2018. For RIIO-2, we are considering more changes based on the lessons we have learnt so far, including the role Ofgem can play in designing metrics. ⁴ We will take this feedback on board and will consider this when we refine the incentive arrangements for RIIO-2.
Roles and Principles Guidance	
Add references to other obligations in the licence to ESO roles and principles (not just C16).	We are undertaking some further work to review the ESO's roles and principles more

⁴ Once we have reviewed the December business plan, we will determine whether or not there is a need for Ofgem to edit or intervene in the design of the final performance metrics through the price control determinations process. https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-2_financial_methodology_and_roles_framework_for_the_eso_0.pdf

Stakeholder feedback	Our response
	widely in order to better align it to the ESO's licence for RIIO-2.
Keep original title of role 1 – Managing system balance and operability as the new title is too specific, and does not capture activities that take place outside of the control room itself, such as outage planning and energy forecasting.	We have kept the title as proposed "Role 1: Control Centre Operations" in order to align with the RIIO-2 framework. The title refers to the "control centre" and therefore captures relevant activities undertaken outside of the control room.
Para 1.15 and 1.16: The challenge to manage system frequency is supported by asset solutions provided by network companies as well as the effectiveness of the market to balance itself and the tools the ESO has to balance the residual energy. It is important that these different services are deployed to minimise overall costs to current and future consumers. The ESO has to make these choices in the best interests to consumers and needs to establish effective methodologies and cost benefit analysis protocols to achieve this. It is not clear the existing ESO framework is driving the ESO to do this and explicit interaction between roles 1 and 3 needs to be achieved through the framework and demonstrated in ESO outcomes.	We will consider how best to do this going forward. We will take this feedback on board and will consider this when we refine the arrangements for RIIO-2.
The ESO framework needs to incorporate incentives to support network companies to provide services that optimise network availability in real time and mitigate the risk of high constraint costs when they are in the overall benefit of consumers.	We consider that the ESO framework sufficiently incentivises the ESO to work with network owners to mitigate the risk of high constraint costs. In particular, paragraph 1.28 states, " <i>We therefore expect the ESO to work with other network operators to identify opportunities that optimise synergies or mutually beneficial operational decisions across network and system boundaries. For example, a single action could address constraints on both the transmission and distribution networks.</i> "

Stakeholder feedback	Our response
	<i>Once identified, the ESO should coordinate with other network operators to optimise these synergies and therefore maximise consumer benefits.</i> We will consider this further for the design of the RIIO-2 framework.
Change the wording of principle 1 to allow the provision of relevant data (eg data in its raw form)	We consider the existing requirement in paragraph 1.17 under Role 1 <i>"the ESO should publish any <u>relevant information</u> it has that would help market participants to balance their own positions"</i> to capture this already.
Localised system issues must be clearly and proactively addressed in the ESO Role 1; Control Centre Operations (risks must be considered on a regional basis and not just at GB level).	We have clarified this in paragraph 1.21, by adding a requirement that the ESO should consider taking a risk based approach at a regional and national level to plan and mitigate against any adverse market conditions that might be expected to arise in the future.
The proposed wording on FES (paragraphs 1.46 to 1.49) risks creating a level of rigidity in the annual FES process, which would reduce the ESO's ability to respond to changes in the operating environment and stakeholder requests.	We have reviewed this text and made the necessary amendments, after discussion with the ESO.
Many "whole system" activities require the ESO to co-ordinate activities for which it has not been funded.	We consider that the ESO is obligated to carry out these functions through its licence. In particular C16 (b) and (c). Therefore we consider the ESO is funded to deliver these activities through the existing RIIO-T1 price control.
The ESO should optimise the timing <u>and coordination</u> of transmission outages to maximise efficiencies across the system as a whole.	We have clarified this in the text 1.31
When co-ordinating, scheduling and approving transmission outages, the ESO should consider how the timings of	We have clarified this in paragraph 1.31 and on page 30 of the roles and principles guidance.

Stakeholder feedback	Our response
<p>transmission outages may optimise consumer benefits (or minimise costs) by considering the impacts of outages across the whole electricity system and across short, medium and long-term time frames. This should involve engaging with other network operators when developing plans and supporting asset and market-based solutions that are intended to deliver forecast benefits in future years.</p>	
<p>Onshore competition text should include a requirement to consult on early competition plan.</p>	<p>We have added a requirement for the ESO to consult on its early competition plan in paragraph 1.57.</p>
<p>Ofgem’s instruction to the ESO to develop an Early Competition Plan is inextricably linked to the proposed modification to standard licence condition C27 and any proposed amendments to this licence condition must remain cognisant of this work.</p>	<p>We consider that the changes proposed to the roles and principles are based on obligations the ESO already has on facilitating competition in networks, whilst remaining open to future developments. Notably, <i>“For ‘late’ competition models we will <u>continue to consider</u> the roles and responsibilities of parties (including the ESO) in relation to the undertaking of preliminary works...”</i></p>
<p>The new text additions require the ESO to undertake activities beyond those for which it is currently funded. The wording in the Roles and Principles document should be limited to the ESO’s role in leading the Early Competition Plan, and the outcomes of this work should determine the ESO’s role in early or late competition.</p>	<p>We will be publishing a decision soon on our consultation on the changes we’d like to make to C27 of the ESO’s licence. We’ll take these comments into consideration as we work with the ESO progress the early competition work. As part of that work we’ll consider the benefits case for competition and the ESO’s role in it.</p>
<p>It may be necessary to place similar obligations on TOs and DNOs, to allow expectations on data sharing to be met.</p>	
ESORI Guidance	
<p>Internal cost reporting - Costs associated with supporting activities such as the Regulation, Customer and Stakeholder, and Assurance teams: we assume that these</p>	<p>We have provided more feedback to the ESO that we would like to see these costs reported (alongside the costs for each role)</p>

Stakeholder feedback	Our response
costs are out of scope for this reporting process.	for transparency and to align with the requirements for RIIO-2.
Add a requirement for the panel to consider internal costs in its evaluation of ESO performance	At this stage, we do not propose to add in a specific requirement for the panel to formally consider the ESO's internal costs for each role. The ESO has an existing internal cost-incentive via the RIIO-T1 totex incentive mechanism (TIM). For 2020-21, the panel will use the costs as useful context for the ESO's performance. The panel will be able to consider the reported high-level costs alongside other evidence when assessing the ESO's performance. We consider RIIO-2 will be the best place to introduce this requirement as the TIM will no longer apply to the ESO and the panel will have full information on the ESO's costs and will be better able to consider costs more comprehensively.
Changing scoring to -5 to +5 with mid-point at 0	We see no significant reason to make this change for 2020-21, however we will consider this further when designing the incentives process for the RIIO-2 period.
The criteria should be amended to reflect that the ESO will not be able to please all stakeholders.	We think paragraph 3.18 is sufficient. In particular, " <i>The panel should consider whether the ESO has provided sufficient justification and explanation of any negative stakeholder feedback they have received.</i> "
Clarifications that the ESO should refer to the topics listed in the Roles and Principles Guidance.	We have clarified this.
Performance metrics should be linked to the roles instead of the principles.	We have clarified this.
Upon considering evidence, the performance panel should remain cognisant	In the ESO roles and principles, the ESO is expected to undertake whole systems planning and thinking. The panel will

Stakeholder feedback	Our response
<p>of whole systems planning and thinking, in that, when benefits from proposed or delivered ESO projects are being evaluated, these must not be counterproductive or at a disadvantage to other areas of the network.</p>	<p>assess how well the ESO has done this when evaluating its performance.</p>
<p>Further clarity on 10% increments used when determining the financial reward/penalty.</p>	<p>We provided further detail in the ESORI guidance to explain how we calculate the final incentives reward/penalty. This is based on how we calculated the incentive for 2018-19. Within each incentive range, we move the ESO up or down by 10% increments because this allows us to use a consistent approach for each role. We added this detail to the ESORI guidance to provide more transparency on our decision making process.</p>